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As New Political Dynamics Emerge From Argentina's Congressional Elections, What Lies Ahead?

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As New Political Dynamics Emerge From Argentina's Congressional Elections, What Lies Ahead?

The June 28 congressional elections in the Republic of Argentina initiated a period of political transition. The opposition achieved a surprising victory in the emblematic Province of Buenos Aires. It is clear now that the ruling Peronist Party has started the search for a new leadership, with its mind set on the 2011 presidential elections. It also seems likely that this new leadership will come from outside of the dominant faction of the Peronist Party--led by former president Nestor Kirchner and his wife, President Cristina Fernandez de Kirchner--that has been governing Argentina since 2003.

In any case, losing the leadership of the Peronist Party means the government's room to maneuver is now narrower. In the government's favor, the opposition remains divided, despite doing well in the election. Therefore, despite growing concerns about decelerating economic activity and persistent inflation, Argentina's ability to muddle through this period of uncertainty still depends primarily on the ability of the country's leadership to react appropriately and timely to the new political context.

Although the new political environment will be more challenging, the government could still ensure governability if it implements a more consensual approach toward policy. However, that will require a significant shift from the style of government that has prevailed since 2003. As a response to the electoral results, the administration introduced five changes in the cabinet, including the important positions of chief of cabinet and minister of economy. These newly appointed officials already played important roles in the government administration, but at different government offices-. Is this cabinet reshuffle a signal of a greater modification on the government's style and/or key economic policies? Will the administration make further concessions? And does it have any other alternative as the economy continues to deteriorate?

Although political events are evolving rapidly, the most likely political scenario in Argentina remains one in which the administration does not introduce substantial modifications to its current policies in general, and its economic policy in particular, in the near term. Even though cabinet changes always provide new opportunities, it remains to be seen whether the change translates into a greater degree of political independence on economic policy management. However, if both politics and economics continue to deteriorate at a gradual rate as expected, the government could give greater political independence to the implementation of a more pragmatic set of economic policies to reduce fiscal pressures and promote stability.

Standard & Poor's low speculative-grade 'B-' rating on Argentina already incorporates most of the weaknesses described under this scenario, but deteriorating economic and fiscal performances and the continuing lack of access to voluntary debt markets could put additional pressure on the ratings in the future if corrective actions are not implemented. Although there still seems to be some time for policy changes, with sources within the government providing financing for the rest of 2009 and part of 2010, the final impact on the rating will depend not only on if economic policy is moderated, but also on when and how that moderation takes place.

A New Political Equilibrium Develops After the Election

The June 28 congressional election was a critical point in the ongoing erosion of support for the government coalition. The current government received about 30% of the total vote, similar to the vote share of the largest opposition party, the Acuerdo Cívico y Social. However, the government lost in the most populated provinces of the country. In the Buenos Aires Province, former president Kirchner, the leader of the government coalition, lost by a small but politically significant margin of 2.5 percentage points to an alliance between Pro, the center-right party, and a dissident faction of the Peronist Party. The government itself had decided to raise the political importance of the election by projecting it as a plebiscite on its leadership. Hence, the results carry greater political implications than a normal midterm poll. The 30% vote share the government coalition received reflects a sharp decline from the 45% vote share Cristina Fernandez de Kirchner received when she was elected president in October 2007.

New leadership for the Peronist Party

The election was a strong and definitive confirmation of the political phenomenon that has been developing for some time now: the government was losing support and facing real problems maintaining its leadership within the Peronist Party. This was a strong hypothesis until June 28. Now it is a fact. In several municipalities of the Buenos Aires Province, where the Peronist Party is almost unbeatable, Peronist candidates for the local legislature received significantly more votes than Nestor Kirchner's candidacy for the national congress, reflecting internal disappointment with the party leadership. (Nestor Kirchner resigned as president of the party a day after the elections.)

The early 2008 conflict between the government and the agricultural sector triggered the first significant challenge to Nestor Kirchner's leadership. The conflict worsened existing internal tensions within the Peronists, and key political players broke away from the government alliance. There is now an open competition for the leadership of the party that will intensify running up to the presidential election in 2011.

There is still a long way to go yet. New leaders are arising, in particular the ones that could show credentials of a more consensual approach towards policies in general, and everything seems to indicate greater chances of seen a process of renovation in the leadership. However, the current government faction cannot be completely ruled out as for now. What should probably be assumed is that when a new leadership is decided, most constituencies within the party will follow.

Leaders emerge in a still-divided opposition

Unlike the more confrontational style of the current administration, most candidates that did well in the recent election, both Peronist and non-Peronist, have emphasized a moderated and consensual approach to policy. This could be interpreted as the population's increasing demand for more moderate policies.

However, it is still not clear that mandate will be taken by the non-Peronist opposition. Despite doing well in the election, the opposition remains divided and lacks the crucial combination of a strong leader and a countrywide party presence. None of the leaders who emerged stronger from the elections belong to the largest opposition party in the country in terms of votes, the Acuerdo Cívico y Social. This divided opposition is what still gives the Peronist Party (with its different factions) the greater chances of continuing to lead the country after 2011. It also gives the government coalition an opportunity to renew itself and become competitive once again.

Losing congress is a new obstacle, but not an insurmountable one

The election had major implications for Argentina's congress. The governing coalition lost its majorities in both houses. (Prior to the election, the majority in the lower house was reached by adding up government allies). Losing the majorities certainly adds to the significant challenges ahead for the administration.

However, losing the majority might not necessarily be catastrophic: the opposition is deeply divided, and new alliances could be built with the dissenting faction of the Peronist Party if the government can modify its approach. In the worst case, the government would have to govern through decrees rather than laws. This would certainly limit the government's options, but would not be a major obstacle for the administration given congress' low popularity and the overall discredited status of political institutions in Argentina.

The current government may still have space to operate if they adapt, and there will be growing pressure for them to do so, in particular from within the Peronist Party. So far all the requests from the opposition (including the dissident Peronists) have been for the president to adopt a more consensual approach to governing. The critical political news is the government losing the leadership of the Peronist party. If the administration is not able to renew its support within its own Party, a divided congress could be used against it to make implementation of policy more difficult.

Policy Tools To Restore Confidence Are Available, But Unlikely To Be Used

Policy actions with limited cost could have a strong effect on expectations

Unlike during other periods of economic stress in Argentina, economic tools with limited costs of implementation remain available. One example is fiscal performance, where, as a result of relatively high inflation, the government could improve its fiscal position by only allowing expenditure to grow more slowly in nominal terms instead of introducing politically unfeasible cuts to nominal expenditure.

In addition, and despite the sometimes-strong rhetoric, it would be a mistake to assume that a change in policy direction should be discarded on ideological grounds. This government will have no ideological qualms about signing an agreement with the International Monetary Fund (IMF) if it found such an agreement necessary. Of course, despite IMF's greater flexibility, any agreement would require the government taking some actions to improve its reputation, including reforming the controversial INDEC, the national statistical agency. However, despite how emblematic intervention of the INDEC has become, making the institute more transparent should not be considered a very ambitious task. Reforming the inflation index should be easier now that private sector and official estimates of inflation have started to converge because of the economic slowdown in Argentina.

In addition, an IMF agreement is still the precondition for negotiating debt reduction for the obligations that remain in default with the Paris Club, a group of creditor countries. These defaults together with the holdouts from the 2005 debt restructuring, are the two main obstacles keeping the government from normalizing its relationship with the international financial community and regaining full access to voluntary financing. The combination of introducing greater transparency to the INDEC and reaching an agreement with the Paris Club and the debt holdouts alone will not solve all the economic challenges Argentina is facing. However, it would certainly provide a strong positive shock to expectations about Argentina and create greater flexibility to solve the more fundamental economic issues of decelerating economic activity, high inflation, and low investment.

However, the main challenge is management

Aside from the economic policies the government has promoted since 2003, the most significant challenge in Argentina has been the quality of government management in general, and economic management in particular. Issues such as setting the basis for a proposal to the holdouts or pursuing an agreement with the Paris Club were always on the government agenda. However, they were never a priority and therefore not implemented. Technical officials, most of whom have appropriate skills and experience, are not incorporated into the decision-making process when key decisions are made. Fundamental decision-making is concentrated in inner circle of the president and the former president. This practice, which has been part of the administration management style since 2003, has been exacerbated in recent years.

Technocratic considerations appear to have played little role in changing policies in both the agricultural sector and in private pensions, the two more emblematic reforms put forward by the administration. Agricultural policy, which triggered a major political conflict in 2008, was designed without a substantial discussion between the technical staff of the secretary of agriculture and the leadership of the farm sector. The counter-reform of the private pension system in 2008, which undid reforms put in place 14 years before, was announced without consultation with the superintendency of AFJPs, the government regulatory agency for the sector. The government's approach in both cases did not involve any debate. By acting abruptly and with limited technical support, the government failed to anticipate, and therefore counterbalance, the negative consequences of its actions. Increasing taxes on agricultural exports triggered greater political polarization and the counter-reform of the pension system significantly increased financial instability despite the relative strength of Argentina's banking system.

Perhaps the biggest risk for Argentina's rating is that the government might not use the limited capacity it still enjoys for changing economic policies in the coming months. The election results provide a warning and therefore an opportunity for the government coalition to review its position. The recent cabinet reshuffle, although providing a new opportunity for policy change, is so far seen as a continuation of the political and economical approach rather than a significant change. So how much time does the government have? It has some, as the sources of financing indicate, but not a lot.

Argentina's Financing Gap: Sources Are Available In 2009, But 2010 Is More Uncertain

Despite the country's history of large economic dislocations, current evidence points toward a gradual process of deterioration, not a major financial crisis. However, if appropriate actions are taken, Argentina could still return to a more sustainable macroeconomic path without major dislocations. Despite ongoing stagflation, the initial point of any correction needed still includes a relatively balanced fiscal budget (surplus of 1% of GDP for 2008 and projected deficit of 0.5% for 2009), a current account surplus (1.6% of GDP in 2008 and a similar surplus projected for 2009) and a significant \$46.7 billion in international reserves. Even under a more conservative calculation that nets out some dollar liabilities, international reserves could still reach a high \$35.6 billion, or 11% of GDP, and seven months of imports. Net general government debt is estimated at a moderate 47% of GDP for 2009, but at least 25% of the total debt is held by government agencies. The problem is that all these indicators, in particular the fiscal, continue to deteriorate. Again, there is some time, but that time is running out.

Lack of access to debt markets constitutes a clear and significant credit weakness. However, the treasury's policy of financing itself by issuing debt to different government agencies will allow it to refinance its debt service for the rest

of 2009 and even provide some cushion for part of 2010. The process of replacing market debt with intergovernmental debt began in 2008 and has turned into the main source of financing in 2009. The large levels of savings of these government agencies may allow the treasury to fund rollovers in the next 12 months. The fact that obligations due are not extraordinary high is also in the government's favor.

The government debt service for the second half of 2009 is estimated at \$ 13.5 billion, but only an estimated \$6 billion is due to private holders of government debt. Of this amount, \$2 billion is for the Boden 12 payment scheduled for August 3, and the government is supposed already have that saved. The remaining \$4 billion (about 1.2% of GDP) is not necessarily an ambitious amount for Argentina. Primary sources of financing include about \$2 billion from government-owned Banco de la Nacion Argentina, which is allowed to lend the government up to 10% of the total deposits of the public sector on its balance sheet, and an additional \$1.8 billion from the central bank, which is allowed to lend the government up to 12% of the monetary base and 10% of international reserves.

In addition, multilateral lenders could still add as much of \$800 millions to the treasury. The treasury will therefore automatically roll over all other debt maturing in the hands of government agencies--with the social security agency (ANSES) in particular--and it could still place new debt with them. There are also always the fresh funds provided by the surplus the ANSES generates based on the ongoing social security contributions. Annual contributions to ANSES are estimated to be about 15 billion Argentine pesos (ARP), or 1.3% of GDP.

It is very clear this policy is not sustainable over the medium term. Not only have stocks of government agencies savings gone down, but flows (new revenues) are also diminishing as a result of decelerating economic activity. However, debt maturing in 2010 is less significant than in 2009. The total amount of principal and interest due in 2010 is equivalent to \$13.2 billion, of which \$7.2 billion is estimated to be in private hands. The government's ambition is to be able to access voluntary markets in 2010, but this will depend on improving economic policymaking. In any case, some of the buffers provided by government deposits, including the ANSES surplus and the additional funds from the Central Bank will still provide some relief. At least another \$1 billion could come from multilateral lenders. All considered, and despite the large level uncertainty on the government's financing program for 2010, it is not too ambitious to foresee a scenario where the government is able to muddle through 2010. Once again, everything depends on the politics.

Two possible default scenarios

In addition to the risks derived from the lack of secure sources of financing for 2010 in the context of an ongoing process of gradual political, economic, and fiscal deterioration, Argentina's risk of default is also derived from two alternative scenarios. First, the possibility the government could implement a liability management operation aimed at improving its debt profile over the short-term that Standard & Poor's could interpret as a distressed exchange and therefore characterize as a default. (For Standard & Poor's methodology on distressed exchanges, please see "General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009, on RatingsDirect.)

For some time, the government has been analyzing the possibility of proposing a debt swap on the Boden 12 bond. The bond is due in 2012 but amortizes annually. For 2010, the Boden 12's capital payment will require an estimated \$2.18 billion due in August. The two previous liability management operations implemented by the administration, the guaranteed loan swap known as Préstamos Garantizados in January 2009 and the offer to prepay the Boden 12's 2009 installment of capital and interest in June 2009, were not characterized as distressed exchanges by Standard & Poor's. (For more information, please see Standard & Poor's rationale in both cases "Republic of

Argentina Ratings Unaffected By Announced Offer Of Bond Prepayment," published June 5, 2009, and "Argentina 'B-' Long-Term Ratings Affirmed Following Proposed Domestic Guaranteed Loan Swap; Outlook Remains Stable," published Jan. 27, 2009, on RatingsDirect.) It is not clear yet whether the government will pursue the Boden 12 operation. It is also unclear what the terms of that potential operation could be. However, if the terms were to meet Standard & Poor's definition of a distressed exchange, Argentina's rating would be lowered to 'SD' (selective default).

Sources of financing could still exist to cover debt service over the next 18 months. However, in the second scenario that could lead to default, increasing fiscal strain at a time of weakening political support could lead the government to take drastic measures in attempt to regain fiscal room to maneuver, such as the one pursued in October 2008 with the counter-reform of the private pension system. Although it is difficult to predict what types of measures those could be, what seems more likely is that these potential actions, taken in a context of deteriorating political support, declining economic activity, and vulnerability to capital outflows, could end up accelerating financial instability. In that context, drastic and unanticipated measures of this type could lead to a run on deposits and the currency that would set the basis for a default on the government debt, despite the modest debt payments due over the medium term.

Significant Domestic Challenges To Economic Recovery Remain, But Help Will Come From Abroad

Both the micro- and macroeconomic policy mix seem less conducive to economic growth

As in recent years, the key to determine how much political leeway the government will have in the near term is how resilient the economy is to current negative shocks. Economic growth solves many political problems.

Despite increasing controversy over Argentina's official statistics on economic activity, the consensus among private sector analysts is that the country is already in, or at least very close to, a recession. Unlike many countries currently suffering recessions, Argentina is aggravated by a persistent high level of inflation, which is estimated by private sector surveys to be at an annual rate of 15% as of mid-2009. Standard & Poor's estimates Argentina's GDP will drop 1.6% in 2009. While the official INDEC GDP data showed a year-over-year increase of 2% in the first quarter of 2009, most private sector estimates are within a range of -3.5% to 0%.

The negative shock to domestic confidence of an external crisis of this magnitude should not be underestimated. However, the lack of predictability of government policies, the history of conflicts between the government and different economic sectors, the growing level of government discretionary intervention in different sectors of the economy, and the increasing lack of confidence in official statistics are some of the internal factors that have also hurt domestic confidence. These factors shorten the planning horizon of economic agents and significantly affect economic activity. Strong capital outflows, which intensified with the counter-reform of the private pension system in October 2008 and continue today, are a reflection of the confidence problem prevailing in Argentina.

Within this context, the conjunction of government policies and current economic conditions do not seem conducive to a recovery. In addition to the problems affecting microeconomics described above, some of the macroeconomic factors that were stimulating high growth in Argentina in recent years have also dissipated. Those were a competitive real exchange rate, expansionary fiscal and monetary policies, and a system of subsidized prices for basic utilities that kept costs low for consumers. After a few years, high inflation started to undermine the

sustainability of such a policy mix.

The very competitive real exchange rate prevailing during the first years after the 2001/2002 crisis has been eroded by high inflation since 2007. Although the central bank was successful in promoting a gradual depreciation of the nominal exchange rate of about 28% between September 2008 and July 2009 to regain competitiveness, inflation will continue to erode these nominal gains. In addition, any government attempt to depreciate the exchange rate more rapidly under the current context of declining domestic confidence will constitute a significant risk because it could trigger a run on the currency.

Fiscal policy, which has become extraordinarily expansive since 2007 with annual nominal growth rates in primary expenditure of 35% in 2007 and 38% in 2008, now shows greater signs of weakness with revenues suffering from economic activity. With greater fiscal strain, there will be also a lesser ability to maintain artificially low utility tariffs compensated with a broad system of cross subsidies, as recent increases in these prices have shown. Finally, monetary policy, although less expansive than fiscal policy, has also been expansionary in recent years, with negative real interest rates during a period of high inflation.

In any case, any attempt to put Argentina on a sustainable path of economic development over the medium term will have to reduce the country's inflation to more moderate levels to be successful. Accurate inflation statistics are a precondition to achieving that goal.

China, India, and Brazil provide optimism from beyond the border

Despite remaining uncertainties on global economic recovery, external factors remain relatively auspicious for Argentina over the medium term. There are basically two reasons for cautious optimism in this regard. First, some rapidly growing emerging markets seem resilient to the current world economic conditions. Despite recent deceleration, China's GDP is expected to expand at least 6.5% in 2009 and 7.0% in 2010. India's economy will likely increase 5.0% in 2009 and 6.2% in 2010. Both are expected to grow at even higher rates over the medium term. Sustained growth in these markets will continue to support relatively high agricultural commodity prices over the long term. Argentina's real economy is not extremely dependent on its exports (total exports only account for 25% of GDP, but about 50% of the exports are somewhat dependent of agricultural prices), but increasing prices of agricultural commodities will contribute to tax revenues and to external liquidity. Export taxes constituted about 12% of government revenues and 3.5% of GDP in 2008.

The second reason is Brazil. Exports to Brazil represent 19% of total exports but encompass products with a greater level of value added within Argentina's export basket. About 40% of the country's industrialized manufactured exports go to Brazil. Of them, cars and trucks account for a significant share of total manufactured exports. Exports to Brazil have significant spillover effects into employment and therefore domestic absorption in Argentina. As Standard & Poor's 'BBB-' low investment-grade rating for Brazil reflects, we are cautiously optimistic about Brazil's medium-term economic performance. If Brazil continues to enjoy GDP growth, it will improve the regional environment in which Argentina operates and provide opportunities for the country's business sector. (For reference, see Standard & Poor's analysis of the Federative Republic of Brazil, published on July 1, 2009.)

Three Possible Political Scenarios

The government's management style of limiting decision-making to a few personalities makes predicting government policies a very difficult task. The element of surprise has been a common denominator to all key decisions taken by

the administrations of both Nestor and Cristina Kirchner. Nonetheless, the new political context has set an important challenge for the administration. How will the administration react? We foresee three major political scenarios and explain why the first of them is expected to prevail against the other two:

Scenario 1: Keep going in the same direction with only minor modifications

This remains the most likely scenario as of now, somewhat enhanced by the recent cabinet reshuffle. The government would not interpret the electoral result as a turning point, would introduce only minor changes in the cabinet or policies, and persist in the same direction while trying to regain political momentum. However, worsening economic conditions would continue to diminish the administration's options. Therefore, the combination of an increasingly worse economic environment and a more unfavorable political balance of forces for the administration could put Argentina onto a more risky path. Under this scenario, despite changes in the cabinet, economic decision-making would remain centralized on the presidential office, and Argentina's economy would continue its process of slow deterioration with negative implications on the country's sovereign credit rating.

A modified version of this scenario is one in which the government, as a consequence of the continuing deterioration of the economy, tries to correct fiscal and monetary policy while maintaining its old political style. With no significant change in the political approach of the administration, the president could rely more on technical inputs from outside the inner political circle and take steps to provide greater moderation to economic policy implementation. The combination of greater access to funding (from voluntary lenders), more consistent macroeconomic policies, and greater credibility in economic statistics could still help sustain confidence and avoid a loss of creditworthiness, if the plan is adopted sooner rather than later.

Scenario 2: A significant moderation of policies with greater political dialogue and a proactive economic agenda

Despite growing economic problems, Argentina's major obstacle seems more political than economic at this point. A more consensual political approach by the administration that proposes solutions to the country's economic problems could put Argentina on a more sustainable economic path. However, the chances of such a change are relatively low because sharing power, stimulating dialogue, and reaching consensus do not seem to be part of this government's management style. Concentration of power seems part of the essence of the Kirchners' administrations. Giving up power is therefore seen as a sign of weakness. It remains unlikely the government could change that intrinsic part of its style. A significant moderation of economic policy therefore remains unlikely under the current administration because a more consensual and moderated political approach would be a precondition.

Scenario 3: A radicalization of policies in a drastic attempt to regain fiscal flexibility

Under this scenario, the government would not only continue with the same political style and economic policy mix but would also radicalize its more controversial policies, such as showing greater discretionary intervention in the economy.

The radicalization scenario had a greater likelihood of occurring if the government had retained control of the Peronist Party following the election. In that case, the government could still have received support within the Peronist Party to take drastic actions aimed at regaining greater fiscal flexibility, and, therefore, gaining greater influence over the behavior of governors, mayors, and other important political players. However, with the leadership of the Peronist Party now in dispute, it would be difficult for the government to reach minimum levels of support to pursue any highly controversial policy. That does not completely rule out the possibility of the

government introducing a drastic action, but severely limits its probability of being implemented.

One of versions of scenario 1 seems to be the most likely path. However, predicting the future is perhaps more difficult in Argentina than in most countries, as its own volatile history indicates.

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