

Landesbank Baden-Württemberg Public-Sector Pfandbrief

Covered Bonds / Germany

Date

May 2007

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DEFINITIVE RATINGS

Cover Pool (€ million)	Ordinary Cover Assets	Covered Bonds (€ million)	Rating
80,221.6	Public-Sector Assets	68,243.5	Aaa

The ratings address the expected loss posed to investors by the legal final maturity. Moody's ratings address only the credit risks associated with the transaction. Other non-credit risks have not been addressed, but may have a significant effect on yield to investors.

SUMMARY

Moody's Investors Service has assigned definitive long-term ratings of **Aaa** to the bonds issued under the public-sector covered bond programme (Public-Sector *Pfandbriefe*) of Landesbank Baden-Württemberg (**Aa1/Prime-1**). As of March 2007 the value of the assets in the Cover Pool of Landesbank Baden-Württemberg ("LBBW" or Sponsor Bank) was €80.2 billion. The majority of the loans in the Cover Pool are claims against public-sector credit entities in Germany. Around 4% of the claims are against public-sector entities outside Germany.

Among others things, the ratings take into account the following factors: (1) the credit strength of the Sponsor Bank; (2) the German legal framework for *Pfandbriefe*; and (3) the credit quality of the Cover Pool.

As is the case with other covered bonds, Moody's considers the transaction to be linked to the credit strength of the Sponsor Bank, particularly from a default probability perspective. Should the Sponsor Bank's credit strength deteriorate – all things being equal – the rating of the Public-Sector *Pfandbriefe* may be expected to come under negative pressure. However, LBBW has the ability – but not an obligation – to commit voluntary enhancements to the transaction such as further over-collateralisation in order to increase the level of de-linkage to its credit strength.

STRENGTHS AND WEAKNESSES WITH MITIGANTS

Strengths

- The 2005 German *Pfandbrief* Act: There are a number of particular strengths to this well established law; these include:
 - The assets to be included in the Cover Pool are subject to conservative eligibility criteria. As a rule, claims directly against sovereigns or regional or local governments, and loans to or other claims against entities guaranteed by them, are eligible assets for Public-Sector *Pfandbriefe*.
 - A cover pool monitor (*Deckungsstocktreuhänder*) will monitor various operations with respect to the Cover Pool.
 - Under the *Pfandbrief* Act a minimum 2% stressed net present value (NPV) over-collateralisation has to be maintained at all times.



- A special cover pool administrator (*Sachwalter*) will be appointed in the case of insolvency of the Sponsor Bank and shall undertake the necessary administrative measures to satisfy those claims of the creditors of the Public-Sector *Pfandbriefe*. Further, this administrator may be appointed prior to the start of the insolvency procedure or liquidation of the Sponsor Bank.
- The Issuer: The Public-Sector *Pfandbriefe* are full recourse to Landesbank Baden-Württemberg (**Aa1/Prime-1**).
- The Cover Pool: The Public-Sector *Pfandbriefe* are supported by a Cover Pool backed by high quality assets. The majority of the claims are against public-sector credit entities, which have a good credit quality.
- A well established and deep market for German *Pfandbriefe*: This benefit can be seen, for example, by the use (in Moody's European Covered Bond methodology) of refinance margins that are relatively low compared with other jurisdictions.

Weaknesses with Mitigants

- In common with most covered bonds, the probability of default of the Public-Sector *Pfandbriefe* is expected to be linked to that of the probability of Sponsor Bank Default. Following the insolvency of the Sponsor Bank, the support of the covered bond issuer diminishes, which affects the pool management in several ways including the following:
 - Principal redemption: The duration of the assets may be longer than the duration of the Covered Bonds. Therefore, following Sponsor Bank Default,¹ investors may need to rely on the proceeds from the sale of all or part of the Cover Pool, or on liquidity borrowing or other forms of funding for repayment before final maturity.
 - Liquidity: the Sponsor Bank does not benefit from any designated source of liquidity if cash flow collections are interrupted, which could affect ongoing interest payments or principal redemption of the Covered Bonds.

Mitigants: Moody's has considered stressed scenarios which include, among other things, the sale of the Cover Pool at stressed refinancing margins. Furthermore, according to the *Pfandbrief Act*, the NPV of the Cover Pool has to exceed the NPV of the outstanding Covered Bonds by at least 2% (over-collateralisation). This over-collateralisation has to be maintained at all times and also in stressed scenarios, i.e. shift of the yield curve and stressed foreign exchange rate movements. The interest yielded by the assets has to be at least as high as that owed to the Covered Bonds.

- As of March 2007 the Cover Pool is concentrated with respect to the following aspects: (i) geographical concentration: around 96% of the claims are against public-sector entities, which are situated in Germany; (ii) obligor concentration: the 20 largest obligors account for around 39% of the total loan balance of the public-sector loans of the Cover Pool. These facts increase the probability of significant defaults.

Mitigants: Moody's public-sector calculator takes into account the impact of concentration on borrower, regional, and country levels.

- As with most Covered Bonds in Europe, there are few restrictions to limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk. **Mitigants:** The quality of the Cover Pool over time will be protected by, among others, the requirements of the *Pfandbrief Act* which sets out rules detailing which assets qualify as ordinary cover assets for Public-Sector *Pfandbriefe*. In addition, Moody's will monitor the Cover Pool. If the quality of the collateral deteriorates, the Sponsor Bank would have the ability, but not an obligation, to increase the over-collateralisation in the Cover Pool. Failure to increase levels of over-collateralisation following a marked deterioration of the collateral may have an impact on the ratings.

¹ Sponsor Bank Default is defined in Moody's rating methodology for European Covered Bonds as removal from the Cover Pool of (i) support provided by entities within the Issuer/Parent group, (ii) ancillary activities of the Issuer/Parent group (i.e. those not related to the Cover Pool) and (iii) usually, management functions of the Issuer.

STRUCTURAL AND LEGAL ASPECTS

LBBW issues Public-Sector Pfandbriefe and Mortgage Pfandbriefe

As a public-sector bank, LBBW used to issue Covered Bonds in accordance with the provisions of the “Act relating to Pfandbriefe and Similar Instruments issued by Public Sector Institutions”.² Following the implementation of the Pfandbrief Act in July 2005, LBBW set up two Covered Bond programmes – a Public-Sector Pfandbrief (Öffentlicher Pfandbrief) and a Mortgage Pfandbrief (Hypothekenspfandbrief) programme – which are compliant with the Pfandbrief Act. LBBW is one of the largest public-sector covered bond issuers in Germany. LBBW will continue to issue Public-Sector Pfandbriefe on a regular basis, in each case constituting direct, unconditional and senior obligations of the Sponsor Bank.

Banks require licence from German FSA to start Pfandbrief Business

The German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or *BaFin*) grants licences for Pfandbrief issuers. The granting of the licence for Public-Sector Pfandbrief business is contingent upon the Sponsor Bank meeting certain requirements under the Pfandbrief Act. This includes requirements on procedures and risk management systems to manage, monitor and control the risks for the Cover Pool and the issuance of Pfandbriefe.

Key characteristics of the German Pfandbrief Act

Moody's understanding from legal and industry advisors is that the key characteristics of the Pfandbrief Act include the following:

- Many of the operations in respect of the Cover Pool are monitored by an independent cover pool monitor (*Deckungsstocktreuhänder*).
- The Pfandbrief Act obliges the Sponsor Bank to *inter alia* manage the market risk of the cover pool by a minimum over-collateralisation of 2% on a stressed NPV basis. This is also monitored by the cover pool monitor.
- The Cover Pool is composed of claims against public-sector entities or claims backed or guaranteed by public-sector entities. The Pfandbrief Act sets out geographic restrictions, including public-sector debt against public-sector entities originating from Member States of the European Union (EU) or from another Contracting State to the Agreement on the European Economic Area (EEA), Switzerland, the United States of America, Canada and Japan – all of which qualify as cover assets. In addition, claims against European States which are full members of the Organisation for Economic Cooperation and Development but not Member States of the EU or EEA also qualify.
- *BaFin* has established a reporting mechanism, whereby the bank has to report key figures on a regular basis (including over-collateralisation). Furthermore, *BaFin* will conduct audits of the Cover Pool (*Deckungsstockprüfung*) on a regular basis (at least once every two years).
- At Sponsor Bank Default, or earlier, if *BaFin* sees a need for this, a special cover pool administrator (*Sachwalter*) will take over management responsibility of the programme. The *Sachwalter* acts independently from the Insolvency Administrator of the Sponsor Bank, and his duty of care is to the Pfandbrief investors. Having an independent cover pool administrator may reduce potential conflict of interest between the Pfandbrief investors and other creditors.
- The *Sachwalter* is expected to run the programme until the maturity of the last Covered Bond; only in the case of insolvency of the Cover Pool is the programme expected to be accelerated. Upon acceleration, the Pfandbrief investors will rank on a *pari passu* basis.

Regular cover pool audits

At or before Sponsor Bank Default, the Sachwalter will take over management responsibility of the programme

Having an independent Cover Pool administrator may reduce potential conflict of interest between the Pfandbrief investors and other creditors

MOODY'S RATING METHODOLOGY

The approach used by Moody's for rating covered bond transactions is detailed in the agency's rating methodology.³ The impact of the credit strength of the sponsor bank, quality of the collateral, refinancing and market risks are considered below.

² Gesetz über die Pfandbriefe und verwandte Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten, ÖPG.

³ “Moody's Rating Approach to European Covered Bonds” published in June 2005 (see Related Research)

Key factors for LBBW's senior unsecured rating

1) Credit Strength of the Sponsor Bank

The Public-Sector Pfandbriefe are full recourse to LBBW. The (unguaranteed) **Aa1/Prime-1** ratings of LBBW are based the bank's own Baseline Credit Assessment of A2 and the assumption that the probability of (i) cross-sector support from German public-sector banks, (ii) support from its public-sector owners, most prominently the State of Baden- Württemberg (rated **Aaa**), the City of Stuttgart (unrated) and the savings bank association of Baden- Württemberg (unrated) and (iii) systemic support is very high.

The Bank Financial Strength Rating of C+ derives from LBBW's strong regional franchise in both commercial and retail banking, good risk management capabilities, and a sound financial profile, but also factors in high borrower concentrations - which are driven by its business model.

For more information on the fundamental credit quality of the Sponsor Bank, please see Related Research: Moody's latest Credit Opinion on LBBW, published in May 2007.

2) Quality of the Collateral

As of March 2007 the Cover Pool comprises loans or bonds to 3,441 borrowers (public-sector entities or loans guaranteed by public-sector entities). These claims add up to a volume of €80.2 billion, including substitute assets worth €1.3 billion. The nominal value of LBBW's currently outstanding Public-Sector Pfandbriefe amounts to €68.2 billion. On a nominal basis these numbers translate into an over-collateralisation of 17.6%.

Total cover pool volume amounts to €80 billion

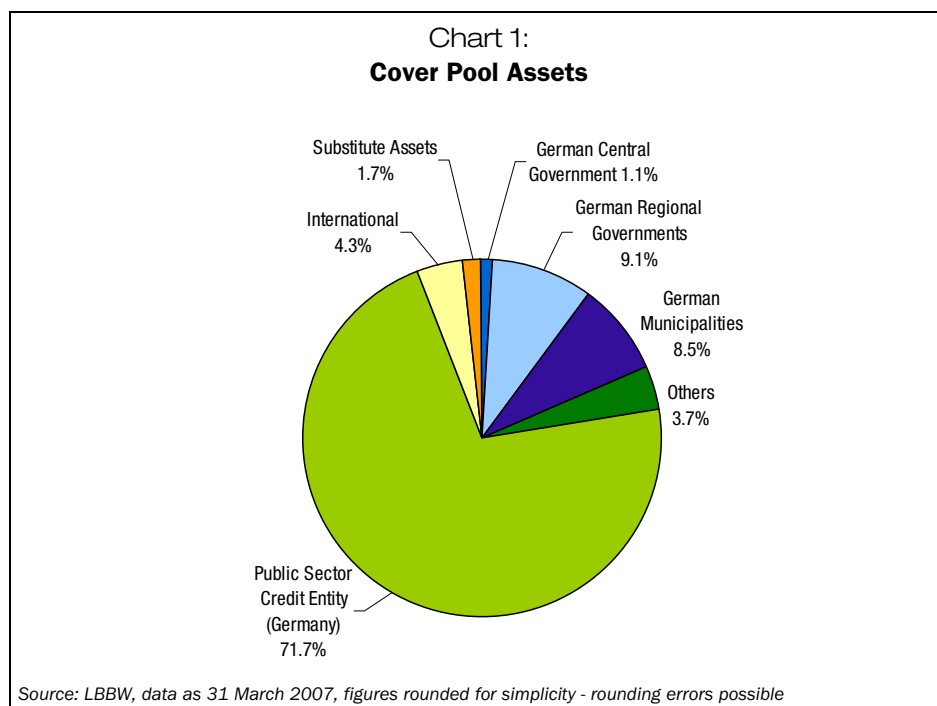
Table 1:

Overview Cover Pool Assets

	Cover Assets
Total pool (€ million)	80,221.6
Number of borrowers	3,441
Average exposure to borrower (€ million)	23.3

Majority of the pool assets are claims against public-sector credit entities

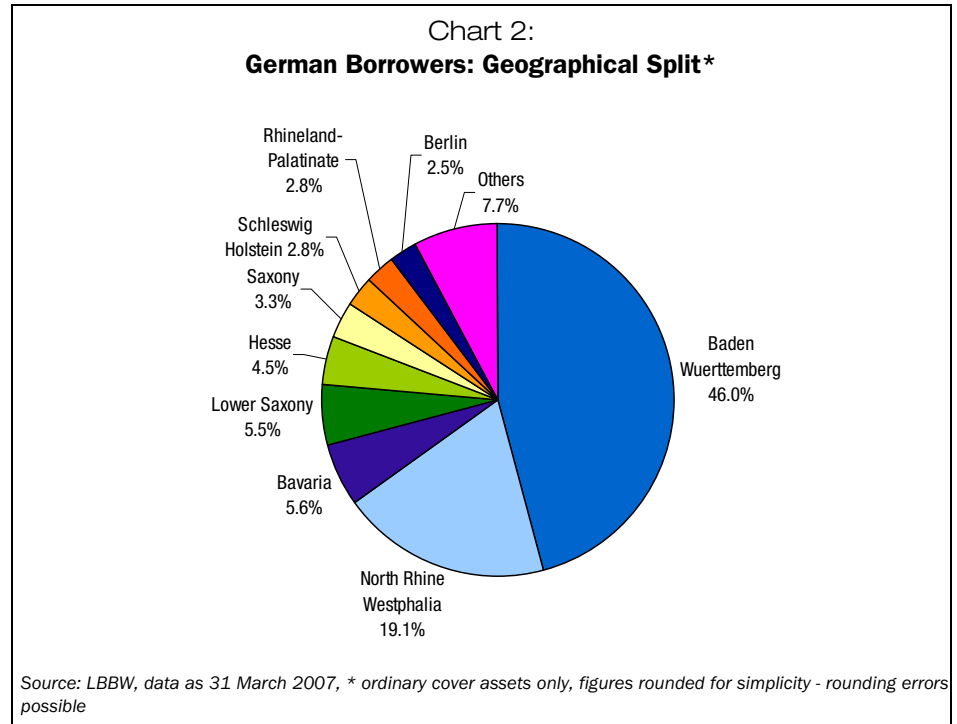
The majority of the ordinary cover assets are claims against public-sector credit entities in Germany. The claims are, for example, loans to German Savings Banks, which are still backed by the guarantees of their municipal owner (*Gewährträgerhaftung*). The portion of the ordinary cover pool assets reported as "Others" in the chart below include, for example, loans to public-sector agencies or institutes which benefit from a public-sector guarantee.



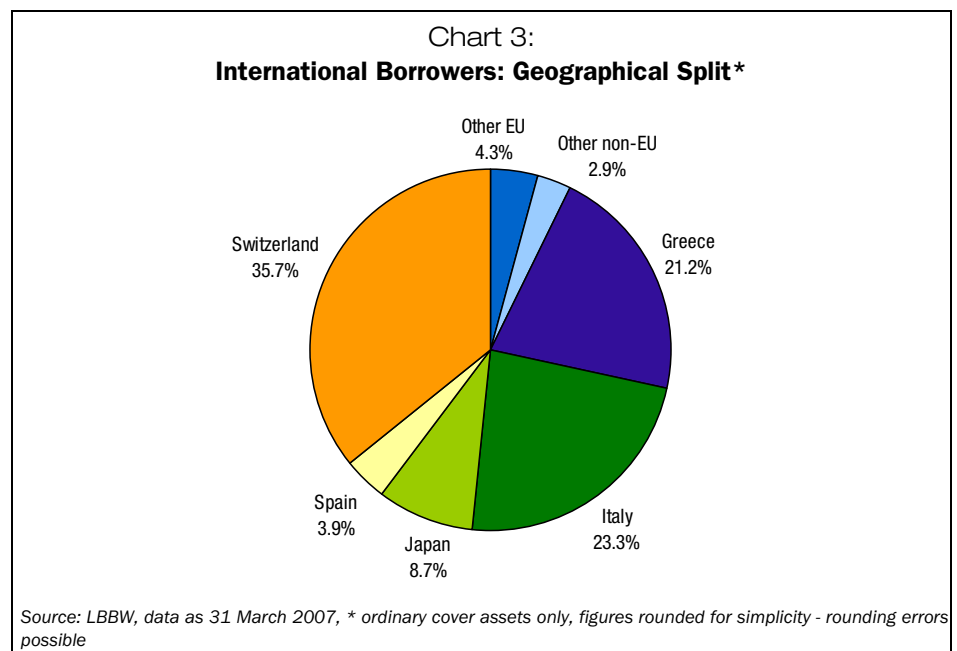
Majority of the public-sector assets are from Germany

The credit quality of the Cover Pool as of March 2007 is good. The current ratings for Moody's-rated public-sector entities were applied accordingly. However, not every borrower is rated by Moody's. Therefore, a rating estimate was used for those public-sector entities that have no Moody's rating assigned.

The geographical focus of LBBW's cover pool for the Public-Sector Pfandbrief is Germany, where the vast majority of obligors are situated. The German public-sector borrowers account for around 96% of the volume of ordinary cover assets. Within Germany, the claims against public-sector entities situated in Baden Wuerttemberg, North Rhine-Westphalia, Bavaria and Lower Saxony account for the majority of the German assets.



The public-sector assets outside Germany currently include claims against public-sector entities from 12 different countries, with Greece, Italy and Switzerland accounting for around 80% of the non-German ordinary cover assets as of March 2007.



From a credit perspective, Moody's sees the following characteristics of the Cover Pool as positive:

High credit quality of ordinary cover assets

- In general, public-sector loans can be associated with a low expected loss in the event of a payment disruption on the loan. This is reflected in the credit ratings of LBBW's Cover Pool assets.
- Within Germany, the claims against public-sector entities are spread among more than 3,000 different borrowers.

From a credit perspective, Moody's regards the following portfolio characteristics as negative:

Some borrower concentration

- Borrower concentration: The 10 largest obligors account for around 25.7% of the ordinary cover pool assets, and the 20 largest account for 39%.
- Country concentration: The majority of the public-sector entities are located in Germany. These entities account for around 96% of the volume of the ordinary cover pool assets.

The above-mentioned factors have been incorporated into Moody's analysis. The result of the Cover Pool analysis is the Collateral Score.⁴ Moody's calculates a Collateral Score based on the credit quality of the public-sector loan pool using a Monte Carlo simulation. For this transaction, Moody's calculated a Collateral Score of 4%, based on the information available on the current pool.

Substitution risks are mitigated by the Pfandbrief Act

As with most Covered Bonds in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk. Mitigants to substitution risk which should protect the quality of the Cover Pool over time include:

- Requirements of the *Pfandbrief Act*.
- The Cover Pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, the Sponsor Bank would have the ability, but not an obligation, to increase the over-collateralisation in the Cover Pool in order to support the current rating. Failure to increase levels of over-collateralisation following a marked deterioration of the collateral may have an impact on the ratings.

Lower refinancing stresses due to level of support provided in the German Pfandbrief market

Where the "natural" amortisation of the Cover Pool assets alone cannot be relied on to repay principal, Moody's assumes that funds must be raised against the Cover Pool at a discount.

Further, due to the depth of the German market and high level of support provided to *Pfandbriefe* in Germany, in the modelling of this transaction Moody's has used refinance margins for public-sector assets which are lower than refinance margins for public-sector assets in other jurisdictions. Specifically, for German *Pfandbriefe* Moody's does not apply the Refinance Stress multiples – which add additional refinancing stress for refinancing transactions – which must be completed within a period of four months following Sponsor Bank Default.

4) Market Risk

Following Sponsor Bank default the transaction may have exposure to increases in interest rates

As with the majority of European Covered Bonds there is potential for market risks. For example, following Sponsor Bank Default, Covered Bond investors may be exposed to interest risk, which may arise from the different payment promises and durations made on the Cover Pool and the Covered Bonds. Following Sponsor Bank Default, the Moody's Covered Bond Model looks separately at the impact of increasing and decreasing interest rates on the expected loss of the Covered Bonds, and takes the path of interest rates that leads to the worst result.

Majority of public-sector debt in the cover pool have a fixed rate

Around 79% of the cover pool assets and 88% of the outstanding Public-Sector *Pfandbriefe* have a fixed rate. The majority of the LBBW's Public-Sector *Pfandbriefe* and cover pool assets are denominated in euros. For non-euro liabilities, the majority of these liabilities are reasonably well matched against same-currency assets. However, there is a small amount of currency risk in this transaction as of March 2007, so in its analysis Moody's has assumed a small (3%) currency mismatch across this programme.

⁴ The Collateral Score can be seen as the amount of risk-free enhancement required to protect a Aaa rating from otherwise unsupported assets - so the stronger the credit quality of the collateral the lower the collateral score. This only considers the credit deterioration of the assets and ignores any risk from refinancing and market risk (see Rating Methodology "Moody's Rating Approach to European Covered Bonds").

The German *Pfandbrief* Law requires *Pfandbrief* issuers to run regularly stress tests regarding interest rate and foreign exchange rate risks. LBBW has opted for the static approach to meet this regulatory requirement. This approach stresses, for example, the interest rates by a parallel upside and downside shift of the yield curve of 250 basis points. As of April 2007, LBBW did not enter a single swap into the cover pool register of its Public-Sector *Pfandbrief*.

The exposure to interest rates risk is mitigated by the mandatory NPV test, taking stressed interest rates scenarios into consideration

The result of Moody's calculations was that the more stressful scenario is currently one of increasing interest rates, as a potential sale of fixed-rate assets would lead to a crystallisation of interest rate losses. Interest rate risk is partially mitigated by the over-collateralisation based on the stressed NPV calculation required by the *Pfandbrief* Act. Moody's has given value to an interest rate stress of 250 basis points reflecting a parallel downside and upside shift on the swap rates. However, the NPV test applied by the Sponsor Bank does not completely immunise the assets against interest rate movements. When modelling interest rate shifts, Moody's applied stresses in its approach exceeding this level.

In the case of insolvency of the Sponsor Bank, Moody's does not currently assume that the special cover pool administrator (*Sachwalter*) will always be able to efficiently manage any natural hedge between the Cover Pool and the Covered Bonds. Moody's is continuing to review whether this approach is unduly conservative.

DE-LINKAGE

The creditworthiness of the Covered Bonds will be affected by the credit strength of the Sponsor Bank and the Cover Pool

All Covered Bonds have an element of rating linkage to (a) the transaction counterparties and (b) the supporting collateral. In other words, the creditworthiness of the Public-Sector *Pfandbriefe* of LBBW will be affected by the credit strength of the Sponsor Bank and the value of the Cover Pool.

There are a number of other areas of linkage that affect most Covered Bond transactions, and these include:

- Refinancing risk. Following Sponsor Bank Default, if principal receipts from collections of the Cover Pool are not sufficient to meet the principal payment on a Public-Sector *Pfandbrief*, funds may need to be raised against the Cover Pool. However, the fact that the Sponsor Bank has defaulted may negatively impact the ability to raise funds against the Cover Pool.
- The dynamic nature of the transaction up until Sponsor Bank Default. For example, prior to Sponsor Bank Default new assets may be added to the Cover Pool, new bonds issued, and new hedging arrangements entered into.
- More generally, by the incorporation of the credit strength of the Sponsor Bank in Moody's rating method.

The probability of default on the Public-Sector *Pfandbriefe* may be higher than expected for **Aaa** rated senior unsecured debt. However, Moody's primary rating target is the expected loss which also takes severity into account, which in this case is consistent with a **Aaa** rating. Furthermore, the Public-Sector *Pfandbriefe* will come under increasingly greater rating stress as the Sponsor Bank's credit strength deteriorates. This is a consequence of the linkage of the transaction to the probability of default of the Sponsor Bank.

The following are selected features of the Public-Sector *Pfandbriefe* that reduce the linkage of the Covered Bonds to the credit strength of the various transaction parties and the collateral.

Mitigants to linkage include the mandatory requirement by law to hold a minimum of 2% over-collateralisation under the stressed market conditions

Mitigants to linkage to the collateral include:

- The legal nominal matching cover test and the requirement to hold a minimum of 2% over-collateralisation on a "stressed" NPV basis.
- The pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, LBBW would have the ability, but not an obligation, to ask Moody's to increase the level of over-collateralisation that Moody's relies on in its analysis.

The above-mentioned provisions should mean there is substantial value in the Cover Pool at the time of Sponsor Bank Default.

Mitigants to linkage to LBBW include:

From an expected loss perspective:

- i) The quality of the Cover Pool at the time of Sponsor Bank Default (see above)
- ii) The segregation of the Cover Pool from the insolvency estate of the Sponsor Bank

From a timeliness of payment perspective:

The level of support that the German legislation provides to mitigate any delay of payments on the Public-Sector *Pfandbriefe* following a Sponsor Bank Default – this includes the following:

- i) The *Pfandbrief Act* offers a variety of ways in which financing can be achieved against the Cover Pool, including complete and partial sales of the Cover Pool and raising liquidity against the Cover Pool
- ii) A special cover pool administrator or *Sachwalter* may take over management responsibility of the programme before Sponsor Bank Default

The *Sachwalter* acts independently from the Insolvency Administrator of the Sponsor Bank, and his duty of care is to the *Pfandbrief* investors. Having an independent cover pool administrator may reduce potential conflict of interest between the *Pfandbrief* investors and other creditors.

MONITORING

Moody's will monitor the transaction on an ongoing basis to ensure that it continues to perform in the manner expected, including checking all supporting ratings and reviewing the assets on an ongoing basis. Any subsequent changes in the rating will be publicly announced and disseminated through Moody's Client Service Desk.

RELATED RESEARCH

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions please refer to the following reports:

Rating Methodology

- Moody's Rating Approach to European Covered Bonds, English version, June 2005 (SF57011)
- Moody's Rating Approach to European Covered Bonds, German translation, July 2005 (SF58550)

Special Report

- 2006 Review and 2007 Outlook EMEA Covered Bonds: Dramatic Growth Recorded in 2006, and Trend to Continue as Market Diversifies in 2007, January 2007 (SF89507)
- European Covered Bond Legal Frameworks: Moody's Legal Checklist, English version: December 2005 (SF66418)
- European Covered Bond Legal Frameworks: Moody's Legal Checklist, German translation, January 2006: (SF67969)

Credit Opinion

- Moody's Global Credit Research – Credit Opinion: Landesbank Baden-Wuerttemberg, 17 May 2007

Analysis

- Landesbank Baden-Wuerttemberg, June 2006 (97947)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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