

RatingsDirect®

Glarner Kantonalbank

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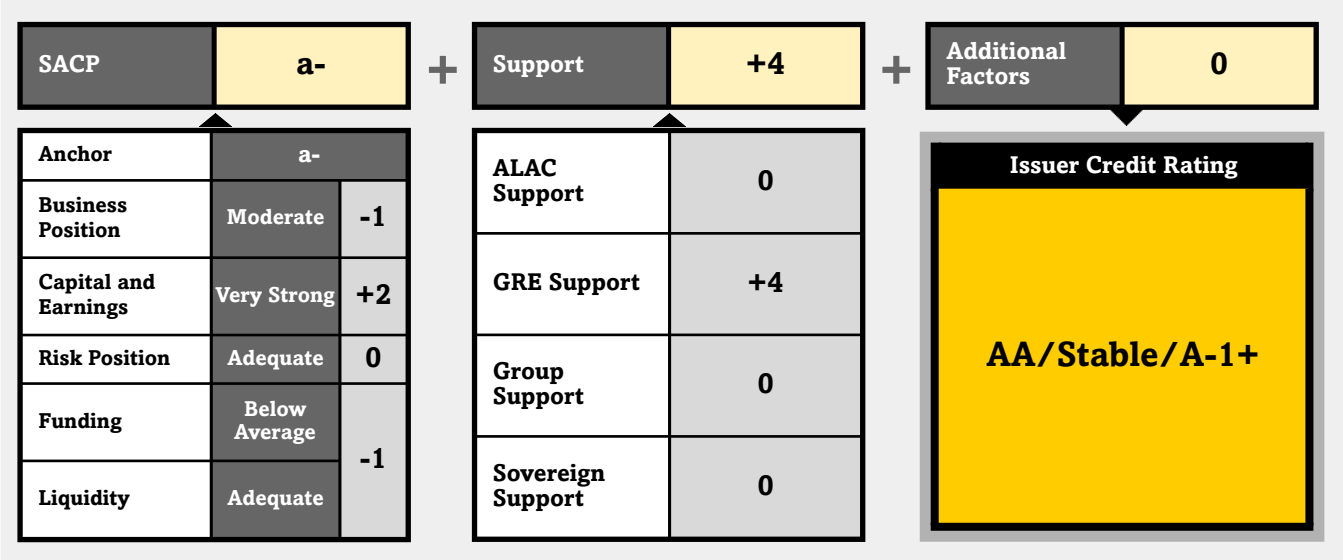
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Glärner Kantonalbank



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Close ties with the Swiss Canton of Glarus, facilitated by its majority ownership of the bank and its statutory guarantee. • Very strong capitalization. • Sound retail banking franchise in the Canton of Glarus and a loan book dominated by well-collateralized residential mortgages. 	<ul style="list-style-type: none"> • Concentration risk because of a focus on residential mortgage lending in the home canton and neighboring economic area, with more price-sensitive relationships with customers outside the home canton. • Weaker cost efficiency and profitability than most rated cantonal peers. • Stronger reliance on wholesale funding activities than the rated cantonal peer group.

Outlook: Stable

The stable outlook on Swiss bank Glarner Kantonalbank (GLKB) reflects S&P Global Ratings' view that GLKB continues to benefit from being a government-related entity (GRE) with an extremely high likelihood of receiving support from the Canton of Glarus over the next two years, if needed. Moreover, we consider that GLKB's capital and earnings provide a substantial buffer against potential domestic financial risks.

The likelihood of a downgrade is remote because, even in the event of a multiple-notch deterioration of the stand-alone credit profile (SACP), the ratings would be cushioned by additional extraordinary support from the canton, assuming everything else remained equal. Nevertheless, a negative rating action may be triggered by a downward revision of our assessment of GLKB's role for or link with the Canton of Glarus, or changes in the statutory guarantee, which may lead to our reassessment of GLKB's status as a GRE. However, we currently consider this scenario unlikely and would expect GLKB's existing obligations to be grandfathered. In addition, a negative rating action could occur if we were to revise downward our assessment of Glarus' creditworthiness.

We consider an upgrade of GLKB remote, given the bank's concentrated business profile and its strong reliance on wholesale funding. However, all else remaining equal, we could raise the ratings on GLKB if we revised upward our assessment of Glarus' creditworthiness.

Rationale

Our ratings on GLKB reflect our 'a-' anchor for pure domestic Swiss banks and GLKB's moderate business position considers the bank's sound market position in its home canton but our view of less stable customer relations outside the canton. At the same time, the bank's very strong capital and earnings mirrors our projected risk-adjusted capital ratio (RAC) ratio of over 22.5% in the next 24 months. Our adequate risk position remains supported by balancing concentration risks in its loan portfolio with sound asset quality and high collateralization. We assess the bank's funding as below average, and its liquidity as adequate, due to weaker funding metrics and higher reliance on wholesale funding activities than its cantonal bank peers. The SACP is at 'a-'. We consider GLKB to be a GRE with an extremely high likelihood of receiving timely and sufficient extraordinary support from Canton of Glarus if needed. We base this opinion on GLKB's very important role for, and integral link with, the local government, the canton. This provides a four-notch uplift to our assessment of GLKB's SACP, leading to the long-term rating of 'AA'.

Anchor: 'a-' for banks operating only in Switzerland.

The anchor reflects GLKB's domicile in Swiss Canton of Glarus and its credit exposures, which are almost exclusively to Swiss-domiciled counterparties.

Our criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating (ICR). Our anchor for a bank operating mainly in Switzerland is 'a-'. We view the trends for both economic and industry risk as stable.

Our economic risk score of '2' for Switzerland is supported by the country's highly diversified and competitive economy, very high household income levels, and banks' prudent loan underwriting standards. However, it also

reflects that risks remain, owing to the cumulative rise in Swiss house prices over the past few years. Although imbalances remain moderate in a global context, they have led the regulator to enact macroprudential measures to rein growth in mortgage indebtedness. We recognize that house price growth has cooled down since beginning 2014, while lending has recently picked up again after several years with moderate growth. In our view, house prices and household indebtedness remain historically high. The very high mortgage debt level is mitigated by the large amount of financial assets, including pensions, held by Swiss households.

Our industry risk score of '2' primarily reflects the banking sector stability and a relatively high share of deposit funding. Banks' net interest margins continue to decline gradually, given the pressure on deposit margins from the negative yield environment. This is partly offset, however, by higher margins on lending products, fee income from investment advisory-related activities, and cost management. As a result, banks are still able to generate returns on core banking products that are adequate to meet their cost of capital. Moreover, in our view, the Swiss regulator's regulatory initiatives are more stringent than those in other European banking industries.

Table 1

Glarner Kantonalbank Key Figures					
--Year-ended Dec. 31--					
(Mil. CHF)	2018*	2017	2016	2015	2014
Adjusted assets	5,999.7	5,637.5	5,276.7	4,987.0	4,475.4
Customer loans (gross)	4,910.3	4,798.3	4,606.1	4,297.9	3,926.8
Adjusted common equity	309.5	301.0	292.1	285.7	276.0
Operating revenues	58.4	73.8	65.8	61.7	57.0
Noninterest expenses	36.2	48.2	45.6	43.6	39.6
Core earnings	16.8	19.4	16.8	17.1	15.6

*Data as of Sept. 30. CHF-Swiss Franc

Business position: Stable franchise in Glarus, but less stable client relationships with customers outside its home area

With total assets of Swiss franc (CHF) 6.0 billion (€5.3 billion) as of Sept. 30, 2018, GLKB remains one of the smaller Swiss cantonal banks, though the leading commercial bank in its home canton Glarus. It mainly focuses on residential mortgage lending near Glarus, complemented by the offering of online mortgages in German-speaking Switzerland through its online platform, hypomat.

We consider its business position as weaker compared with peers in Switzerland and European markets with a similar industry risk profile, such as Germany, Austria, and France. This stems from limited business growth opportunities in Glarus, which already led to material expansion into business areas outside its home region. In our view, GLKB's primary focus on customer loan growth outside its home canton leads to more price-sensitive and therefore less stable client relationships, in particular during an economic downturn, compared with the stable and long-standing customer base in Glarus. However, thanks to the guarantee from the canton, we expect the bank's customer base in Glarus will continue providing it with a sustainable source of revenues.

We acknowledge that the bank has improved its regional diversification by offering selective online mortgages over the past years and note that GLKB recently announced its purchase of a portfolio of Swiss mortgages from a Swiss

insurance group in the amount CHF100 million-CHF150 million annually. While this will boost the bank's regional diversification, we still consider GLKB's regional concentration, in particular in mortgage lending, significant, especially when taken into account exposure to the nearby Canton of Zurich and Glarus' direct neighbors St. Gallen and Schwyz. This will continue to expose the bank's earnings to economic swings in the small economy of Glarus and its neighboring regions.

Under its current management GLKB has demonstrated sound and improving profitability with increasing revenues since 2009, and we expect it will continue to do so. However, GLKB still demonstrates slightly lower profitability ratios than cantonal peers and an above-average reliance on net interest income. Net interest income currently accounts for a high 78% of operating revenues, followed by fee income (14%) and market-sensitive income (8%), and we expect this revenue distribution will remain broadly stable in the coming years.

We observed enhancements in GLKB's cost-efficiency ratio by about 5 percentage points since 2015 and expect further slight potential for improvements to about 62%-65% over the next two years. We note, however, that ratio remains high relative to most of its main cantonal peers, with ratios typically at 50%-60%.

GLKB is also engaging as a vendor of its self-developed online mortgage platform solution, which comprises different modules including elements for granting and administering mortgages. While this supports our view that the bank is proactively executing strategic initiatives in order to cope with the changing landscape in the retail banking industry, we currently do not consider this business as sufficient to provide substantial diversification in terms of risk and earnings. We also believe that this initiative might cannibalize the bank's own online mortgage offerings to some extent, which could result in fewer growth opportunities than previous years.

Table 2

Glarner Kantonalbank Business Position					
	--Year-ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Total revenues from business line (mil. CHF)	58.4	74.5	66.7	64.8	57.1
Return on average common equity	7.0	6.5	5.9	6.9	6.1

*Data as of Sept. 30. CHF--Swiss francs.

Capital and earnings: Very strong capital remains a key rating strength

Our view of GLKB's capital and earnings as one of the main rating strengths is primarily based on our RAC ratio and our expectation that it will stay in the range of 22.5%-23.0% over the next 18-24 months, compared with 23% as of Dec. 31, 2017. The anticipated decrease in the RAC ratio mainly results from our expectation of 3%-4% annual growth in our risk-weighted assets in 2019 and 2020, which will exceed capital buildup through retained earnings over that period. However, this will still allow the bank to maintain a RAC ratio that is very strong in a global comparison.

GLKB's regulatory Tier 1 ratio stood at 17.5% at end-September 2018. In recent years, the bank has improved its capital base by several means to fund business growth. GLKB issued two additional Tier 1 (AT1) hybrid capital instruments totaling CHF200 million (notional) in 2015 and 2018 (replacement of 2012 issuance). Already in 2011, GLKB issued CHF40 million of subordinated convertible loans that can be converted into common equity in 2021, but which we do not currently take into account in our calculation of GLKB's total adjusted capital (TAC). In 2014, GLKB

increased its capital by a further CHF35 million and went public via an IPO. Glarus sold about 31.7% of shares to external investors.

The proportion of AT1 hybrid capital instruments in TAC is higher for GLKB (25%) than most cantonal peers, and we therefore assess GLKB's capital quality as weaker than peers'. However, this does not impair our overall very strong capital assessment.

In our base case, we forecast net income under Swiss accounting standards to range between CHF20 million and CHF25 million until 2020. We expect GLKB will maintain its dividend payout ratio at about 50%, and therefore to generate some internal capital to mitigate the negative impact on the RAC ratio from material customer loan growth. At the same time, we understand, that, unlike non-publicly traded banks, GLKB faces constraints in its ongoing buildup of capital, because it needs to provide its external owners with sufficient dividend payouts. As a risk mitigating factor, we are confident that the majority owner, Glarus, will remain supportive of GLKB's very strong capital position.

Table 3

Glärner Kantonalbank Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Tier 1 capital ratio	17.5	17.0	17.2	18.4	15.0
S&P Global Ratings' RAC ratio before diversification	N/A	23.0	23.3	N/A	N/A
S&P Global Ratings' RAC ratio after diversification	N/A	16.7	15.0	N/A	N/A
Adjusted common equity/total adjusted capital	75.2	75.2	75.2	75.2	79.8
Net interest income/operating revenues	78.3	75.2	74.0	74.7	75.9
Fee income/operating revenues	13.6	13.7	13.6	15.7	17.9
Market-sensitive income/operating revenues	7.0	9.5	9.2	8.4	6.0
Noninterest expenses/operating revenues	62.0	65.3	69.3	70.6	69.5
Preprovision operating income/average assets	0.5	0.5	0.4	0.4	0.4
Core earnings/average managed assets	0.4	0.4	0.3	0.4	0.4

*Data as of Sept. 30. N/A--Not applicable. RAC--Risk-adjusted capital.

Table 4

Glärner Kantonalbank Risk-Adjusted Capital Framework Data					
(CHF 000s)	Exposure*	Basel III RWA	Average Basel III RW (%)	S&P Global Ratings' RWA	Average S&P Global Ratings' RW (%)
Credit risk					
Government and central banks	548,371	6,063	1	891	0
Of which regional governments and local authorities	22,255	5,563	25	801	4
Institutions and CCPs	228,541	131,413	58	46,392	20
Corporate	502,066	378,800	75	364,237	73
Retail	4,389,066	1,884,788	43	1,081,949	25
Of which mortgage	4,239,111	1,749,500	41	983,050	23
Securitization§	0	0	0	0	0
Other assets†	0	0	0	0	0

Table 4

Glarner Kantonalbank Risk-Adjusted Capital Framework Data (cont.)					
Total credit risk	5,668,044	2,401,063	42	1,493,469	26
Credit valuation adjustment					
Total credit valuation adjustment	--	34,438	--	0	--
Market risk					
Equity in the banking book	9,776	61,100	625	73,320	750
Trading book market risk	--	14,363	--	21,544	--
Total market risk	--	75,463	--	94,864	--
Operational risk					
Total operational risk	--	121,538	--	152,243	--
		Basel III RWA		S&P Global Ratings' RWA	% of S&P Global Ratings' RWA
Diversification adjustments					
RWA before diversification		2,790,988		1,740,576	100
Total diversification/concentration adjustments		--		652,338	37
RWA after diversification		2,790,988		2,392,913	137
		Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings' RAC ratio (%)
Capital ratio					
Capital ratio before adjustments		473,492	17.0	400,267	23.0
Capital ratio after adjustments†		473,492	17.0	400,267	16.7

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. CHF--Swiss franc. Sources: Company data as of Dec. 31, 2017, S&P Global.

Risk position: Concentration in residential mortgage lending buffered by high collateralization

We consider GLKB's risk position to be in line with that of peer average operating in Switzerland and countries with similar economic risk profile, such as Austria, Belgium, the Nordics, or Japan. This is owing to its business model, which focuses mainly on well-collateralized residential mortgage lending, and to a lesser extent on lending to small and midsize companies and consumer financing based on prudential underwriting standards.

GLKB's loan book of CHF4.9 billion at end-September 2018 remains dominated by residential real estate loans in Glarus and neighboring regions, and will, in our view, continue to show sound asset quality. GLKB's mortgage loan portfolio represents more than 92% of the loan book, and consists mostly of loans collateralized by residential real estate loans (77% of total loans). Loans backed by commercial real estate account for about 15% of the total loan book.

Growth in customer loans has been significantly above the market at an average annual rate of about 6%-7% since 2010, also due to GLKB's increased focus on business opportunities in neighboring regions and its countrywide offering of selective online mortgage loans. Although GLKB's organic loan growth has slowed, we expect the loan book will continue to expand faster than the market average, also driven by the announcement to purchase a portfolio of Swiss mortgages from an insurer in Switzerland. We acknowledge that GLKB introduced slightly more conservative

underwriting standards in new mortgage lending outside its home economic area and maintains conditions that are more restrictive regarding the type of mortgages available on its online platform.

We consider that the regional focus of the loan book exposes the bank to concentration risks, which are partly offset by high collateralization of the mortgage loan portfolio (estimated average loan-to-value ratio of 55% for mortgage loans). We think that the housing price increases in Switzerland in the past heightened the risk of correction and subsequently could hamper GLKB's currently sound asset quality. Residential real estate price increases in Glarus have been lower than the Swiss average previously, but were above the Swiss average over the past few years. GLKB is also exposed in Swiss hot spots like Zurich, and we believe that there is some positive correlation between the housing markets in Glarus and Zurich, given their proximity.

Positively, GLBK mostly avoids complex products, and we expect the bank to maintain its sound underwriting practices in new mortgage lending, helping it to continue reporting low levels of nonperforming loans (NPL; 90 days past due) in its loan book (less than 0.1% as of end-2017). This supports our estimate that the cost of risk remain below 10 basis points over the next two years, slightly below our estimate for Swiss market. GLKB has limited market risk comprising mainly interest rate risk from mismatches in asset-liability management activities, but these are adequately hedged, in our view.

Table 5

Glarner Kantonalbank Risk Position					
	--Year-ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Growth in customer loans	3.1	4.2	7.2	9.5	8.0
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	37.5	54.5	N/A	N/A
Total managed assets/adjusted common equity (x)	19.4	18.7	18.1	17.5	16.2
New loan loss provisions/average customer loans	0.1	0.0	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.0	0.0	0.0	0.1	0.2

*Data as of Sept. 30. N/A--Not applicable. RWA--Risk-weighted assets.

Funding and liquidity: Below-average metrics, but funding stability is aided by the cantonal guarantee

We assess GLKB's funding as below average compared with domestic peers', but consider the bank's liquidity buffers as adequate.

We view the bank's funding profile to be weaker than that of most domestic peers, since we expect the ratio of customer loans to customer deposits will remain materially weaker than that of rated peers, with the ratio developing toward between 145% over the coming years. This indicates GLKB's higher dependency on wholesale funding sources, mainly through interbank funding and capital market funding, and a lack of sufficient stable customer deposits to fund ongoing material growth of the balance sheet. This exposes the bank to the risk of not being able to adequately replace maturing debt with new issuances during times of stress.

The bank's core customer deposits account for 65% of its funding base, however, due to the cantonal guarantee by its home canton, that we expect to remain very stable. We expect GLKB's stable funding ratio--S&P Global Ratings'

measure of available long-term funding relative to long-term funding needs--will remain below 100% over the next few years, after 96% at year-end 2017, which remains at the lower end compared with metrics of other rated cantonal banks.

Our assessment of GLKB's liquidity as adequate reflects our belief that GLKB benefits from its close ties with and the guarantee provided by the Canton of Glarus. We expect the bank to potentially benefit from a "flight to quality" effect in more challenging economic conditions. We see as supportive of liquidity the bank's loyal customer deposit base, and we do not expect deposits will be withdrawn in large amounts in times of stress. Moreover, we would expect GLKB to profit from any erosion of confidence at other Swiss financial institutions.

Our assessment also reflects our estimate of the bank's still adequate coverage of short-term wholesale funding sources of total funding by liquid assets (1.0x). However, most peer cantonal banks demonstrate materially stronger metrics and GLKB's weaker liquidity ratio mirrors the bank's relatively lower amounts of cash reserves held at central banks and, in our view, a smaller and less liquid security portfolio than peers. We also consider the risk that maturing debt issuances could drain a significant portion of GLKB's liquidity in a stress scenario. We see this risk as more pronounced than for peers, given the bank's small size but significant wholesale funding activities. Overall, we expect GLKB could operate for more than six months without access to market funding in an adverse scenario.

Table 6

Glarner Kantonalbank Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Core deposits/funding base	65.2	66.2	68.3	70.0	72.3
Customer loans (net)/customer deposits	139.3	141.3	141.5	137.0	133.8
Long-term funding ratio	86.3	86.0	88.0	90.4	93.0
Stable funding ratio	99.0	96.3	95.2	98.2	N/A
Short-term wholesale funding/funding base	15.0	15.4	13.2	10.6	7.6
Broad liquid assets/short-term wholesale funding (x)	1.0	0.8	0.7	1.0	N/A
Net broad liquid assets/short-term customer deposits	0.6	(4.3)	(5.5)	(0.4)	N/A
Short-term wholesale funding/total wholesale funding	39.1	41.4	37.3	31.4	25.9
Narrow liquid assets/3-month wholesale funding (x)	2.0	1.6	1.5	1.8	N/A

*Data as of Sept. 30. N/A--Not available.

External support: Extremely high likelihood of extraordinary local government support

We consider GLKB to be a GRE. The long-term rating on the bank is four notches above the SACP, reflecting our view that there is an extremely high likelihood of timely and sufficient extraordinary support from its major shareholder, the Canton of Glarus, if needed. We base this on our view of the bank's integral link with and very important role for the canton, despite the canton's reduced shareholding in GLKB as a result of the an IPO, and potential further dilution due to outstanding convertible bonds. According to cantonal law, the canton must hold more than 50% of shares and voting rights. Changes to the law would need to be approved through a referendum.

Our view on the likelihood of support is mainly based on GLKB's importance to the regional economy of the Canton of Glarus and the cantonal guarantee on all of the bank's liabilities, provided by cantonal law. We think a default by GLKB

would have a significant systemic impact on the local economy. We do not anticipate any change to the bank's current integral link with and very important role for the canton in the medium term.

We expect the existing cantonal guarantees to remain in place in the medium term. While being outside our outlook horizon, we consider the potential risk that future agreements between Switzerland and the EU regarding preferential market access for Switzerland might include the removal of remaining cantonal guarantees for all banks. In such a case, we may decide to lower or remove the GRE status of the bank, if we come to the conclusion that it weakened the role for, or link to, the canton.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Switzerland, Nov. 30, 2018

Anchor Matrix										
Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of January 25, 2019)

Glarner Kantonalbank

Issuer Credit Rating AA/Stable/A-1+

Issuer Credit Ratings History

09-Mar-2017 AA/Stable/A-1+

Sovereign Rating

Switzerland AAA/Stable/A-1+

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