

## Asian Sovereigns To Remain In Debt Markets

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It is often said that an orderly retreat from battle is in many ways harder to orchestrate than an advance. As sovereigns in Asia consider exit strategies from economic stimulus programs, Standard & Poor's Ratings Services anticipates that they will seek to strike a balance to prevent a derailing of the still-nascent recovery. In our view, governments will need to retreat from economic stimulus in a measured fashion while keeping administrative controls in place to avoid potential asset price bubbles and inflation. In addition, almost all sovereigns in the region have borrowed in order to support their stimulus programs, but some have also relied on credit-based measures as a partial substitute for larger amounts of direct sovereign borrowing. We believe that the potential onset of a second broad global economic slowdown could constrain available policy options at the same time that renewed support measures would become necessary.

Standard & Poor's expects that sovereign commercial issuance in Asia during 2010 will likely outpace 2009 levels by 5%, as fiscal improvement lags the nascent economic recovery and policy support remains necessary. This follows a jump in the overall average deficit for the region in 2009, which we estimate to be about 5% for the year, up from nearly 3% in 2008. According to Standard & Poor's survey of borrowing and debt, sovereign requirements for 2010 are likely to bring commercial issuance in the region to US\$2.2 trillion.

### ***Sovereign Fiscal Deficits May Soon Peak***

In Standard & Poor's view, the strong economic rebound in Asia compared with other regions should eventually prove to be a boon for sovereign fiscal trends (see tables 2-3). This recovery faces risks though. Among them, a reversal in perceptions of emerging market risk because of events outside of the region and potential fiscal demands above forecast deficits. Despite

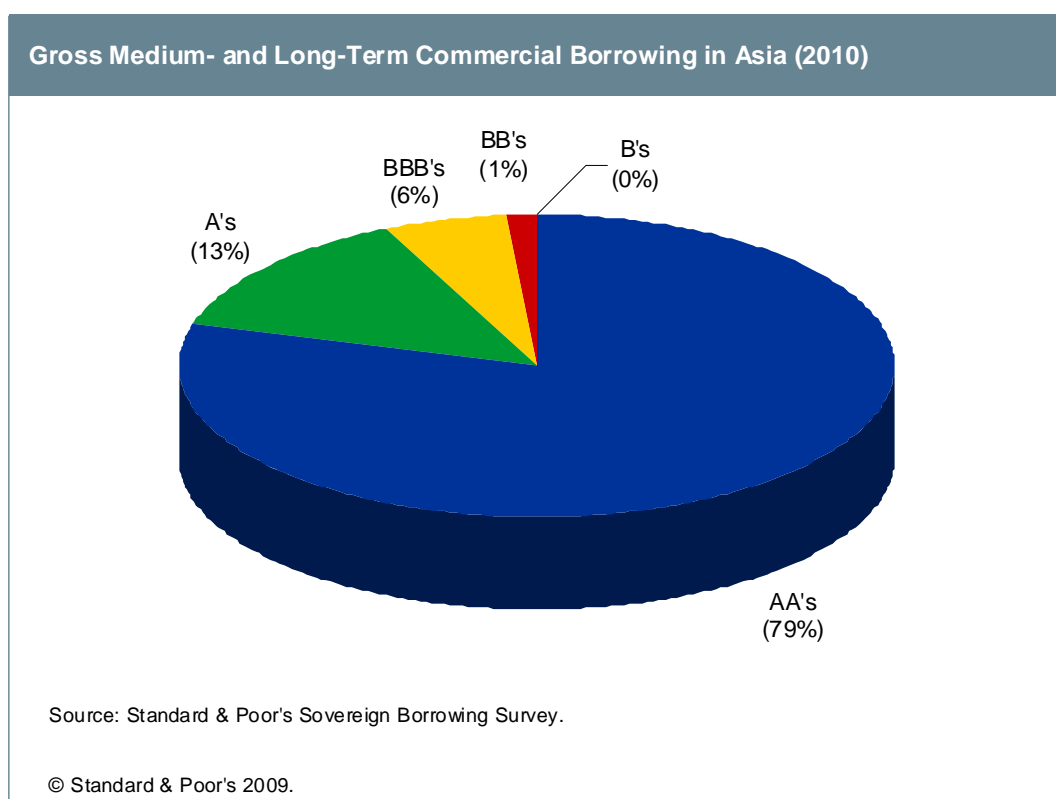
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increased sovereign commercial borrowing in 2010, we expect the average forecast deficit to drop from a cyclical peak of just over 5% to just under 4% for the year. (See table 1.)

Excluding the outsize contribution of Japan to the total, we expect commercial issuance from the rest of Asia to be about US\$471 billion. This will raise the overall total of outstanding short-term and long-term commercial debt of Asia-Pacific governments to an estimated US\$7.1 trillion. We believe that the test for sovereigns in the coming year will be managing macroeconomic crosscurrents while stimulus-based policies are still in place, despite worries over asset and consumer price trends. Longer term, the prospect of lingering deficits, combined with the significant downside risks of a second slowdown in global growth, raises questions about debt sustainability for a number of sovereigns in the region and the implications of borrowing plans on ratings.

Chart 1

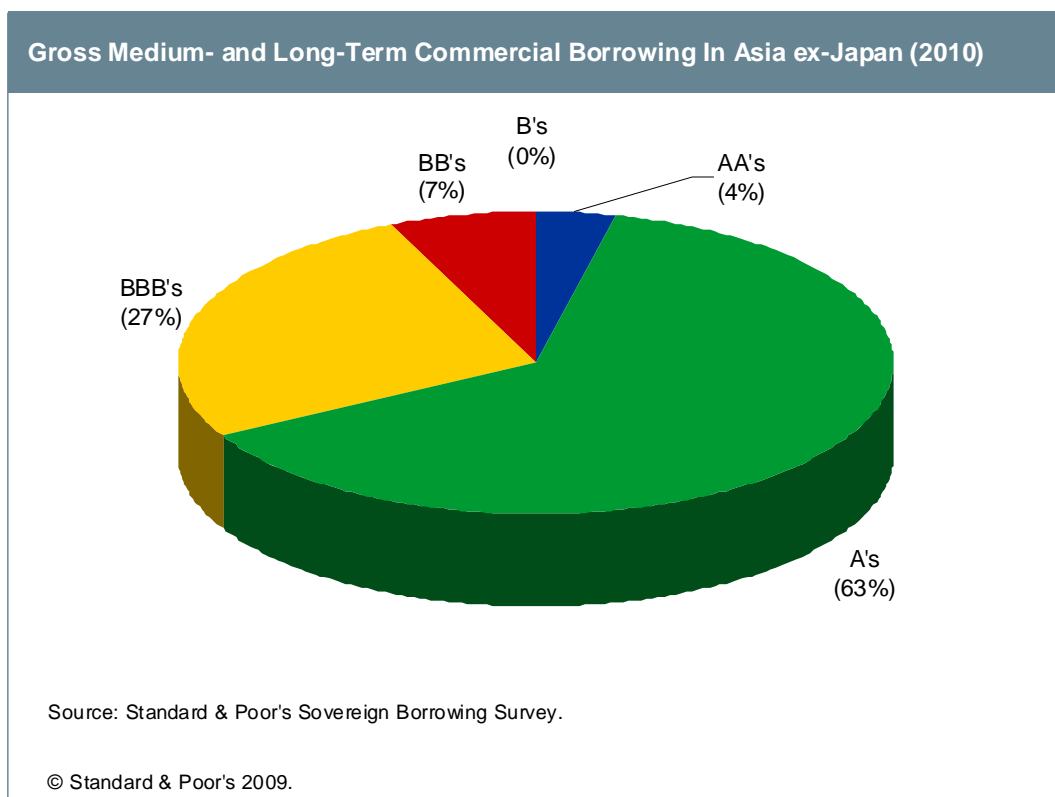


The sovereign borrowing story in Asia has always varied depending on whether one includes or excludes Japan from the calculations. We expect Japan's debt issuance to account for about 80% of the regional total for 2009 and 2010. Some might point to structural similarities in the industrial economies in the rating category of sovereigns that have been active issuers during the past year, such as Korea and China. However, these countries' respective fiscal trajectories do not, thus far, presage a Japan-style outcome. Excluding Japan, we expect issuers in the 'A' to 'AAA' rating category to account for 62% of medium- and long-term sovereign commercial issuance during 2010.

We expect 'A' rated sovereigns to issue a majority of regional debt during 2010. We estimate China and Korea's portion at 39% and 17%, respectively, of the total market. However, 'BBB' rated sovereigns should make up a larger portion of debt issuance, with projected gross commercial

borrowing increasing by 39% compared with 2009 levels. We expect that 'BBB' rated sovereigns' debt issuance will account for 26% of the overall market by the end of 2010, excluding Japan. As a result, future rating outcomes in this category will have an impact on the overall size of Asia's investment-grade market.

Chart 2



Standard & Poor's believes that ultra-loose monetary policies from major central banks around the world have helped fuel high domestic liquidity. We expect this trend to continue through at least the middle of 2010, and renewed appetite for emerging market risk has amplified the effect of these policies. This has helped to lower sovereign spreads relative to U.S. Treasuries and those for corporate issuers perceived to have strong ties to government. Higher levels of inflation or risks to the nascent recovery could reverse these trends, however, and make funding in 2010 more costly than during 2009.

According to the Asian Development Bank (ADB), sovereign issuance in the region tilted in favor of shorter maturities earlier this year to take advantage of favorable pricing at the shorter end of the yield curve, an advantage that went away in many markets during recent months as curves have flattened. If expectations on inflation shift and result in policies that cloud the outlook for the regional and global recovery, both funding availability and the fiscal outlook for sovereigns in the region could change significantly.

A key question for the region is whether the effect of borrowing trends for 2009 and 2010 will shift perceptions of sovereign risk should the global economic recovery falter. Another important dimension is the path of the U.S. dollar, which has generally weakened as a function of improving sentiment in Asia and elsewhere and has helped to fuel the search for yield in the region.

### ***In Search Of The Right Policy Mix***

The apparent contradiction between the words and actions of regulators in the region reflects unique global monetary circumstances. In our opinion, the recovery remains fragile, and steps are still necessary to prevent inflation, asset price bubbles, and unproductive investment.

Thus far, regulators in the region have favored administrative measures to interest rate increases in order to target inflation and asset prices while maintaining a policy stance that supports real economies. This is perhaps most apparent in India, where the Reserve Bank of India (RBI) has increased the proportion of deposits that commercial banks must put into holdings of government securities, increased provisioning requirements for loans issued to real estate companies, and suspended several special refinance facilities. China's recent implementation of increased provisioning requirements for commercial banks, sector-specific lending controls, and other administrative measures to direct the flow of credit despite the stated need for sustained policy support for the coming year reflects similar concerns.

Given that sovereign debt issuance is likely to remain active during the coming year, if not managed properly, the prudential policy mix could run the risk of crowding domestic intermediaries into government debt, and in the process partially crowd out private issuers and borrowers whose investment has helped to drive the recovery thus far. The extent of liquidity on financial institutions' balance sheets has been one area of focus for reforms to prudential regulation (regulation that aims to ensure the safety of depositors' funds and keep the stability of the financial system). Proposals that would require banks, and potentially other financial institutions, to maintain minimum levels of liquid assets, have already surfaced. Under general zero-risk weighting formulas, sovereign or quasi-sovereign debt would probably be an easy means to meet such a requirement.

However, one unintended consequence of such regulations might be that under a reasonable stress scenario—a combination of economic recession and rising sovereign deficits—price volatility for concentrations of “risk-free” assets on domestic financial institutions' balance sheets could cancel out the intended benefits of this aspect of tighter scrutiny. Overall, the potential for moral hazard resulting from regulatory-induced demand and a stronger feedback loop between sovereign finances and domestic financial sector health cannot be ignored. Such a relationship was likely one element of the dysfunction of the credit channel in Japan during the “lost decade.”

### ***Corporate Debt Markets In The Region Remain Small***

The sustained decline in reference sovereign bond spreads has been a welcome trend for corporate issuers in the Asia-Pacific region during much of this year, though domestic buyers continue to dominate these markets. For developed and emerging market sovereigns in the region alike, a combination of explicit and implicit support for corporate issuance—combined with high liquidity stemming from low policy rates and strong increases in yield-seeking foreign capital inflows—has helped to keep domestic capital markets open to key corporate issuers. In many markets, this includes state-owned enterprises (SOE) or conglomerates with strong government backing. As the ADB recently noted, corporate issuance rose 30.3% year-over-year at the end of the third quarter in local-currency terms to support infrastructure projects, bank capitalization increases, and a range of investment programs. (See table 4.)

In the years leading up to the current crisis, many sovereigns in East Asia pursued varying degrees of fiscal consolidation as well as debt issuance targeted toward establishing more reliable benchmarks

against which they could price corporate debt. By the end of 2009, Hong Kong will join Singapore as the second highly rated government in the region to issue debt for the express purpose of creating a benchmark yield curve as part of efforts to establish regional bond market hubs. According to the ADB, issuance of G3 currency bonds in the region has rebounded during 2009, though in the absence of related data, anecdotal reports indicate that domestic buyers dominated these sales despite strong external demand for higher-yielding G3-denominated issues. Similarly, foreign holding of local currency issues in the region remained in single digits in all markets except Indonesia. The surge in issuance during 2009 has not significantly increased the external exposure of sovereigns in the region.

Despite these efforts, corporate debt markets in the region remain small relative to government ones. Given this imbalance, market responses to sovereign fiscal trends and funding needs have had a disproportionate effect on corporate funding channels. A rebound in corporate issuance and related investment has been a key component of the region's economic recovery, and the outcome of sovereign funding needs and reform to prudential regulations could affect the sustainability of this trend.

### ***The Implications For Debt Sustainability***

The eventual outcomes of actual borrowing levels are far from certain and, based on Standard & Poor's survey of sovereigns in the region, it is hard to generalize about the impact of near-term borrowing plans and debt sustainability. For many sovereigns, the cyclical fiscal impact of the global slowdown has been within expectations, and for others it has exacerbated negative structural trends that were arguably present before they felt the full impact of the crisis. In our view, the latter group includes India, Taiwan, Japan, Pakistan, and Sri Lanka. For others, including Thailand, Korea, and Indonesia, painful fiscal consolidations earlier in the present decade served to return overall debt to more manageable levels and should, we believe, help reduce the need for the deep consolidations the International Monetary Fund (IMF) has recently noted will be necessary for most Organization for Economic Cooperation and Development (OECD) sovereigns in the coming years.

Looking at the distribution of sovereign ratings for Asia Pacific relative to individual sovereigns (see table 1), it is generally the case that lower-rated sovereigns carry lower net debt burdens than more highly rated peers. This perceived discrepancy between the overall ratings of many OECD sovereigns and their rapidly growing debt burdens has attracted great attention. Excluding Singapore and Hong Kong (both governments have accumulated significant net asset positions) from the discussion, net debt levels and comparative interest burdens as a share of GDP for most of the rest of the region look moderate compared with the U.K. and the U.S. The latter two have experienced large increases to debt measured on a relative basis. Japan stands out as a regional peer that has accumulated and maintained an enormous government debt burden despite having sustained external surpluses for decades.

In general, developed sovereigns have shown themselves to be better able to withstand economic shocks than lower rated peers. This is not only as a result of a larger stock of accumulated national wealth, but also as a function of more predictable income flows that give the sovereign a broader, more flexible, and more stable base of revenue sources than exist in most emerging markets. In terms of our sovereign ratings criteria, the related factors of higher-per-capita GDP and greater fiscal flexibility backed by deep domestic capital markets, among others, can support a higher debt burden over time. Such flexibility is never without limit, but for many the demonstrated ability to withstand economic cycles that have included world wars, banking crises, stagflation, or other domestic turmoil is a powerful predictor of the future.

A sovereign's debt trajectory is generally dependent on nominal economic growth. Many sovereigns in emerging East Asia have higher expected trend rates of growth than those of more developed peers. Based on our current estimates, for most governments in the region deficits, direct indebtedness and contingent liabilities could peak in 2010. Nevertheless, the medium-term implications of stimulus programs will quickly run up against longer-term obligations, including a range of social welfare programs where unfavorable demographics will prompt costs.

In addition to direct borrowing, some sovereigns in the region have looked to rapid expansion of domestic credit against the economic cycle in support of stabilization and stimulus agendas. Unsurprisingly, this trend is most notable for those markets that have relied on a combination of lending by state-owned commercial or policy banks, as well as government-supported bond issues, to prop up their respective economies. China stands out as a prime case in point, with India, Vietnam, and the Philippines as other ready examples. In contrast, sovereigns with more market-based monetary systems have seen the pace of domestic credit growth shrink or even contract, with the central government reporting a far larger proportion of the cost of stimulus measures on its own balance sheet. Although a fuller elaboration in this area is beyond the scope of this report, it is important to note that directed lending, like direct borrowing, is often a large contributor to Standard & Poor's estimation of the contingent financial sector liabilities that would weigh on sovereign finances in the event of significant economic and fiscal stress.

### *A Tricky 2010*

For many sovereigns in the Asia-Pacific region, 2010 will bring the difficult task of controlling inflation and asset price appreciation at the same time that economic support measures and borrowing needs remain significant. To date, some governments' reliance on directed lending and government-supported corporate borrowing in place of more direct fiscal stimulus measures has helped to stabilize growth. However, one potential economic scenario for the coming year would involve strong support for asset prices as a function of loose monetary policy amid a weakening recovery. Such an outcome could test the fiscal and monetary flexibility of numerous regional sovereigns as funding costs rise and tension between the policy demands of supporting the real and financial economies increases.

Although the borrowing increase we expect during 2010 is below that expected for year-end 2009, we believe that sovereigns in the region are not yet ready to retreat from capital markets either for the own funding purposes or for general economic support programs. However, as history has shown, an orderly and selective retreat from market support measures and accommodative policy—especially during times of increasing economic uncertainty—takes far greater skill than the initial advance. For sovereigns in Asia during 2010, this could mean remaining active issuers in markets that they may otherwise like to tame, with the result of this balancing act important for medium-term fiscal trends.

Table 1

		<i>Debt, Deficits, And Interest</i>											
		<i>Net debt/ GDP (%)*</i>				<i>Government balance/GDP (%)</i>				<i>Interest expenditure/GDP (%)</i>			
	<i>Long-term foreign currency rating</i>	<i>2008</i>	<i>2009e</i>	<i>2010f</i>	<i>2011f</i>	<i>2008</i>	<i>2009e</i>	<i>2010f</i>	<i>2011f</i>	<i>2008</i>	<i>2009e</i>	<i>2010f</i>	<i>2011f</i>
	Median	AAA	21.8	18.9	17.4	18.8	1.2	(1.6)	(2.6)	(1.5)	1.5	1.7	1.9
Australia	AAA	(4.9)	(1.2)	3.5	2.8	1.3	(1.6)	(2.6)	(2.4)	0.5	0.3	0.5	0.8

Table 1

<b>Debt, Deficits, And Interest (cont.'d)</b>		<b>Net debt/ GDP (%)*</b>				<b>Government balance/GDP (%)</b>				<b>Interest expenditure/GDP (%)</b>			
	<b>Long-term foreign currency rating</b>	<b>2008</b>	<b>2009e</b>	<b>2010f</b>	<b>2011f</b>	<b>2008</b>	<b>2009e</b>	<b>2010f</b>	<b>2011f</b>	<b>2008</b>	<b>2009e</b>	<b>2010f</b>	<b>2011f</b>
Singapore	AAA	(81.8)	(81.7)	(76.9)	(76.5)	2.0	(2.0)	3.0	5.0	0	0	0	0
U.K.	AAA	49.4	66.8	78.5	86.1	(5.4)	(11.3)	(12.5)	(10.3)	2.3	3	3.9	4.5
USA United States	AAA	45.1	55.8	66.9	74.8	(4.9)	(14.7)	(11.6)	(9.2)	3.0	3.1	3.8	4.6
Median AA		(2.4)	11.0	15.2	19.9	(0.3)	(5.1)	(4.0)	(3.2)	1.1	0.9	1.0	1.4
Hong Kong	AA	(31.2)	(32.4)	(30.9)	(29.3)	0.5	(4.0)	(3.4)	(1.1)	0	0	0	0
Japan	AA	85.2	94.5	100.3	104.4	(5.1)	(8.2)	(8.4)	(7.5)	2.7	3.1	3.6	4.2
Taiwan	AA-	36.2	43.8	45.7	46.3	(1.4)	(5.1)	(3.5)	(3.1)	1.1	0.8	1	1.4
Median A		23.6	27.9	31.2	33.0	(2.2)	(4.3)	(3.5)	(2.8)	1.7	1.9	2.1	2.3
China	A+	15.4	17.6	19.3	20.0	(1.1)	(3.4)	(3.2)	(2.7)	0.5	0.4	0.5	0.5
Korea	A	13.5	16.7	16.1	14.6	1.3	(3.1)	(0.5)	0.6	1.3	0.6	0.8	0.9
Malaysia	A-	31.7	40.4	44.9	48.0	(5.0)	(8.2)	(7.7)	(7)	2.0	2.1	2.4	2.6
Median BBB		24.6	29.2	37.1	37.3	(1.3)	(4.4)	(3.5)	(2)	1.6	1.8	1.8	2.5
Thailand	BBB+	24.9	28.2	27.3	24.5	1.6	(1.9)	(0.1)	1.2	1.1	0.9	1.4	1.5
India	BBB-	74.7	76.9	78.2	77.9	(11.4)	(11.1)	(11.2)	(10.8)	5.7	6.1	6.2	6.3
Median BB		24.2	30.3	30.1	29.6	(0.8)	(3.5)	(2.9)	(1.9)	2.1	1.6	1.7	1.6
Vietnam	BB	25.1	28.8	29.4	29.0	(3.2)	(6.7)	(4.1)	(3.2)	1	1.2	1.1	1.2
Indonesia	BB-	31.7	30.3	28.2	26.3	(2.3)	(2.0)	(1.8)	(1.8)	2.2	2	1.7	1.6
Mongolia	BB-	24.9	30.4	30.1	29.6	(3.6)	(6.0)	(3.5)	(3.0)	0	0.5	0.5	0.5
Philippines	BB-	39.1	38.2	36.1	33.7	0.4	(2.4)	(1)	(0.5)	3.6	3.5	3.4	3.1
Median B		25.5	32.6	34.6	33.7	(2.2)	(3.4)	(3.2)	(2.2)	1.2	1	1.1	1.1
Sri Lanka	B	79.9	78.9	76.5	72.5	(7.2)	(7.5)	(6.6)	(6.0)	4.8	5.4	5	4.4
Pakistan	CCC+	48.2	45.3	45.0	44.1	(7.2)	(4.4)	(3.5)	(3.0)	4.7	5.1	4.1	4.0

\*A negative number indicates a net asset position. E—Estimate. F—Forecast. Source: Standard & Poor's Sovereign Risk Indicators.

Table 2

<b>Asia Gross Sovereign Medium and Long-Term Commercial Borrowing</b>					
<b>(Bil. US\$)*</b>	<b>2009f</b>	<b>% of total</b>	<b>2010f</b>	<b>% of total</b>	<b>% change</b>
AAA's	16	0.8	11	0.50	(32.0)
Singapore	16	0.8	11	0.50	(32.0)
AA's	1677	80.9	1,722	79.10	3.0
Hong Kong	1	0.0	1	0.00	0.0
Japan	1661	80.1	1,705	78.40	3.0
Taiwan	15	0.7	16	0.70	2.0
A's	263	12.7	292	13.40	11.0
Korea	65	3.1	83	3.80	27.0
China	171	8.2	190	8.70	11.0
Malaysia	28	1.3	19	0.90	(31.0)
BBB's	88	4.3	123	5.60	39.0

Table 2

<b>Asia Gross Sovereign Medium and Long-Term Commercial Borrowing (cont.'d)</b>					
<b>(Bil. US\$)*</b>	<b>2009f</b>	<b>% of total</b>	<b>2010f</b>	<b>% of total</b>	<b>% change</b>
India	69	3.3	100	4.60	46.0
Thailand	20	0.9	22	1.00	13.0
BB's	29	1.4	30	1.40	4.0
Philippines	12	0.6	12	0.60	(2.0)
Indonesia	13	0.6	14	0.70	12.0
Mongolia	0	0.0	0	0.00	N/A
Vietnam	4	0.2	4	0.20	(7.0)
B's	0	0.0	(1)	0.00	N/A
Pakistan	0	0.0	0	0.00	N/A
Sri Lanka	0	0.0	(1)	0.00	N/A
Total	2,074		2,176		5.0
Total ex. Japan	413	19.9	471	21.60	14.0

\*US\$ values calculated based on spot exchange rates for Nov. 9, 2009. f—Forecast. N/A—Not applicable. Source: S&P Sovereign Borrowing Survey, S&P Sovereign Group estimates.

Table 3

<b>Asia Total Long- and Short-Term Commercial Sovereign Debt</b>				
<b>(Bil. US\$)*</b>	<b>2009f</b>	<b>% of total</b>	<b>2010f</b>	<b>% of total</b>
AAA's	16	0.1	199	1.2
Singapore	16	0.1	199	1.2
AA's	9,583	59.2	10,135	59.2
Hong Kong	3	0.0	7	0.0
Japan	9,422	58.2	9,957	58.1
Taiwan	157	1.0	171	1.0
A's	1,300	8.0	1,417	8.3
Korea	300	1.9	323	1.9
China	895	5.5	975	5.7
Malaysia	105	0.6	120	0.7
BBB's	4,995	30.8	5,075	29.6
Thailand	78	0.5	94	0.5
India	4,916	30.4	4,981	29.1
BB's	226	1.4	233	1.4
Philippines	88	0.5	89	0.5
Indonesia	103	0.6	107	0.6
Mongolia	N/A	0.0	N/A	0.0
Vietnam	35	0.2	37	0.2
B's	71	0.4	70	0.4
Pakistan	48	0.3	48	0.3
Sri Lanka	23	0.1	22	0.1
Total	16,191		17,129	
Total ex. Japan	6,769	41.8	7,172	41.9

Table 3

<b>Asia Total Long- and Short-Term Commercial Sovereign Debt (cont. 'd)</b>				
<b>(Bil. US\$)*</b>	<b>2009I</b>	<b>% of total</b>	<b>2010I</b>	<b>% of total</b>

\*US\$ values calculated based on spot exchange rates for Nov. 9, 2009. N/A—Not available. Source: S&P Sovereign Borrowing Survey.

Table 4

**Size And Composition Of Local-Currency Bond Markets**

	<b>LC bond market size and composition</b>				<b>LC bond market growth</b>	
	<b>3Q08</b>		<b>3Q09</b>		<b>3Q08</b>	<b>3Q09</b>
	(bil. US\$)	(% share)	(bil. US\$)	(% share)	(% YoY)	(% YoY)
<b>China</b>						
Total	2,114	100	2,415	100	38.1	14.2
Government	1,901	90	2,015	83.4	36.0	6
Corporate	212	10	400	16.6	60.7	88.2
<b>Hong Kong</b>						
Total	92	100	129	100	(5.2)	39.3
Government	19	20.2	54	41.8	7.0	187.8
Corporate	74	79.8	75	58.2	(7.9)	1.6
<b>Indonesia</b>						
Total	77	100	90	100	(14.2)	17.2
Government	69	89.4	82	90.9	(14.8)	19.2
Corporate	8	10.6	8	9.1	(8.7)	0.5
<b>Korea</b>						
Total	850	100	1,001	100	(17.7)	17.7
Government	387	45.5	460	45.9	(24.0)	18.9
Corporate	464	54.5	542	54.1	(11.5)	16.8
<b>Malaysia</b>						
Total	173	100	181	100	10.4	4.7
Government	97	56.1	101	55.6	2.2	3.9
Corporate	76	43.9	80	44.4	22.9	5.8
<b>Philippines</b>						
Total	56	100	59	100	5.1	6.3
Government	52	92.8	53	88.9	3.2	1.8
Corporate	4	7.2	7	11.1	40.2	63.9
<b>Singapore</b>						
Total	128	100	153	100	14.2	19.6
Government	71	55.3	87	56.9	8.6	23
Corporate	57	44.7	66	43.1	22.1	15.3

Table 4

**Size And Composition Of Local-Currency Bond Markets (cont. 'd)**

**Thailand**

Total	147	100	172	100	12.6	17
Government	119	81.1	136	79.2	15.3	14.4
Corporate	28	18.9	36	20.8	2.2	28.6

**Vietnam**

Total	13	100	12	100	34.7	(4.9)
Government	12	95.8	11	93.7	32.7	(7.0)
Corporate	0.5	4.2	0.8	6.3	107.1	43.8

**Japan**

Total	8,112	100	9,838	100	9.8	21.3
Government	7,286	89.8	8,834	89.8	9.7	21.2
Corporate	826	10.2	1,003	10.2	10.6	21.5

Source: ADB Asia Bond Monitor, November 2009. LC—Local currency.

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