

**Credit Opinion: Kosice, Region of**

**Kosice, Region of**

*Slovak Republic*

**Ratings**

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa1.sk
Issuer Rating -Dom Curr	A3

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**Key Indicators**

**Kosice, Region of**

	2004	2005	2006	2007	[1]2008
Net Direct and Indirect Debt/Operating Revenue (%)	0.00	19.45	19.44	37.20	47.05
Interest Payments/Operating Revenue (%)	0.00	0.00	0.00	0.00	0.57
Gross Operating Balance/Operating Revenue (%)	1.14	7.76	8.33	9.80	3.87
Cash Financing Surplus (Requirement)/Total Revenue (%)	-0.02	1.95	1.06	1.07	-17.22
Discretionary Own Source Revenue/Operating revenue (%) [2]	5.05	14.45	13.95	15.53	14.56
Self-financing ratio	1.00	1.00	1.00	1.00	0.44
Capital spending/Total expenditure (%)	11.07	10.67	8.17	10.93	26.13

[1] Budget adjusted as of August [2] Own taxes + non-tax revenue

**Opinion**

**SUMMARY RATING RATIONALE**

The Region of Kosice's local currency issuer rating of A3 and national scale issuer rating of Aa1.sk reflect a number of factors, including the focused and disciplined fiscal policy applied by the administration, the region's improving operating performance to date and the low level of systemic risk. The ratings are constrained by the weak financial prospects of the region's hospitals (one of key regional responsibilities), its rigid expenditure structure and broad reliance on central government transfers, with only limited leeway to generate additional own-source revenue.

**Credit Strengths**

Credit strengths for the Region of Kosice include:

A focused and disciplined fiscal policy currently in place

Improved operating performance underpinned by recent changes in the financial framework

A low level of systemic risk

## **Credit Challenges**

Credit challenges for the Region of Kosice include:

Weak financial prospects for hospitals, one of the region's key responsibilities, that would require its ongoing financial support

Comparatively high debt burden

Limited revenue flexibility and expenditure rigidity

## **Rating Outlook**

The outlook for Kosice's ratings is stable, reflecting Moody's expectation that the region will maintain its prudent policies and that the rising debt burden will stabilise in 2009.

### **What Could Change the Rating - Up**

Only significant changes within the institutional framework aimed at augmenting the region's self-funding and debt-repayment capacity, notably by promoting discretionary own-revenue streams and broadening spending autonomy, would be likely to exert upward pressure on the rating.

### **What Could Change the Rating - Down**

A decrease in operating margins in the range of low single-digit percentage points on operating revenues or even a moderate increase in the stock of debt above the 2009 target would exert downward pressure on the rating.

## **Recent Results and Developments**

Moody's believes that the financial prospects of Kosice's hospitals should not deteriorate further; thus, the related risk will remain manageable. In December 2008, the regional assembly voted to allow private partnership of its hospitals. The tender is in a preparatory phase and is expected to be concluded in H1 2009. At this stage it is still unclear how the hospitals' pending overdue commercial liabilities will be resolved; there is a possibility that the tendered private partners or even central government will take them over. Moody's is comforted by the regional statements that the resolution of hospitals' liabilities will not require new issuance of debt by the region.

## **DETAILED RATING CONSIDERATIONS**

The rating assigned to the Region of Kosice reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the region and then considers the likelihood of support that the national government would provide to prevent a default by the region.

### **Baseline Credit Assessment**

The Region of Kosice's BCA of 8 (on a scale of 1 - 21, where 1 represents the lowest credit risk) reflects the following factors:

**Financial Position and Performance** - The new fiscal arrangements adopted in 2005 along with Kosice's disciplined fiscal policy boosted its operating performance. While the robust economic growth on the national level boosted the region's operating revenue, the operating expenditure remained well under control over the past three years. As a result, the region gradually improved its operating margins and gross operating balance (GOB), averaging a solid 8.6% of operating revenue over 2005-07.

The region's medium-term fiscal plan forecasts a GOB average of 3.0% of operating revenue, which Moody's assumes as a typically conservative projection. Despite lower income from motor vehicle tax (the tax base shrunk for 2008 only) and an emergency facility provided to one of the region's hospitals, we believe that 2008 GOB will beat its current projection of 3.9%. Our assumption is mainly based on the fact that the fast growing national economy in the recent past will boost the region's personal income tax (PIT) revenue in 2008. Moody's notes that the risk of a significant slowdown in the national economy and a corresponding slowdown in the region's revenue beyond 2008 is becoming highly likely under the current macroeconomic framework. However, we believe the Region of Kosice's fiscal management can adjust its budgetary policy to keep the region's operating expenditure under control.

The traditionally cautious approach toward capital investments (capex) funding by Kosice's management was reflected in the region's pre-funding surpluses for five of the past six years. This will change with the implementation of a massive capex programme funded mainly by debt in 2008 and 2009. During this period, the

region is expected to post broad, double-digit pre-funding deficits, averaging 13.9% of operating revenue. Beyond 2009, as the region's capex becomes considerably scaled down, the pre-funding balances are expected to return to the black.

**Debt Profile** - Despite a modest overall surplus in 2007, the Region of Kosice's direct and indirect debt-to-operating revenue ratio jumped to 36.2% in 2007 from 19.4% a year before. The region slightly over-borrowed in 2007 as some capex payments were postponed to early 2008. Along with speeding up capex implementation in 2008-09, the region's total debt is expected to soar to 54.3% of operating revenue in 2009. The overall debt consists mainly of long-term maturities, represented by bank loans and public and private partnership (PPP) liabilities. There is significant exposure to supra-nationals through the EIB's 30-year credit facility that will account for 63.6% of the region's debt burden at the end of 2009. All bank loans carry floating interest rates. The market-to-market value of interest rates swaps, which the region is using for the EIB's first and second tranches, was slightly positive at the end of September 2008. The region's overall debt burden is denominated in Slovak korunas and euros. The region decided not use any foreign exchange hedging, but Moody's assumes that the risk arising from the exchange rate volatility is fully mitigated by Slovakia's planned entrance into the Eurozone in January 2009.

Despite the aforementioned increase in total debt and given the amortising structure of all debt and the Region of Kosice's skilled fiscal management and no commitment to raise additional debt, we believe that the region's debt service will remain manageable. The Region of Kosice's debt repayments are set to peak in 2010 at a moderate 5.4% of operating revenue, which is within the region's repayment capacity given GOB averaging 8.6% of operating revenue in 2005-07.

The fragile financial position of four daughter companies running hospitals still poses a risk to the region. The region's oversight proved to be ineffective in preventing one of the companies' mismanagement and mounting overdue commercial liabilities. In 2008, the region was forced to step in and pour SKK20 million (EUR 0.7 mil) into the company's equity to prevent its financial collapse. It is expected that the region's Assembly will decide, by the end of 2008, whether to involve private partners, either in the form of a sale or lease, in the region's healthcare companies. Moody's notes that early entry of an experienced private partner would ease our concerns regarding the companies' future performance. However, there is still some risk that the region would need to take over part of the companies, pending commercial liabilities before private partner entry. Taking into account the total amount of short-term commercial liabilities of these four hospital companies (8.5% of the region's operating revenue in 2007, of which 16.2% was overdue), we believe the region is capable of tackling the problem without experiencing any major financial impact.

**Governance and Management Factors** - The region's administration, headed by Mr. Zdenko Trebula, is skilled, focused and disciplined. The region's relatively strict fiscal approach applied in recent years is not expected to weaken substantially in the foreseeable future. The management's fiscal approach is underpinned by improved operating margins and focused fiscal planning. Despite a significant increase in debt, we consider the region's investment strategy as relatively prudent and fairly predictable. In the light of recent financial tension in one of the region's hospitals, Moody's believes that the region will intensify oversight of its daughter companies to minimise the risk of any unexpected financial intervention going forward.

**Economic Fundamentals** - Kosice is the second-largest region in Slovakia with more than 770,000 inhabitants and is located in the eastern part of the country. It has a slowly growing population (2001-06: +1%), compared to a stagnant national population. The region's negative migration flows are triggered by a depressed regional economy, but are fully offset by positive natural population inflows. Despite this fact, the region's population, in line with national demographic trends, is ageing. The proportion of residents aged over 65 (11%) is slightly below the national average (12%), but is expected to gradually rise. This will create pressure on social services, which are also a regional responsibility in Slovakia.

Kosice is Slovakia's third-richest region, according to GDP measures (on a GDP per capita basis, the region reaches around 89% of the national average). The regional output is significantly influenced by the City of Kosice's very strong industrial base, while the rest of the region is industrially underdeveloped. The regional economy is service- and industrial-based, with a relatively strong agricultural foothold. The regional economy has still not fully recovered from the downturn that occurred in the early 1990s, which affected all the important sectors - construction, machinery, heavy industries, chemical, food and agriculture. However, given the institutional and financial framework under which Slovak regions operate - local economic fundamentals only have a marginal impact on their budgets and the growth of the national economy is a key factor - Moody's does not focus closely on the local economic environment. Conversely, the legal framework is the key credit factor due to its critical influence on these issuers.

**Operating Environment** - The operating environment for Slovak RLGs reflects that of OECD emerging market economies, with relatively high GDP per capita within the emerging markets universe, modest GDP volatility and relatively high ranking on the World Bank's Government Effectiveness Index. The combination of these characteristics suggests a low level of systemic risk, as reflected in the A1 rating assigned to the debt issued by the national government.

**Institutional Framework** - Even though the institutional framework for the regional tier of local governments in Slovakia is very young, it is relatively stable and predictable. The self-governing regions were established only in 2002 and have gradually been given responsibilities by the central government. The main responsibilities that have been handed over include the education sector (secondary and specialised schools), regional roads, cultural

centres, healthcare centres and hospitals. Finally, the new financial framework for regions was introduced in 2005. Looking forward, the transfer of any sizable new responsibilities and revenues, excluding those related to regional railways, is unlikely in the foreseeable future. Based on previous experience, Moody's has some concerns that the central government may try to squeeze the funding of existing responsibilities or try to under-finance new responsibilities if redistribution is launched. However, these concerns are mitigated by the regions' size and importance, as well as by procedures for negotiation with regional representatives that must be followed before major changes to the institutional framework may be implemented.

From 2008, the Slovak public sector has switched to accrual accounting under International Financial Reporting Standards (IFRS). In the first stage of this process, the accounting will remain de-linked from budgeting, which will continue on a cash basis. The implementation of IFRS currently represents, by far, the biggest challenge for Slovak municipalities. Not only did the government fail to prepare all necessary guidelines well in advance, but the time schedule for training staff and adjusting IT systems was also very challenging. Moreover, municipalities have to switch to programme budgeting from 2009 along with the adoption of the euro.

Under the current regional government framework in Slovakia, regions have limited scope for control over operating revenue, which is generated by PIT and set and collected nationally, and by transfers from the state budget. As much as 82% of the regions' operating revenue comes from the central government in the form of shared taxes or transfers. The remainder consists of motor vehicle tax, accounting for 12% of operating revenue, and other non-tax revenue (6%), thus limiting the regions' ability to tap into wealth generated by the local economy. While regions only enjoy broad discretion over the motor vehicle tax, the impact of tax rate changes on regional budgets is limited by their relative importance within the budget. The volume of the regions' capital revenue is very volatile from year-to-year; it typically stems from the sale of property and earmarked transfers.

The flexibility of regional expenditure is not much better. Two of the main components of operating expenditure - personnel (38% of 2005 operating expenditure) and transfers to companies/population (39%) - are extremely rigid and the regions' ability to control their growth is very low. The majority of this spending is mandated by national law, with some programmes directly funded by the central government through earmarked transfers provided to the regions. The third category of expenditure - energy and services (23% of 2005 operating expenditure) - is provided mostly by commercial partners, based on long-term contracts, with pricing driven by the market. The only leeway the regions have is flexibility over capex. However, the volume of spending on capital items is strongly correlated with capital revenue - hence, capex is highly volatile. The regions' capex represented 11% of total expenditure in 2005 and part of it (16%) was funded by earmarked transfers. Consequently, the regions' capex flexibility is less than 10% of total expenditure.

The regions' debt level is very low (3% of operating revenue in 2005), reflecting their short history and sufficiency of funds to finance regional responsibilities. Moody's expects the regions' debt to grow steeply in the next few years, as they need to upgrade regional infrastructures to EU standards following Slovakia's entry into the EU. However, we do not expect any excessive rise in the regions' indebtedness under the limits imposed on regional debt and debt service (which cannot exceed 60% and 25% of operating revenue, respectively).

Slovak regions enjoy adequate liquidity. Although the most important operating revenue component (PIT) fluctuates during the year, with revenues typically highest in the first quarter/half, the regions do not face any liquidity problems. There is almost no fluctuation on the operating expenditure side and relatively high fluctuation on the capex side. As regions technically enjoy full discretion over capex, this can be synchronised with their cash flows.

### **Extraordinary Support Considerations**

Moody's ratings of A3 and Aa1.sk reflect the BCA of 8 and our assessment of the moderate likelihood of extraordinary support from the central government (A1, positive), which takes into account the importance of the regions within the Slovak public sector, given their wide scope of responsibilities. This represents some incentive for the central government to intervene in case of financing needs so to avoid a possible political embarrassment.

Moody's rating committee also assesses a very high level of default dependence, reflecting a heavy reliance on central government resources, either in the form of shared taxes, which are determined and collected nationally and redistributed on a formula basis, or transfers.

### **Output of the Baseline Credit Assessment Scorecard**

In the case of Kosice Region, the BCA scorecard (presented below) generates an estimated BCA of 7, close to the BCA of 8 assigned by the rating committee.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength; however, the estimated BCAs generated by the scorecard do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Concomitantly, scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength.

Moreover, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our analysis. Nevertheless, the performance statistics captured in the scorecard are important and, in general, higher ratings can be expected among issuers with the highest rankings from the scorecard.

## **ABOUT MOODY'S SUB-SOVEREIGN RATINGS**

### **National and Global Scale Ratings**

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.

The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

### **Country Ceilings for Foreign Currency Obligations**

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

### **Baseline Credit Assessment**

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

### **Extraordinary Support**

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

### **Default Dependence**

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can materially change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high

(71% - 100%).

## Rating Factors

Kosice, Region of

Baseline Credit Assessment			Sub-Factor	Sub-Factor	Factor	Total
Scorecard - 2007	Value	Score	Weighting	Total	Weighting	
Factor 1: Operating Environment						
National GDP per capita (PPP basis, \$US)	18,914	9	50.0%	6.75	60.0%	4.05
National GDP Volatility (%)	3.5	3	25.0%			
National Govt Effectiveness Index (World Bank)	0.76	6	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.01	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	15	15	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	7.5	7.5	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	0.0	1	33.3%	4.33	7.5%	0.33
Cash Financing Surplus(Req)/Total Revenue (%)	1.2	6	33.3%			
Gross Operating Balance/Operating Revenue (%)	9.1	6	33.3%			
Net Working Capital/Total Expenditures						
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	37.2	1	50.0%	7.25	7.5%	0.54
Short-Term Direct Debt/Direct Debt (%)	51.0	12	25.0%			
Net Debt/Operating Revenue Trend	146.7	15	25.0%			
Factor 5: Governance & Management						
Fiscal Management	1	1	40.0%	2.30	7.5%	0.17
Investment & Debt Management	7.5	7.5	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated (\$US)	16,741	9	100.0%	9.00	7.5%	0.68
Estimated BCA						7

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