

French Covered Bond Market Insights 2019

January 31, 2019

Key Takeaways

- France has one of the most active covered bond markets, with 2018 overall issuance ranking second globally.
- The French legislation is a class leader, balancing strong protection mechanisms for bondholders with ample operational flexibility for covered bond issuers.
- In our view, favorable credit conditions, high ratings, and a stable outlook on most issuers will support ratings stability for French covered bonds.

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S&P Global Ratings is publishing a series of reports taking a closer look at specific covered bond markets. In our third report, we review the French covered bond market.

Overview: France Is A Major Player In Covered Bond Markets

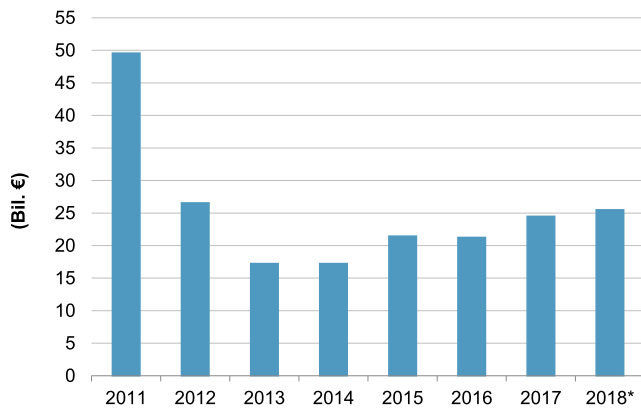
The French covered bond market is one of the most active globally, with over €300 billion of outstanding bonds and €25.5 billion of issuance in 2018. France was the second largest issuer of covered bonds in 2018, following Germany, and the third regarding outstanding volumes, behind Denmark and Germany.

There are currently 19 French covered bond programs, issued by 15 banks. The relatively limited number of parent banks reflects the consolidated nature of the French banking landscape relative to other European countries. The main collateral types backing covered bond programs are residential loans (mortgage and guaranteed), and-to a lesser extent-public sector exposures.

The large outstanding covered bond volumes and stable issuance flow indicates that covered bonds have become a primary funding source for French banks.

Chart 1

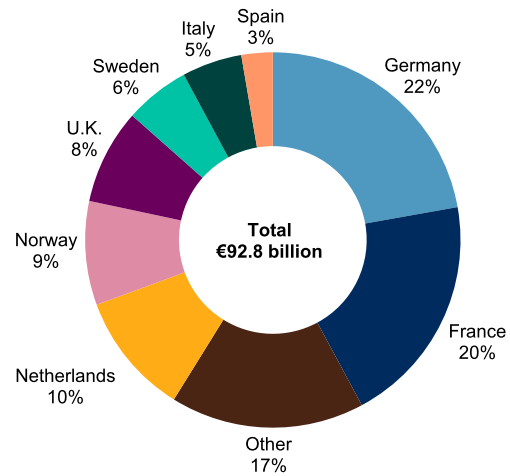
Benchmark French Covered Bond Issuance



Source: S&P Global Fixed Income Research.
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Chart 2

Benchmark European Covered Bonds, 2018



Source: S&P Global Fixed Income Research.
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Covered bonds face competition from other funding instruments

On the supply side, although new issuance in 2018 was strong, it was constrained by regulatory requirements, particularly those applying to liability structures under the EU Bank Recovery and Resolution Directive (MREL requirements). Furthermore, banks in France and in other jurisdictions may increasingly use senior preferred funding when trying to optimize funding costs, to the detriment of covered bond issuance.

Banks' funding indicators contributing to covered bond issuance

French banks' covered bond issuance may gain momentum this year as by June 2019 the funding provided by the European Central Bank's (ECB) targeted longer-term refinancing operations (TLTRO II program), which begins to mature in June 2020, will have a remaining maturity less than one year. Therefore, TLTRO borrowings will no longer be eligible for inclusion in the calculation of banks' regulatory Net Stable Funding Ratio (NSFR), which requires eligible funding to have a maturity longer than one year. As a consequence, we expect additional momentum in covered bond issuance in 2019.

European Central Bank scales back quantitative easing

The ECB has now ended net purchases under its quantitative easing program, which includes the third Covered Bond Purchase Program (CBPP3). However, it will continue reinvesting redemptions of principal from maturing securities held in the CBPP3 portfolio. We do not expect more than a limited price correction as the market has already anticipated this planned and progressive retreat.

An increase in redemptions could be a driving factor for new issuance

Covered bond redemptions in France in 2019 will increase to about €20 billion from approximately €14 billion in 2018. This will most likely sustain issuance requirements in 2019.

A Class-Leading Legal Framework

The French covered bond legislation encompasses two main legal frameworks: "société de financement de l'habitat" (SFH) and "société de crédit foncier" (SCF). An additional framework is exclusively dedicated to one issuer, the Caisse de Refinancement de l'Habitat. The SFH framework covers residential loan collateral and is dedicated to the issuance of "obligations de financement de l'habitat" (OHs). The SCF framework can accommodate multiple collateral types including public sector exposures, residential loans, and commercial real estate loans. Covered bonds issued under this framework are named "obligations foncières" (OFs). Both give credit to a loan-to-value below a 80% threshold for standard residential loans, and prescribe a 15% cap to the proportion of substitution assets in the cover pool.

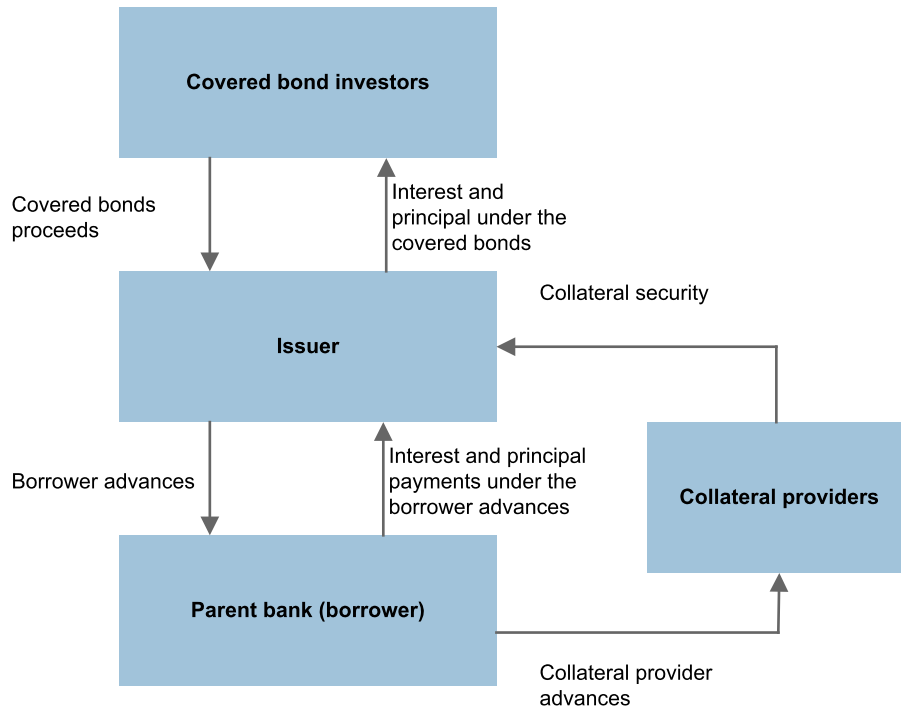
SFHs and SCFs are specialized credit institutions licensed by the "Autorité de Contrôle Prudentiel et de Résolution", the French banking regulator. They are distinct from other entities of the group to which they belong and are dedicated to covered bond issuance. As regulated entities, SFHs and SCFs are subject to quarterly compliance audits with legal covenants from the "contrôleur spécifique", an external auditor.

As with covered bonds in other jurisdictions, bondholders have a dual recourse to receive payments on their debt: they have recourse to the SFH/SCF's parent bank and to the cover pool assets if the parent bank becomes insolvent. The framework stipulates a clear segregation of the cover pool assets for the bondholders' benefit, who have a preferential claim through a legal privilege granted over the eligible assets.

Under a typical program's terms, the SFH/SCF issuer uses the covered bond issuance proceeds to fund a credit facility made available to the parent bank (the borrower; see chart 3). Payments from the parent bank match the terms and conditions of the covered bonds, which ensures full and timely payments to the covered bondholders. A pool of eligible assets (the collateral security) is transferred to the issuer from the collateral providers (the parent bank or its lending subsidiaries), as a security for the covered bond noteholders. If the parent bank defaults on its obligations, this security will be enforced.

Chart 3

Typical French SFH/SCF Covered Bond Structure



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SFH And SCF Legal Framework Requirements

- Minimum nominal overcollateralization of 5%
- Available liquidity at all times to cover the next 180 days of principal and interest flows on covered bonds, as well as flows related to its derivative instruments.
- Maturity mismatch: The assets' remaining weighted-average life should not exceed that of the covered bonds by more than 18 months.

The provisions of the French SFH and SCF legislations are credit-positive in our analysis:

- Overcollateralization: We do not deduct a notch of collateral-based uplift when committed overcollateralization is commensurate with our ratings. Therefore, we would consider the 5% legal minimum overcollateralization in our analysis if it exceeds the level for the reviewed program.
- Liquidity: This legal provision means that we can consider liquidity always covered for six months and do not deduct a collateral-based notch for lack of liquidity.
- Maturity mismatch: The cap on maturity mismatch reflects favorably in our assessment of market value risk in our cash flow analysis.

In our view, these frameworks strike a good balance between an effective protection of covered bondholders, flexibility to include multiple asset types, and clear program management thresholds for minimum overcollateralization, liquidity coverage, and maturity mismatch requirements. More importantly, these legal frameworks are in line with the proposed EU harmonization directive, suggesting no immediate need for a revision.

Features Of French Covered Bond Programs

Residential loans

A fixed-rate lending market. Due to the prevalence of fixed-rate (for life) residential loans in the French market, covered bond programs mainly issue fixed-rate notes and rely on a natural hedge with no ad hoc interest rate swaps. We assess the extent to which these natural hedges affect overcollateralization requirements through our cash flow analysis.

An emphasis on DTI. The main borrower eligibility criterion under French banks' credit underwriting policies is the debt-to-income (DTI) ratio, in contrast to other mortgage markets such as the U.S. or the U.K. where more importance is given to property valuations. Underwriting standards are generally conservative, and the maximum DTI is typically 33%. As a result, the performance of French residential loans is less linked to house prices than in the U.S. or U.K. This, coupled with a very strong social benefit support system, means that portfolio performance is less cyclical and tends to suffer fewer losses in times of economic downturns than in other countries.

Guaranteed loans as market standard. French residential loans are secured either by a traditional mortgage or by a guarantee (known as caution) provided by an insurer or a credit institution. On default of a guarantee-secured loan, the lender recovers the guaranteed amount from the guarantor, which then manages the recovery process and, if applicable, the eventual foreclosure of the property. Loans guaranteed by cautions are a unique feature of the French market. As of 2017, cautions represented almost 60% of outstanding loans and their share is increasing.

Public sector exposures

Public-sector underlying collateral types are relatively diverse, ranging from loans to French local and regional governments (LRGs), public hospitals, and other public entities to export finance loans guaranteed by export credit agencies in France and abroad. Our credit analysis considers the assessment of the creditworthiness of the various obligors and guarantors.

Bond repayment profiles. Although soft bullet issuances are now more common, French covered bond issuers normally have the flexibility to issue in both soft and hard bullet formats. Liquidity requirement for both formats are addressed by the SFH and SCF legislations, which both require a minimum of 180 days of liquidity needs.

Table 1

French Covered Bond Programs

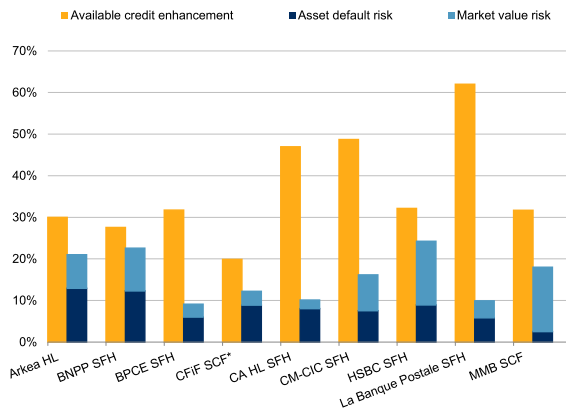
	Year of first issuance	S&P Global Ratings' CB rating
Obligations Foncières - OF		
Arkéa Public Sector SCF	2011	AAA/Stable
AXA Bank Europe SCF	2010	NR
BNP Paribas Public Sector SCF	2009	AAA/Stable
Caisse Française de Financement Local (Caffil)	1999	AA+/Stable
CIF EuroMortgage	2001	NR
Compagnie de Financement Foncier SCF	1999	AAA/Stable/A-1+
Crédit Agricole Public Sector SCF	2012	AAA/Stable
GE SCF	2009	AA/Stable
Société Générale SCF	2008	AAA/Stable/A-1+
MMB SCF (My Money Bank)	2018	AAA/Stable
Obligations à l'Habitat - OH		
Arkéa Home Loans SFH	2009	AAA/Stable
BNP Paribas Home Loan SFH	2006	AAA/Stable
BPCE SFH	2011	AAA/Stable
Crédit Agricole Home Loan SFH	2009	AAA/Stable
Crédit Mutuel-CIC Home Loan SFH	2007	AAA/Stable
HSBC SFH (France)	2008	AAA/Stable
La Banque Postale Home Loan SFH	2013	AAA/Stable
Société Générale SFH	2003	NR
Other		
Caisse de Refinancement de l'Habitat	1985	NR

NR--Not rated.

The target credit enhancement is the overcollateralization required to achieve the maximum potential collateral-based uplift. It covers asset default risk, or credit risk, and market value risk, which is the credit enhancement that we expect to be required to refinance the cover pool in a stressed environment.

Chart 4a

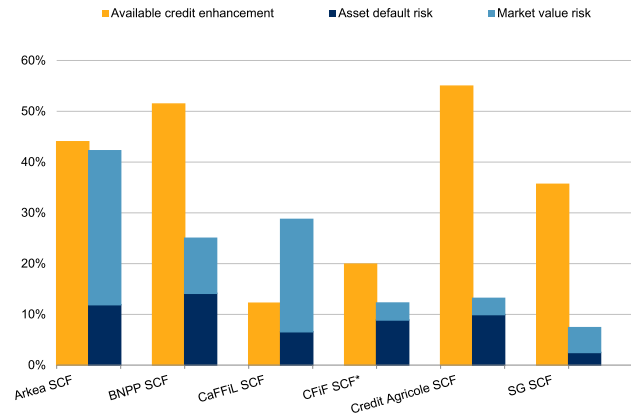
Available And Target Credit Enhancement In French Mortgage Covered Bond Programs



The target credit enhancement is the sum of the asset default risk and the market value risk. Source: S&P Global Ratings. *CFIF has a mixed mortgage and public sector pool. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 4b

Available And Target Credit Enhancement In French Public Sector Covered Bond Programs



The target credit enhancement is the sum of the asset default risk and the market value risk. Source: S&P Global Ratings. *CFIF has a mixed mortgage and public sector pool. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Mortgage Market Overview: A Solid Market With Modest Growth Expectations

The French economy is both stable and wealthy. Compared with European peers, it benefits from low private-sector credit risk and high household savings.

After a 1.6% growth in GDP in 2018, we forecast stable growth prospects from 2019 onwards for the French economy, although at lower rates (see table 2). Unemployment should taper off and we expect inflation to remain at or below 2.0%.

Table 2

Economic Indicators

Year	Real GDP growth (%)	Unemployment rate (%)	Nominal house prices (%)
2017	2.3	9.4	3.3
2018f	1.6	9.1	2.7
2019f	1.6	8.8	2.0
2020f	1.6	8.7	2.0
2021f	1.5	8.6	2.0

Source: S&P Global Ratings. f--Forecast.

Risks

Global trade tensions are rising rapidly, with a danger of escalating further. Potential fallout from unsuccessful Brexit negotiations between the U.K. and the EU 27 remains a concern, and we see the risk as having risen for the near term.

A worsening external outlook, if turmoil in emerging markets continues or if trade tensions reappear, could weigh on growth in France. Domestically, concessions from the government due to popular unrest could weigh on GDP growth and current budget deficit.

Property market outlook

The property market has rebounded since 2016, when real house prices growth became positive following a decline in the aftermath of the financial crisis. In 2017, the market was bolstered by competitive interest rates, with residential house prices recording a real growth of 2.5% and historically high transaction levels. The outstanding volume of housing credit reached an all-time-high of close to €1,000 billion in 2017. We estimate that house prices have grown more slowly in 2018, at 0.6% in real terms, due in part to a reduction in governmental support for housing. This includes in particular restrictions to popular schemes such as subsidized loans ("prêts à taux zero"), home purchase subsidies for lower income individuals ("aide personnalisée au logement"), the Pinel investment scheme, and increased taxation on rents. On a positive note, credit losses should remain low in 2018-2019, albeit above the recent record low levels of 2017.

Local And Regional Government Lending Overview: Reduced Loan Origination Ahead

French LRGs operated a budgetary consolidation in 2017, which we expect to continue in 2018 and 2019. This is due to a favorable economic context, with dynamic tax revenues associated with a tight grip on expenditures. In addition, after four years of central government transfer reductions, the transfer levels have stabilized. Therefore, we expect LRG borrowings to remain low in 2018-2019, despite higher investments.

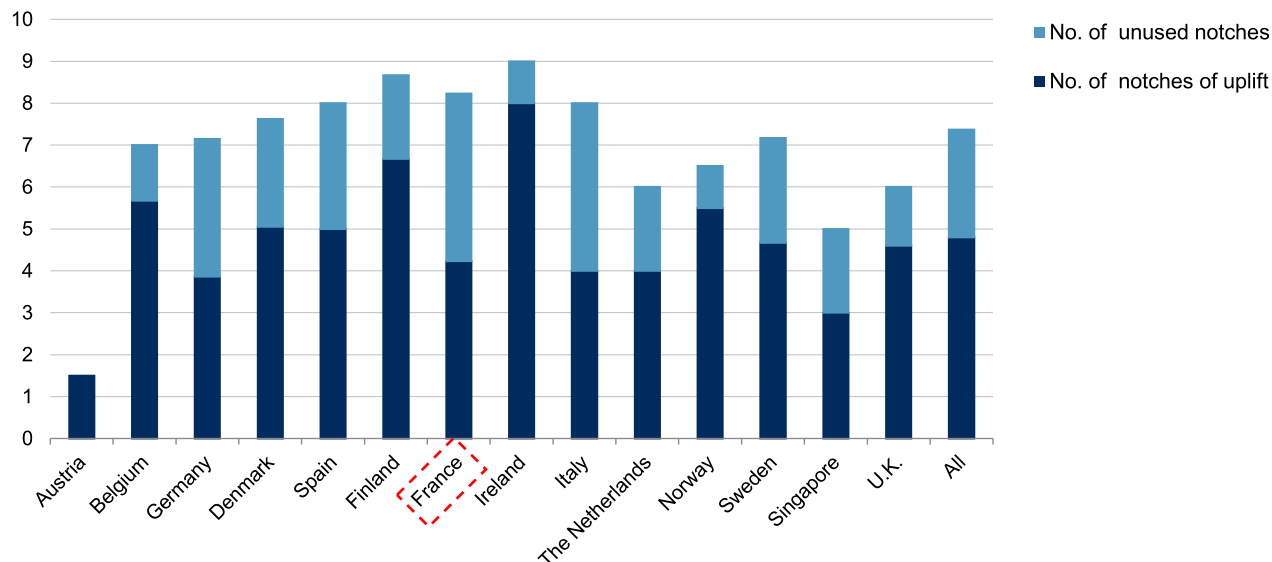
Commercial banks' funding of LRGs have seen their market share decline in 2017, while public funding via key players La Banque Postale, Caisse des Dépôts et Consignations, and the European Investment Bank was buoyant, and increased bond issuances provided funding diversification to LRGs. We expect the respective share of each funding mode to remain stable for the next two years. Funding costs will remain very low, with larger LRGs benefitting from lower rates, particularly when tapping the commercial paper market.

Outlook And Comparison Of French Covered Bond Programs

On top of a strong economy, French covered bonds benefit from the support of highly-rated issuers. In our analysis of covered bond programs, the issuer is the first recourse for bondholders. Therefore, strong issuers benefit the covered bond programs' creditworthiness.

Chart 5

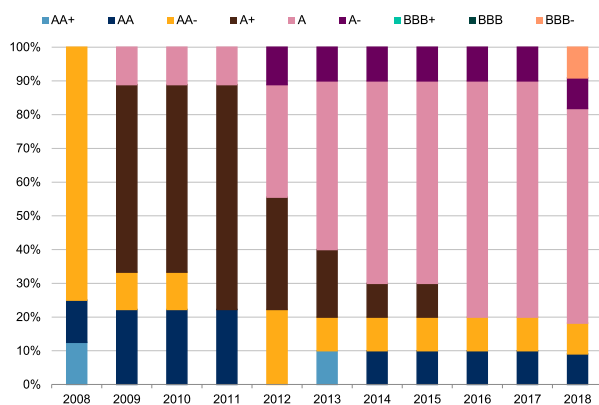
Average Number Of Unused Notches By Country In Q4 2018



Note: This chart does not include pass-through programs, programs with no rating on the issuer and GE SCF S.C.A.
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Chart 6

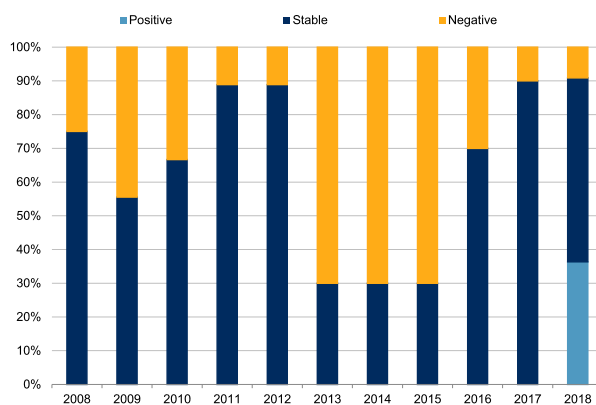
French Covered Bond Issuing Banks' Rating Distribution



Source: S&P Global Ratings.
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Chart 7

French Covered Bond Issuing Banks' Outlook Distribution

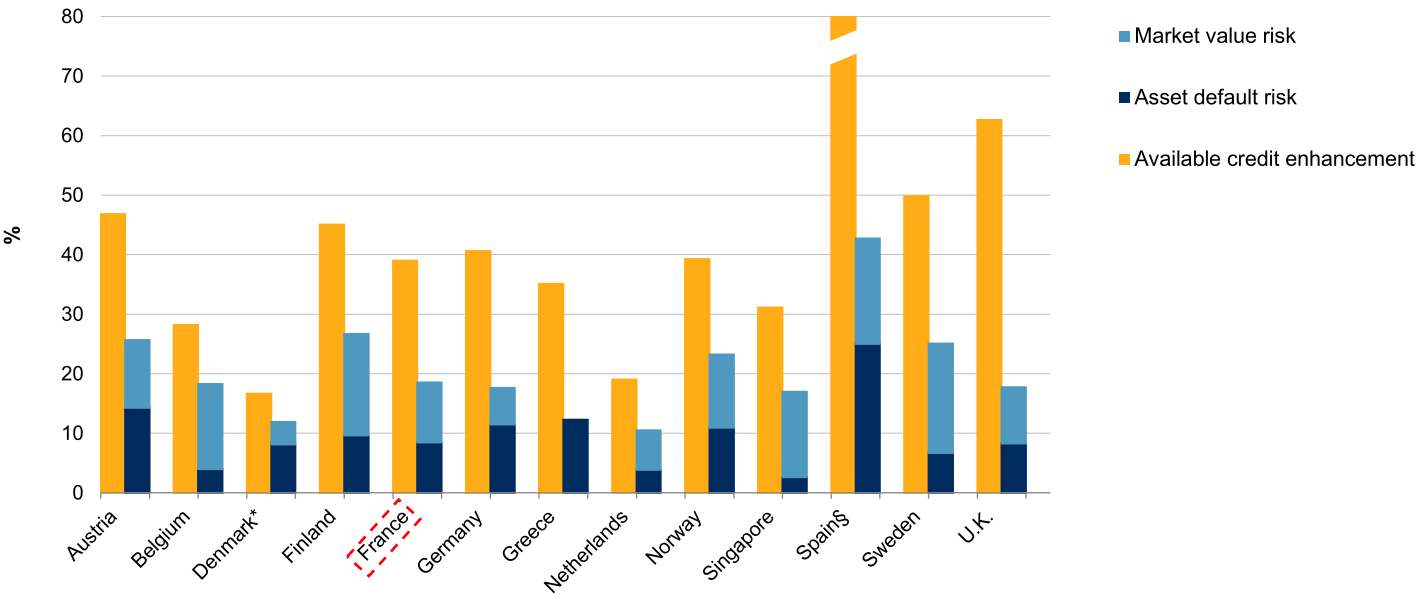


Source: S&P Global Ratings.
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A highly-rated issuer can translate into unused notches of ratings uplift, offering some buffer against decreasing available credit enhancement.

Chart 8

Credit And Market Risk By Country In Q4 2018

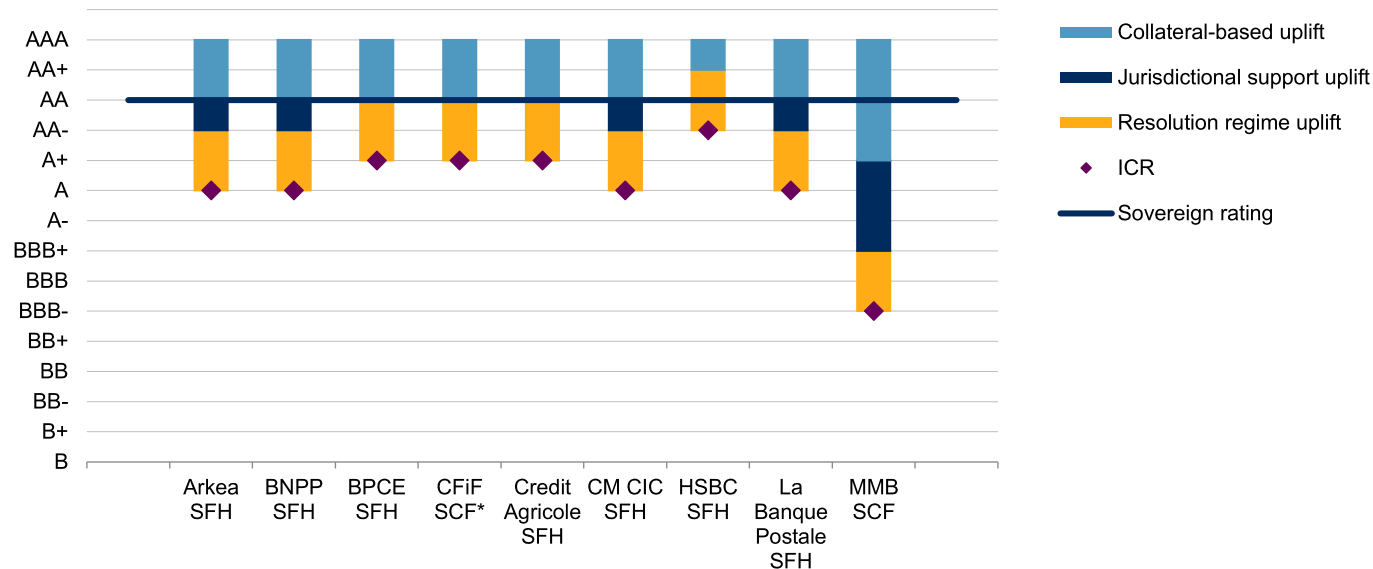


Source: S&P Global Ratings. *Not considering Nykredit Capital Centre General or datapoints for which information is withheld. §Spain's available credit enhancement is 210.5%.
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Charts 9a and 9b show our average cash flow calculations across countries. French programs present on average relatively fairly low credit and market risk.

Chart 9a

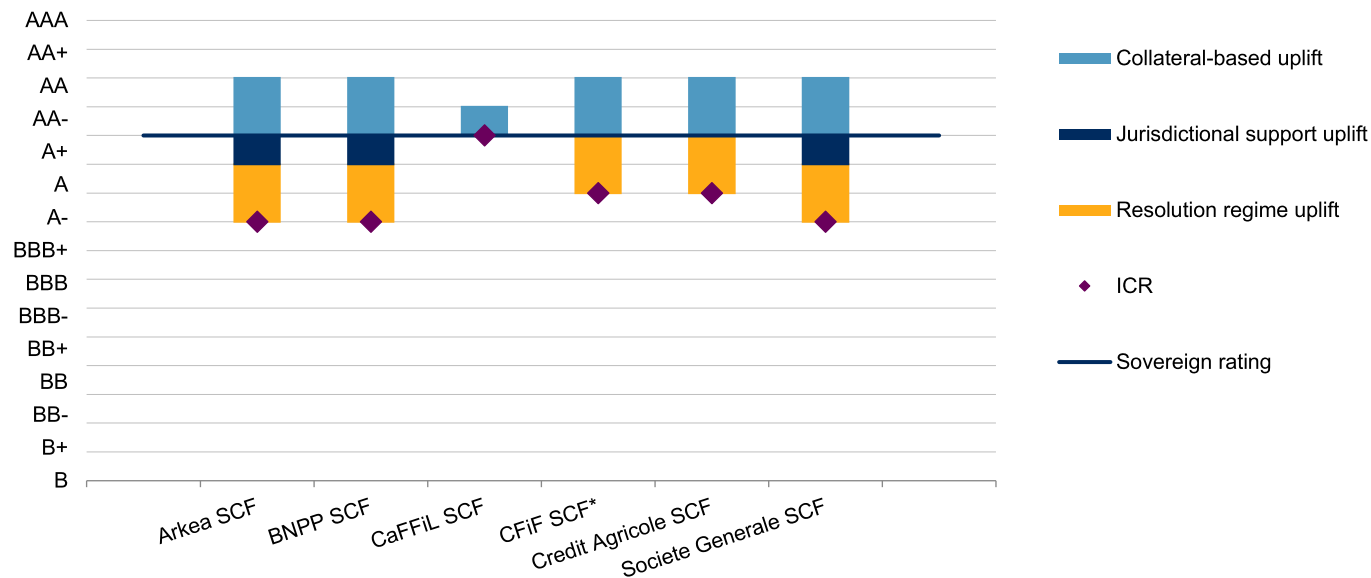
Distribution Of Uplifts Above ICR In French Mortgage CB Programs In Q4 2018



*CFiF has a mixed mortgage and public sector pool. Source: S&P Global Ratings.
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Chart 9b

Distribution Of Uplifts Above ICR In French Public Sector CB Programs In Q4 2018



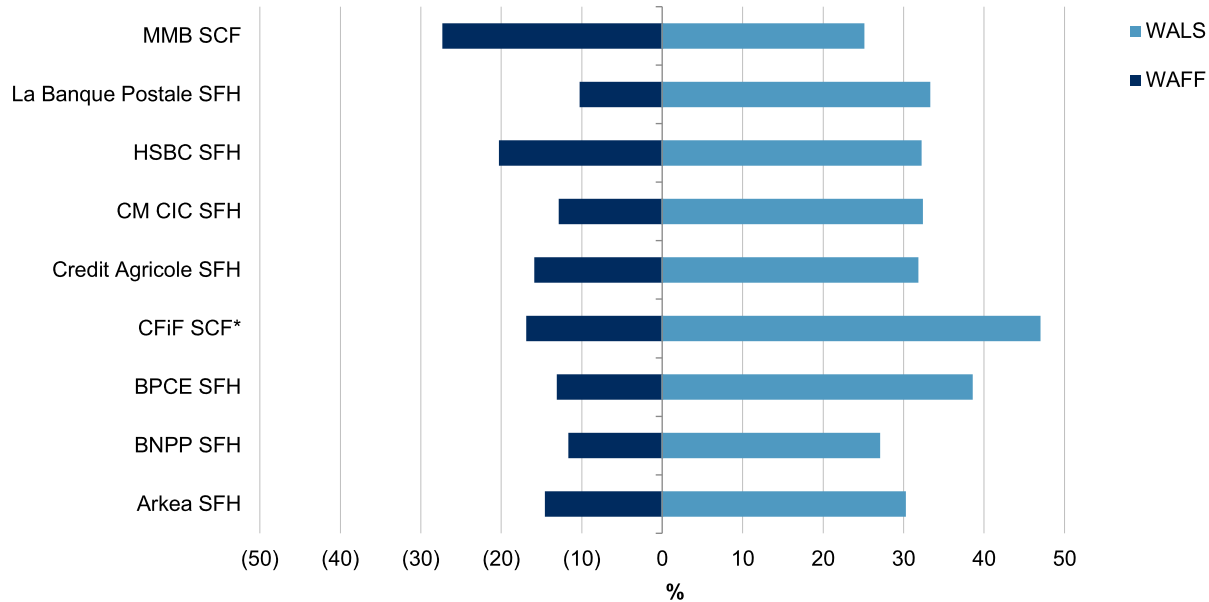
*CFiF has a mixed mortgage and public sector pool. Source: S&P Global Ratings.
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Program comparison

Even though French covered bonds tend to perform strongly on average, there are some differences in characteristics and credit and cash flow results from one program to the next. Below we present and compare the key characteristics of the French covered bond programs that we rate.

Chart 10

Comparison Of WAFF And WALs Across French CB Programs



Source: S&P Global Ratings. *CFF has a mixed mortgage and public sector pool.

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Table 3a

Rated French Mortgage Covered Bond Programs Characteristics

	Arkéa Home Loans SFH	BNP Paribas Home Loan SFH	BPCE SFH	Crédit Agricole Home Loan SFH	Crédit Mutuel-CIC Home Loan SFH	Compagnie de Financement Foncier SCF (CFiF)	HSBC SFH (France)	La Banque Postale Home Loan SFH	MMB SCF
Total outstanding assets (bil. €)*	7.89	35.50	29.20	39.89	34.86	74.41	6.00	9.40	0.66
Total outstanding liabilities (bil. €)	6.07	27.83	22.16	27.14	23.44	61.84	4.54	5.80	0.50
Residential assets (%)	100.00	98.21	100	100	88.94	53.54	97.71	99.42	96.36
Weighted-average CLTV ratio (%)	62.97	57.61	66.36	60.81	62.97	88.51	62.27	64.83	60.59
WAFF (%)	14.44	11.56	12.98	15.76	12.73	16.77	20.15	10.14	27.18
WALS (%)	30.15	26.96	38.48	31.73	32.27	46.90	32.11	33.19	24.99
Available credit enhancement (%)	30	27.55	31.74	46.94	48.69	19.88	32.16	62	31.7
Target credit enhancement (%)	20.99	22.58	9.1	10.1	16.16	12.22	24.22	9.94	18

Table 3a

Rated French Mortgage Covered Bond Programs Characteristics (cont.)

	Arkéa Home Loans SFH	BNP Paribas Home Loan SFH	BPCE SFH	Crédit Agriculture Home Loan SFH	Crédit Mutuel-CIC Home Loan SFH	Compagnie de Financement Foncier SCF (CFiF)	HSBC SFH (France)	La Banque Postale Home Loan SFH	MMB SCF
Overcollateralization consistent with current rating (%)	16.95	17.44	7.55	8.05	11.86	11.39	8.93	8.91	9.28

*As reported by the issuer. CLTV--Current Loan to value. WAFF--Weighted-average foreclosure frequency. WALs--Weighted-average loss severity.

Table 3b

Rated French Public Sector Covered Bond Programs Characteristics

	Arkéa Public Sector SCF	BNP Paribas Public Sector SCF	Caisse Française de Financement Local (CaFFiL)	Compagnie de Financement Foncier SCF (CFiF)	Crédit Agricole Public Sector SCF	GE SCF	Société Générale SCF
Total outstanding assets (bil. €)*	1.85	1.51	57.99	74.41	4.58	0.56	11.09
Total outstanding liabilities (bil. €)	1.29	1.00	51.68	61.84	3.00	0.36	8.18
Public Sector assets (%)	100.00	93.86	93.89	36.56	100.00	73.80	100.00
Scenario default rate (%)	40.34	N/A	40.75	37.76	N/A	N/A	36.9
Scenario loss rate (%)	N/A	13.18	N/A	N/A	19.45	N/A	N/A
Weighted-average cover pool rating	BBB	BBB-	BBB-	BBB	B	N/A	BB+
Available credit enhancement (%)	43.98	51.42	12.20	19.88	54.94	55.82	35.63
Target credit enhancement (%)	42.23	24.99	28.69	12.22	13.14	W/H	7.36
Overcollateralization consistent with current rating (%)	27.06	24.99	9.00	11.39	12.61	W/H	3.04

*As reported by the issuer. N/A--Not available. W/H--Withheld.

Scenario Analysis

Despite a strong economy, we have carried out a scenario analysis with large drops in house prices to gauge whether these would affect the overcollateralization commensurate with our rating or the rating itself. We have decided to test this scenario analysis for 10% and 15% of house price drops, worse than the 8%-10% drop seen after the crisis between 2008 and 2014.

Table 3 shows the effect of the house price decline on our weighted-average loss severity (WALS) calculation. The overcollateralization in line with the current rating does not increase significantly. These hypothetical house price drops do not affect the achievable rating on any of the programs either.

Table 4

Effect Of House Price Decline On Rated French Covered Bond Programs

	Arkéa Home Loans SFH	BNP Paribas Home Loan SFH	BPCE SFH	Crédit Agricole Home Loan SFH	Crédit Mutuel-CIC Home Loan SFH	HSBC SFH (France)	La Banque Postale Home Loan SFH
House price haircut							
Base case							
WALS (%)	30.15	34.94	38.48	31.73	32.27	32.11	33.27
'AAA' credit risk (%)	12.04	11.47	5.90	7.84	8.01	9.97	6.15
Target credit enhancement (%)	20.87	15.85	8.80	10.37	14.00	25.85	9.97
Overcollateralization commensurate with rating (%)	16.46	13.66	7.35	9.11	11.01	9.97	9.02
Available credit enhancement (%)	30.00	27.55	31.74	46.94	48.69	32.16	62.00
10%							
WALS (%)	40.16	39.18	41.63	33.14	34.83	46.76	44.93
'AAA' credit risk (%)	13.72	17.86	10.98	10.37	8.28	13.03	7.44
Target credit enhancement (%)	22.66	22.87	16.17	15.30	14.27	29.20	11.29
Overcollateralization commensurate with rating (%)	18.19	20.36	13.58	12.83	11.27	13.03	10.33
15%							
WALS (%)	43.84	42.98	45.12	36.45	38.16	51.69	48.93
'AAA' credit risk (%)	14.34	18.36	11.49	10.93	8.68	14.05	7.65
Target credit enhancement (%)	23.33	23.50	16.67	19.80	14.54	30.51	11.74
Overcollateralization commensurate with rating (%)	18.84	20.93	14.08	15.37	11.61	14.05	10.72

WALS--Weighted-average loss severity.

Related Criteria

- Methodology And Assumptions: Assessing Pools Of European Residential Loans, Aug. 4, 2017
- Covered Bond Ratings Framework: Methodology and Assumptions, June 30, 2015
- Covered Bonds Criteria, Dec. 9, 2014

Related Research

- Global Covered Bond Insights Q4 2018, Dec. 12, 2018
- Global Covered Bond Characteristics And Rating Summary Q4 2018, Dec. 12, 2018
- Credit Conditions EMEA: Bracing For Turbulence, Nov. 29, 2018
- European Economic Snapshots For Q4 Published, Oct. 11, 2018
- Europe's Housing Markets Are Staging A Soft Landing, Sept. 3, 2018

- Strong Credit Performance In France And Belgium Despite Signs Of Easing Residential Loan Underwriting Criteria, Aug. 30, 2018
- Criteria Guidance: Covered Bonds Criteria, May 2, 2018
- Glossary Of Covered Bond Terms, April 27, 2018

Related Reports

- Transaction Update: Caisse Francaise de Financement Local, Dec. 24, 2018
- Transaction Update: Societe Generale SCF, Dec. 18, 2018
- Transaction Update: Compagnie de Financement Foncier, Dec. 5, 2018
- New Issue: MMB SCF, Oct. 31, 2018
- Transaction Update: Credit Agricole Home Loan SFH Covered Bond Program, July 13, 2018
- Transaction Update: BNP Paribas Home Loan SFH, June 29, 2018
- Transaction Update: Credit Mutuel-CIC Home Loan SFH, June 13, 2018
- Transaction Update: BNP Paribas Public Sector SCF Covered Bond Program, June 12, 2018
- Transaction Update: Arkea Public Sector SCF, May 30, 2018
- Transaction Update: HSBC SFH (France), May 25, 2018
- Transaction Update: Credit Agricole Public Sector SCF, April 11, 2018
- Transaction Update: Arkea Home Loans SFH, March 14, 2018

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