UK Life Insurance

We have changed our outlook to stable from negative for the UK life sector reflecting our expectation of stable earnings, conservative capital management and increasing income diversity from captive asset managers. This outlook expresses our expectations for the fundamental credit conditions in the industry over the next 12 to 18 months.

Summary Opinion

We have changed our credit outlook for the UK life sector to stable from negative. The change in outlook primarily reflects three factors (1) our expectations of earnings stability supported by increasing cash generation; (2) the industry’s strong and resilient capitalisation, which we expect to continue, sustained by conservative capital management; and (3) the strong performance of captive asset managers. However, these factors are counterbalanced by a degree of short-term disruption likely to arise from the Retail Distribution Review (RDR), the risks posed by insurers’ expansion into “new” investment areas and the UK’s weak economic growth outlook.

» The profitability of the UK life industry is stable and supported by growing cash generation. We expect the industry’s earnings to remain healthy overall, whilst earnings quality will improve given the focus on cash generation. The low-interest-rate environment will gradually reduce profitability, but only marginally, given the industry’s relatively low sensitivity to interest rates.

» Capitalisation has improved and we expect continued conservative capital management. The introduction of Solvency II, although postponed, has kept capital in check. Capitalisation has rebounded from its lows according to various capital metrics and is higher than pre-financial crisis levels. In addition the exposure to peripheral Eurozone investments is minimal.

» Captive asset managers have helped insurers to capture significant growth. Captive asset managers have provided income diversity and helped some UK life insurers to expand and partially offset the historical erosion of cash flows in the life insurance market. Over 2013, we expect this trend to continue.

» Short-term disruption is likely to arise from the RDR. The introduction of RDR at the end of 2012 will reduce the number of Independent Financial Advisors (IFAs) and, consequently, life sales are likely to decline over the outlook period.

» Insurers are increasing their credit exposure to “new” asset classes, albeit in modest amounts thus far. The retrenching of the banking system and the low interest-rate environment has meant that insurers are increasingly expanding their investment activities into the realm of banks. We believe that risks arise from the insurance sector’s often limited investment experience in these “new” assets and the need to develop specific expertise that companies might currently lack.

» UK economic growth remains weak, albeit long-term growth prospects for the UK life sector are strong. The operating environment for UK insurers remains challenging, given the weak economic growth prospects and high level of household indebtedness, albeit some pockets of growth exist, particularly in the annuity and protection lines. We also expect long-term growth from the expanding pensioner population, and the continued lack of an adequate level of private pension provision.
EXHIBIT 1
Moody’s-Rated Life Insurers in UK

<table>
<thead>
<tr>
<th>Issuer</th>
<th>IFSR</th>
<th>Rating Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aviva Life &amp; Pensions UK Ltd</td>
<td>Aa3</td>
<td>Negative</td>
</tr>
<tr>
<td>Clerical Medical Investment Group</td>
<td>A2</td>
<td>Stable</td>
</tr>
<tr>
<td>Friends Life Limited</td>
<td>A3</td>
<td>Negative</td>
</tr>
<tr>
<td>Legal &amp; General Assurance Society Ltd</td>
<td>Aa3</td>
<td>Stable</td>
</tr>
<tr>
<td>Prudential Annuities Ltd</td>
<td>Aa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Prudential Assurance Company Ltd</td>
<td>Aa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Prudential Retirement Income Ltd</td>
<td>Aa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Royal London Mutual Insurance Society Ltd</td>
<td>A2</td>
<td>Stable</td>
</tr>
<tr>
<td>Scottish Amicable Insurance Fund</td>
<td>Aa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Scottish Life Fund</td>
<td>A2</td>
<td>Stable</td>
</tr>
<tr>
<td>Scottish Widows plc</td>
<td>A2</td>
<td>Stable</td>
</tr>
<tr>
<td>Skandia Life Assurance Company</td>
<td>A2</td>
<td>Stable</td>
</tr>
<tr>
<td>Standard Life Assurance Ltd</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>Zurich Assurance Ltd</td>
<td>A1</td>
<td>Stable</td>
</tr>
</tbody>
</table>

Source: Moody’s
UK Economic Growth Remains Weak, Albeit Long-Term Growth Prospects for the UK Life Insurance Sector Are Strong

The operating environment for insurers in the UK is set to remain challenging, driven by weak economic growth and high level of household indebtedness

We have recently downgraded the UK sovereign rating1 to Aa1, stable, from Aaa. The downgrade has no direct rating implications for the UK life insurers, whose ratings remain below the current sovereign rating. Nevertheless the sovereign downgrade highlights the challenge that insurers face by operating in a low growth economic environment. We expect the UK’s economic growth to remain sluggish over the next few years due to the anticipated slow growth of the global economy and the drag on the UK economy from the ongoing domestic public- and private-sector deleveraging process.

We have cut our 2013 real GDP growth forecast to 1.0% from 1.4%, which is considerably below the country’s long-term trend growth rate and we expect private consumption growth to be relatively weak, with the household savings rate remaining high as consumers repair their personal balance sheets (Exhibit 2).

EXHIBIT 2
Contribution Analysis to Real GDP Growth

Households in the UK are highly leveraged by global standards, given their high exposure to mortgage loans (Exhibit 3). The private sector is currently deleveraging, and we expect that deleveraging will only slowly recede over the next few years. This will continue to suppress private consumption and consequently the demand for life insurance products.

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1 For more information, refer to ‘Moody’s downgrades UK’s government bond rating to Aa1 from Aaa; outlook is now stable’, 22 February 2013.
EXHIBIT 3
Household Debt (as % of Gross Disposable Income, 2012)

Source: ECB, EC/AMECO, Federal Reserve

Given the fragile economy, the UK life insurance market has been shrinking with significant net cash outflows, although some pockets of growth exist.

The UK life market remains under pressure with life net premiums reducing significantly by 13% per annum since the 2007 peak (Exhibit 4). This significant reduction can be explained by the fragile economy following the 2008-09 financial crisis, leading to many discretionary purchases of life or pensions products being suspended or deferred as consumers’ disposable income has fallen.

EXHIBIT 4
UK Long –Term insurance Net Premium Income: A Declining Trend Since the 2007 Peak

Source: ABI – Annual Long-term Insurance Overview Statistics 2011

Despite the weak economy, there are some pockets of growth in the current market, particularly in the annuity and protection lines. Both these two market segments have remained resilient to the adverse economic condition and we expect to see further growth in the coming quarters. The annuity market is supported by the increasing number of people reaching retirement and by the robust demand for bulk annuity from the corporate sector. Protection is expected to receive a boost by the introduction of RDR (see section below) and public welfare spending cuts.
Long-Term Growth Prospects for the UK Life Insurance Sector Are Strong

We expect the pension market to grow further in the long term. The UK demographic trends, namely an expanding pensioner population, and the continued lack of adequate levels of private pension provision are likely to fuel growth for many years to come, as well as the switch from defined benefit company pension schemes to defined contribution or occupational schemes.

As an example, pension auto-enrolment, which started in October 2012, will increase participation rates in corporate pensions, and thus will be beneficial for the UK life insurance industry. We estimate that once the full 8% minimum total contribution rate is enforced by September 2017, auto-enrolment will result in incremental pension savings of approximately £7.5 billion each year. Nevertheless, we do not expect all this incremental saving to be profitable and the creation of a multi-employer occupational pension scheme by the UK government (National Employment Savings Trust) acts as a low-cost benchmark for the corporate pension industry. As a result only those insurers that are able to expand while maintaining margins, because of high service quality or brand recognition, will benefit from this development.

The Profitability of the UK Life Industry is Stable and Supported by Growing Cash Generation

Underlying profitability will remain robust in the coming quarters

We expect that the industry’s earnings will remain healthy overall, and that earnings quality will continue to improve given many UK life insurers’ focus on cash generation. Both operating profitability and bottom lines have stabilised following the 2008-09 financial crisis (Exhibit 5) and we expect underlying profitability to remain robust over the 12-18 month outlook period.

The recent recovery in performance resulted from a significant reduction in costs and a focus on high margin products, namely annuities and protection. Several key players have established significant cost-saving initiatives, ranging from 15% to 30% reductions of their cost base. Incumbents’ profitability has also been helped by the decision of some international players to either exit the life insurance market (for example AXA sold parts of its UK operation to Resolution in 2010) or scale-back their operations over recent years (for example AEGON N.V. pulled out of some business lines, such as bulk annuity in 2010).  

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2 For more information, refer to “Pensions Auto-Enrolment Is Credit Positive for UK Insurers” published in November 2010.
3 For more information, refer to “Moves by AXA, AEGON Suggest a Rethinking of the UK Life Insurance Market” published on 28 June 2010.
Quality of profits will continue to improve

Many UK life insurers have transformed their business model and have focused on maximising cash flow by reducing capital strain and by managing their back-book of business more efficiently. As a result, cash generation has registered strong growth over the last three years (Exhibit 6).

The low interest-rate environment will gradually reduce profitability, but only marginally, given the industry’s low sensitivity to interest-rate fluctuations

The low interest-rate environment will reduce profitability for the UK insurance industry, but we believe that any reduction will be marginal and will only occur gradually. Around 67% of the total industry’s reserves is unit-linked with no interest guarantees and, as a result, its profitability is less sensitive to credit spreads than in many other European markets. Even for those businesses with interest guarantees, they tend to be low. In addition, most of the UK life insurers closely match the
duration of their assets and liabilities, which limits reinvestment risk. Consequently, we view the UK life market as the least affected in Europe by a persistently low interest-rate environment (Exhibit 7).

**EXHIBIT 7**

**The UK Life Industry is less Sensitive to Interest Rates than other European Markets**

<table>
<thead>
<tr>
<th>Life</th>
<th>UK</th>
<th>France</th>
<th>Italy</th>
<th>Switzerland</th>
<th>Germany</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed products as % technical reserves*</td>
<td>~33%</td>
<td>~85%</td>
<td>~63%</td>
<td>~94%</td>
<td>~93%</td>
<td>~60%</td>
</tr>
<tr>
<td>Average portfolio guarantee rate**</td>
<td>~0%</td>
<td>~1%</td>
<td>~2-3%</td>
<td>~2.5-3%</td>
<td>~3-4%</td>
<td>~3-4%</td>
</tr>
<tr>
<td>Average new business guarantee rate**</td>
<td>~0%</td>
<td>~0%</td>
<td>~1.5%</td>
<td>1.5%</td>
<td>~1.75%</td>
<td>~3%</td>
</tr>
<tr>
<td>Overall risk of guaranteed products</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Figures for all countries represent YE11 non-linked provisions % of total technical provisions, apart from Switzerland for which figures are % of total gross mathematical provisions, and from Italy for which figures are guaranteed provisions %. Figures for UK, France and Germany derived from EIOPA, Italy from ANIA, Netherlands from De NederLandsche Bank, Switzerland from FINMA.

** Figures derived from information disclosed by companies, regulators and other sources including: Aegon, Axa, Generali, Munich Re, Unipol, Zurich, BaFin, FINMA, IMF.

This view is also reinforced by our analysis of the sensitivity of embedded value to movements in interest rates (Exhibit 8). Overall, the impact is marginal for most UK players; however, for some of their continental European peers, a shift in interest rates could have a double digit impact on their embedded values.

**EXHIBIT 8**

**Sensitivities of Embedded Value to Movements of Interest Rates: A Marginal Impact**

Source: Based on 2011 European Embedded Value for Prudential Plc, Legal & General Plc, Standard Life Plc and Ageas N.V. Based on 2011 Market consistent Embedded Value for Friends Life Plc, Aviva Plc and Allianz SE.

Note: A direct comparison of the sensitivities of embedded value by insurer is not exact since the underlying assumptions vary significantly by company.
Capitalisation Has Improved and We Expect Continued Conservative Capital Management

Persistence of key risks makes UK insurers cautious in their use of excess capital

The industry’s capitalisation has improved over the last three years as a result of good earnings retention and a general de-risking of assets and liabilities. We expect that companies will remain cautious in their use of excess capital in 2013, since they want to maintain sufficient buffers ahead of the implementation of Solvency II and given the fragile and volatile financial markets, particularly as a result of the situation in the Euro area.

Capitalisation rebounded from its lows according to various capital metrics and is higher than pre-financial crisis levels. Both the Insurance Groups Directive (IGD) capital cover and IGD capital surplus rebounded for all the major players over the last four years (Exhibit 9). In addition the exposure to peripheral Eurozone sovereign and banks is minimal, ranging from 0% to 5% of total shareholder’s capital for most of the life insurers we rate in the UK.

EXHIBIT 9
IGD Capital and Cover for Selected UK life Insurers: An Improving Trend

With-profit surplus still recovering from volatile equity markets in 2011; we expect surplus position to improve in 2012 and 2013

While IGD surplus and IGD cover have been restored above pre-financial crisis levels, the capital cover within the with-profit business remains below its 2007 level and declined further in 2011. This is evidenced both by the with-profit capital cover (based on the more onerous of the regulatory and realistic peak) and our MASC cover4 (Exhibit 10). This divergent trend is not surprising given that the with-profit surplus is not included in IGD capital and is highly sensitive to equity movement (at year-end 2011 the FTSE 100 was 8% lower than at the end of 2007 and 6% lower than previous year). We expect with profit surplus to increase in 2012 and in the early part of 2013 as the equity market recovers.

4 For details on Moody’s MASC ratio calculations, please refer to ‘Moody’s Comments on New FSA Returns for UK Life Insurers’, September 2005.
We expect that the risk of “burn-through” for shareholder’s capital will remain low, given the current level of with-profit surplus and the flexible product design for most insurers we rate. These product features enable insurers to pass-on declines in equities to policyholders, subject to minimum guarantees.

Credit-default reserves represent another capital cushion for UK life players, although they are likely to be absorbed by the higher capital requirements under Solvency II

We believe that the credit-default reserves built during the recent financial crisis (Exhibit 11) will be absorbed by the higher capital requirements under Solvency II. Many UK life annuity players established sizeable amounts of credit-default reserves because they expected credit default rates to increase. Insurers have maintained these reserves, which are not part of IFRS equity, despite their benign default experience.
Solvency II for UK insurers is expected to be less onerous than previously anticipated

Recent developments with respect to the counter-cyclical adjustments and matching premium for the UK annuity writers indicates a potentially less onerous outcome for UK life insurers than previously anticipated. The European Insurance and Occupational Pensions Authority (EIOPA) has recently launched an impact study which will test different ways of discounting the liabilities of life insurers and we expect a potential softening of previously proposed calibrations. Nevertheless, we still expect capital requirements for the UK sector to increase overall, relative to the current regime, once Solvency II is adopted. As a result, we expect capital management to remain conservative in 2013.

Despite the postponement of Solvency II to after 2014, the UK insurance regulator allows insurers to adopt elements of Solvency II in the current ICA regime. We view this positively since it provides, for those insurers that wish to do so, time to familiarise themselves with the new regime and to use it as an explicit management tool.

Captive Asset Managers Have Helped Some Insurers To Capture Significant Growth

Captive asset managers have provided diversity of income and helped some UK life insurers to grow

An increasing proportion of cash and earnings for some UK insurers are generated by their captive asset managers serving third-party clients. In some cases, the additional cash flows and profitability of the asset-management subsidiaries have offset the erosion in cash flows of their insurance operations as some customers shift from buying insurance to asset-management products.

Insurance players manage a significant portion, at around 30%, of assets in the asset-management industry (Exhibit 12) and five out of the ten-largest asset managers in the UK are part of insurance groups (Exhibit 13).

![EXHIBIT 12](image)

Breakdown of UK assets under management by parent company

Source: IMA, at year-end 2011 (page 97 of Asset Management in the UK 2011-2012, The IMA Annual Survey)
We think that asset managers are in a better position to compete in non-guaranteed saving products relative to insurers given their lower cost base. As a result those insurers with established franchises in this area, such as Legal & General, Prudential and Standard Life, are well-placed to benefit from the shift to asset-management products.

Nevertheless asset management products tend to be lower margin than the more traditional insurance products as they do not provide guarantees and life/income protection. Furthermore competition in asset management is fierce, with a wide open playing field. Despite granular opportunities, flows are highly concentrated among a handful of global and strong players, particularly in the retail space.

**Short-Term Disruption Is Likely To Arise From RDR**

**RDR will prompt positive long-term effects, but will reduce new life premiums over the outlook period**

RDR was finally implemented at the end of last year. We believe that RDR will depress life sales for the insurance sector in 2013, and possibly in 2014, even though it will probably improve the sector’s profitability in the long term. Clearly, there is a risk of a serious disruption to the IFA channel, which is of importance for the distribution of life products in the UK, representing close to 80% of new business sales in 2011.

RDR’s long-term advantages are clear for the insurance industry: it improves the quality of advice and reduces scope for mis-selling, leading to increased transparency for the insurance industry. It also reduces the share of value paid to distributors in the value chain and enhances consumers’ confidence in the industry. Nevertheless, the immediate effects are particularly credit negative for those insurers that operate in the mass-market segment and rely mostly on IFA distribution, due to the expected negative impact on business volumes. We expect a reduction in life overall premiums in 2013, and possibly in 2014, for two main reasons:

(1) Some distribution channels will shrink:
a. Some IFAs have found the new compensation system and professional standards difficult to work with and various sources⁵ expect a reduction in the number of IFAs ranging between 10% and 15%.

b. Several banks, which are insurers’ distribution partners, over recent years closed their in-branch financial planning service or limited their offering to high net-worth individuals.⁶

(2) Some customers are likely to perceive independent advice as too expensive. As a result, there is a risk that a portion of the mass-market will not be served by IFAs, who will instead target only the more affluent customers who can afford to pay for their services.

“Restricted advice” is likely to become an important channel of distribution

Because of the perceived high cost of advice, some IFAs will choose to offer only “restricted advice” and limit themselves to the products of a single company or a limited group of companies. As a result, we expect that IFAs offering “restricted advice” will become an important channel of distribution for the UK life market.

The new distribution rules do not apply to protection products whose market is expected to grow

Conversely, RDR is not applied to protection products. As a result, we expect that the protection market will grow as distributors focus on the sale of these products where they can still receive commission.

How are individual groups responding?

Many of the UK life insurers we rate, such as Standard Life, Legal & General and Prudential, stopped or reduced the payment of up-front commission to IFAs some years ahead of the implementation of RDR. On the other hand, some other insurers, such as Aviva and Scottish Widows, continued to offer commission-based products until end-2012, with the intention to acquire new clients and ultimately benefit from corporate pension auto-enrolment. We consider the first strategy as better-suited for RDR since it reduces the risk of losing clients post-RDR.

Insurers have also strengthened their relationship with those advisors that are likely to survive post-RDR as well as trying to diversify away from the IFA channel. However, the strategy to grow their bancassurance channel has yielded mixed results as many banks have decided to stop selling savings and investment products to the mass market, as they perceived the cost associated to be RDR compliant as too elevated.

Insurers have also redesigned their product offerings in a more simple, clear and transparent format in order to make them more appealing to customers. That, in turn, enables companies to promote a direct proposition and ultimately increases their brand awareness with customers. Some UK life companies, such as Standard Life, have invested heavily over the recent years in developing their online platform capabilities.

⁵ In June 2010 NMG Consulting, a financial services consulting and research firm, calculated a 15% IFA exodus. Source: The cost of implementing the Retail Distribution Review professionalism policy changes, June 2010, page 52.
⁶ In 2011 Barclays decided to stop offering financial advice through its retail branches by closing Barclays Financial Planning and more recently HSBC, Royal Bank of Scotland and Santander have all announced various measurements to reduce their financial advice services.


**Insurers Are Taking Some New Risks by Investing in "New" Asset Classes, Albeit in Modest Amounts, Thus Far**

**UK insurers are investing in asset classes more commonly found in banks**

The retrenching of the banking system and the low interest-rate environment has meant that insurers are increasingly expanding their activities in investment areas traditionally the realm of banks, for example commercial real estate, infrastructure financing and mortgages. These assets are often “real” in nature, offering higher long-term return prospects, and provide insurers with a good opportunity to seek to enhance investment returns.

This process has already begun but, for the time being, the amounts are relatively small. As an example, according to ONS data, UK insurers’ loans to UK borrowers have increased by two thirds to around £27 billion at end-2011 from £16 billion at end-2007 (source: Financial Stability Report June 2012 by Bank of England).

**Limited investment knowledge of these assets poses the greatest risk**

Life insurers are naturally holders of such long-term assets given the long-term nature of their liabilities. As a result, investing in these long-term asset classes does not necessarily pose duration risks. However, risk arises from the often limited investment knowledge by the insurance sector of these asset classes, and the need to develop specific expertise that they might currently lack. In addition, insurers would need to exercise caution in expanding their portfolios if this is through purchasing assets directly from banks, since in this scenario there is likely to be an asymmetry of information between the two parties.

One key question is the amount of capital that would be required to be put aside to cover the risk arising from these asset classes. EIOPA is currently working on this specific theme following a request by the European Commission in September 2012 regarding the calibration and design of capital requirements for investments in “long-term finance”.7

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7 For more information, refer to the “Letter from Jonathan Faull, Director General Internal Market and Services, to Gabriel Bernardino, Chair of EIOPA”, September 2012.
Appendix

RDR – Independent distribution moves from a commission-based to a fee-based profession

The FSA launched RDR in June 2006 to address insufficient consumer trust and confidence in the investment products and services supplied by the market. The aim is to improve customers’ experience in the purchase of investment products by guaranteeing the best execution and enhanced professional standards in the financial advice area.

With RDR, the remuneration of financial advisors will radically change from an up-front commission model set between insurers and financial advisors to a fee-based ‘adviser charging’ model, exclusively set and agreed between financial advisors and customers. This will enhance the independent role of the advisor because remuneration would be agreed with the consumer rather than being dependant on the commission paid by the insurance company. The FSA also raised the minimum level of qualifications for all investment advisers.
Moody’s Related Research

Credit Opinions:
» Legal & General Assurance Society Ltd.
» Prudential Plc
» Prudential Assurance Company
» Aviva Plc
» Aviva Life & Pensions UK Ltd.
» Royal London Mutual Insurance Society Ltd.
» Friends Provident Life & Pensions Ltd
» Clerical Medical Investment Group Limited
» Scottish Widows plc

Industry Outlooks:
» French Insurance: P&C Stable; Life Negative, February 2013 (150833)
» Global Life Insurance Outlook, January 2013 (149055)
» German Insurance: P&C Results Remain Constrained; Unresolved Structural Issues in Life, December 2012 (147834)
» Global Reinsurance Outlook, September 2012 (145188)
» Italian Insurance: P&C is Stable But Life Market Remains Under Pressure, June 2012 (142376)
» UK General Insurance: Stable Outlook, as Modest Rate Increases Prevail, April 2012 (141449)

Special Comments:
» European Insurers’ Performance During Crisis Highlights Distinctions with Banks, December 2012 (148224)
» Interest Rates Low, Low, Low: Are US Life Insurers Concerned Enough?, December 2012 (147199)
» European Insurance: Current Market Conditions Elevate Risk of Intangible Asset Impairments, November 2012 (147422)
» How Further Sovereign Stress Would Affect European Insurers And Their Ratings, October 2012 (145715)

Rating Methodologies:
» Moody’s Global Rating Methodology for Life Insurers, May 2010 (123502)
» Moody’s Global Rating Methodology for Property & Casualty Insurers, May 2010 (121761)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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