

**Sovereigns
Dominican Republic
Credit Analysis**

Dominican Republic

Ratings

Security Class	Current Ratings
Foreign Currency	
Long-Term IDR	B
Short-Term IDR	B
Local Currency	
Long-Term Local Currency	B
Country Ceiling	B+

Outlook

Sovereign Foreign Long-Term IDR	Stable
Sovereign Local Long-Term IDR	Stable

Financial Data

Dominican Republic		
	2007e	2008f
GDP (USDbn)	41	45.6
GDP per head (USD)	4,202	4,602
Real GDP, % change	5.9	6.9
Consumer prices, % change	6.1	10.7
Government debt, % GDP	22.2	21.9
Net external debt, % CXR	16.1	24.9
International Liquidity Ratio	79.3	98.1

Analysts

Theresa Paiz Fredel
+1 212 908 0534
theresa.paiz@fitchratings.com

Casey Reckman
+1 212 908 9155
casey.reckman@fitchratings.com

Related Research

- [Dominican Republic Electricity: On the Edge of Darkness](#)
- [Dominican Republic Banks: Review and Outlook](#)

Rating Rationale

- Fitch recently revised the Rating Outlook to Stable from Positive for both the Dominican Republic's foreign and local currency Issuer Default Ratings, reflecting increased concern that the Dominican Republic's comparatively weak liquidity position relative to 'B' peers will render the country more vulnerable to external shocks in an environment of lower global growth and tighter international liquidity conditions. In spite of the swift economic recovery since the Dominican financial crisis and progress on the structural reform front, a still fragile liquidity position combined with the recurrence of sizable twin fiscal and current account deficits this year constrain the ratings to current levels at this time.
- Although economic growth decelerated to 8.5% last year, it remained broad based and among the highest rates of growth in Latin America and the Caribbean. As is the case with other emerging markets, high international oil and food prices, as well as domestic demand pressures, fuelled an increase in year-end Inflation to 8.9% last year. A favorable balance of payments performance, underpinned by robust capital inflows, foreign direct investment in particular, drove international reserves to record levels in 2007. The country's liquidity position strengthened as a result, though it remained weak relative to peer credits. Similarly, robust economic growth, which contributed to higher than budgeted revenues, underpinned a non-financial public sector surplus of 0.1% of GDP in 2007.
- Nonetheless, advances on these fronts have already begun to unwind this year. In addition to the rapid expansion of the current account deficit, commodity price shocks along with aggregate demand pressures have also contributed to rising inflation, which peaked at 15% in the twelve months ending in August. Inflation averaged 10.1% over this same period. Similarly, the improvement in fiscal balances will be reversed this year, reflecting the increasing cost of large and poorly targeted energy subsidies, reconstruction costs and higher expenditure in the run-up to the elections. Fitch expects the fiscal deficit to reach 2.1% of GDP this year. Despite continued progress toward strengthening the policy framework, the authorities must manage these vulnerabilities carefully to ensure the maintenance of macroeconomic stability over the medium-term.

Key Rating Drivers

- The Dominican Republic's ratings would benefit from stronger external liquidity. Better estimations of short-term external debt underpin the weakness of the Dominican Republic's liquidity ratio, which is among the lowest of all sub-investment grade sovereigns.
- Maintenance of an appropriate policy response which resolves near-term challenges such as rapidly rising inflationary, as well as fiscal and external financing pressures, would be supportive of the sovereign's ratings to the extent that it bolsters confidence.
- By contrast, continued widening of the current account deficit, as well as sharp decline in non-debt creating capital inflows or a return of capital flight which results in downward pressures on the peso and an erosion of international reserves would be negative for the ratings.

Key Indicators for Dominican Republic

Population (2007): 9.8m
 GDP (2007): USD41.0bn
 GNI Per Head at Purchasing Power Parity (2006): USD8,290 (= 19% of USA level)
 Population Growth Rate (2002-2007): 1.6% p.a.
 GDP per Head at Market Exchange Rates (2007): USD4,202
 Modern Sovereign Rescheduling History: Official rescheduling (1985, 1986, 1991, 1992); Restructuring by private creditors (1983, 1986); Brady initiative (1994); Paris Club rescheduling (2004, 2005); Bond restructuring (2005); Restructuring by private creditors (2005)

	2004	2005	2006	2007	2008 ^f	2009 ^f	2010 ^f
Domestic Economy and Finance							
Real GDP Growth (%)	1.3	9.3	10.7	8.5	5.0	4.0	4.5
Unemployment (% of Labour Force)	18.4	18.2	16.2	15.6	14.5	14.5	14.5
Consumer Prices (Annual Average % Change)	51.5	4.2	7.6	6.1	10.7	10.8	7.9
Gross Domestic Savings (% of GDP)	15.7	11.0	10.4	8.2	6.2	5.4	5.0
Gross Domestic Investment (% of GDP)	14.9	16.5	18.4	18.9	20.1	21.3	22.7
Short-Term Interest Rate (%) ⁽¹⁾	36.8	12.6	10.6	8.2	12.0	10.5	8.0
Broad Money (% Change Dec to Dec)	8.8	22.0	16.3	22.1	8.0	12.0	15.0
DOP per USD (Annual Average)	42.12	30.41	33.36	33.26	35.07	36.30	37.01
REER (CPI, 2000=100)	79.3	104.5	99.1	100.9	97.3	92.6	88.9
REER: % Change (+ = Appreciation)	6.3	31.7	-5.2	1.7	-3.5	-4.8	-4.0
Public Finances							
General Government Balance (% of GDP)	-3.5	-0.6	-1.1	0.1	-2.1	-1.2	-0.7
General Government Debt (% of GDP)	25.2	26.6	23.8	22.2	21.9	20.5	18.9
General Government Debt Maturities (% of GDP) ⁽²⁾	2.7	2.8	3.4	2.4	2.1	1.6	2.0
General Government Debt/Revenue (%)	179.9	170.6	147.5	125.0	134.7	132.8	124.7
Interest Payments/Revenue (%)	13.0	8.4	8.6	7.0	11.6	10.5	9.4
Balance of Payments							
Current Account Balance (USDm)	1041	-473	-1262	-2231	-3640	-2827	-2765
Current Account Balance (% of GDP)	4.8	-1.4	-3.5	-5.4	-8.0	-5.5	-4.9
Current Account Balance plus Net FDI (USDm)	1951	650	198	-533	-1140	-927	-765
Current Account Balance plus Net FDI (% of GDP)	9.0	1.9	0.6	-1.3	-2.5	-1.8	-1.3
Gross Financing Requirement (% of Official Reserves) ⁽³⁾	34.0	184.4	159.0	181.0	202.0	157.8	167.7
Current External Receipts CXR (USDm)	12463	13406	15243	16416	16961	17881	19011
Current External Receipts CXR (Annual % Change)	5.7	7.6	13.7	7.7	3.3	5.4	6.3
Current External Payments CXP (USDm)	11421	13879	16505	18646	20602	20708	21776
Current External Payments CXP (Annual % Change)	6.2	21.5	18.9	13.0	10.5	0.5	5.2
External Assets and Liabilities							
Gross External Debt (USDm)	8752	9639	11753	11264	11971	12277	12633
Gross External Debt (% of GDP)	40.6	28.7	33.0	27.5	26.2	24.1	22.3
Gross External Debt (% of CXR)	70.2	71.9	77.1	68.6	70.6	68.7	66.4
Net External Debt (USDm)	4945	4761	2569	2636	4217	5188	5846
Net External Debt (% of GDP)	22.9	14.2	7.2	6.4	9.2	10.2	10.3
Net External Debt (% of CXR)	39.7	35.5	16.9	16.1	24.9	29.0	30.7
Public External Debt (USDm)	6093	6817	8094	7696	8448	8698	8949
Public External Debt (% of GDP)	28.2	20.3	22.7	18.8	18.5	17.0	15.8
Net Public External Debt (% of CXR)	42.4	37.0	39.1	31.3	34.0	33.6	31.8
Public FC Denominated & FC Indexed Debt (USDm)	6266	6979	8218	7868	8620	8871	9122
Short-Term External Debt (% of Gross External Debt)	13.6	13.7	17.8	17.5	16.9	16.9	16.8
External Debt Service (% of CXR)	13.1	11.9	15.0	13.5	12.6	11.2	12.3
External Interest Service (% of CXR)	4.1	4.3	3.9	3.7	3.5	3.4	3.2
Liquidity Ratio (%) ⁽⁴⁾	34.9	66.8	82.1	79.3	98.1	101.2	94.1
Official International Reserves Including Gold (USDm)	806	1851	2127	2559	2680	2682	2896
Official International Reserves in Months of CXP Cover	0.8	1.6	1.5	1.6	1.6	1.6	1.6
Official International Reserves (% of Broad Money)	13.0	27.5	26.3	26.4	26.7	24.5	23.2

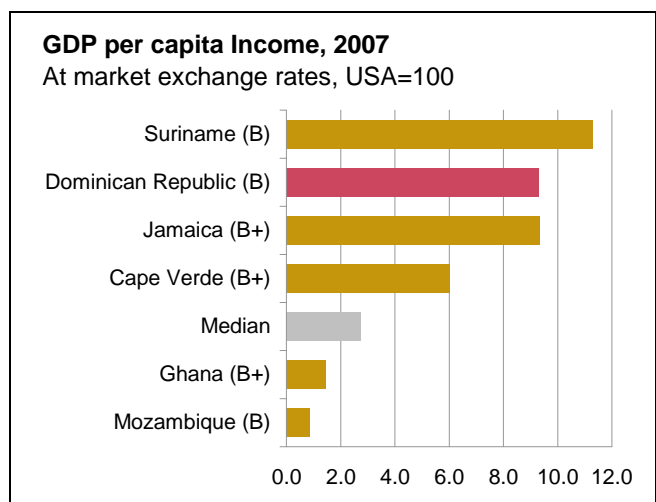
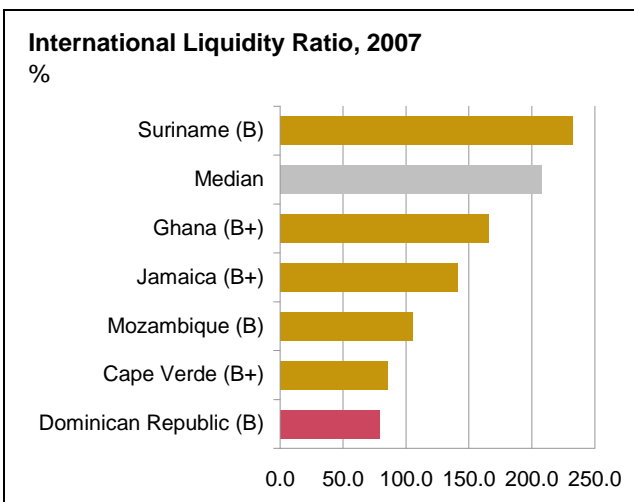
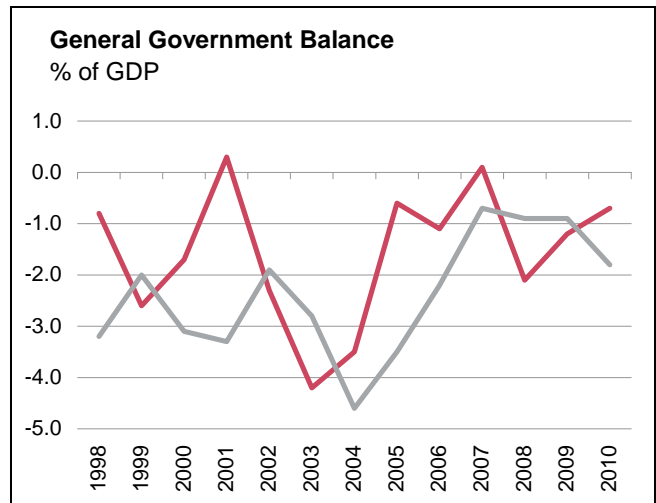
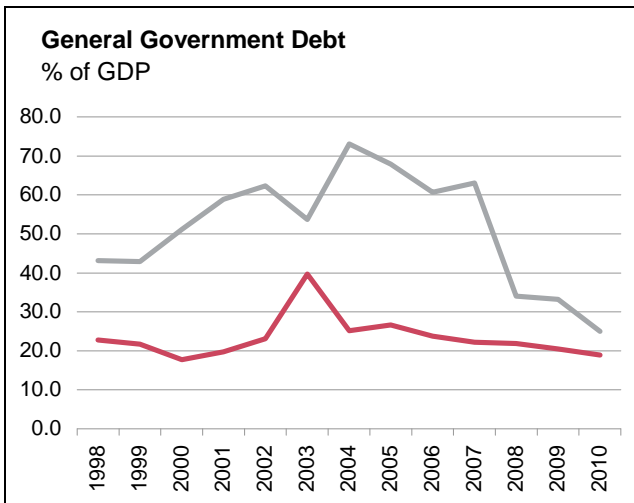
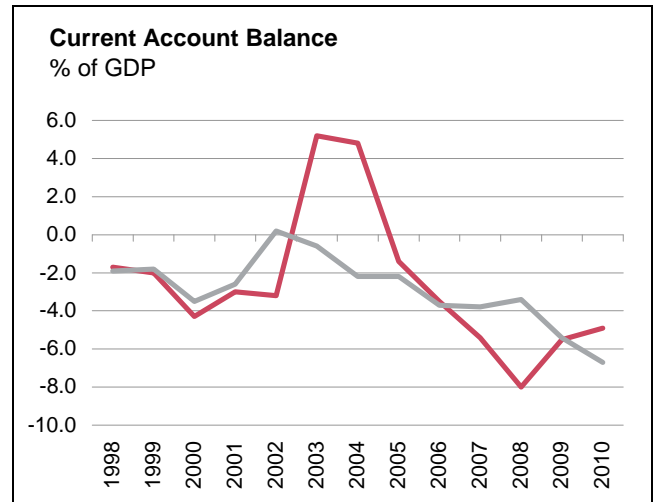
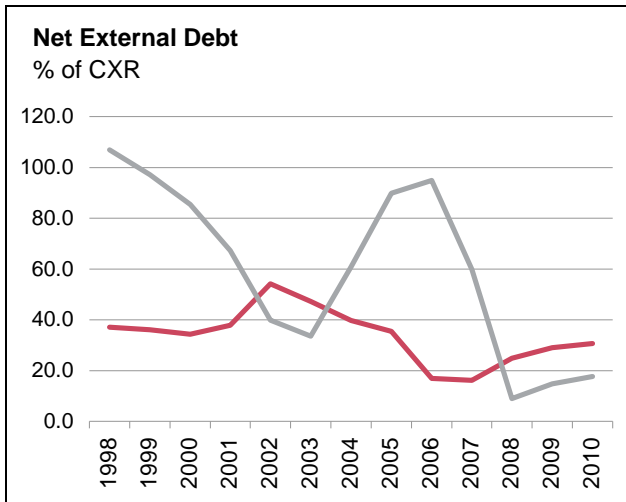
⁽¹⁾ Money market interest rate (annual average).

⁽²⁾ Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year.

⁽³⁾ Current account balance plus amortization of medium and long-term debt, over official international reserves.

⁽⁴⁾ Official reserves incl. gold plus banks' foreign assets/ Debt service plus liquid external liabilities.

Peer Comparison



— Dominican Republic

— B Median

Peer Group

Rating	Country
B+	Cape Verde
	Ghana
	Jamaica
	Kenya
	Sri Lanka
B	Dominican Rep
	Benin
	Cameroon
	Mozambique
	Suriname
	Uganda
B-	Bolivia
	Lebanon
	Malawi
	Mali
	Moldova
	Rwanda

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
05 May 06	B	B
18 Jul 05	B-	B
11 May 05	DDD	B
05 May 05	DDD	CCC+
21 Apr 05	C	CCC+
30 Jan 04	CCC+	CCC+
24 Oct 03	B	B
11 Aug 03	B+	B+

Economic performance and outlook

	2007	2008f	2009f
Real GDP (%)	8.5	5.0	4.0
CPI inflation (% annual avg.)	6.1	10.7	10.8
Budget balance (% GDP)	0.1	-2.1	-1.2
Current account (% GDP)	-5.4	-8.0	-5.5

Source: Fitch Ratings.

Rating Analysis

The swift recovery from the 2003 financial crisis, as well as the country's comparably stronger social indicators and business environment relative to 'B' peers, underpin the country's creditworthiness. Nevertheless, despite these strengths, a still fragile liquidity position combined with the recurrence of sizable twin fiscal and current account deficits this year constrain the ratings to current levels at this time. Furthermore, although Fitch recognizes progress with respect to the government's structural reform agenda, new policy challenges have emerged since the last review. Commodity price shocks and aggregate demand pressures have led to a rapid expansion of the current account deficit and rising inflation. Similarly, the improvement in fiscal balances will also be reversed this year, reflecting the increasing cost of large and poorly targeted energy subsidies, reconstruction costs and higher expenditure in the run-up to the elections. The authorities must manage these vulnerabilities carefully to ensure the maintenance of macroeconomic stability over the medium-term.

Although economic growth decelerated to 8.5% last year, it remained broad based and among the highest rates of growth in Latin America and the Caribbean. As is the case with other emerging markets, high international oil and food prices, as well as domestic demand pressures, fuelled an increase in year-end Inflation to 8.9% last year. A favorable balance of payments performance, underpinned by robust capital inflows, foreign direct investment in particular, drove international reserves to record levels in 2007. The country's liquidity position strengthened as a result, though it remained weak relative to peer credits. Similarly, robust economic growth, which contributed to higher than budgeted revenues, underpinned a non-financial public sector surplus of 0.1% of GDP in 2007. Nonetheless, advances on these fronts have already begun to unwind this year as the sustained oil price shock has contributed to a rapid increase in the island's external financing requirement as well as a re-emergence of a fiscal deficit while lower global growth and tighter international liquidity conditions could negatively affect future capital inflows. Fitch also expects inflation to remain in low double-digits and a pronounced economic slowdown through 2009.

The Dominican Republic's general government debt/GDP ratio still compares favorably with other speculative grade sovereigns, declining below levels pre-2003 crisis levels owing to the stabilization of the currency and robust GDP growth. Fitch expects government debt to stabilize around 22% of GDP in 2008, less than the

median of 28% of GDP for similarly rated sovereigns. Nevertheless, at a projected 135%, the government's debt as a proportion of revenues no longer compares as favorably to peers as in the past. This is due in part to a lower tax base, but more importantly also reflects a lower peer median following the recent debt write-offs that benefited other sovereigns in the 'B' category as a result of the Multilateral Debt Relief Initiative (MDRI). As the central bank's debt burden increased most during the banking crisis, public sector debt significantly exceeds that of the central government but is forecast to continue declining, reaching an estimated 34% of GDP by the end of 2008.¹

On a gross basis, most of the country's external debt ratios also compare favorably with other speculative grade sovereigns. However, on a net basis, the Dominican Republic's external debt indicators have weakened relative to peer medians as many credits in the 'B' category benefited from debt write-offs as well as high commodity prices, which led to comparatively higher reserve accumulation. As a proportion of current external receipts (CXR), the country's gross external debt is forecast to reach 71% in 2008, similar to pre-crisis levels and better than the 'B'

¹ The Banco Central de la República Dominicana absorbed most of the increase in debt during the banking crisis due to domestic issuance of securities and increased IMF borrowing for balance of payment support.

category median of 84%. Net public external debt as a proportion of CXR, however, is forecast to reach 34% by year-end, significantly above the 'B' category median of 3.8%. External debt service as a proportion of CXR, which is slightly more than twice the 6.3% median of 'B' rated peers, has increased since 2005 due to the amortization feature of the restructured 2011 bonds and the resumption of principal payments to the Paris Club and commercial banks. Scheduled public sector external amortizations are more than covered by multilateral and bilateral disbursements this year.

In spite of historically favorable debt ratios, the Dominican Republic's credit profile has been constrained by low liquidity, a situation that can be exacerbated by domestically or externally driven shocks. The country's liquidity ratio has been consistently below 100% and has contributed to payment difficulties in the past. Even though international reserve growth boosted the country's liquidity ratio to 98% this year from 79% in 2007, the country's liquidity position remains tight relative to peers and is substantially below the 'B' median of 260%. Furthermore, when adjusting the liquidity ratio to exclude banks' foreign assets and include banks' resident foreign currency deposits, the ratio declines considerably to 38%, highlighting comparably thin reserve levels. Although private capital inflows have held up in 2008, the fiscal position has deteriorated significantly and the Dominican Republic's external financing requirement is likely to increase by about one-third this year. Fitch forecasts that the country's gross external financing requirement as a proportion of official reserves will reach about 202%, notably above the 'B' category median of 57% and exceeded only by Georgia among similarly rated peers. These weaknesses highlight the importance of delivering promised fiscal consolidation in the second half of 2008 to bolster confidence and reduce the likelihood of a sudden shift in market sentiment which could add to current downward pressures on the sovereign's external liquidity position.

Finally, concerns about vulnerabilities to shocks, particularly in light of comparatively low foreign exchange reserves and a high external financing requirement also depress the sovereign's credit ratings at current levels. As an island nation, the Dominican Republic is vulnerable to natural disasters, dependent on imports of goods and has a limited domestic market, although its proximity to the United States and the implementation of DR-CAFTA detracts somewhat from the latter weakness.

Local Currency Rating

Fitch has equated the local currency and foreign currency Issuer Default Ratings due to lingering concerns with respect to public finance and debt management.

Country Ceiling

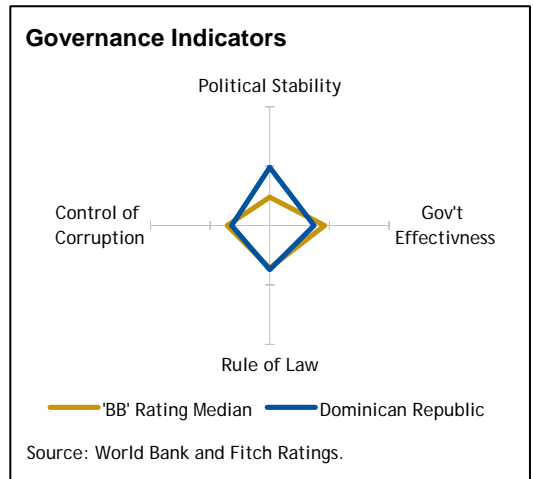
The Dominican Republic's country ceiling is 'B+', one notch above the foreign currency IDR. Membership of DR-CAFTA and WTO underpin the Dominican Republic's commitment to the free flow of capital and international trade, supporting the one notch uplift of the country ceiling over the foreign currency rating.

Credit Fundamentals

As is the case with other sub-investment grade sovereigns, weak institutions and an inefficient bureaucracy, which can detract from the implementation of appropriate economic policies and structural reforms, as well as the enforcement of existing laws and regulations, characterize the Dominican Republic's credit profile. However, based on the various indices highlighted below, the Dominican Republic compares favorably in this regard relative to 'B' peers. The country's political cycle, which currently staggers presidential and congressional elections so that one or the other occurs every two years, also complicates the policy making process and has presented challenges for the execution of the government's reform agenda. It is worth noting that the recently re-elected Fernandez Administration continues to

support the idea of constitutional reform, which includes a proposal to unify the congressional and presidential election calendars, though this is not likely to be a policy priority given the urgency of addressing other near-term challenges. Additionally, even though the previous administration progressed with its reform agenda, the urgent task of fixing the electricity sector remains.

Although there are lingering concerns with respect to implementation and enforcement of recent structural reforms, the Dominican Republic's World Bank governance indicators, which evaluate government effectiveness, control of corruption, political stability and rule of law, are in line with sub-investment grade category medians. At the same time, according to the World Economic Forum's 2007/2008 Global Competitiveness Report, the Dominican Republic ranked 107 out of 131 for the pillar of the index that pertains to institutions, indicating that



only about a 18% of the countries included in the survey are perceived as having less sound and credible institutions. This represents a slight deterioration in the country's standing relative to the 2006/2007 report. Similarly, the country's overall Global Competitiveness Index (GCI) ranking, which captures a broad range of factors affecting an economy's business climate, slipped to 96 from 93. Some of the key factors that weighed on the overall ranking included favoritism in decisions of government officials (128 of 131), quality of electricity supply (130 of 131) and quality of primary education (129 of 131). In fact, with the exception of Honduras, the Dominican Republic's GCI ranking is lower than all DR-CAFTA countries. However, among similarly rated peers, only Sri Lanka and Jamaica rank higher. Likewise, according to the World Bank's "Doing Business" survey, which reviews regulations that affect business activity, the Dominican Republic ranked higher than most 'B' rated sovereigns. The country was listed as one of the top ten reformers in the 2008/2009 'Doing Business' survey, with notable improvements in regulations related to starting a business, paying taxes, registering property and trading across borders. Furthermore the country's rank improved to 97 out of 181 countries from 110 during the previous survey. Compared to its GCI ranking, the Dominican Republic's overall 'Ease of Doing Business' ranking is the second highest among DR-CAFTA countries, exceeded only by El Salvador. The contrasting results of the above mentioned surveys suggest that even though the country's regulatory environment has strengthened, much remains to be done with respect to implementation and enforcement of reforms. If the government is successful on this front, then we may also see an improvement in the country's ranking for the Global Competitiveness Index in coming years as well. Additionally, a deepening of reforms pertaining to the electricity sector, transparency and education may also still be necessary to boost the Dominican Republic's rankings.

The consolidation of the economic recovery has provided some poverty relief and the government estimates that only about 35.8% of the population was living below the national poverty line in October 2007 compared to 36.3% in October 2006. Though the reduction in poverty has been gradual since the crisis, it still represents a material improvement from a peak of 43.4% in October 2004. Poverty levels are comparable to many countries in Latin America and the Caribbean as well as to other similarly rated sovereigns. Social indicators such as life expectancy, infant mortality and literacy, are also in line with regional standards. The Dominican Republic's ranking on the United Nations Human Development Index is high not only to 'B' rated peers, but is exceeded only by Costa Rica among DR-CAFTA countries.

Similarly, the country's GDP per capita is also high relative to the 'B' median. In spite of comparatively better social indicators, the country's social and development needs remain great and will likely contribute to fiscal pressures for some time.

Electricity Sector

The electricity sector crisis is a key credit weakness and will pose a challenge to the Dominican Republic's growth prospects and fiscal sustainability if not addressed appropriately.² While important reforms with respect to the electricity sector, such as the criminalization of electricity theft and a renewable energy law, have been ratified since the last review, it remains to be seen how the government will follow through with their implementation and enforcement. The government has also executed various restructuring plans over the years, however, the results have been poor and the sustained increase in international oil prices has pushed this sector to the brink. The Dominican Republic is heavily reliant on imported oil, which accounts for about 85% of its electricity supply. The total electricity subsidy from the government reached about US\$631 million in 2007 (compared to a budgeted US\$400 million) and is expected to reach around US\$1 billion this year. The liquid petroleum gas (LPG) subsidy is expected to cost the government an additional US\$380 million this year, more than twice the level reached in 2007.

The government has an ongoing program to improve collection efficiency at state-owned distributors, and it is also in the process of renegotiating contracts with energy generators to resolve its outstanding debt with the sector and to obtain more favorable terms for its distributors. Public initiatives to develop alternative sources of electricity generation such as carbon and wind are not expected to address the sector's near term needs. To guarantee a viable and financially self-sustainable sector in the long run, the government will need to embark on unpopular policy choices, including a pass-through of the variable cost of energy or fuel to end-users, strict enforcement of the new electricity law which punishes end-users for electricity theft, and the gradual elimination of subsidies. Along these lines, the government announced that it will be working on a plan to improve the targeting of the LPG and distribution tariff subsidies as well as introducing a national energy savings plan.

Structural Reforms

Structural reform efforts have targeted fiscal sustainability, institutionalization of the budgetary process and improvements in the efficiency of expenditures. The government continued to fine tune its tax regime last year by reducing some tax rates, strengthening anti-tax evasion measures and offering a tax amnesty. The government also implemented additional measures to institutionalize budget and financing mechanisms.³ Although the discretionary powers of the president over expenditure have yet to be eliminated, the current fiscal framework restricts these types of expenditures and provides specific spending guidelines.

Moreover, the law of public credit centralized the supervision and approval of public credit operations at the Ministry of Finance. This law is important because it reduces the potential for other public entities to generate "skeletons" by accessing credit independently. Nevertheless, these improvements in public credit operations did not prevent the confusion that arose because of US\$130 million in debt issued to Sun Land through the Ministry of Public Works due to a difference in interpretation of what constitutes public credit. Furthermore, several aspects of the basic market infrastructure and the debt issuance process for domestic government bonds in particular still need to be addressed. The World Bank is

² Refer to Fitch report "Dominican Republic Electricity: On the Edge of Darkness" dated 4 August 2008 for a more detailed analysis of the key issues faced by the sector.

³ For more detailed information with respect to these measures refer to Dominican Republic Credit Analysis dated 18 September 2007.

providing ongoing technical assistance to modernize the payment system, which includes establishing an electronic book entry, and recording system plus a securities settlement system, as well as creating an adequate securities depository, settlement and custodian agency. Until this agency is established, the Banco de Reservas will act as the depository, settlement and custodian agency. The Ministry of Finance is also modifying its debt issuance process, which aims to simplify Congressional approval of debt issuance, standardize medium- and long-term issuance and utilize an auction mechanism. Currently, outstanding issues of domestic treasury bonds are direct placements, mostly to suppliers in lieu of arrears or to recapitalize public banks.

In an important step toward prosecuting white collar crime and potentially reducing incentives to engage in fraudulent activities, three former executives from the now defunct Banco Intercontinental (BanInter) were successfully prosecuted and recently began serving prison sentences for their role in the collapse of this institution. Furthermore, since the banking crisis that began with the collapse of BanInter earlier this decade forced the Dominican Republic into debt restructuring and a major, broader economic crisis, the government has applied more proactive bank supervision. The Superintendency of Banks implemented better monitoring systems for portfolio and operational risks in banking institutions. The Superintendency has also been increasing its operational capabilities in an effort to move toward the implementation of risk-based consolidated supervision.

Trade Liberalization

The Dominican Republic is in the process of developing trade agreements to diversify its exports market, strengthen its export base and attract the necessary investment to sustain high growth in the medium term. The country was the second to last member of DR-CAFTA to implement the agreement in March 2007. Fitch expects DR-CAFTA to further deepen the Dominican Republic's trade links with the US and more importantly, provide a stable legal framework to attract investment into sectors such as tourism, telecommunications, real estate and infrastructure. At the bilateral level, the Dominican Republic has completed a first round of trade negotiations with Canada, while at the regional level, negotiations with the EU along with Caricom countries have been concluded. Thus far, the DR-CAFTA agreement has supported higher FDI inflows, though it has also contributed to deterioration in the country's trade balance as imports from other member countries have surged and export growth has not been particularly dynamic. Continued improvement of the country's overall business environment with the implementation of microeconomic reforms will be essential to benefit from trade liberalization through export growth.

Financial Sector

The financial sector's overall condition is similar to that of peer credits and does not present a rating constraint. Since the 2003 financial crisis, a robust economic recovery combined with a less volatile operating environment and improvements in the regulatory framework have strengthened the overall condition of the financial sector. In addition, private commercial banks have reduced their exposure to the government since the crisis. Although declining, the system remains concentrated, as the top three banks accounted for 61% of assets as of June 2008. Fitch's Macroprudential Indicator, which has been maintained at MPI 1 since early 2007, also indicates the country's decreased vulnerability to banking system stress.⁴ However, Fitch's Banking System Indicator (BSI), which measures intrinsic bank system risk on a scale from A (very high quality) to E (very low quality), remains unchanged at 'E' for the Dominican Republic.

⁴ For more details refer to Fitch's "Bank Systemic Risk Report" dated March 2008.

Key Facts: Banking system

2007

M2 (% GDP)	24.4
NPL ratio	5.0
Capital adequacy ratio	13.1
Public Ownership, % of Assets	31.0
Foreign Ownership, % of Assets	10.0
Fitch Banking System Indicator	E

Source: Fitch Ratings.

The Dominican banking system's financial profile has notably improved since the crisis. Nevertheless, risks remain and pressures are likely to increase near-term.⁵ A strong economy and excess liquidity drove nominal loan growth to a peak of 24% in 2007, a rate that has yet to decelerate significantly through the first half of this year. Although the bulk of this growth was concentrated in the riskier, but more profitable, consumer and mortgage loan segments, commercial loans still accounted for about 57% of the financial system's loan portfolio at year-end 2007. Asset quality remained stable as the system's past-due loans/total loans ratio declined to 5% by year-end 2007 from a peak of 9.2% in 2003, reflecting robust loan growth as well as continued aggressive write-offs and foreclosures. However, the system's past-due loans/total loans ratio could come under pressure if the global turmoil results in a sustained period of weaker economic growth and tighter monetary policy, particularly in light of rapid growth in riskier segments. Furthermore, loan loss reserve coverage has declined since 2006, both as a proportion of past due loans and total loans, though coverage of past due loans remains well above 100%. Wider financial margins, a decline in provisioning expenses, as well as an increase in other operating income and commissions more than offset higher administrative expenses, contributing to a further improvement in the system's profitability ratios last year. Nevertheless, aggressive expansion strategies have resulted in tighter capitalization levels as the system's equity/assets ratio declined to 12.1% as of year-end 2007 from 12.8% as of year-end 2006. However, the system's risk-weighted capital adequacy ratio improved to 13.1% as of year-end 2007 and is on par with other Central American banking systems. Given the gradual tightening of monetary policy, these generally positive trends are not likely to continue into 2009. A deceleration of loan growth and a rising interest rate environment could eventually pressure asset quality, although the past-due loans/loans ratio improved to 3.6% by mid-2008. In addition, margins and profitability may start to decline as the adjustment to interest rates on the liability side of the balance sheet has been faster. Fitch believes that more conservative capitalization policies would strengthen the system's financial profile, particularly in light of rapid consumer credit growth and the operating environment.

Monetary Policy

Banco Central de la República Dominicana has operational autonomy and independence to achieve its main objectives of maintaining the internal and external stability of the local currency (peso) as well as its convertibility, promoting economic stability and development, and managing the country's international reserves. The proposed law to modify the Monetary and Financial Code is a step in the right direction to further strengthen central bank independence and autonomy. While this draft law was initially sent to Congress in November 2005, it has yet to be approved due to legislative delays. The central bank targets monetary aggregates to reach its inflation goal. Currently, the main mechanisms used by the central bank to implement monetary policy include open market operations (involving the buying and selling of certificates of participation), short-term deposit facilities at the central bank, as well as the establishment of reserve requirements for banks.

As is the case with other emerging markets, external inflationary pressures, above trend GDP growth, and now, an impending US recession, have complicated monetary policy making. However, in the case of the Dominican Republic, policy choices may also be hampered by the need to manage a large stock of central bank certificates issued as a result of the 2003 banking crisis, which has contributed to quasi-fiscal losses. Inflation reached 8.9% at year-end 2007 and consistently increased to almost 15% for the twelve months ending in August 2008. Although inflation has exceeded the desired range of 4% to 6% for the past year, monetary

⁵ For more details refer to Fitch report "Dominican Republic Banks: Annual Review and Outlook" dated 7 April 2008.

policy tightening has been gradual relative to other emerging markets as it appears that more emphasis is being placed on external developments with a view that these are transitory. The central bank increased its overnight deposit rate by one percentage point to 8% on February 1, 2008, the first such move since April 2007. After two subsequent interest rate hikes in March and August, this rate now stands at 9.5%. Since July, banks now maintain the full 20% of their deposit reserve requirements at the central bank (compared to 18% before). Owing to these measures, market interest rates have been increasing since May and should begin to reduce liquidity in the economy. The central bank's ability to more aggressively tighten monetary policy may be constrained somewhat by the implications of higher interest rates on the cost of servicing its own debt instruments, though this is not an immediate challenge as most of these instruments have medium-term maturities. Furthermore, the government's announcement in July that it would increase public sector salaries by 15% may also be counterproductive in the fight against inflation.⁶ Given these policy challenges, Fitch believes that inflation will remain well above 6% through 2009.

The Dominican Republic adopted a flexible foreign exchange rate regime in 1991, and unified the official foreign exchange market operated by the central bank and the free market operated by commercial banks in 2003. The central bank does not predetermine a path for the exchange rate and intervenes in the market only to curb volatility. Unlike higher rated sovereigns, data with respect to market interventions is not public. In light of external pressures and the relative stability of the exchange rate, Fitch believes that some defensive intervention to curb volatility may be occurring. However, the central bank's ability to sustain interventions will be limited by its comparatively thin international reserves. Furthermore, depreciating pressures also may be offset somewhat by record FDI flows this year, though 2009 could prove more challenging to manage.

Recapitalization efforts helped reduce the central bank's capital shortfall to 1.7% of GDP in 2007 from 2.2% of GDP in 2006, in part due to an increase of accounts receivable from the government. Macroeconomic stability continued to lower the servicing cost of the stock of central bank certificates, lengthen maturities and reduce roll-over risk. The quasi-fiscal deficit continued its declining trend thanks to increased compensation for the elimination of the exchange rate commission and lower interest costs, which offset somewhat the increase in the stock of certificates. As a result, the quasi-fiscal deficit declined to about 1.8% of GDP in 2007 from 2.4% of GDP in 2006. The BCRD's stock of securities decreased as a proportion of GDP to 12.5% in 2007 from 13.2% in 2006 in part due to a deceleration in issuance. By year-end 2007, only about 3.5% of the outstanding CDs had a maturity of one year or less, a notable improvement from 2004 when almost all outstanding CDs had short-term maturities. Fitch believes that the eventual recapitalization of the central bank could help reduce monetary policy constraints.

Public Finances

The Dominican Republic's public finances are in line with peer credits and Fitch acknowledges that improvements on this front have occurred, as noted in the 'Structural Reforms' section above. Recent reforms should strengthen budget management if fully implemented; however, putting public finances on a sustainable path will require the political will to reform large and poorly targeted electricity and LPG subsidy programs. Indicative of the government's low debt tolerance, the authorities experienced payment difficulties in 2004 and 2005, which resulted in the rescheduling of Paris Club and commercial bank debt, as well as the completion of a comprehensive debt exchange, deemed a default by Fitch. However, since this time, external arrears have been minimized to one minor

⁶ This increase applied to public sector employees with salaries up to 30 thousand pesos monthly, which benefited close to 98% of all employees. This is expected to add 0.3% of GDP to government expenditures in 2008.

occurrence in 2007 and the government has significantly reduced supplier and contractor arrears as a result of better fiscal account administration and liquidity.⁷ Nevertheless, the higher than budgeted cost of subsidies, re-construction costs as well as pre-election spending led to a rapid deterioration of the fiscal accounts during the first half of this year. As such, a considerable fiscal adjustment in the second half of 2008 will be necessary.

In line with the government's Letter of Intent to the IMF, the 2007 budget targeted a primary surplus of 2.1% of GDP and a non-financial public sector (NFPS) surplus of 0.5% of GDP. Including the targeted quasi-fiscal deficit of 2.3% of GDP, the overall public sector deficit was expected to reach 1.8% of GDP last year, a significant improvement from the 3.2% of GDP deficit reported in 2006. While the overall public sector deficit was in line with the IMF program, this reflected the better than expected performance of the central bank as the authorities fell short of reaching the NFPS targets. Despite higher than budgeted revenues as a result of extraordinary revenues, the NFPS balance only reached a surplus of 0.1% of GDP last year due to unexpected capital expenditures related to Hurricane Noel and tropical storm Olga.⁸ In light of reconstruction needs, the Executive Board of the IMF approved a waiver of non-observance for this performance criterion.

Given the rapid deterioration in the external environment, the underlying assumptions for the 2008 budget, including real GDP growth of 5.5%, inflation of 6.0% and an average exchange rate of DOP36/USD appear optimistic. Even with slightly higher than budgeted revenues during the first half of 2008, the budgeted non-financial public sector deficit was revised to 2.0% of GDP from 0.7% of GDP due to higher than anticipated expenditure growth. Increased fuel and food subsidies, salary and pension hikes, as well as public spending in the run-up to the elections, were the key factors that contributed to a nominal increase of 40% in total expenditures through August. As such, the government announced that it will reduce projected expenditures by 20% during the last quarter of this year, delay construction on new infrastructure projects and prioritize those projects that have been at least 75% completed. However, the measures that will be the most difficult to implement politically included those that pertain to the electricity sector and the targeting of generalized subsidies. If the government delivers on its announced fiscal consolidation, the non-financial public sector's total financing needs will approach about 4.2% of GDP this year, though downside risks remain, particularly with respect to the measures needed to rein in the cost of broad energy and GLP subsidies. Fitch estimates that these subsidies will reach around 3% of GDP in 2008.

After peaking at 40% in 2003, Fitch expects general government debt to reach a forecasted 22% of GDP by the end of 2008, below pre-crisis levels and significantly less than the median of 28% of GDP for similarly rated sovereigns. As the central bank experienced most of the increase in debt related to the crisis, public sector debt including central bank instruments is much higher and is forecast to decline to 34% of GDP in 2008, a slight improvement from the previous year. Continued currency stability and economic growth will contribute to the stabilization of debt ratios this year. About 71% of public debt is denominated in foreign currency. Only about 24% of government debt consists of bonds, the majority of which are issued in international capital markets. All central government domestic bonds are issued in local currency. As many sovereigns in the single-B category benefited from debt forgiveness under the MDRI, at a projected 135%, the government's debt as a proportion of revenues no longer compares as favorably to peers as in the past. Similarly, government debt service appears high relative to peers at around 26% of revenue this year as well. Nevertheless, this level should be manageable as debt

⁷ The occurrence of these arrears is as defined by the IMF and was not related to market debt.

⁸ Extraordinary revenues reached an estimated 2.1% of GDP and include revenues related to the sale of Verizon, nickel revenues from Falconbridge Dominicana, higher dividends from some state-owned companies, tax amnesty and administrative changes to tax collections.

Public Finances*: Sources and Uses

USDmn	2007	2008
Uses		
Budget balance*	-43.6	1016.8
Other liabilities	49.2	194.8
Amortisation	860.7	955.5
Domestic	145.7	130.8
External	715.0	824.7
Sources		
Gross borrowing	817.1	1972.3
Domestic	-118.4	495.3
External	935.5	1477.0
Official	935.5	1477.0
Market	0.0	0.0

*Non-financial public sector

Source: Ministry of Finance, and Fitch Ratings estimates and forecasts.

service is substantially lower than it was during the last period of payment difficulties while the public sector's liquidity position has also strengthened as illustrated by the increase in government deposits to US\$775 million at the end of 2007 from US\$471 million in 2003.

The next large domestic treasury bond maturity is in 2009 and will test the adequacy of measures taken to improve debt management. In addition to strengthening public debt management, the government has been phasing out supplier and contractor arrears as well as improving accounting procedures with programs to verify the stock of these arrears and to monitor and prevent future arrears.

External Finances

The three largest sources of foreign currency are tourism, FTZ exports and workers' remittances. Income from services consists primarily of tourism receipts. The current account deficit continued to expand, reaching 5.4% of GDP last year as the strength of domestic demand and high international oil prices contributed to a deteriorating trade balance. The oil tab alone grew by US\$480 million in 2007, accounting for about half of the overall increase in the current account deficit. Growth in remittances, the majority of which come from the US, decelerated slightly to around 10%, reaching US\$3.0 billion last year. As consumption and investment growth remains robust and oil prices skyrocketed earlier this year, Fitch expects the current account deficit to continue widening in 2008, reaching a forecasted 8.0% of GDP. The current account deficit is likely to ease to around 5.0% of GDP over our forecast horizon, as oil prices have begun to unwind. However, a global slowdown, which would negatively affect receipts from both tourism and remittances, is a downside risk that could continue to pressure current account balances and already thin reserve levels.

Since the financial crisis in 2003, foreign direct investment (FDI) has made a robust recovery, with inflows primarily directed toward the tourism, communications, commercial sectors and real estate. FDI was the most significant component of the Dominican Republic's capital account once again last year, reaching US\$1.7 billion and covering about three-quarters of the current account deficit. FDI flows combined with other capital inflows more than compensated for slippage of the current account deficit, boosting reserves to a record US\$2.6 billion by year-end 2007. However, even though capital flows have held up so far in 2008, current account pressures led to a decline in international reserves of US\$242 million by the end of August. An increase in disbursements to the public sector as well as committed FDI inflows during the last quarter of this year should more than reverse the decline in reserves, leading to a slight accumulation for the year.

The country's liquidity ratio, which represents a credit weakness, has been consistently below 100% and has contributed to payment difficulties in the past. Even though international reserve growth boosted the country's liquidity ratio to 98% this year from 79% in 2007, the country's liquidity position remains tight relative to peers as this ratio is still substantially below the 'B' median of 260%.⁹ Furthermore, when adjusting the liquidity ratio to exclude banks' foreign assets and include banks' resident foreign currency deposits, the ratio declines considerably to 38%, highlighting the comparatively low level of international reserves. Although private capital inflows have held up thus far in 2008, the fiscal position has deteriorated significantly and the Dominican Republic's external financing requirement is likely to increase by about one-third this year. Fitch forecasts that the country's gross external financing requirement as a proportion of official

⁹ With the publication of the Dominican Republic's International Investment Position, more comprehensive data on short-term debt is now available, which resulted in an upward revision of the old short-term debt data series as well as a downward revision of liquidity ratios relative to the last credit analysis published by Fitch.

reserves will reach almost 202%, notably above the 'B' category median of 57% and exceeded only by Georgia among similarly rated peers. If capital inflows do not materialize in the remaining months of this year, reserve loss is likely to continue.

The public sector accounted for about 68% of outstanding external debt in 2007. External public sector debt is predominately medium- and long-term. Most of the public sector's external debt is owed to multilateral and bilateral creditors and benefits from concessional terms. As of the end of 2007, multilateral debt, bilateral debt and bonds (including Bradies) accounted for 33%, 38% and 23% of total public sector external debt, respectively.

Following a sharp deterioration of external debt indicators in 2003, these indicators have quickly recovered to pre-crisis levels. On a gross basis, the sovereign's debt indicators still compare favorably to peers in the 'B' category. However, on a net basis, the Dominican Republic's external debt indicators are now weaker than peers as many credits in the 'B' category benefited from debt write-offs as a result of the Multilateral Debt Relief Initiative as well as high commodity prices, which led to comparatively higher reserve accumulation. In 2007, net public sector external debt accounted for 13% of GDP and 31% of CXR, compared to the medians of 6% of GDP and 10% of CXR for peer credits.

The Dominican Republic's external debt service ratio of almost 14% also remains high relative to the 'B' peer median of 6.3%, in part reflecting the resumption of principal payments to the Paris Club and commercial banks as well as debt write-offs in similarly rated countries. Although this ratio has returned to 2004 levels, when the authorities were forced to seek debt service relief, the Dominican Republic's stronger external liquidity position gives Fitch confidence in the sovereign's capacity to meet these external obligations. This year, about 70% of scheduled amortizations are with official creditors and are more than covered by commitments for multilateral and bilateral disbursements. Most of the increase in bilateral disbursements will come from the PetroCaribe program with Venezuela.

External Finances: Sources and Uses

USDbn	2008f	2009f
Uses	5.2	4.2
Current Account Balance	3.6	2.8
MLT amortisation	1.5	1.4
Public	0.8	0.7
Private	0.7	0.7
Sources	5.2	4.2
Gross borrowing	2.3	1.7
Public	1.5	1.0
Private	0.8	0.7
Net FDI	2.5	1.9
Portfolio equity	0.0	0.0
Other capital, net	0.6	0.6
Change in FX reserves (- = increase)	-0.1	0.0

Source: Fitch Ratings forecasts.

Fiscal accounts summary*

% of GDP	2004	2005	2006	2007e	2008f	2009f	2010f
Revenue & grants (excl. priv'n)	14.0	15.6	16.1	17.7	16.2	15.4	15.2
Expenditure & net lending	17.6	16.3	17.2	17.6	18.4	16.6	15.9
Primary balance (excl. interest)	-1.7	0.7	0.3	1.4	-0.3	0.5	0.7
Overall balance	-3.5	-0.6	-1.1	0.1	-2.1	-1.2	-0.7
Financing:							
Domestic, net	1.3	-0.4	-1.1	-0.7	0.5	0.6	0.2
External, net	2.2	1.1	2.2	0.6	1.6	0.6	0.5
Government debt							
Domestic	25.2	26.6	23.8	22.2	21.9	20.5	18.9
External	3.4	3.3	3.2	2.8	3.0	3.2	3.1
<i>Government debt (% of revenue)</i>	21.8	23.3	20.6	19.4	18.9	17.3	15.9
<i>Government debt (% of revenue)</i>	179.9	170.6	147.5	125.0	134.7	132.8	124.7
<i>interest service (% of revenue)</i>	13.0	8.4	8.6	7.0	11.6	10.5	9.4
Net public debt**	31.8	21.4	21.3	19.6	20.1	19.0	17.7
<i>memo:</i>							
Non-financial public sector balance	-3.2	-0.4	-0.8	0.1	-2.2	-1.2	-0.8
Quasi-fiscal deficit of BCRD	-3.4	-2.5	-2.4	-1.8	-1.5	-1.3	-1.1
Overall public sector balance	-6.6	-2.9	-3.2	-1.7	-3.7	-2.5	-1.9
BCRD securities	11.2	13.1	13.2	12.5	11.7	11.1	10.8

* All figures refer to the consolidated central government, unless noted otherwise.

**Public debt less general government deposits at the central bank and other monetary institutions.

Sources: Ministry of Finance, IMF, and Fitch Ratings estimates and forecasts.

Amortisation schedule on medium- and long-term debt

USDmn	2008	2009	2010	2011	2012
Public sector	824.7	686.4	995.0	572.0	412.5
IMF	115.6	49.3	49.3	49.3	49.3
Other multilateral creditors	98.5	129.8	89.3	84.6	78.5
Bilateral creditors	359.9	304.2	296.2	296.7	266.5
Bonds	106.2	106.2	105.4	105.4	0.0
Other	144.6	97.0	454.7	36.0	18.2
Private sector	704.7	715.7	736.7	700.0	700.0
Total	1529.4	1402.0	1731.7	1272.0	1112.5

Sources: Secretariat of Finance of the Dom. Rep., and Fitch estimates for private sector.

Balance of payments

USDmn	2004	2005	2006	2007e	2008f	2009f	2010f
Current account balance	1041	-473	-1262	-2231	-3640	-2827	-2765
% of GDP	4.8	-1.4	-3.5	-5.4	-8.0	-5.5	-4.9
% of CXR	8.4	-3.5	-8.3	-13.6	-21.5	-15.8	-14.5
Trade balance	-1952	-3725	-5564	-6580	-8463	-8172	-8690
Exports, fob	5936	6145	6610	7237	7092	7234	7524
(annual % change)	8.5	3.5	7.6	9.5	-2.0	2.0	4.0
Imports, fob	7888	9869	12174	13817	15555	15406	16214
(annual % change)	3.4	25.1	23.3	13.5	12.6	-1.0	5.2
Services, net	2291	2457	2985	2968	3140	3378	3643
Services, credit	3504	3935	4567	4717	4977	5325	5698
Services, debit	1314	1219	1213	1478	1582	1750	1837
Income, net	-1825	-1902	-1827	-2028	-2036	-2077	-2115
Income, credit	322	418	700	798	918	1010	1111
Income, debit	2146	2320	2527	2827	2954	3087	3226
o/w: interest payments	506	577	600	600	600	600	600
Current transfers, net	2701	2908	3366	3663	3974	4312	4678
o/w remittances	2230	2430	2748	3033	3260	3505	3768
Capital & financial account, net	480	2040	1915	2589	3757	2831	2981
Non-debt creating flows, net	907	1124	1477	1698	2500	1900	2000
Direct investment, net	909	1123	1459	1698	2500	1900	2000
Portfolio equity investment, net	-2	1	18	0	0	0	0
External borrowing, net	-273	426	804	239	707	306	356
General government	306	94	367	291	668	300	300
Monetary authorities (incl. IMF credit)	27	181	8	39	84	-49	-49
Commercial banks	-255	-72	23	5	5	5	5
Other private sector	-351	222	407	-95	-50	50	100
Net lending abroad	-451	306	-707	478	400	475	475
Capital nes, net	297	185	341	174	150	150	150
Net errors and omissions	-981	-456	-338	330	0	0	0
Change in reserves (-=increase)	-540	-1110	-315	-688	-117	-4	-216
memo:							
Gross borrowing (incl. short-term)	329	876	1755	1143	1532	992	1351
Gross external financing requirement	88	1486	2944	3848	5170	4229	4496
Stock of International reserves, excl. gold	798	1843	2116	2546	2663	2667	2883

Sources: IMF, BCRD, and Fitch Ratings estimates and forecasts.

External debt & liquidity

USDmn	2004	2005	2006	2007e	2008f	2009f	2010f
Gross external debt	8752	9639	11753	11264	11971	12277	12633
<i>% of GDP</i>	40.6	28.7	33.0	27.5	26.2	24.1	22.3
<i>% of CXR</i>	70.2	71.9	77.1	68.6	70.6	68.7	66.4
<i>By maturity:</i>							
Medium- and long-term	7561	8323	9658	9295	9902	10108	10413
Short -term	1191	1316	2095	1969	2069	2169	2219
<i>% total debt</i>	13.6	13.7	17.8	17.5	17.3	17.7	17.6
<i>By debtor:</i>							
Public sector	6093	6817	8094	7696	8448	8698	8949
Non-bank private sector	2420	2637	3468	3373	3323	3373	3473
Banks	238	185	191	196	201	206	211
<i>By creditor:</i>							
Multilateral	1991	2248	2394	2459	n.a.	n.a.	n.a.
Bilateral	2133	2359	2625	2910	n.a.	n.a.	n.a.
Commercial banks	592	488	559	619	n.a.	n.a.	n.a.
Debt securities	1527	1557	1870	1744	n.a.	n.a.	n.a.
Other	2510	2987	4306	3532	n.a.	n.a.	n.a.
Gross external assets*	3806	4878	9183	8628	7754	7089	6787
International reserves, incl. gold	806	1851	2127	2559	2680	2682	2896
Deposit money banks' foreign assets	1053	1102	1295	1463	1390	1460	1533
PV of Brady bond collateral							
Other foreign assets	1948	1925	5762	4606	3684	2948	2358
Net external debt	4945	4761	2569	2636	4217	5188	5846
<i>% of GDP</i>	22.9	14.2	7.2	6.4	9.2	10.2	10.3
<i>% of CXR</i>	39.7	35.5	16.9	16.1	24.9	29.0	30.7
Debt service (principal & interest)	1635	1590	2282	2217	2129	2002	2332
<i>Debt service (% of CXR)</i>	13.1	11.9	15.0	13.5	12.6	11.2	12.3
<i>Interest service (% of CXR)</i>	4.1	4.3	3.9	3.7	3.5	3.4	3.2
<i>Liquidity ratio (%)</i>	34.9	66.8	82.1	79.3	98.1	100.0	92.0
<i>excl. banks' foreign assets</i>	9.9	29.0	51.4	49.3	62.4	65.8	59.6
<i>excl. banks' foreign assets & incl. banks' resident FCDs</i>	6.6	17.8	33.0	32.4	37.9	40.0	37.6
<i>memo:</i>							
Public Foreign Currency & FC indexed debt	6,266	6,979	8,218	7,868	8,620	8,871	9,122

* wide definition

Source: World Bank, BCRD, Fitch Ratings estimates and forecasts.

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