

SPECIAL COMMENT

Shari'ah Risk: Understanding Recent Compliance Issues in Islamic Finance

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Summary

A recent English court decision in a case between two transaction parties has highlighted a particular legal risk for Islamic finance transactions that relates to potential disputes over Shari'ah compliance. This report aims to ensure a wider understanding of the legal or Shari'ah risk associated with Islamic financial instruments that is not present in conventional capital market transactions.

2009 was a critical year for Islamic finance as the downturn tested the resilience of institutions and financing structures that endeavour to comply with the ethical and moral investment guidelines that form part of Shari'ah law. These spiritual and moral obligations and duties in Islam would be of moderate relevance to Moody's credit ratings were it not for the fact that the Islamic finance sector has recorded significant growth over the past decade and a commensurate need for our ratings. The strong retail demand from their native populations also creates a powerful domestic force for financial services consistent with their beliefs. However, the recent crisis has shown that the sector is not without its casualties, with high-profile Islamic names such as Tamweel, Amlak and The Investment Dar falling foul of the credit crunch.

Moody's had previously commented¹ on what we perceive to be the issues relating to 'form over substance' that are prevalent throughout the sukuk (Islamic bond) industry. Indeed, this concept appears to have been of particular significance in the recent court case that is the focus of this report.

While not yet concluded, a recent ruling in the case of Blom Bank (Blom) vs. The Investment Dar (TID) may ultimately have significant implications for the Islamic finance industry. In this case, TID, a distressed Islamic institution, has been granted the right to a trial in its attempt to effectively void an Islamic transaction. The main element of its appeal is that (a) the transaction was not Shari'ah-compliant, and (b) TID therefore did not have the capacity to enter into such a transaction in the first place. TID originally entered into such agreement on the basis that the transaction was Shari'ah-compliant, and it now appears to have 'reversed' its position in order to avoid its current obligation.

This attempt to void the transaction may ultimately be unsuccessful, but it currently constitutes a material development for the industry, highlighting a risk that needs to be carefully understood and/or mitigated against both for the long-term health of the industry and for the assignment of our credit ratings.

Form Over Substance Compliance – Increasing the Risk?

Much of the Islamic finance movement aims to essentially replicate the products and processes of the conventional financial system. The advantage of this approach is that the familiarity permits rapid uptake, integration and regulation of 'new' Islamic products.

However, this practice of creating instruments and investments that are identical in substance to conventional ones creates its own issues. There are usually a complex combination of sub-trades and/or agreements (labelled with Arabic names) that present a very different form to the casual participant and help confuse the substance of the unsecured bond or fixed-term deposit, for example.

This complexity can sometimes make it difficult for some key market participants to form the right opinion on the risk and/or Shari'ah compliance of such instruments. As we shall see below, a thorough analysis of the contracts with an objective eye for the transaction 'substance' was material to the judge's decision in this 'first stage' of the case.

One area of disparity between this 'ideal' and the 'reality' was already highlighted by the Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI) in February 2008, when it published six principles regarding sukuk structures (see right) and initially noted that around 85% of existing sukuk were not in compliance with these principles (although *ijarah* structures were seen as more acceptable). However, such opinions are subjective and were a curiosity for the bulk of sukuk investors, who – were relatively indifferent to the Shari'ah aspect – were more focused on the underlying risks and returns of such instruments.

Sukuk risk, return and security characteristics can vary significantly – even within single 'types' (e.g. *mudarabah*, *musharakah* and *ijarah*). Thus, until there is some broad consensual harmonisation on terminology or form, investors still need to look at each structure individually to understand the cash flow, risk and return profile, irrespective of the name/type of sukuk structure used. The lack of standardisation and transparency, even at such a high and simple level, is a constraint to the 'healthy' growth of a more liquid industry.

Recap of the AAOIFI 2008 Principles on Sukuk Compliance

No human authority exists that can provide definitive rulings on Shari'ah compliance, but AAOIFI has been one of the most active in Islamic capital markets. It's lead scholar is the highly respected Sheikh Taqi Usmani (chairman of the AAOIFI Shari'ah board) who was notable for publicly proposing some principles on sukuk compliance that most of the **asset-based** sukuk issued to date would fail to comply with.

AAOIFI Principle 1: Sukuk holders should have asset ownership. The first point highlighted by AAOIFI relates to assets. It proposes that sukuk investors should have rights over the sukuk assets, that they should be sold 'legally' and that the originating company should 'transfer' the assets.

AAOIFI Principle 2: To be tradable, sukuk should not be backed purely by receivables. The second point raised prohibits the selling of receivables or debts. As such, in both of the Moody's-rated asset-backed sukuk seen to date, the physical assets (land and properties) also had to be sold and legally registered in the 'name' of the sukuk investors.

AAOIFI Principle 3: Sukuk profit should not be supported by the *mudarib*. The *mudarib* is usually the borrower in asset-based structures. If there is an excess income in the sukuk, it is taken by the *mudarib* as an 'incentive fee'; however, if there is a shortfall, the *mudarib* has an obligation to make up the difference.

AAOIFI Principles 4 & 5: Asset purchase undertakings should not be at par value unless the entity is unaffiliated to the original asset owner. Both these principles relate to the purchase undertaking contracts that are key in almost all asset-based structures to date. This mechanism is used to repay principal to the sukuk investors and is generally a contract that (often with a corresponding sale undertaking) 'obligates' the originator to 'buy' back the assets at par value (i.e. independent of the 'actual' realisable asset value). This 'par' element of the purchase is discouraged in the fourth and fifth of AAOIFI's points. Purchase of the assets at some measure of actual value or by an unaffiliated third party is acceptable.

AAOIFI Principle 6: Increased compliance oversight. This encourages more detailed oversight from scholars to ensure compliance. This is more operational and regards the assignment of fatwas and approvals rather than any structural comments, its notes that approving boards should be more hands-on in the documentation and execution.

One of the most obvious examples which has created confusion for some market participants is the usage of 'asset-backed' and 'asset-based' terminology. These are semantically similar descriptions but mask critical differences in financing structure, risk and return.

One may ask – is there any real value in calling a financing or investment 'asset-based' if in fact the assets have absolutely zero effect on the risk, the profits/returns generated or the commercial nature of the transaction? More often than not, the 'based' term is often used to reference a 'looser' asset security structure that has little or no legal relevance in the event of a corporate default or distress.

There is no scope in the courts for such vagaries – either the investors have a legal enforceable claim on assets or they do not. So when crunch time comes, those investors in asset-based structures are left with nothing: no assets, no security, just an unsecured claim in substance like a debt of the company.

Again, we emphasise that the majority of investors happily accept these structures. Many investors – Islamic and non-Islamic alike – simply want a fixed-income bond: rough estimates put the market size at USD45-50 trillion and it is this powerful investor demand that primarily drives the shape of market.

A Very Important, Personal and Subjective Opinion?

Moody's 'pure' focus on credit risk and (particularly for structured transactions) associated operational and legal risks allows us to strip away the sometimes excessive structural and legal complexity and confusion surrounding Islamic instruments that can impede any Shari'ah analysis.

For our ratings, we always have to reach the real 'substance' of the sukuk without being distracted by the 'form'. This focus on the substance of the risk and return is likely also important when trying to assess a product's compliance with a given set of Shari'ah principles or views – but these views are subjective to various schools of Islamic thought and scholars which can also be subject to change. It is this subjectivity / lack of standards that also contributes to this Shari'ah compliance risk issue. Given the legitimate diversity of opinion, consensus will take time and major effort to achieve.

This is our opinion, however, as we have sometimes heard arguments that the 'form' is the most important, but, as

will be described below, the judge also looked through the web of contracts and payments to get to the commercial essence of the transaction for his final decision.

The shortage of top Islamic finance scholars means that a small group of reputable individuals are a key factor in the Shari'ah compliance process. This concentration creates a bottleneck when demand is high, and puts them and their offices under considerable pressure to deliver their approvals quickly. What is particularly perturbing in the case below is that the transaction was deemed to be Shari'ah-compliant by TID's own Shari'ah board at the time of entering the contract but - now that it is in distress - TID appears to be retracting its approval, although it is not yet clear to Moody's which parties within the corporation are driving this 'reversal' of opinion.

It is widely felt that the application of Shari'ah compliance as a commercial and defensive legal tool undermines the credibility and ethical ethos that underpins Islamic finance. Given the consequences of such reversals, it is key for the industry that the approval process be extensively documented, formalised and open to inspection. The reasoning for approvals should be available both for the initial decision and in (perhaps more crucially) the case of any subsequent reversals. Such approvals should also be made public to allow a common body of knowledge to be created for the Muslim Ummah² and would help the industry reach the next level of market maturity and add global credibility to the approval process. AAOIFI again has made some steps in this regard with its institutional certifications of compliance, but for a deeper, stable and more liquid market the concept needs to gain wider acceptance.

The curious case of Investment Dar Company K.S.C.C (Kuwait) vs. Blom Development Bank S.A.L (Lebanon)

This recent court case may have some significant implications for the Islamic finance industry which need to be assessed carefully at by all participants in the sector. Blom Development Bank S.A.L ("Blom") of Lebanon had placed various 'funds' with The Investment Dar Company K.S.C.C ("TID") of Kuwait, pursuant to a *wakala* arrangement (see box).

TID became distressed during the course of 2008/09 with the onset of the credit crunch and announced a restructuring. In May 2009, it defaulted on the profit/coupon of its USD100 million sukuk issue and since

then there has been much confusion regarding the status and progress of the restructuring. However, as of 14 March 2010, TID's petition to place its restructuring under the Financial Stability Law (of Kuwait) had been accepted and crucially all legal proceedings are now stayed in a US Chapter 11 style moratorium precluding any further actions of this nature.

Wakala Agreements – not all are created equal

Wakala = agency, A *wakala* is a type of agency agreement commonly used in Islamic finance transactions. The 'ideal' substance of a *wakala* is a type of managed fund and has been applied 'successfully' in many instances. The fund should conduct only Shari'ah-compliant transactions and is managed by the agent (*wakeel*) for depositors (*muwakkil*), with the funds or 'capital amount' being repaid at maturity with a share of the periodic profits/losses generated by the fund (although excess profit may be legitimately retained as an incentive fee).

In this case, the depositors were ultimately seeking the equivalent of a fixed deposit, and therefore some additional features were implemented. Under this arrangement, the agent notifies the depositors of the profit expected to be generated. Any profit exceeding the expected 'profit' (return), after deduction of the agent fee, is retained by the agent as an incentive fee. The 'capital amount' is obliged to be repaid (regardless of underlying performance), hence with the upside capped and downside also covered, a fixed income deposit is the ultimate result. The depositor takes no risk of shortfall due to poor underlying performance.

Thus, while the initial form or Arabic terminology may suggest a type of fund arrangement, a series of contractual provisions are applied to bring us back to an unconditional obligation of the agent to pay the anticipated profit (like interest) and to return the capital amount (principal) when required, irrespective of the performance of the underlying [Shari'ah-compliant] investments themselves.

Prior to the events above, however, a Master Wakala agreement was entered into in October 2007 between TID and Blom. TID would 'invest' a sum received from Blom (approx. USD10 million) in a Shari'ah-compliant manner. TID was obligated to repay the capital sum together with the agreed 'anticipated' return at the end of the period, irrespective of whether capital actually generated any profit. Needless to say, it failed to fulfil this payment obligation, leading Blom to bring a summary judgment application in the English courts.

Blom made two claims:

- a) TID had acted in breach of the terms of the agreement.
- b) TID held Blom's funds on trust for Blom.

In its defence, TID argued that:

- 1) TID was required by its charter to comply with, and conduct its business activities in accordance with, Shari'ah principles.
- 2) The previously executed *wakala* (or agency) arrangements did not actually comply with Shari'ah principles.
- 3) As a consequence of 1 and 2, TID never had the legal capacity to enter into the agreement at the outset; hence, all related agreements should therefore be considered *ultra vires* (or void).

TID, **itself** an Islamic institution, was arguing that the commercial effect of each of the *wakala* transactions was in **substance** equivalent to that of a conventional bank deposit with interest, that the *wakala* agreements struck were not Shari'ah-compliant because in reality TID was taking deposits at interest (i.e. the unconditional obligation to pay the expected profit).

TID's Legal Capacity

TID's Memorandum of Association explicitly precludes it from entering into non Shari'ah-compliant transactions.

Article 5 Extract: "The objectives for which the company is established shall be Shari'ah-compliant. None of the objectives shall be construed and interpreted as permitting the company to practice directly or indirectly any usury or non-Shari'ah-compliant activities."

Article 6 Extract: "Carry out all financial transactions in a Shari'ah-compliant manner. However, in all cases, this item shall not be construed or interpreted as permitting the company to practice any activities related to banking profession, i.e. accept cash deposits, saving deposits, account opening, issuance of letters of guarantee, open documentary credits and other banking activities."

The judge noted that "For all intents and purposes, the commercial result is equivalent to that of a deposit at interest"³ given that TID's charter prohibited non-Shari'ah transactions (see box above), in his objective opinion the High Court judge felt that TID had indeed a legitimate defence to Blom's first claim but not to the second; thus even if voided, Blom would still have a restitutionary

claim. Hence, the court issued a summary judgment ordering payment of the capital amount but not the anticipated profit required, which necessitated consideration at a full trial, so at this stage the principal was repayable but not profit/interest.

The question of capacity was not fully resolved but will likely be the focus of the future trial. Despite being an English Law governed transaction, the practical fact remains that the companies are based in Kuwait and Lebanon. For capacity, it is the relevant Kuwaiti laws that are key (does lack of capacity void the transaction under Kuwaiti law?) not English ones and enforcement of any judgments would likely require some degree of local cooperation.

A Change of Heart?

Blom rejects TID's assertion of non Shari'ah compliance of the *wakala* agreement (regardless of what the court believes to be the objective substance) given that it was already approved as Shari'ah compliant by both TID and Blom at the outset. From the case summary:

*"It is said on behalf of TID that that contract amounted to a non-compliant Sharia transaction because, in reality and substance, what TID was doing was taking deposits at interest. Blom says that claim is a nonsense. It points to the undoubted fact that **the Sharia committee of (I shall assume) respected scholars had authorised and approved of this form of contract** which is a strong indication that the contract was indeed Sharia compliant."*²⁸

Key here is that this non-compliance argument originates from an Islamic institution – this is an unfortunate development for the whole sector. The clause below is an extract of the disputed *wakala* contract:

*"The wakeel shall not utilise the wakala assets or any other purpose except what is permitted by muwakkil/depositor and within the Sharia parameters. The wakeel confirms that the terms of the master wakala contract and the transactions contemplated hereby are in accordance with the Sharia as interpreted by the **Sharia committee** and it **undertakes that it will not at any time assert that any provision thereof or any transaction effected pursuant hereto contravenes the Sharia**"*³

The second point is important because, in theory putting aside any court opinions actual substance of the contract, the Shari'ah committee of TID effectively agreed not to change their opinion at any time (ie future) – precluding the defence now being put forward by TID. Again we

emphasise that whether or not this is successful will be dependent on the ultimate trial (assuming there is no out-of-court settlement). A final judgement that results in TID having to honour its contractual and commercial obligations (given that they themselves initially asserted compliancy) would be a positive development for the industry. If TID is successful however this would be very negative for the sector.

A Positive Precedent? : Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and others (2004)

This case can be distinguished from the Shamil Bank vs. Beximco Pharmaceuticals Ltd case of 2004. Here an English Court of Appeal was asked to consider whether a working capital facility provided since 1995 breached Shari'ah principles such that the borrower (Beximco) could void the agreements and escape its liabilities under the financing scheme. The financing agreement took the form of *murabaha* agreements (see below) which are very common in Islamic finance.

Murabaha agreements are contracts for the sale of goods whereby the seller (here the bank) agrees to purchase, in its own name, goods specified by the buyer (here the borrower) and sells them to the buyer on a deferred payment basis, payable in instalments. The difference between the original price and the deferred price is the bank's profit. With the use of the liquid commodities markets such 'goods' can then be sold at spot allowing application of Murabaha's for immediate 'cash' funding, usually the primary goal.

The disputed agreements contained the following governing law clause:

"Subject to the principles of the Glorious Shariah, this Agreement shall be governed by and construed in accordance with the laws of England."

The defence argued that the contracts were only valid and enforceable if they were in accordance with **both** the principles of Shariah and in accordance with English law, i.e. stipulating as a condition precedent that the contract would be enforceable only if Shari'ah-compliant. They acknowledge the possible differences in Shari'ah opinions but they argued that prohibition on interest was **universal** and – given that these *murabaha* agreements were in substance interest-bearing loans – they were invalid and unenforceable. Ultimately, in what was a positive outcome for the Islamic finance sector, the court opined that the governing law was solely English and that the **'Shari'ah**

defence' sought here was "a lawyer's construct". As such, the court was against such a construct that would defeat the commercial purpose of the documents and ruled that the terms of the financing scheme were enforceable regardless of their non-compliance with Shari'ah.

Possible Considerations for Shari'ah Risk

While not yet concluded, there are still documentary steps that all parties taking part in transactions or investing in Shari'ah-based financing (both Islamic and conventional) can take to better assess and perhaps try to understand the risk. Moody's may require to see such documents when assigning ratings in the Islamic universe (to both sukuk and Islamic institutions).

These may include:

- » Provision, review and disclosure of approvals from the respective Shari'ah board (fatwa / certificate / approval document etc.) confirming an accurate understanding of the structure with consideration of all relevant documents and hence Shari'ah-compliant.
- » Capacity and authority opinions of the relevant Islamic parties/clients – a relatively straightforward step. However, if express constitutional prohibitions are amended or addressed at the contractual level, then such modifications need to be legal within the relevant jurisdiction and in accordance with any other policies the institution may have.
- » Representations and warranties regarding (i) the Shari'ah compliance of the contract/instrument concerned and (ii) non-conflict with constitutional, capacity and internal policy restrictions. These may include an express waiver of any Shari'ah-related defences (which again need to be legal within the relevant jurisdiction).
- » It is noted that while most GCC countries have a civil code that may incorporate aspects of Shari'ah, only the Kingdom of Saudi Arabia has Shari'ah courts that may rule on commercial and financial disputes.

This list is not necessarily exhaustive but it describes some perhaps obvious healthy legal/operational diligence that should be conducted even if the ultimate case is resolved in favour of enforcing all the contractual obligations.

Conclusions

Moody's provides opinions only on the credit risk associated with such instruments. We do not opine on Shari'ah compliance unless it somehow affects credit risk. The subjectivity of Shari'ah compliance coupled with transactions that comply in form but not substance to the principles may expose parties to this legal / Shari'ah risk.

It should be noted that this particular decision on Shari'ah compliance will ultimately be driven more by an analysis of the capacity and authority of TID, and such issues are not solely the domain of Shari'ah transactions but may apply in many other [conventional] circumstances. Simplistically, many institutions may require some formal licence to enter an agreement (say trading derivatives). However, while verifying the possession of such a licence is a relatively unambiguous constraint, Shari'ah compliance is a subjective issue and (as we are seeing) not necessarily a constant position.

The impact of this latest court ruling is that it increases the uncertainty for all transactions where (in particular) one of the contract parties is 'legally' restricted by its charter or constitutional documents to enter only into Shari'ah-compliant contracts. As we have seen, at times of distress all options, regardless of ethics, may be a consideration for the defaulting party. Such risks are a consideration in our rating process because, if unmitigated, they may have implications for the loss-given-default analysis of such instruments.

Moody's will closely watch the case as the ultimate judgement may set a precedent for future transactions. Such precedent when coupled with legal opinions will likely form part of our rating analysis of such instruments and institutions and we will seek to update the market with our views as more information becomes available

Related Research

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions, please refer to the following reports:

- » [Global Sukuk Issuance Surges as Effects of Credit Crisis Recede: Overview and Trend Analysis, November 2009 \(SF184627isf\)](#)
- » [The Future of Sukuk: Substance over Form?, May 2009 \(SF154199isf\)](#)
- » [Shari'ah and Sukuk: A Moody's Primer, May 2006 \(103338\)](#)
- » [Islamic Banks – Their Strategies and Ratings, May 2009 \(115565\)](#)
- » [Frequently Asked Questions: Islamic Finance, Oil Prices and the Global Crisis, February 2009 \(114816\)](#)
- » [Global Sukuk Issuance: 2008 Slowdown Mainly Due to Credit Crisis, But Some Impact from Shari'ah Compliance Issues, January 2009 \(SF149211isf\)](#)
- » [Gulf Islamic Banks Resilient Amid Global Credit Woes, November 2008 \(112431\)](#)
- » [Frequently Asked Questions: Notable Trends in Global Islamic Finance, August 2008 \(110404\)](#)
- » [Islamic Finance in France: Strong Potential, But Key Obstacles Persist, July 2008 \(109676\)](#)
- » [Islamic Finance: Glossary of Usual Terms and Core Principles, June 2008 \(109441\)](#)
- » [Islamic Banking in East Asia – Growing but not without Challenges, April 2008 \(108469\)](#)
- » [Islamic Banks and Sukuk: Growing Fast, but Still Fragmented, April 2008 \(108331\)](#)
- » [Islamic Finance Explores New Horizons in Africa, March 2008 \(108071\)](#)
- » [Islamic Banks in the GCC: a Comparative Analysis, March 2008 \(107856\)](#)
- » [Islamic Finance: Sukuk Take Centre Stage, Other Shari'ah-Compliant Products Gain Popularity as Demand Increases, February 2008 \(SF124315isf\)](#)
- » [The Benefits of Ratings for Islamic Financial Institutions and What They Address, February 2008 \(107502\)](#)
- » [Risk Issues at Islamic Financial Institutions, January 2008 \(107175\)](#)
- » [Understanding Moody's Approach to Unsecured Corporate Sukuk, August 2007 \(103919\)](#)
- » [Asian Sukuk Poised for Fast Growth: Market Review and Introduction to Moody's Rating Approach, August 2007 \(104446\)](#)
- » [Moody's Approach to Analysing Takaful Companies, May 2007 \(102910\)](#)
- » [Takaful: A Market with Great Potential, October 2006 \(98913\)](#)
- » [A Guide to Rating Islamic Financial Institutions, April 2006 \(97226\)](#)
- » [Moody's Involvement in Rating Islamic Financial Institutions, April 2006 \(97113\)](#)
- » [Regulation and Supervision: Challenges for Islamic Finance in a Riba-Based Global System, January 2004 \(81128\)](#)
- » [Culture or Accounting: What Are The Real Constraints for Islamic Finance in a Riba-Based Global Economy?, January 2001 \(63369\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moody.com/SFQuickCheck.

¹ [The Future of Sukuk: Substance over Form?, May 2009 \(SF154199isf\)](#)

² Arabic word meaning "community" or "nation".

³ Case No: CH/2009/PTA/0455 – THE INVESTMENT DAR COMPANY KSCC vs BLOM DEVELOPMENTS BANK SAL (HTML version of the judgement)

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