

Entering A New Regulatory Environment: Proposed Revisions to the 1988 Basel Accord May Raise Costs and Squeeze Availability of ABCP Liquidity¹

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SUMMARY OPINION

Moody's anticipates that proposed changes to the capital adequacy standards of the 1988 Basel Accord may have significant impact on the economics of the ABCP market — particularly as it will most likely affect the cost and availability of back-up liquidity programs. The anticipated increase in capital charges for already-scarce liquidity back-up lines will, if adopted, squeeze both the availability of liquidity and its cost as a bank product. At the very least, all ABCP conduits will most likely face some upward price pressure unless the costs of the additional capital can be fully passed off to the underlying sellers of receivables or absorbed by the sponsoring banks.

Among chief areas of concern are the new proposal's changes to zero capital requirements. According to the proposed guidelines, even short-term liquidity requirements are deemed to subject banks to credit risk exposure that would require banks to hold reserves.

Overall, the implementation of Basel II will have an impact on several areas of liquidity in ABCP — particularly as the use of standard liquidity lines becomes more expensive.

Moody's anticipates:

- Additional levels of complexity in structured transactions, which may result in increased use of ratings to help clarify the risk for both regulatory purposes and investment decisions;
- Increased use of alternative liquidity which may look to reliance on the underlying cashflow and asset value; and
- Non-Bank Financial Institutions may continue to expand their role as liquidity providers.

¹ *Moody's Investors Service* appreciates the kind assistance and time given by *Mayer Brown and Platt*, and *Cadwalader, Wickersham & Taft* for their comments in preparing this article.



OVERVIEW

On January 16, 2001 the Basel Committee on Banking Supervision² announced revisions to the 1988 Basel Accord — the current standard for capital adequacy for banks. Changes were needed, according to the Basel Committee, in part because the 1988 Accord has not kept up with the rapid pace of financial innovation over the past decade. For example, innovations associated with the rapid growth of securitization — particularly in the \$600 billion plus Asset Backed Commercial Paper (ABCP) market — may in fact have been a by-product of the 1988 Basel Accord as banks sought to interpret and adhere to its specifications.³ The proposed revisions to the 1988 Accord — Basel II — are an attempt to align banks' capital charges more closely to the risks present in today's capital markets.

In general, the BIS proposed revisions focus on three pillars:

- Pillar I: Sound minimum capital standards — the existing Accord with improvements;
- Pillar II: Supervisory oversight of capital adequacy; and
- Pillar III: Market Discipline supported by adequate public disclosure.

While calling for additional protections that may ultimately bolster the banking system, Basel II provides certain challenges for ABCP investors, which this report highlights. This Special Report will discuss the current revised changes within the context of ABCP.

Implications for Asset Securitization: A Change in Economics of ABCP likely, as is a Squeeze in Liquidity

Several concepts presented in Basel II have specific implications for asset securitization, including both traditional and synthetic forms of securitization. We believe that a change in the economics underlying ABCP is very likely.

Included among the proposals is a plan to treat banks that sponsor ABCP conduits differently from banks that securitize their own assets or invest in asset backed securities (ABS).⁴ It is also widely anticipated that an increase in capital charges for liquidity back-up lines will be adopted (perhaps close to the present form described below). This will contribute to an additional squeeze both on the availability of liquidity and its cost as a bank product. This occurs as liquidity continues to become increasingly scarce.⁵

At the very least, all ABCP conduits will most likely face some upward price pressure unless the costs of the additional capital can be fully passed off to the underlying sellers of receivables or absorbed by the sponsoring banks (See *Appendix II*).

Banks that sponsor ABCP conduits as well as provide both liquidity back-up lines and program level credit enhancement, may also have to adapt their business strategies to the new cost structure proposed by Basel II.

Basel, Liquidity, and ABCP — Zero Capital Standard Diminished

Under the terms of the 1988 accord, an ABCP conduit sponsor providing short-term liquidity back-up lines to its conduit is not assessed a capital charge. Under the terms of the proposed revisions, the zero capital standard on liquidity back-up lines designated for short term disruptions would be eliminated and replaced by more stringent requirements. In response to these additional costs, liquidity lines and in some cases tranches of credit enhancement may benefit from receiving a rating. In doing so, the various elements of risk will be clarified. As Basel II is ratings based, higher ratings equate to more favorable capital treatment and may allow conduit sponsors to still achieve significant economic benefit of securitization structures.

2 The *Bank for International Settlements ("BIS")*. Basel Switzerland develops bank guidelines for capital based on recommendations made by its members. The Basel Committee on Banking Supervision, rather than the BIS directly, was responsible for creating the Consultative Document on Asset Securitization. The committee includes representatives from several countries including the United Kingdom, the United States, Japan and major OECD member countries.

3 *Basel Committee on Banking Supervision*, Consultative Document Asset Securitization (Supporting Document to the New Basel Capital Accord) See Section 50 "Under the 1988 Accord, banks may have an incentive to structure embedded credit enhancements in short term commitments or liquidity facilities in order to avoid being assessed a capital charge."

4 The exact form is subject to clarification as revisions are subject to a discussion period ending in May 2001. Implementation, the responsibility of each country's banking supervisory authority, is not expected until 2004.

5 See "Alternative Liquidity Comes of Age," *Special Comment*, January 2000.

How Capital Requirements are Calculated, How they will Change

The new standards stipulate more stringent capital requirements for liquidity commitments. Under the terms of the 1988 Accord, the BIS specifies that liquidity commitments of under a year — which are designed to cover short-term market disruptions — be converted to an on-balance sheet credit equivalent amount by multiplying the commitment amount by a “credit conversion factor” of zero. The minimum capital is calculated by multiplying a percentage by the credit conversion factor. Because the credit conversion factor is zero, however, the required capital under the existing guidelines is zero as well.

Liquidity lines designated to provide credit loss protection for defaults or deterioration of the underlying portfolio are currently fully weighted for capital purposes. This will not change. However, Basel II does recognize the residual risk in lines providing liquidity backup even for short term commitments related to temporary market disruptions and adjusts capital requirements accordingly.

Under the terms of the new proposal, the Basel II Consultative Committee suggests that short-term liquidity commitments, even if designed to cover short-term market disruptions, may subject liquidity banks to residual credit risk. According to the Committee, this represents an exposure, which should be reserved against to protect lending institutions from unanticipated risk of loss related to the securitized product. Therefore liquidity back up lines, designed to cover temporary market disruptions of under one year, are now proposed to be subject to a 20% credit conversion factor.⁶

The ‘zero percent’ credit conversion factor may still apply to liquidity lines under two scenarios: 1) if liquidity is unconditionally cancelable — without prior notice or, 2) if liquidity could be drawn only in the event of a general market disruption.

These limitations are not typically found in liquidity facilities backing most ABCP issued today. The presence of such limitations in liquidity facilities backing ABCP could make the repayment of ABCP by liquidity facilities less certain and could present a problem to the investor and thus affect the rating of the ABCP.

It is more likely that liquidity lines backing ABCP conduits will continue to be designed along traditional lines, conforming to criteria that will most likely attract a 20% credit conversion factor. Basel II dictates several requirements to enable a liquidity line to receive favorable treatment as a liquidity commitment, as opposed to being handled as a direct credit substitute subject to 100% credit conversion. (See *Table 1*). Many of these requirements are present in existing rated ABCP conduit programs. We expect that some of these guidelines will be further clarified during the Basel II comment period. These will require additional analysis from Moody's to assess their consistency with the **Prime-1** rating.

⁶ There continues to be some discussion among various industry experts as to whether liquidity lines greater than one year would also be subject to the 20% credit conversion factor.

Table 1
Requirements for 20% Credit Conversion for Liquidity Facilities¹

Basel II has proposed the following standard provisions to enable liquidity to be treated as a commitment with a 20% credit conversion.

- Liquidity will be written under a separately documented agreement provided to an SPV (Special Purpose Vehicle) — not to investors — at arm's length; at market rates; and be subject to the bank's normal credit and review process;
- The SPV must have the right to select a third party to provide the facility;
- A facility must be fixed in amount and duration — with no recourse to the bank beyond the fixed contractual obligations provided for in the facility;
- Terms and conditions of the facility must be clearly identified including under what circumstances it may be drawn;
- The facility must not be used to provide credit support, cover losses, or act as a permanent revolving funding;
- The facility should either include a reasonable asset quality test to ensure that a drawing would not cover deteriorated or defaulted assets or a term requiring a termination or reduction of the facility for a specified decline in asset quality; and
- The drawings under the facility should not be subordinated to the interests of the noteholders (ABCP) and the payment of the fee for the facility should not be further subordinated or subject to waiver or deferrals.

¹ Most of the provisions listed appear in ABCP conduits currently rated **Prime-1**.

Potential Rating Challenges

Moody's preliminary review of these guidelines reveals several potential challenges to the rating process. Each of these will be evaluated within the context of the **Prime-1** rating.

1. Liquidity Bank Repayment Priority Changes could Increase Investor Risk

The proposed BIS provisions dealing with priority payment allocation for liquidity banks may affect ratings on ABCP programs, and, by extension, may have an impact on the way that ABCP programs are structured in the future. This is because liquidity fees are often subordinated to payments to ABCP holders. The current draft language of Basel II, however, states that these fees "should not be further subordinated or subject to waiver or deferrals." If not further clarified, this language may raise issues from a ratings perspective for the following reasons:

- Moody's, in assigning a **Prime-1** rating, evaluates the conditions which typically require the payment of fees to liquidity banks to be subordinated to the payment in full of ABCP holders. Under current programs, repayment of principal and interest on a liquidity bank's line is typically structured to be subordinated or *pari passu* with ABCP holders. The *pari passu* or equal nature of the claim is frequently "allowed" because any draws on liquidity are allocated to repay ABCP. The 'waterfall' provisions or priority allocation of cashflow from the underlying assets determines the direction of proceeds in the conduit.
- To the extent that liquidity banks obtain a priority ahead of ABCP investors, or to the extent that they need to eliminate their **Excess Funds**⁷ language or **Non-Petition**⁸ clauses to satisfy the conditions necessary for a 20% risk weighting per the BIS criteria, there may be a challenge to the bankruptcy-remoteness of ABCP programs and investor repayment. These may in turn present a challenge to the **Prime-1** rating of ABCP programs. At the present time, however, it does not appear the Excess Funds or Non-Petition provisions of a typical liquidity facility will be challenged directly. It is only an indirect challenge — specifically a challenge to accommodate the 20% risk weighting by Basel II, that may be problematic.

⁷ **Excess Funds** refers to the ability of contract counterparties of ABCP programs to be repaid only to the extent that there are funds available to pay them, subject to the designation of priorities in the program.

⁸ **Non-petition language** refers to the stipulation that limits the ability of any contract counterparty in an ABCP program to accelerate its indebtedness, seek judgements or seek an involuntary bankruptcy petition against the conduit.

2. Conditions Stipulated for “Pure Liquidity” vs. Credit Enhancement

Basel II clarifies the distinction between liquidity that is treated as “pure liquidity” subject to the 20% credit conversion factor, versus liquidity that is a substitute for credit enhancement.

- It has been common, under certain circumstances, for bank sponsors to provide ‘structured’ liquidity — where the liquidity bank may take the risk of credit loss. Under the terms of the proposed new accord — as with the 1988 accord — where liquidity effectively functions as a guarantee against loss, a credit conversion factor of 100% continues to apply.⁹ The entire pool of assets covered by this form of liquidity (which is really credit enhancement) will continue to be treated as a fully weighted on-balance sheet item. (See *Table 2*).
- Thus far, Basel II is silent on certain forms of risks that are traditionally covered by liquidity facilities in ABCP conduits.¹⁰ Depending on their ultimate treatment by Basel II, bank sponsors may have less of an ability to provide “structured” liquidity or to even absorb temporary risks related to certain seller or transaction specific risks which are not adequately reserved against.
- For example, liquidity lines may provide funding for risks that are not directly related to actual losses or defaults. This can include events associated with temporary disruptions in receiving cash flow on the underlying transaction. This often arises where the seller of receivables is involved in businesses subject to dilution related to the return of goods. The cash payment on a previously sold receivable may be diverted temporarily from the collection account designated for ABCP holders. Often the liquidity bank will provide advances against this dilutive item on behalf of the seller of the receivables. Alternatively, a potentially dilutive item may be covered by a special ‘dilution’ reserve. In cases where the reserve is inadequate to cover items diminishing available cash flow, liquidity takes this incremental risk. Other timing issues generally covered by liquidity banks include payment interruptions occurring when an unrated seller of receivables becomes insolvent. In this case cash flow ultimately designated for ABCP repayment may be temporarily co-mingled with the seller’s accounts. In traditional structures liquidity lines typically accommodate these short-term exposures and advance funds associated with seller co-mingling and related credit issues. In most conduit transactions, liquidity will repay ABCP investors to the extent there is ‘non-defaulted’ assets associated with a receivable purchase facility without regard to timing issues. Ratings on liquidity lines may be instrumental in assessing the adequacy of reserves and the other features present in the structure, which help mitigate and isolate unique deal risks.

Table 2
Simplified Risk Weighting and Capital Example for a \$100 Commitment¹

	Liquidity Does Not Meet Guidelines (Treated as Credit Enhancement)	Liquidity Meets Guidelines for “20% Test”
Commitment x 8% Capital x Risk Weighting x Credit Conversion Factor	\$100 Commitment x 8% x 100% x 100%	\$100 Commitment x 20% x 8% x 100%
Capital Required	\$8	\$1.6

¹ While the calculation for Credit Enhancement applies to commitments regardless of the maturity, it is unclear whether the 20% credit conversion calculation will also apply to liquidity commitments greater than one year.

Are Liquidity Ratings Warranted?

Based on the Accord’s guidance — which is open to interpretation by each country’s bank supervisory authority — certain forms of ‘structured’ liquidity (which transfers risk elements related to portfolio deterioration to the liquidity bank) may attract more restrictive capital treatment. This will depend on how strictly regulators in each jurisdiction adhere to the guidelines recommended by Basel II.

⁹ If Liquidity were assigned a 100% credit conversion factor, this would mean that the credit equivalent amount would equal the commitment amount, i.e. 8% minimum capital would be assessed against that credit equivalent amount.

¹⁰ Seller-specific risks often absorbed by liquidity include commingled cash of an asset pool during a seller insolvency or dilutions (i.e. trade receivable deals where returns of goods dilutes the cash flow payable to the structure).

In such cases, an actual credit rating¹¹ of the underlying credit exposure of the transaction backed by the liquidity facility may guide the capital treatment. These calculations may be made according to established ratings-based risk weightings (See *Appendix I*) as illustrated in *Table 3*.

While still subject to further clarification, a highly rated liquidity line may be a preferable option when the underlying assets and structure are complex and the actual credit quality of the transaction is uncertain. While a rating may not improve the credit quality of the transaction, it may clarify the risk for liquidity banks backing illiquid assets or highly structured conduit transactions. Such clarification may benefit liquidity bank's need for an independent assessment of their risk for capital purposes as well as providing investors of another measure of the overall transaction's strength.

Table 3
Hypothetical Risk Capital Calculations for Rated Liquidity Commitments
Assumed Rating on a \$100 Liquidity Commitment¹

	Aaa Rating	Baa3 Rating	Ba1 Rating
Commitment Amount x Credit Conversion Factor for Liquidity x ABS Risk Weighting x 8% Required Capital	\$100 Commitment x 20% x 20% x 8%	\$100 Commitment x 20% x 100% x 8%	\$100 Commitment x 20% x 150% x 8%
Capital Required	\$.32	\$1.6	\$2.40

¹ There is currently no standard to apply a rating to liquidity lines. The assumption is made that the Risk Weightings for rated ABS (*Appendix I*) may apply as reflected in the chart above.

Note: While the calculation for Credit Enhancement applies to commitments regardless of the maturity, it is unclear whether the 20% credit conversion calculation will also apply to liquidity commitments greater than one year.

Credit Arbitrage Programs could Fare Well Under New Proposals

Credit or securities arbitrage conduits currently represent an estimated \$45 billion in transactions (almost 10% of all rated ABCP as of December 2000). These programs are typically set up for regulatory purposes by banks that hold large portfolios of **Aaa/Aa** rated ABS. Holding the securities directly on balance sheet, requires capital. Selling securities into an ABCP conduit, however, offers a regulatory advantaged way of earning spread income on these securities without incurring the capital charge. This is because the liquidity that backs these ABCP programs currently, as noted, have a zero percent credit conversion factor under present BIS rules.

Under the new proposed rules we anticipate that banks may still be able to achieve favorable capital treatment without selling securities into ABCP conduits. If, for example, the underlying ABS securities are explicitly rated in the highest rating category (**Aaa**); the capital required for holding the highly rated securities on the balance sheet and off the balance sheet (in an ABCP conduit) may be the same.

If liquidity supporting a securities arbitrage program were to meet the "20% test" the risk weighting would still be favorable — calculated at 20% (Credit Conversion) times 20% (Risk Weighting). While not as attractive as the current standard, this may still provide an economic incentive for banks to continue to sell their highly rated securities into ABCP conduits. The current guidelines do not make clear whether or not this is intended.

Under the new regulatory regime, the profitability of these securities arbitrage transactions may be more dependent than before on other costs associated with securitizing assets. For example, the regulatory and accounting treatment of hedges on these programs may become a more important component in determining the economics of securities arbitrage programs.

¹¹ Credit ratings under Basel II in certain cases may be assigned either by an approved independent rating agency or, subject to each country's supervisory authority, the bank's own internal risk weighting system if qualified. While this is still under discussion, it is not clear that the ratings matrix in *Appendix I* will apply or some other form of a risk weighting designation will be adapted. It may also be the case that where the underlying assets are actually rated, regulators would look through to the rating on the assets, bypassing the need for a separate rating on the related liquidity lines.

Hedges have been important in these programs as they cover 'negative carry' or the yield differential between the assets — income earned on the securities portfolio, and the liabilities — related to conduit administrative and commercial paper interest expense.

It is not clear how Basel II may be broadened to focus on swap exposure or synthetic securitization structures relying heavily on derivatives and their appropriate capital treatment.

Potential Increased Use of Ratings May Reduce Required Capital Allocation

The Basel Committee on Banking Supervision has made several other recommendations regarding risk-weightings for banks investing in ABS. Among these suggestions, capital risk weightings for ABS held by investing banks would have been assigned by a qualifying external rating agency or a 'qualifying internal ratings system' if approved by the investing bank's supervisory authority as illustrated in *Appendix I*. To the extent that there becomes a need to have liquidity lines and conduit level credit enhancement rated, the possibility exists (though it is not specifically addressed) that the rating scale and capital charge pertaining to ABS risk-weightings may be applicable. By defining and clarifying the credit rating of the liquidity line may actually lead to a more precise understanding of both the risk and the capital treatment.

Basel II makes a very clear distinction between first and residual credit exposure. This may also be expanded to the various risks underwritten by a liquidity bank in its liquidity line. The primary exposure, subject to first loss credit enhancement, would carry the normal capital charge as described in this article. Additional risks undertaken by liquidity banks with less credit enhancement (second loss positions) may result in a capital charge equal to or greater than the amount of that residual exposure. A third party rating of this second loss exposure may be useful in evaluating and isolating the specific risk elements — reducing the required capital allocation.¹²

Last, two issues regarding the use of the 20% conversion factor have been the subject of discussion. These may also require further clarification. The questions relate to liquidity commitments in securitization transactions of greater than one year. There is some discussion as to whether longer-term commitments are subject to a 20% or a 50% conversion factor. If the higher credit conversion factor were applied for liquidity commitments backing long term assets which were not renewable annually, for example, additional expense may result making these assets uneconomic to securitize.

Other areas requiring clarification relate to situations where banks acting as ABCP sponsors provide both first loss credit enhancement on the assets they sell to their conduit and liquidity to the sponsored program. While this is unclear, a strict interpretation may mean that all of the assets sold to an ABCP conduit in this situation would be retained fully on the balance sheet of the sponsoring bank. Moody's will evaluate these and other issues as the regulatory process evolves.

¹² In the Consultative Document on Asset Securitisation, the Basel Committee makes a distinction in Section 16-17 between first and second loss credit protection. Significant discretion will be given to national regulators as to whether capital is assessed against the face amount of the second loss enhancement. Other issues arise with respect to cash advances — which are not allowed to be provided by liquidity facilities if they are to be risk weighted as true liquidity. In circumstances in which second loss credit enhancement serves a variety of functions, there may be some value in having a rating assigned to this component of the conduit structure.

Work in Progress

Moody's will review future developments relating to Basel II and provide periodic updates on how they may affect ABCP, liquidity facilities and asset-backed securities. In general, regulatory concerns underlying capital charges as reflected in the revisions to Basel Accord create some tension with the interests of capital market participants such as ABCP holders.

Contractual commitments to ABCP investors, for example, create potential liabilities to conduit sponsors and administrators. These must be measured and capitalized to protect the banks' safety and soundness. Challenges to ABCP investors and the ratings process posed by Basel II relate to creating additional complexity as conduit sponsors adjust their pricing and potentially their structures to accommodate the new regulatory regime. Ratings on liquidity lines may also be useful in securities arbitrage programs or complex receivable transactions help sponsoring banks evaluate their credit exposure and allocate capital more efficiently. For investors, any real or perceived increase in risk, which may result as the market adapts, may be partially clarified by the increased use of ratings. Additional growth, rather than contraction, of ABCP issuance may be a likely result of removing potential uncertainty associated with the new market developments arising from the Basel II regime. Moody's is committed to working with issuers and conduit sponsors to facilitate the transition to the new regime of Basel II.

APPENDIX I — RATINGS AND CAPITAL CHARGES

Basel II proposes minimum capital requirements for investments in Asset Backed Securities, as noted in the chart below. Basel has not yet made clear whether, if liquidity lines and credit enhancement were to be rated, the same credit conversion scale would be applied to both.

Ratings have been adapted in this chart to the Moody's standard, which may differ from the rating notation used for illustrative purposes in the Consultative Document: Asset Securitization (Supporting Document to the New Basel Capital Accord January 16, 2001).

Table 4
**Basel II: Standards for Risk Weighting Classifications,
Compared to Moody's Ratings on Asset Backed Securities¹**

Moody's Rating	Aaa to Aa3	A1 to A3	Baa1 to Baa3	Ba1 to Ba3	B1
BIS Risk Weighting	20%	50%	100%	150%	Full Deduction
Capital Charge Example	20% x 8% = 1.6%	50% x 8% = 4%	100% x 8% = 8%	150% x 8% = 12%	Fully Deduct this asset
Risk Weighting X Capital	Required Capital %	Required Capital %	Required Capital %	Required Capital %	in the calculation
e.g. 8% = Required Capital %					of capital

¹ Section 27 of the Consultative Document details the risk weighting on ABS securitization tranches. For transactions rated in the B1 category for example, this exposure is most likely fully deducted from capital.

APPENDIX II

Table 5
Simplified Risk Weighting And Return Calculations
Credit Enhancement and Liquidity Under Existing and Proposed Guidelines

	Current & Proposed Guidelines	Revised under Basel II	Current Guidelines
	Liquidity as Credit Enhancement	Liquidity Meeting New Revised Guidelines	Liquidity Under Existing Guidelines
\$ Commitment x 8% Capital x Risk Weight x Credit Conversion Factor	\$100 Commitment x 8% x 100% x 100%	\$100 Commitment x 8%x 100% x 20%	\$100 Commitment x 8% x 100% x 0% Credit Conversion Factor
Required On Balance Sheet Capital %	8%	1.6%	Zero
Simplified Return on Capital %¹	6.25%	31.3%	Infinite Return

1 Assume 50bps Commitment Fee on an un-drawn liquidity line supporting an ABCP conduit. The simplistic return calculation is Fee Income/Capital.

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