

Norwegian Hull Club

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Norwegian Hull Club

Major Rating Factors

Strengths:

- Strong competitive position.
- Strong capitalization.

Weaknesses:

- Concentration on a volatile insurance class.
- High investment risk tolerance compared to non-life insurance industry norms.

Operating Company Covered By This Report

Financial Strength Rating

Local Currency

A-/Stable/--

Rationale

The ratings on Norway-based marine mutual insurer Norwegian Hull Club (NHC) reflect the club's strong capitalization and strong competitive position. These positive factors are offset by the club's concentration on a volatile insurance class, and by its high investment risk tolerance.

In our view, NHC's competitive position is strong, supported by membership diversity and its good, long-standing relationships with many of its members. The club has a 19% market share of marine hull insurance written out of the Nordic region. In 2010 the club's gross premium increased significantly by 22% to \$190 million (\$156 million in 2009) reflecting growth across most of its products. For 2011, we forecast that the club's gross premium income is likely to increase by about 5%-10% compared to 2010, mostly reflecting an increase in new business.

Standard & Poor's Ratings Services believes NHC's capitalization is likely to remain strong, supported by its extremely strong risk-based capital adequacy, measured using our proprietary model, and comprehensive reinsurance program. The club's total adjusted capital increased to \$203 million at year-end 2010 (compared with \$160 million in 2009) largely reflecting the below-mentioned very strong level of underwriting surplus. The club revised its reinsurance program in 2011, retaining a higher proportion of high-value claims and therefore the proportion of premiums ceded will be reduced significantly under the new program. While this increases the potential volatility in the club's risk-based capital we expect the club to carefully manage it.

In our opinion, NHC's concentration on the volatile marine insurance sector means that there is potential for significant earnings volatility and regular underwriting losses, as demonstrated in prior years. For 2010, the club has reported a very strong underwriting performance with a combined ratio of 77% (compared with five-year average of 111% over 2005-2009), reflecting a favorable claims environment, and positive run-off gains. In addition, the club benefitted from the restructuring of the insurance portfolio, which led to a significant decrease in net retention levels of the poor-performing H&M business during 2008. These, coupled with good investment returns, have led to a record pretax surplus of \$48.9 million (\$28.4 million in 2009). If there is no abnormal loss experience for the remainder of this year, we believe that the club is likely to post a good bottom-line surplus for 2011.

In our opinion, NHC's investment risk tolerance, in common with most marine mutuals, is high compared with non-life insurance industry norms. At February 2011, the club's aggregate exposure to equities, hedge funds, real estate, and speculative-grade bonds stood at 40% of total invested assets. In our view, this level of investment risk

can lead to significant volatility in net income and capital as we saw in 2008.

Outlook

The stable outlook reflects Standard & Poor's view that the club will maintain its strong competitive position and strong capitalization. We believe that the club will maintain its strong competitive position by carefully managing the growth in its premium to ensure that financial strength and member service are not weakened, nor the club's portfolio quality diluted. We believe that the club is likely to achieve good underwriting performance over the pricing cycle such that its risk-based capital adequacy, measured using our model, does not fall to a level below its current ratings.

A deterioration in the club's operating performance, to the extent that it prompted a weakening in its capital adequacy to a level below that of its current ratings, would lead to negative rating action. A positive rating action is regarded as unlikely, reflecting the potential volatility in the club's results arising from both its insurance and investment activities.

Corporate Profile: Norway-Based Global Marine Insurer

NHC was formed from the merger of Norwegian marine mutuals Bergens Skibsassuransforening-Gjensidig and Unitas Gjensidig Assuransforening on Jan. 1, 2001. NHC is a mutual insurance club based in Norway with offices in Bergen, Oslo, and Kristiansand, writing marine hull-related insurance for domestic and international shipping companies.

Competitive Position: Strong, Reflecting Its Niche Position In The Marine Segment

Table 1

Norwegian Hull Club Competitive Position				
	--Year-ended Dec. 31--			
(Mil.\$)	2010	2009	2008	2007
Total revenue	141.1	125.1	154.2	158.0
Gross premiums written	189.6	156.0	162.3	175.9
Annual change in gross premiums written (%)	21.5	(3.9)	(7.8)	12.8
Net premium earned	126.3	112.9	138.8	141.6
Annual change in net premium earned (%)	11.9	(18.7)	(2.0)	23.7

We regard NHC's competitive position as strong, reflecting its niche position in the marine sector. Nonetheless, as a marine underwriter, it is exposed to concentration risk and the cyclicity of the marine market. The club has a large market share in the Nordic marine hull insurance market and good, long-standing relationships with most of its members. NHC has a diverse marine exposure by product, vessel type, and location and a good spread of members. In recent years, the club has substantially increased the proportion of premium emanating from loss-of-hire and energy-related business. This follows the club's decision to significantly reduce its exposure to the unprofitable H&M book, which now accounts for a significantly lower proportion of the club's total premium. It is also building its presence in protection and indemnity (P&I), buildings risks, total-loss-only (TLO), war, and other marine business.

Alongside Gard Marine & Energy Ltd. (A/Stable/--), NHC is the leading marine hull underwriter in Nordic market, and accounts for approximately 3% of the world market (Source: The Nordic Association of Marine Insurers [Cefor]). The club maintains its market share of 19% in marine hull insurance written out of the Nordic region (Source: Cefor). The Nordic region hosts one of the largest marine insurance markets in the world. In our view, the club will continue to benefit from this leadership status.

The club's geographic spread of policyholders remains good. Members domiciled in Norway or Germany represent the largest group. The remainder of the premium emanates from the rest of Europe (notably Greece), the Far East, and the U.S. Member diversity remains good, with the 15 largest members accounting for 39% of the mutual premiums and the largest member accounting for just 6% of gross mutual premiums.

NHC's competitive advantage reflects the long-standing nature of many of its client relationships. This is, in part, due to the club's mutual status. That said, because of the significant reduction in H&M business the club's premium written on a mutual basis has reduced significantly to 40% of the total premium (60% previously), with the remainder stemming from fixed-premium-paying customers. Low barriers to exiting the club reduce the effect of its mutual status. NHC benefits from its position as claims leader on about 62% of all vessels it covers. This provides a useful source of fee revenue and useful data for the underwriting operation.

NHC's corrective actions on pricing adequacy for the H&M business in 2008 and 2009 were partly balanced by growth in LOH and other segments, notably energy-related segments. In 2010, the club's gross premium increased by 22% to \$190 million compared to the 2009 level. This reflects growth across most business segments notably in LOH, P&I, builder's risk, and marine hull-related products.

In common with most of its peers the club is highly dependant on brokers as a source of business. In 2010, 85% of its premium emanated via brokers, with the top two accounting for 33% of the total premium.

Prospective

We believe NHC's competitive position is likely to remain strong, with the club placing emphasis on quality membership. We believe that the club will carefully manage the relatively new product mix to ensure that financial strength and member service are not harmed, and that the club's portfolio quality is not diluted. We forecast that the overall premium level is likely to increase by about 5%-10%, despite some rate reductions in its H&M and LOH business. We expect the business line composition to be largely maintained over the medium term, with most of the gross premium stemming from LOH, conventional hull insurance, and offshore energy business.

We do not anticipate any changes in the competitive environment that could significantly affect NHC. The club's strong competitive position, strong reputation in the market, and tendency to lead on its business should reduce the impact of any threats, such as the potential for increased competition arising from the London market given the reduced capacity provided by the Norwegian market.

Management And Corporate Strategy: Focus On Pricing Adequacy Persists

NHC benefits from the high level of experience of its management team. Maintaining an appropriate risk profile and a high level of both member and vessel quality is core to NHC's strategy. The club has definitive goals and has explicit targets for underwriting performance and risk-based capital; we view this positively. The club's experience in and focus on marine business allows it to maintain tight operational and financial controls.

Corporate strategy

The management is committed to write marine insurance at profitable levels and at the same time offer members high-quality supplementary services, which in turn provide additional fee revenues. The club places strong emphasis on the maintenance of its financial strength by ensuring a balanced product mix and strong risk-adjusted capital.

NHC remains focused on the quality of members and vessels covered. The significant underwriting deficits of 2008 and 2007 have partly triggered a clear reduction in NHC's willingness to retain prestigious long-term relationships by compromising on bottom-line profitability.

Operational management

Standard & Poor's considers NHC to have a very capable and experienced management team. We believe that the quality of underwriting processes remains strong, with clear guidelines for four underwriting teams, each responsible for energy, bluewater marine, P&I, and yachts. The chief operating officer, Arne Birkeland, who reports to CEO John Wiik is managing all four teams.

Financial management

We regard NHC's financial strategy as good. It has set clear goals, which are oriented toward maintaining the club's financial strength. The club seeks to maintain at least 30% capital redundancy above the highest of local regulators' and Standard & Poor's 'A' capital requirements. We believe that the club will proactively manage its risk profile to have an at least strong level of risk-based capital measured using our model. On the underwriting side, the club aims to achieve a combined ratio of 95% over the pricing cycle. Given the club's diversified product mix and increased fixed-premium exposure relative to its historical levels we believe it is well positioned to achieve this provided it carefully manages the potential exposure to large claims.

Enterprise Risk Management: Risk-Conscious Management Team, In Line With Club Philosophy

We consider the club's enterprise risk management (ERM) to be adequate, with adequate risk controls for two of its main risks, that is, investments and reserving. We believe that the club has strong risk controls for its third main risk, i.e., underwriting. In our view, ERM is of relatively low importance to the rating given the club's size, relatively simple structure, and marine-focused status.

NHC's risk-management culture is adequate. The club has an ERM committee comprising of senior management including the CEO and the risk manager, enhancing its risk management framework. The committee which meets once a month facilitates a widespread, robust, and embedded assessment and management of risk within the club. The club has clear performance indicators to closely monitor the overall risk profile of the club and the board determines tolerance levels for various risks, with a supervisory committee to review compliance in more detail. The club uses a risk register to define and manage key risks through various controls and mechanisms. The club has a risk matrix which measures the probability and severity of the risks identified.

Investment-related risk controls are adequate. Target asset allocations are set in conjunction with the board, including currency mix, duration, credit quality, derivatives use, and concentrations. Although the club does not have a defined risk appetite for investment risk, it does actively monitor it.

Insurance underwriting-related risk controls are strong. The management has clear underwriting guidelines and is committed to improving its underwriting tools, which it revises continuously. It produces monthly management

underwriting reports that focus on issues of concern. The portfolio is analyzed with vessel-specific Monte Carlo simulations, based on the club's own, as well as external, data sources.

Reserve-related risk controls are adequate. Standard & Poor's considers that the club's estimating and reserving practices appear conservative by insurance industry standards, as reflected in a historical absence of material reserve-related problems.

Accounting: Norwegian Generally Accepted Accounting Practices, With Full Credit Given To Security Reserves

In adjusting the 2010 figures reported under Norwegian generally accepted accounting principles (GAAP) to total adjusted capital (TAC), the material changes we made included:

- Security reserves (\$161.8 million in 2010) added to TAC. This liability is not expected to crystallize and Standard & Poor's consequently views it as loss-absorbing capital.
- Recognition of loss reserve discount.

Combined ratio calculations exclude other insurance-related income (\$7.7 million in 2010), which includes claims-leading income and fees.

Operating Performance: Good, Reflecting Favorable Claims Environment

Table 2

Norwegian Hull Club Operating Performance				
	--Year-ended Dec. 31--			
(Mil. \$)	2010	2009	2008	2007
Return on revenue (%)	30.8	0.7	(5.9)	(9.0)
Return on equity (%)	118.8	90.6	(125.3)	(11.6)
EBIT adjusted to Total equity adjusted (%)	23.9	0.6	(6.1)	(8.1)
EBITDA adjusted to Capital (%)	23.4	0.6	(6.2)	(8.3)
EBIT	49.8	28.4	(43.8)	(4.3)
EBIT adjusted	43.5	0.9	(9.2)	(14.2)
EBITDA	49.8	28.4	(43.8)	(4.3)
EBITDA adjusted	43.5	0.9	(9.2)	(14.2)
Net loss ratio (%)	58.2	90.0	100.4	106.4
Total net expense ratio (%)	19.0	20.1	17.4	15.3
Net combined ratio (%)	77.3	110.0	117.7	121.7
Net investment yield (%)	2.4	2.4	3.1	3.5

In our opinion, NHC's concentration on the volatile marine insurance sector means that the potential exists for significant earnings volatility and regular underwriting losses, as demonstrated in prior years. The club's 2010 net combined ratio reduced significantly to 77% (110% in 2009). This reflects a combination of factors: lower average claim cost, absence of large claims, and a reduction in claims frequency. Furthermore, the club benefitted from prior year run-off gains, which reduced the combined ratio by 7 percentage points. In addition, the club benefitted from the restructuring of the insurance portfolio. The latter led to a significant decrease in net retention levels of the

poor-performing H&M business during 2008, teamed with increased exposure to more profitable segments, notably energy business. These, coupled with the significant investment gains, resulted in a record pretax surplus of \$48.9 million (\$28.4 million in 2009). For the period ended March 31, 2011, the club posted a good combined ratio of 94%. This, together with investment income, resulted in a good bottom-line surplus.

Over the long term, the club's underwriting performance has been marginal, with a five-year average combined ratio of 111% over 2005-2009. The combined ratio was significantly affected by large claims during 2007 and 2008. The improvement in recent years reflects the reduction in average claims size and the club's reduced exposure to the H&M segment, which performed particularly poorly. At the same time, the club diversified into more profitable segments of marine business.

Prospective

We believe that the underwriting performance for year-end 2011 is likely to be good. This largely reflects a continuation of reduced average claims size because of reduced costs of repair and spare parts. If the loss experience for the remainder of this year is normal, we forecast that the club is likely to post a combined ratio close to 95%.

We expect its exposure to claims arising from the Japanese tsunami to be small. Including the investment income we forecast that the club is likely to lead to a good bottom-line surplus in 2011.

Over the medium term, we anticipate that the club will post acceptable combined ratios, such that the bottom-line results do not weaken the club's risk-based capital. However, although the club's focus is on maintaining the strength of its risk-adjusted return, the potential for significant earnings volatility exists. This stems from the club's concentration on a volatile insurance class where claims size and frequency are unpredictable and from its significant exposure to risky asset classes as shown in 2008.

Investments: Aggressive Relative To Non-Life Insurance Industry, But Not By Comparison With Peers

Table 3

Norwegian Hull Club Liquidity And Investments				
	--Year-ended Dec. 31--			
(Mil. \$)	2010	2009	2008	2007
Invested assets to total assets (%)	73.9	78.5	80.5	77.5
Invested assets to loss and unearned premium reserve (%)	239.4	153.5	133.9	142.2
Common equity investments to capital (%)	29.1	36.1	51.3	57.9
Real estate investments to capital (%)	12.9	11.0	17.3	19.2
Total invested assets adjusted	306.3	291.1	278.1	328.0
Investment portfolio composition				
Cash and cash equivalents (%)	10.4	9.1	8.8	6.7
Total bonds (%)	56.7	60.1	56.3	48.8
Common stock (%)	19.3	19.9	23.1	30.5
Real estate (%)	8.5	6.0	7.8	10.1
Total mortgages and loans (%)	4.5	4.3	3.5	3.1
Investments in affiliates (%)	0.6	0.6	0.4	0.7
Total portfolio composition (%)	100.0	100.0	100.0	100.0

Strategy

The credit quality and other exposure risks of investments are good overall, but in common with most of its peers, the club has significant exposure to volatile asset classes. At the end of February 2011, the club held 57% of its total invested assets (excluding its working capital of about \$10 million, which is held as cash) in bonds, 17% in equities (including private equity), 12% in money market funds, 5% in hedge funds, and 9% in real estate. At this stage, given the generous level of surplus capital, we consider the investment mix to be appropriate for the current ratings. We do not expect significant changes over the next two years.

Credit risk

In our view, credit risk is fairly low. As at Dec. 31, 2010, 5% of the fixed-income portfolio comprised government bonds (including securities issued by government agencies) and 95% corporate bonds. The ratings profile of the bond portfolio is strong overall, with 13% invested in 'AAA' rated debt, 12% in 'AA', 36% in 'A', 25% in 'BBB', and 14% in speculative-grade and unrated bonds.

Market risk

In our view, the club's high exposure to market risk stemming from its exposure to equities, hedge funds, and real estate is reduced to some extent by the spread of the club's portfolios by geography and sector. Most placements are in global funds, and all are managed through third parties. The club does not have any exposure to "subprime" residential mortgage-backed securities.

Asset-liability management

The average net duration of NHC's bond portfolio, at about 1.4 years, is close to the club's estimate of the mean term of the respective underlying liabilities, which is about 1.6 years. The club achieves currency hedging by holding primarily U.S. dollar assets against the mainly U.S. dollar liabilities. It also undertakes some forward foreign exchange hedging to cover local overheads.

Liquidity: Continued Strong Levels Of Liquidity

Liquidity remains strong, with highly liquid assets (that is, cash, and bonds rated 'A' or above) covering net technical reserves by 110%. In addition, NHC has committed bank lines of \$60 million, which can be used to cover temporary liquidity needs and to issue guarantees on behalf of members. Bonds and equities are held in very liquid investments, with no real concentration risk attached.

Capitalization: Strong, But High Investment Risk Adds Volatility

Table 4

Norwegian Hull Club Capitalization				
	--Year-ended Dec. 31--			
(Mil. \$)	2010	2009	2008	2007
High-risk assets to total adjusted capital (%)	42.8	48.1	69.6	78.5
Total adjusted capital	203.3	160.4	125.3	172.8
Reinsurance utilization (%)	25.8	26.3	20.1	12.3

NHC's strong capitalization reflects its extremely strong capital adequacy, measured using Standard & Poor's proprietary model, and also its comprehensive reinsurance program. However, the significant market risk (see

"Investments") within NHC's balance sheet adds volatility to the capital adequacy, as we saw in 2008. We believe the club's capitalization is likely to remain strong over the rating horizon.

Capital adequacy

In 2010, the club's capital increased by 27% to \$203 million (2009: \$160 million), reflecting the record surplus (see "Operating Performance") that was largely retained. Given the level of excess capital, the club decided to pay a one-off dividend based on 5% of the earned premium for 2010 and this equates to about \$3.7 million. In our view, the significant premium growth during 2010 will be carefully managed so that it does not constitute a threat to the club's risk-based capital. We expect capital adequacy to comfortably support the rating in the near term.

In its preparations for the European Commission's Solvency II directive on insurance regulation, the club completed the relevant studies which indicate that the club has a comfortable margin compared to the capital requirements.

Reserves

We consider NHC's reserving to be good. The ratio of net technical reserves to net premiums was 88% at year-end 2010 (79% in the previous financial year), reflecting the short-term nature of the business written. In common with most marine mutuals, the club has experienced positive run-off gains, which equated to \$9 million in 2010 (7% of the net technical reserves).

Reinsurance

The club benefits from a comprehensive reinsurance program and high-quality reinsurers. In recognition of the improved claims environment, NHC revised its program for 2011, increasing its net retention levels for single large claims. This is likely to lead to 5%-10% reduction in the cost of the club's reinsurance cost. Under the new program, the club is likely to cede a significantly lower proportion of its gross premium (26% in 2010 and 2009). In a year with a relatively higher number of large claims the new structure is likely to increase the potential volatility in underwriting performance. That said, the potential volatility is still lower than that of 2008 and prior years. We expect the club to actively manage its potential exposure to high-value claims as demonstrated during 2009 when it reduced its underwriting capacity across all of its products in 2009 and changed its product mix.

Financial Flexibility: Good, Supported By Mutual Status

Table 5

Norwegian Hull Club Financial Flexibility				
	--Year-ended Dec. 31--			
	2010	2009	2008	2007
Debt leverage including additional pension deficit as debt (%)	2.2	2.6	0.0	0.0
Financial leverage including additional pension deficit as debt (%)	2.2	2.6	0.0	0.0

Financial flexibility is good, largely reflecting the club's adequate access to capital relative to its needs. Standard & Poor's regards NHC's operational needs for additional capital as low, given its extremely strong capital (see capitalization section) and the selective growth in underwriting exposures.

A need for additional capital could arise if the club were to suffer an exceptional volume of retained losses. The preferred means of capital reinforcement would be through prospective earnings and/or capacity provided by its reinsurers. Alternatively, hybrid debt capital could be raised if market conditions permit. Ultimately, as a mutual, the club can request additional calls from mutual members (accounting for about 40% of the total premium) of up

to one year's premium. However, management considers additional calls on members to be a last resort due to the fixed pricing structure of the hull market. There have been no additional calls since 1947.

Ratings Detail (As Of May 27, 2011)*

Operating Company Covered By This Report

Norwegian Hull Club

Financial Strength Rating

Local Currency

A-/Stable/--

Counterparty Credit Rating

Local Currency

A-/Stable/--

Domicile

Norway

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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