

Credit Analysis

Moody's Global Sovereign

February 2008

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Ireland

Ireland's Aaa government bond rating is supported by successful macroeconomic management and a competitive economy. Economic development has been characterised by strong growth which, supported by a favourable demographic profile and outward-oriented policies, contributed to a substantial rise in wealth levels over the past two decades. Deregulation and structural reforms played a key role in Ireland's efforts to make growth sustainable and the economy much more resilient to shocks.

Strong investment spending and foreign direct investment (FDI) remain catalysts for the Irish economy's capacity to grow amidst the dynamics of population ageing, helped by immigration and the baby boom of the late 1970s. The success of the Irish government and the National Treasury Management Agency (NTMA) in consolidating public finances resulted in a marked drop in spending ratios and large fiscal surpluses between 1995 and 2000. Continued fiscal discipline in subsequent years helped to substantially reduce gross debt to about 25% of GDP at present.

Strong economic growth, supported by the booming property market, has led to consistently higher tax revenues in recent years. However, higher interest and recent tensions in credit markets have started to slow growth in what had been the most dynamic sectors of the economy. The correction in the Irish housing market and, thus, the construction sector, is expected to continue at least in 2008, still a soft landing is expected in these key economic sectors. These trends pose risks for domestic demand generally. The possibility that the US slowdown could turn into recession and a further strengthening of the euro against the dollar would further weigh down Irish growth, given Ireland's close trade and investment links with the US, with obvious consequences for the fiscal balance.

Considerable fundamental strengths, such as sound policy orientation and longstanding political stability, suggest the continuation of prudent fiscal policies can be expected. Indeed, Ireland's fiscal position remains sound even though public infrastructure and social spending are being raised. Such increases do not represent a trend change in Ireland's overall fiscal stance. Still, the fiscal position is likely to weaken in these times of less favourable growth conditions.

This Credit Analysis provides an in-depth discussion of credit rating(s) for Ireland and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. [Click here to link.](#)



Moody's Investors Service

Ireland

Macroeconomic Performance

Increasing downside risks to GDP growth

Since the Irish economy is not as diversified as larger economies, it is particularly exposed to external risks such as global demand swings and exchange rate volatility. Because the full effects of recent turmoil in the financial markets are yet to be ascertained, Ireland faces an unusually high degree of uncertainty based on international factors. Given the close trade and FDI links with the US, a recession in the US and a forecasted growth slowdown in the UK, Ireland's second most important trading partner, will undoubtedly have a negative impact on growth in Ireland. This happened between 2001 and 2003 when Irish growth rates slowed partly due to a downturn in the US economy at that time. Moreover, with US growth prospects abating, the dollar weakened considerably against the euro in recent months, which may further aggravate the situation for Ireland.

Domestic risks are also present for Irish growth, mainly related to the unbalanced growth pattern that has built up over recent years. Since 2004 the economy was mainly driven by demographics (young population), immigration and increasing labour market participation, which have led to increases in employment, average earnings, and real disposable income. These factors have fuelled strong domestic demand and a housing and construction boom. At the same time, the net contribution from exports also declined due to some sector-specific issues (chemicals and information communications technology (ICT)) as well as the general deterioration in cost competitiveness in recent years. As a result, the composition of growth has become overly dependent on domestic demand, particularly construction investment.

Housing market development expected at more sustainable levels

Housing market developments are a risk factor for the Irish economy. Reflecting strong demographics, substantial real income development, and ongoing catch-up effects, Irish house prices have risen about 15% annually for several years. Since the beginning of 2007, house prices have slowly but steadily declined, prompted by weaker demand due to higher interest rates and what is now excess supply. House prices fell by about 6% in the first eleven months of 2007 and the Economic and Social Research Institute expects a further decline of about 3% on average in 2008. However, as opposed to the US or the UK, in Ireland the increase in housing wealth seems not to have been used to fund personal consumption, suggesting decline in house prices would not cut consumption significantly and limiting the impact on growth. Instead, the increase in real disposable income explains the rise in real personal consumption.¹ Furthermore, even though private households' accumulation of debt and hence debt service represent risk factors, real income after debt service has risen substantially and nonperforming debts of this kind have been minimal. In addition, the ratio of net household wealth to disposable income has increased materially in recent years, reaching 775% in 2005.

Construction activity slowing over the short term

Due to the reliance on the construction sector for growth, Ireland's cooling housing market may well have a profound negative effect on the overall economy via a reduction in investment and employment. The decade-long housing construction boom raised the share of construction investment to more than 10% of GDP in 2006, the highest in the OECD, supporting growth and employment. It accounts for about 13% of total employment, which is far in excess of the 8% recorded in the EU25. The slowdown in house prices caused construction investment to fall significantly in 2007 and construction employment also started to contract. For the first eleven months of 2007, housing output totalled 71,598 units, well below the 84,955 units for the same period in 2006, as supply started to adjust to long-run underlying demand. The downturn occurred despite last year's maturing of special savings incentive accounts (SSIA's) that supported home improvement investment.

On the one hand, a rebalancing of the Irish growth composition with a more sustainable level of housing output and construction will return the economy to a more sustainable, although lower, growth path. On the other hand, the uncertainty in financial markets could lead to a more profound correction of house prices, which could have a

¹ See V. Hogan and P. O'Sullivan "Consumption and House Prices in Ireland", ESRI Quarterly Economic Commentary, Autumn 2007, pp. 46-61. Only a permanent fall in house prices is likely to have a long lasting impact on consumption.

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large negative impact on investment and employment and materially slow economic growth in 2008. Given the huge infrastructure needs of the economy, a more gradual adjustment of the construction sector seems possible.

Dampened outlook for overall growth

Considering the size of Ireland's external and internal macro imbalances – with the current account deficit at well over 4% of GDP and high inflation among other signs of domestic asset bubbles – the economy likely reached a turning point in 2007. At close to 5%, real GDP growth was still high in 2007; however, the unwinding of the imbalances is expected to take growth below potential at 3% in 2008. This is still quite fast, however, when compared to average Eurozone growth currently forecast at below 2%.

The adjustment in residential construction and the adaptation of the economy to external conditions will be crucial in determining the scale and duration of the slowdown. With underlying fundamentals indicating still-relatively-strong demand for housing, house-building should reach a more sustainable level over the medium term. Although construction employment may contract sharply, the economic slowdown may dampen immigration, partly offsetting the impact of weaker economic activity on domestic unemployment and labour market participation. Furthermore, inflation could moderate in line with the slowdown in domestic economic activity and a modest easing in labour market conditions.

Poor international cost competitiveness hampers rebalancing

The Irish (harmonized) inflation rate has remained noticeably above the Eurozone average over the last two years, reflecting mainly domestic inflationary pressures, such as higher prices in a broad range of domestic services and food. Continuing high energy prices contributed more indirectly through higher input costs in the non-energy sector. Higher mortgage interest payments for homeowners, which are not reflected in the harmonized inflation rate, increased the national inflation measure even more, to 4.9% in 2007, significantly higher than that of the country's main trading partners.

Due to the tightness in the labour market, wage increases have been strong over recent years, outpacing productivity growth and, thus indicating a clear deterioration in Irish cost competitiveness against its main trading partners. The recent strength of the euro against the dollar has put further pressure on Ireland's relative cost position, affecting trade and FDI flows with the US and making a future rebalancing of growth towards a materially greater contribution from net exports difficult. In this respect, continued strong investment in infrastructure, human resources and R&D, and the provision of a supportive business climate are crucial. On the other hand, the easing in domestic demand could reduce inflationary pressures in 2008, particularly in the services component. The social partnership strategy "Towards 2016," agreed upon by the government, trade unions and employers in 2006, is intended to moderate wage growth in the future. The pact specifies a cumulative rise in pay of 10% over 27 months.

Political/Social Developments

Authorities seek to further secure sustainability of public finances

Although Ireland has a relatively less generous pay-as-you-go pension system than many other EU countries and also benefits from a developed second pillar of corporate and private pension schemes, the European Commission² estimates that the government will experience a considerable 7.8% of GDP rise in age-related costs by 2050. The bulk of the increase will come from rising pension expenditures. This is due to the fact that Ireland's current demographic profile is set to change considerably over the coming decades as the positive effect of young immigrants on GDP and the fiscal position wanes over time. The old-age dependency ratio is expected to triple by 2050 while the share of the working population is projected to start declining by the mid-2030s, reducing the social security contributions base. This means that increasing age-related spending will have to be financed by a diminishing share of the population. However, Ireland has the advantage of starting from a healthy fiscal position with debt to GDP at 25%. Moreover, the government is setting aside budget

² See "The Long-Term Sustainability of Public Finances in the European Union", European Commission October 2006.

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revenues in a National Pensions Reserve Fund, equal to 1% of GNP per year, which will help ease the future funding burden.

The authorities are aware that further reform measures are still needed to secure the long-term sustainability of public finances. A Green Paper on pension policy was published in October 2007, discussing all aspects of the pension system. A comprehensive framework for addressing the pension agenda over the long-term is also being planned.

Public services face higher costs and value-for-money problem

Despite considerable outlays over the past decade, the quality of public services, especially in health care and education, and the infrastructure is perceived as insufficient, necessitating further investment by the government. To ensure a more efficient allocation and management of resources, a comprehensive "value-for-money" framework has been developed. This strategy should help to tackle inefficiencies evident in the health sector where costs are rising markedly as staff numbers increase but achieve only moderate efficiency gains, especially in the hospitals sector. The establishment of a Commission on Financial Management and Control Systems in the Health Service in 2002 is an important step towards better budgetary control. The merger of the eleven health authorities into one major national health agency (Health Service Executive) is designed to re-organize the system, to clearly assign responsibilities and to raise cost efficiency.

Government Finance and Debt

Starting with a high budget surplus in 2000, the fiscal situation weakened continuously to roughly balanced budgets in 2003 as a result of an economic slowdown and the introduction of income tax cuts and tax credits at that time. Since then, various revenue-raising measures as well as measures to increase tax discipline have been implemented. In 2004, one-off factors (special tax investigations and high revenues from capital gains tax) and the underlying strong economic activity brought about a general government surplus of 1.3% of nominal GDP.

High surpluses in 2005 and 2006 due to buoyant economic growth

Government spending has increased substantially over the last years, mirroring new long-term priorities of health care, education, social welfare and intensified investment into infrastructure and the quality of public services. However, for 2005 and 2006, strong growth helped to achieve better-than-planned general government budget results. A surplus of 1.2% of GDP in 2005 reflected relatively buoyant consumer demand and activity in the asset and property market, as well as below-budget government spending due to capacity problems in the construction sector. Compared to an initially planned deficit of 0.6% of GDP, a budget surplus of 2.9% of GDP was achieved in 2006 due to the continuation of stronger-than-anticipated tax receipts from stamp duties, capital gains, value-added and income taxes.

Less bright growth outlook impacts fiscal position

Tax shortfalls due to lower property-related taxes are the main reason the budget outcome for 2007 is expected to come in significantly below the target of a 1.2% of GDP surplus. Lower interest payments, an increase in investment income of the Pensions Reserve Fund, and a higher social security sector net surplus could only partly offset the projected shortfall in tax receipts of 0.9% of GDP. At 12%, current public expenditure growth was slightly higher than in 2006, and significantly above the nominal GDP growth rate. The budget is expected to start turning into deficit in 2008 when the full effects of lower housing output will be felt in the construction sector, slowing economic and revenue growth considerably. The government plans to decrease current public expenditure growth to 8.2% in 2008 in line with less favourable nominal GDP growth. However, the government remains committed to its investment spending program on economic and social infrastructure and capital investment under the National Development Plan and the Transport 21 Programme. Therefore, public investment spending at about 6% of GNP until 2013 will remain well ahead of the EU average level, improving the long run growth potential of the economy.

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Automatic stabilizers to cushion the cyclical deterioration

It seems to Moody's that the government is well aware of potential risks related to the present pattern of economic growth. Nevertheless, inadequate infrastructure and the lack of timely access to healthcare, especially emergency services, indicates that further reforms are necessary to guarantee more efficient services. Therefore, it is understandable that the government plans to maintain capital expenditure growth related to the National Development Plan at high levels, allowing the budget to cyclically deteriorate with expected lower growth of fiscal revenues. The mildly stimulative budget may help to cushion the growth slowdown to some extent and to finance further improvement of public services. This will become even more important if some of the potential risks for the Irish economy impact economic growth in a more severe way than expected, leading to a deeper and prolonged slowdown in growth and, thus, revenues.

While the authorities estimate that a 1% change in the growth rate of the economy would lead the general government balance to deteriorate by about 0.4 percentage points in the short run, fiscal stabilizers seem to have ample room to operate. Moody's generally believes the expected deterioration of the Irish government's fiscal position should not be a cause for concern provided public current expenditure growth is controlled in order to preserve a strong underlying fiscal position. In this respect, the establishment of a commission on taxation should help to ensure the efficiency and appropriateness of the Irish taxation system. Also, at about 25% of GDP, general government debt is at a very low level, leaving sufficient room to prioritize economic and social infrastructure spending without exerting any pressure on the government's Aaa ratings. For 2008, a slight increase in the debt ratio can be expected in line with the forecast of lower growth and a budget deficit. However, taking into account funds accumulated in the National Pensions Reserve Fund, net debt at end-2007 is estimated at some 14% of GDP.

Peer Group Comparison

In contrast to many other Eurozone governments, the Irish authorities have managed to keep general government budget balances well under control. After having decreased continuously for several years, the Irish general government debt ratio stabilised at close to 25% of GDP in 2007, remaining well below the Eurozone average of some 66.5%, and also less than half the 53.4% mean of the advanced industrial countries. The Irish general government debt to revenue ratio at some 69% is also well below the Eurozone average of 145.8% as well as the mean of advanced industrial countries at 135.8%. While risks to long-term sustainability suggest the necessity of further medium-term reform efforts in many Eurozone countries, Ireland is in a better starting position than most other Eurozone countries due to its low debt, favourable demographic situation and a highly developed pension system.

Financial Stability and Banking Sector

Supervision of Ireland's banking sector has been enhanced by the unification of supervision under the Irish Financial Services Regulation Authority within the Central Bank (Central Bank and Financial Services Authority of Ireland Act, 2003). Furthermore, the introduction of a new liquidity management framework for banks and the improvement in the capacity for insurance supervision in 2007 were important steps to further strengthen the regulatory and supervisory framework.

Reflecting the strength of the economy, high levels of capitalization and profitability have strengthened the Irish banks' capacity to weather potential macroeconomic shocks without meaningful distress. Asset quality remains sound, reflected by low arrears levels. However, low interest rates by historical standards had underpinned strong private-sector credit growth over recent years with the ratio of private sector credit to disposable income reaching 160% in 2006. The dominant factor behind this was residential mortgage lending, due to strengthened demand and the fact that Irish banks continued to ease credit standards for house purchase loans. As a result, the risk weighting for residential mortgage loans that exceed 80% of the value of the property were increased.

In line with the decline in price growth for homes and slowing demand in the housing market, residential mortgage borrowing started to decline in 2007. But Irish banks report no significant direct exposure to US subprime mortgages and very limited indirect exposures through investments and credit lines. As a result, recent

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stress tests indicate that, notwithstanding international financial market turbulence, major Irish lenders continue to have adequate buffers to cover extreme shocks such as a significant increase in unemployment and/or a sharp decline in house prices. Even a substantial withdrawal of private sector deposits would not seem to cause major problems, given banks' ample liquidity.

Rating History

	Foreign Currency Ceilings				Government Bonds		Outlook	Date
	Bonds & Notes		Bank Deposits		Foreign Currency	Local Currency		
	Long-term	Short-term	Long-term	Short-term				
	Rating Withdrawn [1]	WR	WR	WR	WR	--	--	--
Rating Raised	Aaa	--	Aaa	--	Aaa	Aaa	--	May-98
Review for Upgrade	Aa1	--	Aa1	--	Aa1	--	--	March-98
Outlook Assigned	--	--	--	--	--	--	Stable	March-97
Rating Confirmed	--	--	--	--	--	Aaa	--	February-97
Rating Raised	Aa1	--	Aa1	--	Aa1	--	--	February-97
Review for Downgrade	--	--	--	--	--	Aaa	--	January-97
Review for Upgrade	Aa2	--	Aa2	--	Aa2	--	--	January-97
Rating Raised	Aa2	--	Aa2	--	Aa2	--	--	August-94
Review for Upgrade	Aa3	--	Aa3	--	Aa3	--	--	June-94
Rating Assigned	--	--	--	--	--	Aaa	--	September-92
Rating Assigned	Aa3	--	Aa3	--	Aa3	--	--	July-87
Rating Assigned	--	P-1	--	P-1	--	--	--	December-86

[1] Ireland's country ceilings were replaced by the Aaa and P-1 ceilings assigned to the Eurozone.

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Annual Statistics

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	2000	2001	2002	2003	2004	2005	2006	2007F	2008F
Main Economic Indicators									
Real GDP (%y/y)	8.9	6.1	6.4	4.3	4.3	5.9	5.7	4.8	3.0
Private Consumption (%y/y)	10.8	5.6	4.2	3.0	4.1	7.3	5.7	6.6	3.8
Public Consumption (%y/y)	12.8	12.8	7.0	1.2	1.5	4.0	5.3	4.8	3.6
Gross Fixed Investment (%y/y)	6.5	0.4	3.3	5.5	6.9	11.8	3.1	1.5	-1.6
Domestic Demand (%y/y)	8.8	4.1	4.4	4.1	3.6	7.9	5.7	3.8	2.3
Contribution to GDP Growth									
Net Exports	1.7	2.4	2.9	1.7	0.4	-1.0	0.0	0.7	1.1
Domestic Demand	8.5	3.6	3.8	3.2	3.1	6.7	5.0	3.4	1.9
Stockbuilding	0.4	-0.4	0.1	0.4	-0.5	-0.1	0.8	0.4	0.3
Unemployment Rate (%y/y)	4.2	4.0	4.4	4.6	4.4	4.3	4.4	4.6	5.6
GDP Deflator (%y/y)	5.9	5.5	4.6	2.6	2.2	2.7	2.3	2.7	2.5
CPI (harmonized index, %y/y)	5.3	4.0	4.7	4.0	2.3	2.2	2.7	2.8	2.4
Comparison: Prices in Eurozone									
CPI (harmonized index, %y/y)	2.1	2.4	2.3	2.1	2.2	2.2	2.2	2.1	2.1
Indicators of Competitiveness									
Output (% growth)	8.9	6.1	6.4	4.3	4.3	5.9	5.7	4.8	3.0
Employment (% growth)	4.6	3.0	1.8	1.9	3.0	4.7	4.4	3.5	1.1
Labour Productivity (% growth)	4.3	2.8	4.6	2.3	1.1	1.2	1.4	1.2	1.8
Wages (% growth)	8.0	7.5	5.5	6.4	6.4	5.0	4.5	5.2	4.0
Unit Labour Costs (% growth)	3.7	4.5	0.9	4.0	5.2	3.8	3.1	4.0	2.2
Comparison: Eurozone									
Output (% growth)	3.8	1.9	0.9	0.8	2.0	1.5	2.8	2.6	2.0
Employment (% growth)	2.4	1.5	0.6	0.4	0.8	0.9	1.5	1.6	1.0
Labour Productivity (% growth)	1.7	0.5	0.4	0.8	1.5	0.9	1.4	1.1	1.1
Wages (% growth)	2.8	2.8	2.8	2.8	2.5	2.0	2.4	2.6	2.8
Unit Labour Costs (% growth)	1.1	2.2	2.4	2.0	1.0	1.1	1.0	1.4	1.7
Public Finances (% of GDP)									
General Government Balance	4.7	0.9	-0.4	0.4	1.3	1.2	2.9	0.5	-0.9
Central Government	4.4	0.8	0.1	-0.1	1.0	0.6	2.3	0.2	-1.1
Local Authorities	-0.1	-0.5	-0.3	0.3	0.1	0.2	0.2	-0.1	-0.1
Social Security Funds	0.5	0.6	-0.1	0.2	0.3	0.4	0.4	0.4	0.3
General Government Revenues	36.3	34.3	33.2	33.8	35.2	35.4	37.1	36.6	36.1
General Government Expenditures	31.6	33.4	33.6	33.4	33.9	34.2	34.2	36.1	37.0
Primary Expenditures	29.6	31.9	32.3	32.2	32.7	33.1	33.2	35.2	36.0
Interest Payments	2.0	1.5	1.3	1.2	1.2	1.1	1.0	0.9	1.0
Primary Balance	6.7	2.4	0.9	1.6	2.5	2.3	3.9	1.4	0.1
General Government Debt	37.8	35.5	32.2	31.1	29.5	27.4	25.1	25.1	25.9
External Accounts									
Total Exports (% volume growth)	20.2	8.6	5.2	0.6	7.3	5.2	4.4	6.8	5.6
Total Imports (% volume growth)	21.8	7.1	2.6	-1.6	8.5	7.7	4.4	5.9	4.5
Current Account (% of GDP)	-0.4	-0.4	-1.0	0.0	-0.6	-3.5	-4.2	-4.4	-3.9

Ireland

Moody's Related Research

Banking System Outlook:

- Banking System Outlook: Ireland, October 2005 (94644)

Special Comments:

- Has Fiscal Consolidation Stopped in Europe?, October 2002 (76312)
- A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)
- A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 (81176)
- EU Enlargement - The Rating Implications, July 2004 (88160)
- European Union: New Stability and Growth Pact's Focus on Sustainability Might Prove Positive, May 2005 (92684)
- The EU Premium: Ratings Strengthened for Countries Moving Toward EMU Convergence, August 2005 (93809)
- The European Union's ERM2 Experience Justifies some Credit Enhancement, March 2006 (96914)
- The Future of European Capital Markets: Local vs. Global Influences, March 2006 (97013)
- A Guide to Moody's Sovereign Ratings, August 2006 (98177)
- Sovereign Default and Recovery Rates, 1983-2006, June 2007 (103415)

Rating Methodologies

- Piercing the Country Ceiling: An Update, January 2005 (91215)
- Revised Foreign-Currency Ceilings to Better Reflect Reduced Risk of a Payments Moratorium in Wake of Government Default, May 2006 (97555)
- The Local Currency Deposit Ceiling, August 2006 (98554)

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