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Bank of Aland PLC

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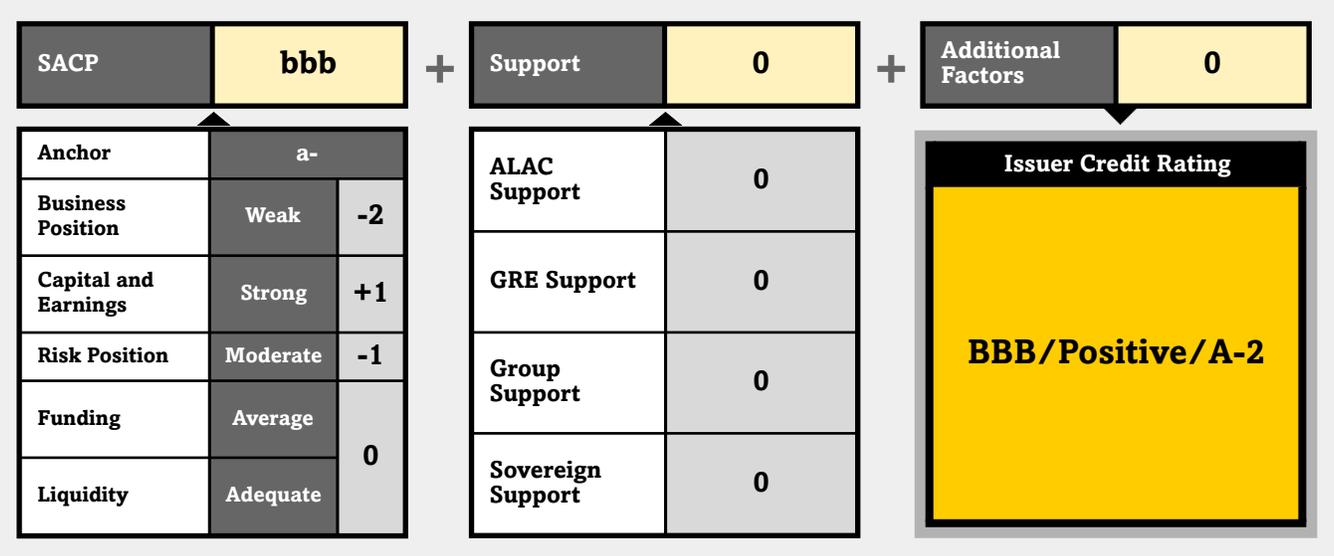
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Related Research

Bank of Åland PLC



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Business operations in economically robust regions in Finland and Sweden. • Sound funding position, supported by stable customer deposits. • Strong risk-adjusted capitalization and low credit losses. 	<ul style="list-style-type: none"> • Concentration risk in the loan book, due to the bank's focus on retail mortgage lending. • Modest market position in mainland Finland and Sweden could expose the bank to revenue volatility. • Lower cost efficiency than peers, distorted by nonbanking activities.

Outlook: Positive

The positive outlook on Bank of Åland reflects our view that the bank will continue to build up its capital base, improve earnings, and uphold a sound approach to risk over the next two years.

We could raise the rating if Bank of Åland's capitalization improves, as indicated by a sustained increase of its risk-adjusted capital (RAC) ratio beyond 15% over the next 24 months including further earnings retention. An upgrade would depend on the bank's efforts to uphold sound profitability and an unchanged stance toward prudent underwriting standards and collateralization.

We could revise the outlook to stable over the next 24 months if Bank of Åland's profitability and the pace or quality of its capital buildup remain weaker than our expectation. More aggressive lending standards to increase earnings, higher-than-expected credit losses, or sustained high costs with a subsequent drag on the bank's internal capital generation, would also weigh on the rating.

Rationale

Our ratings on Bank of Åland reflect its 'a-' anchor for its operations in Finland and Sweden, and our view of the bank's concentrated retail private and premium banking franchise in Finland's Åland Islands, and certain areas in mainland Finland and Sweden. The ratings also incorporate Bank of Åland's strong capital and earnings profile, due to our expectation that its RAC ratio will increase to 14.8%-15.2% by year-end 2019 on the back of internal capital buildup and recent hybrid capital issuance. The ratings reflect Bank of Åland's sound but concentrated loan portfolio and our expectation that the bank will maintain prudent underwriting standards and high level of collateralization. We expect the bank to maintain its deposit franchise complemented by its access to the covered bond market, which contribute to the sound funding metrics and comfortable liquidity cushions. The bank's stand-alone credit profile (SACP) is 'bbb'.

We consider Bank of Åland to have low systemic importance in Finland. Because we view the prospect of extraordinary government support for Finland's banking sector as uncertain since the implementation of the EU Bank Recovery and Resolution Directive on Jan. 1, 2016, our long-term issuer credit rating on the bank is 'BBB'.

Anchor: 'a-' for Bank of Åland's operations in Finland and Sweden

To determine a bank's anchor, we use our Banking Industry Country Risk Assessment's (BICRA's) economic risk score and the industry risk score. The anchor is the starting point in assigning an issuer credit rating under our criteria for banks. The anchor is based on an economic risk score of '2' for Finland and Sweden and an industry risk score of '3' for domicile country Finland (on the scale from '1', the strongest score, to '10', the weakest). The 'a-' anchor for Bank of Åland considers the weighted-average economic risk in all countries the bank is exposed to, primarily Finland (65% of lending) and Sweden (35%) based on our estimate of the bank's loan growth. Under our BICRA methodology, Sweden has similar economic and industry risk scores to Finland. We view the economic risk trend and the industry risk trend in the Finnish and Swedish banking industry as stable.

We view Finland as an innovative, wealthy, and open economy, with mature political and institutional structures. The near-term economic picture has brightened following a prolonged recession over 2012-2015. After strong growth in 2017 supported by healthy domestic demand and a strongly improving external environment benefiting Finnish exports, we forecast growth will slow somewhat as domestic factors and structural constraints will weigh on the economy. House prices have stabilized nationwide and market activity, especially in the growth regions, is now picking up. While we forecast moderate credit demand from households in 2018-2019, we observe a gradual increase in household debt. However, we expect Finnish banks' asset quality to remain strong in the next two years, based on the sound financial position of the household and corporate sectors, the banking sector's moderately conservative underwriting standards, and the persisting low interest rate environment.

We do not consider the banking sector's competitive landscape to be distorted despite concentration due to the presence of large pan-Nordic banks and the domestic cooperative banking group OP Financial Group. We also deem the sector's overall profitability and capitalization to be resilient and expect the banks to maintain their restrained risk appetite. That said, the sector remains highly interconnected with the Nordic banking systems, which results in potential spillover risks on the Finnish economy from external events. As a key industry risk, we see that Finnish banks depend more on international market funding than many other banking systems in Europe. That said, we consider that

the banks continue to have good access to the euro-denominated unsecured and secured market.

Table 1

Bank of Åland -- Key Figures					
	--Year ended Dec. 31--				
(Mil. €)	2018*	2017	2016	2015	2014
Adjusted assets	5,285	5,336	5,121	4,593	4,285
Customer loans (gross)	3,974	3,989	3,821	3,629	3,359
Adjusted common equity	207	205	195	193	180
Operating revenues	65	128	120	125	121
Noninterest expenses	50	100	91	92	96
Core earnings	12	21	20	24	18

*As of end-June.

Business position: Retail and premium banking franchise in selected regions of Finland and Sweden

In our view, Bank of Åland holds a specialized retail and private banking franchise on Finland's Åland Islands, and in certain selected areas in mainland Finland and Sweden. However its concentrated business focus makes it vulnerable to cyclical swings in the countries of operations. We therefore assess the business position as weak.

As of June 30, 2018, Bank of Åland reported total assets of €5.3 billion (assets under management of €5.65 billion) and has about 200,000 customers and 700 employees. Bank of Åland focuses on providing retail private banking services, offering both basic and advanced private banking products. The bank's expanding asset management operations complement this offering, enabling it to serve affluent customers in selected regions in Finland since the 1980s and in Sweden since 2009, following the acquisition of Kaupthing Bank Sweden.

The bank holds a leading position in its wealthy but very small home region, Finland's Åland Islands, with a loan market share of 50% in its core business of private and premium banking. The business generated in Finland including Åland Islands represent 72% of Bank of Åland's income while the share of income in Sweden continues to increase primarily as a result of volume growth. We anticipate that over time, Sweden is likely to represent a larger share of Bank of Åland's revenues, given that the bank remains committed to its selective growth strategy in the country. That said, the bank's market shares in mainland Finland and Sweden remain small, and as a result we consider Bank of Åland's revenues are likely to be vulnerable to economic swings in these markets, relative to larger and more diversified Nordic peers.

In addition to banking and asset management, Bank of Åland owns credit card company CompassCard and IT company CrossKey, which provides banking technology consulting services to several domestic banks. We understand that the bank is likely to remain the sole shareowner of both companies. Generally, we consider that CrossKey's higher expenses, which have weighed on the bank's overall cost-efficiency metrics (cost-to-income ratio of 78% in 2017), will improve over the coming years.

Bank of Åland benefits from a loyal customer base, in our opinion, and has taken steps to broaden its distribution channels by initiating various partnerships with financial technology companies, such as Dreams and Trustly. We expect further investments in the bank's digital infrastructure to improve the customer experience and to make internal

processes more efficient. Bank of Åland has also raised brand awareness by launching the first environmentally-friendly credit card, the Baltic Sea Card, which allows its customers to offset the carbon footprint of their purchases. In our view, management remains focused on a long-term prudent strategy, which is underpinned by a strong local shareholder collective.

Table 2

Bank of Åland PLC -- Business Position					
	--Year ended Dec. 31--				
	2018*	2017	2016	2015	2014
Total revenues from business line (mil. €)	65	128	120	125	121
Retail banking/total revenues from business line	73.35	72.48	73.24	70.68	68.27
Commercial & retail banking/total revenues from business line	73.35	72.48	73.24	70.68	68.27
Asset management/total revenues from business line	7.66	7.69	7.46	7.11	9.21
Other revenues/total revenues from business line	18.99	19.83	19.29	22.21	22.52
Return on average equity	10.09	9.09	9.06	11.94	8.62

*As of end-June.

Capital and earnings: Strong risk-adjusted capitalization, underpinned by earnings growth and hybrid capital issuance

We assess Bank of Åland's capital and earnings as strong, reflecting our expectation that the bank's RAC ratio will increase to 14.8%-15.2% over the next 18-24 months. Similar to other Nordic peers, the RAC ratio remains a rating strength to Bank of Åland.

As of Dec. 31, 2017, Bank of Åland's RAC ratio was 13.7%. The growth in S&P Global Ratings-risk-weighted assets driven by the new lending and the acquisition of Swedish pension assets was more than countered by the increase in the bank's total adjusted capital (TAC), our measure of loss-absorbing capital for banks. The transition to International Financial Reporting Standard No. 9 (IFRS 9) lowered capital by around €3.0 million in 2018, which we consider minor compared with peer banks.

In order to support its growth strategy, Bank of Åland issued a SEK 200 million (about €19 million) Tier 2 instrument to institutional investors in May 2018, which qualifies as intermediate equity inclusion in our TAC. The combined amount of Tier 2 instruments issued by Bank of Åland now represents approximately 14% of adjusted common equity, whereas many of its Nordic peers have no hybrid instruments in their capital base. We therefore regard Bank of Åland as having lower quality of capital than its peers. We do not include any additional hybrid capital instruments in our forecast but understand that the bank could target a further Tier 2 capital issuance. We would view negatively any further hybrid capital issuance at the expense of organic capital growth through earnings.

We anticipate that the growth in customer base and associated loan volumes and assets under management will be the main drivers of earnings growth. In line with the bank's stated strategy to expand the Swedish operations, we project the bank will maintain an average pace of 5% in lending growth over the next two years. A large share of revenues come from a relatively narrow business line, mainly from its private and premium banking business. In the medium term, we anticipate that net interest and net fee income will contribute equal amounts to revenues, as asset management and private banking services remain focus areas for Bank of Åland's strategy. As asset management fees

can be subject to market swings, this could, in our view, create some earnings volatility. Nevertheless, we forecast that the bank will generate annual net profits of €25 million-€35 million in the next two years after a dividend payout of 50%. This translates into a strong three-year average earnings buffer above 1.50% (an earnings buffer of about 1.0% indicates adequate earnings capacity).

Table 3

Bank of Aland PLC -- Capital And Earnings					
	--Year ended Dec. 31--				
	2018*	2017	2016	2015	2014
Tier 1 capital ratio	12.80	12.90	11.80	11.90	10.90
S&P RAC ratio before diversification	N/A	13.74	13.33	13.00	11.20
S&P RAC ratio after diversification	N/A	11.30	10.40	11.10	9.70
Adjusted common equity/total adjusted capital	85.39	92.33	92.97	95.74	100.00
Net interest income/operating revenues	42.66	43.67	45.75	43.23	40.88
Fee income/operating revenues	39.45	38.84	37.31	37.21	38.31
Market-sensitive income/operating revenues	4.89	2.57	3.50	6.43	5.61
Noninterest expenses/operating revenues	76.15	77.98	75.79	73.33	79.96
Preprovision operating income/average assets	0.59	0.54	0.60	0.75	0.59
Core earnings/average managed assets	0.44	0.39	0.40	0.55	0.43

*As of end-June. RAC--Risk-adjusted capital. N/A--Not available.

Table 4

Bank of Aland PLC Risk-Adjusted Capital Framework Data						
(Mil. €)	Exposure*	Basel III RWA	Average Basel III RW (%)	S&P Global RWA	Average S&P Global RW (%)	
Credit risk						
Government and central banks	750	0	0	7	1	
Of which regional governments and local authorities	27	0	0	1	4	
Institutions and CCPs	627	100	16	86	14	
Corporate	864	528	61	432	50	
Retail	3,305	665	20	809	24	
Of which mortgage	2,843	541	19	647	23	
Securitization§	0	0	0	0	0	
Other assets†	68	60	88	68	99	
Total credit risk	5,640	1,353	24	1,402	25	
Credit valuation adjustment						
Total credit valuation adjustment	--	0	--	0	--	
Market risk						
Equity in the banking book	1	1	179	6	875	
Trading book market risk	--	0	--	0	--	
Total market risk	--	1	--	6	--	
Operational risk						
Total operational risk	--	188	--	209	--	

Table 4

Bank of Åland PLC Risk-Adjusted Capital Framework Data (cont.)				
(Mil. €)	Basel III RWA		S&P Global RWA	% of S&P Global RWA
Diversification adjustments				
RWA before diversification	1,542		1,617	100
Total diversification/concentration adjustments	--		349	22
RWA after diversification	1,542		1,967	122
(Mil. €)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	198	12.8	222	13.7
Capital ratio after adjustments‡	198	12.9	222	11.3

*Exposure at default. §Securitization exposure includes the securitization 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. Sources: Company data as of Dec. 31, 2017, S&P Global.

Risk position: Concentration risks in the loan portfolio due to focus on residential mortgages and some single-name exposures

In our view, Bank of Åland follows a prudent approach in its loan underwriting, demonstrated in its good asset quality, sound collateralization, and low cost of risks. This is countered by the concentration risks and cyclical nature of its loan book due to the focus on mortgage lending. We expect that the bank will continue to have moderate geographic diversity, but a narrow number of client segments, and some large single-name exposures. Generally, the bank's product offering primarily comprises plain vanilla retail banking and related asset management products. Furthermore, its foreign currency exposure and interest rate risks in the banking book are not significant. The bank does not use complex financial instruments in its daily operations.

Bank of Åland's loan portfolio amounted to €4.0 billion as of June 2018 and continues to be retail-focused (72% of the gross loan book). The bulk of the loan portfolio consists of home loans to individuals. The growth in the corporate portfolio mainly results from collateralized real estate financing in Sweden. Further growth in Sweden should provide some diversification, while we do not believe this will lead to an accumulation of high-risk exposures given the bank's prudent underwriting standards and the sound collateralization of these exposures.

We view positively Bank of Åland's focus on wealthy individuals, entrepreneurs and their related corporations, and its strategy of engaging mainly in collateralized lending. Much of this is a result of the bank's focus on long-term customer relationships. In our view, the asset quality of the bank remains sound with a reported share of stage three loans to total client loans of 0.69% as of June 30, 2018 (previously defined as loans past due 90 days before the transition to IFRS 9). The continued reduction in Bank of Åland's shipping finance portfolio will likely support the bank's asset quality. This portfolio represented about €46 million or about 1.15% of total lending on June 30, 2018 and is, in our view, adequately provisioned.

Bank of Åland has managed its loan book well over the recent economic cycle. Between 2014 and 2017, the bank posted an average of 8 basis points (bps) of annual loan losses, and for the first six months of 2018, it reported loan

losses of 3bps. Over the coming years, we expect Bank of Åland to outperform the Finnish market average and the projected loans losses of 6bps are well below our estimate of normalized losses over the cycle.

Table 5

	Bank of Aland -- Risk Position				
	--Year ended Dec. 31--				
	2018*	2017	2016	2015	2014
Growth in customer loans	(0.75)	4.40	5.29	8.04	7.63
Total diversification adjustment / S&P RWA before diversification	N/A	21.60	28.20	17.00	15.60
Total managed assets/adjusted common equity (x)	25.67	26.08	26.28	23.80	23.90
New loan loss provisions/average customer loans	0.04	0.05	0.11	0.09	0.05
Net charge-offs/average customer loans	0.10	0.11	0.09	0.20	0.07
Gross nonperforming assets/customer loans + other real estate owned	0.69	0.77	1.31	2.00	1.52
Loan loss reserves/gross nonperforming assets	40.51	33.76	25.21	16.35	30.93

*As of end-June. N/A--Not applicable. RWA--Risk-weighted assets.

Funding and liquidity: Funding profile dominated by customer deposits and covered bond issuance

We assess Bank of Åland's funding profile as average, owing to a stable core customer deposit base covering 63% of the bank's funding base. This is also reflected in the balanced stable funding ratio of about 118% as of Dec. 31, 2017 (112% of June 2018). Customer deposits show only limited concentration, and we expect they will remain a stable source of funding.

Over the past few years, Bank of Åland has diversified its funding sources and increased the use of wholesale funding to aid lending growth. The wholesale funding mainly through covered bond issuance now represents approximately 38% of the funding base. Both Finnish and Swedish covered mortgage pools are used in the program. The average maturity of Bank of Åland's funding profile is approximately three years, which the bank is likely to maintain given that it has established a solid investor base beyond Finland and Sweden.

We assess the Bank of Åland's liquidity as adequate, reflecting a ratio of broad liquid assets to short-term wholesale funding (BLAST) of 2.9x as of year-end 2017, and 2.4x as of June 2018. Given the maturing long-term funding and changes in assets held with other banks, the ratio is somewhat volatile. Bank of Åland's liquidity reserve amounted to approximately €1.0 billion or 19% of the total assets as of June 30, 2018, leading to a liquidity coverage ratio of 135%. This is in line with peers' and well above the regulatory minimum of 100%. This portfolio consists of cash and securities, which are all eligible for repurchase agreement transactions at the Finnish or Swedish central banks. We therefore believe that under stressful conditions involving the closure of access to capital market funding and a significant deposit outflow, Bank of Åland could survive for more than six months, but dependence on the central bank through repurchase agreement activity could become significant thereafter. In our view, Bank of Åland's liquidity profile compares fairly well with the average bank in Finland and Sweden.

Table 6

Bank of Åland -- Funding And Liquidity					
	--Year ended Dec. 31--				
	2018*	2017	2016	2015	2014
Core deposits/funding base	63.13	63.34	64.11	58.74	55.23
Customer loans (net)/customer deposits	128.04	126.38	125.78	143.72	151.91
Long term funding ratio	91.25	91.35	90.69	87.26	79.58
Stable funding ratio	111.51	117.69	112.12	101.63	92.09
Short-term wholesale funding/funding base	9.15	9.05	9.74	13.37	21.39
Broad liquid assets/short-term wholesale funding (x)	2.39	2.90	2.44	1.28	0.79
Net broad liquid assets/short-term customer deposits	20.43	27.32	22.03	6.45	(8.02)
Short-term wholesale funding/total wholesale funding	24.44	24.47	26.91	32.26	47.77
Narrow liquid assets/3-month wholesale funding (x)	6.12	6.28	6.00	1.87	1.40

*As of end-June.

External support: No notches of uplift to the SACP

We do not factor any external support into our assessment of Bank of Åland. We believe the prospect of extraordinary government support for Finnish banks is uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers.

In addition, we assess Bank of Åland as having low systemic importance in Finland, given the small market share of customer deposits and loans in Finland. We understand that the Finnish authorities have not identified Bank of Åland as having a critical role to the Finnish financial system. Consequently, we do believe that it would be subject to a bail-in driven resolution and therefore do not consider it to be eligible for consideration of additional loss-absorbing capacity and resolution counterparty rating criteria.

Additional rating factors:None

No additional factors affect this rating.

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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 Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 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: Banking Industry Country Risk Assessment Methodology And Assumptions,

Nov. 9, 2011

- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Nordic Bank Ratings Continue To Stand Tall, Aug. 16, 2018
- Finland-Based Bank Of Åland Outlook Revised To Positive On Potentially Stronger Capitalization And Profitability, July 25, 2018
- Banking Industry Country Risk Assessment Update: July, July 24, 2018
- Banking Industry Country Risk Assessment: Finland, Feb. 2, 2018
- Nordic Banks' Capitalization Should Remain Stable Despite Revised Basel III Standards, Jan. 24, 2018
- Banking Industry Country Risk Assessment: Sweden, Nov. 24, 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 August 17, 2018)

Bank of Aland PLC

Issuer Credit Rating

BBB/Positive/A-2

Senior Secured

AAA/Stable

Issuer Credit Ratings History

25-Jul-2018

BBB/Positive/A-2

17-Nov-2016

BBB/Stable/A-2

20-Nov-2012

BBB/Negative/A-3

Sovereign Rating

Finland

AA+/Stable/A-1+

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

Ratings Detail (As Of August 17, 2018) (cont.)

across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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