Tax Supported
Sector-Specific Criteria

U.S. State Government Tax-Supported Rating Criteria

Analysts

Laura Porter
+1 212 908-0575
laura.porter@fitchratings.com

Karen Krop
+1 212 908-0661
karen.krop@fitchratings.com

Douglas Offerman
+1 212 908-0889
douglas.offerman@fitchratings.com

Ken Weinstein
+1 212 908-0571
ken.weinstein@fitchratings.com

Alexandra Edwards
+1 212 908-9181
alexandra.edwards@fitchratings.com

Rich Raphael
+1 212 908-0506
richard.raphael@fitchratings.com

Related Research

Applicable Criteria

- *Tax-Supported Rating Criteria, Aug. 16, 2010*

This report replaces the previous report of the same title dated Dec. 28, 2009.

Summary

This report fully incorporates and expands upon tax-supported rating criteria, with a focus on U.S. state government debt, and updates and replaces Fitch Research on "U.S. State General Obligation Bond Rating Criteria," dated April 25, 2008. This report identifies rating factors considered by Fitch Ratings in assigning ratings to a particular entity or debt instrument within the scope of the criteria. Not all rating factors in this report may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

To determine the rating for a tax-supported bond issued by a U.S. state government, Fitch first evaluates the nature of the legal security and then analyzes the following four major factors to establish the general credit quality of the state:

- Debt and other long-term liabilities.
- Economy.
- Finances.
- Management and administration.

Fitch's rating process involves analyzing trends in these areas. Actual and potential future obligations and exposures are identified. The major rating factors are interactive. For example, while a state may have a vibrant and wealthy economy, weak fiscal management may offset positive credit factors, resulting in a reduced ability to meet obligations. In turn, a weak economy may be offset by other strengths, such as proactive management or a very low debt burden. The emphasis on specific factors may be influenced by the nature of the rated security, with the analysis of bonds backed by a specific revenue stream focusing more on economic drivers of that revenue and less on management and administrative factors.

Rated Security

Prior to an analysis of the state government's general credit quality, Fitch details the nature of the security being rated and evaluates the relationship between the credit quality of the security and the general credit quality of the state.

Legal Pledge

A security's rating takes into account the strength of the legal pledge. If a debt obligation carries two pledges, such as a special tax pledge backed by a general obligation (GO), Fitch takes note of the "double-barreled" feature but does not consider the two pledges to be additive. Instead, Fitch will rate the issue based on the stronger of the two pledges.

The GO full faith and credit pledge is the broadest security a U.S. state government can provide to the repayment of its long-term debt, and the rating on this type of obligation reflects the general credit quality of the issuer.

In cases where bond payment requires annual or biennial legislative appropriation, this lesser long-term commitment to repayment generally is reflected in a lower rating than the GO rating. Such debt is typically rated one notch below the GO rating. However, in cases where there is not clear essentiality for the project being funded (e.g. stadium financing), concerns about non-appropriation may be heightened, and such debt can be rated two or more notches below the GO rating. Similarly, if there are concerns about the adequacy of funds from which appropriation may be made, the mechanism for or timing of the appropriation and debt service payments, or the issuer's commitment to the obligation, the debt may be rated more than one notch below the GO rating. Conversely, if the risk of non-appropriation is judged effectively eliminated, for example through a mechanism that traps substantial operating funds if appropriation is not made, the appropriation debt can be rated on par with the GO credit. Fitch considers the issuer's recognition and treatment of the obligation in its legislative, administrative, and budget processes a significant indicator of its commitment to the debt.

The rating for a special tax security, where payment is derived from a specific tax revenue source, while still informed by the analysis of the state's general credit, also reflects structural factors, such as lien status, indenture requirements, and debt service coverage, and places more emphasis on analysis of the breadth and stability of the revenue stream used to secure the bonds.

The rating of special tax bonds issued by states may be higher than that of the GO credit, although this is rare because state GO bond ratings tend to be at or above the level that a special tax bond would support due to the broad nature of the GO pledge and states' inherent credit strengths (states generally have broad economic and tax base resources, and all possess sovereign powers under a federal government system with substantial, although varying, control over revenue raising and spending). A special tax bond rating may be higher than the GO rating if bondholders are granted a statutory lien and an irrevocable priority security interest in the special tax, and the flow of the pledged revenue is structurally protected from the state's general financial operations. The amount of credit Fitch will give to such a structure is tempered by the risk that a state, faced with extreme financial stress, could exercise its sovereign powers to the detriment of bondholders.

Lien Status

In state tax-supported ratings, the lien status is generally only a rating consideration for special tax bonds, which normally provide a first lien on pledged revenue. Rating distinctions between senior and subordinate lien debt generally are based on notably weaker legal protections for subordinate bonds provided by the indenture. Fitch only makes such distinctions in cases where there are no cross-default provisions between the liens and, when made, the distinctions are generally small (one to two notches).

Indenture Requirements and Relevant Statutes

Similar to lien status, indenture requirements are most relevant to special tax bonds. Important indenture provisions include the issuer's covenants, the flow of funds, any requirements that enhance or hinder bondholders' ability to be repaid, recourse available to bondholders that could prevent a default, and, in particular, the additional bonds test (ABT). Bondholder protections incorporated into statute are particularly strong.

Since special taxes are almost always levied at a fixed rate, bondholder protections for debt obligations supported by such revenues generally do not include rate covenants. Consequently, restricting future debt service coverage dilution through limits on additional bond issuance is a critical rating factor. In analyzing projected debt service coverage, Fitch considers the ABT and practical limits to additional issuance. Regardless of current issuance plans, Fitch considers the impact of leveraging the pledged revenue to the full extent permitted by the test.

ABTs for special tax bonds cover a broad range but are generally based on historical collections and require coverage by pledged revenue in a recent 12-month period of maximum annual debt service (MADS). Narrower and/or more volatile taxes require higher coverage thresholds for additional issuance to achieve high ratings, although greater coverage can only partially offset an inherently weak tax base. Fitch views ABTs based solely on projected revenue unfavorably. If variable-rate debt is permitted, Fitch views most favorably a calculation of MADS utilizing a significantly higher long-term interest rate than the prevailing rate at the time of issuance. Regardless of the stated ABT, Fitch takes a conservative approach to estimating annual debt service for variable-rate debt.

For special tax bonds, a debt service reserve fund (DSRF) can provide a buffer against low tax-collection periods. Fitch believes this protection is more important for structures with relatively weak coverage or revenue streams with significant volatility and has little impact on the credit quality of bonds whose coverage and ABTs are already strong. However, if coverage begins to erode, an issuer's rating may decline more quickly in the absence of a DSRF. Debt service reserves funded with a surety bond provide value up to the rating of the surety bond provider, although cash-funded reserves are a stronger enhancement.

Bank Bond Ratings

In conjunction with or subsequent to a borrower's issuance of variable-rate demand bonds, Fitch may be asked to assign a long-term rating to the borrower's corresponding bank bonds, i.e. variable-rate demand bonds that have been tendered and not remarketed and then purchased by the liquidity provider in accordance with the liquidity support agreement. Fitch bases this rating on its analysis of the underlying credit strength of the issue, taking into consideration the potential negative effects of a purchase of the bonds by the bank, which may include a ramp-up in interest rate and an accelerated repayment of principal. Since these factors are considered in Fitch's analysis of the underlying rating of all parity debt, including any VRDOs, bank bonds whose security is on parity with their corresponding VRDOs carry the same underlying long-term rating as those VRDOs. Similarly, an obligation arising from commercial paper being purchased by a liquidity provider would be assigned the same rating as the issuer's parity obligations.

Debt and Other Long-Term Liabilities

In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature of the issuer's outstanding liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Debt Ratios and Trends

Debt analysis includes a review of trends in the amount of debt issued and outstanding and in debt in relation to resources. Sustained increases in debt at a rate in excess of economic growth may ultimately overburden a tax base and strain budget resources. State debt measures are reviewed in the context of factors that affect the magnitude of borrowing, such as the allocation of functions between the state and other levels of government.

State debt analysis focuses on net tax-supported debt, which includes all long-term, fixed obligations of the issuer, excluding debt fully supported by user charges, tobacco settlement bonds, and unfunded pension and other post-employment benefit (OPEB) liabilities, which are considered separately in the context of an issuer's overall long-term liabilities. Fitch includes grant anticipation revenue vehicles (GARVEEs), which are special obligations supported by the state's share of federal transportation funds, in the calculation of net tax-supported debt because, by dedicating this portion of a state's transportation resources, a GARVEE bond is effectively committing state

resources. Bond anticipation notes and commercial paper are included in debt calculations because of the likelihood that such instruments will be replaced with long-term debt. Fitch also includes bonds issued to fund a pension obligation (POB) in net tax-supported debt calculations but gives some consideration to debt ratios without POBs used for system funding (as opposed to budget relief) in recognition that such debt is replacing another pre-existing, albeit “softer,” long-term liability of the state.

In general, a low debt burden is a positive credit factor. Fitch considers net tax-supported debt measured against a state’s personal income the best indicator of debt burden, because a state typically derives its financial resources directly or indirectly from this wealth base. Generally, a ratio of net tax-supported debt-to-personal income less than 2% is considered low. Debt to personal income ranging from 2%–7% is considered moderate. A debt-to-personal income ratio greater than 10% is generally considered very high, a point at which servicing debt poses a significant ongoing constraint on resources. Fitch also reviews debt per capita. Although not a wealth measure, debt per capita links outstanding obligations to the population benefiting from the debt and allows for ready comparability among states.

Another measure of affordability is debt service as a percentage of own-source, general fund revenues (i.e. taxes and fees levied by the state). This measure is used cautiously, as each state defines such revenues differently. Nonetheless, the ratio reveals the relative burden of debt against other budgetary needs and, under stress scenarios, may indicate the extent to which debt service could crowd out other needs.

For special tax bonds, debt ratio analysis includes the calculation of historical, current, and projected future coverage of debt service by the pledged revenue source.

Debt Structure

Fitch reviews the types and proportions of debt utilized (e.g. GO, appropriation backed, or special tax). A change over time in the composition of debt, such as a shift to appropriation debt from GO, may indicate a change in public support for debt issuance. The amount of short-term debt is also reviewed in relation to prior-period short-term borrowing; the presence of short-term borrowing may indicate uneven timing of revenue receipts, careful management of resources, or financial stress and could present a financial pressure in and of itself.

Fitch also analyzes the rate at which debt is repaid. The pace of debt amortization is a general indicator of the level of conservatism of a state’s debt management. Fitch considers a 50% rate of amortization over 10 years to be average, 60% above average, and greater than 65% rapid. A state that maintains rapid debt amortization, even considering a higher-than-average debt burden, benefits from greater financial flexibility and the fiscal capacity to continuously finance its capital requirements, as debt rolling off makes room for new issuance. Fitch’s analysis also notes changes to the pace of amortization over time. For some special tax bond securities, slow amortization rates may exacerbate concerns about limited or volatile revenue sources.

The review of outstanding debt includes an assessment of the uses of borrowed funds. The use of bonding for noncapital purposes is considered a credit weakness, and deficit borrowing is a clear negative credit factor, although this can be mitigated to some extent if issuance is limited and in the context of a larger plan to address an overall state financial shortfall.

Another consideration is the percentage of fixed-rate debt in the issuer’s debt structure. Fitch views high levels of short-term debt, variable-rate debt, and/or derivatives with concern, as they expose the issuer to the possibility of unexpected

and, in extreme cases, unaffordable future financial demands. Fitch looks for whether the issuer has a clear understanding of the benefits and risks of entering into these types of transactions. Generally, a level of 15%–20% of variable-rate debt is considered a prudent maximum for states.

Future Capital and Debt Needs

Debt factors are considered within the context of the issuer's infrastructure needs and capital plans. Current debt levels may be low; however, future capital projects may significantly increase debt ratios, weakening the issuer's debt profile. Fitch evaluates the impact of expected future debt on the issuer's debt ratios and views favorably a comprehensive and realistic approach to capital planning. The issuer's ability to meet its capital needs where there are restrictions on debt issuance is also a consideration.

In rating special tax bonds, Fitch reviews the issuer's stated plans for issuance in light of existing capital needs, expected economic growth levels or deferred maintenance, and alternative funding sources, recognizing the possibility that there may be future issuance not currently foreseen that would dilute coverage.

Pension and Other Post-Employment Benefit Funding

Fitch reviews pension and OPEB funding as part of the analysis of debt, recognizing that pension and retiree health benefits represent a more flexible commitment to future payments than debt to the extent that they can be influenced by a variety of actuarial, accounting, investment, or other policy decisions of the sponsoring government. Fitch's analysis focuses on the size of the liability, the funded ratio, measures of affordability, and actuarial and other assumptions influencing the burden. A stable funded ratio of 70%–80% typically indicates a state pension system is adequately funded, given assumptions underlying the plan. As with net tax-supported debt, Fitch measures the unfunded liability against state personal income, a measure that incorporates the wealth base from which the liability will be paid. Although Fitch does not have specific criteria for actuarial assumptions, it takes note of changes to such assumptions from year to year or if assumptions are outside the broad average among state pension systems. Fitch views favorably entities that have well-funded pension plans and consistently fund the annual required contribution (ARC). In cases where a pension or OPEB unfunded liability is sizable, Fitch views positively actions or plans to reduce it over time. Concerns arise if the liability level is high or increasing, or if the actual contribution is below the ARC.

Indirect Risks and Contingent Liabilities

In looking at a state's debt obligations, Fitch examines not only liabilities directly incurred and payable by the issuer, but also outstanding debt for which the issuer may in the future have an obligation. Examples include moral obligations, where the issuer may support — but is not legally obligated to support — the debt upon failure of the primary security. Such obligations are monitored but typically excluded from direct debt calculations unless the issuer's resources have been relied on to cover the obligation during the past three years.

Economy

Fitch's economic analysis considers the capacity of the issuer's economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Major Economic Drivers

The evaluation of the economy begins with a determination of the types of economic activity that dominate in the state. Although most states benefit from broad economic and tax bases, some economies may be overweighted in an industry like automobile

manufacturing or natural resource mining. Fitch identifies the major economic drivers for a state and their direction and considers factors that will either enhance or inhibit growth. Fitch also reviews a state's own forecast of economic trends against both recent experience and other published forecasts. A broad, diverse, and stable economy is a credit strength, and undue concentration in one or a small group of industry sectors or a high level of cyclicality may be cause for concern. For special tax bonds, the analysis includes a determination of the particular economic drivers of the pledged tax revenue.

Employment

Fitch reviews trends in employment and seeks an understanding of why a given sector has expanded or contracted. Historical and recent gains or losses in overall state nonfarm employment are evaluated not only to gauge general expansion, but also to track cyclicality and sensitivity to broader national and regional trends. Fitch also considers employment within the various geographic regions or major metropolitan statistical areas of the state to understand regional activity and appreciate distinct regional differences. Trends in unemployment are reviewed in the context of labor force changes and other factors that may have an impact, such as cyclicality. Gross state product trends complement the employment data in cases where the state economy has a large natural resources or agricultural component.

Income and Wealth

Income levels are evaluated on both an absolute basis and relative to regional and national averages. Reviewing trends in the issuer's income and wealth, compared with those of the region and nation, provides an indication of the rate of economic value being created, which has implications for future revenue performance.

Fitch analyzes a state's personal income per capita and its relation to national averages. Total personal income growth is tracked against national and regional averages, which is indicative of the robustness of overall economic growth. The components of personal income are also a valuable analytical tool for understanding which sectors are most influential in the economy, both in their importance to the state and performance over time. Similar to employment, broad growth and balanced sources of income serve as credit positives.

Other Demographic Factors

Fitch reviews key demographic metrics, particularly population trends. Fitch considers the reasons why a particular area attracts or loses population. Demographic structure and projections are important for assessing future expenditure pressures, particularly in healthcare and education.

Among the other demographic factors that Fitch considers are age profile, educational attainment, and poverty level. Each measure serves as an important indicator of current or future demand for state infrastructure and governmental services and as a gauge of economic potential. Internal and international migration data, as well as birth and death rates, further inform the analysis of population growth figures and testify to dynamics of the populace. The age of a state's population is considered not only as a median for comparative purposes, but is also evaluated by age cohort to generally capture school, workforce, and retirement ages. Educational attainment — percentages holding a high school or equivalent degree or at least a bachelor's degree — is reviewed to assess the competitiveness of a state's workforce.

Tax Burden

Comparing the level of taxation, regionally and nationally, can provide an indication of competitiveness, financial flexibility, and/or tax relief pressures. Fitch reviews tax

rates in comparison to those of other states nationally and in the region. The analysis of tax rate levels considers the state's role in funding public services versus the role of local governments and the relative breadth or narrowness of tax bases.

Finances

The analysis of a state's finances is focused on evaluating its financial resources and flexibility to support its obligations over the near and long terms. Fitch focuses on the general fund and any other large funds that are responsible for major functions or receive substantial tax revenues, such as education funds or property tax relief funds. State financial recordkeeping and reporting vary considerably. As such, Fitch reviews budgetary and generally accepted accounting principles (GAAP)-based financial reports; budgetary reports are more timely, while GAAP reports allow for more comparability among the states.

Revenue Analysis

Fitch reviews revenue sources for volatility and diversity. In general, a diverse revenue system with a foundation of broad-based taxes is more stable and better able to capture the issuer's economic wealth, resulting in a stronger financial profile. Reliance on economically sensitive revenues, such as real estate transaction or gaming taxes, may expose the issuer to financial volatility and lead to a credit concern.

To determine the stability of a state's revenue structure, Fitch analyzes the historical performance of revenues throughout economic cycles, focusing on base growth (e.g. growth removing the impact of tax rate increases or cuts, or base broadening or narrowing) to fully capture baseline trends. The underlying causes of volatility, such as above-average exposure to capital gains, commodity prices, or real estate transaction revenues, are evaluated. Fitch's analysis also considers changes to tax rates or bases over time.

The dilution of the general fund through the dedication of major revenue sources to specified purposes, whether by policy decision or voter mandate, generally is viewed negatively as an inhibitor to financial flexibility; however, the motivation for the revenue diversion can mitigate this concern, such as if the diversion addresses a long-standing funding pressure for the state.

To evaluate the state's current financial position monthly, or as frequently as possible, budgetary basis results are compared with budget forecasts for the current year, as well as prior-year results. This provides an early indication of possible financial pressure.

For special tax bonds, the revenue analysis considers the nature of the tax and the historical performance of the pledged revenue stream, including its average rate of growth and year-to-year volatility. If a tax has been recently imposed, historical estimates based on the most similar existing tax are considered. If no similar tax exists, Fitch will look at relevant economic variables to gauge past economic activity.

Expenditure Analysis

Fitch reviews trends in expenditures, the expected stability in each major spending item, and the issuer's flexibility to make adjustments in spending, both as part of the annual budget process and during the course of the fiscal year. The centralized ability, or mandate, to implement timely spending cuts to maintain balance is a credit strength. The analysis also considers potential funding pressures, including outstanding litigation and unfunded mandates from the federal government. The level of state spending does not necessarily correlate to credit strength; comparatively high-spending states can achieve higher ratings, whereas states with much more limited spending can

be financially strained. However, Fitch's state credit analysis does consider the state's expenditure profile as an indicator of burdens being placed on the state.

For special tax bonds, the expenditure analysis focuses on the planned use of pledged revenues remaining after payment of debt service. In general, the ability to reduce such planned spending in the event of weakness in the pledged revenue source is a positive rating factor.

Operating Margin Trends

Fitch evaluates recurring revenues, compared with recurring expenditures. Concerns arise when operating expenditures consistently exceed operating revenues, as the use of nonrecurring revenue is unsustainable and usually leads to depletion of reserves and deeper financial imbalances.

Fund Balance and Reserve Levels

Fitch views a satisfactory fund balance and reserve position as an important cushion against potential revenue and expenditure volatility. The amount Fitch considers satisfactory varies based on such factors as economic concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending. More volatile financial profiles dictate larger financial cushions that will give the state time to react in a downturn. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features, but fund balances that have been maintained consistently over time also are beneficial. Similarly, segregated funds that are available, or could be made available, for general expenditures can contribute to financial flexibility. Annual surpluses in and of themselves are not considered significant financial cushions, as they can be, and often are, appropriated for operations or special purposes.

Fitch reviews trends in reserves and fund balance, with the key metric being reserves and balance levels as a percentage of state own-source (i.e. nonfederal) revenues. A general target for prudent reserve levels is 5%–10% of recurring state own-source revenues. Since fund balance designations are discretionary and vary among states, GAAP financial statement analyses focus on the unreserved fund balance as a percentage of revenues.

Liquidity

Fitch analyzes a state's cash position with a focus on the timing of tax collections and disbursements and the availability of internal borrowable funds, if necessary. Those in the strongest position do not depend on external cash flow borrowing. The liquidity analysis is particularly important in periods of financial stress. Balance sheet analyses look at trends in the state's cash and current position, with liquidity a key credit factor for states in financially strained situations or in cases where states are issuing short-term debt or providing self liquidity on variable-rate debt.

Management and Administration

Management practices and actions can positively or negatively influence the other major credit factors, affording strong ratings to entities with limited economic or financial resources or weaker ratings to more diverse or affluent entities.

Institutionalized Policies and Budgeting Practices

Fitch views positively implementation of and consistent adherence to sound processes and policies for financial operations and debt. Strong, notable practices include established rainy-day reserve funds (particularly those with automatic funding sources and limits on use), multiyear revenue and expenditure forecasts, restricting use of

nonrecurring revenue to nonrecurring expenses, sound capital planning, and conservative investment policies and practices. Concerning debt policy, affordability guidelines, careful consideration of future needs and the requisite effects on debt levels, and centralized debt management are signs of credit strength.

Fitch reviews an issuer's budgeting practices, particularly revenue and expenditure estimations, and compares the key assumptions included in an issuer's budgets with actual revenues and expenditures over time. Fitch views conservative estimates favorably and is concerned if an issuer does not appear to be fully incorporating current economic, political, or financial conditions. Forecasts developed on a consensus basis among multiple entities are also viewed favorably by Fitch due to the diversity of constituencies employed in their development. Regular intrayear budget reviews, which can allow an issuer to identify underperforming revenues or overspending in time to make necessary adjustments to eliminate or lessen budget gaps, are also a positive credit factor. Budgetary policies that conservatively limit appropriations to a level below that of estimated revenues are viewed favorably, and an ongoing constitutional or statutory authorization or mandate to order expenditure cuts to maintain budgetary balance is a credit positive.

Financial Reporting and Accounting

Fitch assumes compliance with GAAP and relevant Government Accounting Standards Board policies; failure to comply creates significant concerns. Fitch views negatively late release of audited financial statements. Additional financial reporting, such as interim financial results throughout the year, is viewed positively.

Political, Taxpayer, and Labor Environment

A key credit element for states is the efficiency with which an elected government can make service and spending decisions, as well as its ability to adjust and react to changing economic and financial conditions. Fitch evaluates management's willingness and ability to make necessary budget modifications in a timely fashion in lean years and prudent use of surplus moneys in strong revenue environments. A history of cooperation between the executive and legislative branches gives Fitch comfort that financial challenges will be handled effectively.

Evidence of taxpayer dissatisfaction, with either the level of taxation or service provision, is a credit concern, as it may reduce an issuer's flexibility to address budget shortfalls. A negative taxpayer environment could include voter or legislative attempts to contain the government's legal ability to raise revenues. This concern increases in environments with easy access to the voter initiative process. As state government spending is more programmatic in nature and not as labor-intensive as that of local governments in most cases, labor relations is a less significant state credit factor.

Revenue and Spending Limitations

Establishing and adhering to policy guidelines is considered a credit positive. However, onerous statutory or constitutional operating limitations are potential credit risks. In addition, Fitch recognizes that, in some instances, practical limitations are just as restrictive. An inability to raise revenue or fund programs to adequate levels due to political or other practical concerns can have long-term implications for an issuer's financial and economic health.

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