

ISSUER CREDIT RATING

The Housing Finance Corporation Ltd.

Issuer Credit Rating
A+/Stable/A-1

Issuer credit rating history:

June 24, 2004
A+/A-1

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The Housing Finance Corporation Ltd.

Major Rating Factors

Strengths:

- Not-for-profit status, with links to the U.K. government and sector regulator;
- Strong credit counterparties in the form of established housing association borrowers, with no history of defaults;
- Loans secured by fixed and floating charges over social housing properties, with a robust level of asset overcollateralization;
- Rising values of secured assets and surpluses of borrowers increasing; and
- Prudent lending policy.

Weaknesses:

- Low capital reserves relative to comparator banks and building societies;
- Exposure to single sector, with some borrower-concentration risk;
- Limited business growth in recent years, due in part to a conservative lending policy;
- Weak competitive position due to the continued aggressive lending activity of large banks and building societies; and
- Small staffing numbers, which heightens vulnerability to staff turnover.

Rationale

The ratings on the U.K.-based not-for-profit lender The Housing Finance Corporation Ltd. (THFC) reflect THFC's strong capacity to meet its financial commitments. The ratings are further supported by THFC's prudent lending policy to creditworthy counterparties in the social housing sector, strong levels of overcollateralization, and good management. These

factors are offset by THFC's low capital reserves, single-sector exposure, and weak competitive position.

THFC is a dedicated, not-for-profit lender to the U.K. social housing market. It has a high-quality loan portfolio, secured by a broad diversification of properties in terms of size and location. THFC has a relatively narrow line of lending business, however, which focuses entirely on the U.K. social housing sector and presents a single-industry risk. There are also significant obligor concentrations, as the top 10 borrowers account for about 25% of THFC's total loan book, albeit they are all concentrated in the U.K. social housing sector where there has been no history of default to date. THFC's loan book is characterised by low turnover and reflects a microcosm of the U.K. social housing market, with no experience of cash default or economic loss to date.

THFC provides a public-policy role and has close links to the U.K. government, the sector regulator (the Housing Corporation), and the sector's trade body (the National Housing Federation). No formal support is provided by these entities, however. THFC's not-for-profit status also provides it with a degree of financial flexibility (in that it has no shareholder dividend payment requirements) and financial conservatism. In recent years, THFC has expanded its agency role, managing housing debt transactions that provide some fee income and offer limited diversification from its core lending activities.

THFC provides well-structured loans, which are principally secured by way of a fixed charge over about 100,000 U.K. social housing properties. It uses conservative lending covenants (relative to the market), with a minority of loans secured by a floating charge and £6.0 million (\$10.7 million) of dedicated reserves.

Negative pledges on all debt restrict THFC and its subsidiaries from borrowing or creating any charge that might rank in priority to its existing debt. All creditors of THFC and its subsidiaries are secured on floating charges that rank *pari passu*. Despite the fact that all creditors are secured in this way, the ratings on specific debt issues may differ from the ratings on THFC and its subsidiaries if, for example, there are reserves or liquidity facilities dedicated to particular issues. In December 2004, THFC, through its subsidiary THFC (Funding No. 1) PLC, issued a 'AA-' bond, which benefited from a 24-month dedicated liquidity facility provided by ABN AMRO Bank N.V. (AA-/Stable/A-1+). In the event that the facility is withdrawn or the liquidity provider is downgraded, then the rating on this bond could be lowered.

THFC's capital base of £6.0 million is low in comparison with the reserves of potential comparator banks. Overall, liquidity and financial flexibility, although adequate relative to the current asset profile, are relatively limited.

The competitive position of THFC in the funding market is relatively weak due to the continued activity of banks and building societies, which are providing aggressive funding to the social housing sector. This makes THFC's business strategy potentially difficult to achieve, although THFC expects to address this situation in the future with new capital market products. To date, however, THFC has had limited success with new bond issues. In 2005, it had no new borrowers, but lost just one borrower.

THFC's strategy is to seek to offer innovative products and price benefits for existing and potential new customers. That said, THFC may come under competitive pressure to relax certain lending standards at the margin. Its conservative lending policy is, however, key to the rating, but if over time financial performance improves and reserves are increased there may be scope for some adjustment.

THFC is staffed by an experienced team. The low number of employees, however, leaves THFC vulnerable to turnover and key personnel risk.

Outlook

The stable outlook reflects the quality and diversity of THFC's loan portfolio, its prudent lending policies, and its plans for new business development. Although there has been some business growth in the past year, there has been little new business, which is a concern. Consequently, the successful implementation of THFC's business development strategy and achievement of near term growth will be crucial to maintain current ratings. Material slippage against financial targets, increased exposure to business risks, or a declining market position may put at risk its credit standing. On the positive side, Standard & Poor's Ratings Services expects some improvement in THFC's reserves over time, which will improve capital ratios and bolster THFC's credit profile.

Business Profile

THFC is a niche lender dedicated to the social housing sector, and is different from any other lender, or previously rated entity, because:

- It is a not-for-profit entity, incorporated under the Industrial and Provident Societies Act with limited liability. This means that on a winding up, the reserves must be returned to THFC's borrowers.
- It was set up in 1987 by the Housing Corporation (the industry regulator), the NHF, and the private sector to encourage funding to registered social landlords (RSLs).
- It has a public-policy role that helps to differentiate it from other traditional lenders to the sector.
- It enjoys close links with government (through the Office of the Deputy Prime Minister and the Treasury), the Housing Corporation, and NHF, although there is no formal support from any of them.
- It acts as an aggregating financial intermediary, which diversifies the risk to those that lend to THFC and allows access to the capital markets for RSL borrowers that would ordinarily not be able to do so owing to their size. (This improves cost effectiveness for borrowers through economies of scale).
- It funds itself through borrowing from banks and issuing bonds to the capital markets.
- It requires borrowers to pay interest payments and principal repayments one month in advance of the due date of THFC's own financial obligations, which enhances internal liquidity.

Business Description

THFC has a book of social-housing loans of about £1.5 billion. It lends to 124 RSLs of varying sizes (the total number of housing associations in the sector is about 5,000, although about 90% of these are extremely small and have no future debt requirements and no development activity). Many of THFC's loans date back to the late 1980s and early 1990s when it had just been established and its competitive position was much stronger than is now the case. THFC was one of the first private lenders to the U.K. social housing market and was an early innovator, with the first full securitization and the largest-ever index-linked bond issue in social housing. More recently, THFC issued a new, albeit relatively small, Eurobond in December 2004, and plans further bond issues in the future. It also introduced the European Investment Bank (EIB; foreign currency AAA/Stable/A-1+) to the sector. In addition, THFC manages several structured social housing transactions, including Haven Funding PLC and Haven Funding (32) PLC, Sunderland (SHG) Finance PLC, and Harbour Funding PLC bonds, all of which are rated by Standard & Poor's.

Despite the expansion of conventional lending sources, which have competed principally on price and relaxation of covenants, THFC has failed to keep pace with the bank market. As a result, THFC's market share has experienced steady erosion since the early-to mid-1990s.

THFC actively manages its portfolio, particularly in the case of existing borrowers that have relatively high interest debt burdens from existing THFC facilities and are seeking refinancing solutions. In such instances, THFC can arrange for the redemption of old debt. Where possible THFC will seek to provide the refinancing, but at the very least will ensure that the redemption fee charged is greater than the net present value of future management fees.

Management

THFC has a very small operational team of nine experienced professionals; the chief executive arriving three years ago as part of a concerted effort to reposition THFC through a drive to increase its revenues and develop a positive business strategy. The team is experienced in social housing, banking, accountancy, and corporate treasury functions, with associated professional qualifications. We believe that the management team is appropriately qualified for the size and nature of the business, although the small size of the staff does leave THFC vulnerable to staff turnover risk, even though knowledge is generally well shared across the team.

Ownership And Legal Status

THFC is a not-for-profit Industrial and Provident Society. It is owned by its nonexecutive board members, six of whom hold directly (or via their employers) a fully paid £1 share in THFC.

This represents THFC's total share capital (not including reserves). THFC has no explicit government support, other than the nomination of a board member from the sector regulator, the Housing Corporation, which is a nongovernmental departmental body.

Regulation

THFC is not formally regulated by the Financial Services Authority (FSA), but is subject to its oversight as an Industrial and Provident Society. This oversight is not viewed by Standard & Poor's to be equivalent to the market regulation for a financial services organization such as a bank or building society. THFC's day-to-day close working relationship with the Housing Corporation, and its board representation, although not a formal regulatory relationship does, however, give some comfort.

Corporate Governance

THFC is governed by a board with seven voting members, which includes a nominee from both The Housing Corporation and the NHF. There are four independent board members, and one executive member (THFC's chief executive). All members have equal votes, and all are required to act in the best interest of THFC. In Standard & Poor's opinion, the board members exhibit an appropriate, relevant, and mixed skill set. They may only serve a maximum of three consecutive three-year terms of office. Nominated board directors can serve an unlimited tenure, up to an age limit of 70, unless reconfirmed annually. The chairman must be re-elected annually for a five-year maximum term. The governance terms are currently under review by THFC, with a view to ensuring that arrangements continue to reflect best practice.

Separate committees exist for credit, audit, remuneration, and personnel issues. The credit committee approves all new loans, whether to existing or new borrowers, which should help to ensure that lending is impartial and without bias. Under its rules, a board meeting can be deemed to constitute a quorum with only three board members in attendance, although in practice the majority of board members are actively involved in all internal decision-making.

Group Structure And Strategy

Structure

THFC operates as a group structure, with a service company—T.H.F.C. (Services) Ltd.—providing all the administrative and management services to THFC and its main subsidiaries. These subsidiaries are individual special-purpose vehicles set up for the specific purpose of individual capital markets bond issuance. The subsidiaries are separately constituted legal entities and are entirely owned by THFC. In practice, there is very little difference in the credit quality of the loans held by each subsidiary, and a number of obligors have separate loans granted by different subsidiaries. Consequently, there is considerable overlap in the obligor pools. In future, THFC may set up separate subsidiaries for lending to nontraditional businesses such as key-worker accommodation schemes in order to ring-fence these high-risk loans or investments in unregulated businesses, much as RSLs do.

Strategy

THFC is trying to pull itself out of a period of relative stagnation. In recent years, it has lost market share as other funders, namely banks and building societies, have competed more aggressively on price and covenant packages. Its main strategic business areas are: new bond issuance using the THFC credit rating, the restructuring of existing bonds, and the provision of administrative support to social housing bonds.

Despite securing a strong rating, THFC only issued £67.4 million in December 2004 and did not issue any further tranches in 2005. In 2005, bank and building society RSL lending margins continued to fall and consequently the social housing lending market continued to be dominated by banks and building societies. This competitive climate is in part due to pressure on banks and building societies to grow their corporate lending portfolios to make up for a tightening in retail lending. Banks and building societies are also factoring in lower regulatory capital requirements for lending to social housing associations under Basel II.

The objective for THFC is to draw itself back into the mainstream of funding the affordable housing sector in the U.K., although Standard & Poor's considers that this will be challenging in the current competitive lending environment. THFC is also considering widening its lending remit to include lending to regeneration and key-worker schemes, and general-needs core business. Although regeneration and key-worker projects are priorities for government housing policy in the U.K., and lending to these projects will heighten THFC's public-policy role, this type of project does carry greater inherent risk. We believe that if THFC develops in this direction, it may risk diluting the credit quality of its existing loan portfolio. Therefore, it is expected that reserves, or liquidity, would grow appropriately to reflect these higher risks.

Generally, THFC has focused on the traditional small and midsize housing associations, which are likely to have less experienced management teams and boards than larger RSL organizations. They are also likely to have less sophisticated information systems and financial management. On the positive side, such associations tend to be involved in less diversification and development activities, helping to balance out some of the operational risk.

THFC plans to remain focused on the U.K. social housing market, in line with its rules. THFC's aim is to achieve an annual surplus in the region of £250,000. (In the financial year ended March 31, 2005, THFC achieved an annual pretax surplus of £376,000 (post-tax £263,000) due to higher interest rates and fees related to increased pre-payment activity).

THFC has a good reputation as an administrator and security trustee of structured social housing transactions, and it aims to increase its activity in this area of operation.

THFC's success in increasing its share of the social housing association lending market depends on the ability of the capital markets to compete with bank financing, mainly on price. While bank margins remain aggressively low, THFC will continue to face a challenging task to significantly increase market share.

Risk Management

Asset quality

All of THFC's loans are secured, and covenants are conservatively structured. THFC's borrowers can choose to secure their lending by either a fixed charge over specified properties, or by a floating charge, subject to asset coverage tests. The majority of its lending is carried out via a fixed charge over properties. THFC amended its trust deed in financial 2003 in order to permit its borrowers more flexibility to use spare borrowing capacity in existing pledged security to raise new borrowing from THFC. This might influence existing customers to extend their loans with THFC, rather than refinance them elsewhere.

THFC and its subsidiaries pledge security to their respective investors in the form of a floating charge over its assets (that is, the social housing loans book), and its capital reserves of about £6 million. All of THFC's secured creditors, including institutional investors and lenders, legally rank *pari passu*, and have the benefit of overcollateralization over secured asset values compared with the value of THFC's loans.

In terms of the quality of the loans offered as security for THFC's borrowing, there have been no defaults within the sector to date (although this does not include loan restructuring). This is due in part to the early intervention and supportive framework of the sector regulator in instances where housing associations face financial pressures.

THFC exhibits no sector diversification. It is restricted by its own rules and regulations, which only permit it to lend to RSLs. Furthermore, THFC does not lend to "non-mature" large-scale voluntary transfer associations, which are generally more risky than traditional associations due to their being 100% debt-financed on transfer and having higher maintenance requirements.

THFC has two key loan covenants based on asset coverage and asset-specific income coverage. Assets are typically valued on a market value basis (subject to tenancies), which is generally about two-thirds of the actual open market value. THFC requires periodic revaluations of individual security portfolios to ensure that secured assets provide coverage valued to be at least 150% of the outstanding loan balance. In practice, the well-seasoned nature of the lending and associated security means that there is typically a cushion over and above this 150% threshold and is currently estimated to be about 260% (on market value subject to financing basis). THFC covenant arrangements ensure income coverage is sufficient to meet interest repayments.

Approximately one-third of THFC's lending is to associations with housing stock based in London and southeast England, a region that has high property values and a high demand for affordable housing. Overall, THFC's loan portfolio is generally representative of the social housing sector as a whole.

The top 10 largest borrowers are a mixture of sizes and have differing levels of development activity and operate in different geographic areas. Therefore THFC is not particularly exposed to any one area, and its lending policy has resulted in a relatively balanced portfolio.

Standard & Poor's believes that THFC's asset performance is in part determined by its internal credit scoring process. The scope of our review, therefore, includes a validation of THFC's credit approach, an assessment of the predictability of its internal credit scoring model to evaluate credit risk appropriately, and a review of the adequacy of its monitoring and control procedures.

There has been some adjustment to THFC's credit scoring system recently, which has led to an overall improvement in the portfolio credit score. THFC is using the Housing Corporation Assessment indicators for financial viability and management and governance, as well as asset values (which continued to grow in 2005). Of 124 borrowers, 33 have been upgraded and 23 downgraded. The majority, however, have remained unchanged. The likely maximum loss in any one year can be assessed from the loss given default ratio derived from default probabilities associated with the internal ratings for borrowers. Any new borrowers are similarly credit scored.

Standard & Poor's continues to monitor THFC's internal credit scoring system, which is an important rating factor. THFC's prudent lending policy and strong borrower base, which is measured by the internal credit scoring system, helps offset its low level of capital reserves. We recognize that there may be pressure to erode some of the strong credit standing of the portfolio over time in order to compete with banks. Any increased credit exposure from a relaxation of credit policy, or a rebalancing of existing weaker borrowers, or introduction of weaker new borrowers is likely to weigh on the ratings on THFC, unless there is a corresponding increase in reserves.

Asset liability management

All THFC funding is sourced from banks or directly from the capital markets. THFC has good relationships with its own funders, including the EIB.

Standard & Poor's considers the biggest weakness in THFC's financial structure to be the size of its available liquidity, which stands at about £6 million of reserves, with an additional liquidity cushion provided by borrowers who pay interest one month in advance. If a borrower was to default on interest payments for a significant period and if THFC could not realize the borrower's collateral, then THFC's reserves could be severely depleted, depending on the extent of its exposure to the borrower in question. In a worst-case scenario where its two largest borrowers were to default before THFC managed to crystallize its security (the timing of which is estimated at 12 months), THFC would have no revenue reserves with which to cover the respective interest payments. Unless the bank was able to organize an additional liquidity facility, committed but available at call, this could bring about the default of THFC itself. THFC and its subsidiaries have no general standby liquidity facilities for their obligations, other than the specific and dedicated facility for the recent bond issue (THFC {Funding} No. 1). Standard & Poor's notes, however, that THFC has had no liquidity issues throughout its existence. Virtually all interest payments are made by direct debit and the one-month liquidity buffer has proved to be sufficient.

In effect, THFC takes no interest-rate risk. Its own borrowings are immediately onlent to RSLs, on a substantially identical interest and principal repayment profile. Nevertheless, THFC's income stream is exposed to a certain level of interest-rate risk in terms of its earnings as its investment income (that is, interest payments received one month in advance of due date) is adversely affected by lower interest rates. THFC tries to mitigate the effect of this risk through periodically reviewing its hedging policies and making prudent assumptions in the budget. It does not, however, make use of derivative funding, other than interest rate swaps, forward rate agreements, and purchased interest-rate options. Most of its interest income is fixed at short-term (less than 12 months) rates.

In addition, the majority of THFC’s liabilities (about 90%) are not due before 2016. There are three key principal refinancing peaks—in 2016, 2023, and 2025—that could drive some income volatility, although in practice most RSLs refinance rather than pay down debt. Absolutely no currency risk is taken: All borrowing and lending is conducted in British pounds sterling.

We consider that the new management team has made good progress in ascertaining the potential operational risks that a small organization might face. These risks are reviewed by the board on a regular basis.

Profitability

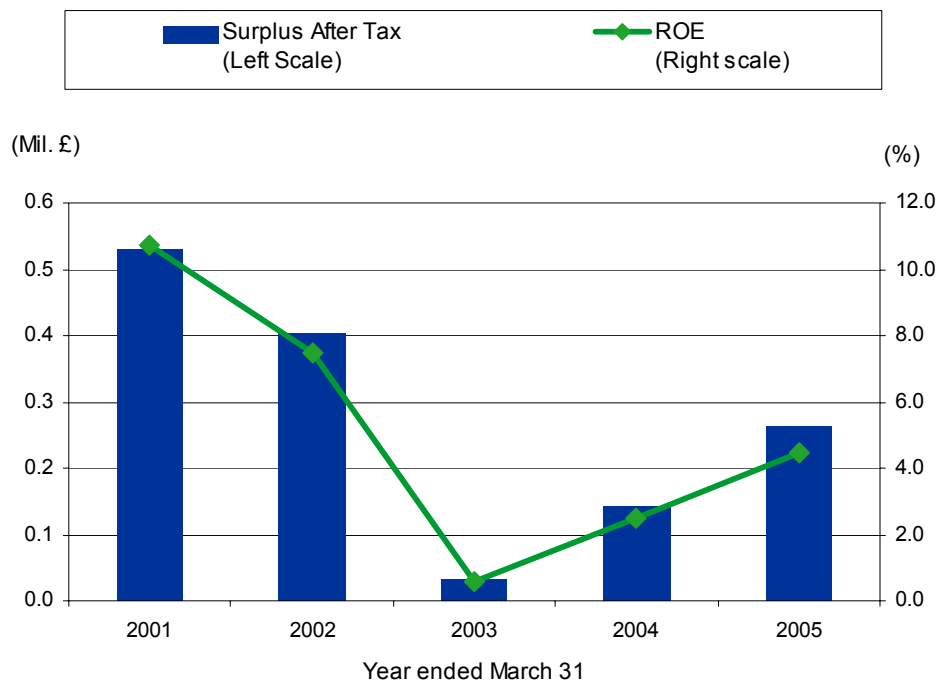
THFC is a not-for-profit organization. Under its rules it cannot trade for profit, but any annual surpluses are accumulated as reserves. THFC’s aim is to make a steady surplus each year in order to increase reserves.

In the financial year ending March 31, 2005, THFC made a surplus before tax of £376,000 (2004: £189,000). This continues a steady trend of profitability improvement since 2003 (see chart 1 below), although it is still less than the profits achieved in 2001 and 2002.

Chart 1

The Housing Finance Corporation Ltd.

Profitability



THFC’s net interest margin, unlike a commercial bank, is effectively zero, reflecting the exact balance of lending interest income to interest payable. Other income received reflects interest income on the free one-month float and fees related to THFC’s arrangement of new issues and management of third-party portfolios.

The profit increase in financial year 2005 was primarily due to an increase in interest income on the monthly float and an increase in issuance fees. The monthly float, which is conservatively invested in cash accounts at major U.K. financial institutions, together with interest on reserves, produced interest income of £733,000 in financial year 2005, compared with £655,000 in the

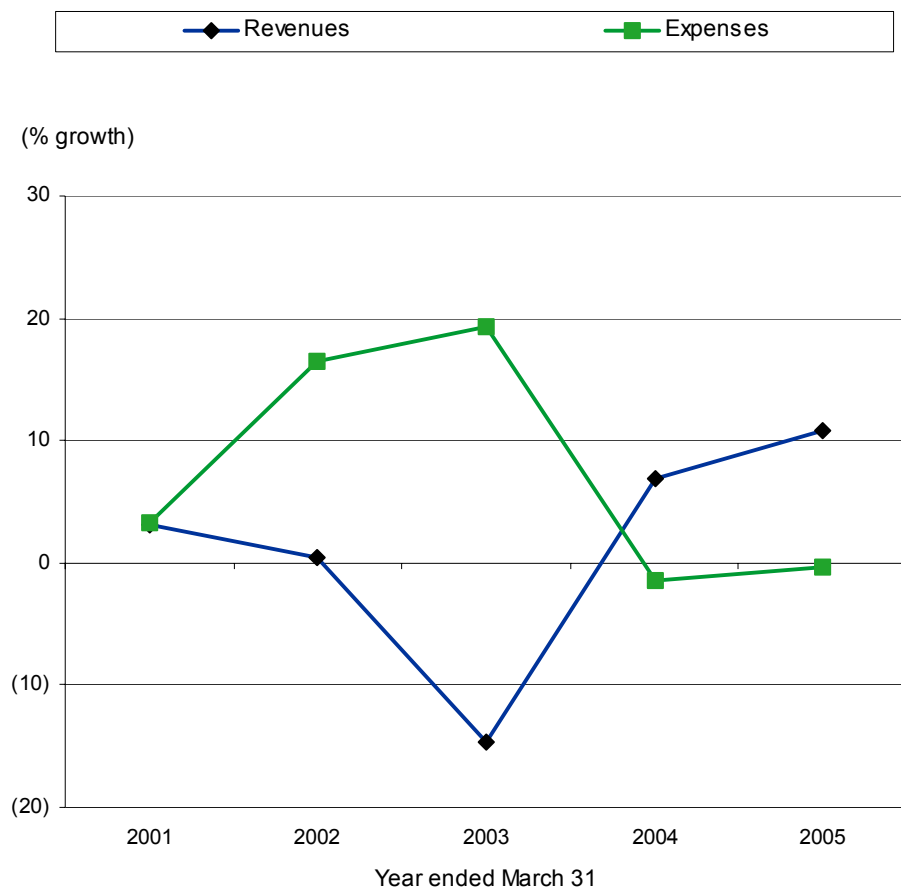
previous year. Fees receivable and other income totaled £1.1 million in financial year 2005, up by £100,000 on the previous year.

Profitability was also aided by relatively stable expense growth (see chart 2). Although THFC has moderately high overhead costs, part of this reflects the buildup of staff in anticipation of future growth. In the event that THFC is unsuccessful in its transition strategy, it could wind down with relatively limited additional expense owing to the small size of its team and the maintenance of a small leasehold office (there is no branch network).

Chart 2

The Housing Finance Corporation Ltd.

Income/Expense Growth 2001-2005



Costs are carefully controlled, reflecting the limited income sources and the fixed nature of the majority of THFC’s expenses. Although it is a not-for-profit organization, virtually all of THFC’s surpluses are subject to taxation.

Capitalization

At March 31, 2005, THFC’s reported equity-to-assets ratio was a low 0.38%, unchanged from the previous year (see chart 3). In addition, the absolute size of THFC’s capital base—£6.0 million—is small, although THFC is expecting to post an additional £0.5 million to reserves in 2006. Furthermore, Standard & Poor’s considers the financial flexibility of THFC to replenish its reserves in the event of a stress scenario to be limited. THFC’s capitalization, therefore, does not compare

favorably with that of a commercial bank. The weak nature of THFC's capital base is, however, partially mitigated by the very-low-risk nature of the loan book.

All of THFC's lending is secured lending. For the majority of its portfolio, THFC has a fixed charge over identified pledged assets. In addition, THFC's asset-coverage covenant is required to be at least 150% and any release or withdrawal of security is not permitted if coverage levels are less than 200%. The current asset coverage is greater than 200%.

Chart 3

The Housing Finance Corporation Ltd.

Capital Analysis

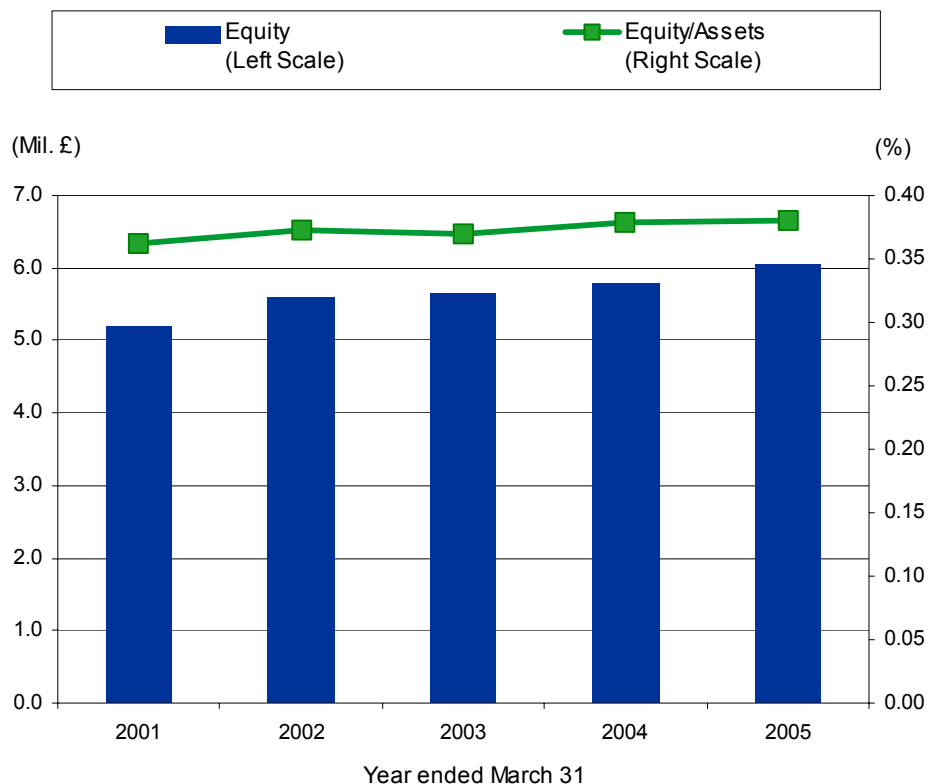


Table 1.

The Housing Finance Corporation Ltd. Balance Sheet Statistics					
<i>Financial Performance</i>					
—Year ended March 31—					
	2005	2004	2003	2002	2001
(Mil. £)					
<i>Assets</i>					
Cash and money market instruments	12.1	11.9	11.7	11.5	11.1
Customer loans	1,551.0	1,488.1	1,485.5	1,467.4	1,402.3
Other assets	25.4	25.2	25.7	25.7	25.6
Total assets	1588.5	1525.3	1522.9	1504.6	1439.0
<i>Liabilities</i>					
Borrowings	1,551.7	1,488.9	1,486.2	1,468.1	1,403.0

Table 1.

The Housing Finance Corporation Ltd. Balance Sheet Statistics (cont.'d)					
Other liabilities	30.8	30.6	31.1	30.9	30.8
Equity	6.0	5.8	5.6	5.6	5.2
Total liabilities and equity	1,588.5	1,525.3	1,522.9	1,504.6	1,439.0

Table 2.

The Housing Finance Corporation Ltd. Profit And Loss Statement Statistics					
—Year ended March 31—					
	2005	2004	2003	2002	2001
(Mil. £)					
<i>Revenues</i>					
New issue fees*	0.230	0.148	0.015	0.201	0.218
Annual fees†	0.721	0.729	0.693	0.689§	0.615§
Investment income	0.733	0.655	0.728	0.799	0.910
Other income**	0.169	0.141	0.129	0.146	0.085
Total revenues	1.853	1.673	1.565	1.835	1.828
<i>Expenditures</i>					
Staff costs††	0.748	0.740	0.646	0.575	0.523
Directors' costs	0.092	0.093	0.161	0.112	0.107
Legal, trustee, and registrar costs	0.236	0.211	0.297	0.220	0.196
Premises	0.102	0.075	0.085	0.047	0.031
Other	0.302	0.365	0.316	0.308	0.226
Total expenditures	1.480	1.484	1.505	1.262	1.083
<i>Profitability</i>					
Surplus before tax	0.376	0.189	0.060	0.573	0.745
Tax	0.113	0.047	0.028	0.170	0.215
Surplus after tax	0.263	0.142	0.032	0.403	0.530

*New issue (arrangement) fees are charged to existing borrowers as well as new borrowers for additional facilities. †These fees are index linked. §These years saw an increase in fees owing to the Sunderland Finance bond issue (2001 issuance). **Income is received from managed transactions. There can be an element of interest rate mismatch, although the trend has been positive, about £20,000 a year, in favor of THFC. ††Staff costs do include an element of bonus payment, which will not be paid in the event of targets not being achieved.

Table 3.

The Housing Finance Corporation Ltd. Ratio Analysis					
—Year ended March 31—					
	2005	2004	2003	2002	2001
<i>ANNUAL GROWTH (%)</i>					
Customer Loans	4.22	0.18	1.23	4.64	23.17
Equity	4.55	2.52	0.57	7.75	11.34
Revenues	10.76	6.90	(14.71)	0.38	3.04
Expenses	(0.27)	(1.40)	19.26	16.53	3.24
Surplus after tax	85.21	343.75	(92.06)	(23.96)	2.12
<i>OTHER RATIOS (%)</i>					
Net surplus/revenues	14.19	8.49	2.04	21.96	28.99
Expenses/total assets	0.09	0.10	0.10	0.08	0.08
ROE: net surplus/average capital and reserves	4.45	2.49	0.57	7.46	20.37

Table 3.

The Housing Finance Corporation Ltd. Ratio Analysis (cont.'d)					
	—Year ended March 31—				
	2005	2004	2003	2002	2001
Equity/total assets	0.38	0.38	0.37	0.37	0.36
Equity/total loans	0.39	0.39	0.38	0.38	0.37

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