

## Rating Report

### Report Date:

July 26, 2011

### Previous Report:

July 27, 2010



Insight beyond the rating

# Government of Canada

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## Recent Actions

July 27, 2010

Confirmed

## Rating

Debt	Rating	Rating Action	Trend
Short-Term Liabilities, Local & Foreign Currency – Issuer Rating*	R-1 (high)	Confirmed	Stable
Long-Term Local Currency – Issuer Rating*	AAA	Confirmed	Stable
Long-Term Foreign Currency – Issuer Rating*	AAA	Confirmed	Stable

\*Ratings and trends also apply to related federal entities. Please see note on page 8.

## Rating Update

DBRS has confirmed the long- and short-term ratings of the Government of Canada (the Government or Canada) at AAA and R-1 (high) with Stable trends. While still facing notable challenges, Canada's fiscal and economic performance continues to be the envy of many sovereign peers with its strong credit profile supported by a manageable debt burden, prudent fiscal management and sound financial system. The Government exceeded budget expectations in 2010-11 and in the latest budget, made plans to accelerate its return to balance by a year to 2014-15. Despite the uncertainty surrounding global fiscal consolidation plans and European debt troubles, Canada has considerable flexibility to withstand these headwinds without compromising its strong credit profile.

Based on preliminary results, Canada posted a deficit of \$36.2 billion in 2010-11 compared to a \$49.2 billion shortfall originally anticipated. This equates to a moderate 2.2% of GDP and leaves Canada well ahead of G7 peers in its fiscal recovery efforts. Further improvement is anticipated this year with the deficit budgeted to fall to \$32.3 billion, or less than 2.0% of GDP. While the Government remains on track with its budget plan to return to balance by 2015-16, it has committed to finding an additional \$4 billion in annual savings in direct program spending by 2014-15, allowing for a return to balance that year. The Government has remained committed to not raising taxes or cutting transfers thus leaving it dependent on strong cost management and supportive economic conditions to achieve its fiscal targets. (Continued on page 2.)

## Rating Considerations

### Strengths

- (1) Manageable debt burden
- (2) Prudent, credible fiscal planning
- (3) Effective debt management strategy
- (4) Strong liquidity position
- (5) Sound financial system

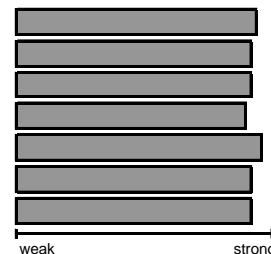
### Challenges

- (1) Stagnant productivity growth and aging population
- (2) Unfunded public sector pension liability
- (3) Rising household indebtedness
- (4) Challenge from low-cost global manufacturers

## Summary Statistics and Country Characteristics

	For the year ended December 31				
	2010	2009	2008	2007	
Nominal GDP (CAD billions)	1,625	1,527	1,600	1,530	Fiscal Management
GDP per capita	47,642	45,284	48,013	46,450	Debt and Liquidity
Real GDP growth (% change yoy)	3.2%	(2.5%)	0.5%	2.2%	Economic Structure
Current account balance (% GDP)	(3.1%)	(3.0%)	0.3%	0.8%	Economic Performance
Inflation (% change year over year)	1.8%	0.3%	2.3%	2.2%	Monetary and Financial
Total external debt (% GDP)	67.6%	66.5%	63.0%	53.7%	External Trade and Finance
General government external debt (% GDP)	16.7%	13.5%	8.9%	9.6%	Political Environment
	For the year ended March 31				
	2010-11*	2009-10	2008-09	2007-08	
Central government balance (% GDP)	(2.2%)	(3.6%)	(0.4%)	0.6%	
Primary balance (% GDP)	(0.3%)	(1.7%)	1.5%	2.8%	
Central government debt (% of GDP)	36.4%	36.6%	32.1%	25.5%	
Central government external debt (% of GDP)	0.9%	0.5%	0.6%	0.6%	

\*projection



## Rating Update (Continued from page 1.)

Following a stronger-than-expected recovery in 2010, the economy is expected to grow by 2.9% in 2011, which appears in line with the current private-sector consensus and recent International Monetary Fund (IMF) forecast. The budget assumes real GDP growth of 2.8% in 2012 which is somewhat above the IMF forecast, presenting downside risks given the current uncertainty surrounding fiscal consolidation in the United States, and efforts already underway in Europe where sovereign debt troubles could cause further disruptions in global demand.

Canada's debt-to-GDP ratio (as measured by DBRS) is projected to have finished 2010-11 at 36%, down from 37% one year earlier. At this level, debt is easily manageable for the rating and remains low by international standards. Debt is expected to grow somewhat faster in 2011-12, in part due to the Government's plan to boost liquidity. As economic growth begins to slow, the debt-to-GDP ratio could rise slightly again. The solid economic and fiscal performance in 2010-11 is unlikely to be repeated. As a result, DBRS believes that disciplined expenditure management will be required to achieve fiscal targets, and potentially even further fiscal measures, beyond those already contemplated, if economic conditions prove unfavourable.

## Rating Considerations Details

### Strengths

(1) **Manageable debt burden.** Canada's debt burden remains easily manageable, thanks to steady debt reduction through the late 1990s and early 2000s. Unmatured federal government debt was estimated at 36% of GDP for the year ended March 31, 2011, down from a peak of 58% in 1994-95. In addition, Canada's gross debt as measured by the IMF, compares favourably with G7 peers.

(2) **Prudent, credible fiscal planning.** The Government maintains a thorough budgeting process and conducts quarterly updates on the fiscal outlook, on top of regular monthly financial statements in accordance with the IMF's *Code of Good Practices on Fiscal Transparency*. In addition, economic assumptions built into the budgeting process are based on a survey of private-sector forecasters.

(3) **Effective debt management strategy.** The Government actively pursues a predetermined debt structure and well-distributed maturity profile in order to reduce refinancing risk and minimize interest costs. Under the current *Debt Management Strategy*, a target has been set for the annual refixing share of debt in the range of 31% to 37%. An effort is also being made to ensure that the market for government benchmark debt continues to be well functioning and liquid, which is especially important as borrowing has ramped up considerably in recent years.

(4) **Strong liquidity position.** Underpinning the solid R-1 (high) short-term rating, liquid financial resources were estimated to be \$59 billion at March 31, 2011, including \$10 billion in operating cash balances and \$49 billion in foreign currency reserves, covering foreign currency debt over six times. DBRS notes that the government has embarked on a prudential liquidity plan aimed at maintaining liquidity levels sufficient to cover at least one month of projected cash flows, including debt service requirements. This will involve increased government deposits held with financial institutions and growing liquid foreign exchange reserves.

(5) **Sound financial system.** A relatively sound financial system allowed the Government to focus more on precautionary measures to preserve confidence during the financial crisis rather than directly intervening to bail out financial institutions. This strength has been recognized by the World Economic Forum which has ranked Canada's banking system as the soundest in the world for three years running.

### Challenges

(1) **Stagnant productivity growth and aging population.** Over the past two decades, Canada's productivity growth has underperformed both the United States and many other OECD countries. This has slowed the rate of growth in potential output and, consequently, the standard of living. Stimulating productivity growth will become increasingly important as Canada's population ages and the labour force potentially shrinks. A rising

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dependency ratio will also require greater productivity increases in order to maintain sufficient economic growth to cover the higher costs of government services.

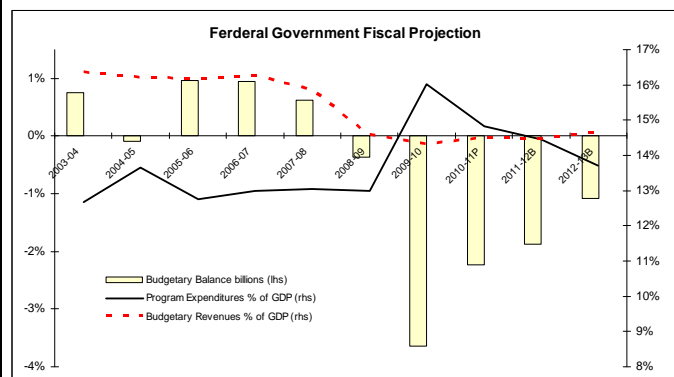
(2) **Unfunded public sector pension liability.** The unfunded pension liability of the federal public sector, along with the non-pension future employee benefits, amounts to approximately 12% of GDP. While this is not overly large, the liabilities represent a future strain on government finances and have the potential to increase unmatured government debt.

(3) **Rising household indebtedness.** Enticed by historically low borrowing costs, Canadian households have been taking on an increased debt load as measured by household debt to income. This poses a risk to the broader economy should household spending get squeezed as interest rates rise, though DBRS believes the likelihood of a significant housing market correction and pullback in consumer spending occurring to be remote.

(4) **Challenge from low-cost global manufacturers.** The emergence of developing economies pursuing export-led growth strategies presents a significant competitive challenge to the Canadian manufacturing sector. Lower labour and production costs have led to the dislocation of labour-intensive industries like textile, and the relocation of factories and jobs from Canada to abroad. DBRS notes that Canada is not alone in this regard. Nonetheless, this trend is expected to continue, as developing economies move from lower value-added exports to more complex products such as automobiles and pharmaceuticals.

**Fiscal Management and Policy**

The 2011 budget – originally introduced on March 22, 2011, but not passed due to the defeat of the Government on a motion of non-confidence (see: DBRS Comments on Canada’s 2011 Budget: Well-Balanced but Possibly Short-Lived, March 23, 2011) – was reintroduced on June 6, 2011, following the re-election of the Conservative government with a majority position. The latest budget implements some modest revisions from what was originally tabled with the main changes being a commitment to provide the Province of Québec with \$2.2 billion in transition funding related to prior sales tax harmonization and a goal to achieve an additional \$4.0 billion in annual savings allowing for a return to balance by 2014-15, a year earlier than planned.



As expected at the time of last year’s review, Canada outperformed fiscal targets and, based on preliminary results, recorded a budget deficit of \$36.2 billion compared with a shortfall of \$49.2 billion originally budgeted. This improvement stems largely from the impact of a stronger-than-expected economic recovery on total revenues and lower spending as some infrastructure funding was moved forward into 2011-12. Year-over-year, total revenues were up by 7.8%, led by personal income tax (PIT) and GST receipts. Corporate income tax (CIT)

receipts were down from the prior year but nonetheless well above budget expectations contributing to the improvement. Most program areas came in below budget, reflected in part by the deferral of certain infrastructure funding into 2011-12 as the deadline for some programs was extended. Total spending declined by almost 1% year-over-year. Direct program expenses were held flat along with transfers to persons while transfers to other levels of government declined as a result of reduced stimulus funding.

In 2011-12, the Government is forecasting a deficit of \$32.3 billion or less than 2% of GDP. This is somewhat weaker than what was anticipated in last year’s plan but reflects the extension of certain infrastructure monies, mentioned above, and the Government’s election commitment to provide \$2.2 billion in transition assistance to the Province of Québec related to prior sales tax harmonization. Through continued strategic reviews, \$500 million in annual savings have been identified along with \$1.0 billion in annual

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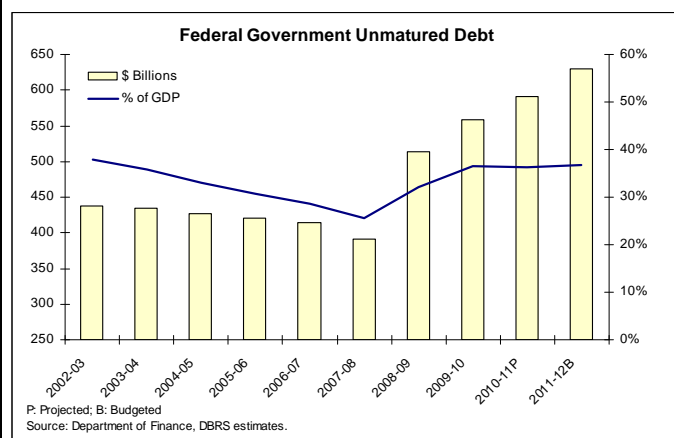
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savings through the closure of tax loopholes. In addition, the government has incorporated the use of a prudent nominal GDP assumption, which presents upside risks to the revenue forecast of roughly \$1.5 billion. Based on the budget, a one percentage point change in real GDP is expected to result in a \$3.3 billion change in the fiscal balance.

The medium-term fiscal outlook remains largely on track with the plan presented in last year's budget with an anticipated return to balance forecast by 2015-16. However, the Government has committed to achieving additional savings beyond those measures that have already been identified with a goal of returning to balance by 2014-15. The Government hopes to recognize \$4.0 billion in additional annual savings through a Strategic and Operating Review of direct program spending. This would entail a 5% reduction in direct program spending with specific details to be presented in the 2012 budget. Achieving this target will be dependent upon strong fiscal discipline, something considered more likely given the re-elected Government's majority position. However, the unsteady U.S. economic recovery and significant contractionary fiscal measures needed to bring its fiscal balance back to a more sustainable path, combined with European austerity measures and ongoing debt rising debt burdens adds material downside risks to the outlook.

**Debt and Liquidity**

Canada's unmatured debt reached \$591 billion in 2010-11 based on the March 2011 Fiscal Monitor. This represents an increase of 5.7% over the prior year as debt growth slowed after two years of solid gains. This equates to 36.4% of GDP, down from 36.6% in 2009-10 and below prior year expectations due largely to stronger-than-expected GDP growth. After including unfunded pension liabilities and netting financial assets, DBRS estimates Canada's debt-to-GDP level to be roughly 45%, also somewhat reduced from the level experienced in the year before. Based on the budget, Canada's unmatured debt is forecast to grow by 6.7% in 2011-12 although solid growth projected in nominal GDP will hold the debt-to-GDP ratio at 36.7%. While nominal debt has increased markedly in recent years, Canada's debt-to-GDP ratio remains very manageable and compares favourably with other G7 countries.



For 2011-12, total debt issuance of \$263 billion is planned, of which \$224 billion is required for refinancing needs, primarily treasury bills (t-bills). The Government's prudential liquidity plan will contribute \$12 billion to borrowing needs although cash balances will only increase by \$4 billion. Financing requirements for Crown corporations, including the Business Development Bank of Canada (BDC), Canada Mortgage and Housing Corporation (CMHC) and Farm Credit Canada (FCC), whose borrowing programs were consolidated with those of the federal government in 2008-09, are forecast at only

\$3 billion.

Gross bond issuance of \$102 billion is planned for 2011-12, somewhat above the \$96 billion conducted in 2010-11. As the Government embarks on its effort to move to a more efficient debt structure, it has announced the addition of four new maturity dates to help smooth the maturity profile and reduce the size of single day maturities. The size of the t-bill program will continue to contract and is now expected to be \$150 billion by the end of fiscal year 2011-12, down \$13 billion from March 31, 2011, and more than 20% below the peak reached in 2008-09.

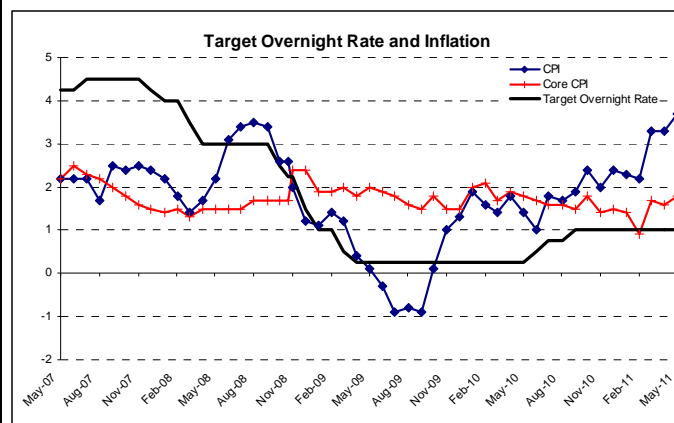
## Economic Structure and Performance

Canada's economy recovered soundly in 2010 with real GDP growth of 3.2%, the fastest growth in ten years. The recovery was one of the fastest among G7 countries as strong growth in the first quarter of 2010 provided sufficient momentum into year end. By year end, the labour markets had shown a notable improvement, with the unemployment rate falling to 8.0% in 2010, from 8.3% in 2009. This helped support strong retail sales growth of 5.5% while housing starts rose by a robust 27.4%.

Following a stronger-than-expected recovery in 2010, the budget assumes real growth of 2.9% in 2011, which appears in line with the current private-sector consensus and recent International Monetary Fund (IMF) forecast. First quarter GDP growth was strong once again, though this is expected to have slowed in Q2 2011, in part due to supply disruptions as result of the earthquake in Japan. Notably, a strong labour market has helped reduce the unemployment rate to 7.4% as of June 2011, down by 0.5% from a year ago and it remains well below the U.S. unemployment rate when measured on a comparable basis. This has continued to support growth in retail trade, up by 3.6% year-over-year as of April 2011. Investment in non-residential building construction is up 5.8% through the second quarter of 2011 compared with the period a year ago though private sector investment will need to fill the void as government stimulus projects reach completion.

The budget assumes real GDP growth of 2.8% in 2012 which is somewhat above the IMF forecast and DBRS believes the risks remain tilted to the downside. Uncertainty in the United States regarding the significant contractionary measures required to get its fiscal situation on a more sustainable path and possible disruptions in global demand as a result of the European debt crisis are likely to weigh on growth prospects over the medium term.

## Monetary Policy and Financial Stability



The Bank of Canada's target overnight rate has been held steady at 1.0% since the last 25 basis point increase in September 2010. As inflation pressures continue to mount, the Bank is generally expected to resume its tightening cycle later in 2011, although rising uncertainty in both the United States and Europe could point to a delay.

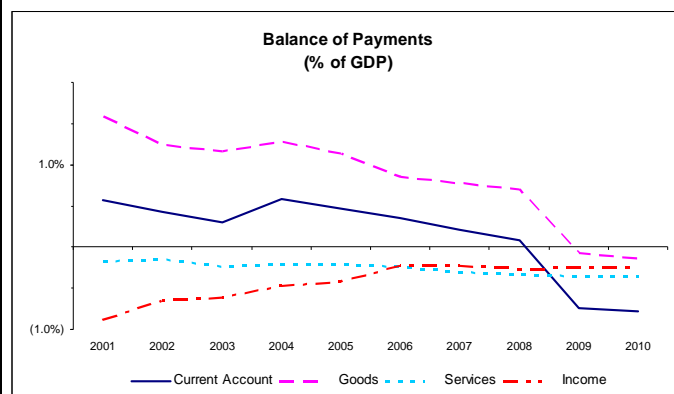
In the Bank of Canada's latest *Monetary Policy Report* released on July 20, 2011, the output gap was estimated to be minus 0.7% for the second quarter of 2011. The Bank now expects the economy to return to full capacity by mid-2012 – roughly six months later than had been anticipated at the time of DBRS's last review.

Low borrowing costs, and easing lending conditions have resulted in a pickup in credit growth in recent months, particularly for the business sector implying access to credit will continue to support the recovery. In addition, the implementation of Basel III is expected to be very manageable for Canadian banks given the lengthy phase-in period and the widely held view that Canadian banks are well-capitalized.

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**Balance of Payments**



For the second consecutive year, Canada's current account balance was in a deficit position (0.8% of GDP) in 2010 and has been declining steadily since 2004. The goods deficit has continued to widen, as a result of weakness in machinery and equipment and consumer goods, only partially offset by growth in energy products and industrial goods surpluses. The service deficit remained unchanged as did the investment income deficit as an improvement in direct investment income was offset by a decline in portfolio

investment income. By destination, Canada's goods surplus with the United States has been dramatically reduced through 2009 and 2010 as a result of the unsteady economic recovery faced by the United States and the strengthening Canadian currency. Absent a sustained recovery south of the border, this is unlikely to change in the near term.

**Political Environment**

**Last Election:** May 2, 2011

**Next Election:** October 19, 2015

**Party in Power:** The Conservative Party of Canada holds a majority government with 166 of 308 seats.

Following the defeat of the minority Conservative Party government in March 2011, a general election was held on May 2, 2011. As a result, the Conservative Party of Canada, led by Stephen Harper, secured a majority government – the first majority government in over eight years. The New Democratic Party of Canada is now the official opposition, having made significant gains in the recent election at the expense of the Liberal Party and Bloc Québécois.

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**Canada: Selected Indicators**

For the year ended March 31, unless otherwise noted

\$ billions unless otherwise noted.

	2010-11**	2009-10	2008-09	2007-08	2006-07	2005-06
<b>Public Debt</b>						
Central Government	590.8	559.1	514.0	390.7	414.2	421.1
% GDP	36.4%	36.6%	32.1%	25.5%	28.6%	30.7%
<b>Domestic Debt</b>						
Central Government	n.a.	468.0	441.4	340.0	359.0	361.5
% GDP	n.a.	30.6%	27.6%	22.2%	24.7%	26.3%
<b>External Debt</b>						
General Government*	270.9	205.9	141.8	147.1	144.1	138.3
% GDP	16.7%	13.5%	8.9%	9.6%	9.9%	10.1%
Central Government	n.a.	91.1	72.6	50.7	55.2	59.7
% GDP	n.a.	6.0%	4.5%	3.3%	3.8%	4.3%
Gross External Debt*	1,098.3	1,015.7	1,008.3	821.8	811.8	737.9
% GDP	67.6%	66.5%	63.0%	53.7%	56.0%	53.7%
Net External Debt*	1,049.8	968.7	956.6	779.5	767.6	697.1
% GDP	64.6%	63.4%	59.8%	51.0%	52.9%	50.7%
% of Current Account Receipts	191.9%	193.0%	148.9%	125.9%	128.3%	121.1%
<b>Fiscal Balances (% GDP)</b>						
Central Government Balance	(2.2%)	(3.6%)	(0.4%)	0.6%	0.9%	1.0%
Revenues	14.5%	14.3%	14.6%	15.8%	16.3%	16.2%
Expenditures	16.7%	18.0%	14.9%	15.2%	14.5%	15.2%
Interest Payments	1.9%	1.9%	1.9%	2.2%	2.3%	2.5%
Interest Payments (% revenues)	13.1%	13.3%	13.0%	13.9%	14.1%	15.4%
Central Government Primary balance	(0.3%)	(1.7%)	1.5%	2.8%	3.2%	3.5%
General Government Balance	(3.6%)	(3.4%)	0.9%	2.5%	2.6%	2.5%
<b>Balance of Payments &amp; Liquidity*</b>						
Current account balance	(50.9)	(45.2)	5.3	12.8	20.5	25.9
% GDP	(3.1%)	(3.0%)	0.3%	0.8%	1.4%	1.9%
Trade balance	(31.8)	(26.9)	23.4	28.6	35.5	50.3
Foreign direct investment (% GDP)	(1.0%)	(1.5%)	(1.5%)	4.0%	1.1%	(0.2%)
International reserves	48.5	47.0	51.7	42.3	44.2	40.8
International reserves (ratio to short-term external debt)	n.a.	14.2%	16.9%	13.8%	17.5%	18.9%
International Investment Position	(196.2)	(110.4)	(48.3)	(129.8)	(90.9)	(164.9)
External assets	1,475	1,461	1,495	1,212	1,182	996
External liabilities	1,671	1,572	1,543	1,342	1,273	1,161
<b>Other Indicators*</b>						
Real GDP (% change yoy)	3.2%	(2.5%)	0.5%	2.2%	2.8%	3.0%
Inflation (CPI)	1.8%	0.3%	2.3%	2.2%	2.0%	2.2%
Exchange rate index (CERI % change yoy)	10.3%	(5.7%)	(0.6%)	4.9%	6.8%	7.3%
Exchange rate (end of year CAD/USD)	0.99	1.05	1.22	0.99	1.17	1.17
Credit to private sector (% change yoy)	5.6%	2.8%	10.7%	9.0%	9.2%	7.0%
Government 1-year bond yield	1.1%	0.6%	2.6%	4.3%	4.2%	3.1%

\* Based on calendar year-end. \*\*2010-11 government data are projections and not yet finalized. n.a. = not available.

Note: General Government consists of federal, provincial and local governments; General Government total debt is calculated as financial liabilities minus financial assets. Central Government debt (also known as unmatured debt) consists of marketable bonds, notes and bills, Canada Savings Bonds, Canada Investment Bonds, Canada Premium Bonds, Canadian Pension Plan (CPP) bonds and foreign currency bills, bonds and notes, obligations related to capital leases, amortization and foreign currency valuation adjustments. General Government balance includes the CPP and Québec Pension Plan.



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### Rating

Debt	Rating	Rating Action	Trend
Short-Term Liabilities, Local & Foreign Currency – Issuer Rating	R-1 (high)	Confirmed	Stable
Long-Term Local Currency – Issuer Rating	AAA	Confirmed	Stable
Long-Term Foreign Currency – Issuer Rating	AAA	Confirmed	Stable

### Rating History

	Current	2010	2009	2008	2007	2006
Short-Term Liabilities, Local & Foreign Currency – Issuer Rating	R-1 (high)	R-1 (high)	R-1 (high)	R-1 (high)	R-1 (high)	R-1 (high)
Long-Term Local Currency – Issuer Rating	AAA	AAA	AAA	AAA	AAA	AAA
Long-Term Foreign Currency – Issuer Rating	AAA	AAA	AAA	AAA	AAA	AAA

### Related Research

- [DBRS Comments on Canada's 2011 Budget: Well-Balanced but Possibly Short-Lived](#), March 23, 2011.

#### Notes:

All figures are in Canadian dollars unless otherwise noted.

The ratings and trends of the Government of Canada apply to the debt of the following entities guaranteed by the Government of Canada either explicitly or implicitly through agency status:

Business Development Bank of Canada	Farm Credit Canada
Canada Mortgage & Housing Corp.	NHA Mortgage-Backed Securities
Canada Post Corporation	The Canadian Wheat Board (only guaranteed debt)
Export Development Canada	

For the definition of Issuer Rating, please refer to Rating Definitions under Rating Policy on [www.dbrs.com](http://www.dbrs.com).

Generally, Issuer Ratings apply to all senior unsecured obligations of an applicable issuer, except when an issuer has a significant or unique level of secured debt.

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