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Graubündner Kantonalbank

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Graubündner Kantonalbank

SACP	aa-		+	Support	+2	+	Additional Factors	0
Anchor	a			GRE Support	+2		Issuer Credit Rating <div style="background-color: yellow; padding: 10px; text-align: center;"> AA+/Negative/A-1+ </div>	
Business Position	Adequate	0		Group Support	0			
Capital and Earnings	Very Strong	+2		Sovereign Support	0			
Risk Position	Adequate	0						
Funding	Average	0						
Liquidity	Strong							

Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Very strong capitalization, supported by stable earnings. • A strong retail franchise in the home market. • Close ties with the Canton of Graubünden, due to the canton's majority ownership of the bank and a statutory guarantee. 	<ul style="list-style-type: none"> • Limited growth potential due to regional focus and lack of diversity. • Concentration risk owing to focus on residential real estate lending. • Exposure to the volatile tourism sector in the home market, Graubünden.

Outlook: Negative

Standard & Poor's Ratings Services' negative outlook on Switzerland-based Graubuendner Kantonalbank (GKB) reflects its view of the growing economic imbalances in Switzerland (unsolicited ratings; AAA/Stable/A-1+) stemming from residential real estate price increases observed over the past four years. If real estate prices were to drop significantly in Switzerland this could put pressure on the quality of GKB's mortgage loan book.

If we were to take a more negative view of the economic environment in which Swiss banks operate, based on growing economic imbalances in Swiss real estate markets, we would review the ratings on all domestically oriented banks, including GKB. This could result in a downward revision of GKB's anchor, and, subsequently, of the stand-alone credit profile (SACP) and long-term rating by one notch.

Further negative rating actions may be triggered by a change in GKB's role for or link with the Canton of Graubunden (AA+/Stable/A-1+) or changes in the statutory guarantee, which may lead to a weaker assessment of GKB's status as a government-related entity (GRE). However, we currently consider this scenario unlikely and would expect GKB's existing obligations to be grandfathered.

We view the likelihood of an upgrade as remote at this stage, barring an upgrade of the canton. We might revise the outlook to stable if we believed that the risks arising from the increase in real estate prices would not meaningfully affect GKB's creditworthiness.

Rationale

Our ratings on GKB reflect our 'a' anchor for Swiss banks, GKB's "adequate" business position, "very strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The SACP is at 'aa-'.

We consider GKB to be a government-related entity (GRE) with an extremely high likelihood of receiving timely and sufficient extraordinary support from Graubunden if needed. We base this opinion on GKB's very important role for, and integral link with, the local government, the Canton of Graubunden. This provides a two-notch uplift to our assessment of GKB's SACP, leading to the long-term rating of 'AA+'.

Anchor: 'a' for banks operating only in Switzerland

Our bank criteria use the Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning a rating. Switzerland is in BICRA group '1', owing to our evaluation of very low economic risk and low industry risk. Consequently, the anchor for a commercial bank, like GKB, operating only in Switzerland is 'a'.

The BICRA score includes our evaluation of economic risk. In this respect, we view Switzerland as a highly diversified and competitive economy, benefiting from one of the highest GDPs per capita in the world and very robust government finances. We believe that large parts of the Swiss banking market demonstrate a conservative risk and lending culture, which has accompanied moderate growth of house prices and loan portfolios.

The Swiss banking industry is supported by its sizable and very stable customer deposit base. Pure domestic Swiss banks have not loosened credit standards in recent years, thanks to sound earnings potential from core products. We

consider regulatory standards to be more stringent than in other developed countries.

Table 1

Graubuendner Kantonalbank Key Figures					
--Year-ended Dec. 31--					
(Mil. CHF)	2014*	2013	2012	2011	2010
Adjusted assets	20,235.7	20,000.7	19,363.6	17,861.8	16,967.3
Customer loans (gross)	16,020.9	15,840.4	15,296.2	14,529.2	13,842.0
Adjusted common equity	2,214.2	2,116.3	2,033.7	1,936.9	1,844.8
Operating revenues	194.0	386.7	393.0	391.3	385.7
Noninterest expenses	90.0	183.4	188.0	195.7	191.1
Core earnings	99.5	190.6	193.8	193.7	195.2

*Data as of June 30. CHF--Swiss franc.

Business position: A strong regional franchise complemented by private banking activities

We consider GKB's business position to be "adequate" compared with that of domestically focused Swiss banks because we project GKB's extraordinary business stability to continue, partly offsetting its highly concentrated business model by region and product.

GKB is a midsize cantonal bank with total assets of Swiss franc (CHF) 20.2 billion (about €16.7 billion) as of June 30, 2014. It is the leading commercial bank in its home canton, enjoying continued high and stable market shares in retail and corporate banking (approximately 45%-50%). The customer base has proven to be very stable, and we expect this to continue providing GKB a sustainable source of revenues: 60%-65% from net interest income, 30% from fee income, and 5% market-sensitive income. Consequently, we expect the bank's stability in the future to be superior to that of larger domestic and international peers in countries with similar industry risk as Switzerland.

Like most other Swiss cantonal banks, GKB operates almost solely in its home region, Graubunden, with a focus on residential mortgage lending and lending to small and midsize companies, a business model we do not think the bank will change any time soon. GKB engages selectively in corporate syndicated lending across Switzerland as a partner to larger cantonal or commercial banks, mainly to highly rated large Swiss corporate entities. However, in our opinion, this selected expansion does not provide any meaningful diversification in terms of risk and earnings.

The lending activities are complemented by the private banking operations, which focus mainly on domestic clients and some cross-border business with German and Italian clients owing to the geographic proximity (total assets under management estimated at CHF16 billion). These activities are partly conducted through GKB's subsidiaries Privatbank Bellerive AG (not rated; 62.5% participation) and Private Client Bank AG (not rated; 50% participation). We believe that this niche activity will expand moderately, fueled by domestic clients, and continues to contribute stable earnings of about 15%-20%. We also think that this activity will provide some diversification, but not lead us to revise our business position assessment upward.

In our view, the bank's management continues to demonstrate a strong track record, underpinned by prudent underwriting standards and conservative risk management. We expect this to provide ongoing stability to GKB's sound financial position.

Table 2

Graubündner Kantonalbank Business Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Total revenues from business line (mil. CHF)	194.0	388.6	394.9	393.9	389.3
Other revenues/total revenues from business line	100.0	100.0	100.0	100.0	100.0
Return on equity§	7.9	7.3	7.4	7.6	7.9

*Data as of June 30. §After allocation to reserves for general banking risks. CHF--Swiss franc.

Capital and earnings: One of the highest risk-adjusted capital ratios worldwide, supported by strong earnings capacity

We view GKB's "very strong" capital and earnings position, also in the global context, as a key rating strength. Our view is based primarily on our projection that the risk-adjusted capital ratio (RAC) for GKB will gradually increase to 26.0%-26.5% in the next 12-18 months, from 25.7% at year-end 2013. We believe, therefore, that GKB's capitalization will remain at the upper end of our range for a "very strong" assessment and superior to that of other cantonal banks and banks we rate globally.

In our view, GKB's earnings are predictable and stable, and we do not expect any changes to the bank's dividend policy of distributing 50%-60% to the home canton and other shareholders. Even though the low-interest-rate environment continues to put pressure on GKB's net interest margin and operating revenues, we believe that the bank is able to generate stable net profits, which we estimate at CHF155 million-CHF165 million in 2014-2015 (CHF 161 million in 2013). This will enable the capital base to expand steadily to maintain GKB's outstanding capital position. We estimate GKB's three-year average earnings buffer at 180 basis points (bps) to 190 bps, which indicates excellent capacity for its earnings to cover normalized losses.

A revision of our view of currently very low economic risk in Switzerland would push down GKB's RAC ratio because we would use higher risk weights on exposures in our calculation. However, we do not think that such a scenario would change our assessment of GKB's "very strong" capital and earnings, underpinned by a RAC ratio that is well beyond the 15% mark.

We view GKB's capital to be of very high quality because it includes only core Tier 1 capital in the form of share capital, a capital surplus, and reserves. We anticipate that GKB's majority owner, the Canton of Graubünden, which holds 85.1% of its capital with 100% of the voting rights, will remain supportive of the current capital levels. We also believe that GKB will not experience pressure from major dividend distributions that could weaken its RAC ratio.

Table 3

Graubündner Kantonalbank Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Tier 1 capital ratio	18.8	18.9	18.4	17.3	17.1
S&P RAC ratio before diversification	N.M.	25.7	25.3	24.0	21.9
S&P RAC ratio after diversification	N.M.	24.8	24.4	21.5	17.0
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	61.5	63.0	64.4	65.6	64.3

Table 3

Graubündner Kantonalbank Capital And Earnings (cont.)					
Fee income/operating revenues	29.8	29.2	27.8	27.1	29.0
Market-sensitive income/operating revenues	4.8	5.3	5.2	5.4	4.4
Noninterest expenses/operating revenues	46.4	47.4	47.8	50.0	49.5
Preprovision operating income/average assets	1.0	1.0	1.1	1.1	1.2
Core earnings/average managed assets	1.0	1.0	1.0	1.1	1.2

*Data as of June 30. N.M.--Not meaningful.

Table 4

Graubündner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data						
(CHF 000s)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)	
Credit risk						
Government and central banks	267,479	68,273	26	8,024		3
Institutions	3,676,911	1,172,140	32	431,943		12
Corporate	5,226,147	3,085,798	59	3,430,873		66
Retail	10,379,670	5,330,607	51	2,108,646		20
Of which mortgage	10,047,093	5,108,870	51	1,908,948		19
Securitization	0	0	0	0		0
Other assets	1,762,713	595,489	34	701,803		40
Total credit risk	21,312,920	10,252,307	48	6,681,289		31
Market risk						
Equity in the banking book¶	63,281	145,682	230	364,710		576
Trading book market risk	--	57,152	--	85,729		--
Total market risk	--	202,834	--	450,438		--
Insurance risk						
Total insurance risk	--	--	--	0		--
Operational risk						
Total operational risk	--	727,363	--	1,113,740		--
(CHF 000s)		Basel II RWA		Standard & Poor's RWA		% of Standard & Poor's RWA
Diversification adjustments						
RWA before diversification		11,182,504		8,245,468		100
Total adjustments to RWA		--		304,666		4
RWA after diversification		11,182,504		8,550,133		104
(CHF 000s)		Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital		Standard & Poor's RAC ratio (%)
Capital ratio						
Capital ratio before adjustments		2,113,803	18.9	2,116,312		25.7
Capital ratio after adjustments§		2,113,803	18.9	2,116,312		24.8

Table 4

Graubuendner Kantonalbank RACF [Risk-Adjusted Capital Framework] Data (cont.)

*Exposure at default. Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §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, 2013, Standard & Poor's.

Risk position: Exceptional loan loss experience despite regional concentration in Graubuenden

We consider GKB's risk position to be "adequate," owing to its business model, which is focused mainly on low-risk collateralized residential mortgage lending and lending to small- and midsize companies based on prudential underwriting standards.

We still regard GKB's regional concentration in a canton that relies considerably on the cyclical tourism sector as a key risk to its lending activities. This is because it exposes the bank to fluctuations in the local economy. However, thanks to GKB's prudent management of risks and consistent very low risk appetite, we expect it to be able to demonstrate resilience against economic stress. We believe, however, that risk costs will gradually surpass the currently unsustainably low level of 4 bps-6 bps.

Residential real estate loans, mainly from the home region, occupy 61% of GKB's loan book. High granularity and adequate collateralization on the loan portfolio mitigate the concentration risk; we estimate the average loan-to-value ratio at about 60% for mortgage loans. Moreover, we observe that the share of nonresidential mortgage loans, at about 20% of GKB's portfolio, is higher than that of its cantonal bank peers. Although we consider this to elevate GKB's risk profile compared with its peers', we believe that the financing is mainly to small and midsize corporate clients in the home canton, and our RAC framework adequately captures these exposures. We expect GKB's lending growth to slow to about 2%-3% in 2014-2015 from 3.6% in 2013, in line with the trend we have observed at some other cantonal banks following the changes in the regulatory framework (including a new capital buffer) and tightening of banks' lending criteria.

Like its domestic peers, GKB is exposed to the risks related to the steady increases in residential real estate prices in Switzerland. We continue to observe a moderately high rise in real estate prices in Graubuenden, especially in the winter-tourism resort areas. We view positively, however, that the majority of the bank's mortgage loan book relates to borrowers in residential rather than tourist areas, and that the tourism sector represents 6% of the overall mortgage portfolio by object type.

Furthermore, we expect the bank to maintain its conservative underwriting practices in mortgage lending. According to our projections, we will see this in the high asset quality of the bank's credit portfolio, with nonperforming loans at about 0.30%-0.35% of customer loans in the next two years, compared with 0.19% in June 2014 and 0.39% in December 2013. However, we expect this level to be unsustainable over the full economic cycle.

To diversify its loan book geographically and by sector, GKB participates in syndicated corporate loans across Switzerland. Although corporate lending increases the credit risk in GKB's loan book, mitigating factors are that borrowers are mainly large rated Swiss corporations, and GKB participates selectively and with small amounts. We don't believe that this activity, today representing less than 5% of GKB's loan book, will provide any significant diversification benefit nor, in its current magnitude, increase GKB's credit risk to an extent that would lead us to lower

our capital or risk assessment.

We understand GKB's private banking activities have never focused on offshore business. Moreover, GKB has conducted only a limited amount of cross-border business with customers in Germany and Italy. However, like many other Swiss banks active in private banking, GKB has applied for a non-prosecution agreement as a "category 2" bank under the U.S. Department of Justice's investigation of Swiss banks' role in tax evasion. We understand that GKB has prudently provisioned to meet potential fines relating to its acceptance of undeclared funds from U.S. clients. Consequently, in our base case we assume that any potential fine would be offset by these provisions and GKB's annual earnings. In our view, the bank uses a prudent approach in its private banking business. Therefore, we do not expect it to face significant legal or reputation risks in the future.

Table 5

(%)	--Year-ended Dec. 31--				
	2014*	2013	2012	2011	2010
Growth in customer loans	2.3	3.6	5.3	5.0	3.7
Total diversification adjustment / S&P RWA before diversification	N.M.	3.7	3.4	11.7	28.8
Total managed assets/adjusted common equity (x)	9.1	9.5	9.5	9.2	9.2
New loan loss provisions/average customer loans	0.0	0.1	0.1	0.0	(0.0)
Net charge-offs/average customer loans	0.1	0.0	0.0	0.0	0.1
Gross nonperforming assets/customer loans + other real estate owned	0.2	0.4	0.3	0.3	0.2
Loan loss reserves/gross nonperforming assets	814.6	351.3	462.0	570.2	857.2

*Data as of June 30. N.M.--Not meaningful.

Funding and liquidity: A favorable funding profile, owing to stable retail deposits

We assess GKB's funding as "average" and its liquidity position as "strong" because of its strong base of customer deposits. GKB holds a very granular and stable core deposit base, which accounts for 82% of its total funding. We also view favorably the bank's superior capital base. We don't consider GKB's deposits to be very confidence sensitive because of the bank's public-sector ownership, the statutory guarantee from the Canton of Graubuenden, and GKB's sound brand. Moreover, the shareholder and guarantee structure gives GKB access to low-cost unsecured funding (12% of funding base) and the ability to issue covered bonds (6%). In our view, GKB will continue to benefit from a so-called "flight to quality," with customers steering away from riskier banks during difficult economic periods toward banks with a sound reputation. Therefore, we expect GKB's stable funding ratio to remain at a comfortable 105%-110% over 2014-2015, compared with 106.8% as of December 2013.

Our assessment of GKB's "strong" liquidity reflects our estimate that the bank's one-year liquidity ratio (broad liquid assets to short-term funding) was 2.9x at year-end 2013. In our view, the bank should withstand a market stress without access to capital market funding for more than 12 months. GKB's liquid assets comfortably cover its short-term wholesale funding needs, minimizing the risk of a gap in its liquidity profile. GKB's solid customer base will likely help it weather potential capital market stress, in our opinion.

Table 6

(%)	--Year-ended Dec. 31--				
	2014*	2013	2012	2011	2010
Core deposits/funding base	80.3	82.1	82.7	82.0	80.6
Customer loans (net)/customer deposits	112.1	110.8	109.8	115.5	117.9
Long term funding ratio	93.4	95.1	94.5	96.0	95.9
Stable funding ratio	103.5	106.8	105.8	103.1	103.4
Short-term wholesale funding/funding base	7.5	5.5	6.2	4.5	4.6
Broad liquid assets/short-term wholesale funding (x)	1.9	2.9	2.6	2.8	2.9
Net broad liquid assets/short-term customer deposits	8.5	13.5	12.5	10.6	11.1
Short-term wholesale funding/total wholesale funding	37.9	30.7	35.6	25.2	23.8
Narrow liquid assets/3-month wholesale funding (x)	2.7	5.3	4.7	2.9	3.2

*Data as of June 30.

External support: Two notches of uplift for likely support from Graubunden

We regard GKB as a GRE and assess the likelihood that GKB's owner, the Canton of Graubunden, would provide timely and sufficient support to GKB as extremely high. We base our assessment on our view of the bank's:

- Integral link with the canton. We expect Graubunden to provide considerable and timely credit support in all circumstances to GKB, due to the canton's majority ownership of GKB and of 100% of the voting rights, and its provision of a statutory guarantee for GKB; and
- Very important role in the canton, owing to the large impact of GKB's activities on the local economy.

Because of these factors, we incorporate a two-notch uplift into the long-term rating on GKB. We do not envisage that the bank's GRE status or our view of an extremely high likelihood of extraordinary government support will change in the foreseeable future.

GKB benefits from Graubunden's statutory guarantee, which ultimately covers all of its liabilities, excluding those of its subsidiaries Privatbank Bellerive and Private Client Bank, subordinated liabilities, and nonvoting participation certificates ("Partizipationskapital"). We note, however, that the guarantee does not ensure timely repayment, as defined by our criteria, but we believe that the canton has strong incentives to help GKB meet its obligations on time, due to the bank's importance to the regional economy.

Additional rating factors: None

No additional factors affect the ratings.

Related Criteria And Research

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Swiss Canton of Graubünden 'AA+/A-1+' Ratings Affirmed On Very Low Debt And High Liquid Reserves; Outlook Stable, Aug. 22, 2014
- Banking Industry Country Risk Assessment: Switzerland, Dec. 6, 2013
- Outlook On Nine Swiss Banks To Negative On Exposure To Rising Property Prices; Ratings On All Swiss Banks Affirmed, July 3, 2012

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 September 25, 2014)

Graubündner Kantonalbank

Counterparty Credit Rating

AA+/Negative/A-1+

Counterparty Credit Ratings History

03-Jul-2012

AA+/Negative/A-1+

17-Dec-2010

AA+/Stable/A-1+

20-Sep-2010

AA/Watch Pos/A-1+

Sovereign Rating

Swiss Confederation (Unsolicited Ratings)

AAA/Stable/A-1+

Related Entities

Graubünden (Canton of) (Unsolicited Ratings)

Issuer Credit Rating

AA+/Stable/A-1+

Senior Unsecured

AA+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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