

Credit Market Research

Weathering the Crisis

A Corporate Governance Perspective

Analysts

Martin Hansen
+1 212 908-9190
martin.hansen@fitchratings.com

Douglas Meyer, CFA
+1 312 368-2061
douglas.meyer@fitchratings.com

Harold W. Purnell
+1 212 908-0628
harold.purnell@fitchratings.com

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Overview

The ratings resilience of mutual companies, including both U.S. insurers and UK building societies, provides insight into the benefits to financial strength of aligning risk-return preferences of management and risk-averse stakeholders (e.g. policyholders). The credit performance and ratings of the larger mutual insurers have held up particularly well, an observation with potential corporate governance implications for financial institutions more broadly.

- **Relative to the return-focused view of equityholders, the ownership structure of mutuals aligns the interests of managers with those of policyholders and thus promotes a stronger focus on maintaining financial strength.** Based on Fitch's review of large U.S. insurers and UK building societies, mutual ownership has pursued a more conservative business strategy than publicly held companies, resulting in lower risk exposure and leverage entering the crisis, and thus greater financial resiliency. By comparison, publicly traded insurers and other financial services companies generally have not fared as well in maintaining credit strength through the crisis.

Mutuals Versus Stock-Owned Insurers

Type of Insurer	Fitch's Financial Strength Ratings Downgrade Rate		Rated 'AA' and Above (as of 6/30/2009)	'Pre-crisis' Operating Leverage (of the 50 Largest U.S. Life Insurers; Year-end 2006)	'Pre-crisis' RBC Ratios (of the 50 Largest U.S. Life Insurers; Year-end 2006)	Equity-based Compensation (% CEO Total; Six of the Largest Mutual and Six of the Largest Stock-owned U.S. Life Insurers, 2008)
	2008	2009 (First Half)				
Mutual	0	31	56	6.8	496	0
Stock-owned	28	46	16	10.0	390	49

- **"Through-the-cycle" capital management is challenging when times are favorable, but favorable when times are challenging.** The mutuals' structural inability to replenish capital through equity markets compels them to manage capital levels conservatively during benign economic conditions, with "buffer" capital to weather potential market downturns. Stock-owned companies also manage capital with a forward-looking view, but tend to hold relatively less capital during growth periods to optimize return on equity. This focus on capital efficiency is sharpened by shareholder constituencies pressuring managements to meet return-oriented targets and bolster share prices. However, the expectation that additional equity capital is readily accessible when needed has been challenged by the unprecedented evaporation of funding and spike in capital costs during the crisis.
- **Demutualization — often characterized positively as enhancing financial flexibility, capital efficiency, and strategic growth — can also increase risk profile and undermine financial strength.** UK building societies that previously demutualized generally fared worse during the crisis than those retaining mutual

status. Many U.S. life insurers incurred downgrades in their financial strength ratings post-demutualization. These experiences illustrate how a change in ownership structure can reduce the alignment in interests between policyholders and management, resulting in more aggressive expansion and leverage.

- **The structure of executive compensation can affect an institution's financial strength both negatively and positively.** While there has understandably been a lot of focus recently on equity-based compensation and potential managerial incentives to pursue excessive risk-taking, a notable governance practice of some mutuals is to link compensation to measures of financial strength or conservatism, such as maintaining capital ratios or managing expenses based on predefined targets. By comparison, larger stock-owned insurers tie executive compensation primarily to growth-oriented measures, such as return on equity or sales growth, rather than to capitalization or other prudential measures.

Although this study illustrates that the financial strength of larger mutual insurers was relatively more resilient than that of stock-owned companies during the crisis, it does not mean to suggest that either form of ownership is "preferable" from a credit perspective. For example, mutual ownership can pose unique challenges for smaller insurers, which under stress conditions may be particularly constrained by mutuals' inability to raise capital dynamically.

Potential Implications for Assessing Financial Strength

The crisis has underscored how these factors can affect the credit quality of financial institutions, particularly during stress conditions. As such, Fitch is more closely assessing the interplay between these corporate governance considerations and an institution's financial strength as part of its broader, ongoing reevaluation of the credit ratings process and criteria for financial institutions. While these factors were already reflected within the strong ratings of mutuals, Fitch notes some potential implications for credit analysis of financial institutions more generally.

- Holding buffer capital well beyond regulatory or model-derived levels is a prudent managerial strategy and a positive differentiating factor for an institution. For example, mutual life insurers entered the financial crisis with much stronger risk-based capital ratios than their stock-owned counterparts (see the Difference in Capital table on page 6). Such a buffer helps to cushion against "tail" stress in the scale and volatility of portfolio losses, in internal capital generation, and in capital market accessibility. The interplay of adverse asset performance and capital pressure under stress conditions is an important consideration within an institution's scenario analysis and long-term capital planning.
- Those institutions that rely on internal models in determining their capital needs typically recognize diversification through some form of capital reduction or offset. As demonstrated during the financial crisis, the benefit of holding a diversified portfolio (e.g. across different sectors or geographies) can erode quickly under stress, as the performance of different types of assets can become more highly correlated than originally assumed by internal capital models. Overly optimistic assumptions about diversification (e.g. if calibrated solely based on "normal" market conditions) can result in an insufficient capital buffer under stress scenarios when correlations increase.
- The structure of executive compensation, particularly the definition of performance targets, merits closer review of potential managerial incentives to pursue either higher risk or, alternatively, more conservative strategies.

Differing Stakeholders, Differing Risks

Corporate governance, and the interplay of key stakeholders within the governance process, influence a financial institution's risk profile and, in turn, its ability to weather crisis. The observed stability in the financial strength of mutuals during the crisis is explained in large part by the conservative risk-return preferences of the main corporate stakeholders within a mutual — namely, the policyholders.

Mutual Ownership and Risk Aversion

In a mutual company, policyholders are also owners of the company. A policyholder's primary economic interest is to maintain the long-term financial strength of the insurer to maximize claims-paying ability on insurance contracts. Excess returns generated by the company accrue to policyholders in the form of either improved terms (e.g. pricing) or dividends, economic benefits which are subordinate to maintaining the overall financial strength of the insurer.

The mutuals' investment and underwriting objectives are therefore to minimize volatility or risk profile and to generate stable, consistent long-term financial performance sufficient to meet policy claims. Strategy and operations tend to focus on conservative underwriting, narrow market scope, cautious balance sheet management, and a risk-averse investment approach.

During the financial crisis, mutuals benefited from their strategic focus on lower-risk, protection-oriented insurance products (which can be repriced based on recent experience), while stock companies have had much greater exposure to underperforming asset accumulation products (which have underperformed over the past two years). Coupled with their relatively stronger capitalization, the mutuals were better positioned to weather the crisis.

Additionally, the mutual form of ownership, by construct, precludes the insurer from raising equity capital dynamically. Since there are no stock investors, there is no external source of shareholder equity. (In some limited instances, mutuals have sold minority interests in subsidiary companies to third-party investors, which if transacted above the carrying value effectively increases capital levels.) This constraint on raising equity capital, in turn, creates a discipline for mutuals to maintain a cushion or buffer of capital to weather potential economic downturns or financing shocks. In other words, mutuals have little choice but to take a "through-the-cycle" approach to capital management — an approach that is of particular value when challenged by market stress.

Stock Ownership and Risk Appetite

By comparison, in a stock company, shareholders own the company. Shareholders' primary economic interest is to maximize their financial return on equity, whether in the form of capital appreciation or dividends. Unlike a mutual, excess returns generated by a stock company's operations accrue to equityholders rather than policyholders. Shareholders, of course, are also interested in the continued viability of the insurer as a going concern. Additionally, for stock-owned insurance companies, financial strength is an important marketing attribute in attracting underwriting clients and maintaining access to funding and credit markets.

However, for stock-owned companies, a potentially competing interest to financial stability is the maximization of return on equity, an interest not shared by policyholders. A stock company has a stronger appetite than a mutual for investment risk, capital efficiency (or operating leverage), mergers and acquisitions, and entrance into new product lines and markets to enhance revenue growth. To the extent that the objective of return maximization dominates that of financial stability, stock companies are inclined to take on more risks than mutuals.

Private Equity

An emerging corporate governance issue is that new forms of capital are seeking to enter the financial institutions space, notably private equity. If viewing the differing risk-return preferences of various stakeholders as a continuum, private equity investors typically tend to have a stronger preference for leverage and risk-taking than traditional public shareholders. The governance challenge will be to incorporate stakeholder influences that provide balance in risk appetite.

Additionally, management of stock companies might presume the flexibility to tap equity investors when additional capital is needed down the road. Although capital levels are buttressed by both regulation and supervision, stock-owned companies tend to operate with a relatively lower capital buffer than mutuals, reflecting a more dynamic approach to capital management. As evidenced during the financial crisis, this more dynamic approach can be undermined by sudden or unexpected shocks to capital markets, with additional capital either prohibitively expensive or unavailable.

Given the value of a risk-averse business model in weathering stress conditions, it is not surprising that mutual ownership has been a differentiating factor in maintaining financial strength through the credit crisis, as evidenced by their relatively strong credit ratings performance to this stage.

Insurer Rating Downgrades Disproportionately Affect Stock Companies

Beyond a few notable exceptions (such as AIG), the insurance sector has held up relatively well during the global financial crisis. While there has been a clear uptick in the number of downgrades affecting insurer financial strength ratings of late, these downgrades generally have consisted of one or a few notches and have largely culminated in ratings that remain investment grade.

The financial strength ratings of mutuals have held up particularly well, with no downgrades occurring among Fitch-rated mutuals in 2008, and a little more than a quarter of mutuals downgraded so far in 2009 (see the Downgrades Rates table below). In contrast, the financial strength ratings of stock-owned insurers have been affected more severely by the crisis, with over a quarter downgraded in 2008, followed by almost half of the Fitch-rated population incurring downgrades through the first half of 2009.

Downgrades Rates for Mutual and Stock Insurers

(% of Fitch-rated population of top 50 life and top 50 P&C insurers incurring a downgrade in a given year)

Type of Insurer	2006	2007	2008	As of 6/30/09
Mutual	0	0	0	31
Stock-Owned	2	2	28	46

Source: Fitch Ratings.

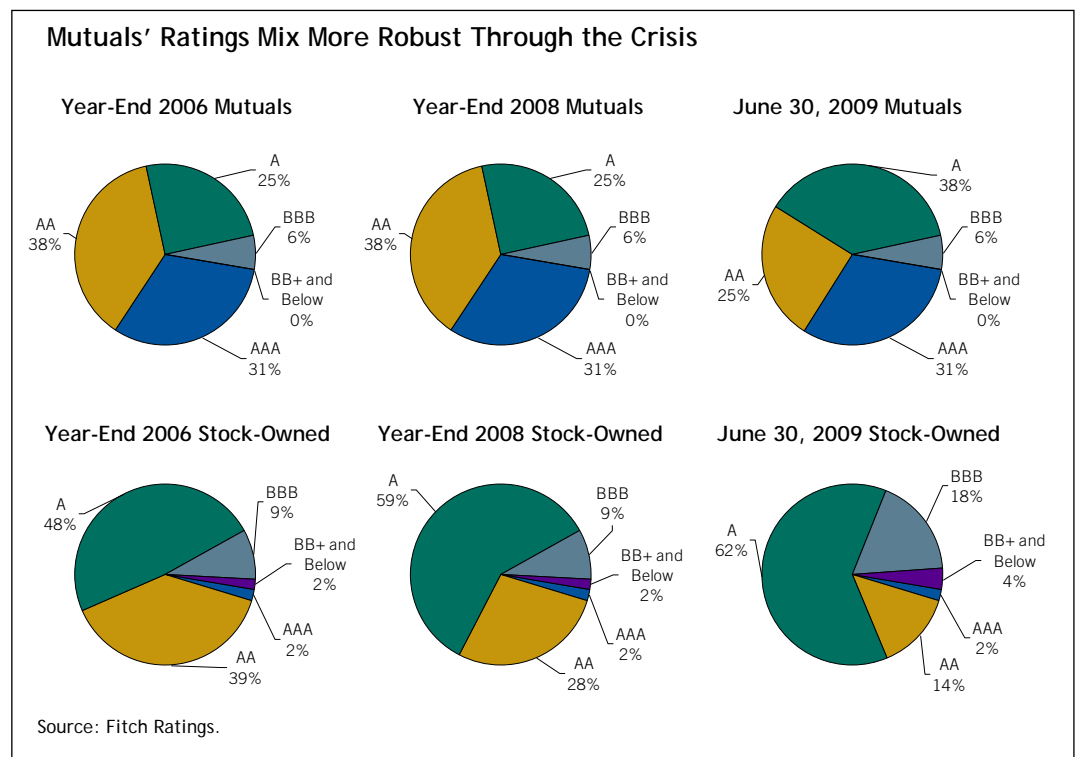
More Resilient Ratings Distribution of Mutuals

The higher incidence of financial strength rating downgrades among stock-owned insurers has resulted in a clear weakening in their financial strength ratings distribution (see the Mutuals' Rating Mix chart on page 5).

As of end of 2006, the mutuals' ratings distribution was markedly stronger than that of the stock-owned insurers, with 69% of mutuals rated 'AA' or above, compared to 41% of the stock-owned insurers (i.e. a difference of 28%). Since then, this credit quality gap has

widened even further, given the higher downgrade rate experienced by stock-owned insurers during the crisis. By mid-year 2009, 56% of mutuals were rated 'AA' or above while only 16% of stock-owned insurers remained at this level (i.e. the initial difference of 28% had grown to a gap of 40%).

Mutuals experienced some negative ratings drift over this period, but with a milder decline in their overall ratings mix than stock-owned insurers. The relative stability of mutuals, particularly at the 'AAA' level, shows how their inherent financial strength and conservatism were already reflected within their "pre-crisis" ratings.



“Through-the-Cycle” Capital Management

The mutuals' relative stability during the financial crisis illustrates the importance of strong capital ratios and lower operating leverage in buttressing an institution's financial strength against unexpected financial shocks or economic downturn.

Mutuals as a group entered the credit crisis not only with higher financial strength ratings than stock-owned insurers, but also with stronger risk-based capital ratios and lower operating leverage (see the Difference in Capital table on page 6). As noted, mutuals by definition lack the ability to access equity capital markets, imposing a discipline to manage capital levels and operating leverage based on a through-the-cycle approach. Their limited flexibility in replenishing capital compels mutuals to hold a higher buffer during benign periods, in anticipation of market shocks. Arguably, the mutuals have a higher propensity to hold "excess" capital on the balance sheet relative to stock-owned insurers that seek to balance interests of shareholders.

The crisis has exposed both the prudential value of maintaining strong through-the-cycle capital buffers and, on the flip side, the challenges created by higher leverage and more dynamic capital management when facing an unexpected stress scenario. During the crisis,

Difference in Capital and Leverage of Mutual Versus Stock-Owned Insurers

(%)

	2004	2005	2006	2007	2008
Risk-based Capital Ratios					
Mutuals (of the Top 50 Life)	453	477	496	492	492
Stock-owned (of the Top 50 Life)	368	387	390	401	401
Operating Leverage (Total Liabilities/Surplus)					
Mutuals (of the Top 50 Life)	7.80	7.30	6.80	6.60	8.00
Stock-owned (of the Top 50 Life)	9.50	9.90	10.00	9.60	11.00
Mutuals (of the Top 50 P&C)	1.90	1.90	1.70	1.60	2.00
Stock-owned (of the Top 50 P&C)	2.70	2.70	2.30	2.20	2.40

Source: Highline Data, Fitch Ratings.

market sentiment has shifted from a focus on capital efficiency and return-on-equity maximization to the preservation of capital and coverage against “tail” risks. A risk-averse business model, viewed by many as staid and unsophisticated during benign conditions, quickly becomes a differentiating success factor during a crisis.

This shift in sentiment from capital efficiency to preservation is manifest in management letters from both mutual and stock-owned companies. Management letters to shareholders from 2006 primarily emphasized the insurer’s stock price performance, return on equity, premium growth, investment income, capital efficiency and share repurchases, and product innovation, with cursory mention of capital ratios and financial strength ratings. Interestingly, mutual letters to policyholders from this period shared much of the return-focused positioning of shareholder letters, reflecting the positive financial market sentiment prevailing at that time. The mutuals’ performance-oriented posture, to some degree, was beginning to sound more and more like that of the stock companies.

By 2008, a much different tone emerged, with mutual insurers emphasizing a “back to basics” message focused on their robust financial strength ratings, strong surplus and buffer capital, high quality investment portfolio, simple and transparent product lines, and foresight in choosing not to join in the earlier wave of demutualizations. Mutuals are increasingly positioning mutuality — and the focus on through-the-cycle capital preservation as opposed to shorter-term capital efficiency — as a cornerstone of policyholder communication and marketing efforts. Not surprisingly, recent shareholder letters have concentrated on managerial efforts to shore up capital and on the value of long-term business planning. Unlike their messaging from 2006, little mention is made of share price and return on equity. In a stark role reversal, the conservative posture of stock insurers today sounds increasingly like that of traditional mutuals.

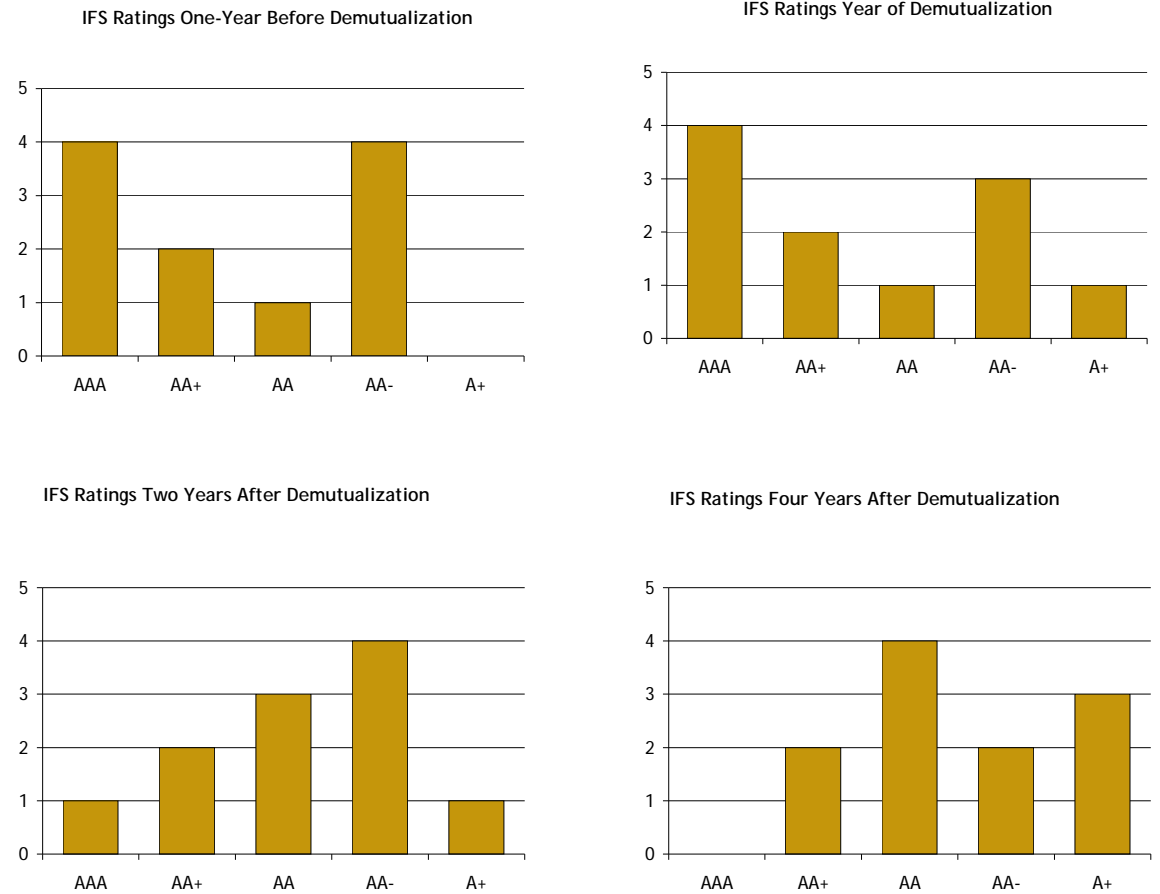
“Demutualization”: Shifts in Risk Appetite

The experience of mutual life companies that shifted to stock ownership during the late 1990s and early 2000s provides a natural case study for analyzing the relationship between corporate organization (e.g. mutual versus stock) and risk appetite. The motivations for demutualizing typically have involved corporate objectives that increase risk — namely, taking a more aggressive investment approach, expanding into new product lines, rewarding employees with stock-based compensation, growing the balance sheet, increasing operating leverage, and pursuing mergers and acquisitions.

While these objectives were often positioned positively by demutualizing insurers as unlocking corporate value and promoting growth, the flip side of demutualization has been increased risk profile and diminished financial strength. Of a sample of 11 Fitch-rated insurers that demutualized in the late 1990s and early 2000s, nine experienced a

subsequent downgrade in their financial strength ratings (when comparing their ratings

"Post-Demutualization" Deterioration in Ratings Mix of Insurers



Source: Fitch Ratings.

See Andrea Beltratti, and Rene M. Stulz, "Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation" (July 13, 2009). Fisher College of Business Working Paper No. 2009-03-012. Available at SSRN: <http://ssrn.com/abstract=1433502>.

one year before demutualization with their ratings three years after demutualization).

The decline in financial strength is evidenced by the weakened ratings mix of insurers after demutualization (see the "Post-Demutualization" chart above). One year prior to demutualization, several insurers (still organized as mutuals) were rated 'AAA' and none were below the 'AA-' level. Two years post-demutualization, the number of 'AAA' insurers noticeably declined. Four years after demutualization, none of these insurers retained a 'AAA' financial strength rating, while several now fell below the 'AA-' level.

The diminished financial strength of demutualized insurers illustrates how an influential shareholder constituency within the governance process tends to increase an institution's risk appetite and profile. Another example of this relationship is demutualized UK building societies (see the box on Demutualization on page 8). Additionally, recent academic research indicates that banks with more pro-shareholder boards generally fared worse during the crisis.

Demutualization of UK Building Societies

Another sector that has experienced extensive demutualization is UK building societies, which after the UK Building Societies Act of 1986 gained the ability to convert from mutual to stock ownership. Mutual building societies traditionally have been organized and operated with a conservative, long-term view designed to protect the economic interests of their members, either by reducing borrowing costs on residential mortgages or by providing a stable, low-risk savings product. The core function of a mutual building society is to provide affordable loans and a stable investment product for its members.

The wave of demutualizations (occurring primarily in the 1990s) in some cases was motivated by a desire for windfall gains by corporate insiders or short-term investors and brought with it a change in risk profile in many of the now stock-owned former building societies. Depending on the institution, this change in profile post-demutualization reflected increased risk exposure on the asset side, changes in funding and leverage, or both.

The influence of shareholder interests has generally shifted managerial focus toward shorter-term growth and profitability objectives, potentially contributing to the instability and financial challenges faced by several of the demutualized building societies both prior to (e.g. Abbey National) and during the financial crisis (e.g. Northern Rock, Bradford, and Bingley, Halifax). Interestingly, Nationwide Building Society, the largest remaining UK building society that has retained a mutual structure, has weathered the crisis well to this stage.

There are other examples of European mutuals that have remained stable in the crisis, notably Rabobank in the Netherlands.

Compensation Structure and Managerial Incentives

A potential contributing factor to the differing risk profiles of mutuals versus stock-owned institutions is the design and composition of executive compensation and its influence on managerial incentives.

The following analysis is based partly on anecdotal information. It is not intended to favor any particular approach to compensation, but rather to note some broad trends and potential impact on managerial risk-taking. Generally, the design of mutual compensation seems to promote risk aversion, while stock-owned compensation appears to promote greater risk-taking. Risk-taking, of course, can be beneficial to credit quality to the extent that it generates product innovation and more robust earnings.

Conditioning compensation on corporate performance can be either explicit (e.g. tied to specific financial targets) or implicit (e.g. in the form of stock-based compensation). In either case, the fundamental assumption is that a rational management, seeking to maximize its compensation, will direct the operations of the company in line with the incentives laid out by these conditions.

While there is limited public information on executive compensation for mutuals, on the following page is average CEO compensation as compiled by Fitch for six of the largest U.S. mutual life insurers. This data is compared with the average CEO compensation of a corresponding sample of six of the largest stock life companies (see the CEO Compensation table). Notably, the structure of CEO compensation differs, with stock-based companies linking a significant portion to equity-based components (such as stock and option awards).

CEO Compensation: Sample of Large Mutual Versus Stock-owned Life Insurers

(\$)

	Average Total Compensation	...of which, Salary	Salary, % of Total (%)	Equity-Based Compensation	Equity-Based, % of Total	Bonus Compensation	Bonus, % of Total (\$)
Mutual^a							
2008	9,194,857	994,070	10.8	0	0.0	6,655,519	72.4
2007	6,993,736	943,113	13.5	0	0.0	5,485,470	78.4
2006	5,192,436	888,526	17.1	0	0.0	3,642,971	70.2
Stock-owned^a							
2008	12,236,745	933,169	7.6	6,043,730	49.4	1,578,710	12.9
2007	17,364,483	892,864	5.1	7,722,947	44.5	5,274,495	30.4
2006	13,415,577	818,081	6.1	4,393,376	32.7	5,669,862	42.3

^aCompensation data is based on 6 of the top 10 largest U.S. mutual and stock-owned life insurers (i.e., total of 12 institutions). Source: Fitch Ratings, Regulatory Filings.

The structure of mutual compensation is in certain cases designed to promote risk aversion and balanced corporate growth. For example, some mutuals link variable compensation to statutory capital targets, providing explicit disincentives against increasing risk exposure without a commensurate increase in capital or surplus level. Several also tie compensation to expense management, helping to support financial and operational prudence. And, mutuals by definition do not award equity-based compensation.

Unlike the mutuals, none of the larger stock-owned insurers appears to link compensation to capitalization or other measures of conservatism. Indeed, a review of compensation practices of the largest stock-owned insurers shows that the factors used in determining performance-based compensation (e.g. operating earnings, earnings per share, return on equity, and product sales) generally promote increased risk exposure.

Executive compensation for stock-owned insurers on balance appears to promote greater risk-taking than for mutuals, due both to the linkage of performance targets with growth-oriented measures as well as to stock-based awards. While the significant equity-based portion of compensation creates some incentives for conservatism (after all, a failure of the insurer would eliminate future income and render stock awards worthless), it also creates competing incentives to pursue higher-risk strategies to elevate stock prices.

Implications for Risk Governance of Financial Institutions

This study illustrates that stakeholders focused primarily on financial stability and capital preservation can help to promote a risk-averse business model and conservative, through-the-cycle capital management. While policyholders do not have an active role within the corporate governance of a mutual (e.g. unable to determine dividend rate or replace management), managerial risk-taking is disciplined by the strong preferences for financial strength among policyholders. Absent that financial strength, customers might choose to contract with another competing insurer.

Conservative capitalization and risk aversion are thus core objectives of the management of mutuals, an interest that is aligned with that of policyholders and not subject to the potentially competing interests of return-oriented shareholders. This risk aversion might seem unremarkable in benign environments but becomes an important factor in maintaining financial strength during market stress.

For stock-owned institutions, interests can differ between more risk-inclined shareholders and other more risk-averse stakeholders (e.g. policyholders, creditors, regulators), which could have implications for capital management over the economic cycle. Shareholders are averse to raising additional buffer capital during benign environments (when cost of

capital is low, but their economic objective is to maximize return on equity). Some institutions even reduce capital by repurchasing stock to support share prices and to increase return on equity.

This approach, in turn, creates challenges in raising “emergency” capital when required under stress (when market access is constrained, cost of capital is high, and management wants to avoid shareholder dilution amid a falling stock price). The potential bias of shareholders against holding excess capital (or, the flip side, their appetite for leverage) is at odds with the dominant preference of policyholders, creditors, and regulators for financial stability and institutional strength over the economic cycle.

Understanding the differences in risk appetite and governance of the central stakeholders within financial institutions is now, more than ever, an important element in assessing their risk profile and financial strength. The role of governance has taken on particular relevance not only because of the weaknesses in risk management processes exposed by the financial crisis, but also due to the changing dynamics and balance of influence within the corporate governance of financial institutions more broadly. As one example, governments have in several instances become direct financial stakeholders in several important financial institutions, creating a new and still evolving dimension within the governance process.

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