

European Investment Banks Face A Continued Fight To Remain Competitive

September 28, 2020

Key Takeaways

- A surge in trading volumes enabled most European investment banks to increase capital market revenues in the first half of 2020, but not all benefited.
- European firms have steadily lost market share to their bigger U.S. rivals, in a trend we think will continue because scale is an important competitive advantage.
- If European firms struggle to meet earnings targets in the next two to three years, they may downsize further or possibly consider structural changes such as partnerships and mergers.

Booming trading volumes triggered by the COVID-19 pandemic provided a welcome boost to most European investment banks' earnings for the first half of 2020. Buoyant capital market revenues showed the strength of their diversified business models by mitigating increased credit losses on retail and corporate lending. However, structured equity derivatives were a weak spot as companies suddenly cut dividends, causing pain for French banks that specialize in these products.

Investment bank activities have been a problem child for European banks since the 2008 global financial crisis. Confronted by increased regulatory capital charges, structural revenue pressures, and fierce competition from larger U.S. firms, European players downsized and restructured in a bid to achieve stronger, more consistent returns on capital. Some have now achieved their targeted business models but others--notably Deutsche Bank, HSBC, and Société Générale--continue to reshape.

Given economies of scale in investment banking, S&P Global Ratings believes that the U.S. "bulge bracket" firms are well placed to gain further market share. European banks therefore face a continued fight to remain competitive and sufficiently profitable. If this outcome proves elusive, it could lead to renewed restructuring and capital reallocations, and add impetus to calls for European banks to consolidate.

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Shape of the European investment bank sector

European investment banks are an eclectic group in terms of profile and size. They have followed different paths since 2008, with many reallocating capital toward other market segments where they are more competitively advantaged and therefore better placed to achieve sustained satisfactory profitability.

As in other regions, stand-alone European investment banks are uncommon and typically focus on capital-light advisory business, where their influence has grown. The limited presence of pure-play investment banks in sales and trading reflects the funding synergies and diversification benefits that arise when these activities are included within broader business models. Therefore, when we refer to European investment banks, we usually mean divisions of larger groups.

For rated European banks, we see three broad investment bank configurations:

Full-service investment banks. These firms maintain a material presence across all three market segments--fixed income, equities, and origination and advisory--and in multiple regions. The main banks in this bracket are Barclays, BNP Paribas, and Credit Suisse. These three firms do not operate universally across all products, client types, and regions, but still maintain a broad footprint.

Segment-focused investment banks. These firms have taken a more selective approach by prioritizing particular market segments where their franchises are strongest. Examples include Deutsche Bank, which has exited equities entirely, downsized its rates business outside Europe, and refocused on its more competitive fixed-income, advisory, and financing activities. UBS is another case. It was among the first major investment banks to restructure following the global financial crisis, reducing its presence in rates and credit and prioritizing equities, foreign exchange, origination, and advisory.

Capital markets functions embedded in corporate banking divisions. Although the investment bank label is not a natural fit, Europe's national champion banks typically offer capital markets services to their corporate and institutional customers. Many of these banks scaled back these activities as regulatory capital charges on market and counterparty risks increased following the global financial crisis. Nevertheless, the provision of core trading and underwriting products remains integral to their corporate banking franchises. Examples include ABN AMRO and NatWest, both of which announced this year that they would further shrink and refocus their corporate and investment banking divisions. This illustrates the ongoing struggle to achieve satisfactory returns on allocated capital.

European investment banks' first-half results were a mixed bag

Following a long-term structural decline, the capital markets revenue pool grew significantly in the first half of this year. The COVID-19 outbreak ignited market volatility and led to strong trading volumes and wider bid/offer spreads. Massive central bank intervention underpinned asset values and encouraged new debt and equity issuance, benefiting banks' underwriting businesses (see "Capital Markets Revenue Should Be A Bright Spot For Banks In A Tough 2020," published on June 23, 2020). We expect market conditions to be generally less buoyant over the remainder of the year, but the global sector's full-year 2020 revenues should still register a very strong double-digit growth rate. The uncertain progression of the COVID-19 pandemic adds some uncertainty to the outlook, and events such as the U.S. presidential election also have potential to spark renewed

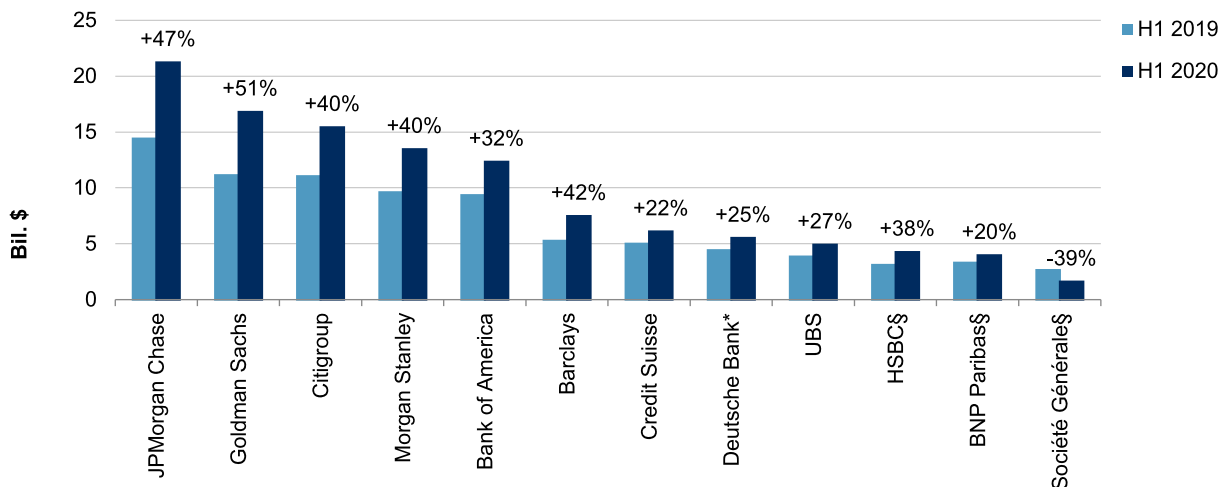
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volatility.

Whereas the five large U.S. firms all benefited strongly from the first-half operating environment, the performance of European banks was more nuanced (see chart 1). Structured equity derivatives were a source of pain as many companies abruptly cut dividends in response to COVID-19 and market volatility increased associated hedging costs. French banks BNP Paribas, Natixis, and Société Générale are particularly strong in these products and were therefore most affected. An industrywide feature of the first-half results was increased credit charges prompted by the effect of the pandemic on the real economy. Certain European corporate and investment banks also incurred sizable impairments on exposures to potential fraud cases in Germany and Singapore. In response to the latter case, and also reflecting ESG (environmental, social, and governance) concerns, some European investment banks have pulled back from commodity trade financing.

Chart 1

Most Investment Banks Recorded Strong First-Half Revenue Growth Disclosed sales and trading, origination/underwriting, and advisory revenues



Source: Bank disclosures, S&P Global Ratings calculations. *Figures exclude equities revenues, which the bank does not separately disclose. §Figures exclude origination and advisory revenues, which the bank does not separately disclose. H--Half.

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First-half revenue growth was powered by fixed-income sales and trading, particularly macro and investment-grade credit products, where European banks such as Barclays, BNP Paribas, and UBS performed on a par with the leading U.S. firms (see table 1). Origination revenues increased significantly but advisory segments were adversely affected by fewer mergers and acquisitions.

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Table 1

Fixed Income Sales And Trading Was The Sweet Spot

Year-on-year revenue changes in the first half of 2020

	Fixed income, currencies, and commodities	Equities	Observation and advisory	Key
Bank of America	+34%	+25%	+35%	Increase of more than 50%
Barclays	+78%	+22%	+5%	Increase of up to 50%
BNP Paris	+82%	-82%	Not disclosed	Decrease
Citigroup	+53%	+19%	+18%	Increase of up to 50%
Credit Suisse	+43%	+13%	+3%	Increase of up to 50%
Deutsche Bank	+22%	Not disclosed	+35%	Increase of up to 50%
Goldman Sachs	+83%	+35%	+32%	Increase of more than 50%
HSBC	+57%	-40%	Not disclosed	Decrease
JPMorgan Chase	+66%	+33%	+22%	Increase of up to 50%
Morgan Stanley	+84%	+22%	+22%	Increase of up to 50%
Société Générale	+30%	-89%	Not disclosed	Decrease
UBS	+108%	+4%	+8%	Increase of more than 50%

Figures based on revenues in U.S. Dollars. Sources: Bank disclosures; S&P Global Ratings calculations.
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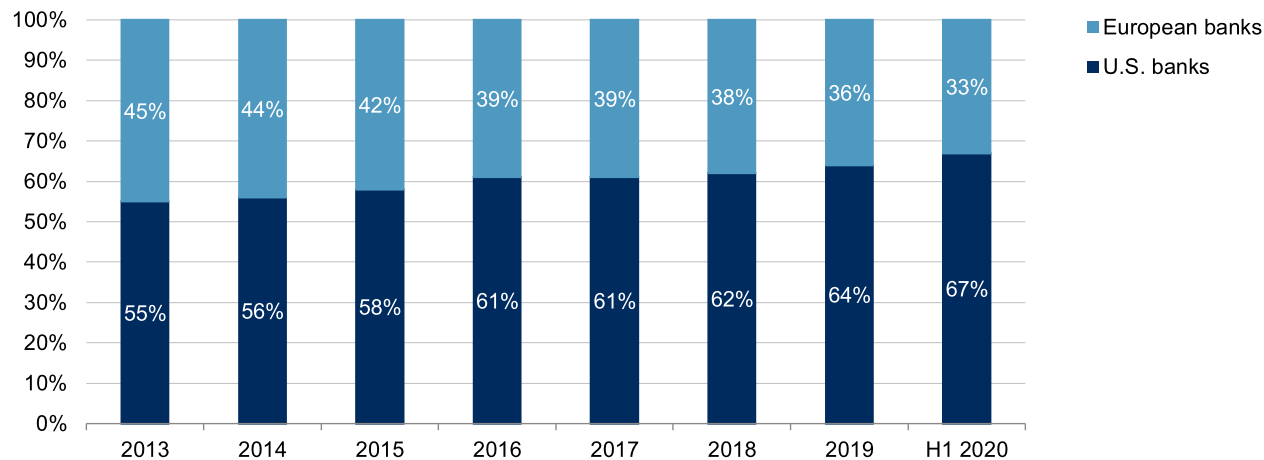
European investment banks have consistently ceded market share

European investment banks have steadily and consistently lost market share to U.S. competitors since the global financial crisis (see chart 2). U.S. banks fine-tuned their capital markets activities during that period--for example, Morgan Stanley reduced its fixed-income footprint--but remained significantly invested in the industry. In contrast, European investment banks have, in aggregate, materially withdrawn capital from their capital markets businesses.

Chart 2

U.S. Investment Banks Have Steadily Gained Global Market Share From European Peers

Market shares of global investment bank revenues among 12 European and U.S. banks



H--Half. Note: U.S. banks are Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, and Morgan Stanley. European banks are Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, HSBC, Société Générale, and UBS. Source: Coalition.

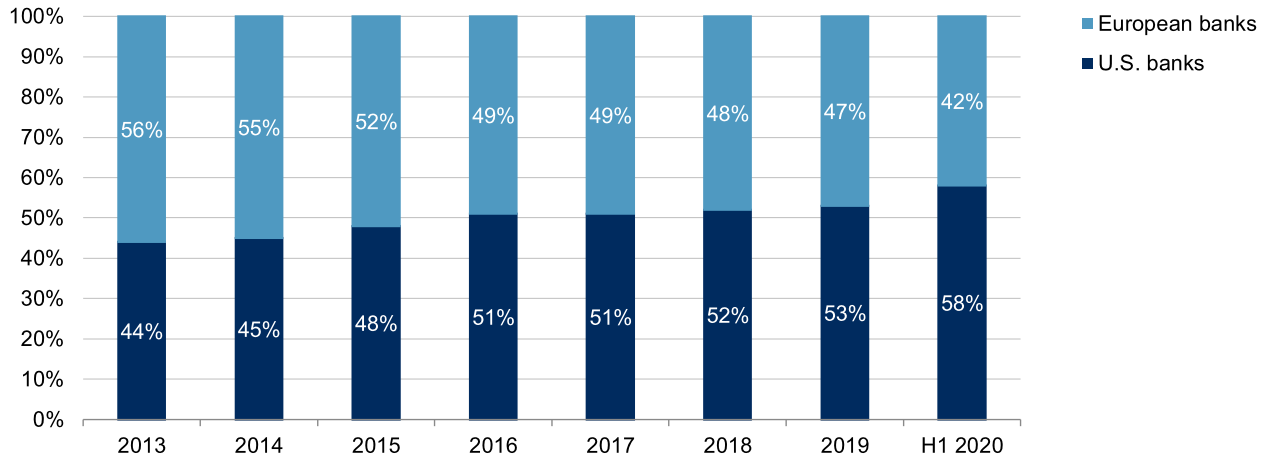
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Even in their home markets, European investment banks play second fiddle to the leading U.S. firms, highlighting their struggle to remain competitive (see chart 3).

Chart 3

Even Within Europe, U.S. Investment Banks Are The Leading Force

Market shares of EMEA investment bank revenues among 12 European and U.S. banks



EMEA--Europe, Middle East, and Africa. H--Half. Note: U.S. banks are Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley. European banks are Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, HSBC, Société Générale, and UBS. Source: Coalition.

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We see several interconnected reasons why European banks have retreated from capital markets activities to a greater extent than U.S. rivals:

- U.S. capital markets are much larger, more profitable, and more integrated than in Europe, where banks remain the primary source of private-sector financing. Current regulations and technology favor "flow monsters" that can access large client trading and financing volumes and maximize operating leverage. U.S. banks' unrivaled domestic distribution networks are therefore a significant competitive advantage, and they are adept at leveraging their scale and diversification to win business. European investment banks have struggled to compete in the U.S. market for several decades and never truly leveraged their late 1990s acquisition spree, which included Deutsche Bank's takeover of Bankers Trust. In contrast, Barclays' 2008 purchase of Lehman's U.S. platform was a successful transaction that expanded its local presence. Even so, it is very difficult for foreign banks to match the breadth and depth of the U.S. banks' franchises among domestic corporates and institutions.
- European banks took longer to adjust to the stricter regulatory requirements and structural pressures on revenues that followed the global financial crisis. Alongside higher capital charges on trading and counterparty risks and new loss-absorbing capacity requirements, which diluted returns on equity for all investment banks, Basel III curbed balance sheet leverage and short-term wholesale funding, which some European banks had exploited before the crisis to gain a competitive edge. Certain European investment banks announced several restructuring programs over the past 10 years as they incrementally recognized the growing challenge of making satisfactory returns. Prospective clients and employees look for strategic consistency as a sign that investment banks are committed for the long haul, and U.S. houses fare better on that front.

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- To a greater extent than in the U.S., the role of investment banks in triggering the global financial crisis put them in the crosshairs of European politicians, regulators, and media. This was a factor behind the introduction of bonus caps, for example, which EU banks must apply globally and had the counterintuitive effect of increasing fixed pay, which reduces financial flexibility when revenues fall.
- Regulations have evolved in different directions in each market. For example, certain European banks are more affected than peers by the so-called balkanization of their operating models. As Switzerland and the U.K. sit outside the EU and have implemented ring-fencing regimes, large firms there must maintain at least four material subgroups: a domestic ring-fenced bank, a domestic non-ring-fenced bank, an EU subsidiary, and a U.S. intermediate holding company. Each entity must meet regulatory capital, loss-absorbing capacity, funding, and liquidity requirements on a stand-alone basis, which constrains the fungibility of resources and dilutes overall returns. Conversely, ring-fencing policy can enhance governance and transparency and is intended to improve resolvability.

Regulation continues to evolve and the final Basel III standards will significantly redesign market risk capital charges through the Fundamental Review of the Trading Book (FRTB). Impact studies indicate that FRTB will increase most banks' capital requirement, but the impact is less significant than other aspects of the final Basel III regime including output floors, which will likely affect European banks more than U.S. peers. Following the COVID-19 outbreak, the Basel Committee postponed implementation until 2023, and we expect that banks will be able to mitigate part of the FRTB impact through proactive capital and risk management.

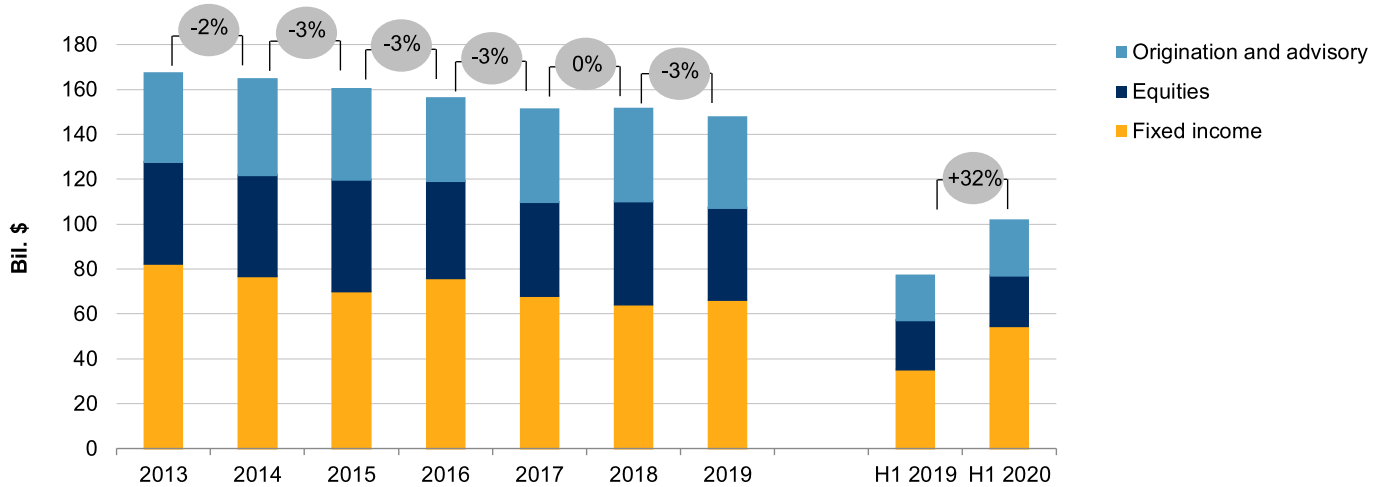
U.S. investment banks will likely gain further market share

The surge in trading revenues triggered by the COVID-19 pandemic is expected to propel the 12 leading global investment banks' aggregate return on equity to 12% this year, according to Coalition. This would be a strong improvement from 7.5% last year, and sustained earnings at this level would encourage banks to maintain their capital allocations to this business. However, the global investment bank revenue pool was in a multiyear decline before this year (see chart 4). This structural trend may well reassert itself in time, potentially prompting further strategic reviews by weaker performers.

Chart 4

Large Investment Banks' Revenues Were In A Steady Decline Until This Year

Aggregate investment bank revenues for 12 European and U.S. banks



H--Half. Note: Banks are Bank of America, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Morgan Stanley, Société Générale, and UBS. Source: Coalition. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

Due to the regulatory environment and investment banks' high fixed-cost bases, we see scale as an important competitive advantage, particularly in low-margin products such as cash equities. As such, we expect U.S. firms will continue to build their market share steadily over time. The question for European players is whether they can remain relevant to clients, invest in competitive trading platforms, and ultimately achieve targeted levels of profitability.

Market indicators such as price-to-book ratios suggest stakeholders, predominantly shareholders, are skeptical that certain European investment banks have viable long-term business models. The pickup in capital markets revenues in the first half has not enhanced these groups' relative stock performance, indicating that investors remain focused on longer-term structural issues. Of course, market prices are also significantly influenced by factors outside the investment bank arena, including the eurozone's prolonged negative interest rates. Activist and strategic investors have become prominent voices in the debate over the appropriate capital allocations to capital markets businesses. For example, Sherborne contends that Barclays should downsize its investment bank but appears to have won little support from other shareholders. Cerberus bought stakes in Deutsche Bank and Commerzbank in 2017 and reportedly backed both their unsuccessful merger talks and subsequent restructuring programs.

For the large European investment banks, our ratings assume that Barclays, Credit Suisse, and UBS have essentially completed internal restructurings. They will no doubt continue to hone their business models, but we expect they will maintain a fairly stable capital markets presence. BNP Paribas, Natixis, and Société Générale announced targeted risk reductions in structured products following their first-half losses on equity derivatives, with the aim of reducing earnings volatility. Otherwise, their capital markets divisions appear in a relatively steady state, with BNP Paribas in particular actively deploying its balance sheet in the first half of the year to win underwriting market share. Deutsche Bank stands out as the firm that remains in a significant transition. In our

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view, it has executed its restructuring plan well to date and substantially completed the reprofiling of its investment bank, but has further to go to realize its targeted end-state profile across all its business lines. Since February, HSBC has also been reshaping its capital markets division, with an emphasis on shifting resources toward Asia and the Middle East where its franchise is strongest.

For national champion banks with capital markets activities embedded in their corporate banking divisions, we see them prioritizing products, currencies, and regions that are important to core corporate clients, and paring back institutional business to areas that are sufficiently profitable or necessary to manage risks. This is a feature of the strategic changes announced this year by ABN AMRO and NatWest.

Improving cost efficiency is key to strengthening returns from capital markets activities, as for European banks' other businesses (see "European Banks Count The Cost Of Inefficiency," published on Oct. 22, 2019). Investment banks' profit margins increased markedly in the first half as revenues outpaced compensation accruals to a surprising degree. This improvement is likely unsustainable as revenues normalize, but there is scope for investment banks to reap productivity improvements by deploying technology. Most European investment banks suspended headcount reductions when the COVID-19 pandemic arrived, but these are likely to restart despite the recent increase in revenues. Banks' accelerated compliance investments should also begin to taper.

European banks' competitive challenges could spur consolidation

Ultimately, if certain European investment banks still struggle to compete and meet returns targets, they will likely instigate further restructurings and capital reallocations. They may also look more favorably at partnerships, mergers, and acquisitions to bolster their franchises. Recent examples of in-fill transactions include BNP Paribas taking over Deutsche Bank's prime finance and electronic equities clients, Société Générale acquiring Commerzbank's equity market and commodities activities, and BNP Paribas partnering with NatWest to provide execution and listed derivatives to the latter's clients. Such deals are a relatively low-cost and low-risk method for the acquiring firms to increase volumes through their platforms.

Joint ventures have gained popularity in European asset management, and there are also certain examples in investment banking, such as ABN AMRO's recently announced partnership with Oddo BHF in Benelux equity brokerage services. Joint ventures can be an effective way for subscale firms to remain relevant to clients. There may also be scope for partnerships or outsourcing for specific processes, such as certain back-office functions. It may be more difficult to agree on a larger-scale joint venture that would meet regulatory requirements and provide both partners with sufficient influence over the entity's management and strategy.

The potential for transformational mergers and acquisitions between European investment banks is part of the broader debate over consolidation in the region. Regulators are taking a more accommodative stance, and the economic disruption triggered by COVID-19 may in time lead banks to see integration as a solution to excess capacity and low structural profitability (see "ECB Set To Ease Regulatory Hurdles To Eurozone Bank Consolidation," published on July 3, 2020).

How we reflect European investment banks' strategic challenges in our ratings

Our ratings reflect the full scope of banking groups' operations. Capital markets activities are often a focus area in our analysis because we generally see them as more risk-intensive, opaque, and potentially volatile than most other banking businesses. The extent of each group's reliance

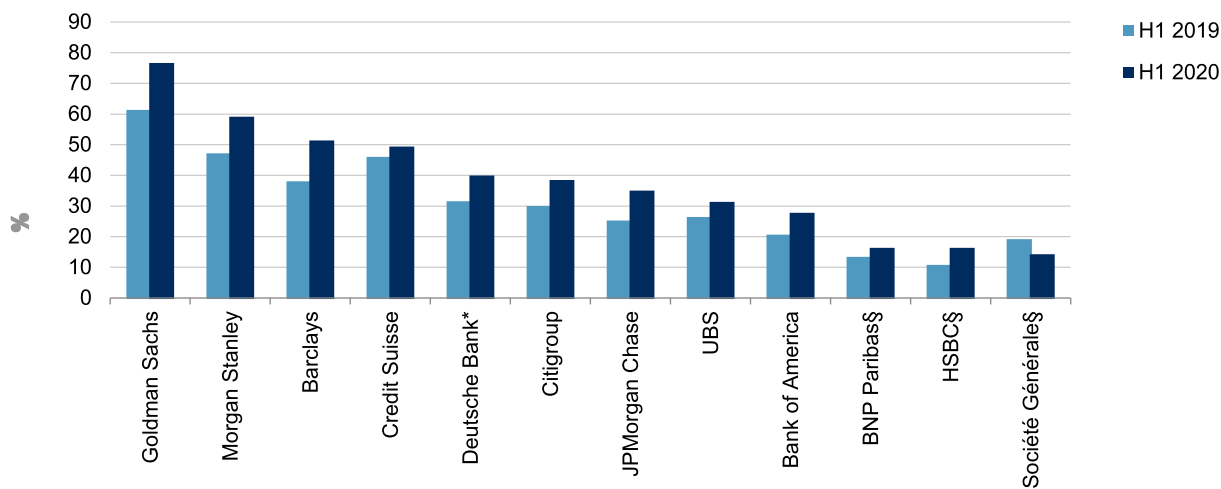
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on investment bank revenues differs markedly across the leading firms, and mostly increased in the first half of this year amid the surge in trading volumes (see chart 5). This upturn coincided with a sharp increase in credit loss charges on retail and corporate exposures, giving weight to the argument that investment bank earnings are loosely correlated with the performance of other divisions. We see some validity in this view, but the values of the securities in banks' trading inventories could have been much more volatile if central banks and governments had not responded to the COVID-19 pandemic so quickly and comprehensively.

Chart 5

Earnings Contributions Of Investment Bank Activities Vary Significantly

Disclosed sales and trading, origination/underwriting, and advisory revenues as a percentage of total group revenues



*Figures exclude equities revenues, which the bank does not separately disclose. \$Figures exclude origination and advisory revenues, which the bank does not separately disclose. H--Half. Sources: Bank disclosures; S&P Global Ratings calculations.

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For banks that are active in capital markets, the opportunities and risks arising from these businesses are relevant to each of our bank-specific rating factors. European investment banks' ongoing strategic challenges are addressed primarily in our business position analysis. Of the 12 leading European and U.S. investment banks, four European firms have an adequate business position assessment--Barclays, Credit Suisse, Deutsche Bank, and Société Générale--whereas the outcomes for the peers are higher (see table 2). There are different reasons for the lower business position scores on these four groups, which encompass factors outside the investment bank arena. However, a common feature is a weaker track record in executing a stable strategy and achieving consistent groupwide performance, including the contribution from their investment bank divisions.

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Table 2

Rating Components For Selected Global Investment Banks

	Anchor	Business position	Capital and earnings	Risk position	Funding and Liquidity	Group SACP	ALAC uplift	Additional factors	Core opco long-term ICR and outlook
JPMorgan Chase	bbb+	Very strong	Adequate	Adequate	Average and Adequate	a	1	0	A+/Stable
Bank of America	bbb+	Strong	Adequate	Strong	Average and Adequate	a	1	0	A+/Stable
HSBC	bbb+	Strong	Adequate	Strong	Above average and Adequate	a	1	0	A+/Stable
UBS	a-	Strong	Strong	Moderate	Average and Adequate	a	1	0	A+/Stable
Citigroup	bbb+	Strong	Adequate	Adequate	Average and Adequate	a-	2	0	A+/Stable
Morgan Stanley	bbb+	Strong	Strong	Moderate	Average and Adequate	a-	2	0	A+/Stable
Credit Suisse	a-	Adequate	Strong	Moderate	Average and Adequate	a-	2	0	A+/Stable
Goldman Sachs	bbb+	Strong	Adequate	Moderate	Average and Adequate	bbb+	2	1	A+/Stable
BNP Paribas	bbb+	Very strong	Adequate	Adequate	Average and Adequate	a	1	0	A+/Negative
Barclays	bbb+	Adequate	Strong	Moderate	Average and Adequate	bbb+	2	0	A/Negative
Société Générale	bbb+	Adequate	Adequate	Adequate	Average and Adequate	bbb+	2	0	A/Negative
Deutsche Bank	bbb+	Adequate	Adequate	Moderate	Average and Adequate	bbb	2	(1)	BBB+/Negative

Note: Data as of Sept. 18, 2020. Table sorted by ICR and outlook, then Group SACP, then business position. SACP--Stand-alone credit profile. ALAC--Additional loss-absorbing capacity. Opco--operating company. ICR--Issuer credit rating. Source: S&P Global Ratings.

Our risk position assessment reflects our view of the elevated risk profile of many capital markets businesses. Our methodology stipulates that risk position will be moderate, at best, if we expect investment bank activities will contribute more than 50% of group revenues over the long term. We also maintain moderate risk position assessments on certain groups that fall below this threshold, partly because our capital and earnings assessment may not fully capture the risks presented by inherently complex capital markets businesses.

We have taken rating actions on various European investment banks since the COVID-19 outbreak. In May, we revised the outlook on Société Générale to negative from stable and lowered the group stand-alone credit profile due to its continuing profitability challenges, especially in its investment bank division. However, capital markets activities were not a major factor in our downgrade of HSBC in May or our revision of the outlooks on Barclays, BNP Paribas, and Deutsche Bank to negative from stable in April. The latter actions were primarily due to a weakening in asset quality and profitability triggered by the pandemic. In contrast, we did not take rating actions on the Swiss or U.S. banks because we believe they are better placed to maintain robust earnings and balance sheets through the recession.

Capital Markets Union would benefit European investment banks--and their competitors

The EU's Capital Markets Union (CMU) project has potential to generate increased revenues for European investment banks. As the leading players in the region, U.S. investment banks would also benefit. Despite widespread policymaker support, progress on the CMU has been slow until now, and the EU recently published a new action plan to rebuild momentum. It's possible that a re-energized Commission, spurred by the High Level Forum's recommendations and a post-Brexit realization that the EU needs to rely less on markets in third countries, will drive forward the necessary changes to make CMU a reality. Still, CMU's effects are unlikely to be visible in investment banks' earnings for several years because it is a long-term project that must clear many hurdles to achieve success.

CMU is intended to integrate Europe's shallow, fragmented capital markets and facilitate improved access to cross-border financing for both the public and private sectors. The EU's debt-financed €750 billion COVID-19 recovery fund and the growth of green bond markets are just two examples that illustrate the importance of efficient financing to the region's economy. A successful CMU would cannibalize some revenues from the European banking system by reducing the current over-reliance on their balance sheets for funding. However, we see it as positive on the whole for the banking sector, and investment banks in particular should gain from the opportunity to intermediate increased capital markets volumes (see "The EU Capital Markets Union: Turning The Tide," published on Feb. 25, 2020). This is true in particular if the European Green Deal becomes reality, because the necessary step change in investment implies a financing need that banks cannot meet from their own balance sheets.

Does Europe's reliance on U.S. investment banks matter to its real economy?

There are mixed opinions about whether U.S. investment banks' increasing market share of European investment bank revenues is a potential vulnerability for the region's economy. It could be a concern if foreign banks prioritized their home markets in a stress scenario and reduced their commitment to Europe, with insufficient time for local firms to fill the gap.

Media reports suggested that U.S. investment banks pulled back from certain European corporate loan syndications at the peak of COVID-19 outbreak in March and April this year. However, revenue data indicates this was probably not a widespread phenomenon, and reduced risk appetite for specific borrowers was probably behind any instances more than an overarching regional policy. Still, European banks' reduced investment bank capacity means the region's capital markets could be susceptible to changes in U.S. banks' strategies or U.S. regulatory and political developments. We heard anecdotal evidence that some clients, including non-European ones, are

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wary of U.S. investment banks gaining greater dominance and therefore encourage European firms to remain invested in the industry. Again, it is difficult to say whether this is a widely held view and whether it translates into a material tangible benefit for the European players.

Related Research

- EMEA Financial Institutions Monitor 3Q2020: Low Profitability Lingers On, July 24, 2020
- Global Banks Outlook Midyear 2020: A Series Of Reports Look At The Profound Implications Of The COVID-19 Shock, July 9, 2020
- ECB Set To Ease Regulatory Hurdles To Eurozone Bank Consolidation, July 3, 2020
- Capital Markets Revenue Should Be A Bright Spot For Banks In A Tough 2020, June 23, 2020
- The EU Capital Markets Union: Turning The Tide, Feb. 25, 2020
- European Banks Count The Cost Of Inefficiency, Oct. 22, 2019

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