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Asset Management

<u>Morgan Stanley's LIBOR Decision Raises Uncertainty</u>

The remaining tenors of USD LIBOR trading will be discontinued after June 30, 2023. All necessary LIBOR reference rate guidance is in place for a smooth transition to a Secured Overnight Financing Rate (SOFR) based replacement benchmark. Notwithstanding expected industry standards that transition labeled LIBOR issuance to SOFR, Morgan Stanley surprised the market with a legal interpretation of certain "fallback language" on some preferred stock issues that will keep the original coupons fixed-for-life rather than switching to a new floating rate dividend as labeled on the prospectus -- **but was this business decision appropriate?**

<u>Laws are in place and are intended to remove LIBOR uncertainties:</u>
LIBOR uncertainties arose because the risk that LIBOR would one day <u>cease</u> or be <u>permanently unavailable</u> was **unfathomable**. Consequently, most LIBOR deals do not consider this risk in documentation (i.e., in "fallback" language that directs what to do if LIBOR quotes cannot be found) but rather consider only a <u>temporary absence</u> of needed LIBOR quotes. Many preferred securities issued before 2017 had a multi-step process of fallbacks or steps to obtain a LIBOR benchmark if there were difficulties in finding the rates where normally published (e.g., on Reuters) <u>but did not manifest any conditions for replacement benchmarks</u> (e.g., SOFR) <u>to be permanently adopted in place of LIBOR</u>. **Consequently, these fallback provisions can be viewed as being inadequate**. Federal legislation and New York State law direct the application of industry standard replacement benchmarks when a security's prospectus does not specifically address LIBOR cessation. **Fundamentally, the spirit of the legislation was to ally LIBOR based market uncertainties and fallback inadequacies by replacing LIBOR with SOFR**.

<u>Background:</u>
The Alternative Reference Rates Committee (ARRC) that contemplated SOFR to replace LIBOR states: *"fallback language addresses the temporary unavailability of LIBOR, not permanent unavailability."* The legislation intends to cure this inadequacy by requiring issuers of legacy LIBOR paper to adopt the industry standard SOFR replacement, rather than follow <u>temporary fallbacks</u> to LIBOR determinations that will not be available. Indeed, if calculation agents were to follow the fallback sequences to obtaining future LIBOR quotes (intended to only be temporarily disrupted) when they won't be available, then they would sequentially default to the final stop every quarter making assumed temporary but "variable" calculations functionally fixed into perpetuity as LIBOR would always be unavailable -- for example if no LIBOR is available, **Morgan Stanley Series K** says the dividend payable would be based on the initial dividend rate (i.e., 5.85%); and **CitiGroup Series K** states the payment would be the initial LIBOR rate (i.e., at issuance) of 0.2381% plus the spread of 4.3916%.

In either case, were it not to be for the clarity of the LIBOR cessation legislation that replaces LIBOR with SOFR based reference rates, having a permanent fixed payment to perpetuity in the absence of sufficient LIBOR quotes (like in these two examples) <u>would **not** be maintaining the spirit of the deals which are to float the dividends in keeping with the floating rate label on the</u>

securities. Furthermore, given that ARRC has established industry standards and legislation has codified the transition in the spirit of business as usual, any business decision to do otherwise based on flawed fallback language appears inappropriate.

SOFR replacement benchmarks are in place:
The SOFR replacement benchmarks are intended to maintain the spirit of the deals in LIBOR legacy issuances. The most referenced floating rate benchmark for our junior subordinated capital securities market was 3-month LIBOR; and the industry standard replacement benchmark is 3-month term SOFR + 26.161 bps when LIBOR is unavailable.

The Bottomline:
Calculation agents can simply switch the words "3-month LIBOR" with the words "3-month term SOFR+0.26161%" when calculating prospective floating rate payments on legacy LIBOR preferred securities deals. This new rate based on SOFR supplants LIBOR by fairly representing the short-term rate on inter-bank credit risks. Therefore, in every case, SOFR is available in place of LIBOR when considering fallback sequencing – in other words, even though LIBOR is unavailable, SOFR is available in place of LIBOR so the calculation agents will have what they need to calculate the floating rate payments through Reuters, London Banks or NY Banks as the case may be, which functionally cures permanent unavailability of LIBOR with SOFR.

Morgan Stanley's treatment of LIBOR legacies (in-part) appears inequitable and unfair:
On April 28th, Morgan Stanley announced that they would be transitioning to industry standard benchmarks for their preferred securities **except** for five fixed-to-floating securities (i.e., the preferred series E, F, I, K and M) that will retain their initial fixed coupon (to perpetuity) because the last fallback step says "initial dividend rate" rather than referencing a LIBOR calculation.

These exceptions were unexpected because in February 2023, Citigroup published their plans to transition to the industry standard SOFR benchmarks for their securities (e.g., **CitiGroup Series K**). This announcement reassured concerned investors that they would follow industry standard replacement benchmarks and by implication the spirit of the floating rate deals. The motivation for CitiGroup to formally announce their plan was primarily because their preferred stocks had economically punitive or "weak" fallback language because the final fallback was LIBOR at issuance or 0.2381% rather than a market rate of about 4.85% at the time – so, CitiGroup satisfied a material economic concern with appropriate manners. Goldman Sachs and JP Morgan followed suit with similar manners. **Adoption of the ARRC industry standard is best practice and was certainly reassuring to investors.**

Morgan Stanley's LIBOR to SOFR split transitioning decision appears inequitable and unfair to investors. For example, if the series K preferred (which has the lowest reset rate of the 5 exceptions) were to go floating rate today and industry set ARRC standards were used (for example, similar to what the company is adopting on its active LIBOR floaters), then the quarterly floating rate on the series K would be 3-month term SOFR + 26.161bps + the initial series K spread or **8.79134%** (5.03873+0.26161+3.4910) rather than 5.85%.

The difference in fallback language between CitiGroup and Morgan Stanley (noted above) is more form than substance. In both cases, documented fallback language was intended to offset a temporary unavailability of LIBOR with an interim substitute rate, but not a permanent fixed rate which manifestly changes the spirit of the deal from one of mitigated floating rate risk to one of heightened long run fixed duration risk. In recognizing this, CitiGroup, Goldman Sachs and JP Morgan have upheld the spirit of their LIBOR floating rate preferred deals by adopting the SOFR benchmarks in lieu of LIBOR – **Morgan Stanley's partial adoption appears inappropriate on 5 counts** because they are not adopting industry standards intended to maintain the integrity of floating rate transactions. Documentation (in these five cases) is functionally unable to cure a permanent unavailability of LIBOR when the spirit of the legislation was to provide the cure by adopting a SOFR benchmark so temporary fallbacks would not be necessary. **As a result, Morgan Stanley has made a business judgement to fix payments based on a legal opinion on LIBOR fallback events that do not have to happen when legislation on SOFR makes the process of a fallback unnecessary**. The implication transposes $4.1 billion in less risky floating-rate preferreds into higher risk fixed-rate-forever preferreds far more sensitive to interest rate volatility.

Conclusion:

Morgan Stanley's LIBOR to SOFR transitioning decision appears inequitable and unfair to investors and potentially undesirable for some risk profiles. We urge Morgan Stanley to reconsider their business decisions on these five preferred stocks and adopt the LIBOR cure with SOFR benchmarks in keeping with the spirit of the laws and industry best practices. Deciding otherwise could negatively impact the capital risk profiles to investors and potentially impair income flows. **We do not believe Morgan Stanley willfully intends to force a change on its shareholder investor profiles but may if they follow the inadequate fallbacks in these five cases despite the documentation flaws having been effectively cured by legislation (intended to override the inadequacies) together with an industry standard of adoption.**

Phil Jacoby
Chief Investment Officer
Spectrum Asset Management, Inc.
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Roberto Giangregorio
Vice President, Portfolio Mgt.
Spectrum Asset Management, Inc
May 8, 2023

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