

Credit Opinion: Arab Bank Australia Limited

Arab Bank Australia Limited

Sydney, New South Wales, Australia

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-1
Bank Financial Strength	D+
Issuer Rating	A3
Senior Unsecured MTN -Dom Curr	A3
Subordinate MTN -Dom Curr	Baa1
ST Issuer Rating	P-1
Other Short Term -Dom Curr	P-1
Parent: Arab Bank PLC	
Outlook	Stable
Bank Deposits -Fgn Curr	Ba3/NP
Bank Deposits -Dom Curr	A3/P-2
Bank Financial Strength	C+

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Key Indicators

Arab Bank Australia Limited

	[1]2008	2007	2006	2005	2004	Avg.
Total Assets (USD Millions)	946	769	689	643	789	[2]4.94
Total Assets (AUD Millions)	1,343	878	873	877	1,011	[2]6.31
Shareholders' Equity (AUD Millions)	107	105	103	100	88	[2]6.38
NPL/Shareholders' Equity & Loan Loss Reserves(%)	23.60	21.11	16.73	10.22	6.66	[2]53.95
Overhead Ratio (%)	77.35	91.22	83.80	71.82	58.16	[2]5.75
Shareholders' Equity/Total Assets (%)	8.01	11.91	11.79	11.35	8.68	[2]0.07
Pre-provision Profit/Avg Total Assets (%)	0.63	0.26	0.50	0.93	1.35	[2]-13.34
Liquid Assets/Total Assets (%)	32.55	16.14	12.84	7.08	10.52	[2]21.34
Total Risk-Weighted Ratio (CAR) (%)	13.73	18.81	18.37	15.90	18.32	[2]-5.58
"Non-Performing" Loans/Gross Loans (%)	2.87	3.06	2.31	1.29	0.72	[2]59.58

[1] As of December 31. [2] Compound annual growth rate.

Opinion

SUMMARY RATING RATIONALE

Moody's continues to assign ratings to bank obligations independent of the Australian government's guarantee of certain deposits and debt instruments. The rationale for these non-guaranteed ratings is discussed in this research report. Individual bank obligations that are covered by the government guarantee may separately be assigned "backed" ratings, on a case by case basis.

Moody's assigns a bank financial strength rating (BFSR) of D+ to Arab Bank Australia Limited, which translates into a baseline credit assessment of Baa3. The outlook is Stable.

The rating reflects the bank's niche franchise in the Arabic community in Sydney and Melbourne (and progressive expansion to the broader community), and ample capital ratios for its risk profile.

Besides a small subordinated debt issue to its parent, the bank is totally self-funded with around a quarter of total funding sourced from the issuance of short-term instruments such as domestic certificates of deposits, with the balance sourced from customer deposits.

However, the rating is constrained by its small market share resulting from strong competition, the bank's reliance on relatively high-cost term deposit funding, concentration risk arising from its smaller customer base, and overweight positions in construction and development finance.

The bank's long-term global local currency (GLC) deposit rating of A3 is based on the very high probability of support from Arab Bank Australia's parent, Arab Bank plc, and the low probability of systemic support, in case of need - which results in a 3 notch lift from the Baa3 baseline credit assessment. The short-term GLC deposit rating is Prime-1.

Support from the parent is highly likely given the shared branding. The parent also has a strong track record of providing support to its subsidiaries and has a very large pool of global liquidity, relative to the size of Arab Bank Australia.

With regards to the prospect for systemic support, Australia is considered a high support country but Arab Bank Australia is viewed as having low systemic importance, due to its small market share.

The bank's long- and short-term GLC issuer ratings - which address the risk of senior non-deposit obligations - and its senior debt ratings are also A3/Prime-1, reflecting the same support considerations as the deposit ratings.

Thus the deposit and debt ratings of Arab Bank Australia incorporate four main elements: (1) the bank's BFSR of D+, which addresses its stand-alone credit profile, (2) Moody's assessment of a very high probability of support from its parent (a component of joint default analysis, referred to as JDA), (3) Moody's assessment of a low probability of systemic support in Australia (also a component of JDA) and (4) the seniority of its deposits and other obligations.

The bank's foreign currency obligations are rated the same as its local currency obligations. Australia's sovereign ceilings for deposits and debt are at Aaa, and therefore do not constrain the bank's foreign currency ratings.

Credit Strengths

- [1] Credit enhancement provided by strong relationship with parent
- [2] Well established niche franchise
- [3] Large proportion of customer deposit funding
- [4] Ample capital ratios, with all profits retained to support the local franchise

Credit Challenges

- [1] Maintaining retail deposit growth levels
- [2] Risk-adjusted profitability impacted by competitive deposit pricing
- [3] Borrower concentration high on a global scale due to single large exposures to the property development and construction sector, as a percentage of pre-provision profit
- [4] Asset quality under pressure in a weaker economic climate

Rating Outlook

The outlook for Arab Bank Australia's BFSR is Stable. The bank's reasonably strong deposit base and relatively low reliance on the wholesale debt markets is a strength to its funding profile.

However, the slowing property sector, price competition from the major banks, together with borrower repayments, has resulted in housing loan growth below system growth. Prospects for loan growth rely to a significant extent on

a turnaround in the housing market, which may be possible from recent reductions in official interest rates and an addition to the first homeowners grant by the government. However, the speed of the turnaround is not expected to be fast.

Maintaining risk-adjusted profitability remains a challenge, as competition continues to pressure margins, particularly in retail deposits.

The stable outlook for Arab Bank Australia's deposit and debt ratings reflects our expectation that it will continue to enjoy strong support from Arab Bank plc if required. It also incorporates our expectation that the potential for systemic support will continue to be low, after the immediate crisis period is over, due to the bank being a small foreign-owned bank.

What Could Change the Rating - Up

Given the challenging economic environment, an upgrade to Arab Bank Australia's rating is not considered likely in the near-term.

What Could Change the Rating - Down

BFSR

[1] Erosion of its capital base, either through an increase in asset impairment, rapid asset growth, or dividend upstreaming to its parent

[2] A fall in the proportion of customer deposit funding resulting in greater wholesale funding reliance

[3] A significant rise in problem loans (defined as non-accrual loans and 90 days past due loans) as a percentage of pre-provision profit or as a percentage of shareholders equity and loan loss reserves

Deposits & Debt

[1] A downgrade of Arab Bank Australia's BFSR

[2] A downgrade of its parent's BFSR

[3] A lower systemic support assumption

Recent Results

For FY2008, Arab Bank Australia reported net profit of A\$4.8million, an increase of +348% or A\$3.4million from FY2007. The result was impacted by a gain from derivatives trading of A\$1.0million, an increase in foreign exchange earnings of +A\$0.7million, and recovery of GST of A\$0.9million.

Derivative financial instruments are used as part of the Group's trading activities, but mostly to hedge certain assets and liabilities.

Net interest income rose +10% in FY2008 and was lower than loan growth. This was mainly attributable to the faster increase in funding costs, with interest expense rising +34% compared to interest income of +13%.

The rise in commission and other fees of +23% also contributed to the increase in non-interest income.

Total assets were A\$1.343billion, up +54% from FY2007, with gross loans rising +24% to A\$893million, of which 41% related to housing loans. There were no securitised loans at FY2008.

The Tier 1 capital ratio stood at 10.2% at FY2008, compared to 14.3% at FY2007.

DETAILED RATING CONSIDERATIONS

Detailed rating considerations for Arab Bank Australia's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a BFSR of D+ to Arab Bank Australia. The BFSR scorecard outcome of C-, based on the FY2008 year only, is one notch above the bank's current assigned rating. The extremely challenging economic environment is unlikely to maintain the bank's fundamentals above its current assigned rating for a prolonged period.

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

Arab Bank Australia is a subsidiary of Arab Bank plc, which has extensive international operations. In Australia, the bank currently has 10 branches located in Australia's two largest cities, Sydney and Melbourne.

With a strong franchise position within the Arabic community in Australia, Arab Bank Australia focuses on establishing relationship banking connections with its customers. Whilst a substantial portion of its lending book continues to be towards this group, the bank has been able to diversify and grow its customer base outside this segment on the deposit side, with a large proportion of its deposit customers outside this group.

The bank is facing challenges to its franchise (i) strong retail deposit competition (ii) slowing housing market in NSW and VIC, where the majority of the bank's customers are located, is also impacting property development and construction

Referencing the scorecard, Arab bank Australia's overall franchise score of D accurately reflects the challenges to its business.

Factor 2: Risk Positioning

Trend: Neutral

Arab Bank Australia's risk positioning is supported by its controls and processes adopted under a risk management framework originated by the Arab Bank group. Its control framework is becoming more complex as the bank matures.

With reference to the scorecard, Arab Bank Australia continues to have relatively high borrower concentration levels, resulting in a subfactor score of E. This is mostly related to large property development and construction exposures.

In common with other Australian banks, Arab Bank Australia has very low levels of market risk.

Referencing the scorecard, the overall risk score of D is in line with the bank's rating.

Factor 3: Regulatory Environment

Trend: Neutral

All Australian banks are subject to the same score on regulatory environment. This factor does not address bank specific issues; instead, it evaluates whether regulatory bodies are independent and credible, demonstrate enforcement powers and adhere to global standards of best practices for risk control. Moody's views the Australian regulatory environment as a positive factor that provides a strong underpinning to Australian bank ratings. Please refer to Moody's Banking System Outlook for Australia to obtain a detailed discussion on the Regulatory Environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is also common to all Australian banks. Moody's assigns an A- for the overall operating environment. Economic volatility is low - although not the lowest amongst developed countries - and the country has a strong legal system with good enforceability of creditor claims. We see these factors as supporting average bank asset quality and profitability over economic cycles. Please refer to Moody's Banking System Outlook for Australia to obtain a detailed discussion on the Operating Environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Neutral

Arab Bank Australia's risk-adjusted profitability (measured as pre-provision, pre-tax profit as a percentage of average risk-weighted assets or after-tax net income as a percentage of average risk-weighted assets) has

improved in FY2008, after being under pressure particularly over the past couple of years.

Whilst lending growth has recovered, generating new lending volumes, the bank has been able to arrest the slide in interest margins, assisted by the repricing of risk by most lending institutions in Australia.

However, margin compression is still a challenge due to higher funding costs mostly driven by strong retail deposit competition. This is evident in the bank's interest expenses to average interest bearing liabilities growing at a faster than interest income to average interest earning assets, with the former rising 1.0% compared to the latter at 0.8% in FY2008.

The bank's profitability measures in both pre-provision profit to average risk-weighted assets and net income to average risk-weighted assets are at the bank's D rating level.

Factor 6: Liquidity

Trend: Neutral

Arab Bank Australia continues to be predominantly retail deposit funded, and focuses on growing its customer base outside its niche market through flagship term deposit products. The bank recently introduced a new high yielding at-call savings account to enable the bank to compete in that product segment.

Retail deposit growth was +47% in FY2008, with most improvement in 2H2008. The noticeable increases were during the bank's marketing campaigns targeting term deposits (commencing in July 2008) and at the introduction of the government deposit guarantee in October 2008 (in line with similar growth observed at other Australian banks).

The bank currently holds a considerable level of liquid assets, mostly invested in short term securities issued by Australian banks, although a growing proportion of these assets are being invested in government guaranteed securities with longer-dated maturities.

Access to the wholesale deposit market continues, through the bank's combined ECD, TD and MTN debt programme. The bank increased its issuance of domestic certificates of deposit in FY2008 as lending growth begun to rise again.

The government deposit and debt guarantee provide a strong backstop to Arab Bank Australia's funding and liquidity position. More importantly, Moody's also expects that they have underpinned market confidence sufficiently to allow the bank to return to a more sustainable funding profile in the mid-term.

Factor 7: Capital Adequacy

Trend: Weakening

Arab Bank Australia's regulatory ratios declined in FY2008, mostly driven by a sharp increase in risk-weighted assets of +31%, compared to loan growth of +24%.

The bank's Tier 1 capital was reduced by A\$9million (or 1.3 percentage points in the Tier 1 ratio), which related to a regulatory adjustment the bank received in previous years but no longer receives.

Any changes in the loan mix towards construction/development and commercial lending will likely see a disproportionate rise in risk-weighted assets which may have the effect of reducing the bank's capital ratios further. However for now they remain well above regulatory minimums.

Arab Bank Australia currently has A\$25million in subordinated debt from its parent, which qualifies as Tier 2 capital for regulatory purposes. A further injection of subordinated debt from its parent is expected during FY2009 to cover risk weighted asset growth.

Arab Bank Australia's present dividend policy means that all profits are retained in the business to support further growth. With reference to the scorecard, this has resulted in the bank holding a sound level of equity (most of which is core capital) which results in a subfactor score of B+.

Factor 8: Efficiency

Trend: Neutral

The bank's cost to income ratio reflects a bank of its size and niche franchise. Overall, expense management has been sound, with the bank reporting flat growth in FY2008.

The bank's cost to income ratio improved to 77.4% in FY2008 from 91.2% in FY2007 driven by higher operating income, which places the bank in the efficiency subfactor score of D.

To move into the higher subfactor score of C, the bank would need to improve its cost to income ratio below 55%.

Factor 9: Asset Quality

Trend: Weakening

Asset quality is declining for almost all Australian banks, in line with a weaker economic environment.

Arab Bank Australia's reported asset quality ratios showed improvement in FY2008 after declining in FY2007. The bank is susceptible to single impaired loans, which have the ability to make a noticeable impact to the asset quality ratios, highlighting the vulnerability single large exposures have to a bank of this size.

Whilst non-accrual loans remain very low at 0.1% of gross loans, Arab Bank Australia's 90 days past due loans, at 2.8% of gross loans, brings the bank's non-performing loans to gross loans ratio to 2.9%.

The bank has sound credit underwriting standards, with very low loan losses to date. The bank has taken a significant increase in charge for debt provisions in FY2008, reporting A\$759k specific and A\$135k collective compared to A\$69k and A\$64k respectively in FY2007. This had the effect of doubling provision expenses to pre-provision profit to 11.4% in FY2008 compared to 5.8% in FY2007.

With reference to the scorecard, Arab Bank Australia is within the subfactor score of C when measured by either non-performing loans as a percentage of gross loans or non-performing loans as a percentage of shareholders equity and loan-loss reserves.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's JDA analysis is used to assess the potential for systemic support during normal market conditions. Moody's will continue to incorporate this approach into its ratings of bank obligations that are not covered by the Australian government's guarantee Scheme for Large Deposits and Wholesale Funding. Guaranteed obligations will be assigned separate "backed" ratings where appropriate.

We view Australia as a high support country. Please refer to Moody's Banking System Outlook for Australia for a fuller discussion of systemic support and the government guarantee scheme.

Moody's assigns a global local currency (GLC) deposit rating of A3 to Arab Bank Australia Limited.

The GLC deposit rating is supported by the bank's Baseline Credit Assessment of Baa3, as well as the A3 Baseline Credit Assessment of its parent, Arab Bank plc, and the Aaa local-currency deposit ceiling (LCDC) in Australia. The bank receives a 3 notch uplift from its Baseline Credit Assessment, bringing the GLC deposit rating to A3.

Moody's expects a very high level of parental support from Arab Bank plc based on the following: (1) shared branding (2) the bank's small size means that providing assistance would not create a financial strain on the group (3) the parent has a strong track record of providing support to its subsidiaries.

The probability of systemic support in the event of a stress situation is judged to be low. This is based on Arab Bank Australia's national market share and relative importance to the country's banking system. Arab Bank Australia held market shares of less than 1% total deposits (excluding CDs and from financial corporations) and total loans at February 2009 (APRA data).

Additionally, the regulator's own Probability And Impact Rating System - which measures the systemic impact of the failure of an individual institution - uses asset size as a major input. Arab Bank Australia's relatively small asset size suggests it would score relatively low on this metric.

Although the Australian government has made it clear that support will be available to foreign banks as much as domestic banks during the crisis period, we believe that once market conditions have stabilised, the regulator may look to Arab Bank Australia's parent to be the primary source of support in case of need.

Foreign Currency Deposit Rating

The Foreign Currency Deposit ratings of Arab Bank Australia are unconstrained because Australia has a country ceiling of Aaa.

Foreign Currency Debt Rating

The Foreign Currency Debt ratings of Arab Bank Australia are unconstrained because Australia has a country ceiling of Aaa.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the GLC rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of government support for the bank in case a stress situation occurs and the degree of dependence between the issuer rating and the LCDC.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be reminded that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt obligations may also be constrained by the country ceiling for foreign currency bonds and notes, however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Arab Bank Australia Limited

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C-	
Factor: Franchise Value						D	Neutral
Market Share and Sustainability				x			
Geographical Diversification				x			
Earnings Stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						D	Neutral
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			x				
- Risk Management				x			
- Controls	x						
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness					x		
- Quality of Financial Information				x			
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management			x				
Market Risk Appetite	x						
Factor: Operating Environment						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C-	
Factor: Profitability						D	Neutral
PPP % Avg RWA - Basel II				0.84%			
Net Income % Avg RWA - Basel II				0.58%			
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) % Total Assets		-7.09%					
Liquidity Management			x				
Factor: Capital Adequacy						B+	Weakening
Tier 1 ratio (%) - Basel II		10.15%					
Tangible Common Equity / RWA - Basel II	11.46%						
Factor: Efficiency						D	Neutral
Cost/income ratio				77.35%			
Factor: Asset Quality						C	Weakening

Problem Loans % Gross Loans			2.87%			
Problem Loans % (Equity + LLR)			23.60%			
Lowest Combined Score (15%)					D	
Economic Insolvency Override					Neutral	
Aggregate Score					C-	
Assigned BFSR					D+	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information

[2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral

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