

Credit Opinion: Banco del Estado de Chile

Banco del Estado de Chile

Santiago, Chile

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits -Fgn Curr	A2/P-1
Bank Deposits -Dom Curr	Aa1/P-1
Bank Financial Strength	C+
Banco Estado, New York Branch	
Outlook	Stable
Bank Deposits	A2/P-1

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Key Indicators

Banco del Estado de Chile

	[1]2008	2007	2006	2005	2004	Avg.
Total Assets (US Millions)	28019.15	24877.53	20155.80	20193.78	15098.75	[2]22.61
Total Equity (US Millions)	1194.90	1176.47	953.03	868.42	742.23	[2]17.92
ROAA	0.52	0.46	0.48	0.42	0.57	0.47
ROAE	11.84	9.69	10.52	9.21	11.27	9.73
NIM	4.08	3.02	3.29	2.90	2.73	2.84
NPL % Gross Loans	1.27	1.20	0.79	0.72	0.84	0.94
NPL % (Share Eq.+ Res)	14.49	12.61	8.46	7.66	8.17	9.56
Op.Exp. % Op.Inc.	56.86	57.61	59.84	60.69	64.55	61.07

[1] As of June 30. [2] Compound annual growth rate.

Opinion

SUMMARY RATING RATIONALE

BancoEstado's C+ bank financial strength rating (BFSR) reflects the bank's extensive franchise, solid profitability and asset quality, as well as its relatively low risk balance sheet. Lower profit ratios than those of peers reflect the bank's more liquid and hence less risky balance sheet, which results in lower margins and pre-tax profitability. High loan growth and borrower concentrations are also risks for BancoEstado as for Chilean banks in general. The C+ BFSR translates to a Baseline Credit Assessment of A2.

Moody's believes that BancoEstado's local currency deposits would receive full support based on its government ownership, policy mandate, and the importance of its deposit franchise as the third largest deposit-taking institution in Chile, with 87% of savings accounts in the system. This assumption of support lifts BancoEstado's global local currency deposit ratings to Aa1. BancoEstado's A2 long term foreign currency deposit rating is constrained by the A2 Chile country ceiling for deposits. The Aa1 local currency and A2 foreign currency deposit ratings apply also to Banco del Estado's New York branch.

BancoEstado is Chile's only public sector bank, with a significant economic and social role, and is a leading full

service commercial bank. Its primary mission is to promote home ownership and finance and to provide banking services to low and middle income individuals, as well as to underserved segments of the population in order to promote national savings. Management's strategy has been to diversify the business mix by expanding in consumer, small business, and microfinance lending coupled with fee-based insurance and payment products. BancoEstado reported US\$ 27.4 billion in assets (CHP 14,765 billion), \$16.7 billion in deposits, and \$1.2 billion in equity as of June 30, 2008.

Credit Strengths

- Third largest bank in deposits (16% market share), loans and fees (14% and 13%), and second largest in insurance brokerage
- 100%-owned and implicitly guaranteed by the Republic
- Most geographically dispersed network in the country and the largest in ATMs through alliances with D&S and La Polar
- Conservative, forward-looking professional management focused on commercialization and electronic delivery
- Robust and granular core deposit base and relatively liquid balance sheet
- Solid asset quality with risk management having been tested through down cycle
- Solid risk-weighted pre-provision profitability and improving operating efficiency

Credit Challenges

- Lower profitability ratios and higher operating leverage relative to private sector peers' due in part to social mission and higher tax rate
- Slowing economy, rising inflation, and interest rates could further impact portfolio growth and quality
- Maintenance of good asset quality and cost control
- High corporate borrower concentrations remain a potential source of earnings and asset quality volatility
- Heightening competition in all customer segments in a relatively mature market
- Government ownership lends itself to public scrutiny which slows its ability to cut costs

Rating Outlook

The outlook for BFSR and deposit ratings is stable.

What Could Change the Rating - Up

Upward pressure on the BFSR could come about if BancoEstado's profitability improves significantly coupled with continued strong asset quality and liquidity, as well as reduced borrower concentrations. As the long term foreign currency deposit rating is constrained, an upgrade would result from an upgrade of the country ceilings.

What Could Change the Rating - Down

Downward pressure on the BFSR could result from a marked decline in financial fundamentals. The foreign currency deposit ratings would decline with a downgrade of the country ceilings.

Recent Results and Developments

2007 earnings rose 5.8% in peso terms to US \$106.8 million, primarily reflecting higher trading and mark-to-market gains and affiliate income as net interest income rose a slight 1.8%. The adjusted net interest margin (including hedges) declined 3% from 3.33%, due mainly to higher funding rates that largely offset the benefits of growth in commercial and mortgage loan volumes. Provisions have also taken a larger bite out of earnings throughout the year (39% up from 30% in 2006). Net income from fees and commissions were also weaker by 4.7%.

BancoEstado continued to control operating costs (up a modest 4%) despite strong business growth. Pre-provision profit to average risk-weighted assets improved slightly to 3% from 2.8%, boosted by increased income from

subsidiaries and affiliates, and non-operating income. Return on average assets and equity remained relatively stable at 0.46% and 9.7%, respectively, reflecting higher provisions and monetary correction.

Asset quality deteriorated during the year as non-performing loans rose a sharp 78.6% on a nominal basis to reach 1.2% of gross loans, a 40-50 basis point increase from record lows a year earlier. While this trend is in line with rising non-performers in the system, BancoEstado's rate of increase far surpassed that of the system and of its large peers reflecting high consumer lending growth in recent years. This level nonetheless continues to be low relative to regional and global peers while the bank also maintains conservative reserve coverage levels. The bank's above average liquidity and adequate capitalization provide solid support to its expanding operations.

First half 2008 results continued solid with improved NIM and pre-provision profit to average RWA as rising funding and provisioning costs were offset by higher income on inflation-indexed assets and costs remained under control. NPLs rose another 10 basis points to 1.3% (20% on nominal basis) and reserve coverage declined as a result of increased write-offs in the consumer book.

DETAILED RATING CONSIDERATIONS

Detailed considerations on BancoEstado's ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a C+ BFSR to BancoEstado in light of its important franchise, conservative management, and earnings capacity in the context of its social mission. This mission tends to limit the bank's diversification potential, as well as its profitability and pricing power on an after tax basis. High borrower concentrations, coupled with the potential earnings impact of deteriorating asset quality, are also risks Moody's views for the Chilean banks in general.

As a point of reference, the assigned BFSR is one notch below the outcome of Moody's bank financial strength rating scorecard. In the case of BancoEstado, the scorecard does not fully capture the limitations to the bank's earnings capacity or the extent of the competitive challenge in Chile.

The BFSR scorecard outcome was positively affected by both quantitative and qualitative indicators, including the bank's financial fundamentals, franchise value, and Chile's strong regulatory framework. Chile's relatively high score for the operating environment of C+, when compared with other developing market countries, also bolstered the final score. The scorecard outcome continues to be tempered by the risk positioning score that generates a D+, heavily influenced by the low score on borrower concentration.

Qualitative Rating Factors (70% weighting)

Factor: Franchise Value

Trend: Improving

BancoEstado scores a C+ for franchise value, reflecting its importance as the third largest bank in Chile. The bank's operating footprint across Chile, characterized by a broad and diverse client base of companies, low and middle income individuals, and underserved segments of the population generates relatively stable earnings.

BancoEstado is the market leader in savings deposits and residential mortgages for low to middle income individuals and also lends to large and medium sized corporations. The bank is also one of the largest providers of administrative and transaction services to government-owned and private enterprises, including payroll services. The bank also has one of the largest treasury operations in the country as a primary dealer in government securities and serves as an important source of liquidity to the system. BancoEstado may not lend to public sector entities and hence is more insulated than the typical public sector bank from politically-based lending pressure.

Moody's has a positive view on BancoEstado's ability to maintain its solid franchise value. Its public policy *raison d'être* continues to support growth and diversification and its alliances with non-banks should continue to strengthen the bank's competitive position. In recent years, BancoEstado has significantly expanded the distribution of insurance products through its alliance with MetLife of the US, its ATM network through alliances with local D&S and La Polar retailers, as well as its micro-finance and small business lending activities. Its New York branch offers trade and cash management services to Chilean corporations.

BancoEstado's C+ score for franchise value in the scorecard is negatively affected by the D score for geographic diversification based on Chile's GDP, which is applied to all Chilean banks with a national presence.

Factor: Risk Positioning

Trend: Neutral

BancoEstado's risk management structure reflects policies and practices commensurate with the bank's risk profile and business mix. BancoEstado has a rating of D+ for risk positioning that is negatively affected by the bank's borrower risk concentration and corporate governance scores. At the same time, the bank receives relatively high scores for controls and risk management, financial reporting transparency, and liquidity management.

BancoEstado's low score for borrower risk concentrations, which is more heavily weighted in the scorecard, is not uncommon for major lenders in Chile because of their size, large lending books, and the limited depth of the local loan sales and securitization markets. The bank's largest borrowing clients are nevertheless among the best names in the market. The score overrides the bank's above average score for industry concentrations.

The D corporate governance score also negatively affects the risk positioning score but only because of BancoEstado's government ownership rather than on major issues related to corporate governance. The bank's government ownership is equated to a closely held firm dominated by one shareholder, automatically scoring the bank at D for corporate governance. Though a public sector bank, BancoEstado meets the test for an independent board of at least 25% of its members, comparable to the standards of private sector institutions.

Management sets high standards and procedures for the bank's risk management and controls, and liquidity management for which it scores a B. The bank has a well established risk management structure as well as a deep bench of experienced credit and market professionals. The bank's trading activities are primarily related to its large government securities portfolio and dealing in foreign exchange forwards for clients, as BancoEstado is primarily a loan and deposit-taking bank as are the Chilean banks in general. Its market risk appetite score of C is the average for the large Chilean banks.

The bank publishes complete financial statements on a monthly basis; as of January 2008 they are completely based on IFRS. The statements provide comprehensive information about asset quality and capitalization, but limited with respect to business line performance, market risk exposure and stress testing information, and details on the largest credits.

Factor: Operating Environment

Trend: Improving

All Chilean banks are subject to the same score on operating environment, which is scored C+. This incorporates a score of D for economic stability, and B scores for integrity and corruption and for the Chilean legal system. Economic stability is based on the standard deviation of Chile's nominal local currency GDP growth rates during the last 20 years. The integrity and corruption score is taken from a World Bank index, which ranks 212 countries worldwide. The predictability and fairness of the Chilean legal system is based on our chosen proxy of the typical time (i.e., one to two years) it takes to foreclose on a residential mortgage.

Factor: Regulatory Environment

Moody's assessment of Chile's regulatory environment considers its proven institutional framework and high standards, the independence of its regulatory body, and its 20-year history of setting and enforcing prudential standards. The assessment also incorporates the supervisors' enforced asset quality measurement, loan loss provisioning and write-off rules, capital and liquidity regulations, and restrictions regarding related-party transactions. We also consider the Chilean regulators' track record of preventive and corrective measures and their increasing commitment to transparency assisted by a comprehensive and user-friendly website (www.sbif.cl).

The Chilean regulators continue to bolster regulatory and accounting standards through the adoption of IFRS, the latter which became effective in January 2008, as well as regional leadership on Basel II together with the other major countries. The system's transition toward Basel II dovetails with improvements in regulation and supervision that have been implemented during the last two decades.

Quantitative Rating Factors (30% weighting)

Factor: Profitability

Trend: Neutral

BancoEstado's risk-weighted recurring earnings power falls short when compared to its larger peers, but still generates an average score of C on the global scorecard. The profitability score, which includes efficiency on our scorecard, is BancoEstado's lowest financial factor scores, and therefore receives a 30% extra weighting relative to other financial factors.

The bank has been generating higher net interest income and fees aided by new business alliances and products (e.g., insurance, factoring, ATMs, and electronic banking). Nevertheless, the bank's fee generation capacity and pricing policy remains limited partly because of its important role in bancarización, i.e., offering financial services to under-banked customers throughout Chile.

BancoEstado's operating expense base relative to earnings reflects in part the bank's mission as well as continuous technology upgrades of its branch and ATM network and other points of sale. BancoEstado's higher cost structure and tax rate (56.5%) claim more of the bottom line than do those of the other banks, however, net income has grown healthily in recent years.

We have refined our analysis of the Chilean banks by adjusting risk-weighted assets following the guidance of Basle II to allow for comparability across markets. We believe that reported risk-weighted assets may not be fully reflective of the bank's asset risk profile since sovereign exposures (rated A1 by Moody's in local currency) are currently weighted at 0%. We therefore adjusted the banks' average risk-weighted assets by assigning a 50% weight to government securities instead of the 0% weight required by Chilean regulators and 50% to mortgage loans instead of 60%. The capital adequacy score (adjusted) was lowered to C+ from B as a result, because of the bank's large holdings of government securities; however, this did not affect the final scorecard outcome.

Factor: Liquidity

Trend: Neutral

BancoEstado scores B for liquidity. The liquidity score is a combination of two scores, and BancoEstado scores B on both. The qualitative sub factor measures the quality of the bank's liquidity management. The quantitative measure reflects the bank's low dependence on market funds stemming from its strong core retail funding in the form of highly diversified and relatively inexpensive individual deposits. Its longer term loan book of high quality mortgages is match funded through letras hipotecarias (mortgage bonds) issued and traded in the market or through its deposits and capital base, allowing the bank to maintain a relatively strong liquidity position. BancoEstado's holdings of liquid assets to total assets (32%) are well above those of its peers and the system (22%).

Factor: Capital Adequacy

Trend: Neutral

BancoEstado's capitalization ratios are good compared to both its global and local peers, and lead to an adjusted score of C+. BIS capitalization well exceeds minimum regulatory standards and Moody's believes they adequately reflect the level of risk undertaken by BancoEstado.

Factor: Efficiency

Trend: Improving

BancoEstado's efficiency score is C. BancoEstado's efficiency ratio compares well to the global average, and increasingly better vis-a-vis its local peers. Given its developmental role, management expects efficiency ratios to remain above the system average (now 7 basis points differential). Increasing efficiency gains will depend on the continued streamlining and automation of the bank's operations given the breadth of its network and social mission.

Factor: Asset Quality

Trend: Weakening

BancoEstado's asset quality score declined to B+ from A, as a result of a sharp increase in non performing loans as of December 31, 2007 to 1.2% from 0.8%. While this non-performing loan level is still relatively low, it is the highest since year end 2003. As of June 30, 2008, the NPL ratio rose another 7 basis points to 1.27% (a 14 basis point increase when adjusted for loan growth). We remain cautious as to the recent sharp upward trend in problem loans primarily from the consumer segment as well as the declining level of reserves, which covered 135% of problem loans as of June 30th, down from 171% as of year end 2007, and below an average 220% for the three previous years. Problem loans represented a high of 14.5% of reserves plus shareholders' equity, up from the prior three year average of 9.6%.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local currency deposit rating of Aa1 for BancoEstado, reflecting the bank's Baseline Credit Assessment of A2 (mapped from the C+ BFSR) and lifted to Aa1 by Moody's view that the bank's local currency deposit obligations would be fully supported by the system. Moody's assesses Chile as a high support country based on its history of no local currency deposit defaults exhibiting the Chilean authorities' high level of interest and willingness to support the stability of the financial system.

The support probability is measured against Chile's Aaa local currency country ceiling for deposits. This ceiling represents the risk that an important bank would be allowed to default upon local currency deposits either resulting from limited local currency resources or the imposition of a domestic deposit freeze. Moody's believes that

BancoEstado's local currency deposits would be fully supported based on its government ownership, policy mandate, and the importance of its deposit franchise to the Chilean financial system. This is reflected in the bank's Aa1 long term and Prime-1 short term local currency deposit rating.

Notching Considerations

Senior debt would be rated similarly to deposits. Junior obligations would be subject to Moody's standard notching practices.

Foreign Currency Deposit Rating

Moody's assigns an A2 foreign currency deposit rating to BancoEstado as well as to its New York branch. The rating is constrained by the country's foreign currency deposit ceiling.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the GLC rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of government support for the bank in case a stress situation occurs and the degree of dependence between the issuer rating and the LCDC.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be reminded that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt obligations may also be constrained by the country ceiling for foreign currency bonds and notes, however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Banco del Estado de Chile

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						B-	
Factor: Franchise Value						C+	Improving
Market Share and Sustainability		x					
Geographical Diversification				x			
Earnings Stability		x					
Earnings Diversification [2]							
Factor: Risk Positioning						D+	Neutral
Corporate Governance [2]				x			
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management		x					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency		x					
- Global Comparability		x					
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration					x		
- Borrower Concentration					x		
- Industry Concentration		x					
Liquidity Management		x					
Market Risk Appetite			x				
Factor: Operating Environment						C+	Improving
Economic Stability				x			
Integrity and Corruption		x					
Legal System		x					
Financial Factors (30%)						B-	
Factor: Profitability						C	Neutral
PPP % Avg RWA		2.78%					
Net Income % Avg RWA				0.80%			
Factor: Liquidity						B	Neutral
(Mkt funds-Liquid Assets) % Total Assets		-7.89%					

Liquidity Management		x					
Factor: Capital Adequacy						B	Neutral
Tier 1 ratio (%)			7.61%				
Tangible Common Equity % RWA	7.61%						
Factor: Efficiency						C	Improving
Cost/income ratio			59.38%				
Factor: Asset Quality						B+	Weakening
Problem Loans % Gross Loans		0.90%					
Problem Loans % (Equity + LLR)	9.58%						
Lowest Combined Score (9%)						C	
Economic Insolvency Override						Neutral	
Aggregate Score						B-	
Assigned BFSR						C+	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information

[2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral

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