

Special Comment



February 2009

European Credit Insurance: What Can We Expect In 2009?

The industry will remain under pressure but the major players are acting to mitigate their losses

Summary Opinion

As the financial crisis initiated in 2007 has turned into an economic crisis, the credit insurance industry is currently facing a challenging period characterised by a sharp increase in claims and a subsequent deterioration in profitability and capitalisation.

Although this situation is not unusual for credit insurers and is illustrative of the inherent risks attached to this industry, with profitability heavily exposed to a deterioration in the economic environment, the current crisis appears to be particularly severe. Moody's expects the global macroeconomic environment to remain challenging for at least the next 18 months, with negative implications for the credit insurance industry in the short term.

Nonetheless, we expect credit insurers to be able to partially mitigate the effects of this crisis thanks to a high degree of flexibility in their underwriting processes. The major players have already taken substantial measures and there is still room to take additional measures given the strong flexibility these players have in managing their risk profiles. Credit insurers have also reinforced their balance sheets in recent years, protecting them to a large extent from exposure to other than insurance risks.

However, Moody's expects 2009 to be another challenging year for the industry, with further deterioration in loss ratios expected in most countries. Results to be reported for 2008 and in the coming quarters could materially erode selected credit insurers' capital buffers. The most affected players will be those with low diversification or high exposure to the most damaged economies, or those whose risk management and control of the underwriting process has proved to be weaker, with under-scaled measures or late reaction in the cycle. Nonetheless, most credit insurers benefit from substantial parental support from large to medium-sized financial institutions, which Moody's expects to contribute to a reasonable degree of rating stability.

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Analyst Contacts:

Paris 33.1.53.30.10.20

Benjamin Serra
Analyst

London 44.20.7772.5566

Simon Harris
Managing Director



Moody's Investors Service

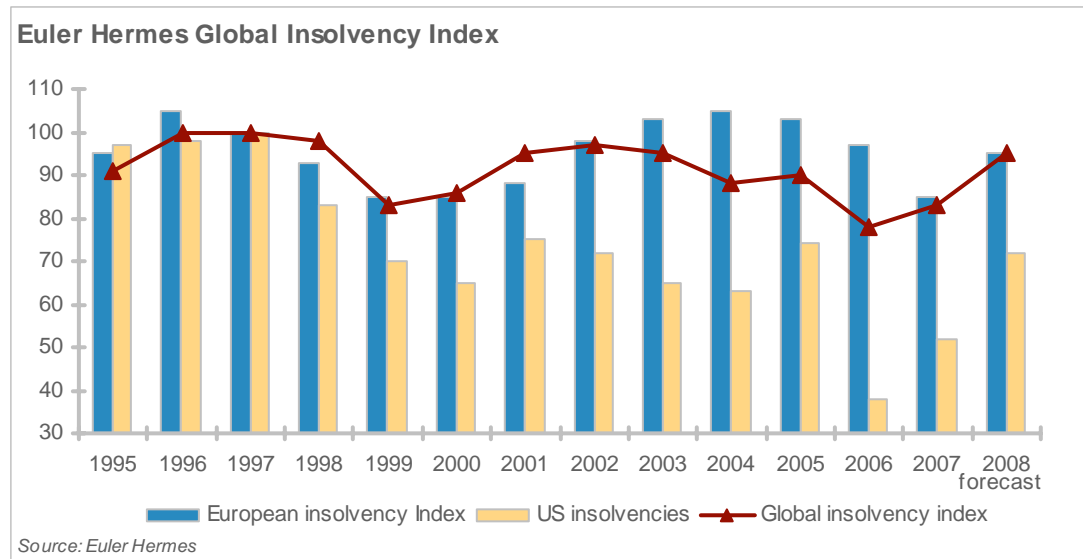
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Macroeconomic Environment

From the financial crisis to the economic crisis

The financial crisis started in 2007, triggered by rising defaults in US sub-prime mortgage securities. This led to a significant increase in the credit risk premium in financial markets, and turned into a liquidity crisis in 2008 which first hurt financial institutions. Consequently, banks have severely tightened their conditions for credit granting, which in turn has had repercussions on the development of several activity sectors such as construction. The financial crisis finally progressively spread into the “real economy” throughout last year and has turned into an economic crisis, translating into an increase in insolvency rates worldwide.

Exhibit 1



This crisis has not only impacted advanced economies, but also started to impact some emerging market countries at the end of last year. Within Europe, although the impact of the crisis has been milder overall than in the US so far, there have been significant differences across countries, with Ireland, Spain and recently the UK officially declared as being in recession.

Moody's central macroeconomic scenario for 2009 and 2010 is characterised by economic stagnation and deleveraging

In the current highly uncertain economic environment, Moody's central macroeconomic scenario for 2009-2010 (“Global Healing”) – as detailed in *Moody's Global Financial Risk Perspectives: “Global Macro-Risk Scenarios 2009-2010 – From Global Integration to Global Disintegration?”* published in December 2008 – has changed to a period of economic stagnation and de-leveraging, with both tight financial conditions and high risk aversion. In this scenario, world economic growth is expected to be close to 3%, the point at which the economy is considered to be in global recession. Advanced economies are expected to experience a rather severe downturn with either moderate output contraction or no growth in 2009, followed by a rebound in 2010, although still below potential growth. Emerging market economies are also expected to be significantly impacted by the current crisis as opposed to previous periods with growth below potential, leading to a global stagnation for 2009-2010.

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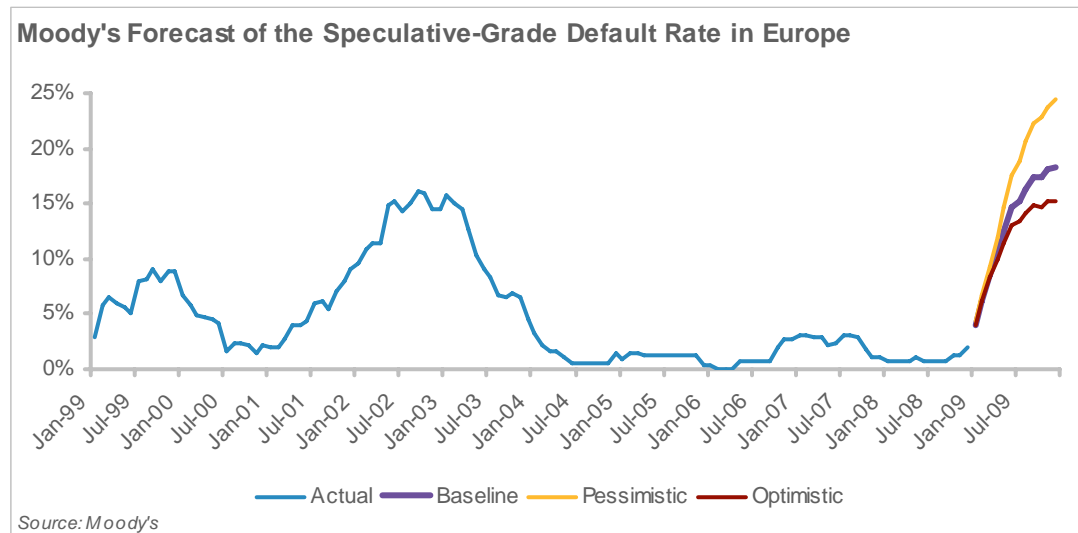
If current government policies fully succeed, a "Global Resilience" scenario might be possible, whereby financial markets' stability is restored as a result of lower risk aversion, and a global recession is avoided with a sharp rebound in 2010. Economic growth remains weak in advanced economies, but close to potential in emerging market economies.

The worst case scenario would be a "Global Disintegration", similar to the situation in Japan in 1990, with a severe global recession whereby world growth is well below 3%, coupled with a deflationary environment, extreme risk aversion and a sharp and prolonged contraction in financial markets in spite of expansionary policies from both governments and central banks.

The level of insolvency rates is expected to continue to rise

Based on Moody's central scenario above and the experts' consensus about the slowdown in worldwide economic growth, we expect the increase in insolvency rates to continue in 2009.

Exhibit 2



Furthermore, this increase in insolvency rates is likely to hit all economic sectors, all regions, and companies of all sizes. In particular, Moody's forecast of a global stagnation may imply an increase in insolvency rates not only in mature economies but also in emerging markets and even in all economies that were immune from the economic crisis in 2008. This forecast is actually confirmed by the various data reported recently by credit insurers.

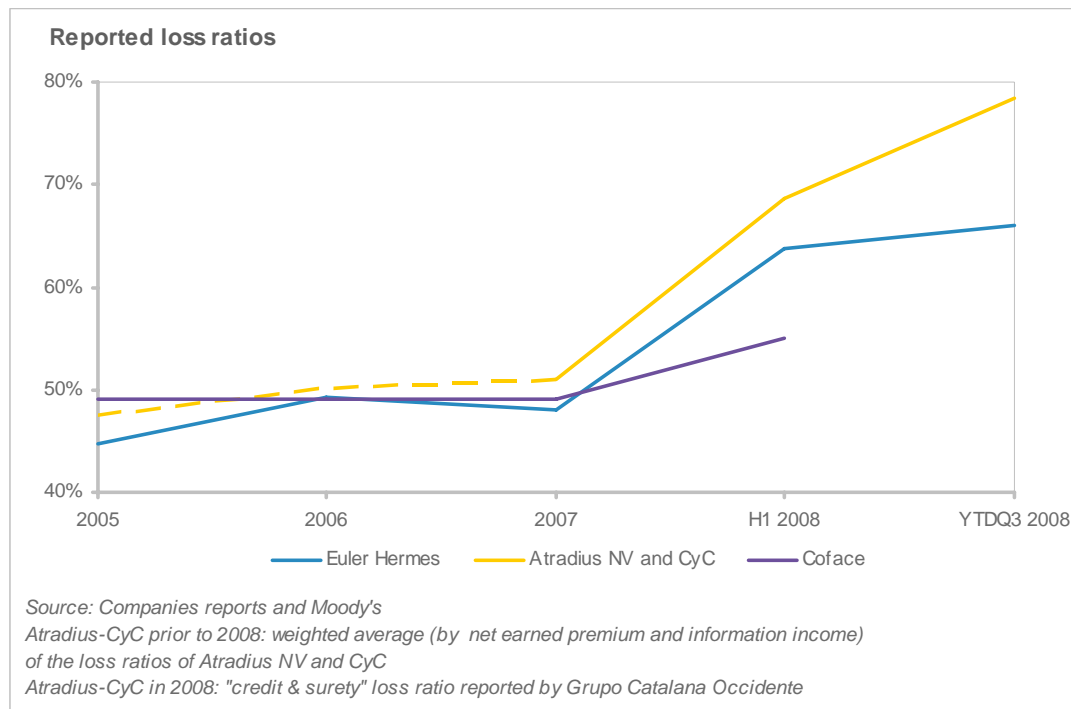
The Credit Insurance Industry in 2008

Increase in insolvency rates translated into a deterioration in loss ratios in the first three quarters

The increase in insolvency rates has translated into an increase in claims frequency in credit insurance. As the crisis spread to all European countries, credit insurers recorded increasing loss ratios throughout 2008, as evidenced by the figures reported by the industry's three main players (Exhibit 3).

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Exhibit 3



But credit insurers have activated the right levers to mitigate the impact of the economic crisis

There are a number of measures that credit insurers can take, and did take in 2008, to limit the impact of the current economic conditions on their loss ratios.

- Short-term contracts allow for prompt tariff adjustments**

Credit insurers have increased average premiums on policies, for new business in the first instance, and then at renewal for the existing business. The short-term nature of the contracts (most of the contracts being annual) allows the companies to reprice their entire portfolio relatively speedily.

Companies have usually applied different increase rates by country and by economic sector, but amongst our rating universe, we have noted price increases of up to 30% for existing business and 60% for new business.

As part of the negotiation of the terms of the policies, most of the credit insurers have also increased deductibles, which allows them not only to reduce claims payment, but also to share the risks with the policyholders and therefore reduce the risk of adverse selection.

- Credit insurers proactively cut limits on the most exposed buyers**

Credit insurers can also reduce their current exposures to specific sectors, countries and loss-making or riskier names by cancelling or reducing their credit limits, not only at renewals, but also during the life of the policy. Indeed, although the credit insurance policy is traditionally written on an annual basis, credit limits are granted for shorter periods, typically six months. Therefore, the exposure to any buyer can be reduced relatively rapidly.

For example, during 2008, most credit insurers drastically reduced their exposure to some sectors such as motor or construction. However, most of the time the reduction in exposure is limited to specific names, as illustrated by the Woolworths saga, the UK retail company on which Atradius, Euler Hermes and Coface each successively decided not to grant any new limits a few weeks before the company filed for bankruptcy.

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This strategy can only be implemented in conjunction with continuous monitoring and review of large and small exposures with the most up-to-date internal and external financial information. Hence, the three main players have developed internal ratings that allow them to monitor their risk in an efficient way. Credit insurers also benefit from information coming from their policyholders (e.g., late payments from a specific buyer) in order to monitor their exposures.

■ Credit insurers also manage their portfolios of policyholders

As all traditional insurers, credit insurers also monitor their risk by policy, and recurrent loss-making policies may not be renewed. For example, sellers who persistently deal with non-performing buyers may find that credit insurers no longer offer cover to those sellers.

Nonetheless, Q4 results are unlikely to show any improvement

Although Moody's acknowledges the efficacy of all the measures listed above, we caution that these measures can only be fully implemented after a time lag, of typically six months minimum for cutting limits and one year to reprice the whole portfolio.

Furthermore, for commercial reasons, severe measures may be difficult to implement in a specific country if the economic crisis has not yet started to materialise, even if the insurance company anticipates a deterioration. Indeed, these measures can realistically be implemented without substantial risk of business loss only if the policyholders have tangible proof of the deterioration in their own environment.

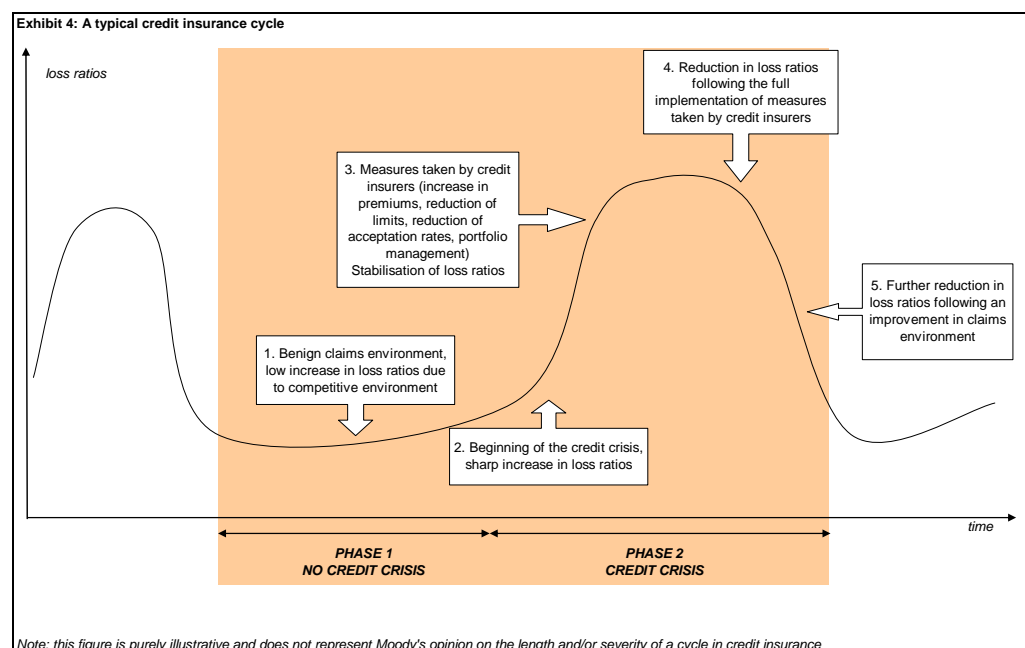
Given that in some European countries (e.g. Germany) the economic crisis only started to materialise in the fourth quarter of 2008, Moody's expects the Q4 results of the largest European credit insurers to reflect this additional deterioration in the macroeconomic environment.

The Q4 results will also be impacted by large claims, as the number of large companies closing or defaulting accelerated (e.g., Woolworths in the UK) in Q4.

Where Are We in the Cycle?

A traditional credit insurance cycle

Exhibit 4



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A traditional credit insurance cycle can be divided into five periods:

1. a period of benign claims environment, in which loss ratios are stable or deteriorate moderately following competitive pressure and more permissive risks underwriting
2. a period of sharp increase in loss ratios, corresponding to the beginning of the credit crisis
3. a period of stabilisation or lower increase in loss ratios, following a tightening of the underwriting process and implementation of initial measures (increasing rates, cutting limits, portfolio management)
4. a period of reduction in loss ratios after a stabilisation of the macroeconomic environment and full implementation of measures
5. a period of further reduction in loss ratios after an improvement in the claims environment (end of the credit crisis)

Although a credit insurance cycle looks similar to the cycles experienced by traditional primary P&C insurers, it differs in the amplitude of the deterioration in loss ratios, and the speed of the deterioration. A credit crisis is actually an external economic shock that is imposed on credit insurers. In that regard, it is more comparable to a reinsurance cycle. Nonetheless, credit insurers can react more quickly thanks to the shorter nature of their liabilities.

Probable scenarios for 2009-2010

The current cycle may be more prolonged than the previous ones

The results reported by credit insurers so far are typical of those reported during the beginning of an economic crisis, and in line with the typical credit insurance cycle described above. Nonetheless, what distinguishes the current cycle is the successive waves of deterioration in the claims environment experienced since 2007 that have broken on credit insurers as additional sectors and countries have been hit by the economic crisis.

Since the economic crisis has been slow to materialise in some regions and has not yet fully materialised in some countries, and given our macroeconomic expectations of a slow recovery for the world economy, we expect that the period of increase in insolvency rates of the current cycle may be longer than in some of the previous cycles. In other words, credit insurers with widely diversified geographic exposures are likely to see that losses remain at high levels for some time, as different economies approach the rate of maximum losses at different times. As a point of comparison, during the last cycle, credit insurers reported two years of high loss ratios and then a sharp decrease in loss ratios. In this cycle, high loss ratios are likely to be recorded for 2008 and 2009 at least and the phase of the cycle when loss ratios start decreasing may be softer.

A deterioration in loss ratios is still expected in some countries

As mentioned previously, because the economic situation has only started to deteriorate in some major countries and will deteriorate soon in other countries, credit insurers have not yet been able to significantly increase premiums or cut limits in those countries. Given that there is an inevitable time lag between when a company starts to change its underwriting rules and when these changes can apply to its whole portfolio (see above), credit insurers' loss ratios are likely to increase in those countries in 2009.

In light of their worldwide exposures, the industry's leading players are therefore likely to continue to see their profitability remaining under significant pressure in 2009.

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Moody's expects loss ratios to ultimately stabilise going forward, as in previous cycles

However, the severity of the crisis for the industry remains challenging to predict at this stage. On the one hand, the economic crisis is now global and its severity appears to be comparable to some of the most severe crises in history. The number of Insolvencies of large companies is also set to grow, therefore increasing the risks that credit insurers will experience multiple large claims. On the other hand, the magnitude and the speed of the measures taken by credit insurers have also increased, which should help to some extent offsetting the deterioration in the environment.

In summary, while insurers are likely to experience a deterioration in their loss ratios in some countries, in other countries the effects of the measures could start to be seen at some point in 2009.

Therefore, Moody's expects the current cycle to follow the same dynamics as the previous cycles experienced by credit insurers with loss ratios stabilising going forward. Whether this stabilisation happens in 2009 or in 2010 will largely depend on the evolution of the global economic environment and on the extent of measures taken by credit insurers, but also on the speed with which credit insurers adjust their underwriting processes in the countries that are affected by the crisis.

The Strengths of the Industry at this Point of the Cycle

Demand increases and competition is limited

Demand increases in crisis periods

The main competitor for credit insurers remains self-insurance, as many sellers view credit insurance coverage as too costly and prefer retaining their risks. In times of crisis, perceptions of risk change and risk aversion increases. Therefore, demand for credit insurers tends to increase, giving credit insurers substantial negotiation power. Indeed, the various government plans put in place in some jurisdictions (e.g., France) or likely to be put in place in others (e.g. the UK) to provide credit insurance coverage when credit insurers have decided to reduce their exposure to some risks show that the demand and need for credit insurance is currently high.

Competition is currently limited

This dominant position is reinforced by limited competition. Indeed, the industry is dominated by three large global players and Moody's expects this situation to continue given the high barriers to entry in the industry (particularly the need to collate and evaluate huge volumes of information on a wide range of buyer risks). Since all these players have similar characteristics and evolve in the same environment, none of them can afford any under-pricing strategy for a long period during an economic crisis.

Furthermore, there is little alternative to credit insurance today, as banks have tightened the conditions to provide credits or guarantees to their clients and securitisation of receivables would be very challenging to achieve in the current environment.

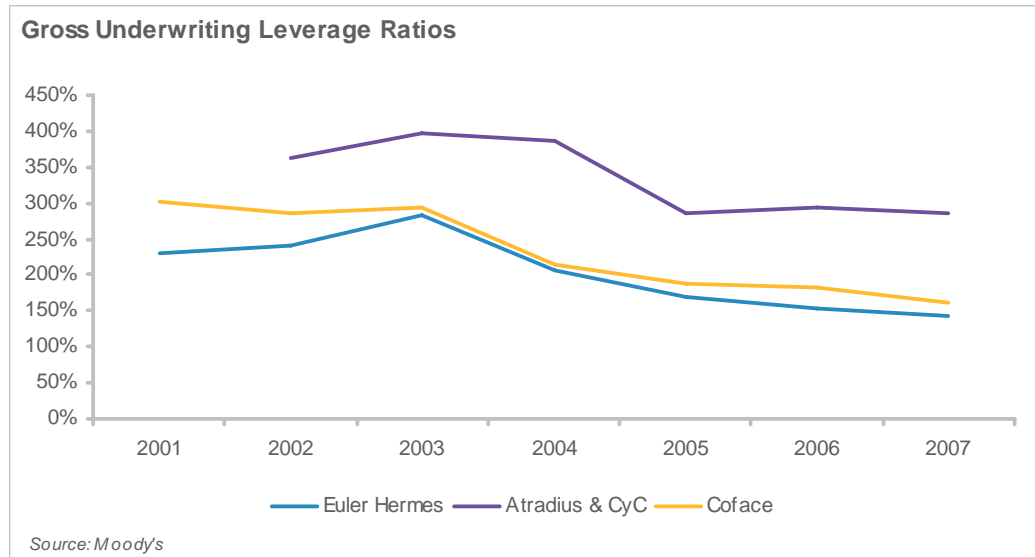
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Balance sheets have been reinforced in recent years

- Capitalisation has been reinforced in the benign period of the cycle**

Moody's believes the industry entered the crisis with good levels of capitalisation, which have been reinforced in recent years during a period of benign economic environment. Gross Underwriting Leverage¹ ratios in the industry have significantly decreased since 2003.

Exhibit 5



This improvement in capitalisation has provided industry players with some buffer to absorb the shock experienced in 2008. Nonetheless, the capitalisation of some companies will deteriorate if they report significant losses in 2008.

Moody's will therefore monitor the situation reported at year-end 2008 by each player and assess the remaining buffer in light of our expectations for 2009 and beyond.

- Investment risk is more limited than for most of the traditional insurers**

Moody's considers investment risk across the industry to be fairly conservative with a low exposure to equities or alternative investments, a good-quality fixed income portfolio and insignificant exposure to structured investments. Equities exposure has been significantly reduced to low levels since the last crisis in 2002. Furthermore, fixed-income securities are often highly rated with a large proportion of government bonds, which limits the correlation between the credit risk borne on the liability side of the balance sheet and the credit risk on the asset side.

- Reinsurance agreements provide good protection against extreme events**

In general, credit insurers also have adequate and protective reinsurance policy, and many Groups use reinsurance protection to a significant degree. The reinsurance protection is traditionally composed of quota-share treaties, by which insurers and reinsurers share the net results, and excess-of-loss treaties, protecting credit insurers against very large claims. In addition, reinsurance counterparties are often highly rated, in the Aa or A range.

Nonetheless, Moody's notes that premium retention has also gradually increased in the past few years and we expect the cost of reinsurance to increase substantially at renewals in 2009.

¹ Defined as (Gross Premiums Written + Gross Loss Reserves) / (Shareholders' Equity)

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■ Financial flexibility is good

Financial flexibility has been good in the past five years, with low financial leverage ratios and relatively high earnings coverage ratios – especially in recent years – following strong profitability in this period.

Financial flexibility will deteriorate to some degree in the short term, especially due to lower earnings coverage. Nonetheless, given the low level of debts in the industry, Moody's believes that the financial flexibility of the major industry players will remain consistent for their respective rating levels. Some of the industry's leading players also have access to wide capital pools through their being part of large financial institution groups.

■ Liquidity risk is also limited

Moody's considers the industry's liquidity profile to be very strong given the high-quality and liquid investments held by credit insurers. Cash, listed equities and highly rated bonds represent a high proportion of the credit insurance asset portfolio, with relatively short maturities in line with the short-tail nature of the liabilities.

Liquidity problems might arise in cases of large claims, implying quick and large payments. However, these cases are usually hedged thanks to cash-call clauses in reinsurance contracts. Furthermore, leading credit insurers have historically not been forced to trigger these clauses.

■ Reserve adequacy has been strong historically

Reserve adequacy is generally strong since most insured claims are reported and settled quickly. In addition, given the capping of the liabilities (since a claim cannot exceed the limit granted by the insurer) and given the conservative approach used by companies (they traditionally reserve up to the cap as soon as a payment incident is reported), Moody's considers the level of adequacy of credit insurers' reserves to be high.

Nonetheless, we will continue to monitor the reserving practices of credit insurers, as some reserve releasing or strengthening could significantly affect the reported profitability.

What Will Differentiate the Industry Players?

Since all credit insurers evolve in the same troubled environment, they will all face the same pressures on their results and capitalisation. Nonetheless, there are several factors that may differentiate the extent to which credit insurers will be affected.

■ Geographic exposure

The main industry players have a global exposure (which Moody's sees as a credit strength), but those groups with greater exposure to the most severely hit countries such as the US, Spain, the UK and Ireland are likely to report the worst results for 2008. At the same time, these companies may start to recover at some point in 2009, while companies with larger exposure to other EU countries could face more deterioration in early 2009. Although exposure to emerging markets may have been a positive factor for past results, it may negatively impact 2009 results.

■ Diversification of earnings

Credit insurers have developed ancillary services complementary to credit insurance (e.g., factoring, debt collection) in recent years. Although the economic slowdown and the subsequent slowdown in trade are likely to translate into lower revenues related to some of these services, earnings generated by these business lines will reduce the focus on earnings purely from credit insurance and therefore reduce the volatility of the companies' results. Therefore, those companies with greater diversification of earnings should have less volatile net results.

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■ Risk management and implementation of changes to underwriting processes

As mentioned previously, credit insurers have decided to implement wide-ranging measures in order to mitigate their losses. Moody's believes that the measures announced by the main players have been taken in time and that they are appropriate and of the right magnitude in most cases. Nonetheless, in some selected countries, the deterioration in the economic situation has exceeded some companies' expectations and measures taken by these companies have had to be strengthened.

In addition, Moody's cautions that there is a difference between the measures decided and the effective implementation of the measures. The implementation of risk control measures is challenging to apply uniformly to all policyholders. For example, large clients have more negotiation power, and competitive pressure can also explain some premium rate pressure in certain sectors/client bases. Control over the distribution channels and the underwriting processes is key in this matter. We will continue to monitor the pace at which the measures are implemented for each credit insurer², as we believe this is a key factor in anticipating when it will be able to stabilise its loss ratios.

■ Large claims

Large claims in credit insurance (similarly to traditional insurance) can never be ruled out. In times of crisis, when claims frequency increases, the number of large claims may also increase. A multiplication of the number of large claims would be seen as negative by Moody's, as it would obviously severely impact the net results of the company and its capitalisation. Although this could be mitigated through reinsurance, it would also demonstrate a lack of reactivity of the company to reduce its exposures to the riskiest buyers and/or a deficiency in the monitoring of its exposures.

■ Product risk

The bulk of products sold by credit insurers are short-term products (one year usually) with short-term exposures (six months usually). However, some policies may have different characteristics. Some policyholders benefit, for example, from policies with a duration of two or three years. For these policies, a pricing change will be more difficult, and the risk for the insurance company is higher. Some insurance companies have sold more generous policy features (e.g., in terms of criteria for granting limits), which reduce their flexibility in managing risks, at least until they renew these policies.

Besides the traditional credit insurance products, companies also sell longer-term products such as bonding insurance or surety. Because of the longer duration of these products, the risk for credit insurers is higher. Nonetheless, the impact of these products should be of second order, given the weight of these products in most of the companies' business mix.

■ Management of expenses and claims management

Insurers that managed to reduce their costs in recent years will be the best positioned to protect positive results in spite of the increase in claims.

However, Moody's believes that an increase in costs related to claims management costs may also have a positive impact on profitability. Indeed, limiting potential frauds and enhancing debt collection processes should be areas of focus for credit insurers to restrain the increase in claims frequency and increase recovery rates, which will be beneficial to loss ratios.

² Besides the exposure by risk category, by sector and by country, the main factors to monitor are (i) the acceptance rates, (ii) the rates of automatic decisions and of manual decisions, (iii) the effective price increase compared to the increase set in the company's plan of action (for existing business as well as for new business), and (iv) the pace of decrease in limits granted in names/sectors where a reduction has been decided.

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■ Parental support

Moody's ratings of credit insurers reflect in many cases varying degrees of parental support, ranging from high levels of explicit and implicit support from some state governments to export credit agencies, to lower levels of implicit support from large to medium-sized financial institutions in Europe. In most cases, these parental institutions are both highly rated and substantial in size. Consequently, in assessing the credit insurers' ability to withstand the current poor economic conditions, we factor in not only the credit insurers' inherent stand-alone credit strengths and ability to manage exposure risk, but also the ability and willingness of parents to support the insurance operations. In most cases, we expect that this overall contributes to a reasonable degree of rating stability.

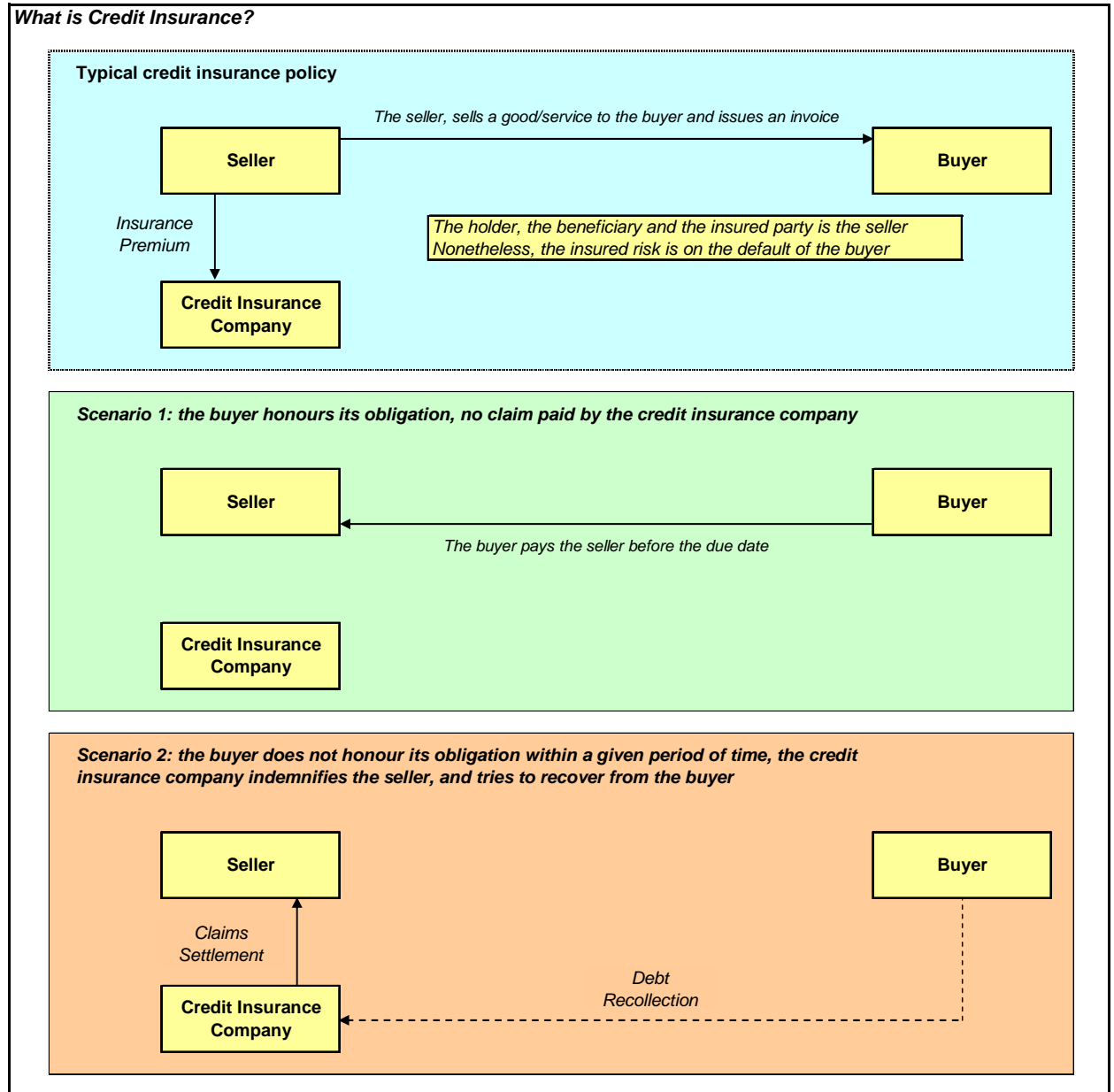
Credit Insurers Insurance Financial Strength Ratings

Name	Group	Company's Rating	Company's Outlook	Parent Company/ Main shareholders	Parent Company's Rating	Parent Company's outlook	Parent % ownership
Euler Hermes Kreditversicherungs-AG	Euler Hermes	Aa3	STA	AGF/Allianz SE	Aa3	Stable	68%
Atradius Credit Insurance NV	Atradius	A2	STA	Grupo Catalana Occidente	NR	-	50%
Atradius Trade Credit Insurance Inc.	Atradius	A2	STA	Grupo Catalana Occidente	NR	-	50%
Atradius Re Ltd	Atradius	A2	STA	Grupo Catalana Occidente	NR	-	50%
Credito y Caucion Seguros y Reaseguros	Atradius	A2	STA	Grupo Catalana Occidente	NR	-	50%
Coface SA	Coface	Aa3	STA	Natixis	Aa3	Stable	100%
Coface Kreditversicherung AG	Coface	Aa3	STA	Natixis	Aa3	Stable	100%
Sace S.p.A.	-	Aa2	STA	Republic of Italy	Aa2	Stable	100%
KECIC	-	Baa1	STA	Republic of Kazakhstan	Baa1	Stable	100%
ICIEC	Islamic development Bank (IDB) Group	Aa3	STA	Islamic Development Bank	Aaa	Stable	67%

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Appendix 1: What Is Credit Insurance?

A credit insurance policy is an insurance contract that provides protection against the risk of default of the debtor of a receivable. Under a typical credit insurance contract, the seller (owning the receivables), as the insured party, pays a premium, and the credit insurance company agrees to pay the beneficiary of the insurance contract (also the seller in most cases) a specified portion of any losses it may incur due to debtor (also called buyer) defaults on the making of a valid claim. The right to make a claim will usually arise when the buyer is insolvent or has failed to make a payment within a certain period of time after the receivable invoice was issued.



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Author	Senior Associate	Production Associates
Benjamin Serra	Laura Perez Martinez	Cassina Brooks Diana Brimson

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