
Rating References in Pension Fund Investment Policies

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STANDARD
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Overview

- Pension plan boards play an important role in establishing appropriate risk management policies for their organizations. In exercising their oversight responsibilities, board directors or trustees make decisions about how to manage investment risk on behalf of plan members and beneficiaries.
- Pension investment processes have considered credit ratings in a number of different ways for many years. Ratings are commonly used as benchmarks for screening and filtering credit risks associated with potential fixed-income investments, especially over the medium- and long-term. Ratings can supplement, but certainly not replace, the credit research efforts and firsthand analysis pension plans undertake to understand their risk exposures.
- There are characteristics of credit ratings that pension plan directors or trustees should consider, including the nature of credit ratings, their functionality, and their limitations. Understanding the attributes of ratings, we believe, can help improve the quality of oversight directors or trustees provide to their organizations.
- Credit ratings from different rating agencies may not be directly comparable, something directors or trustees should consider in their investment processes when analyzing information from multiple rating providers.
- Rating agencies, including S&P, publish an extensive amount of credit research to make their rating opinions easily accessible. They also publish the principles and methodologies they use to assign ratings. And their ratings performance studies describe how well the ratings they assign correlate with observed default frequencies. These resources can help directors or trustees better understand ratings.

Plan Oversight And Credit Ratings

Pension boards play a central role in the governance structures for their plans. Whether their affiliation is with a private or public sector pension plan, endowment, foundation or other similar type of trust fund, board directors and trustees fulfill a similar role in exercising oversight responsibilities for plan members or beneficiaries. These can encompass investment strategies and actuarial considerations for plan obligations, accounting and disclosure policies, plan administration, and other dimensions of governance. One essential component of a board member's role is to establish appropriate risk management policies for the investment programs that he or she oversees.

Although much of what follows is framed in terms of the way that pension funds refer to credit ratings in their investment policies, we see these considerations also applying more generally to other investors such as endowments, foundations, or other similar types of trust funds.

Directors and trustees who belong to a pension plan's investment committee typically set guidelines for managing investment risk in a statement of investment policies and procedures (SIPP). This is an area of board responsibility where some knowledge of credit ratings can be helpful. Credit ratings are one of several tools that investors should consider when making decisions about purchasing bonds and other fixed-income investments. Investors often use ratings as a reference for assessing the credit risk associated with potential investments they are considering. For this reason, ratings are relevant to discussions directors or trustees have with their investment managers or with investment consultants. Whether the focus is on policy design, for instance establishing the guidelines governing eligible investments, or matters concerning the performance of internal and external investment managers, we believe a shared understanding of the nature of credit ratings, their functionality, and their limitations can help to improve the effectiveness of these discussions.

Toward this end, and in an effort to enhance transparency, Standard & Poor's has developed educational resources to aid investors' and market participants' understanding of the ratings we assign. These resources describe what credit ratings are, how they work, the role of criteria in the ratings process, what ratings performance is and how Standard & Poor's measures how well its ratings correlate with observed default frequencies. This information is freely available at www.understandingratings.com.

STANDARD & POOR'S

UNDERSTANDING RATINGS

ABOUT CREDIT RATINGS

LAUNCH
aboutcreditratings.com

GUIDE TO CREDIT RATING ESSENTIALS
Find out what credit ratings are, and are not, who uses them, and how they may be useful to the capital markets.

WATCH...

Why Standard & Poor's Credit Risk Benchmark Is A Valuable Tool For Investors
As Standard & Poor's celebrates its 150th year of empowering investors, the key to rebuilding its market position lies in our credit risk benchmark.
00:05:13 min

What Are S&P's Corporate Credit Ratings?
What exactly is a Standard & Poor's corporate credit rating, and what role does it play in the global financial markets?
00:04:18 min

How Credit Estimates Differ From Ratings
In this CreditMatters TV segment, Standard & Poor's Senior Director David Gillmor discusses the ways

PEOPLE

LEARN about our greatest resource - the people of Standard & Poor's. We provide investors and markets with the research, data and information they need to make informed and timely investment decisions.

WATCH...

WATCH REPLAY: The U.S.: What Prompted Standard & Poor's To Revise Its Outlook To Negative
In this CreditMatters TV video, Standard & Poor's David Beers, global head of Sovereign Ratings, takes an in-depth look at the fiscal situation the U.S. finds itself in and the potential milestones that could spur a downgrade.
4/18/11 | 00:11:23 min

To Preserve Credit Quality, U.S. State And Local Governments Face Hard Choices
Standard & Poor's Managing Director Steve Murphy and Director Gabriel Petek discuss the dynamics shaping the municipal markets, how the U.S. economy could affect state and local governments, state budget

PERFORMANCE

WATCH Global Chief Credit Officer Mark Adelson as he takes an in-depth look at how ratings perform in times of economic stress.
00:10:10 min

GUIDE TO RATINGS PERFORMANCE
"The overall consistency of rating performance demonstrated by our default and credit rating transition studies we believe has helped to establish S&P's ratings as useful benchmarks of relative credit risk."

WATCH...

U.S. ABS Ratings Performance: What's Behind The Strong Track Record
In this CreditMatters TV segment, S&P's Managing Director Mike Binz discusses recent criteria changes, the effects of the TALF program on the ABS sector, regulation, our expectations for issuance volume, and more.
2/8/10 | 00:14:18 min

Do Credit Spreads Measure Credit Risks?
In this CreditMatters TV segment.

CRITERIA

READ The Time Dimension of S&P's Credit Ratings. The concept of credit is inherently connected to time, as an obligor's default risk may not remain constant as time passes.

GUIDE TO CREDIT RATINGS CRITERIA
Find out what S&P's credit ratings criteria are, how they are applied in the rating process, and how our criteria are governed and refined over time.

WATCH...

S&P's Pursuit of Ratings Comparability
S&P's Chief Credit Officer Mark Adelson discusses the importance of some of our recent criteria changes and how these changes facilitate ratings comparability, which helps investors across all sectors to assess credit risk.
8/31/09 | 00:16:46 min

Standard & Poor's Updated Criteria For Counterparty Risk In Structured Finance Transactions
In this CreditMatters TV segment.

How Ratings Are Referred To In Investment Policies

Pension investment processes have considered credit ratings for many years, in recognition of their historical correlation with relative default risk across issuers, asset classes, regions, and economic cycles. Although recent financial regulatory reforms, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, include provisions to reduce the use of ratings in certain regulatory contexts, these changes do not restrict pension plans or other investors from continuing to consider ratings in their SIPP. Although the approach for including rating references in fixed-income investment policies can vary, some features we understand are common to many pension fund guidelines, including:

- Establishing minimum rating thresholds for permitted investments (overall or by asset class)
- Requiring a minimum number of ratings for eligible investments
- Designating reference credit rating agencies and reference priority for the agencies when considering the eligibility of investments
- Defining an approach for handling ratings-related exceptions, for example if eligible investments are not rated
- Determining processes for responding to rating changes (especially downgrades that lower a rating below the minimum threshold); and
- Comparing and reconciling in-house research and external manager credit opinions with rating agency ratings

The Use Of Ratings In Fixed-Income Indices

Credit ratings may also be referenced in fixed-income indices that pension funds and other investors use to benchmark their investment performance. Index rules relating to ratings can vary across index providers, but some of the common approaches we have observed for determining index eligibility include:

- Recognizing a minimum rating threshold for index inclusion purposes
- Requiring a minimum number of ratings for index-eligible securities
- Designating reference credit rating agencies when considering the index eligibility of securities
- Defining a process for the index treatment of defaulted securities; and
- Responding to rating changes (especially downgrades below the minimum rating that require securities to be removed from the index)

Some index providers classify fixed-income securities with reference to ratings from only one agency. However, indices that refer to information from multiple rating agencies are more common. These follow a number of different approaches but usually base index classification of securities on the lower rating when only two ratings are available. When ratings coverage by three or more agencies is available, indices often base classification on the most common rating or, in some cases, the middle rating if all agencies differ in their rating opinions.

We understand that pension plans and other investors often use standard indices covering the more common asset classes or markets as a benchmark to measure their investment performance. But they may also use custom indices for monitoring investments with characteristics that differ from the risk profile of the standard indices.

Defining Exposure Tolerances

Credit exposure policies are an important element of a pension fund's enterprise risk management framework. Such a framework typically incorporates specific exposure limits, reporting requirements, channels for approvals and exceptions, requirements for security commitments or capital reserves commensurate with credit risk assumed, and the specification of roles and responsibilities encompassing corporate staff, management, and board members.

The pension fund board determines the level at which funds set portfolio credit risk tolerances. The board may have the expertise within its organization to independently establish a risk budget, but often it will seek support from external investment consultants who can help articulate investment policies and asset allocation strategies for the board. To a great extent, the risk budget will consider investment objectives that are appropriate for meeting the organization's obligation to plan members and beneficiaries. It may also be a function of the organization's experience managing credit exposures and incurring or avoiding losses.



An investment policy may indicate what proportion of the portfolio could consist of securities with a particular rating level. We have observed that investors often set these limits with reference to index weights for securities in the fixed-income index they use to benchmark investment performance. We understand that fixed-income pension investment guidelines commonly set eligible investment-grade thresholds within the ‘BBB’ rating category (typically at the ‘BBB-’ rating level). Other guidelines may have a different risk bias that sets the eligibility threshold for investments at a higher or lower rating. The aim of such policies is to help limit the potential for losses due to credit defaults to a level commensurate with the risk tolerance of the pension fund. It may also help the board to evaluate fund manager performance with reference to the quantity of credit risk assumed.

When ratings are used to help assess the credit risk exposures of a portfolio for management purposes, the investment process should recognize certain limitations of credit ratings. They are not: guarantees of credit quality, substitutes for the judgment investment professionals need to exercise, a substitute for an issuer’s inadequate transparency or disclosure practices, indications of the market liquidity of a debt security or its price, investment advice, or recommendations to buy, hold, or sell.

What Is A Credit Rating?

A Standard & Poor’s credit rating is a forward-looking opinion about relative credit risk. It expresses our opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time. Credit ratings can also speak to the credit quality of an individual debt issue—such as a corporate or municipal bond, or a structured finance debt issue backed by a pool of auto loans—and the relative likelihood that the issue may default.

General Summary Of The Opinions Reflected By Standard & Poor's Ratings

 INVESTMENT GRADE	'AAA'	Extremely strong capacity to meet financial commitments Highest rating
	'AA'	Very strong capacity to meet financial commitments
	'A'	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances
	'BBB'	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions
	'BBB-'	Considered lowest investment grade by market participants
 NON- INVESTMENT GRADE	'BB+'	Considered highest speculative grade by market participants
	'BB'	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
	'B'	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
	'CCC'	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments
	'CC'	Currently highly vulnerable
	'C'	A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued
	'D'	Payments default on financial commitments
Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.		

Typically, we express the credit ratings we assign as letter grades that range from 'AAA' to 'D'. But we also use rating qualifiers, for instance we assign the (sf) subscript to distinguish a structured finance instrument or obligor from any other instrument or obligor. So whereas a corporate bond might receive a 'AA' rating, a structured finance debt issue considered to have comparable credit risk characteristics would be assigned a rating of 'AA(sf)'. Ratings are not static measures; they can and do change. They are typically subject to ongoing surveillance and may be adjusted up or down to reflect changes in the perceived creditworthiness of an issuer or likelihood of default for individual debt issues.

Credit Ratings Vs. Market-Based Indicators

Credit analysis seeks to understand the factors that can shape credit, such as financial performance; access to capital; contingent obligations; macro- and microeconomic trends; political, regulatory and legal threats; competitive and industry analysis; and management's capabilities. For example, part of the credit analysis process may involve an assessment of how aggressive or conservative a company's financial policies are and whether they are consistent with the company's past performance and future business requirements.

In addition to assigning a rating symbol, our ratings coverage often includes analytical commentary expressing views on the issuer's current and prospective credit profile, industry conditions, and topical themes. When we take rating actions, we typically publish the rationale underlying our change in opinion on an issuer's or issue's perceived creditworthiness and make such information easily accessible. We believe that this is an important point of differentiation between the fundamentally derived ratings that credit rating agencies such as Standard & Poor's publish and market-based indicators.

In contrast, we have observed that a similar level of transparency is not always available for interpreting movements in other measures of credit risk, such as credit spreads embedded in bond prices or the pricing of credit default swaps. The sometimes limited trading activity of these instruments or the potential price volatility associated with them (in some instances due to technical factors unrelated to changes in credit risk), have historically limited their utility for investment policy reference purposes.

Rating Agency Analytical Approaches Can Differ

Credit ratings from different rating agencies may not be directly comparable, something directors or trustees should take into account when considering information from multiple rating providers in their investment processes. Ratings from different rating agencies can differ with respect to, among other things:

- Basic rating symbols and definitions
- Analytical criteria
- Sector- and issuer-specific analytical judgments; and
- Historical ratings transition performance

Pension funds that approach their default exposure tolerances quantitatively should consider whether specified rating thresholds in their SIPP associated with different rating providers represent quantitatively comparable levels of risk. This may not necessarily be the case if ratings performance differs across rating providers.

A common point of differentiation is the different analytical judgments agencies may express in their sector- or issuer-specific ratings coverage. In some cases, changes in the business climate can affect the credit risk of a wide array of issuers and securities and rating agencies may differ in

their opinion of these potential effects. Rating agencies can also differ significantly on analytical issues, particularly when they use different approaches on specific ratings criteria questions, such as: the support provided by liquidity backup, counterparty risk, or the credit implications of holding company structures (See Appendix I).

The agencies may use rating systems with different rating definitions as the starting point for forming their analytical opinions. For instance, when considering corporate issuers with a noninvestment-grade rating, the agencies may assess recovery, which is the likelihood that investors will recoup the unpaid portion of their principal in the event of default. Standard & Poor's does this by assigning recovery ratings to debt instruments based on our post-default recovery expectations. After establishing a debt issue's recovery rating, we may then adjust the credit rating for the issue up or down relative to the credit rating of its issuer. This separates our assessment of default likelihood from estimates we make about recovery prospects. Other rating agencies may use a different framework for assessing recovery.

Pension funds should consider how they address these or other points of differentiation. In the absence of any consideration for different analytical approaches, the extent of any potential ratings divergence may not always be apparent. And because the rating methodologies the agencies use can evolve over time, we believe it's important to carefully consider the appropriate context for including rating references in investment processes.

Some Reasons For Board Directors Or Trustees To Stay Informed About Ratings

Investment policies can refer to one or to multiple rating providers. Policies that refer to a rating from a single source have the benefit of comparability of risk levels across different investments. Comparability of ratings is important because ratings can serve as a common vocabulary to describe credit risk. When ratings are comparable across sectors, investors can better use them to compare the credit risk of securities in different sectors.

Ratings are designed primarily to provide relative rankings of overall creditworthiness among issuers and obligations. To further the comparability of our ratings across different sectors and over time, we use hypothetical stresses as benchmarks for calibrating our criteria. Each level of stress is associated with a particular ratings category. We consider these hypothetical scenarios in the process of associating quantitative and qualitative factors, such as levels of leverage and business risk, with different rating categories.

We expect that issues or issuers rated in each category, regardless of their asset class, should generally be able to withstand these corresponding conditions of economic stress without defaulting. For example, we typically would not expect a 'AAA' rated issue or issuer to default even under extreme stress conditions such as the Great Depression of 1929, while we generally would not expect a 'BB' rated entity to default under a modest level of stress in line with market conditions in the United States in 2001.

In our view, the potential downside of investment policies that refer to a rating from a single source is that they exclude from formal consideration in the investment decision-making process the significance of other rating agency perspectives that may be available. On balance, we believe investment decisions benefit from considering more sources of risk information. An investment policy that considers more than one rating subjects the issuer or issue to additional analysis, and it provides the investor with the benefit of a second opinion.

Fixed-income index providers and the indices they calculate are generally silent on the analytical differences between rating agencies. Index classification rules typically make no attempt to adjust for analytical differences that may limit the comparability of ratings between rating agencies. That could mean that securities with different credit risk characteristics or default experience could receive similar treatment from an index classification perspective, something investors should consider in understanding their risk exposures.

It is up to the pension fund to exercise good judgment in comparing in-house views with ratings-related risk analytics, taking appropriate account of differences between rating agency methodologies. Rating agency analysis should supplement but never serve as a substitute for in-house efforts.

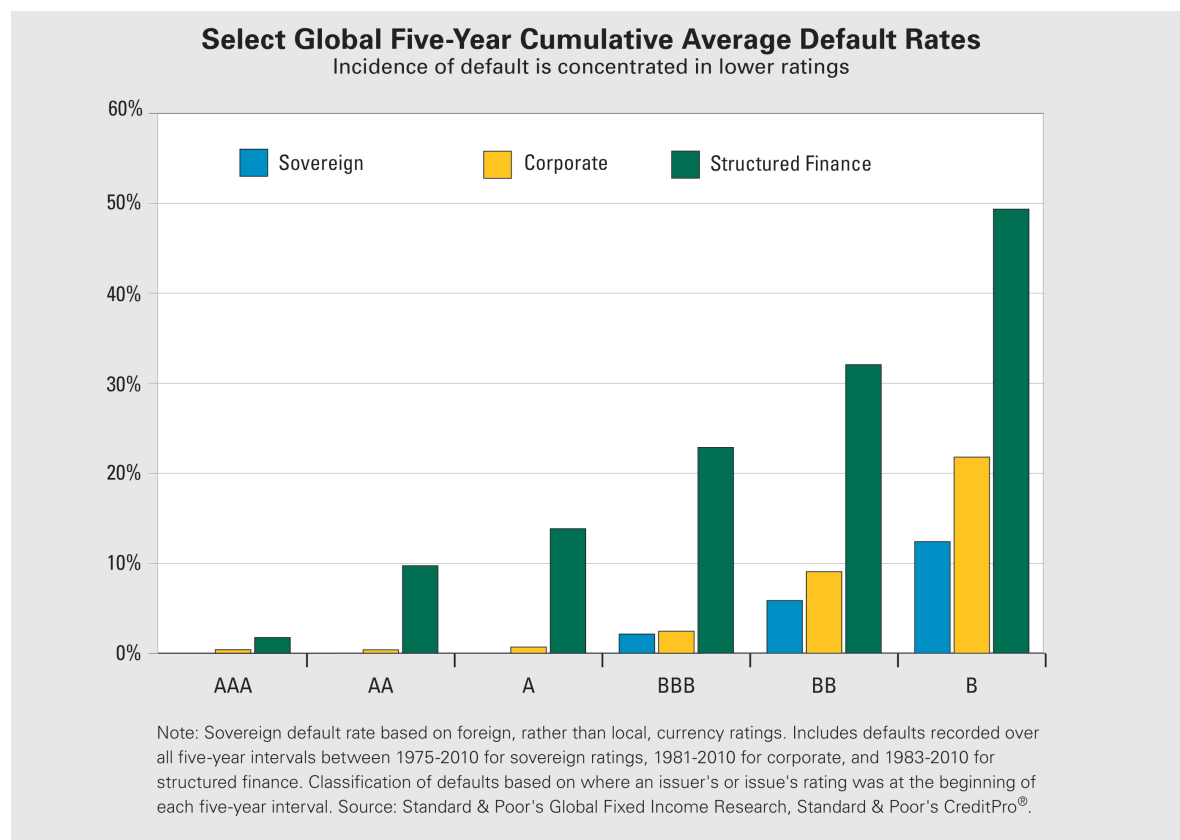
With these potential issues in mind, pension fund board directors or trustees may want to consider certain questions when considering ratings in their SIPP. For instance:

- How does their pension fund's in-house analysis, or that of its external investment managers, consider rating agency analytics?
- What is the analytical basis for their pension fund's current eligible investment rating threshold, and what resulting degree of default risk does a portfolio incorporate?
- Based on the ratings distribution of current pension fund holdings, what level of defaults should a pension fund expect in a credit cycle downturn?
- How does their pension fund's investment process handle issuers that, based on internal research, it believes rating agencies have over- or underrated?
- Has their pension fund established in-house positions on certain credit risks that rating agencies might approach in distinctly different ways? And does it have a consistent process for handling split ratings?
- Does a single rating cover any portions of their pension fund's bond or money market portfolio, and does this reflect any underlying analytical considerations?

In Comparing Agencies, Look To Performance

Rating agencies publish an extensive amount of research to track how well their ratings perform. If ratings were to perform as expected, issuers and issues with high ratings, such as 'AAA' and 'AA', would default less frequently than those with lower ratings, such as 'B' or 'CCC'. More generally, if ratings perform as intended, issuers or securities that default should have lower ratings than those that do not. This information can be helpful when pension fund directors or trustees make decisions about which agency's ratings to consider in their SIPP.

Standard & Poor's ratings performance studies, also commonly referred to as default and transition studies, have tracked the performance of government issuers since 1975, corporate issuers since 1981, and structured finance obligations since 1974. Our structured finance default studies focus on securities, while issuers are at the heart of our corporate and government default studies. We conduct our default and transition research both globally and regionally based on ratings coverage of issuers in more than 100 countries around the world.



In the wake of the recent financial crisis, there has been much discussion about the performance of credit ratings. We have conducted a comprehensive review of our credit ratings. This review has demonstrated that Standard & Poor's ratings for nearly all asset classes performed broadly as expected in the face of the extreme stresses experienced during the recent financial crisis, with the exception of ratings on certain U.S. residential mortgage-backed securities (RMBS) and collateralized debt obligations backed by structured finance collateral (SF-CDOs). The performance of ratings for certain U.S. RMBS and SF-CDOs issued from 2005 through 2007 has been below our expectations.

Our report entitled "A Global Cross-Asset Report Card of Ratings Performance In Times of Stress" (June 8, 2010), as well as details on the changes that Standard & Poor's has made based on lessons learned from the recent financial crisis, can be found on our public website, www.understandingratings.com, where we also post our current default and transition studies for issuers and securities.

Deciding The Appropriate Context For Ratings

Ultimately, investment policy decisions will reflect a risk-return trade-off dictated by the objectives of the organization in the context of the market environment. By examining the cumulative default and transition performance of respective rating categories over multiple economic and credit cycles, pension plan boards can make informed decisions about suitable investment thresholds.

On an ongoing basis, pension fund board members can play a role in ensuring that the practices of investment and portfolio managers recognize the nature of credit ratings, their functionality, and their limitations and the potential for ratings (and for different ratings from different rating agencies) to play a useful role in helping them assess the credit risk exposures the organization assumes.

Credit ratings can be an effective source of information on relative credit risk. Although they can benefit investors as a publicly observable, shared benchmark for credit risk, they should supplement and not replace an investor's thoughtful judgment and oversight of credit risk exposures and tolerances. We believe that paying attention to the credit ratings associated with investment exposures can enhance board members' understanding of credit risks critical to the continuing success of their pension fund and its strategy.

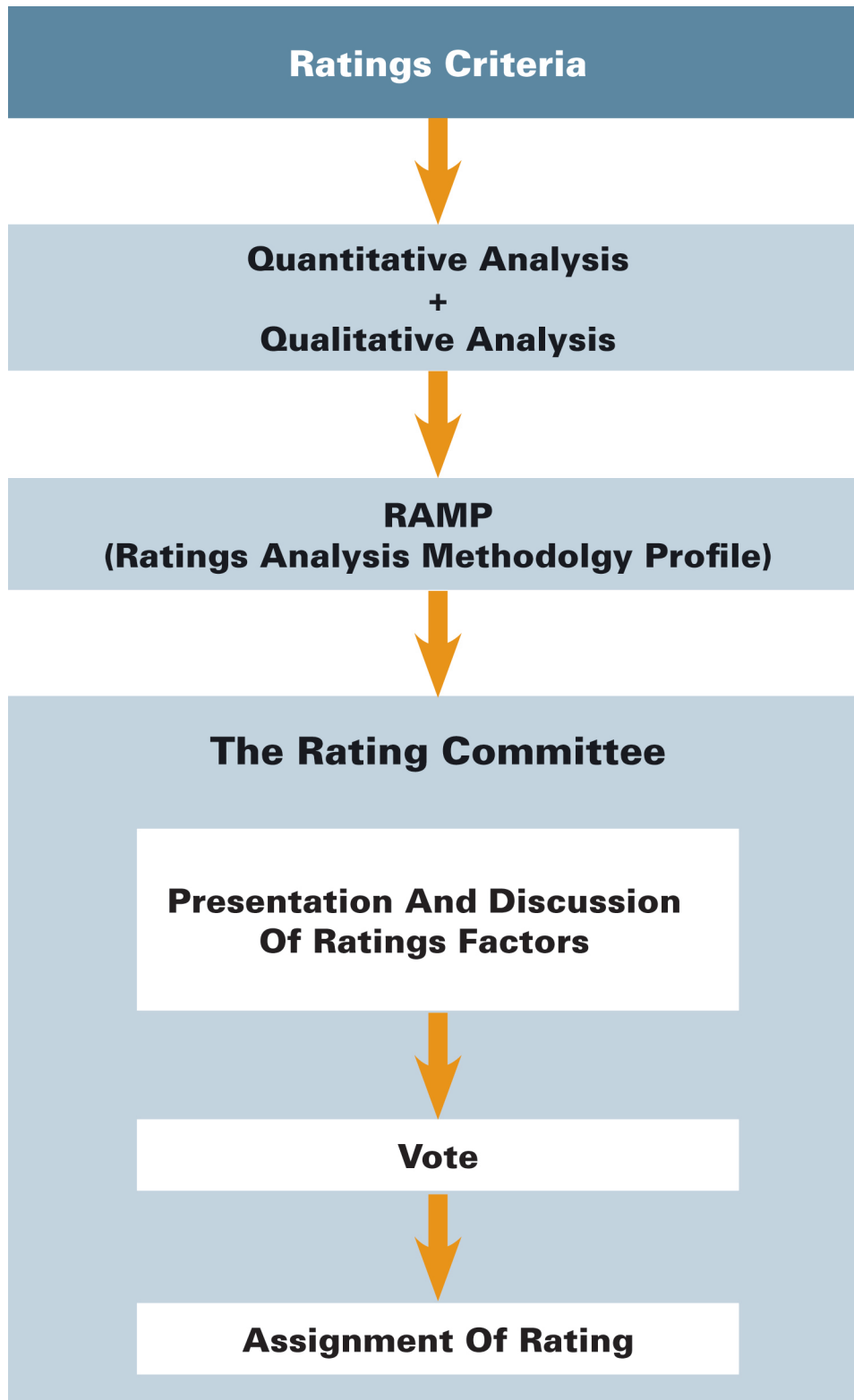
Appendix I

Ratings criteria are published principles, methodologies, and assumptions that our analysts use to assign ratings; they provide the framework by which our analysts assess creditworthiness. Specifically, our criteria inform our analysts as they identify risks and assess each risk's potential impact on creditworthiness. Our criteria guide our analysts, and the rating committees they participate in, as they combine and weigh these risks to determine final credit rating opinions.

To support the integrity and quality of our ratings criteria, Standard & Poor's has developed an organizational structure and created a process that governs the development, refinement and revision of criteria in addition to the application of these criteria in our ratings process.

We believe that the application of our criteria, and refinements to our criteria, help to support the quality and comparability of our ratings. This intended comparability over time, and across sectors and asset classes, provides market participants with a benchmark to help them evaluate the credit risk of a broad range of debt instruments.

Application Of Ratings Criteria



Additional Reference Documents

Guide to Credit Rating Essentials

Guide to Ratings Performance

Guide to Credit Ratings Criteria

Understanding Standard & Poor's Ratings Definitions

2010 Annual Global Corporate Default Study And Rating Transitions

Global Structured Finance Default Study—1978-2010:

Credit Trends Started To Improve In 2010, But U.S. RMBS Faces Challenges

Default, Transition, and Recovery:

Sovereign Defaults And Rating Transition Data, 2010 Update

Rating Performance And Comparability:

2011 Update On The Modified Gini Coefficient Study

The Wishes Of Crowds: Do Credit Spreads Measure Credit Risk?

Note: These documents may be found on www.understandingratings.com.

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