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Ratings

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Research Update:

Republic of Albania 'B+/B' Ratings Affirmed; Outlook Stable

Primary Credit Analyst:
Niklas Steinert, Frankfurt (0049) 69 33 999 248; niklas.steinert@spglobal.com

Secondary Contacts:
Ludwig Heinz, Frankfurt (49) 69-33-999-246; ludwig.heinz@spglobal.com
Ravi Bhatia, London (44) 20-7176-7113; ravi.bhatia@spglobal.com

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Research Update:

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Overview

- We expect Albania's high economic growth rates to support ongoing fiscal consolidation, which is likely to result in a gradual reduction of the country's high public debt burden.
- We are therefore affirming our 'B+/B' long- and short-term sovereign credit ratings on Albania.
- The stable outlook reflects our expectation that Albania will continue to gradually progress toward strengthening its institutional framework, building up on the country's past cooperation with international institutions, such as the International Monetary Fund, and due to preparatory efforts in the EU accession process.

Rating Action

On Aug. 4, 2017, S&P Global Ratings affirmed its 'B+/B' long- and short-term sovereign credit ratings on the Republic of Albania. The outlook remains stable.

Outlook

The stable outlook reflects our expectation that the government of Albania will maintain its commitment to fiscal consolidation, particularly on the revenues side, supported by steady economic growth and the authorities' increased capability to enforce tax compliance. Lower risks associated with the country's gradually declining debt-to-GDP ratio will also help to reduce the government's interest bill as a share of government revenues. At the same time, the country will continue to strengthen its institutions ahead of the EU accession process, and we expect its external financing position will not deteriorate.

We could raise the ratings if structural reforms established a stronger track record of more robust institutions and strengthened economic growth prospects. A positive action could also follow should ongoing fiscal consolidation efforts result in a faster-than-expected decrease in government debt.

We could lower the ratings if we observed deterioration in government finances—for example, due to a significant deviation from our current forecast—alongside resumed constraints on borrowing conditions. We could also lower the ratings if we saw a marked deterioration in Albania's external position and ability to fund its high current account deficit.

Rationale

The ratings on Albania reflect the country's steady progress toward fiscal consolidation, despite political tensions in mid-2017, aided by steady economic

growth and reform progress. We believe that the policy anchor provided by the International Monetary Fund's Extended Fund Facility arrangement (IMF EFF) that concluded in February 2017 strengthened Albania's fiscal framework. In particular, the formalized deficit brake, the "organic budget" law, and generally enhanced institutional oversight, helped to prevent the renewed accumulation of arrears and secured the country from a fiscal slippage ahead of this year's general elections. A prudent fiscal framework, political commitment, and declining interest spending will likely enable the government to set the country's currently high public debt burden on a gradual downward trajectory. Overall, we note that Albania fiscally outperforms its peers in the same rating category. The current exchange rate regime is more stable than peers', and Albania has improved its institutional set-up.

Institutional and Economic Profile: Cooperation with international organizations strengthen Albania's institutional framework and supports economic development

- The results of the recent general elections enable the new government to push ahead with structural reforms.
- The new government's actions will likely support gradual improvements in Albania's institutional effectiveness and predictability.
- The economy is growing at a relatively fast pace, albeit from a low base.

Despite high pre-election tensions, the July general elections went smoothly, pointing to Albania's capacity to reach political compromise. The Socialist party emerged as the winner and will form the new government, which we expect will deliver policy continuity. In particular, we expect the government will advance in widening structural reforms, thus building on recent improvements in the nation's institutional framework. Aided by its cooperation with international organizations—such as the IMF (which expressed willingness to renew its engagement with Albania after the EFF program concluded in February 2017) or the EU, in the run-up to the EU accession process—the Albanian government has made significant efforts to strengthen the rule of law and combat the informal sector.

We note that last year's judicial reform has the potential to create a more independent judiciary. This will improve the country's business environment, for example, by increasing the effectiveness of enforcement of property rights and offering a more effective bankruptcy resolution process.

We expect that Albania, coming from a low base, will be able to generate solid economic growth rates of about 3.8% per year on average in real terms during 2017-2020. Growth will primarily stem from strong domestic demand, with rising consumption and private investment, in our view. Economic development in 2017 will also benefit from two large investment projects in the energy sector, for which most of the construction will occur this year. Progress on the Trans-Adriatic Pipeline (TAP), which will connect Albania with Italy and the Caspian Sea, appears on track, with completion expected by year-end 2018 and costing an estimated €1.5 billion. An improved business environment and stonger institutions will help the country to attract more foreign direct investment (FDI) in energy, tourism, and agriculture.

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Flexibility and Performance Profile: Continued fiscal consolidation will reduce risks and improve sustainability of the large stock of public debt

- Albania's government continues to pursue budget consolidation as revenues have risen and fiscal reforms have proven effective.
- The country's large public debt burden is likely to start declining.
- External vulnerabilities remain high whereas monetary flexibility is severely limited by high euroization.

The government will continue on a path of fiscal consolidation as general government deficits are projected to decline to merely 1% of GDP in 2020. Revenue growth has been solid as tax revenues have consistently risen by over 8% over the past 18 months on the back of rapid nominal GDP growth and stronger tax enforcement. At the same time, the shadow economy continues to weigh on revenues, leaving room for improvements in tax compliance.

On the expenditure side, we acknowledge efforts to prevent the accumulation of government arrears through tighter monitoring. Successful implementation and adherence to the "organic budget" law, which stipulates limits on government spending in an election year, also delivered sound results. The government is currently in surplus for the first half of 2017. However, we forecast a deficit of 1.9% of GDP for the full year 2017, which will be significantly lower than in 2013-2014 when election-driven arrears subsequently resulted in financing pressures for the government.

Fiscal consolidation will reduce Albania's general government net debt to slightly above 62% of GDP in 2020 from 72% at the end of 2016. Partly benefiting from a global decline in interest rates, Albania reduced its interest payments to 8.9% of general government revenues in 2016 from over 11.7% on average in 2012-2015. The interest bill (as a share of general government revenues) will likely remain suppressed in the medium term as the revenue base of the budget expands.

Although the average maturity of government debt has lengthened considerably over the past three years, for the domestic portion of debt, average maturity remains relatively short, at slightly above two years. Domestic debt currently accounts for around 54% of the total public-sector debt stock and approximately 49% of total government debt is denominated in foreign currency. Albania's banking system still holds the largest share of domestic debt, and about 24% of the banking system's assets are government securities. However, higher revenue growth, generally improved government finances, and lower risks associated with Albania's still-high public debt stock have markedly reduced interest payments.

At the same time, Albania's external vulnerabilities remain high. The current account deficit has slightly contracted recently due to higher exports, but we still forecast it will average a high 9.6% of GDP over the coming four years. We expect FDI to remain the key external financing source since a number of large FDI projects remain in the pipeline. For example, the TAP project has stayed on schedule. Given that the largest share of the TAP investments, totaling €1.5 billion, will be executed in 2017, we estimate the FDI inflow at 9% of GDP in 2017. Further FDI

inflows are related to Albania's energy sector, particularly projects in the hydropower sector. The improvement of the institutional environment could therefore help by attracting a broader base of FDI inflows in the coming years. Albania's DFI projects are very import intensive, which is the primary reason behind material trade imbalances.

Remittances present another major source of foreign financing and we estimate a relatively steady, but declining, transfer balance of above 7% of GDP over our forecast horizon (compared with an average 13% of GDP over 2004-2008). Albania has been hit by the economic developments in Greece, where a significant Albanian diaspora lives, but migration of Albanians to other countries will help by further diversifying remittance sources.

Albania's external indebtedness is relatively low, as financing for the current account deficit has historically been more in the form of net foreign investment than in debt-creating inflows. Narrow net external debt of the country, by our definition, has even significantly decreased at the end of 2016 to 13% of current account receipts (CARs) due to higher external assets of the financial sector and we expect this ratio to remain close to 10% in the near-term and to slightly pick up at the end of our forecast horizon. At the same time, we see a risk that Albania's large projected FDI flows could drop or reverse in the coming years, especially as Albania's net external liability position is much weaker than its narrow net external debt position, surpassing it by over 110% of CARs in 2017.

The deposit-funded financial sector has strengthened its position as a net external creditor. This ongoing rise of the financial sector's net foreign assets—partly reflecting high liquidity—mirrors the country's limited lending opportunities for banks in recent years. We estimate domestic growth of bank credit to the entire domestic sector at merely 2% over the next years. Generally, the high share of foreign currency in the economic system hinders the effectiveness of Albania's monetary policy, as it does in several economies across the region. Despite the Bank of Albania's (BoA's) efforts to achieve de-euroization, deposits in foreign currencies will remain well above 50% of total deposits. However, loans in foreign currencies have decreased over the past years and could dip below 50% of total loans over the next years.

Since the second quarter of 2016, the BoA has maintained a rather accommodative policy to try and meet its 3% target inflation rate. Nevertheless, the central bank missed the target again in 2016. We project that the target inflation rate will not be reached before 2019.

At the same time, we acknowledge some progress toward the reduction of nonperforming loans in the banking system to 18% at the end of 2016 from its peak of 25% in September 2014, although mainly driven by write-offs. Capital buffers and liquidity in the banking system remain comfortably above minimum capital requirements. Subsidiaries of Greek banks maintain a sizable presence in Albania and the authorities have taken measures to limit exposure to their parents and prevent contagion risks to the rest of the sector.

The lek remains a free-floating currency, which has more recently been underscored by strong upward pressure. The BoA has intervened only marginally in the foreign exchange market in the past years, primarily with the intent of increasing its foreign currency reserves in line with its targets. The central bank's only significant open market operations included three-month liquidity injections to help enforce its policy rate, which remains historically low at 1.25%.

Key Statistics

Table 1

Republic of Albania Selected Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ALL)	1,301	1,333	1,350	1,395	1,428	1,473	1,565	1,666	1,777	1,904
Nominal GDP (bil. $)	13	12	13	13	11	12	13	14	15	15
GDP per capita (000s $)	4.4	4.2	4.4	4.6	3.9	4.1	4.4	4.9	5.1	5.3
Real GDP growth	7.2	1.4	1.0	1.8	2.2	3.4	3.7	3.7	3.9	4.0
Real GDP per capita growth	7.6	1.6	1.2	2.0	2.5	3.7	3.9	3.9	4.0	4.1
Real investment growth	9.0	(5.7)	(1.7)	(2.9)	4.3	15.3	5.0	4.0	3.7	3.2
Investment/GDP	33.5	29.8	27.2	26.7	25.0	23.3	27.5	27.4	27.4	27.1
Savings/GDP	20.5	19.6	16.3	13.8	14.2	13.7	17.0	17.6	18.1	18.5
Exports/GDP	34.0	33.4	28.7	28.2	27.4	28.9	28.5	28.6	28.7	28.7
Real exports growth	8.2	2.3	(11.4)	1.4	0.7	10.9	4.3	5.6	5.7	5.5
Unemployment rate	14.3	13.8	16.4	17.9	17.5	15.6	14.3	14.2	14.1	14.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(12.9)	(10.2)	(10.9)	(12.9)	(10.8)	(9.6)	(10.6)	(9.8)	(9.3)	(8.6)
Current account balance/CARs	(30.4)	(24.5)	(28.3)	(34.0)	(28.5)	(24.2)	(27.0)	(25.3)	(23.8)	(22.0)
CARs/GDP	42.5	41.6	38.6	38.1	37.9	39.6	39.1	38.9	39.0	39.1
Trade balance/GDP	(27.1)	(23.2)	(20.6)	(22.3)	(22.5)	(24.3)	(24.8)	(24.2)	(23.8)	(23.2)
Net FDI/GDP	6.6	6.8	9.6	8.1	8.0	8.9	9.0	7.0	6.5	6.5
Net portfolio equity inflow/GDP	0.0	0.1	(0.1)	0.3	0.6	0.0	0.5	0.5	0.5	0.5
Gross external financing needs/CARs plus usable reserves	112.2	114.3	120.9	127.3	122.8	110.7	113.5	113.8	113.4	112.9
Narrow net external debt/CARs	19.8	21.3	22.1	24.8	20.8	12.5	11.2	10.9	13.6	15.8
Net external liabilities/CARs	93.1	83.3	75.1	92.9	109.8	108.3	124.1	132.6	142.8	158.7
Short-term external debt by remaining maturity/CARs	33.9	45.0	56.4	63.4	70.5	60.3	57.9	53.0	50.5	49.6
Usable reserves/CAPs (months)	4.3	4.6	4.9	4.9	5.8	6.4	5.9	5.4	5.2	5.1
Usable reserves (mil. $)	2,474	2,600	2,773	2,665	3,139	3,109	3,070	3,075	3,106	3,169
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.5)	(3.4)	(5.0)	(5.2)	(4.1)	(1.8)	(1.9)	(1.5)	(1.2)	(1.0)
Change in debt/GDP	5.2	4.9	5.3	3.9	2.9	1.4	1.9	1.5	2.7	2.5

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Table 1

Republic of Albania Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Primary balance/GDP	(0.4)	(0.3)	(1.7)	(2.3)	(1.4)	0.7	0.3	0.7	0.9	1.1
Revenue/GDP	25.4	24.8	24.2	26.3	26.6	27.6	28.0	28.0	28.0	28.0
Expenditures/GDP	28.9	28.2	29.2	31.5	30.6	29.4	29.9	29.5	29.2	29.0
Interest /revenues	12.4	12.6	13.2	10.9	10.2	8.9	8.0	7.8	7.7	7.7
Debt/GDP	62.5	65.9	70.4	71.9	73.2	72.4	70.0	67.3	65.7	63.9
Debt/Revenue	245.9	265.7	290.3	273.7	275.5	261.8	249.9	240.2	234.8	228.1
Net debt/GDP	61.3	64.4	68.3	70.2	70.7	70.2	67.9	65.4	64.0	62.2
Liquid assets/GDP	1.2	1.5	2.1	1.7	2.5	2.2	2.0	1.9	1.8	1.7
MONETARY INDICATORS (%)										
CPI growth	3.4	2.0	1.9	1.6	1.9	1.3	2.5	2.7	3.0	3.0
GDP deflator growth	(2.1)	1.0	0.3	1.5	0.1	(0.2)	2.5	2.6	2.7	3.0
Exchange rate, year-end (ALL/$)	107.54	105.85	101.86	115.23	125.79	128.17	119.64	119.47	122.81	126.49
Banks' claims on resident non-gov't sector growth	12.1	2.4	(1.2)	2.4	(2.4)	0.0	1.5	2.0	2.0	2.0
Banks' claims on resident non-gov't sector/GDP	41.6	41.5	40.5	40.1	38.3	37.1	35.4	34.0	32.5	30.9
Foreign currency share of claims by banks on residents	37.3	35.2	33.3	32.2	30.2	27.6	26.9	26.3	26.1	26.0
Foreign currency share of residents' bank deposits	48.4	48.8	48.0	48.4	50.1	52.1	54.0	55.0	55.0	55.0
Real effective exchange rate growth	(1.0)	(0.5)	1.5	2.3	0.5	3.4	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. ALL—Albanian lek. CARs—Current account receipts. FDI—Foreign direct investment. CAPs—Current account payments. N/A—Not available. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Albania Ratings Score Snapshot

Key rating factors	
Institutional assessment	Weakness
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Weakness
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Global Sovereign Rating Trends Midyear 2017 - July 12, 2017
- Central And Eastern Europe And CIS Sovereign Rating Trends Midyear 2017 - July 13, 2017
- Sovereign Risk Indicators - July 06, 2017. An interactive version is available at http://www.spratings.com/sri.
- Why Politics Matters To Sovereign Ratings - November 06, 2015
- Default, Transition, and Recovery: 2016 Annual Sovereign Default Study And Rating Transitions - April 03, 2017
- Sovereign Ratings History - July 12, 2017
- Sovereign Debt 2017: Global Borrowing To Drop By 4% To US$6.8 Trillion - February 23, 2017

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the

committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the fiscal assessment: debt burden had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Albania (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	B+/Stable/B	B+/Stable/B
Transfer & Convertibility Assessment	BB	BB
Senior Unsecured		
Foreign Currency	B+	B+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Additional Contact:
SovereignEurope; SovereignEurope@standardandpoors.com

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