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## Research Update:

# Iceland 'A/A-1' Ratings Affirmed; Outlook Stable

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## Research Update:

# Iceland 'A/A-1' Ratings Affirmed; Outlook Stable

Ratings:

Foreign and Local Currency: A/Stable/A-1

For further details see ratings list.

## Overview

- We project that, over the next three years, Iceland will continue to display strong growth, with the sovereign's substantial current account surpluses narrowing only gradually, and the general government budget posting modest deficits.
- We are affirming our 'A/A-1' ratings on Iceland.
- The outlook is stable.

## Rating Action

On Dec. 22, 2017, S&P Global Ratings affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Iceland at 'A/A-1'. The outlook is stable.

## Outlook

The stable outlook balances the potential for improvements in Iceland's fiscal position against the risks of the economy overheating in the next two years.

We could raise the ratings if Iceland's fiscal performance materially exceeded our forecasts, while the risks posed by the overheating of the domestic economy moderated.

We could lower the ratings if we observed that the present economic overheating, potentially fanned by procyclical policy, rapid wage growth, and further appreciation of an already very high real effective exchange rate, put the country's long-term growth prospects, balance of payments performance, or financial stability at risk.

## Rationale

Our ratings on Iceland remain supported by the country's high per capita income levels, favorable growth prospects, and strong institutional arrangements, characterized by the government's commitment to sustainable public finances and an effective system of checks and balances between state bodies. The ratings are primarily constrained by the comparatively limited flexibility of Iceland's monetary policy, the risks stemming from the overheating of the domestic economy, the possibility of the real effective exchange rate overshooting, and the economy's inherent volatility and susceptibility to external shocks, which could negatively affect the country's balance of payments and banking system, in our view.

**Institutional and Economic Profile: Strong growth ahead but the overheating of the domestic economy poses risks**

- We expect broad policy continuity after the formation of a majority coalition government in the wake of the early general elections in October 2017.
- The Icelandic economy will post an average annual growth rate of 2.5% over the next three years.
- Economic overheating and a potentially overvalued real effective exchange rate continue to challenge Iceland's competitiveness and pose risks to the country's external and fiscal positions.

A majority coalition government comprising the Left-Green Movement, Independence Party, and Progressive Party was formed following the general elections in October 2017. Katrin Jakobsdottir of the Left-Green Movement assumed the post of Prime Minister, while incumbent Bjarni Benediktsson of the Independence Party stepped down to become the Minister of Finance, a post he held before. The October poll marked the country's second early election in the past year. This time, mainstream Icelandic parties fared better, and the negotiations on government formation concluded notably faster.

Although the new government has yet to fully articulate its agenda, we do not expect any radical changes. In our view, despite the multiple changes in government following the 2008 financial crisis, political leaders have maintained a general consensus on the key policy priorities. We anticipate the new administration will broadly maintain a pro-business focus and remain committed to sustainable public finances over the coming years. We also assume that an increasing focus on social issues and infrastructure shortfalls is likely.

However, internal government disagreements on specific policy items could emerge, given that the coalition comprises both center-left and center-right parties. The incoming administration controls only a narrow majority in the Icelandic Parliament.

Importantly, the political commotion of the past 1.5 years has not hindered growth. Largely underpinned by the substantial uptick in tourism inflows and booming domestic consumption, the Icelandic economy grew by 7.4% in 2016 after an already strong 4.3% growth in 2015. According to high frequency data, growth has moderated throughout this year, and we have revised our 2017 forecast down to a still-high 4%. The tapering was largely owing to the fishermen's strike early in the year as well as the slowdown in the pace of tourist sector expansion, at least partially reflecting capacity constraints and a stronger exchange rate.

Throughout 2017-2019, Iceland will remain among the wealthiest countries globally, with GDP per capita exceeding US\$70,000. However, we note that the size of the economy in absolute terms remains small, estimated at just US\$23 billion in 2017. The Icelandic economy depends greatly on the fortunes of key trade partners, which goes smoothly in good times but is a key source of vulnerability when global economic conditions are less accommodating. Historically, Iceland has exhibited substantial volatility as demonstrated by multiple boom-bust cycles.

For 2018-2019, we assume a soft landing, that is, a gradual convergence from the present high growth rates toward a 2.5% annual average long-term real growth. However, there are downside risks to this expectation. Although not part of our baseline expectation, if materialized, each of the four scenarios described below could have a detrimental impact on Iceland's economic growth and balance of payments dynamics. Specifically:

- The upcoming round of wage negotiations could set off a wage-inflation spiral. In 2018, a large number of wage agreements are set to expire, mostly in the public sector. In the event the agreed hikes turn out too high, clauses in other private-sector contracts risk being triggered, reopening the negotiations and leading to an even broader increase in wages. That, in turn, poses risks for Iceland's competitiveness.
- More broadly, there are multiple signs of overheating in the domestic economy. The Central Bank of Iceland (CBI) estimates a positive output gap of about 2% of potential GDP, with unemployment being below the natural rate. Alongside a substantial 30% appreciation of the consumer price index-based real effective exchange rate of the Icelandic krona over the past three years, and potentially procyclical fiscal policy, this could create additional pressure on the competitiveness of the domestic economy, particularly in the non-tourism-related sectors.
- There could be risks if the sizable tourism inflows--which have underpinned much of the growth in recent years--stopped suddenly. Under such a scenario, the banks' and households' balance sheets could bear the brunt of a correction in the housing market. House prices have risen substantially over the past two years. Such a scenario would also have a detrimental impact on the country's balance of payments performance.
- In our view, the economy is also exposed to adverse changes in terms of trade, given the export concentration in the tourism, fishing, and energy sectors. Terms of trade have been particularly favorable in recent years, which has contributed substantially to the positive dynamics of U.S. dollar-expressed GDP. We believe that a larger-than-anticipated reversal in the terms of trade trend could contribute to the economy's weaker growth and external performance.

**Flexibility and Performance Profile: Current account surpluses will prevail, albeit moderating, while the general government budget will see minor deficits**

- The Icelandic economy is currently in a net external asset position, which we forecast will further strengthen to 13% of GDP by 2020, on the back of recurring current account surpluses.
- Modest general government deficits won't keep net debt levels from reducing toward 30% of GDP in 2020, versus an estimated 34% this year.
- Monetary policy flexibility has somewhat improved following the earlier lifting of capital controls but remains structurally constrained by the economy's size and significant dependence on foreign developments.

Strong growth in the tourism sector has underpinned a substantial improvement in Iceland's external position in recent years. Last year's current account surplus amounted to almost 8% of GDP, the highest on record. We estimate that the economy is currently in a net external asset position of 7% of GDP. Although we project the balance of payments dynamics to weaken owing to strong consumption pulling in imports and moderating tourist flows, the current account will still remain in surplus over the next three years. Consequently, the net international investment position will improve further to a projected 13% of GDP in 2020.

The composition of the improvement will, however, shift away from growth in central bank foreign exchange reserves. The latter have expanded considerably in recent years given the central bank's interventions on the foreign exchange market in order to build enough buffers ahead of the liberalization of capital controls, which concluded in March 2017. Going forward, the CBI's interventions will be rather limited, but we expect a pick-up in foreign investment by the Icelandic pension funds, which have had limited opportunities for that previously, given the years of operations from within the confines of capital controls. This is particularly true given the gradual tightening of monetary policy in the U.S. and the European Central Bank's likely tightening from 2019.

Rapid economic growth has led to a consistent improvement in Iceland's fiscal performance. The general government budget has been close to balance over the past three years. Last year's 3% of GDP headline deficit actually includes a one-off impact from the pension reform that has been explicitly recognized upfront as an expenditure. Excluding that, the outcome was close to a 1% of GDP surplus. In 2016, the Treasury also received one-off revenues related to the settlement of the old defaulted banks, mostly in non-liquid form (equity stakes in commercial banks). Unlike the authorities or the International Monetary Fund, we have excluded this one-time windfall from our fiscal calculations.

We currently estimate a 1.7% of GDP general government surplus in 2017. We project deficits will emerge from 2018 as growth moderates while expenditures rise-- particularly in the social sphere and infrastructure. Under this baseline scenario, Iceland's net general government debt will reduce to just over 30% of GDP in 2020 from 34% of GDP at end-2017.

We believe, however, that the pace of debt reduction could be faster than we presently anticipate. This could happen, for example, if the authorities go ahead with the sale of commercial banks and use the proceeds to pay down debt (which we have not factored into our base-case scenario). It could also happen if the fiscal policy is tightened more in an attempt to cool off the economic boom.

Although Iceland's fiscal performance has been strong in recent years, we believe a substantial part of the improvement is cyclical in nature and could partially reverse if growth slows down sharply. We still see some risks from contingent fiscal liabilities--particularly from the high stock of government guarantees to public-sector entities, such as the Housing Financing Fund or energy company Landsvirkjun--which we currently assess as moderate.

In our view, Iceland's monetary flexibility has improved following the March 2017 lifting of the capital controls and given the adherence to a broadly flexible exchange rate arrangement in recent months. We also believe that the accumulation of substantial extra net foreign exchange reserves has underpinned CBI's improved ability to act as a lender of last resort for the domestic banking system both in foreign and local currencies. Nevertheless, policy effectiveness remains limited by the structural features of the Icelandic economy, including its small size and pronounced dependence of domestic price level on the value of the exchange rate and foreign prices.

We also note that Iceland's Real Effective Exchange Rate (REER) tends to be particularly volatile over the economic cycle, and subject to large valuation swings that have historically exacerbated the cyclicity already inherent in Iceland's economy. According to CBI data, the consumer price index-based REER has appreciated steeply in recent years (30% appreciation since end-2014) and now hovers at the level of the pre-2008 peak. The REER calculated on the basis of unit labor cost has appreciated by an even larger 40% over the same time period.

The Icelandic banks remain well capitalized and liquid. Domestic credit has picked up lately, and we expect it to grow by close to 5% annually over the next three years. This is a notable turnaround as domestic credit growth has averaged close to 0% over the past few years. Importantly, the substantial increases of house prices, particularly in the capital area, have therefore not been fueled by the financial system funding to the domestic economy. In fact, private sector leverage has been on a steady declining trend as a percentage of GDP since 2008. For full details on the banking system, see "Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions," published Oct. 25, 2017, and "Banking Industry Country Risk Assessment: Iceland," published March 10, 2017.

## Key Statistics

Table 1

Republic of Iceland Selected Indicators										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>ECONOMIC INDICATORS (%)</b>										
Nominal GDP (bil. ISK)	1,708	1,788	1,900	2,019	2,232	2,449	2,547	2,697	2,847	3,006
Nominal GDP (bil. \$)	15	14	16	17	17	20	23	25	26	27
GDP per capita (000s \$)	46.3	44.7	48.3	53.1	51.4	61.0	69.1	73.7	74.4	75.1
Real GDP growth	2.0	1.3	4.3	2.1	4.3	7.4	4.0	2.8	2.5	2.5
Real GDP per capita growth	1.7	1.0	3.6	0.9	3.2	6.3	2.2	1.3	1.0	1.0
Real investment growth	11.6	5.3	2.2	16.0	18.5	22.8	8.0	2.0	3.0	3.0
Investment/GDP	15.4	16.0	15.4	17.2	19.0	21.4	21.8	21.9	22.5	23.0
Savings/GDP	16.1	17.7	23.4	22.9	25.1	29.2	26.1	24.8	24.4	24.0
Exports/GDP	56.3	56.7	55.2	52.9	53.3	48.5	45.6	45.6	45.2	44.7
Real exports growth	3.4	3.6	6.7	3.2	9.2	10.9	4.0	3.5	3.5	3.5
Unemployment rate	7.1	6.0	5.4	5.0	4.0	3.0	2.6	2.6	3.0	3.5
<b>EXTERNAL INDICATORS (%)</b>										
Current account balance/GDP	0.7	1.7	8.1	5.7	6.1	7.7	4.3	2.9	2.0	1.0
Current account balance/CARs	1.2	2.6	13.2	9.9	10.5	14.3	8.7	5.8	4.1	2.1
CARs/GDP	61.4	63.0	61.4	57.9	58.0	54.0	49.7	49.0	48.6	48.2
Trade balance/GDP	2.1	0.7	0.4	(0.5)	(1.6)	(4.2)	(4.8)	(5.6)	(6.0)	(6.5)
Net FDI/GDP	7.4	29.6	(0.3)	4.2	4.1	3.5	1.0	2.0	0.0	0.0
Net portfolio equity inflow/GDP	0.6	0.6	(0.0)	(0.2)	(2.4)	(5.7)	(3.0)	(4.0)	(2.0)	(2.0)

**Table 1**

<b>Republic of Iceland Selected Indicators (cont.)</b>										
	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>
Gross external financing needs/CARs plus usable reserves	112.0	95.5	96.6	100.0	93.5	90.1	78.9	84.1	85.5	87.9
Narrow net external debt/CARs	96.5	88.5	71.1	58.3	143.2	53.9	42.9	40.1	44.6	48.0
Narrow net external debt/CAPs	(103.4)	(93.7)	(77.4)	(70.3)	(157.1)	(58.7)	(45.3)	(43.3)	(47.2)	(49.8)
Net external liabilities/CARs	110.9	44.4	19.3	9.5	9.8	(7.5)	(14.1)	(19.3)	(24.1)	(26.9)
Short-term external debt by remaining maturity/CARs	65.0	61.6	50.3	50.0	41.9	44.8	36.7	36.6	36.2	37.2
Usable reserves/CAPs (months)	5.6	8.2	5.8	5.3	5.4	6.3	8.2	7.1	6.8	6.6
Usable reserves (mil. \$)	5,984	4,008	4,017	3,988	4,895	7,231	6,880	6,880	6,880	6,880
<b>FISCAL INDICATORS (% , General government)</b>										
Balance/GDP	(5.5)	(3.7)	(1.8)	(0.1)	(0.8)	(3.1)	1.7	(0.5)	(0.5)	(0.5)
Change in net debt/GDP	14.0	(7.4)	1.3	(6.5)	(3.0)	(3.7)	(4.5)	0.6	0.6	0.6
Primary balance/GDP	(1.4)	1.0	2.7	4.6	3.7	0.9	5.0	2.1	2.0	1.9
Revenue/GDP	39.9	41.4	41.9	44.9	41.7	42.0	41.8	41.5	41.5	41.5
Expenditures/GDP	45.5	45.2	43.7	45.0	42.5	45.1	40.1	42.0	42.0	42.0
Interest /revenues	10.3	11.4	10.9	10.4	11.0	9.3	7.8	6.3	6.1	5.9
Debt/GDP	114.6	99.7	90.8	84.0	67.6	52.8	41.0	39.3	37.8	36.4
Debt/Revenue	286.9	240.5	216.8	187.1	162.2	125.7	98.0	94.7	91.1	87.8
Net debt/GDP	81.2	70.2	67.4	56.9	48.4	40.5	34.4	33.1	32.0	30.9
Liquid assets/GDP	33.4	29.5	23.4	27.2	19.2	12.4	6.6	6.2	5.9	5.6
<b>MONETARY INDICATORS (%)</b>										
CPI growth	4.0	5.2	3.9	2.0	1.6	1.7	1.8	3.0	3.0	3.0
GDP deflator growth	3.0	3.3	1.9	4.1	6.0	2.1	0.0	3.0	3.0	3.0
Exchange rate, year-end (ISK/\$)	122.71	128.99	115.55	126.90	129.59	112.82	105.00	108.15	111.39	114.74
Banks' claims on resident non-gov't sector growth*	(8.7)	(5.2)	(2.6)	(2.9)	(0.1)	1.6	6.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP*	206.3	186.9	171.3	156.5	141.4	131.0	133.5	132.4	131.7	130.9
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	9.8	9.4	8.9	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	14.0	14.1	18.5	18.0	16.5	8.6	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.4	(0.3)	4.6	6.7	2.3	12.0	N/A	N/A	N/A	N/A

\*The data presented includes Housing Financing Fund and domestic lending by the Icelandic pension funds. Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. ISK--Icelandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as

international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

## Ratings Score Snapshot

**Table 2**

### Republic of Iceland Ratings Score Snapshot

#### Key rating factors

Institutional assessment	2
Economic assessment	2
External assessment	3
Fiscal assessment: flexibility and performance	2
Fiscal assessment: debt burden	4
Monetary assessment	4

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §§15 and §§126-128 of the rating methodology.

## Related Criteria And Research

### Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 18, 2017
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017

### Related Research

- Credit FAQ: What's New In S&P Global Ratings' Updated Sovereign Rating Methodology? - December 18, 2017
- Sovereign Risk Indicators - December 14, 2017. An interactive version is also available at <http://www.spratings.com/sri>.
- Sovereign Ratings History - December 07, 2017
- Banking Industry Country Risk Assessment Update: December 2017 - December 07, 2017
- Global Sovereign Rating Trends Third-Quarter 2017 - October 06, 2017
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions - April 18, 2017
- Default, Transition, and Recovery: 2016 Annual Sovereign Default Study And Rating Transitions - April 3, 2017
- Banking Industry Country Risk Assessment: Iceland - March 10, 2017



- Sovereign Debt 2017: Global Borrowing To Drop By 4% To US\$6.8 Trillion - February 23, 2017

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the monetary assessment improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

## **Ratings List**

	Rating	
	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	A/Stable/A-1	A/Stable/A-1
Transfer & Convertibility Assessment	A	A
Senior Unsecured		
Foreign and Local Currency	A	A
Foreign Currency	A-1	A-1
Short-Term Debt		
Local Currency	A-1	A-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our

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criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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