

# Terra BoligKreditt AS

## Covered Bonds / Norway

This pre-sale report addresses the structure and characteristics of the proposed transaction based on the information provided to Moody's as of August 2007. Investors should be aware that certain issues concerning this transaction have yet to be finalised. Upon conclusive review of all documents and legal information as well as any subsequent changes in information, Moody's will endeavour to assign definitive ratings to this transaction. The **definitive** ratings may differ from the **provisional** ratings set forth in this report. Moody's will disseminate the assignment of definitive ratings through its Client Service Desk. This report does not constitute an offer to sell or a solicitation of an offer to buy any securities, and it may not be used or circulated in connection with any such offer or solicitation.

### Estimated Closing Date

[August 2007]

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## PROVISIONAL (P) RATINGS

Series	Rating	Amount (million)	Expected Maturity	Final Maturity	Coupon
Series 1	(P)Aaa	NOK [·]	[·]	[·]	[·]%

The ratings address the expected loss posed to investors by the legal final maturity. Moody's ratings address only the credit risks associated with the transaction. Other non-credit risks have not been addressed, but may have a significant effect on yield to investors.

## OPINION

### Summary

Moody's has assigned a provisional long-term rating of (P)Aaa to the covered bonds (the "Covered Bonds") to be issued by Terra BoligKreditt AS (the "Issuer" or "Sponsor Bank") under the terms of a EUR [3] billion programme (the "Programme") established according to the amendments to Chapter 2, Subsection IV of the Norwegian Financial Institutions Act of 1988 (the "Financial Institutions Act"), and the regulations issued by the Ministry of Finance of the Kingdom of Norway (the "Regulations"), which came into legal effect on 1 June 2007, (together the "Legislation").

The Covered Bond investors will benefit from:

1. The credit strength of Terra BoligKreditt ("TBK", not rated): The Issuer is a subsidiary owned by a group of banks that form – together with the Issuer and other entities – the Terra Group.
2. The Norwegian legal framework: Pursuant to the terms of the Legislation, the Issuer is regulated and supervised by the Financial Supervisory Authority of Norway. Investors and eligible swap counterparties will – on a *pari passu* basis – have the benefit of a priority right in respect of a pool of assets (the "Cover Pool").
3. The Cover Pool: As of the date of this report, the Cover Pool solely comprises high-quality loans backed by residential use assets located in Norway.
4. The Issuer's obligation to maintain [2.75]% of "committed" over-collateralisation on a Net Present Value basis.

As is the case with other covered bonds, Moody's considers the issuances to be linked to the credit strength of some transaction counterparties and, in particular, the Issuer and the banks of the Terra Group. However, the Issuer has the ability – but not an obligation – to further enhance the transaction in order to increase the de-linkage to the Sponsor Bank's credit strength.



## Strengths of the Transaction

- The Covered Bonds are full recourse to the Issuer. The Issuer is a subsidiary owned by a group of banks that form – together with the Issuer and other entities – the Terra Group.
- The Cover Pool initially comprises prime Norwegian residential mortgages (including a small amount of lending to housing co-operatives). The quality of the Cover Pool is evidenced by a low weighted average Loan-to-Market Value of [52.9%].
- The members of the Terra Group are incentivised by guarantee obligations to pass high quality loans to the Issuer. Inter alia, each bank is obliged to refund the Issuer any losses that may arise on the portion of a loan that is in excess of 50% LTV.
- The Issuer is committed to maintain [2.75]% of over-collateralisation on a Net Present Value basis. Moody's considers this over-collateralisation to be "committed".
- Commingling, clawback and set-off risk are well addressed by the combination of the Legislation and the structure put in place by the Issuer.
- Refinancing risk is lower than many other jurisdictions. The Issuer has the ability to reset the loan rates on all loans with six weeks' notice to the borrower, and in the event of Sponsor Bank Default, the administrator will be able to similarly reset loan rates. Moody's believes this right to reset margins should reduce the level of refinancing risk compared to many other covered bonds.
- The currency swaps are expected to be stronger than typically found in covered bond transactions. For example, provisions are expected to be included that mean swaps should survive in the event of a delayed payment following Issuer Default.

## Weaknesses and Mitigants

- As with most covered bonds, the probability of default of the Covered Bonds is expected to be linked to the probability of default of the Sponsor Bank. The duration of the assets may be longer than the life of the Covered Bonds. Therefore, following the occurrence of a Sponsor Bank Default,<sup>1</sup> investors may need to rely on the proceeds deriving from the sale of all or part of the Cover Pool, or other forms of funding for repayment before final maturity. **Mitigants:** The transaction enjoys stronger than usual mitigants against "refinancing risk". These include: (i) Moody's has considered stressed scenarios, which include amongst others the sale of the Cover Pool at stressed refinancing margins; (ii) refinancing risk is more limited than in many other covered bond transactions given loan rates to borrowers can be changed at short notice; and (iii) the maturity extension on the Covered Bonds of up to 12 months.
- There are few restrictions or limitations in respect of the future composition of the Cover Pool. This creates some substitution risk for the Cover Pool. **Mitigants:** (i) the 75% LTV threshold on mortgages against which Covered Bonds can be issued; (ii) as per Regulations, the Issuer will not take into account non-performing loans (over 90 days in arrears) when computing the matching tests; (iii) the pool composition will be monitored; and (iv) the Issuer has stated he does not intend to include any "commercial" loans in the cover pool [footnote: loans to housing co-operatives are included in the Cover Pool, but for current purposes are not being considered "commercial"].
- The Cover Pool has an average seasoning of less than one year. Further, the Cover Pool contains a small amount of prior ranks, loans to housing co-operatives and tenants residing in these properties, and holiday homes. **Mitigants:** The exceptionally low LTV of the loans in the Cover Pool.
- Valuations of properties may be based on purchase contracts. **Mitigants:** The collateral benefits from a low LTV which limits the related risk.

<sup>1</sup> Sponsor Bank Default is defined as the removal from the Cover Pool of (i) support provided by entities within the Issuer/Parent group, (ii) ancillary activities of the Issuer/Parent group (i.e. those not related to the Cover Pool and (iii) usually, management functions of the Issuer.

## STRUCTURE SUMMARY

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Issuer:	Terra BoligKreditt AS
Structure Type:	Covered Bonds under Norwegian Law
Originator:	Member banks of Terra Group
Lender:	Terra BoligKreditt AS
Servicer:	Relevant originating bank
Credit Enhancement/Reserves:	[2.75]% committed over-collateralisation on an NPV basis
Rating of Notes if Issuer rated one notch below its current level	(P)[ <b>Aaa</b> ] <sup>2</sup>
Hedging:	[•]
Arranger/Lead Manager:	UBS Investment Bank

## COLLATERAL SUMMARY

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Collateral	Mortgage Loans backed by property in Norway
Total Pool	NOK[6,306.4] million
Number of Loans:	[5,294]
Number of Borrowers:	[5,235]
Number of Properties:	[5,269]
Geographic Diversity:	Norway: 100%
Average LTV (unindexed):	[52.9%]
Prior ranks by value (based on sample exercise):	[below 2%]
Junior ranks by value (based on sample exercise):	[averaged across the entire Cover Pool, below 6%]
WA Remaining Term (months):	[286.35]
WA Seasoning (months):	[10.75]
Delinquency Status:	[0.2]% of the portfolio is between 2 and 6 months in arrears; no loan is in arrears more than 6 months
Collateral Score:	[1.8]

<sup>2</sup> This sensitivity considers what the covered bond rating would look like should the credit rating of the Issuer be one rating below the currently assessed level. All other things equal, this transaction would be rated (P)**Aaa** at the date of this report if the Issuer carried a rating one notch below its current assessment.

## TRANSACTION SUMMARY

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### **The Issuer has been licensed to issue Covered Bonds under the Legislation**

In its capacity as a regulated “Credit Institution” (*kredittforetak*) under the terms of the Legislation, Terra BoligKreditt obtained a licence from the Norwegian FSA on 18 June 2007 to issue covered bonds (*obligasjoner med fortrinnsrett*) and is thus entitled to issue covered bonds. The licence and the subsequent maintenance of such licence are subject to the Issuer satisfying, on an ongoing basis, several requirements in respect of procedures and risk control systems set out by the Legislation and other applicable regulations.

Subsequently, loans have been added to the balance sheet of TBK. This has been performed by the borrowers entering into new loan contracts with TBK rather than by means of asset transfer.

## STRUCTURAL AND LEGAL ASPECTS

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### **Insolvency scenarios under the Legislation**

Following the insolvency of the Issuer, the Legislation does not contemplate the dissolution of the Issuer. The Legislation does not include any acceleration event or event of default. In the event of the insolvency of the Issuer, either of the following two scenarios may occur:

1. Timely payments to the creditors with a preferential claim over the Cover Pool can be maintained by the Bankruptcy Administrator<sup>3</sup> appointed by the competent court.
2. The Bankruptcy Administrator cannot make timely payments and does not believe it can remedy this situation, and a halt to the payments is called. In the event of a halt of payments all preferential claims over the cover pool will be calculated by discounting them to present value, on the date when the payments have been halted.

### **Commingling Risk**

Commingling risk is effectively addressed. Payments under the assets are made direct to an account in the name of the Issuer, and this account is registered in the Cover Pool. This account is held by a Prime-1 rated bank. In the event that the account bank ceases to be rated **Prime-1** by Moody’s, TBK has agreed to redirect payments to another account at a bank with a suitable short-term rating from Moody’s

### **Set-Off Risk**

The Issuer does not take deposits. In addition, all loans are directly granted by the Issuer and no loan has been or will be transferred to it from a third party. Moody’s is of the opinion that this eliminates any set-off risk.

### **The Cover Pool**

### **Composition and monitoring**

The Issuer manages the Cover Pool and the register, under the supervision of the Independent Inspector appointed by the Norwegian FSA. The management of the Cover Pool includes, among other tasks, performing the assets/liabilities matching test. The tests are carried out by the Issuer, both on a par value basis and on a net present value basis.

### **Over-collateralisation**

The Legislation does not require the Issuer to over-collateralise the Covered Bonds. However, in assigning its rating, Moody’s has relied on the contractual commitment by the Issuer pursuant to the covenant included in the Programme Prospectus to maintain a certain level of over-collateralisation. Moody’s considers this over-collateralisation to be “committed”.

### **The Covered Bonds**

The Covered Bonds are supported by the Cover Pool. Such Covered Bonds constitute senior direct and unconditional obligations of the Issuer. The structure of the Programme allows for the issuance of Covered Bonds with different terms and/or interest-yielding mechanisms.

<sup>3</sup> The Bankruptcy Administrator is the person appointed by the court in accordance with Norwegian bankruptcy legislation to act as administrator of a bankrupt estate pursuant to the Norwegian bankruptcy legislation.

## MOODY'S RATING METHODOLOGY

Moody's covered bond Rating Methodology report (Moody's Rating Approach to European Covered Bonds, published 13 June 2005) details the approach used for rating covered bond transactions. The impact of the credit strength of the Sponsor Bank and the quality of the collateral is considered below.

### 1) Credit Strength of the Issuer

**The default probability of the Issuer has been estimated through a monitored credit indicator**

Terra BoligKreditt AS was incorporated as a limited company ("aksjeselskap") under Norwegian law in March 2003 and is located in Oslo.

The Issuer is wholly owned by Terra-Gruppen AS, which is in turn wholly owned by 79 small and medium sized Norwegian savings banks (the Terra Banks). Terra-Gruppen AS is a holding company for several companies offering services to the Terra Banks and their customers. The Terra Banks form a banking product collaboration, which forms the 4th largest financial institution in Norway within consumer banking with total assets of approximately NOK 138 billion. It serves 750,000 customers via 200 branches covering the whole country.

The business of the Issuer entails the funding of the mortgages generated by the Terra Banks in an inexpensive way by issuing covered bonds in the domestic and foreign debt capital markets.

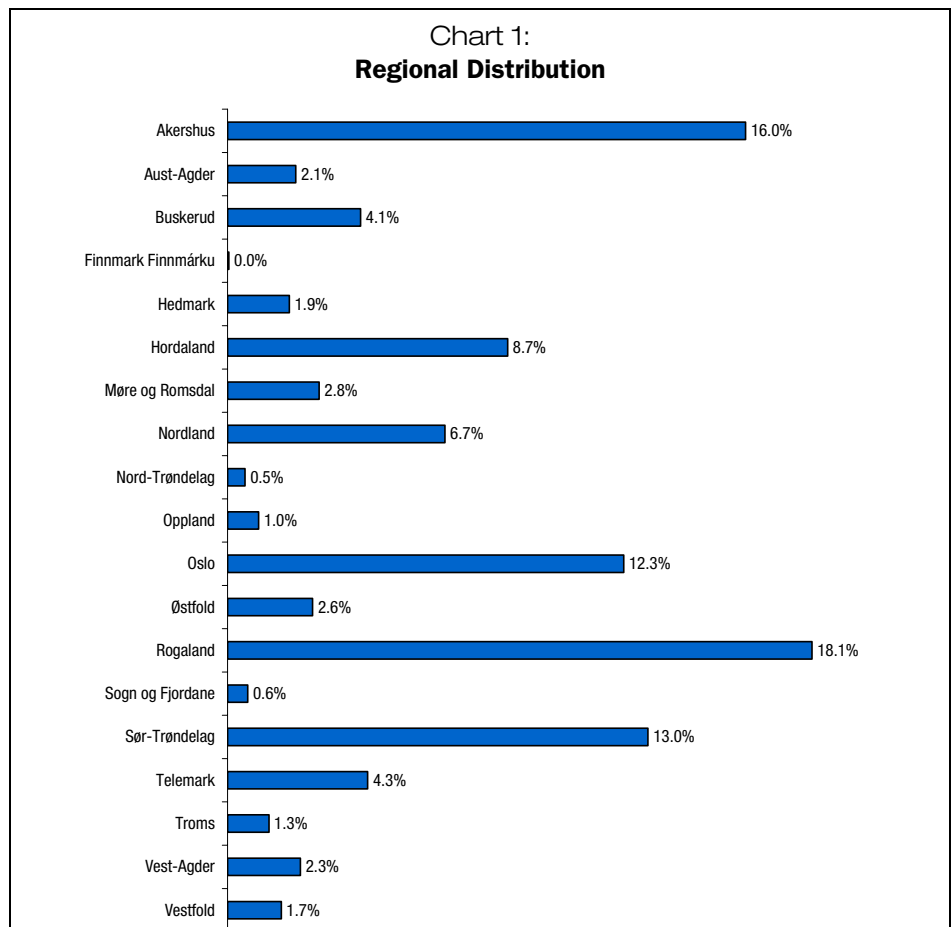
The members of the Terra Group source the collateral for the Cover Pool and service this collateral.

For the purposes of assessing the default probability of the Issuer, Moody's has performed a private credit indicator, which will be monitored on a periodic basis.

### 2) Quality of the Collateral

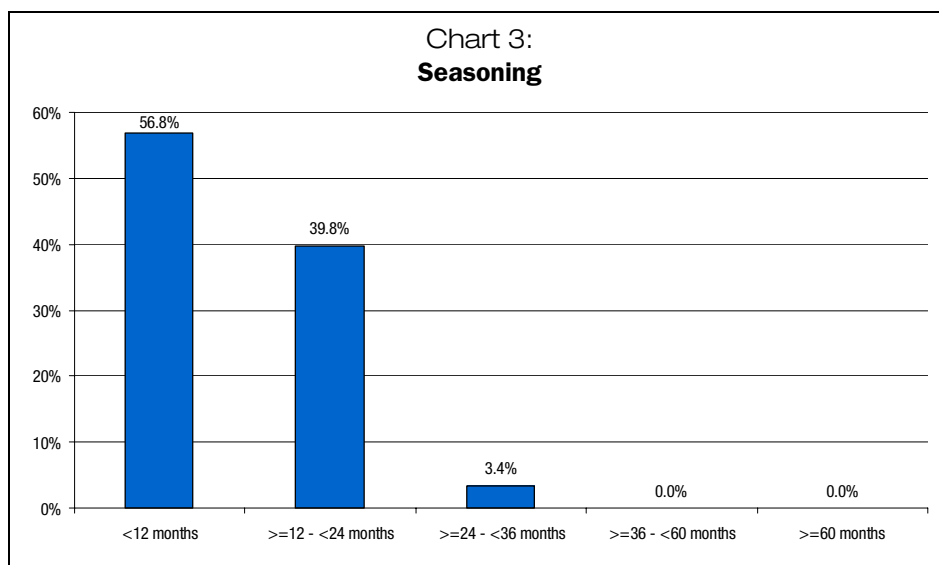
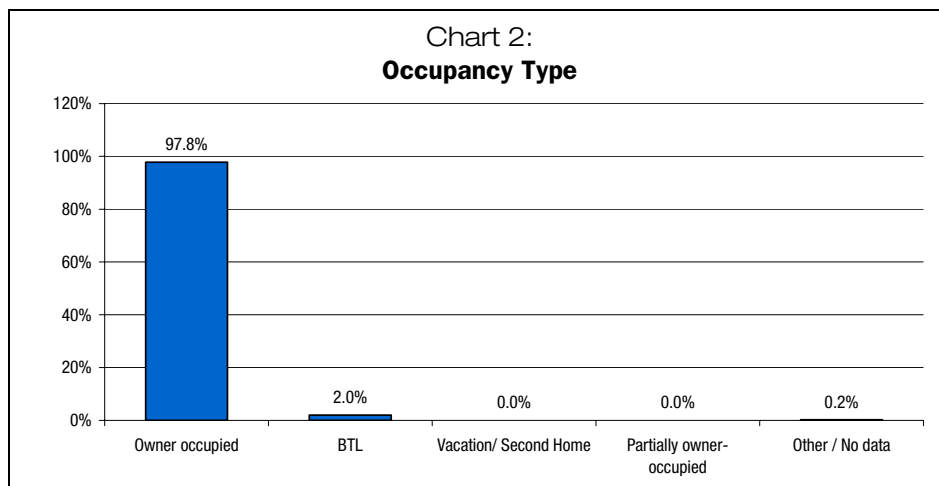
**The Cover Pool consists of residential assets located in Norway**

The loans in the Cover Pool are secured against residential use properties that are geographically well dispersed across Norway. The initial pool does not comprise substitute collateral.



**Mainly single-family and owner-occupied properties**

The Cover Pool mainly comprises loans secured by single-family houses and tenant-owner apartments. The average seasoning is [11] months.



**Condominiums, Co-operatives and Holiday Homes are included as collateral**

The cover pool includes loans secured against co-operatives, condominiums, and holiday homes. The only one of these collateral types that individually makes up more than 2% of the cover pool is loans to individual tenants living in co-operatives (these make up [8.5%] of the Cover Pool). When analysing the loans to individual tenants living in co-operatives, Moody's has made what it believes is a conservative estimate for the level of debt held at the co-operative level (this debt ranks senior to the loan in the Cover Pool, and the amount of the dent at the co-operative level is subject to change).

Going forward, Moody's expect that loans backed by holiday homes will not exceed 1% (by value) of the Cover Pool.

**High credit quality of the cover assets**

The high credit quality of the Cover Pool is evidenced, among other things, by the low LTVs of the loans. As at date of this report, the Cover Pool:

- Consists solely of prime Norwegian residential use mortgage loans originated by banks of the Terra Group
- Has a low weighted average un-indexed LTV of [52.9%]. On an indexed basis, the weighted average LTV of the Cover Pool is [48.6%].

**The assets in the Cover Pool initially consist solely of prime Norwegian residential mortgage loans**

Moody's has been provided with comprehensive data on the collateral; hence few assumptions have been necessary in our analysis.

For a random sample of loans in the Cover Pool, the Issuer has cross-referenced Land Registry entries against data on junior- and senior-ranking loans. The results of this sample showed that about 30% of the pool has on average junior ranking loans of 17%. Moody's has taken this into account in its modelling, but given the low LTVs, this has not had a material negative impact on the Collateral Score

**The Collateral Score is 1.8%**

**Substitution Risk is mitigated by the strengths of the Covered Bond Legislation and Regulations along with programme-specific features**

The credit quality of the collateral in the Cover Pool is measured by the Collateral Score, which can be seen as the amount of risk-free enhancement required to protect a **Aaa** rating from otherwise unsupported assets. This considers only the credit deterioration of the assets and ignores any risk from refinancing and market risks (see Related Research). For this transaction, the Collateral Score is 1.8%.

As with most covered bonds in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk.

Mitigants to substitution risk that should protect the quality of the Cover Pool over time include:

- a) Provisions in the Legislation that restrict issuance of Covered Bonds only against mortgages with an LTV up to: (i) 75% of the prudent market value for residential properties; or (ii) 60% of the prudent market value for commercial properties.
- b) As per the regulations, the Issuer will not take into account non-performing loans (over 90 days in arrears) when computing all matching requirement tests. However, the priority right of the Covered Bond investors remains as long as such loans are registered in the Cover Pool.<sup>4</sup>
- c) The ongoing ability of the Issuer to ensure that non-eligible loans are removed from the Cover Pool.
- d) The Issuer is committed not to include any commercial loans in the cover pool.

In the near term Moody's expects the Cover Pool to continue to consist solely of Norwegian residential mortgage loans. The Issuer has stated it does not at present intend to finance assets other than Norwegian residential mortgage loans.

### **3) Refinancing the Cover Pool**

Where the "natural" amortisation of the Cover Pool assets alone cannot be relied upon in order to repay the principal component of the Covered Bonds, Moody's assumes that funds must be raised against the Cover Pool at a discount. Given (i) the ability under Norwegian law to reset the margin on floating-rate loans with six weeks' notice to the borrower, and (ii) extendable maturity on the Covered Bonds, refinancing risk is relatively well addressed in this transaction.

### **4) Market Risk**

At the date of this report, it is understood that the majority of the Covered Bonds will be fixed-rate bonds denominated in Norwegian krone as well as in other currencies. At the same time, 100% of the Cover Pool is denominated in Norwegian krone, with the majority of assets being floating rate.

For the small proportion of fixed-rate assets the Issuer is expected to enter into asset side swaps with suitably rated counterparties in order to mitigate the interest rate risk. On the liability side, swaps are expected to be entered into where notes are issued in currencies other than NOK.

Moody's considers the current swaps that have been drafted for this programme to be stronger from a credit point of view than many of the other swaps found in the covered bond market. Specific provisions have been included which should:

- i) increase the probability that the swaps will survive a late payment to the covered bondholders (prior to an administrator calling a "halt of payments");
- ii) improve liquidity through an extended grace period; and
- iii) increase the chances of timely payments should any administrator be required to sell assets.

<sup>4</sup> Mortgage loans in arrears will not be allowed to be added to the Cover Pool, but mortgage loans that move into arrears while in the Cover Pool will remain (although the member banks have the ability to replace these assets with performing assets should they so choose).

## DE-LINKAGE AND RATING SENSITIVITY

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**The creditworthiness of the Covered Bonds will be affected by the credit strength of the Sponsor Bank and the quality of the Cover Pool**

All covered bonds have an element of rating linkage to (a) the transaction counterparties and (b) the supporting collateral. Accordingly, the creditworthiness of the Covered Bonds will be affected by the credit strength of the transaction counterparties and the value of the Cover Pool.

Areas of linkage that affect most covered bond transactions include:

- Refinancing risk: Following Sponsor Bank Default, if principal receipts from collections of the Cover Pool are not sufficient to meet the principal payment on a covered bond, funds may need to be raised against the Cover Pool. However, the fact that the Sponsor Bank has defaulted may negatively impact the ability to raise funds against the Cover Pool.
- The dynamic nature of the transaction: For example, up to Sponsor Bank Default new assets may be added to the Cover Pool, new bonds issued, and new hedging arrangements entered into.
- More generally, the incorporation of the credit strength of the Issuer in Moody's rating methodology.

The probability of default on the Covered Bonds may be higher than expected for **Aaa**-rated senior unsecured debt. However, Moody's primary rating target is the expected loss which also takes severity into account, which in this case is consistent with a **Aaa** rating. Furthermore, the Covered Bonds will come under increasing rating stress as the Sponsor Bank's credit strength deteriorates.

The following are selected features of the Covered Bonds that reduce the linkage of the Covered Bonds to the credit strength of the various transaction parties and the collateral:

**There is a maximum refinancing period during which the Cover Pool can be monetised if requested.**

**Extendable maturity on the Covered Bonds.** There is a maximum refinancing period of 12 months between the scheduled and final maturity date during which the Cover Pool can be monetised if required. This increases the probability that investors will be repaid on a timely basis following Sponsor Bank Default.

**Regulatory provisions aim to ensure prudent management of liquidity and interest rate risk. However, these provisions need to be interpreted on an Issuer-specific basis.**

- **Liquidity matching requirements in the Regulations.** In accordance with the Regulations,<sup>5</sup> TBK has established liquidity risk guidelines and limits. In Moody's understanding, the Issuer will always have 6 months of net cash outflow covered by liquidity instruments.

- **Swap provisions.** The swaps are expected to be stronger than typically found in covered bond transactions which should limit linkage between the credit strength of the Issuer and the rating of the Covered Bonds. For example, provisions are expected to be included that mean swaps should survive in the event of a delayed payment following Issuer Default.

- **Provisions that aim to ensure that the Cover Pool has substantial value at the time of Sponsor Bank Default.** The legal framework requires the Issuer to carry out assets/liability matching tests both on a par value and on a net present value basis. See also the eligibility criteria and the restrictions imposed by the Legislation and Regulations discussed above.

## ORIGINATOR, SERVICER AND OPERATIONS REVIEW

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**Review**

Moody's visited TBK. We have not visited member banks of Terra Group which originate and service the loans for TBK.

**Origination**

However, TBK has put in place origination criteria that need to met by all member banks. In case of material violation of these criteria, the loans have to be bought back by the relevant member bank.

**Guarantees**

Furthermore, member banks are providing guarantees which support the performance of the pool. *Inter alia*, each bank covers any loss that arises on the portion of the loan that is in excess of 50% LTV. This loss guarantee help align the incentives of the member banks to that of the Issuer.

<sup>5</sup> The Regulations stipulate that liquidity risk should remain within prudent limits at all times. Limits should be established, regulating divergence between future receipts and future payments.

## **Valuation**

Valuations may be prepared through a number of different means. Accepted valuations include those based on purchase contracts, which is unusual outside Norway. Moody's does usually penalise this type of valuation in its collateral analysis, however given the low LTVs currently in the Cover Pool, no penalty has been applied to these loans currently. Further, going forward Moody's expects automated desk top valuations to be used.

## **Moody's will monitor this transaction.**

## **MONITORING**

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Moody's monitors the transaction on an ongoing basis including checking supporting ratings and reviewing the assets. Any subsequent changes in the rating will be publicly announced and disseminated through Moody's Client Service Desk.

## **RELATED RESEARCH**

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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:

### **Rating Methodology**

- Moody's Rating Approach to European Covered Bonds, published 13 June 2005 (SF57011)

### **Special Report**

- European Covered Bond Legal Frameworks: Moody Legal Checklist, published 8 December 2005 (SF66418)

*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.*

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