

## USAA Insurance Group And Operating Subsidiaries

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# USAA Insurance Group And Operating Subsidiaries

## Major Rating Factors

### Strengths:

- Extremely strong competitive position, liquidity, and capital adequacy
- Well-recognized franchise and dominant market presence among members of the U.S. military
- Low-cost structure, mainly as a result of direct marketing
- Excellent enterprise risk management

### Weaknesses:

- Higher geographic concentration in areas exposed to catastrophic losses from natural events
- Investment exposures to hybrid securities and commercial mortgage-backed securities (CMBS)
- Narrow life product suite as a result of the challenge of selling complex products via direct distribution

### Operating Companies Covered By This Report

#### Financial Strength Rating

Local Currency

AA+/Negative/--

## Rationale

The insurer financial strength ratings on United Services Automobile Assoc. and its related entities (collectively, USAA) including USAA's property/casualty operations (collectively, USAA P/C) and USAA's Life operations (collectively, USAA Life) are based on the group's extremely strong competitive position among members of the U.S. military and their families. Other strengths include the company's low cost structure, excellent enterprise risk management (ERM), extremely strong liquidity and capital adequacy, and very strong operating results. Offsetting these positive factors are the group's concentration in property catastrophe risk, narrow life product suite, investment exposure to CMBS, and somewhat limited financial flexibility resulting from its reciprocal ownership status.

The niche to which USAA offers its products and services is unique, has demonstrated favorable risk characteristics, and is generally restricted to members of the association. This efficient direct marketing distribution drives a low-cost structure and enables the company to provide a variety of financial services to its members on very attractive terms while reaping the benefits of perhaps the best persistency of any large insurer and still realizing excellent underwriting results. USAA P/C ranks as the seventh-largest private passenger automobile insurer and the sixth-largest homeowners' insurer based on 2010 direct premiums written. USAA Life ranks as the 12-largest term life and 13-largest fixed annuity writer. Within its current membership base, which consists of more than 8 million individuals, USAA P/C has a market share of almost 79% among its traditional core group of military officers, and it retains an impressive 97% of eligible members. Its retention rate consistently ranks among the best in the industry and is a testament to its membership loyalty.

The company maintains liquidity that is extremely strong as a result of its stringent underwriting and expense controls. In addition, its operating results are very strong, though they are somewhat volatile because of increasing loss costs resulting from weather- and non-weather-related events.

USAA's consolidated and USAA P/C's capital adequacy is also extremely strong and is consistently higher than its personal lines peer group average. However, USAA Life capital adequacy, although improved from 2009, isn't redundant at the extremely strong threshold. This is mainly a result of exposure to CMBS, holdings of lower rated investment-grade securities, and changing business mix (with a greater focus on annuities over the past couple of years). However, USAA Life has reported high yields from these investments and appears to be getting compensated for the risk. The company maintains one of the highest yields in the industry, which, coupled with its low cost structure, has enabled it to introduce extremely competitive products into the marketplace.

Standard & Poor's Ratings Services views USAA's overall ERM program as excellent, and we consider it important to the company's long-term health and sustainability.

USAA P/C's concentration in property/catastrophe risk in its top four states (40% of 2010 direct premiums written) is somewhat of a limiting factor. USAA's membership is generally concentrated in military communities, but the company has demonstrated that it can manage its exposure through modeling, reinsurance, and sound underwriting criteria.

Marketing exclusively to the military community somewhat limits its potential growth and operational scale, and the group's product offerings are somewhat limited relative to similarly rated peers'. However, USAA believes its potential market is more than 60 million individuals of which it has only captured 8 million members. The challenge of selling complex products via direct distribution further limits USAA Life's product suite.

## Outlook

The negative outlook reflects our view that the link between the ratings on USAA and the sovereign credit ratings on the U.S. could lead to a decline in the insurers' financial strength. This is because USAA's business and assets are concentrated in the U.S. (see "Counterparty Credit Ratings And The Credit Framework," published April 14, 2004, on RatingsDirect on the Global Credit Portal).

Under our criteria, the local-currency sovereign credit rating on the U.S. constrains the ratings on domestic insurance operating and holding companies. If we were to lower our rating on the U.S. again, we would likely take the same rating action on USAA and its core operating companies and their related obligations. Alternatively, if we were to revise the rating outlook on the U.S. to stable, we would likely revise the outlook on USAA and its core operating companies and obligations to stable, assuming there is no deterioration in USAA's business and financial profiles.

We expect USAA to remain focused on being a provider of choice for the military community. Through this chosen niche, the company will sustain its extremely strong competitive position, dominant market share, and membership loyalty.

We expect USAA P/C's operating performance to remain stable through different underwriting cycles and to generally outperform the industry, with a combined ratio in the mid-90% range in 2012, assuming about four points of normalized catastrophe losses. We expect the significant catastrophic activity in 2011 to hamper USAA P/C's operating results and generate a combined ratio in the low 100%s. We expect USAA Life's operating earnings will remain very strong, with generally accepted accounting principles (GAAP) EBIT (excluding realized and unrealized gains/losses) operating income of at least \$380 million and in line with 2010 and statutory earnings of about \$250 million for each of the next two years. Liquidity likely will remain very strong, with a liquidity ratio

exceeding 240%, reflecting the large increase in sales of fixed annuities that have surrender charges. We expect life premiums will grow at a single-digit rate (higher than the market average) and that fixed-annuity deposits will be better than peers', though low yields in the market will still pressure them.

Standard & Poor's expects USAA to maintain a high-quality investment strategy, modest operational and financial leverage (less than 10%), and extremely strong consolidated capital adequacy and liquidity. We could lower the ratings if USAA does not meet these expectations.

## Competitive Position: Extremely Strong Based On Its Leading Position As The Foremost Provider Of Personal Lines Products To The Military Community

USAA's competitive position is extremely strong. Its brand identity within this market segment in the past 89 years is unmatched. USAA has capitalized on this phenomenon by offering a breadth of financial products, including property/casualty insurance, life insurance, banking products, and asset-management services. Its high-quality customer service, which is reflected in its extremely strong rankings in numerous surveys, also contributes to its sustainable competitive advantage. This position enables USAA to provide financial services to its members on very attractive terms while reaping the benefits of having the market leading persistency of 97% in each of the past five years and lapse rates of less than 3% in USAA Life while still achieving excellent underwriting results.

**Table 1**

| USAA Insurance Group/Selected Statistics |          |          |          |          |          |
|--|----------|----------|----------|----------|----------|
| --Year ended Dec. 31--                   |          |          |          |          |          |
| (Mil. \$)                                | 2010     | 2009     | 2008     | 2007     | 2006     |
| Total revenue                            | 11,178.9 | 10,338.2 | 9,691.4  | 9,677.4  | 9,459.4  |
| Net income                               | 850.0    | 616.8    | 804.1    | 1,114.8  | 1,547.4  |
| Combined ratio (%)                       | 96.9     | 95.4     | 100.0    | 96.7     | 88.6     |
| Return on revenue (%)                    | 8.9      | 10.4     | 7.2      | 12.7     | 19.5     |
| Total assets                             | 27,077.1 | 24,755.4 | 23,160.9 | 21,963.3 | 20,231.7 |
| Statutory surplus                        | 15,922.7 | 14,545.7 | 13,479.5 | 12,904.5 | 11,699.9 |

**Table 2**

| USAA Insurance Group/Competitive Position |          |         |         |         |         |
|---|----------|---------|---------|---------|---------|
| --Year ended Dec. 31--                    |          |         |         |         |         |
| (Mil. \$)                                 | 2010     | 2009    | 2008    | 2007    | 2006    |
| Private passenger auto liability          | 3,997.8  | 3,700.1 | 3,380.0 | 3,237.3 | 3,204.3 |
| Private passenger auto physical damage    | 3,284.9  | 3,059.5 | 2,872.6 | 2,736.7 | 2,777.1 |
| Homeowners multiple peril                 | 2,791.5  | 2,680.9 | 2,349.4 | 2,302.2 | 2,271.8 |
| Inland marine                             | 159.3    | 148.1   | 139.2   | 127.9   | 115.8   |
| Allied lines                              | 156.1    | 135.7   | 104.1   | 92.8    | 101.7   |
| Fire                                      | 136.5    | 120.0   | 104.3   | 95.2    | 89.0    |
| Other premiums                            | 153.3    | 148.5   | 133.8   | 116.8   | 172.6   |
| Total net premiums written                | 10,679.4 | 9,992.8 | 9,083.5 | 8,708.9 | 8,732.2 |
| Total change in net premiums written (%)  | 6.9      | 10.0    | 4.3     | (0.3)   | 6.9     |

In general, eligibility for products is restricted to members of the military community and their spouses and

dependent children. For the total USAA enterprise, the number of members increased 9% in 2010, with membership comprising officers (20%), NCOs (14%), enlisted (9%), associates (36%), and families (20%). In 2009, USAA expanded eligibility further to all honorably separated officer and enlisted personnel, regardless of when they served. These newly eligible groups, which supported USAA's mission to serve the entire military community, added the potential for about 40 million new members to USAA's market base. Standard & Poor's believes that the company can sustain its membership and accompanying revenue growth given its loyal and deep relationships, enhanced awareness and communication of innovative product solutions, and exceptional customer service.

### **Diversification**

USAA membership is diverse in a number of key demographic categories, including military versus civilian, age, income, family composition, geographic location, and eligibility status. Because of the mobile nature of its membership, much of which are active-duty military, USAA conducts its business primarily by Internet, telephone, and mail. Its Internet channel, similar to many of its peers, is the company's largest communication and distribution platform. The majority of USAA inbound contacts are through self-service, including the Internet, mobile, and speech channels. This strategy not only assists the company in effectively providing members access to key products and services through their channel of choice, but it also provides significant operational efficiencies for USAA to continue to expand cross-selling and ways to best address its members' needs. In 2011, USAA introduced what it calls "Member Experience" by integrating the call centers across the group. We believe that the company will continue to refine its operating model, which uses innovative technology to streamline processes and speed up decision making. It is also continually improving its front- and back-office functions to minimize costs and direct resources to areas where they can have the biggest impact. Although USAA has yet to realize the full potential of technology, we believe this model will continue to set USAA apart from the competition.

USAA's combined membership and target niche typically has lower-risk traits (highly educated, strong income earners, mostly employed and married) than the general population. Coupled with a well-balanced age distribution and high brand loyalty, USAA possesses a demographic profile that generally allows it to realize better underwriting performance than most of its peers.

### **P/C**

USAA P/C writes insurance predominately in three lines of business: private-passenger auto liability, private-passenger auto physical damage, and homeowners' multiple peril. These lines contributed about 94% of net premiums written in 2010, which is consistent with the past five years.

The concentration in personal lines, however, renders USAA dependent on the vagaries of this sector. Also, USAA's geographic concentration is in military communities. As a result, its most heavily concentrated states of Texas, California, Florida, and Virginia, represent 40% of 2010 direct premiums written, while its top 10 states account for 61% of direct premiums written. The company has implemented several underwriting standards and programs to mitigate potential exposure.

### **Life**

USAA Life leverages the USAA customer database and brand name to reach its target market of military officers, noncommissioned officers, enlisted personnel, and their families. In contrast to USAA P/C, USAA Life is open (although not marketed) to nonmembers. However, nonmembers only account for a small proportion of customers. USAA Life had a membership growth of 5.6% in 2010 to 1.4 million members. The business mix continues to evolve, with significant growth in fixed annuity sales beginning in 2008. The direct distribution method makes it

difficult for the company to sell more complex products to its customers. However, members exhibit positive demographics, which allows USAA Life to be competitive and sustain profitability.

**Table 3**

| <b>USAA Life/Selected Statistics</b>                       |                               |             |             |             |             |
|--|-------------------------------|-------------|-------------|-------------|-------------|
|  | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>   | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| Liquidity ratio (%)  | 241.1                         | 245.1       | 243.2       | 242.2       | 243.1       |
| Total assets (including separate accounts)                 | 17,259.7                      | 15,216.7    | 12,920.9    | 11,143.8    | 10,440.7    |
| Total premiums and considerations                          | 2,016.6                       | 2,293.1     | 1,982.9     | 1,134.2     | 983.7       |
| Pretax income  | 399.0                         | 317.0       | 223.7       | 221.9       | 185.3       |
| Total adjusted capital (including asset valuation reserve) | 1,557.9                       | 1,322.3     | 1,135.6     | 1,049.1     | 1,006.6     |

**Table 4**

| <b>USAA Life/Business Statistics</b>                      |                               |             |             |             |             |
|---|-------------------------------|-------------|-------------|-------------|-------------|
|   | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>  | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| Total revenue   | 3,226.6                       | 3,393.1     | 2,910.6     | 1,971.6     | 1,690.1     |
| Total premiums and considerations                         | 2,016.6                       | 2,293.1     | 1,982.9     | 1,134.2     | 983.7       |
| Premium revenue increase (%)                              | (12.1)                        | 15.6        | 74.8        | 15.3        | 9.9         |
| Deposits  | 93.5                          | 103.8       | 95.2        | 88.3        | 88.8        |
| Total premiums, considerations, and deposits              | 2,110.2                       | 2,396.8     | 2,078.0     | 1,222.5     | 1,072.5     |
| Premiums, consideration, and deposit revenue increase (%) | (12.0)                        | 15.3        | 70.0        | 14.0        | 19.8        |
| Net first-year premiums                                   | 825.6                         | 575.6       | 210.4       | 196.3       | 144.5       |
| Net first-year increase (%)                               | 43.4                          | 173.5       | 7.2         | 35.8        | (22.1)      |
| Net single premiums*                                      | 427.4                         | 1,089.1     | 1,199.0     | 420.7       | 278.3       |
| Net single increase (%)                                   | (60.8)                        | (9.2)       | 185.0       | 51.2        | 111.0       |
| Separate accounts assets                                  | 5.2                           | 4.9         | 4.9         | 12.9        | 42.9        |
| Increase in separate accounts assets (%)                  | 6.6                           | 0.3         | (62.0)      | (70.0)      | (89.3)      |
| <b>Major lines</b>  |                               |             |             |             |             |
| Individual life   | 401.1                         | 377.0       | 361.8       | 348.2       | 346.0       |
| Individual annuities                                      | 1,468.7                       | 1,785.7     | 1,494.3     | 660.0       | 489.0       |
| Group life  | 0.0                           | 0.0         | 0.0         | (0.2)       | 7.7         |
| Group annuities   | 0.0                           | 0.0         | 0.0         | 0.0         | 1.0         |
| Group accident and health                                 | 0.5                           | 0.5         | 0.6         | 0.5         | 0.7         |
| Individual accident and health                            | 146.4                         | 129.8       | 126.3       | 125.7       | 124.6       |
| Aggregate of all other                                    | 0.0                           | 0.0         | 0.0         | 0.0         | 14.6        |
| Deposits  | 93.5                          | 103.8       | 95.2        | 88.3        | 88.8        |

\*Excludes annuity and fund deposits for 2001 and later.

### Prospective

We expect USAA's competitive position to remain extremely strong based on its sustainable competitive advantage and leadership position within its chosen niche market. USAA's targeted customer base exhibits better risk characteristics than the general population, and we expect this to continue. Its focus on direct marketing will continue to lead to an expense ratio that is significantly better than that of its peer group, offsetting its

line-of-business concentration. We expect both P/C and life operations to continue to grow more than the industry in 2011 and 2012.

## Management And Corporate Strategy: USAA Is The Provider Of Choice For The U.S. Military Community

We view USAA's management and corporate strategy as positive and a strength to the ratings, reflecting its continued success as the provider of choice for the U.S. military community, highly effective management team, and leading edge use of technology.

### Strategic positioning

USAA's corporate strategy focuses on being the provider of choice for the military community. The corporate strategy also aims at expanding the existing core military officer base to include families and dependents, enlisted personnel, and veterans.

Standard & Poor's expects USAA to generate growth organically through its niche target market, not through acquisitions.

### Operational effectiveness

The management team at USAA is well-seasoned and committed to its members and their customer experience, and it will continue to provide a breadth of highly competitive financial products and services to maintain member value and retention.

The enterprise offers a wide variety of products and services in an effort to cover almost all the financial needs of its members. These products include property/casualty insurance, life and health insurance, annuities, mutual funds, discount brokerage, banking, credit cards, and other services. This strategy, which USAA pursued with its full resources before stock insurers had started to follow similar paths, has enhanced relationships and promoted better member retention. It also has facilitated the group's fundamental goal of building strong relationships and providing good value to its members.

### Financial management

USAA is focused on providing reasonable distributions to its members, in line with its reciprocal (mutual) structure. As part of this financial management, the company is focused on maintaining extremely strong capitalization and strong operating performance to support its distribution-paying strategy. However, USAA will not pay excessive distributions that result in capital adequacy inconsistent with the rating. The ratio of distributions to net-premiums-earned averaged 7% from 2006-2010. USAA's total leverage has continued to decline to 1.09x in 2010 from 1.12x in 2009. We expect the company to manage its financial profile to levels consistent with the rating category.

### Governance and financial policies

USAA, a mutual insurance company, is owned by its policyholders, and there is no large controlling interest. The board of directors is independent with exception of the president and CEO, Josue "Joe" Robles Jr.

## Enterprise Risk Management: Excellent, With Industry-Leading Risk-Management Practices

We consider USAA's ERM framework to be excellent, and it is our opinion that the firm's ERM construct and execution is a strength to the overall ratings.

An excellent score for risk culture, risk controls, strategic risk management and emerging risk management, supports our opinion, though a strong score for risk models partially offset these strengths. We believe USAA has strong capabilities to consistently identify, measure, and manage risk exposures and losses within predetermined tolerance guidelines. There is clear evidence of the enterprise's practice of optimizing risk-adjusted returns.

Although USAA has a diverse product portfolio including life, personal lines, bank, and asset management, USAA has limited the risk by not engaging in products that increases its risk profile, and it exploits its position as a non-public company by having an adequate capital cushion.

We consider USAA's risk culture to be excellent. We base our view on a well-defined organizational risk appetite statement that is clearly connected to the organizational strategy. Moreover, an influential risk management department emphasizes risk monitoring through a robust set of risk reporting mechanisms and a set of delegated accountability to manage risks.

USAA's risk appetite statement is consistent with its objectives as an organization for its members and aims to protect its members, reputation, and financial strength. Given that it is not a publicly traded firm, USAA has the luxury of focusing on long-term returns and maintaining capital without the pressure to generate a sufficient return for its shareholders.

We continue to view USAA's investment risk controls as strong. This reflects USAA's position that investment risk-taking is subordinate to insurance risk-taking, and recently it has adopted an even more conservative bias in its investment strategy.

We score risk controls related to underwriting, pricing, and cycle management at USAA as excellent. Our views favorably consider USAA's meticulous approach to underwriting through its unique multiproduct offering to an extremely loyal set of members. In addition, this approach has consistently translated from a strategy to results.

We consider catastrophe risk controls at USAA to be excellent. Given the importance of catastrophe risk and the risk it imposes on the organization, USAA has devoted ample resources to catastrophe risk management. We view favorably the emphasis on data quality, including precision underwriting and well-documented risk tolerances for catastrophe risk.

We score reserve risk controls at USAA as excellent. Although the adverse reserve risk for USAA's P/C operations is relatively modest compared with an insurance company with long-tailed liabilities, our view mainly reflects USAA's use of claims as a strategic partner in its business and conservative reserving substantiated by consistent releases, external reviews, and the process for selecting best estimate reserves.

We consider risk models at USAA to be strong. USAA has been taking thoughtful steps in incorporating an enterprise-wide economic capital model and, though this initiative is evolving, we view favorably the evident conservatism in the current modeling approach and the extensive scrutiny that models receive in the enterprise as

USAA uses their results to determine profitability metrics and capital adequacy.

We continue to score USAA's strategic risk management as excellent. Our view favorably considers a well-seasoned practice with a proven track record of executing risk/reward trade-offs and evidence of integrated risk and capital management, but the lack of a robust economic capital model at the enterprise level partially offsets the strengths.

Although we recognize the ERM framework as excellent, we expect USAA to demonstrate a robust economic capital model that captures all the significant enterprise risks to maintain its overall ERM score.

## Accounting

USAA and its insurance company subsidiaries are required to file statutory statements. The group is not publicly traded and thus is not subject to SEC filing or Sarbanes-Oxley.

The company also produces GAAP financial statements on a voluntary basis. In 2008, management decided to reclassify all investments on a GAAP basis to trading securities, which has added more volatility to net income over the past three years but will not affect capital. Because of this accounting convention, we focus on EBIT excluding realized and unrealized gains/losses in our analysis of GAAP earnings, and we review the economic loss potential of these invested assets, with less reliance on reported accounting losses.

For USAA, the areas most subject to significant management judgments include reserves for property/casualty losses and loss-adjustment expenses, reserves for future policy benefits, deferred policy acquisition costs, and valuation of investments. The company has not made material changes in the actuarial assumption or methods it uses to establish and record reserves from those it used in the past. Standard & Poor's believes that USAA uses a conservative approach in its accounting practices.

## Operating Performance: Volatile But Better Than Industry Average

We view USAA's operating performance as very strong with both its P/C and life operations maintaining profitability better than the industry average.

USAA's expense ratio consistently ranks as one of the lowest in the sector for both P/C and life. USAA's direct marketing and low-cost distribution channels directly contribute to these favorable results. We expect USAA's focus on mail, telephone, and Internet venues will keep its expense ratio among the best in the personal lines and life industry. However, going forward, we believe USAA's expenses will be somewhat pressured as a result of higher marketing costs associated with outreach initiatives.

### P/C

USAA P/C's operating returns in the past five years have been somewhat volatile because of increasing loss costs, competition, catastrophe losses, and the payment of policyholder dividends, but they continue to be very strong and above industry averages. Management has implemented various corrective actions to bolster USAA P/C's operating results, which include increasing rates where appropriate, refining underwriting capabilities with additional risk segmentation, enhancing technology, and further increasing efficiency through streamlined staffing. Standard & Poor's believes the company will maintain operating results appropriate for the ratings.

Table 5

| USAA Insurance Group/Operating Statistics          |          |          |         |         |         |
|--|----------|----------|---------|---------|---------|
| --Year ended Dec. 31--                             |          |          |         |         |         |
| (Mil. \$)  | 2010     | 2009     | 2008    | 2007    | 2006    |
| Total revenues                                     | 11,178.9 | 10,338.2 | 9,691.4 | 9,677.4 | 9,459.4 |
| Pretax operating income (excluding realized gains) | 994.1    | 1,070.8  | 697.8   | 1,230.5 | 1,846.9 |
| Net income   | 850.0    | 616.8    | 804.1   | 1,114.8 | 1,547.4 |
| Return on revenue (%)                              | 8.9      | 10.4     | 7.2     | 12.7    | 19.5    |
| Return on assets (%)                               | 3.3      | 2.6      | 3.6     | 5.3     | 7.9     |
| Return on statutory surplus (%)                    | 5.6      | 4.4      | 6.1     | 9.1     | 14.3    |
| Loss ratio (%)                                     | 75.6     | 74.2     | 81.3    | 75.6    | 68.7    |
| Expense ratio (%)                                  | 13.1     | 13.6     | 13.8    | 15.0    | 14.3    |
| Policyholders' dividend ratio (%)                  | 8.2      | 7.7      | 4.9     | 6.1     | 5.5     |
| Combined ratio (%)                                 | 96.9     | 95.4     | 100.0   | 96.7    | 88.6    |
| Operating ratio (%)                                | 9.6      | 11.5     | 7.8     | 13.8    | 21.7    |
| <b>Portfolio performance</b>                       |          |          |         |         |         |
| Net investment income                              | 685.2    | 671.5    | 697.0   | 919.5   | 875.0   |
| Net yield (%)                                      | 3.0      | 3.2      | 3.5     | 4.9     | 5.1     |
| Net capital gain or loss                           | 679.9    | 469.7    | 266.1   | 365.6   | 588.3   |
| <b>Portfolio composition</b>                       |          |          |         |         |         |
| Cash and short-term investments (%)                | 3.6      | 4.1      | 6.5     | 20.8    | 18.7    |
| Bonds (%)  | 55.6     | 56.6     | 56.1    | 48.4    | 43.4    |
| Preferred and common stocks (%)                    | 29.1     | 28.1     | 26.2    | 20.8    | 26.5    |
| Real estate and mortgage loans (%)                 | 4.0      | 4.5      | 5.3     | 5.7     | 6.1     |
| Other invested assets (%)                          | 7.8      | 6.7      | 5.8     | 4.4     | 5.3     |
| Invested assets to total assets (%)                | 88.5     | 88.2     | 88.9    | 89.4    | 88.8    |
| Average maturity of bond portfolio (years)         | 5.9      | 5.6      | 5.1     | 2.0     | 2.2     |

N.A.--Not available.

The company has generated very strong underwriting results over the past five years, with an average statutory combined ratio of 95.5%. An extremely strong expense ratio, which averaged 14.0% during the same period and is typically among the industry's best, supports these results. Its return on revenue (ROR) averaged a strong 11.7%. USAA P/C's statutory expense ratio was 13.1% in 2010 and its combined ratio of 96.9% in 2010 was in line with our expectations. On a segment basis, auto and homeowners lines posted an underwriting profit of \$714 million and \$265 million, respectively, and combined ratios (before policyholder's dividends) of 89.9% and 90.1%, respectively. For 2010, premiums written increased almost 7% over 2009 to \$10.7 billion, comprising auto (68%), homeowners (26%), and other (6%). The combined ratio as of July 31, 2011, deteriorated to 100.0%, mainly because of significant catastrophic activity this year.

## Life

USAA's cost-efficient direct marketing distribution enables USAA Life to offer attractively priced products to its membership. This, combined with superior customer service, has consistently resulted in industry-leading persistency, as lapse rates of less than 3% demonstrate. Disciplined and effective strategic management has enabled USAA Life to meet customers' needs while profitably growing its business. GAAP EBIT (excluding realized and

unrealized gains/losses) increased to \$380 million in 2010—a record for USAA Life—from \$332 million in 2009. The improvement in earnings was a result of revenue growth in all lines of businesses, favorable mortality, and efficient operations. The statutory return on assets increased to 246 basis points and, at a five-year (2006 to 2010) average of 207 basis points, is well above industry peers'. USAA Life's general expense ratio of 10% also compares favorably with the industry and reflects the company's adoption of more streamlined processes as well as the increase in annuity premiums.

**Table 6**

| <b>USAA Life/Summary Operating Statistics</b> |                               |             |             |             |             |
|---|-------------------------------|-------------|-------------|-------------|-------------|
|   | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>                              | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| Pretax income                                 | 399.0                         | 317.0       | 223.7       | 221.9       | 185.3       |
| Net income                                    | 244.6                         | 42.8        | 25.3        | 105.7       | 120.8       |
| Return on revenue (%)                         | 12.4                          | 9.3         | 7.7         | 11.3        | 11.0        |
| Return on assets (%)                          | 2.5                           | 2.3         | 1.9         | 2.1         | 1.7         |
| Pretax GAAP income                            | 379.7                         | 670.6       | (666.7)     | 275.5       | 239.2       |
| Pretax GAAP rate of return on capital (%)     | 2.2                           | 4.4         | (5.0)       | 2.1         | 1.9         |

**Table 7**

| <b>USAA Life/Operating Statistics</b>            |                               |             |             |             |             |
|--|-------------------------------|-------------|-------------|-------------|-------------|
|  | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>                                 | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| General expenses                                 | 248.9                         | 231.2       | 211.2       | 208.0       | 184.1       |
| General expense ratio (%)                        | 10.0                          | 8.4         | 8.9         | 14.0        | 14.5        |
| Expense ratio (%)                                | 5.3                           | 4.1         | 4.0         | 7.2         | 8.0         |
| Unit expenses (in whole dollars)                 | 208.9                         | 208.5       | 199.3       | 208.7       | 203.9       |
| General expenses as a percentage of total assets | 1.4                           | 1.5         | 1.6         | 1.9         | 1.8         |
| Commission ratio (%)                             | 0.1                           | 0.1         | 0.1         | 0.1         | 0.1         |
| Lapse ratio (ordinary only) (%)                  | 2.4                           | 2.5         | 2.6         | 2.6         | 2.5         |
| Mortality ratio (%)                              | 270.6                         | 233.3       | 244.0       | 286.9       | 286.1       |
| Investment spread (%)                            | 2.2                           | 2.3         | 2.1         | 2.3         | 1.8         |
| <b>Accident and health</b>                       |                               |             |             |             |             |
| Loss ratio (%)                                   | 76.8                          | 77.6        | 68.0        | 80.4        | 77.2        |
| Expense ratio (%)                                | 15.3                          | 16.5        | 10.7        | 14.1        | 14.2        |
| Combined ratio (%)                               | 92.1                          | 94.0        | 78.7        | 94.4        | 91.4        |

### Prospective

In spite of the competition in the personal lines insurance segment and significant catastrophe activity this year, Standard & Poor's expects USAA's operating results to remain very strong. We expect USAA P/C to produce very strong underwriting results, with a combined ratio (with a normalized catastrophe component) in the mid-90% range and an ROR of 7%-10% in 2012.

We also expect USAA Life's operating earnings to remain very strong, with GAAP EBIT (excluding realized and unrealized gains/losses) operating income of at least \$380 million, and in line with 2010, and statutory earnings of about \$250 million for each of the next two years.

In addition, we expect the company to continue to focus on expense control despite significant investment in membership growth and excellent customer service.

## Investments And Liquidity: Very Strong, With Above-Average Liquidity

Standard & Poor's views USAA's investments as very strong. USAA's investment management company, IMCO, manages its portfolio.

### P/C

To help support its short-tailed liability profile in its property/casualty business, it maintains a conservative, well-diversified portfolio, with an average credit quality of 'AA-' and duration of 3.7 years as of July 31, 2011. Its asset allocation includes corporate bonds (35%), municipals (18%), treasuries/agencies (10%), asset-backed (8%), mortgage-backed (5%), common stocks (7%), cash (5%), and real estate (10%). The majority of its common stock portfolio is investments in subsidiaries. The company lengthened the duration of its fixed-income portfolio to reduce income volatility, and it has continued to reduce its targeted allocation to treasury/agency securities.

### P/C liquidity

USAA P/C's five-year average underwriting cash flow ratio of 116.8% demonstrates that its liquidity is well above that of its peer group. We believe that USAA P/C's extremely strong liquidity is a result of more stringent underwriting and expense controls. Furthermore, USAA P/C's five-year average operating cash flow ratio of 118.5% highlights how net investment income substantially supports liquidity. Net investment yield was 3.0% in 2011, compared with 3.2% in 2010, because of changes in market conditions. We expect further deterioration in the yield in 2011 and 2012 as a result of prevailing low interest rates.

**Table 8**

| USAA Insurance Group/Financial Statistics                       |                        |          |          |          |          |
|---|------------------------|----------|----------|----------|----------|
|   | --Year ended Dec. 31-- |          |          |          |          |
| (Mil. \$)   | 2010                   | 2009     | 2008     | 2007     | 2006     |
| Total assets  | 27,077.1               | 24,755.4 | 23,160.9 | 21,963.3 | 20,231.7 |
| Statutory surplus   | 15,922.7               | 14,545.7 | 13,479.5 | 12,904.5 | 11,699.9 |
| Loss and loss adjustment expense reserves/statutory surplus (x) | 0.3                    | 0.3      | 0.4      | 0.4      | 0.4      |
| Common stock to surplus (%)                                     | 43.6                   | 42.1     | 39.7     | 30.9     | 40.7     |
| Reinsurance utilization ratio (%)                               | 5.4                    | 4.7      | 5.7      | 6.2      | 4.0      |
| Reinsurance recoverables to surplus (%)                         | 3.2                    | 3.4      | 5.8      | 5.2      | 5.5      |
| Underwriting cash flow ratio (%)                                | 116.8                  | 123.8    | 107.0    | 121.2    | 123.4    |
| Operating cash flow ratio (%)                                   | 109.9                  | 118.7    | 105.4    | 120.5    | 122.7    |

### Life

USAA Life maintains one of the highest yields in the industry. Its statutory yield averaged 6.13% over the past five years (2006-2011), which has enabled it to introduce extremely competitive products into the marketplace. Reflecting market conditions, yields have decreased slightly but remain very strong compared with peers. Its investment portfolio is well-diversified and comprises mainly high quality, liquid fixed income investments (96% as of July 31, 2011) with an average quality of 'A+' as of July 31, 2011. Within its fixed income portfolio the main exposure are municipals (21% as of July 31, 2011), financial (14%), and industrial (12%) corporate bonds. Although slightly reduced as a proportion of the fixed income portfolio, USAA Life's exposure to commercial

mortgage-backed securities (CMBS) remains somewhat high at about 12% (from 16% for the same period last year). Its strong investment risk controls mitigate the risk, and USAA Life has reported high yields from its CMBS investments and appears to be getting compensated for the risk. USAA Life has a few single-name concentrations within its portfolio, which exceeds 10% of total adjusted capital, but well within when analyzed on an enterprise level.

**Table 9**

| <b>USAA Life/Investment Statistics</b>                  |                               |             |             |             |             |
|---|-------------------------------|-------------|-------------|-------------|-------------|
|   | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>  | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| Net investment income                                   | 1,004.8                       | 905.8       | 724.7       | 638.3       | 551.2       |
| Total invested assets                                   | 16,820.9                      | 14,817.0    | 12,641.9    | 10,872.9    | 10,138.2    |
| Net realized capital gains                              | (16.5)                        | (126.6)     | (104.8)     | (33.3)      | (1.1)       |
| High-risk assets to total invested assets (%)           | 4.8                           | 6.1         | 8.6         | 15.8        | 7.3         |
| Net investment yield (%)                                | 6.35                          | 6.60        | 6.16        | 6.08        | 5.48        |
| Five-year realized capital gains to invested assets (%) | 0.00                          | 0.00        | 0.01        | 0.14        | 0.07        |
| <b>Portfolio composition</b>                            |                               |             |             |             |             |
| Cash, cash equivalents, and short-term investments (%)  | 0.9                           | 1.3         | 1.7         | 1.2         | 0.8         |
| Bonds (%)   | 90.4                          | 89.3        | 53.5        | 60.5        | 67.8        |
| Mortgage-backed securities (%)                          | 4.9                           | 5.8         | 30.4        | 22.6        | 22.6        |
| Mortgages (%)   | 0.0                           | 0.0         | 0.0         | 0.0         | 0.0         |
| Policy loans (%)  | 1.0                           | 1.1         | 1.3         | 1.4         | 1.4         |
| Stocks (%)  | 1.3                           | 1.5         | 12.1        | 13.6        | 6.9         |
| Real estate (%)   | 0.0                           | 0.0         | 0.0         | 0.0         | 0.0         |
| Other (%)   | 1.5                           | 0.9         | 1.0         | 0.7         | 0.4         |

### Life liquidity

We view USAA Life's liquidity as very strong. The 2010 liquidity ratio, as measured by our liquidity model (see Life: Liquidity, published April 22, 2004), was very strong based on a liquidity ratio of 241% in 2010--about flat from 245% in 2009. We view liquidity as very strong, despite that more than one-third of annuity assets under management can be surrendered without any surrender charges, because of its extremely loyal members with surrender rates on fixed deferred annuities lower than 3% over the past 10 years and very strong asset-liability management (ALM) matching.

**Table 10**

| <b>USAA Life/Liquidity And Reserves Statistics</b>          |                               |             |             |             |             |
|---|-------------------------------|-------------|-------------|-------------|-------------|
|   | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>  | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| <b>Allocation of reserves</b>                               |                               |             |             |             |             |
| Individual life   | 21.3                          | 22.7        | 25.6        | 28.7        | 30.0        |
| Group life  | 0.1                           | 0.1         | 0.1         | 0.1         | 0.0         |
| Individual annuities  | 71.4                          | 69.7        | 66.2        | 62.7        | 62.0        |
| Group annuities (including guaranteed investment contracts) | 0.0                           | 0.0         | 0.0         | 0.0         | 0.1         |
| Accident and health   | 0.4                           | 0.4         | 0.5         | 0.7         | 0.6         |
| Other   | 6.8                           | 7.1         | 7.6         | 7.8         | 7.2         |

**Table 10**

| <b>USAA Life/Liquidity And Reserves Statistics (cont.)</b> |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| Liquidity ratio (%)  | 241.1 | 245.1 | 243.2 | 242.2 | 243.1 |

**Prospective**

Standard & Poor's does not expect any major changes in USAA's investment strategy in the medium term. Liquidity should also remain extremely strong for the USAA group.

**Capitalization: Extremely Strong And Will Likely Remain So**

Both USAA's stand-alone P/C and USAA's consolidated enterprise capital adequacy were extremely strong at year-end 2010, with a sizable redundancy at the 'AAA' level. USAA proactively manages the potential for catastrophe losses arising from various catastrophe loss perils. It uses reinsurance selectively to mitigate potential losses, as a reinsurance utilization ratio for USAA P/C that averaged 5.2% over the past five years demonstrates. The company also maintains very low financial leverage.

**Life**

Although strong earnings consistently contribute to surplus, providing a source of internal funding to support capital needs, USAA Life's capital adequacy remains deficient at the 'AAA' level of required capital. The main reasons are the significant increase in sales of fixed annuities since 2008 and our adoption of incremental asset stress factors in 2009, which increased the required capital charge on the CMBS holdings. Management's goal is to retain a redundancy at the 'AAA' level of capital at the life companies. We view the excess capital within the group as available to support the life group. In 2010, total adjusted capital increased 18% to \$1.56 billion and reached \$1.7 billion as of June 30, 2011.

**Table 11**

| <b>USAA Life/Capitalization Statistics</b>  |                               |             |             |             |             |
|---|-------------------------------|-------------|-------------|-------------|-------------|
|   | <b>--Year ended Dec. 31--</b> |             |             |             |             |
| <b>(Mil. \$)</b>  | <b>2010</b>                   | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
| Total assets  | 17,259.7                      | 15,216.7    | 12,920.9    | 11,143.8    | 10,440.7    |
| General account assets  | 17,254.5                      | 15,211.8    | 12,916.0    | 11,131.0    | 10,397.8    |
| Total liabilities excluding separate accounts (excluding asset valuation reserve) | 15,718.1                      | 13,869.0    | 11,801.9    | 10,103.6    | 9,410.6     |
| Total adjusted capital (including asset valuation reserve)                        | 1,557.9                       | 1,322.3     | 1,135.6     | 1,049.1     | 1,006.6     |
| Unrealized capital gains  | (4.7)                         | 10.5        | (22.9)      | (5.6)       | 6.3         |
| Capital adequacy ratio (%)  | N.A.                          | N.A.        | N.A.        | 216.2       | 289.5       |
| Company action level to NAIC risk-based capital ratio (%)                         | 510.9                         | 462.6       | 471.4       | 541.2       | 616.8       |
| High-risk assets to total adjusted capital ratio (%)                              | 51.6                          | 67.9        | 95.6        | 163.6       | 73.6        |
| Surplus from operating earnings after dividends (%)                               | 240.4                         | 276.3       | 332.1       | 351.9       | 293.2       |
| Stockholder dividends/net income  | 14.2                          | 28.4        | 32.5        | 35.5        | 38.4        |
| Net premiums to gross premiums (%)  | 83.1                          | 85.7        | 85.0        | 78.6        | 78.7        |
| Net reserves to gross reserves (%)*   | 86.6                          | 87.0        | 86.9        | 87.2        | 88.4        |
| Stockholders' dividends   | 6.2                           | 4.2         | 2.5         | 6.3         | 57.5        |
| Stockholders' dividends to net operating income (%)                               | 2.4                           | 2.5         | 1.9         | 4.6         | 47.2        |

\*Includes annuity and fund deposits. N.A.--Not available.

### **Prospective**

Standard & Poor's expects USAA to sustain its extremely strong capital adequacy.

### **P/C reserves**

Standard & Poor's considers USAA's reserves to be adequate. With the exception of 2005, the company has consistently released reserves in the past six years. USAA has some concentration in property catastrophe risk, but this risk is limited. Texas, California, and Florida constituted 13%, 10%, and 10%, respectively, of direct premiums written in 2010, and these states have greater potential for catastrophe losses than other zones. However, USAA P/C has limited its catastrophe exposure through modeling, reinsurance, and underwriting, achieving a net 1-in-250 probable maximum loss-to-surplus ratio of 5.3% in 2010. Further, USAA P/C limits its new business growth in high-probable maximum-loss locations, and cedes wind and hail coverage in certain zones.

### **Reinsurance**

*P/C* USAA P/C uses a relatively small amount of reinsurance, with the reinsurance utilization ratio from 2006-2010 averaging 5.2%. In addition, the reinsurance recoverable-to-surplus ratio has a five-year average of 3.9%. USAA P/C has reinsurance for catastrophe losses with highly rated companies. USAA's specific reinsurance programs include traditional excess-of-loss reinsurance and reinsurance funded through the capital markets and the Florida Hurricane Catastrophe Fund, a state-sponsored program. The company also limits its exposure through participation with other state-sponsored programs such as wind pool programs and the California Earthquake Authority. For catastrophe exposure excluding Florida, USAA retains the first \$350 million in losses under its 2010-2011 occurrence reinsurance program. In the first layer, USAA retains 35% of the next \$500 million in excess of the \$350 million attachment point.

*Life* The USAA Life relieves capital strain related to Regulation XXX reserves through reinsurance from multiple highly rated reinsurers. As part of balancing its risk appetite and growing fixed annuity sales, USAA Life has increased its annuity coinsurance.

## **Financial Flexibility: Extremely Strong Capital Position And Operating Prospects Allow Ample Latitude To Self-Fund Strategic Initiatives**

We consider USAA's financial flexibility to be appropriate for the rating, but to have a slight disadvantage when compared with that of its stock peers because of its formation as a reciprocal organization. As a result, it is more limited than publicly traded companies in its ability to obtain external equity financing. However, we believe that the enterprise has more than sufficient resources to support both potential losses and sensible growth. USAA also has access to capital market loans through USAA Capital Corp. In September 2011, USAA issued \$250 million through USAA Capital Corp. at very favorable rates.

Moreover, in an extreme situation, USAA has a surplus and liquidity recovery plan to ensure that it can recover its financial position after a major loss. The parent company can allocate amounts to subscribers' accounts in excess of what it needs to support its individual operations and chooses to pay out in policyholder dividends or subscribers' account distributions for its policyholders. The policyholder may not withdraw these accounts until membership is terminated. In addition, the parent can recapture balances in these accounts if, in the board's opinion, its financial health requires this action. Recapturing subscribers' account contributions generates taxable income, but losses would likely offset taxes arising from such a decision because the board would recapture subscribers' account contributions only in a situation of financial stress. Reinsurance utilization, temporary suspension, or delay of subscribers' account distributions and policyholder dividends, capital market borrowings, securities lending program

and borrowings from affiliated entities offer increased financial flexibility. In any case, the group's extremely strong capital position and operating prospects give it ample latitude to self-fund the initiatives it requires.

## Related Criteria And Research

- Analysis Of Insurer Capital Adequacy, Dec. 18, 2009
- Interactive Ratings Methodology, April 22, 2009
- Analysis Of Nonlife Insurance Operating Performance, April 22, 2009
- Evaluating Insurers' Competitive Positions, April 22, 2009
- Life: Liquidity, April 22, 2004
- Counterparty Credit Ratings And The Credit Framework, April 14, 2004

### Ratings Detail (As Of November 1, 2011)

#### Operating Companies Covered By This Report

##### USAA Life Insurance Co.

Financial Strength Rating

*Local Currency*

AA+/Negative/--

Counterparty Credit Rating

*Local Currency*

AA+/Negative/--

##### United Services Automobile Association

Financial Strength Rating

*Local Currency*

AA+/Negative/--

Issuer Credit Rating

*Local Currency*

AA+/Negative/--

##### USAA Casualty Insurance Co.

Financial Strength Rating

*Local Currency*

AA+/Negative/--

Issuer Credit Rating

*Local Currency*

AA+/Negative/--

##### USAA General Indemnity Co.

Financial Strength Rating

*Local Currency*

AA+/Negative/--

Issuer Credit Rating

*Local Currency*

AA+/Negative/--

##### USAA Life Insurance Co. of New York

Financial Strength Rating

*Local Currency*

AA+/Negative/--

Issuer Credit Rating

*Local Currency*

AA+/Negative/--

#### Related Entities

##### USAA Capital Corp.

Issuer Credit Rating

*Local Currency*

AA+/Negative/A-1+

Commercial Paper

*Local Currency*

A-1+

**Ratings Detail** (As Of November 1, 2011) **(cont.)**

|                             |     |
|-----------------------------|-----|
| Senior Unsecured (5 Issues) | AA+ |
|-----------------------------|-----|

|                 |       |
|-----------------|-------|
| <b>Domicile</b> | Texas |
|-----------------|-------|

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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