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## Sparebanken Nord-Norge

### Company Background, Strategy and Competition

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#### A LEADING SAVINGS BANK IN NORTHERN NORWAY

Sparebanken Nord-Norge (rated A3/P-2/C) is a leading savings bank in the region of Tromsø and its surrounding area (Northern Norway). Local market shares total around 40% and 30% in retail and corporate customers, respectively. This is based on (i) the bank's **strong local brand name recognition**, (ii) **proximity banking** enabling closer customer contact, and (iii) its good product range. The bank also offers a sophisticated multi-channel distribution network.<sup>1</sup> A particularly innovative concept within the distribution network is its "mobile" branches, which have been an effective response to low population densities in the region. The bank has also actively promoted the use of its internet services for efficiency purposes.

**Nordlandsbanken** remains Sparebanken Nord-Norge's main local competitor. It seems that the recent acquisition of the former by Den norske Bank at the end of 2002 has had so far little impact on the operating environment in northern Norway. Furthermore, with respect to the possible merger between Den norske Bank and Gjensidige NOR, like other rated domestic peers, Sparebanken Nord-Norge's management expects to take short-term advantage of some business disruption during the integration process. That said, in the longer term, the merged banking group is likely to enjoy a higher pricing power as a result of its targeted economies of scale, which would represent a not insignificant source of pressure for the more local and regional players in Norway.

#### ACTIVE MEMBERSHIP OF THE SPAREBANK 1 ALLIANCE REMAINS STRATEGIC, DESPITE THE DEPARTURE OF SPAREBANKEN VEST

Sparebanken Nord-Norge is one of the four founding members of the SpareBank 1 Group or Alliance formed in 1996, which initially focused on (i) joint marketing efforts, (ii) common IT/Internet platforms and (iii) the creation of joint product companies, mainly for purposes of synergies. More recently, the alliance's activities were extended to new areas – including staff training, risk management and balance scorecards – aiming at economies of scale together with the transfer of know-how among group members. This development triggered the departure of Sparebanken Vest, effective from 1 January 2004, given that these redefined objectives within the Alliance no longer matched those of the bank. Nonetheless, other member banks – **including Sparebanken Nord-Norge – remain strongly committed to the Alliance**. Management continues to see strategic value in this co-operation in terms of branding, synergies and expertise. The restructuring measures undertaken following a difficult year 2002 are also expected to enhance the upside of this cooperation. Their main features are as follows:<sup>2</sup>

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1. See section "Issuer Profile" for more detailed information.

2. See separate report on SpareBank 1 Group for more detailed information.



- The cooperation with member bank Swedbank rated Aa3/P-1/B (headquartered in Stockholm), was strengthened so as to become more business-oriented, rather than financial only.
- A rationalisation programme is being implemented successfully and ahead of schedule.
- Risk management procedures were tightened within the group, and product companies have been given clear profitability targets.
- It was agreed that during 2004 Sparebanken Vest will remain the sole distributor of the SpareBank1 product, and during 2005, the main distributor in its local market (the region of Bergen and its surrounding areas). As such, it should be “business as usual” for the Alliance in this respect in the next two years.

In our opinion, the Alliance has been **relatively successful overall**. The SpareBank 1 brand is among the most recognised in Norway, while member banks have been learning from each others’ best practices. Moreover, we can also see some increasing convergence in the rated banks’ financial fundamentals.

## STRATEGY REMAINS CONSISTENT AND PRUDENT

In the last two years, Sparebanken Nord-Norge has been **actively focusing on cross-selling**, especially in off-balance-sheet savings-related products (namely pension funds, mutual funds and life insurance), a segment offering high structural growth in Norway. In order to achieve a 30% market share in the segment, seen as the bank’s natural market position, staff training and sales incentives have been successfully implemented. Non-life insurance is another area where the bank has shown progress, as reflected in increased market shares. These efforts have contributed to the gradual diversification of the bank’s revenue, even during the previous year when appetite for such products decreased. That said, we continue to view **cross-selling as a difficult exercise**.

More recently, Sparebanken Nord-Norge has **focused even more on profitability**, partly to counteract negative pressures from the more difficult economic environment and lower interest rates. Efficiency is a priority for management, and active cost savings are targeted (see below). In addition, Sparebanken Nord-Norge aims to secure the quality of its asset portfolio to maintain loan losses at low levels. That said, unlike the other rated member banks, no active re-pricing of the loan portfolio has been achieved at this point, although some opportunity appears to exist.

## Financial Fundamentals

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### PROFITABILITY REMAINS SOUND DESPITE PRESSURES

At the end of September 2003, Sparebanken Nord-Norge posted improved and sound profitability indicators given that:

- Unlike in 2002, Sparebanken Nord-Norge **did not have to provide major financial support to the Spare-Bank 1 product companies**.
- Lending continued to grow at a good pace, mainly driven by retail clients (+13.5%) while the bank has enjoyed **historically higher margins** in its relatively less competitive regional market.
- Trading activities remained a positive income contributor together with the gradually rising fees and commissions from the bank’s successful cross-selling strategy.
- **Rationalisation efforts favourably impacted cost efficiency** which is today among the highest of the Norwegian savings banks we rate. Excluding one-offs, Sparebanken Nord-Norge’s cost-to-income ratio totalled 60% at year-end 2002 and just below 60% at end-September 2003. In the medium term, management targets a ratio of 55%. This progress has not been made at the expense of service quality, and it also aims to anticipate Norway’s restructuring banking industry.

Nevertheless, Sparebanken Nord-Norge faces a number of challenges as follows:

- **High pressure on interest margins** is expected to be maintained given low interest rates and the rising savings disintermediation in Norway. As previously mentioned, unlike other rated member banks, Sparebanken Nord-Norge’s management has not aggressively re-priced its corporate loan portfolio, which provide give some leeway, although to a limited extent. The successful ongoing revenue diversification should also help attenuate future pressures, even though cross-selling remains a slow exercise.
- **Keeping loan losses at low levels is also essential for the bank’s future profitability**. This is especially true for Sparebanken Nord-Norge given its larger corporate loan portfolio, which it has no plan to divest. Origination is nonetheless selective and monitoring has been tightened (see below).

## HIGHER WEIGHT OF CORPORATE LOANS PUTS PRESSURES ON ASSET QUALITY, BUT RISK IS MITIGATED BY STRICT RISK MANAGEMENT

Unlike other rated savings banks in Norway, Sparebanken Nord-Norge has shown some deterioration in its asset quality since 1999, although starting from low loan losses. At year-end 2002, problem loans reached 3.2% of total lending compared to 1.6% in 1999 even though, contrary to other Norwegian banks, Sparebanken Nord-Norge was not directly impacted in 2002 by the Finance Credit Norge affair<sup>3</sup>, but only indirectly via the SpareBank 1 Group. Problem loans have continued to increase in the last nine months (up by 20% since the beginning of the year, to reach 3.6% of total lending at end-September 2003). This is mainly due to the following factors:

- Pressures from the bank's **corporate loan portfolio that is comparatively larger** in the currently more difficult economic environment. Corporate lending accounts for close to 45% of total lending (at the bank's limit), compared to around one third for the other Norwegian rated savings banks (with the exception of Sparebanken Midt-Norge, also at 45%). However, while new corporate lending is very selective, unlike Sparebanken Midt-Norge for example, the bank has no plan to reduce its exposure. In light of the increasing number of bankruptcies among SMEs, Sparebanken Nord-Norge thus shows an **inherently higher risk profile**.
- Similar to Sparebanken Midt-Norge, one of Sparebanken Nord-Norge's large corporate exposures (>300 million) is also classified as very high risk and provisioned as such. While not translating into any concentration risk, accounting for about 1% of total lending and 16% of core equity, this exposure has been hurting the asset quality. Overall, comparatively the bank shows a slightly larger number of exposures classified as high and very high risk loans, at around 20%. However, management is strongly committed to bring these down to about 17%.

Going forward, **no major improvement is expected in asset quality, with further deterioration more likely** given that corporate loans will remain a large proportion of the portfolio. We, nevertheless, remain comfortable since:

- The bank shows **no concentration risk** by customer and industry. Commercial real estate, the largest sector exposure, represents 10% of total lending and shows a moderate risk profile overall.
- Significantly, **exposure to fish farming, Norway's troubled industry, is moderate** (below 3% of total lending and about 40% of core capital), despite the higher reliance of the local economy on fishing-related activities. In short, although the industry might continue to put pressure on the bank's portfolio, this should not trigger any crisis situation.
- Similarly, Sparebanken Nord-Norge has also shown **modest ambitions in shipping**, which represents about 6% of corporate commitments and 2.6% of total lending. We view positively the bank's approach to the industry given that it is characterised by inherent higher volatility and risk.
- In light of the more difficult times, **risk origination and monitoring have been tightened**. The bank's close relationship with its customers also allows for more proactive management.

Nevertheless, although asset quality indicators remain at sound levels, we will continue to monitor them closely. A good control over asset quality remains a key requirement for the bank to maintain its current ratings.

## LOW MARKET RISKS

Market risks, which are mainly interest and exchange rate, are modest. The bank has **limited proprietary market activities**. All equity-related securities account for less than 1% of total assets (as such complying with regulatory authority rules<sup>4</sup>) and for about 16% of core capital. We also note the bank's extremely prudent management in this respect. For example, unlike other rated Norwegian savings banks, Sparebanken Nord-Norge posted trading profits at year-end 2002. We note that Sparebanken Nord-Norge is indirectly **exposed to capital markets via the SpareBank 1 Group** through its joint ownership of the product companies. Due to its relatively high proportion of equity investments, the bank had to cover losses made by the life insurance company. Since then, risk management practices have been strengthened, and their limit to inherently more volatile instruments was significantly reduced.

## LIQUIDITY RISK IS CONSERVATIVELY MANAGED

Like other rated savings banks in Norway and despite some stabilisation in the past four years, Sparebanken Nord-Norge has been increasingly reliant on market funding. Deposits account for about 57% of total funding. This has been the result of high lending growth in the past together with ongoing savings disintermediation. Sparebanken Nord-Norge is characterised by a **tight structural liquidity**: (i) market funds have been to a large extent short-term

3. At the end of 2002, Norwegian financing company, Finance Credit Norge, defaulted on its debt obligations following an alleged fraudulent accounting case involving its owners.

4. Trading securities cannot exceed 4% total assets.

(50% historically on average), while (ii) the bank has low liquid assets compared to other rated savings banks in Europe, kept just above the supervisory authority 6% minimum requirement<sup>5</sup>. Nonetheless, we believe that Sparebanken Nord-Norge's liquidity risk is moderate given its **strict management guidelines** as follows:

- The bank applies **conservative refinancing limits** which secure liquidity over one month standalone. Significantly, Sparebanken Nord-Norge has been operating well below these limits.
- Management also **decided to lengthen the maturity of market funding** to avoid any distress situation going forward. As a result, long-term funds have been gradually increased towards the new 60% target. In mid-2003, they already totalled close to 58%. Market funding has also been successfully diversified in past years, both by instruments and by geographic area.
- **Customer deposits remain a priority source of funding**, underpinning stable deposits in past years, even though competition remains intense especially as the savings disintermediation progresses. Management closely follows the proportion of deposits in total funding and would take action if it were to deteriorate significantly.
- Finally, like other rated member banks, Sparebanken Nord-Norge generates **frequent liquidity risk reports**, including to the top management. A detailed liquidity contingency plan was also established, clearly highlighting action steps in a stress scenario.

Along with other members of the Alliance, Sparebanken Nord-Norge has shown **good progress in its preparation work for Basel 2**, especially on the credit risk side. While no major impact is expected, more precise estimates should start being processed before the end of 2003. Regarding operational risk, the bank has indicated that it is likely to follow the standard approach and is currently working towards this goal.

## **ECONOMIC CAPITALISATION IS GOOD**

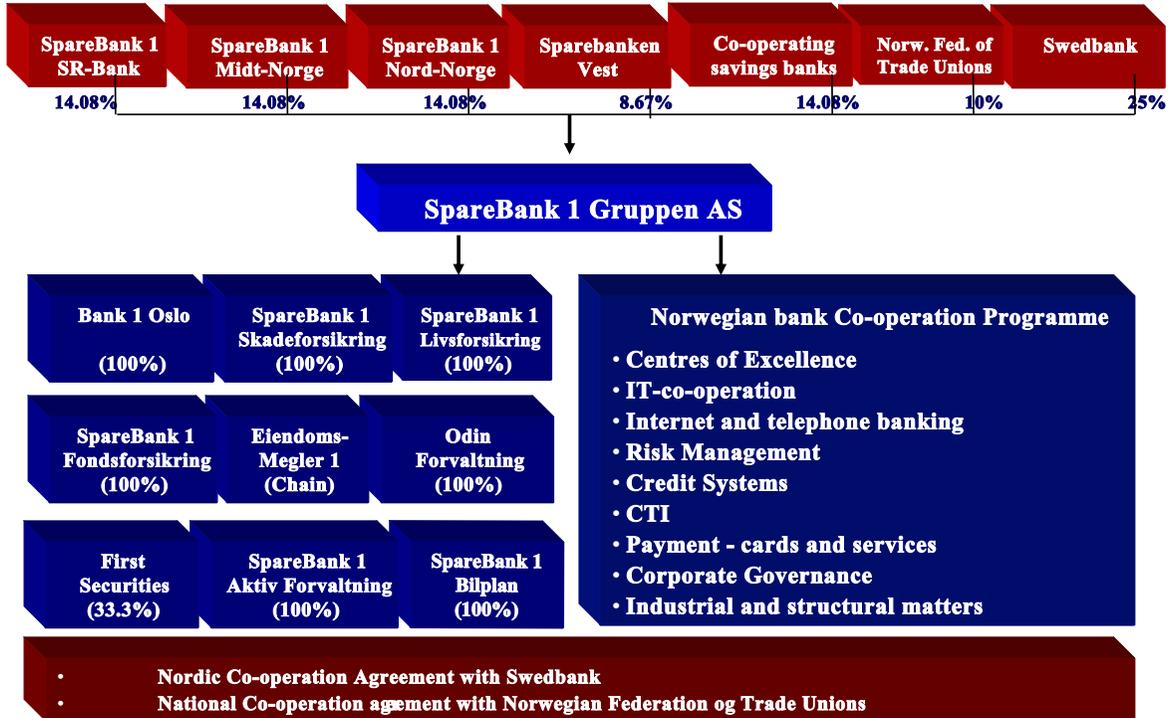
Sparebanken Nord-Norge enjoys good economic capitalisation. This is based on its **good recurring earnings capacity and moderate risk profile**, although higher than other rated Norwegian savings given its large corporate loan portfolio. At the end of September 2003, Sparebanken Nord-Norge reported Tier 1 and total regulatory capital ratios of 8.5% and of 10.5%, respectively, compared to 7.9% and 10% at year-end 2002. Excluding the hybrid capital instruments issued in June 2003, these ratios account for 8.4% and 10.4%. Sparebanken Nord-Norge's targets remain 9% and 12%, including hybrids.

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5. As a percentage of total deposits and funding.



## The SpareBank 1 Alliance



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### Related Research

#### Banking Statistical Supplement

[Norway, May 2003 \(78200\)](#)

#### Banking System Outlook

[Norway, January 2003 \(77230\)](#)

#### Analysis

[Sparebanken Rogaland, November 2003 \(80054\)](#)

[Sparebanken Vest, October 2003 \(79935\)](#)

[SpareBank 1 Group AS, November 2003 \(80099\)](#)

[Sparebanken Midt-Norge, November 2003 \(80035\)](#)

*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.*

## Sparebanken Nord-Norge (Consolidated)

	12/31/02	12/31/01	12/31/00	12/31/99	12/31/98
<b>Summary Balance Sheet (NOK million)</b>					
Cash & central bank	436	345	335	447	251
Due from banks	289	184	269	94	414
Securities	2,782	2,735	2,282	2,365	1,924
Gross loans	33,574	30,973	29,237	24,904	22,682
Loan loss reserves (LLR)	-679	-526	-421	-322	-267
Insurance assets	0	0	0	0	0
Fixed assets	565	591	588	573	526
Other assets	912	964	853	568	595
Total assets	37,879	35,266	33,143	28,629	26,125
Total assets (USD million) <sup>[1]</sup>	5,447	3,901	3,780	3,560	3,428
Total assets (EUR million)	5,197	4,404	4,015	3,546	2,937
Demand deposits	17,337	15,837	14,415	11,894	11,280
Savings deposits <sup>[2]</sup>	2,845	2,592	2,902	2,598	2,957
Due to banks	4,452	3,142	2,552	2,651	1,491
Market funds	9,298	9,772	9,530	8,289	7,432
Insurance liabilities	0	0	0	0	0
Other liabilities	835	794	699	619	583
Total liabilities	34,767	32,137	30,098	26,051	23,743
Subordinated debt	871	885	902	724	718
Shareholders' equity	2,237	2,240	2,142	1,853	1,663
Total capital funds	3,112	3,129	3,045	2,578	2,382
Total liabilities & capital funds	37,879	35,266	33,143	28,629	26,125
Derivatives - notional amount	—	—	—	—	—
Derivatives - replacement value	—	—	—	—	—
Contingent liabilities	941	919	766	742	711
Risk weighted assets (RWA)	26,602	24,988	24,570	21,050	19,303
Assets under management (NOK million) <sup>[3]</sup>	—	—	—	—	—
Number of employees	950	944	932	1,004	1,073
<b>Summary Income Statement</b>					
+Interest income	2,965	2,880	2,530	2,227	1,879
-Interest expense	1,944	1,948	1,601	1,365	1,046
=Net interest income	1,021	932	929	862	833
+Trading income	24	0	2	83	-15
+Fee & commission income	243	238	190	148	130
+Insurance income (net)	0	0	0	0	0
+Other operating income	-92	24	49	45	60
=Operating income	1,196	1,194	1,170	1,138	1,008
-Personnel expenses	370	350	337	327	326
-Other operating expenses	355	327	411	302	287
= Operating funds flow	471	517	422	509	395
-Amortisation/depreciation	68	70	65	67	60
(Total operating expenses)	793	747	813	696	673
=Preprovision income (PPI)	403	447	357	442	335
-Loan loss provisions	245	138	102	93	96
+Other non operating adjustments <sup>[4]</sup>	0	0	249	51	0
+Extraordinary profit / loss	0	0	0	0	0
=Pretax income	158	309	504	400	239
-Taxes	94	104	120	106	78
=Net income	64	205	384	294	161
-Minority interests	1	1	0	0	0
=Net income (group share)	63	204	384	294	161
<b>Growth Rates (%)</b>					
Gross loans	8.40	5.94	17.40	9.80	4.37
Total assets	7.41	6.41	15.77	9.58	6.72
Customer deposits (demand and savings)	9.51	6.42	19.49	1.79	3.87
Net interest income	9.55	0.32	7.77	3.48	6.93
Fee and commission income	2.10	25.26	28.38	13.85	7.44
Operating expenses	6.16	-8.12	16.81	3.42	11.06
Preprovision income	-9.84	25.21	-19.23	31.94	-2.90
Net Income	-69.12	-46.88	30.61	82.61	-17.01

## Sparebanken Nord-Norge (Consolidated)

	12/31/02	12/31/01	12/31/00	12/31/99	12/31/98
<b>Income Statement in % Average Risk Weighted Assets</b>					
Net interest income	3.96	3.76	4.07	4.27	4.49
Trading income	0.09	0.00	0.01	0.41	-0.08
Fee and commission income	0.94	0.96	0.83	0.73	0.70
Insurance income	0.00	0.00	0.00	0.00	0.00
Operating income	4.64	4.82	5.13	5.64	5.43
Operating expenses	3.07	3.01	3.56	3.45	3.63
Preprovision income	1.56	1.80	1.57	2.19	1.81
Loan loss provisions	0.95	0.56	0.45	0.46	0.52
Extraordinary profit	0.00	0.00	0.00	0.00	0.00
Net income	0.25	0.83	1.68	1.46	0.87
<b>Liquidity, Funding (including sub debt) &amp; Balance Sheet Composition</b>					
Avg. liquid assets % avg. total assets	9.26	8.99	9.38	10.04	9.30
Avg. gross loans % avg. total assets	88.25	88.01	87.65	86.91	87.77
Avg. customer deposits % avg. total funding	57.60	57.17	56.34	57.42	60.70
Avg. interbank funds % avg. total funding	11.33	9.11	9.22	8.28	5.81
Avg. market funds (excl. interbank) % avg. total funding	28.45	30.87	31.56	31.42	30.38
Avg. sub debt % total funding	2.62	2.86	2.88	2.88	3.11
Avg. liquid assets % avg. customer deposits	17.54	17.20	18.21	19.13	16.84
Avg. gross loans % avg. customer deposits	167.17	168.44	170.21	165.64	158.94
Avg. market funds reliance <sup>[5]</sup>	19.18	21.87	22.27	21.64	21.08
Avg. RWA % avg. total assets	70.53	72.44	73.85	73.70	73.31
<b>Breakdown of Operating Income in %</b>					
Net interest income % operating income	85.37	78.06	79.40	75.75	82.64
Trading income % operating income	2.01	0.00	0.17	7.29	-1.49
Fee & commission income % operating income	20.32	19.93	16.24	13.01	12.90
Insurance income % operating income	0.00	0.00	0.00	0.00	0.00
Other operating income % operating income	-7.69	2.01	4.19	3.95	5.95
<b>Profitability</b>					
Yield on avg. earning assets (%)	7.94	8.62	8.52	8.50	7.83
Cost of interest bearing liabilities (%)	5.80	6.23	5.67	5.46	4.54
Net interest margin (%)	2.47	2.75	3.16	3.33	3.54
Recurring earning power (PPI % avg. assets)	1.10	1.31	1.16	1.61	1.32
Risk-weighted recurring earning power (PPI % avg. RWA)	1.56	1.80	1.57	2.19	1.81
Return on average assets (%)	0.17	0.60	1.24	1.07	0.64
Return on avg. RWA (%)	0.25	0.83	1.68	1.46	0.87
Return on equity (period end) (%)	2.82	9.11	17.93	15.87	9.68
Net interest income coverage of loan loss provisions	4.17	6.75	9.11	9.27	8.68
Loan loss provisions % preprovision income	60.79	30.87	28.57	21.04	28.66
Internal capital growth (%)	2.81	3.64	10.96	8.24	3.85
Dividend payout ratio (%)	0.00	61.76	47.14	53.40	61.49
<b>Efficiency</b>					
Cost/income ratio (operating expenses % operating income)	66.30	62.56	69.49	61.16	66.77
Operating expenses % average assets	2.17	2.18	2.63	2.54	2.66
Operating income / employee (NOK thousand)	1258.95	1264.83	1255.36	1133.47	939.42
Operating expenses / employee (NOK thousand)	834.74	791.31	872.32	693.23	627.21
PPI / employee (NOK thousand)	424.21	473.52	383.05	440.24	312.21
Total assets / employee (NOK million)	39.87	37.36	35.56	28.51	24.35
<b>Asset Quality and Risk Measurement</b>					
Problem loans % gross loans	3.20	2.11	1.76	1.61	1.63
LLR % problem loans	63.22	80.31	81.75	80.30	72.16
LLR % gross loans	2.02	1.70	1.44	1.29	1.18
Loan loss provisions % gross loans	0.73	0.45	0.35	0.37	0.42
Problem loans % (shareholders' equity + LLR)	36.83	23.68	20.09	18.44	19.17
Replacement value % shareholder's equity	—	—	—	—	—
<b>Capital Adequacy (Period End)</b>					
Tier 1 ratio (%)	7.87	8.44	8.27	8.49	8.55
Total capital ratio (%)	9.99	10.58	10.36	10.58	11.58
Shareholders' equity % total assets	5.91	6.35	6.46	6.47	6.37
Equity participations % shareholders' equity	11.89	14.24	16.11	10.90	8.60

[1] USD figure uses historical exchange rate against the NOK.

[2] Full disclosure may not be available for all years. The amount is then included in demand deposits.

[3] As reported by the bank.

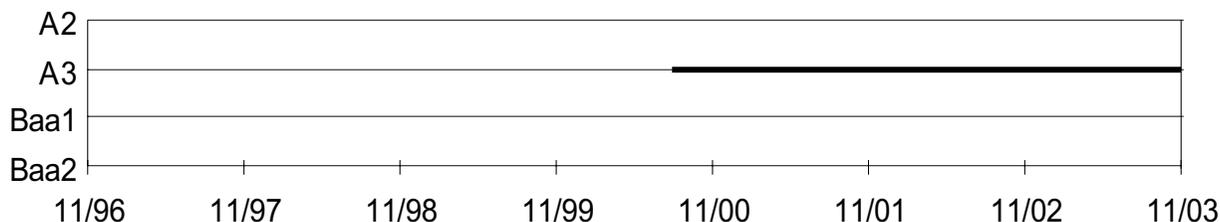
[4] This may include value adjustments of securities.

[5] Avg. [(market funds-liquid assets) % (earning assets-liquid assets)].

Description	Coupon (%)	Currency	Face Amount (mil)	Maturity	Moody's Rating
<b>Sparebanken Nord-Norge</b>					
Flt Rt Euro Medium Term Notes	—	EUR	20	2006	A3
Flt Rt Euro Medium Term Notes	—	EUR	35	2006	A3
Flt Rt Euro Medium Term Notes	—	EUR	115	2006	A3
<209>	—	USD	60	—	Baa2
Euro MTN Program	—	EUR	2,000	—	A3/Baa1
Long-Term Bank Deposit Rating	—	—	—	—	A3
Bank Financial Strength Rating	—	—	—	—	C
Short-Term Bank Deposit Rating	—	—	—	—	P-2

## Rating History

### Long-term Bank Deposits



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