

International Special Report

The Role of Multilaterals in Structured Finance

Ratings

African Development Bank (AfDB)	AAA/F1+
Council of Europe Development Bank (CEDB)	AAA/F1+
International Bank for Reconstruction and Development (IBRD)	AAA/F1+
Inter-American Development Bank (IADB)	AAA/F1+
Banco Latino-Americano de Exportaciones (BLADEX)	A-/F2
Corporación Andina de Fomento (CAF)	A-/F2

Analysts

New York

International Structured Finance
C. Mia Koo
1 212 908-0651
mkoo@fitchibca.com

Paris

Supranationals
Eric Paget-Blanc
33 1 4429 9133
epaget-blanc@fitchibca.com

London

Sovereign
Richard Fox
44 20 7417 4357
rfox@fitchibca.com

■ Summary

A recent trend in the capital markets is the growing role of multilateral development banks (MDBs) in structured finance. By using multilateral guarantees and umbrella structures, emerging market issuers are able to access funding where funding was previously unavailable or prohibitively expensive. Whether through an explicit guarantee or loan participation, issuers faced with sovereign ceiling constraints have found multilateral support to be a viable method of obtaining economic sources of funding.

This report highlights Fitch IBCA's views on MDBs' participation in structured finance. In particular, it discusses the preferred creditor status of the multilaterals, as well as the approach to rating transactions structured with a multilateral guarantee or loan participation structure.

■ The Sovereign Ceiling

Traditionally, a sovereign's rating on its foreign currency obligations has been regarded as the ceiling on ratings for all issuers domiciled in that country. The assumption is that the sovereign will force all other domestic issuers to default before succumbing to default itself and that an act of sovereign default will, in any case, precipitate widespread default among domestic issuers. Circumstances leading to an external debt crisis, which include economic and political upheavals, balance of payments crisis, and trade shocks, can directly affect the debt servicing capacity of private borrowers. More importantly, governments facing defaults may force private sector defaults by imposing exchange controls and other restrictive measures that impede access by issuers to the foreign currency necessary to service their obligations. This cap on ratings is known as the sovereign ceiling.

A sovereign's local currency rating is usually not a ceiling on other ratings due to the government's limited interest in restricting access to its own currency. Foreign currency is a very valuable commodity in a default crisis, as opposed to local currency, the value of which may be ravaged by high inflation in those circumstances. However, sovereign foreign currency ratings do not always act as a ceiling. For example, Fitch IBCA has rated issuers (YPF S.A. and MetroGas S.A. in Argentina), transactions (PDVSA Ltd. Finance in Venezuela, BHN III in Argentina, and Sino Commercial Properties Funding Ltd. in Hong Kong), and project financings (Cerro Negro Finance, Ltd. and Fertilizantes Nitrogenados de Venezuela in Venezuela) higher than their respective countries' sovereign rating.

Among the mechanisms that may exempt a transaction from exchange controls is the involvement of multilateral agencies, which, through their preferred creditor status, imply that the government will provide foreign currency to service their obligations. In other cases, some forms of multilateral support, such as a loan guarantee, allow issuers, including government-sponsored entities, to bypass exchange controls altogether. When a multilateral directly guarantees debt payments, as with World Bank partial guarantees, transaction ratings can benefit due to the support of the multilateral and the likely exemption from controls derived by its participation.

■ Multilateral Development Banks

MDBs are highly rated financial institutions controlled by sovereign shareholders. As such, MDBs retain supranational status, whereby they benefit from special statutes conferring some elements of sovereign power on them, placing them above the jurisdiction of any one sovereign state. Their main mission is to enable countries that are less developed or experiencing economic difficulties access to foreign currency resources on more advantageous terms than would be available solely on the basis of their own international credit standing.

Financing takes the form of loans extended directly to states, local authorities, or public institutions; loans and equity investments in privately owned companies or project finance; or guarantees granted to loans from private banks or bond issues. Some MDBs extend loans to financial institutions that undertake to distribute these resources to the local economy. In general, MDBs finance only a portion of project costs with the objective of leveraging funds from private resources. MDB loans to governments can also form part of the multilateral aid package granted to a country faced with financial difficulties. In such cases, the loans are often conditional upon the implementation of economic policies recommended by the International Monetary Fund (IMF) in conjunction with MDBs.

MDBs grant loans only to eligible countries and avoid lending to countries with severe payment difficulties. For example, in Africa, only 13 countries are eligible for MDB loans. However, non-eligible countries have access to MDB financing through special concessional funds managed by the MDBs, such as the International Development Association (IDA), managed by the International Bank for Reconstruction and Development (IBRD), or the African Development Fund (AFD), managed by the African Development Bank (AfDB). These funds

Global MDBs

African Development Bank
Asian Development Bank
Caribbean Development Bank
Council of Europe Development Bank
European Bank for Reconstruction and Development
European Investment Bank
International Bank for Reconstruction and Development
International Finance Corp.
Inter-American Development Bank
Nordic Investment Bank

Regional MDBs

African Export-Import Bank
Banco Latino-Americano de Exportaciones
Corporación Andina de Fomento
Western African Development Bank
Central American Bank for Economic Integration
Eastern African Development Bank
Eastern and Southern African Trade and Development Bank
Islamic Development Bank

MDB – Multilateral development bank.

collect concessional resources provided by industrialised countries, which are redistributed by the MDBs.

Some MDBs offer standard guarantees to private bank loans used to finance state-sponsored projects or public corporations whose risk is of a sovereign or quasi-sovereign nature. The World Bank was the first to introduce partial guarantees, i.e. guarantees that either cover only specific risks of a project (partial risk guarantee) or apply only to a portion of the funding of a project (partial credit guarantee). In 1999, the IBRD expanded the partial credit guarantee program for projects with a policy-based guarantee to support adjustment operations. Partial guarantees are generally offered to countries eligible for MDB loans. In conjunction with a pilot program initiated in 1998, the World Bank approved a partial risk guarantee in a country eligible for IDA loans, Côte d'Ivoire.

The high credit rating of MDBs is linked to the strong support they receive from top-grade member countries. These member countries control a significant share of MDB capital. In some cases, the capital comprises mainly subscribed but uncalled

capital. With other MDBs, all capital is paid in. For those with callable capital, shareholders commit to pay up uncalled capital if the MDB is not able to fulfill its obligations on its bonds in the market.

Fitch IBCA currently rates six MDBs. When assigning a rating to a MDB, a distinction is made between:

- Global MDBs, i.e. MDBs that count among their shareholders several 'AAA' rated countries, e.g. the U.S. or Western European countries. These MDBs include the AfDB, Council of Europe Development Bank (CEDB), Inter-American Development Bank (IADB), and IBRD, which are all rated 'AAA/F1+' by Fitch IBCA.
- Regional MDBs, i.e. MDBs with a local scope, such as Corporación Andina de Fomento (CAF) and Banco Latino-Americano de Exportaciones (BLADEX) in Latin America, whereby capital is controlled by regional countries. These MDBs have an ownership base and field of operation limited to countries in a specific geographic area. Their 'A-' rating reflects the lower credit quality of the shareholders.

For more information on Fitch IBCA's methodology for rating MDBs, see Fitch IBCA Research on "Risk Analysis of Multilateral Development Banks and Other Supranationals," dated March 1999, available on Fitch IBCA's web site at www.fitchibca.com.

■ Preferred Creditor Status

In addition to the high credit quality of their member countries, the rating of MDBs reflects their "preferred creditor status." The preferred creditor status means that, during a period of political and economic turmoil, when restrictions and controls on foreign currency payments are imposed, a member government would not likely prevent payment to a multilateral bank. Unlike commercial banks, MDBs do not reschedule sovereign debts (although, on occasion, new lending has been made available to help a sovereign meet its obligations). Rather, the host government would most likely place priority on MDB loans to maintain access to financial support. This is a de facto status for sovereign borrowers because, in most cases, the sovereign has indemnified the multilateral.

Historically, multilaterals have often been the only source of new lending in a period of financial distress. Nonpayment to these institutions would impair access to committed or new credits. The presence of a multilateral bank in a securitization is, in effect, an implied extension of the preferred

creditor status to investors. Supporting this further is historical evidence, which shows that of the 82 sovereigns that the World Bank has lent to, only 17 have been assigned non-accrual status. Fifteen of the 17 are considered to be severely indebted low-income countries.

■ World Bank Guarantees

The World Bank Group provides support to public and private infrastructure development for developing and transition economies. Through its various member financial organizations, the World Bank Group offers various forms of financing for projects, including political risk insurance, equity investments, loans, and guarantees. The main group members providing financial support are: the World Bank, comprising the IBRD for middle-income countries and the IDA for poorer countries; the International Finance Corp. (IFC); and the Multilateral Investment Guarantee Agency (MIGA). Several recent capital market transactions, such as the Electricity Generating Authority of Thailand, the Republic of Argentina's bond issues, and Garanti Leasing in Turkey have used World Bank support via IBRD partial guarantees or IFC loan participations.

The World Bank offers three forms of guarantees — partial risk, partial credit, and policy-based. The guarantees are designed to protect creditors from certain sovereign-related risks, such as the inability to convert and transfer foreign currency. Financial participation by the host country government is required in conjunction with a private or public project via a counter-guarantee. Defaulting on World Bank debt would likely result in a halt on all disbursements of bank loans, as well as a stop on the approval of new projects.

The partial risk guarantee is available to cover the risk of default due to nonperformance of contractual obligations undertaken by governments or certain political force majeure events. Any given government obligations will differ depending on the nature of the project and industry involved. Examples of common obligations include the maintenance of an agreed upon regulatory framework, the delivery of inputs, and the payment for outputs. In addition, the risks of currency transfer and convertibility can also be covered by a partial risk guarantee. These guarantees can be provided in IBRD- and IDA-only countries. Coverage is available up to 100% of principal and interest obligations. The privately owned and operated Azito power plant in Côte d'Ivoire benefited from this type of guarantee. The guarantee applies to a debt tranche of \$30.3 million, with the total project

IBRD Borrower Payment History

IBRD Borrower	IBRD Borrowers Defaulted on Sovereign Debt	IBRD Borrowers Placed in Non-Accrual Status by IBRD*	Year**
Algeria	Algeria		
Argentina	Argentina		
Armenia	Armenia		
Bahamas, The			
Bangladesh			
Barbados			
Belarus	Belarus		
Belize			
Bolivia	Bolivia		
Bosnia and Herzegovina	Bosnia and Herzegovina	Bosnia and Herzegovina	1992
Botswana			
Brazil	Brazil		
Bulgaria	Bulgaria		
Burkina Faso	Burkina Faso		
Cameroon	Cameroon		
Chile	Chile		
China			
Colombia			
Congo, Democratic Republic of	Congo, Democratic Republic of	Congo, Democratic Republic of	1993
Congo, Republic of	Congo, Republic of	Congo, Republic of	1991, 1997
Costa Rica	Costa Rica		
Cote d'Ivoire	Cote d'Ivoire		
Croatia	Croatia		
Cyprus			
Czech Republic			
Dominica			
Dominican Republic	Dominican Republic		
Ecuador	Ecuador		
Egypt, Arab Republic of	Egypt, Arab Republic of		
El Salvador	El Salvador		
Estonia			
Ethiopia	Ethiopia		
Fiji			
Gabon	Gabon		
Ghana	Ghana		
Grenada			
Guatemala	Guatemala	Guatemala	1990
Guinea	Guinea		
Guyana	Guyana	Guyana	1986
Haiti	Haiti		
Honduras	Honduras	Honduras	1989
Hungary			
Iceland			
India			
Indonesia	Indonesia		
Iran, Islamic Republic of	Iran, Islamic Republic of		
Iraq	Iraq	Iraq	1990
Jamaica	Jamaica		
Jordan	Jordan		
Kazakhstan			
Kenya	Kenya		
Korea, Republic of			
Latvia			
Lebanon			
Lesotho			
Liberia	Liberia	Liberia	1986, 1987
Lithuania			
Macedonia, Former Yugoslav Republic of	Macedonia, Former Yugoslav Republic of	Macedonia, Former Yugoslav Republic of	1992
Madagascar	Madagascar		
Malawi	Malawi		
Malaysia			
Mauritania	Mauritania		
Mauritius			
Mexico	Mexico		
Moldova	Moldova		
Morocco	Morocco		
Nicaragua	Nicaragua	Nicaragua	1984

*At least three months overdue. **Year of placement in non-accrual status. IBRD – International Bank for Reconstruction and Development.

IBRD Borrower Payment History (continued)

IBRD Borrowers	IBRD Borrowers Defaulted on Sovereign Debt	IBRD Borrowers Placed in Non-Accrual Status by IBRD*	Year**
Nigeria	Nigeria		
Oman			
Pakistan	Pakistan		
Panama	Panama	Panama	1988
Papua New Guinea			
Paraguay	Paraguay		
Peru	Peru	Peru	1987
Philippines	Philippines		
Poland	Poland		
Portugal			
Romania	Romania		
Russia	Russia		
St. Kitts and Nevis			
St. Lucia			
St. Vincent and the Grenadines			
Senegal	Senegal		
Seychelles			
Sierra Leone	Sierra Leone	Sierra Leone	1987, 1998
Slovak Republic			
Slovenia	Slovenia		
South Africa	South Africa		
Sri Lanka			
Sudan	Sudan	Sudan	1994
Swaziland			
Syrian Arab Republic	Syrian Arab Republic	Syrian Arab Republic	1987
Tanzania	Tanzania		
Thailand			
Togo	Togo		
Trinidad and Tobago	Trinidad and Tobago		
Tunisia			
Turkey	Turkey		
Turkmenistan	Turkmenistan		
Uganda	Uganda		
Ukraine	Ukraine		
Uruguay	Uruguay		
Uzbekistan	Uzbekistan		
Venezuela	Venezuela		
Yugoslavia, Federal Republic of (Serbia/Montenegro)	Yugoslavia, Federal Republic of (Serbia/Montenegro)	Yugoslavia, Federal Republic of (Serbia/Montenegro)	1992
Zambia	Zambia	Zambia	1987, 1992
Zimbabwe	Zimbabwe		

*At least three months overdue. **Year of placement in non-accrual status. IBRD – International Bank for Reconstruction and Development.

estimated to cost approximately \$223 million. An IFC A/B loan completed the financing package.

The partial credit guarantee covers all credit risks encountered during a specified portion of a financing term, whereby all events of nonpayment are included. These guarantees are usually applied to state-sponsored projects that involve sovereign borrowing. One of the main benefits of the partial credit guarantee is access to long-term financing that is otherwise unavailable, either through a “rolling guarantee” or a liquidity guarantee, such as a contingent takeout facility. The guarantee covers a portion of the financing at the minimum necessary level and, in most cases, for principal payment only. The partial credit guarantee is available only in countries that are eligible for IBRD lending.

Policy-based guarantees are partial credit guarantees that apply to private loans granted to a sovereign in the context of a structural reform package, conditioned upon the implementation by the country of IMF policy recommendations. This guarantee can cover a portion of both interest and principal. The first operation under this enhancement mechanism was Argentina’s issuance of a series of zero-coupon notes.

■ Structured Transactions with Guarantees

By using a guarantee, a transaction may receive a rating higher than the sovereign ceiling and, in some cases, to the level of the multilateral providing the guarantee. In rating a transaction with a multilateral guarantee, Fitch IBCA’s analysis focuses on several important factors:

- **Type of guarantee:** The guarantee or support mechanism in place will be reviewed for its availability and usage, payment schedules, cure periods, tenor, events of default, and opt-out clauses, among other things.
- **Credit quality of the ultimate obligor:** In most cases, the obligor will be a sovereign entity or state-owned company. If the obligor is a quasi-sovereign entity, a public corporation, or local authority, Fitch IBCA will investigate the ability of the government to pressure the borrower to honour its obligations, as the obligor itself may not regard the MDB as a preferred creditor.
- **Sovereign's dependence on the MDB, which grants the guarantee:** A sovereign that is highly dependent on a MDB for financing its infrastructure lowers the risk of default on a loan from this MDB. The proportion of MDB loans in the country's debt will be a valuable indication.
- **Proportion of other MDB financing in the sovereign debt structure:** If a country uses other MDB loans, it is important to know what priority it gives to the MDB offering a guarantee as far as debt service is concerned. The issue here is to rank, for a particular country, the preferred creditor obligation vis-à-vis each MDB from which it borrows. In general, having a significant exposure to multilateral debt diminishes the ability to give priority to all preferred creditors.
- **Track record of MDBs' debt repayment:** In most cases, obligors are less likely to default on preferred creditor obligations than on unsecured obligations since a default may lead to a loss of access to multilateral financing. Multilaterals are one of the few reliable sources of financing in the middle of a crisis and history shows that governments are loath to jeopardize that financing. A country's solid track record in MDB's debt repayment will constitute an element of comfort for Fitch IBCA and positively influence the level of notching above the sovereign ceiling.
- **Impact of the guarantee on the MDB's credit quality:** Since providing a guarantee constitutes a contingent liability for an MDB, it will be taken into consideration in the course of Fitch IBCA analysis of the MDB's credit quality. Fitch IBCA will review the level and quality of outstanding guarantees and integrate them in its rating assessment. Note that a downgrade in an MDB's rating may negatively affect the rating of the bonds it guarantees.

Fitch IBCA will rate guaranteed transactions on a case-by-case basis. In cases where a rolling guarantee or conditional guarantee is issued, a notching approach

will be used to rate the transaction. For example, Fitch IBCA rated the Republic of Argentina's guaranteed transaction four notches above the sovereign ceiling due to a strong track record of payments, combined with a low exposure to multilateral debt.

■ Case Studies

Electricity Generating Authority of Thailand

In October 1998, the World Bank provided a partial credit guarantee, which enhanced market receptivity to a bond issue from the Electricity Generating Authority of Thailand (EGAT). The 10-year bond issue carried a non-accelerable and unconditional guarantee of principal from the World Bank, as well as a single rolling coupon guarantee to protect investors from a short-term liquidity crisis in Thailand. Although the bond issue carried a guarantee from the Kingdom of Thailand, the presence of a World Bank guarantee enabled the transaction to be rated significantly higher than Thailand's sovereign rating. If the issuer and Thailand were to default, the World Bank guarantee would be available to make payments.

The Republic of Argentina

In October 1999, the Republic of Argentina issued \$1.5 billion in zero-coupon notes with a rolling World Bank policy-based guarantee. The issuance was made in six series, with the first series maturing in October 2000 and the final series maturing in October 2004. The first series carries a World Bank guarantee, ensuring timely payment by an 'AAA' institution. Thus, the series A notes are rated 'AAA' by Fitch IBCA. If Argentina pays down the series A notes as scheduled, the guarantee will be rolled over to the subsequent series. If Argentina does not pay on time, the World Bank will make payment on the notes. Argentina then has 60 days to fully repay the World Bank; if not, the guarantee will not be extended to the subsequent series of notes.

Although the first series of notes is rated 'AAA', the subsequent series are rated 'BBB+', which is four notches higher than Fitch IBCA's 'BB' long-term foreign currency rating on Argentina. The higher rating reflects Fitch IBCA's opinion that Argentina is less likely to default on these notes than on the rest of its unsecured obligations since a default may lead to a loss of access to World Bank financing. In addition, Argentina has a strong track record of payments to the World Bank and low overall exposure to multilateral debt. Since the World Bank's establishment in 1946, Argentina has never defaulted on a loan from that institution. Supporting the likelihood of preferred payment is the fact that

multilateral debt was less than 15% of all foreign currency debt in Argentina in 1998.

It is important to note that the World Bank guarantee will not be available for any series of notes that are accelerated but will be available for any subsequent series that have not been accelerated. As long as the World Bank guarantee is in effect, Fitch IBCA will rate the notes next due 'AAA' and all other non-accelerated notes, if any, will be rated 'BBB+'. For more information, see Fitch IBCA Research on "Argentina Serial Zero Coupon Notes with Rolling World Bank Guarantee," dated Oct. 4, 1999, available on Fitch IBCA's web site at www.fitchibca.com.

■ Inter-American Development Bank

The IADB, rated 'AAA' by Fitch IBCA, was established in 1959 to help accelerate economic and social development in Latin America and the Caribbean. It finances the development of borrowing member countries, supplements private investments, and provides technical assistance. Historically, the IADB made loans exclusively to its member countries and required a government guarantee for loans made to borrowers other than national government entities. As the IADB is a multilateral institution, it is generally exempt from general country debt restructurings. Since its inception in 1959, the IADB has placed loans for five countries in non-accrual status, including Honduras, Nicaragua, Panama, Peru, and Suriname.

In 1995, the IADB formed the private sector department to facilitate financing of private investment in infrastructure and the development of capital markets. The IADB private sector department, which targets up to 5% of the IADB's total loan portfolio, provides various forms of support to financing initiatives, such as long-term U.S. dollar-denominated loans, A/B loan participations, and credit guarantees. To date, the IADB has not experienced any debt writeoffs in the private lending program.

In the IADB's loan participation program, the A portion of the loan is funded by the IADB, while the B portion is participated to financial institutions or investors in the capital markets. Under the program guidelines, the IADB's limit on the A portion is the smaller of \$75 million, or 25%, of the total project cost (40% in smaller economies). There is no limit on the size of the B portion. To date, the IADB has supported three A/B loan participations to institutional investors in Latin America. In analyzing an IADB A/B loan participation, Fitch IBCA assigns the local currency rating of the underlying obligor as

the transaction rating. Although the IADB's presence in the transaction implies that the obligor would be exempt from currency controls, there is no guarantee that the obligor will make timely payments. As such, the transaction rating is limited to the underlying obligor's credit quality.

■ International Finance Corp.

As a member of the World Bank Group, the IFC's mission is to promote to private sector development in its developing member countries. IFC works globally and currently has investments in more than 100 countries. The main forms of IFC financing include market rate loans, equity, and quasi-equity investments. To date, the IFC has never been included in any country's general reschedulings. IFC has the largest and oldest B loan program of all the MDBs that began in the 1960s. Currently outstanding IFC B loans account for approximately \$8.5 billion. Unlike a World Bank guarantee, the IFC does not require a counterguarantee from the host country government in a loan participation. Also, the IFC's own portion of financing is generally no more than 25% of project cost. The size of the B portion is sized to meet market demand. In the capital market, the IFC has launched seven successful Latin American and European A/B loan participation securitizations. IFC pioneered this program in 1995. To date, IFC's preferred creditor status has always been upheld.

■ Loan Participation Securitizations

In a loan participation program, the multilateral institution extends a loan to a company, keeps part of the loan for its own portfolio (A loan) and participates the remainder to syndicated banks (B loans). The two loan portions rank *pari passu* and the multilateral remains as the lender of record. In an IFC A/B loan securitization, the B loans, or loan participations, are the assets being sold to a trust. As such, the IFC extends its umbrella to participating investors, thereby mitigating currency convertibility and transfer risks. The IFC's A/B loan structure is applicable to unsecured borrowings with private companies in emerging markets and secured borrowings involving a pool of collateral.

During a period of exchange controls, a host country government is expected to allow obligors to continue making timely payments on debt associated with multilateral banks, while other foreign currency obligations are subject to controls and reschedulings. When rating an A/B loan securitization, Fitch IBCA will look to the local currency rating of the ultimate obligor as a cap on the transaction rating. Unlike a transaction with political risk insurance, timely debt service is implied rather than guaranteed in an A/B

loan transaction. Although the implied exemption from currency controls is not as strong as a guarantee, the consequences of nonpayment on multilateral participation loans are as equally severe as a default on guaranteed debt.

For the IADB and IFC A/B loan structures, Fitch IBCA ensures that: 1) the country from which the transaction is originating has a clean track record of payments made by private and public sector entities to multilaterals; 2) the multilateral is and remains the lender of record; and 3) the A/B loan structure is cross-defaulted.

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Telephone: New York, 1-800-753-4824, (212) 908-0500, Fax (212) 480-4435; Chicago, IL, 1-800-483-4824, (312) 214-3434, Fax (312) 214-3110; London, 011 44 20 7417 4222, Fax 011 44 20 7417 4242; San Francisco, CA, 1-800-953-4824, (415) 732-5770, Fax (415) 732-5610

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