

2012 Outlook: Major Portuguese Banks

Tracking Portuguese Sovereign Developments

Outlook Report

Rating Outlook

NEGATIVE

Portuguese Banks' Outlook Negative: Fitch Ratings considers the outlook for the Portuguese banking sector to be negative and vulnerable to sovereign developments. The sector's short-term financial strength and its long-term prospects will be directly affected by: Portugal's likely two-year recession; its banks' loss of access to wholesale funding markets; and, more recently, uncertainty over how the euro-zone crisis will be resolved.

Support-Driven IDRs: Except for the IDRs of Santander Totta SGPS and Banco Santander Totta SA, which are driven by support from their Spanish parent, Banco Santander ('AA-/Negative'), the major banks' IDRs are aligned with that of the Portuguese Sovereign ('BBB-/RWN') and are at their Support Rating Floor, based on Fitch's assessment of available sovereign support and international support from the IMF/EU. Any downgrade of the sovereign IDR would lead to a downgrade of the banks' IDRs.

Sovereign Risk Increased: Portuguese banks are highly exposed to the domestic economy (through loans), which Fitch expects to contract by 2% in both 2011 and 2012. The agency also expects unemployment to peak at 13.5% in 2012. In addition, the banks are increasingly at risk from their sovereign debt exposure (between 98% and 202% of Fitch eligible capital at end-H111) amid potential contagion risks from the prolonged, unresolved euro-zone crisis affecting peripheral European countries such as Portugal.

Liquidity Risk Remains High: With no access to wholesale markets, Fitch believes that Portuguese banks will continue to make use of the ECB liquidity facility to meet their large short- and medium-term debt maturities in H211 and 2012. More positively, banks are actively deleveraging and attracting deposits, which helped to improve their loans/deposits ratios in H111. However, further improvements will be needed at some banks. The banks are also increasing liquidity buffers, which combined with the stability of deposits mitigates liquidity risks.

Rising Asset Quality Problems: With loan contraction expected to continue and impaired loans likely to rise due to a weakening economy, which itself is highly indebted, Fitch expects a worsening of Bank of Portugal (BoP)-defined non-performing loans (NPLs)/total loans ratios in H211, and that these will peak in 2013. Fitch expects the rise in impaired loans to be mostly in large corporate/SME sectors, especially in construction and real estate. However, the absence of a housing boom in Portugal somewhat mitigates loss severity.

The move to the international 90-day NPL definition required by the IMF/EU will mean a deterioration in banks' asset quality indicators, doubling the NPL ratio at some banks, and may require further impairment charges to support coverage levels.

Further Capital Support Likely: All major Portuguese banks reported regulatory core capital levels between 8.4% and 10.6% at end-H111. Fitch believes that all the major banks will comply with the minimum regulatory core capital ratio of 9% by end-2011 without state support. However, recapitalisation may, in Fitch's view, be needed at some banks in 2012 to comply with higher regulatory requirements, calling for further private capital support measures. If the latter cannot be found, the Bank Solvency Support Facility (EUR12bn) could provide capital.

Loan Impairments to Rise: Domestic profitability will be depressed in H211 and 2012 by continued deleveraging, high funding costs and the rising cost of credit. The sale of some profitable non-core businesses (eg, insurance and/or foreign bank subsidiaries) may help capital levels but could jeopardise future earnings. However, further loan repricing, cost cuts and profitable international operations could help results in 2012.

Figure 1
Major Portuguese Banks' Ratings

Bank	LT IDR ^a	VR ^b
Caixa Geral de Depositos, S.A.	BBB-/RWN	bb
Banco Comercial Portugues	BBB-/RWN	bb-
Banco BPI	BBB-/RWN	bb
Santander Totta SGPS	AA-/Negative	bb
Banco Santander Totta SA	AA-/Negative	bb

^a Long-Term Issuer Default Rating

^b VR: Viability Rating

Source: Fitch

Related Research

[Portugal \(July 2011\)](#)

[Major Portuguese Banks: Semi-Annual Review and Outlook \(May 2011\)](#)

Analysts

Maria Rivas
+44 20 3530 1163
maria.rivas@fitchratings.com

Cristina Torrella
+34 93 323 8405
cristina.torrella@fitchratings.com

Roger Turro
+34 93 323 8406
roger.turro@fitchratings.com

- Banks' performance correlated to sovereign developments.

Vulnerable to Sovereign Developments

The two-year recession that Fitch expects Portugal to face, its banks' ongoing lack of access to wholesale funding and, more recently, uncertainty over how the euro-zone crisis will be resolved will have a direct effect on Portuguese banks' short-term performance, but also on their long-term creditworthiness.

While the major Portuguese banks will continue to actively reprice their lending and cut costs, Fitch expects further funding and liquidity pressures and increasing asset quality problems to weigh heavily on their performance. More positively, the banks' profitable international operations and non-recurring gains from asset sales should support net income.

Portuguese banks' credit risk profile will be affected by their exposure to the economy and the sovereign. The banks are deleveraging and attracting customer deposits to improve their funding mix and are increasing liquidity buffers, but further improvements are needed. Regulatory capital levels generally improved in H111, but these do not incorporate sizeable sovereign risk through negative valuation adjustments, although these will not necessarily translate into impairments.

Although Fitch expects all the major Portuguese banks to remain profitable in H211, they will have to continue reducing costs in order to support profits in 2012.

- Funding and liquidity risks remain high.

ECB Reliance Likely to Continue; Deleveraging and Stable Deposit Bases Mitigate Liquidity Risks

The euro-zone crisis has revealed the vulnerability of the major Portuguese banks' funding and liquidity. The banks are reliant on wholesale funding and have large debt maturities to repay between now and 2014. Medium-term debt maturities for H211 and 2012 amount to EUR15.4bn, which Fitch views as considerable. Banco Comercial Portugues (Millennium bcp) and Caixa Geral de Depositos (CGD) will face the greatest difficulties in view of their larger debt maturities between now and end-2012 (see Figure 4 in the *Annex*).

With no access to wholesale markets and despite the EU/IMF requirement to reduce ECB funding, Fitch believes Portuguese banks will continue to make use of the ECB liquidity facility to meet their refinancing needs in the short to medium term. Furthermore, the IMF and the EU require the Portuguese banks to improve their loans/deposits ratio to 120% by end-2014.

The whole banking system's use of ECB funds increased to EUR46bn at end-August 2011 from EUR40bn at end-2010 (see Figure 5 in the *Annex*). Among the banks, only Banco BPI managed to reduce its use of ECB funds in H111, from EUR3.5bn at end-2010 to EUR1bn at end-H111, helped by loan deleveraging and deposit growth. The other banks, conversely, increased their recourse to ECB funding, with Millennium bcp and CGD being the most exposed. The latter's funding, however, also includes funding provided to a bank in which the government intervened, Banco Portugues de Negocios.

Customer deposits grew by 4.5% yoy on average at end-H111 for the major Portuguese banks. This growth was assisted by increasing corporate deposits, a shift of off-balance-sheet customer funds (mainly in the form of mutual funds) to on-balance-sheet customer deposits and, for some banks, by competing strongly on deposit rates. CGD experienced the strongest growth (9% yoy in H111) in customer deposits, mostly related to public-sector deposits, which partly reflects the benefits it receives from being fully owned by the Portuguese Republic.

Banks started to deleverage in H111, albeit to differing degrees. To improve its comparatively high loans/deposits ratio of 170% at end-H111, Santander Totta SGPS (Santander Totta) experienced the largest loan contraction of 8%, helped by loan sales. Other banks reported loan contractions of between 1.5% and 3%. Fitch expects loan contractions to be of this order or even larger in H211 and 2012.

Related Criteria

[Global Financial Institutions Rating Criteria \(August 2011\)](#)

[Short-Term Ratings Criteria for Corporate Finance \(November 2010\)](#)

The agency also expects that any improvement in banks' loans/deposits ratios (see Figure 3 in the *Annex*) from now until 2014 will mostly come from a contraction of the loan portfolio rather than significant increases in customer deposits. Achieving the latter will prove challenging given the recessionary environment and the expected rise in unemployment.

All banks have continued to reinforce their pools of ECB-eligible assets (see Figure 4 in the *Annex*), largely via self-retained securitisations and covered bond issues. This, together with the liquidity support of the ECB, banks' deleveraging, and the stability of customer deposit bases, helps mitigate liquidity risks. A key risk-mitigating factor to date has been precisely the stability of customer deposits (see Figure 6 in the *Annex*). However, the Portuguese banking system remains vulnerable if risk aversion towards peripheral European countries such as Portugal persists for too long.

Under the EU/IMF package, the programme of government-guaranteed senior debt issues was extended to EUR35bn (from the original EUR20bn). To date, Millennium bcp, Banif – Banco Internacional do Funchal, S.A. ('BB'/Stable) and CGD have announced their intention to issue state-guaranteed debt. Fitch envisages further use of this facility as banks could face increasing difficulties in further strengthening unencumbered asset pools via covered bonds and securitisations, as some have already reached the maximum issuance limit.

- Fitch expects asset quality deterioration to accelerate as the economic recession in Portugal deepens.

Asset Quality Deteriorating

The larger Portuguese banks showed only a modest deterioration in asset quality indicators in H111, despite the deepening of Portugal's recession and banks' loan deleveraging. Impaired loans/total loans ratios according to the BoP's standards (see Figure 7 in the *Annex*) ranged from 4.1% at Millennium bcp to 1.9% at Santander Totta (from 4.5% to 1.4% at end-2010).

Loan contraction during H111 was mostly in domestic corporate loan portfolios and overall international loan portfolios. Fitch estimates that these portfolios will continue to be reduced.

In H111, the rise in impaired loans was centred on banks' domestic loan books, particularly in the corporate segment, and largely associated with the construction, real estate and wholesale trade sectors. Retail impaired loans also increased, but given their granularity, the impact on impaired loan levels was less acute. On a positive note, the absence of an economic and housing boom in Portugal pre-crisis prevented a sharp deterioration in banks' asset quality.

With loan contraction expected to continue and impaired loans likely to increase, Fitch expects impaired loans/total loans ratios to worsen in H211. The agency expects them to peak in 2013, due to the two-year economic recession that Fitch forecasts for Portugal in the context of its highly indebted economy.

Under the EU/IMF support package, banks will soon be required to report asset quality ratios under the commonly used international 90-day NPL definition. As a result, Fitch expects an overall increase in NPLs and NPLs/total loans ratios at all banks, albeit to differing degrees. Loan loss coverage levels are likely to decline, and a further strengthening of impairments may be needed.

Fitch estimates that NPLs/total loans ratios could at most double for most banks. Those banks that have a higher proportion of retail mortgage loans in their portfolios rather than corporate/SME loans could see their ratios rise the most as corporate/SME loans tend to be entirely classified as impaired at an early stage.

- Banks' exposure to sovereign debt represents an add-on risk.

Sovereign Bond Exposure Manageable but Risk Remains

The banks' overall exposure to Portuguese sovereign debt accounted for between 98% and 202% of Fitch eligible capital at end-H111. Exposure to other European peripheral countries (eg: Greece and Ireland) is limited, with only Banco BPI holding EUR418m in Greek bonds and Millennium bcp being exposed through its Greek banking operations.

Fitch considers that the euro-zone crisis, in particular in Greece, and the greater risk of contagion to peripheral European countries such as Portugal exacerbate Portuguese banks' sovereign risk and put pressure on their capital. The latter is reflected in increased unrealised losses, which hit the banks' equity and Fitch core capital (FCC) in H111, notably at Banco BPI (FCC of 3.1% at end-H111). However, it should be noted that all the banks reported much higher regulatory core capital ratios as unrealised losses from debt securities are not deducted from regulatory core capital. Although the negative revaluation reserves will not necessarily translate into impairments, Fitch views these as significant compared with banks' equity.

- Fitch believes that recapitalisation may be needed in 2012.

Further Capital Support Likely

At end-H111, the major Portuguese banks improved or at least maintained their regulatory core capital ratios (see Figure 8 in the *Annex*) thanks to capital increases (Millennium bcp: EUR1.3bn; CGD: EUR550m) or a reduction in risk-weighted assets helped by balance sheet deleveraging. Banco BPI and Santander Totta are the strongest capitalised with regulatory core capital ratios of 9.1% and 10.6%, respectively, at that date. CGD's ratio stood at 8.4% and Millennium bcp's at 8.5%. Both of these latter two banks expect to meet the minimum 9% core capital ratio required by the BoP by end-2011, largely through asset sales and deleveraging processes, consequently reducing the level of risk-weighted assets.

Recapitalisation will, in Fitch's view, be needed at some banks in 2012. The combined effect of lower internal capital generation through retained earnings and sovereign risks could have an impact on banks' capital. This could prevent weaker-capitalised banks from complying with higher regulatory requirements in 2012 (core capital ratio of 10%), requiring further privately sourced capital support measures. If the latter cannot be found, the Bank Solvency Support Facility (EUR12bn) could provide capital to banks in need.

- Weak earnings outlook for H211 and 2012, mostly due to higher credit costs.

Rising Cost of Credit, but Improved NIM and Cost Containment

In H111, the majority of major Portuguese banks reported a year-on-year decline in operating profit despite a general widening of their net interest margins (NIMs) and cost containment. The decline was mostly owing to lower revenues as a result of lower business activity and most notably higher loan impairment charges due to rising NPLs.

Margins widened across the board, reflecting increased lending spreads in the banks' corporate and SME loan portfolios, despite costlier retail funding costs. Banks with greater reliance on cheaper ECB funding benefited from lower overall wholesale funding costs, supporting their NIM. Furthermore, the NIM was supported by high-margin lending in emerging markets at some banks (eg: Millennium bcp and Banco BPI). Only Santander Totta experienced a narrowing of its NIM due to higher funding costs, reflecting its higher share of short-term wholesale funding compared with the other banks.

Fee income remained broadly flat, despite lower business volumes, helped by a slight increase in guarantees and payment-order-related fees. Other operating income came largely from income/losses from financial operations, in many cases from the sale of sovereign and debt securities. In the case of Millennium bcp, sizeable valuation losses from its Portuguese government securities trading portfolio explain the decline in other operating income.

CGD's other operating income also benefited from revenues from its life and non-life insurance operations (31% of total operating income in H111). With the announcement of the sale of its insurance company, CGD will see its revenue generation capacity reduce despite a fall in costs and will face the challenge of improving the profitability of its banking business.

More positively, profit contributions from banks' international operations improved in H111 and helped to compensate for a decline in profits from their domestic activities. This was particularly relevant at Millennium bcp and Banco BPI.

Banco BPI's Angolan subsidiary accounted for a significant 74% of its H111 pre-tax profit, contrasting with only 10.6% of total assets. Millennium bcp's international subsidiaries performed well to account for around half of the group's net income. This was fuelled by a recovery of Millennium bcp's Polish subsidiary, followed by that of Mozambique and Angola. This compensated for losses from its Greek and Romanian operations. No further impairments were taken in H111 regarding the Greek operations. In Q211, Millennium bcp announced that it considers its Polish subsidiary a non-core business. This suggests that the total or partial sale of this subsidiary cannot be ruled out. While this should support capital ratios, it could jeopardise profits from Millennium bcp's international business in 2012.

The cost of credit has increased significantly, reflecting the deteriorating economic environment. On average, loan and other operating impairment charges accounted for 60% of average total pre-impairment operating profit in H111, a sharp increase on the 36% average a year earlier.

Cost control has been key for all major Portuguese banks in H111, with a particular focus on their domestic operations. The deterioration of the banks' cost/income ratios in H111 mostly reflected lower operating revenues, as costs were contained or slightly declined. Banco BPI's cost/income ratio compared unfavourably with those of its peers at 72.6%, which factors in non-recurring staff costs from early retirements. Santander Totta is the most cost-efficient bank, reflecting cost synergies within the Santander group.

Bottom-line gains from debt buybacks helped to boost pre-tax profit and absorb non-earmarked provisions and expenses at Banco BPI. Millennium bcp benefited from a significant tax reversal. Santander Totta was negatively affected by the build-up of other provisions.

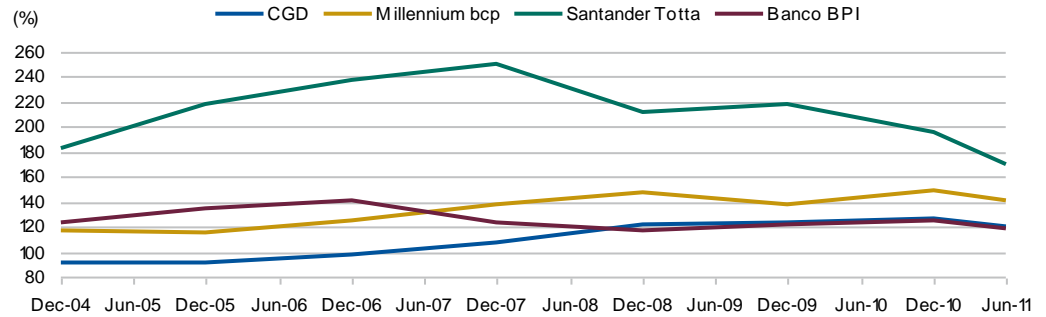
Figure 2
Fitch's Published Portuguese Bank Ratings

	LT IDR ^a	ST IDR ^b	Viability Rating (VR)	Individual Rating	Support Rating	SRF ^c
CGD	BBB-/RWN	F3/RWN	bb	C/D	2/RWN	BBB-/RWN
Millennium bcp	BBB-/RWN	F3/RWN	bb-	C/D	2/RWN	BBB-/RWN
Santander Totta SGPS	AA-/Negative	F1+	bb	C/D	1	-
Banco Santander Totta SA	AA-/Negative	F1+	bb	C/D	1	-
Banco BPI	BBB-/RWN	F3 RWN	bb	C/D	2/RWN	BBB-/RWN
Caixa Economica Montepio Geral	BB/Stable	B	bb-	C/D	3	BB
Banif - Banco Internacional do Funchal, S.A.	BB/Stable	B	b+	D	3	BB
Banco Popular Portugal SA	BBB+/RWN	F3	-	-	1	-

^a Long-Term Issuer Default Rating
^b Short-Term Issuer Default Rating
^c Support Rating Floor
 Source: Fitch

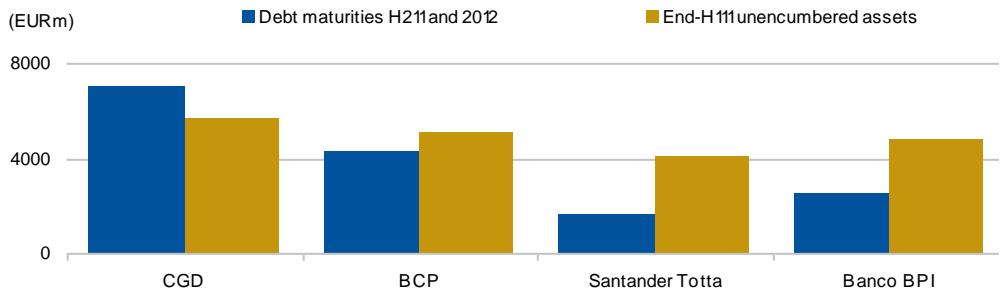
Annex

Figure 3
Loans /deposits ratio evolution



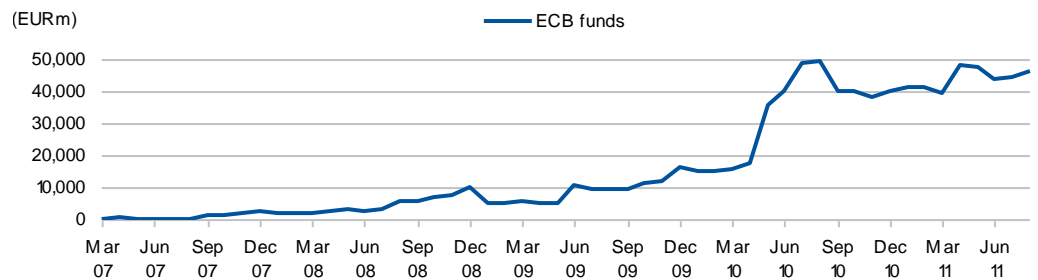
Figures do not consider retail bonds or securitisations
Source: Fitch and banks' accounts

Figure 4
Debt Maturing Profile and Unencumbered assets pool



Source: Banks' data; excludes retail placed bonds
Figures do not take into account additional haircuts from sovereign rating

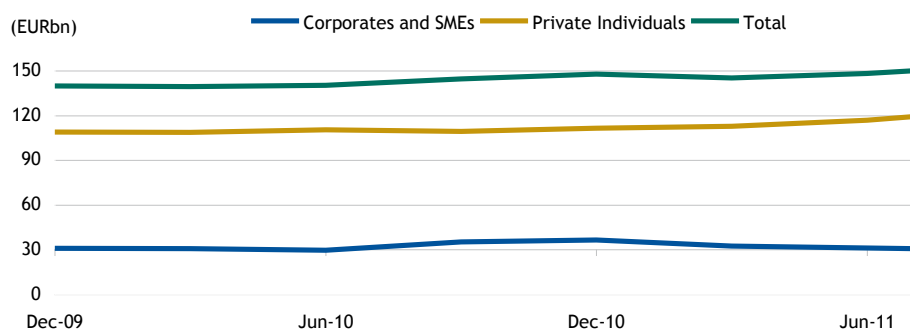
Figure 5
Portuguese Use of ECB Facilities



Source: ECB, Banco de Portugal

Figure 6

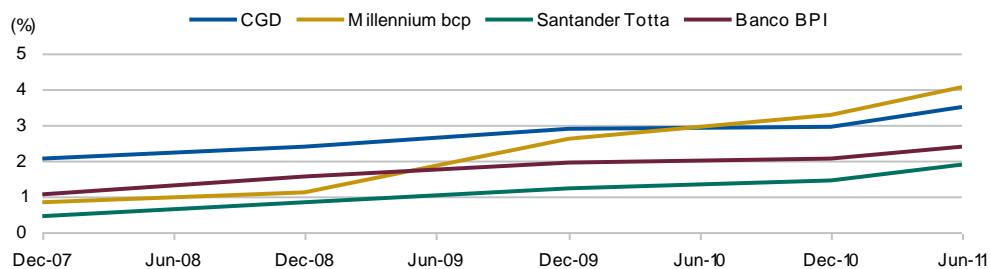
Evolution of Customer Deposits in Portugal



Source: Bank of Portugal

Figure 7

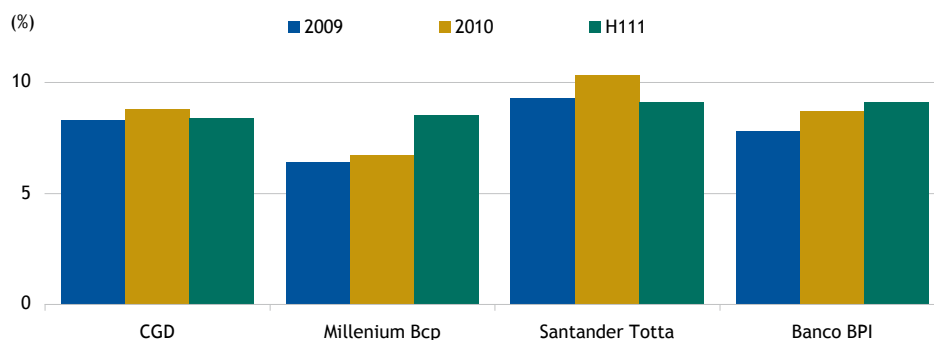
Major Portuguese banks NPLs/loans ratio



Under BoP rules

Figure 8

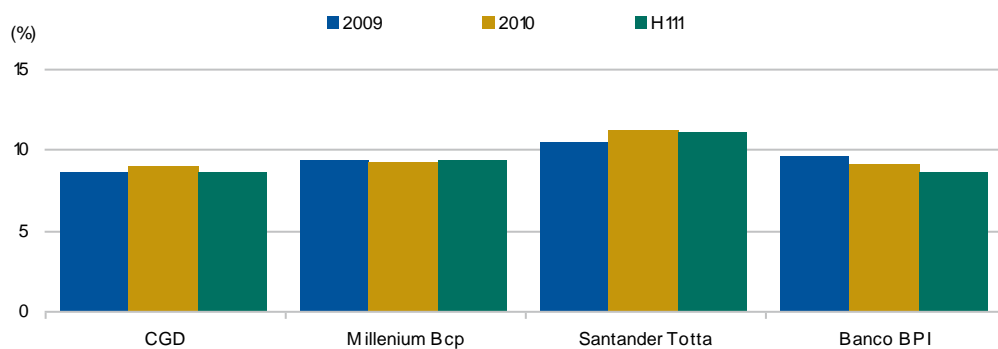
Major Portuguese Banks' Core Capital Ratio



Source: Banks' financial statements, Fitch

Figure 9

Major Portuguese Banks' Tier 1 Capital Ratio



Source: Banks' financial statements, Fitch

Figure 10
Financial Position and Performance Summary

(EURm)	CGD		Millennium bcp		Banco BPI		Santander Totta	
	H111	H110	H111	H110	H111	H110	H111	H110
Balance sheet								
Assets	123,701.0	123,578.9	99,716.6	98,993.3	43,224.8	49,350.7	41,508.8	52,274.6
Gross loans	85,295.0	82,617.0	76,645.4	78,176.4	29,710.6	31,108.0	30,124.4	33,816.3
Equity	6,126.2	6,606.3	5,366.91	5,299.6	1,350.8	1,679.8	2,481.0	2,527.0
Equity/assets (%)	4.95	5.35	5.38	5.35	3.13	3.40	5.98	4.83
Portuguese Government Securities/ equity (%)	113	69*	104	107*	151	152*	82	94*
Fitch core capital ratio / weighted risks	5.32	7.22	8.11	7.52	3.07	5.51	8.54	8.97
Regulatory core tier 1 capital ratio (%)	8.40	8.10	8.50	6.60	9.10	8.10	10.60	7.90
Regulatory tier 1 capital ratio (%)	8.56	8.22	9.30	8.55	9.60	8.60	11.30	11.14
Regulatory total capital ratio (%)	11.53	11.95	10.5	10.03	10.70	10.80	11.30	12.05
Income statement								
Net interest revenue	918.2	801.0	808.8	724.1	305.0	320.0	311.0	377.2
Other operating income	731.3	661.2	497.1	597.3	233.6	249.0	147.0	200.0
Operating expenses	993.1	1,001.5	795.5	804.5	379.6	367.5	279.6	277.7
Pre-impairment operating profit	656.4	460.7	510.4	516.9	159.0	201.5	178.4	299.5
Loan Impairment charges (net of recoveries)	385.0	320.8	562.1	393.0	80.7	50.5	76.9	79.5
Operating profit	271.4	139.9	-51.7	123.9	78.3	151.0	101.5	220.0
Other non-operating income and expenses	-50.1	-2.7	1.0	88.4	64.7	-9.3	-18.3	77.6
Pre-tax profit	221.3	137.2	-50.7	212.3	143.0	141.7	83.2	297.6
Tax	91.0	15.2	-179.3	21.7	12.0	-9.4	10.5	46.0
Net profit	130.3	122.0	128.6	190.6	131.0	151.1	72.7	251.6
Performance ratios								
Net interest margin (%)	1.59	1.41	1.77	1.62	1.49	1.42	1.46	1.58
Non-interest expense/gross revenue (%)	60.34	68.52	62.06	62.24	72.55	66.25	61.71	48.10
Pre-impairment op. profit/average total assets	1.06	0.76	1.04	1.07	0.72	0.84	0.80	1.20
Operating profit/average total assets (%)	0.44	0.23	-0.11	0.26	0.36	0.63	0.46	0.88
Operating profit/average equity (%)	7.86	4.10	-1.86	4.42	9.89	15.75	7.79	17.10
Funding								
Net loans/customer deposits (%)	129.07	141.99	161.35	177.60	128.19	142.64	170.26	210.42
Asset quality								
NPL according to Bank of Portugal/total loans (%)	3.52	2.99	4.06	3.09	2.37	1.97	1.88	1.39
Provisioning/NPL (%)	98.87	105.16	94.34	93.25	83.88	91.53	104.77	111.78
Impairment charge/pre-impairment operating profit (%)	58.65	69.63	110.13	76.03	50.75	25.06	43.11	26.54
Loan impairment charge/gross loans	0.84	0.52	1.49	1.00	0.47	0.31	0.46	0.38

* As of end-2010

Source: Portuguese banks' results announcements and Fitch

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