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DOES FINANCIAL REFORM ENTAIL REAL CHANGE? FOR WHOM, BY WHOM AND HOW ¹

Domenico Siniscalco ²

1) The text and the tables (slides) are closely integrated and must be read together.

2) Vice Chairman Morgan Stanley, former Minister of Economy and Finance, Rome

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Domenico Siniscalco (Vice Chairman Morgan Stanley, former Minister of Economy and Finance, Rome)

Introduction

Laudato Si' mi' Signore, the encyclical letter by Pope Francis, primarily deals with global common goods. The message is fundamental and timely for two reasons at least. First, the key messages of the Letter are topics that clearly need to be addressed in the emerging in countries as well as in the developed world, given the current trends in economic development, wealth distribution and social dynamics. All men and women of good will today are looking for guidance in these areas to avoid the decline in the quality of human life and the breakdown of societies, with the emergence of poverty and deprivation. Second, it is obviously true that the modern world is increasingly interconnected by market flows, such as goods, services, capitals, as well as by externalities, i.e. by interdependencies that are not reflected (or fully reflected) in market variables, but still are vital to mankind: climate change and the environment, migrations, diseases, access to common goods, demography itself.

Human institutions which are still fundamentally crafted around national states and inter-governmental policies (with few exceptions, like ECB), are not yet suitable to deal with such externalities. Hence the need of ad hoc international agreements (such as the international agreements on climate change, or on the ozone layer) but also the fundamental need for a new ethics. In a sense, just like Adam Smith's 'Invisible Hand' requires Adam Smith's 'Moral Sentiments' to work, in the case of global common goods, international agreements need ethics to work and operate across countries and across generations. No contract or agreement, as a matter of fact may be 'complete' and/or fully enforceable.

Pope Francis' focus on 'our common home' addresses a whole set of public goods and externalities: first climate change, then water, biodiversity, but

also addresses sources of externalities, such as inequality, technology and last but not least the financial system. Indeed, 9 years after the beginning of a greatest financial and economic crisis, everybody understands that financial stability is a public good. A pre-condition to operate the human economic system. But banking bailouts with taxpayer money have been deeply controversial.

An audit of the crisis which began in 2007-8 is still to be carried out. But a few milestones have been identified. 1) the financial crisis is related to a set of co-determinants: global unbalances; banking deregulation; interconnectedness between public debts, private debts and banks; lack of long term view. 2) the impact on the real economy, unemployment and inequality has been dramatic; 3) the macroeconomic effects have been severe, but have been contained by a huge policy effort.

The policy response has been different across regions, but fundamentally relied on several pillars. 1) Monetary policy 2) Fiscal Policy 3) An often implicit redesign of central banking 4) A deep reform of the financial system. In this paper I consider the reform of the financial sector and I discuss whether it entailed real change, for whom, by whom, and how.

1) THE FINANCIAL REFORM: THREE STAGES

The main objectives of the financial reform, which occurred after the crisis of 2007-8, have been evolving over time.

At the beginning of the crisis, soon after the Lehman shock, the *first stage* of the financial re-regulation, extremely important and very urgent, has been to stabilize the financial and banking system. Given the high degree of interconnectedness among banks and financial institutions, legislators and regulators find appropriate to contain the financial contagion in the system. This objective has been successfully attained by injecting capital and reducing assets in the banking system, mainly by providing public guarantees and injecting liquidity and taxpayer's money. The recapitalization of banks by Governments amounts to 6.3% of EU GDP. Guarantees were 29.8% (a big number). In this phase taxpayer's money played a crucial role

through a huge Bail out effort, which was aimed to prevent systemic effects. Asset Relief Intervention was 5.1% and other measures reached 2.9pc. On aggregate the EU Government support for banks was 44.1 % of EU GDP or Euro 5.7trn (see slide 1). The data for the US economy are still to be exactly estimated as the TARP data are clearly incomplete. Central banking, in the meantime, changed dramatically, aiming at financial stability as well and fundamentally acting through QE, negative Repo rates and other non-conventional instruments.

Having stabilized the system, as a *second stage* legislators and regulators tried to address more fundamental weaknesses of the financial system: lack of capital (as emerged from the data gathering and the stress testing process of 2014); lack of clear resolution regimes (addressed in the Bail in discipline as opposed to the Bail out regime, primarily aimed at breaking the circuit between Banks and Public Debts), weak prudential rules, fragmented supervision, incentive to excessive risk taking related to compensation models, too close a link between public debts and banks' balance sheets, via Government bond holdings by the banks and Bail outs by Governments. At the beginning the new regulatory framework was proposed and administered by a huge number of entities. After the dust settled, a few building blocks emerged with very few differences among Europe and the US. The main building blocks of the second stage of reforms are highlighted in slide 2. In addition to such building blocks, Central banks gradually shifted their mission including the stabilization of financial markets among their targets, towards the more fundamental objective of price stability.

The *third stage* of the re-regulation of the financial and banking system is still to come and is highlighted in slide 3. The So called SREP, the RWA Inflation, the review on the Quality of Capital, the management of Non Performing Loans, a new wave of Stress Tests, the TLAC (which in my opinion is a way to mitigate through liquidity constraints some flaws of Basel 3) and finally the new augmented capital requirements proposed by the Financial Stability Board in November 2015 are the new even tighter pillars of regulation.

As of today, the Regulatory Requirements that banks face are manifold both on capital and liquidity (see slide 4). Whenever a constraint is relaxed another kicks in. Looking at the set of constraints one can try to answer an important question. As far as the re-regulation are we 80-90 % done, and the banking system is now a much safer industry, or is there still a long way to go? I am inclined to believe we are almost done, but the real effectiveness of the new regulation vis a vis systemic shocks and unintended consequences still remains to be tested. In a sense, all the new regulatory developments are important because, without a stable consistent regulatory framework, banks cannot optimize their structure and their balance sheet (see slide 5 and 6).

What should be discussed at this stage, however, is a deeper set of questions.

- 1) Can we ensure stability by regulating banks only, given their crucial role in the financial and economic system, or are there other financial non-banking systemic institutions?

More Importantly:

- 2) Is stability the sufficient feature of a healthy financial system, or should we aim for other objectives, such as access to credit, allocation of capital, selection of investment and support of growth? After all, the history of money shows the crucial role of financial institutions in promoting human development.

2) THE ECONOMIC CONSEQUENCES OF RE-REGULATION

No doubt the new banking regulation, together with the learning process by managers and shareholders, has dramatically changed the structure of the banking industry. RoEs are markedly down for global financial institutions as well as by the smaller banks (slide 7). Valuation levels are down (P/E and P/B, see slide 8). Lower Beta, increased dividends and ultimately increasing earnings per share are trying to help the sector (slide 9).

The real issue, however, is the impact of banking regulation on the real economy (i.e. on non-financial companies and ultimately GDP). After many years of serious constraints to lending, from 2013 we finally observe a clear recovery in loans growth (slide 10). Banks are stronger, but liquidity in the market has significantly dried down (Slide 11). As a result data show that the reliance of Europe on EU wholesale banking is clearly down, but we cannot easily say whether EU corporates are more reliant on non EU (i.e. US banks see slide 12) or market and non banking sources of credit (slide 13) or other classes of players (slide 14).

The overall risk profile of banks, is improving in developed economies: not so much in Emerging Markets which suffer also from economic weaknesses, unrelated to credit and markets (slide 15). Wealth management and asset managers are now playing the non banking lending game (slide 16) and this phenomenon takes us back to our original questions at the end of section 1. 1) Can we ensure stability by regulating banks only, given their crucial role in the financial and economic system, or are there other systemic sources of instability? 2) Is stability the sufficient feature of a healthy and efficient financial system, or stability is simply a necessary condition and should we aim for other objectives?

In front of this qualified audience I leave answers to the two questions above to our discussion, even if I have in my mind a NO answer to both questions.

Just like in Climate Change, policy must aim to multiple objectives and to overcome the trade offs. From Albert Hirschman, we all know that regulation and deregulation, as well as many government policies, are very rarely “optimal”. Policies are historically given, and inevitably follow a pendulum from too strict to too lax and back. The regulation of banks in the 1930s, the Deregulation in the 1990s, and the current re-regulation are all examples of such a pendulum. Against this background I believe we are now approaching a pause and need to rethink regulation holistically in view of the aims of a stable but efficient banking system: in the secret hope that Hegel rather than Hirschman is right paradigm to understand policy and that we will finally achieve a balanced outcome. We all need a synthesis after all.

Does Financial Reform Entail Real Change? For Whom, by Whom and How

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Vice Chairman, Morgan Stanley

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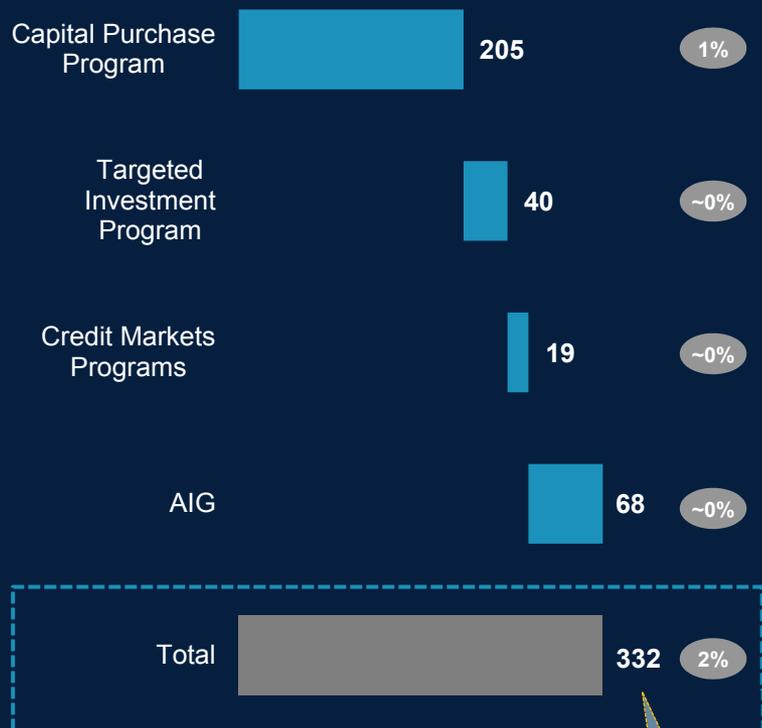
January 29-30, 2016

Government Support for Banks: Larger Scale than Usually Perceived?

Speed vs. Size?

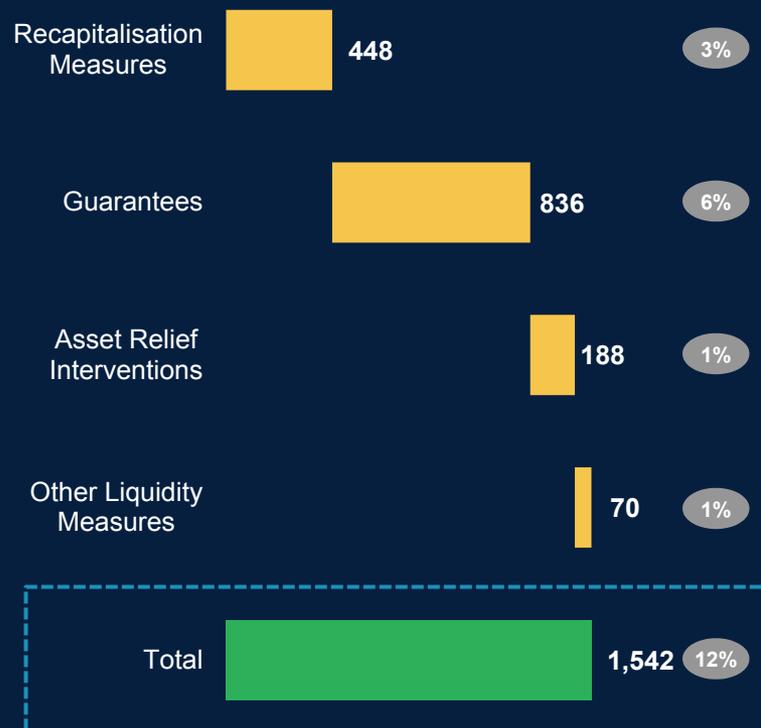
US – TARP⁽¹⁾ Used Amounts

\$ Bn



EU – Used Amounts 2008-2014

€ Bn



xx As % of GDP (%)

Source: DG Competition, Daily TARP Update

\$700 MM initially approved

A Regulatory Reform with Several Building Blocks

Europe

Building Blocks

- **Strengthened Regulation**
 - CRD IV and CRR (2014)⁽¹⁾: capital strengthening, macro-prudential
 - BRRD (2015)⁽²⁾: harmonised resolution regimes,
 - DGSD (forthcoming)⁽³⁾; harmonised coverage, easier and faster
 - EBA⁽⁴⁾ single rulebook (ongoing): single harmonised prudential rules
- **Strengthened Supervision**
 - Establishment of Single Supervisory Mechanism
- **Strengthened Resolution**
 - Agreement on Single Resolution Mechanism (SRM) and annexed Resolution Fund (2014)

Data Gathering

- **Overall Risk Assessment**
 - Supervisory judgments on key risk factors
- **Asset Quality Review (AQR)**
 - Assessment of data quality, asset valuations, classification of non-performing exposures, collateral valuation and provisions
 - Covers credit and market exposures
 - The AQR is driving more provisions, recaps, NPL sales and balance sheet repair
- **Stress Test**
 - Forward-looking assessment of banks' resilience under stress

US

Building Blocks

- **Strengthened Regulation**
 - Dodd-Frank Act (2010) defined regulatory structure of US financial institutions with the creation of Financial Stability Oversight Council and overhaul of FDIC, OCC and Federal Reserve Bank
 - Volcker Rule (implemented by Dodd-Frank Act) prohibiting certain “banking entities” from engaging in proprietary trading
- **Strengthened Supervision**
 - Increased centralization and strengthening of role of Fed Reserve Board while lessening the work of examination staff at the 12 Federal Reserve Banks
- **Strengthened Resolution**
 - Resolution plans periodically submitted to FDIC by banking organizations

Data Gathering

- **Stress Test**
 - Comprehensive Capital Analysis and Review (CCAR) under supervision of Federal Reserve Board for banks with assets >\$50 Bn
- **Resolution Plans**
 - Periodical submission of resolution plan to the Fed Reserve Board and FDIC for banks with assets >\$50 Bn

... And a Lot Still to Come?

Europe vs. US

Europe

	Description and Expected Future Development		Description and Expected Future Development
1 Pillar 2/ Supervisory Review and Evaluation Process ("SREP")	<ul style="list-style-type: none"> Key area of market focus—stipulates banks' Pillar 2 (and hence minimum CET1 ratio) requirements Recent comments from officials appear to indicate Pillar 2 will be binding for Maximum Distributable Amount restrictions 	4 NPLs	<ul style="list-style-type: none"> "Elevated levels of NPLs are a serious concern in Europe" ⁽¹⁾ ECB will be analysing current national regulations, legal frameworks, accounting regimes and supervisory practices relating to NPLs <ul style="list-style-type: none"> Aiming for consistent supervisory practice in the area of NPL recognition, coverage and write-offs
2 RWA Inflation	<ul style="list-style-type: none"> Various reviews underway <ul style="list-style-type: none"> IRB RWA floors based on Standardised Approach Review of Standardised risk weights (aims to introduce more risk sensitivity) Fundamental Review of the Trading Book (Market Risk) Sovereign risk weights—concerns around 0% risk weight 	5 Stress Tests	<ul style="list-style-type: none"> No stress tests in 2015 <ul style="list-style-type: none"> Instead, "Transparency Exercise" will be conducted as in 2013 with publication of detailed information on balance sheet and portfolios (but no projections)
3 Quality of Capital	<ul style="list-style-type: none"> Focus on harmonisation of items where National Competent Authorities currently have discretion <ul style="list-style-type: none"> e.g. Danish Compromise, deferred tax, AFS reserves etc. Capital messaging by banks is now two dimensional <ul style="list-style-type: none"> How CET1 is calculated as well as numerical targets 	6 TLAC/MREL	<ul style="list-style-type: none"> TLAC: Indicative minimum levels for G-SIBs phased-in to 20% of RWAs (plus CET1 buffers on top) or 2x the applicable minimum leverage ratio Expect TLAC framework to gradually drill down and apply to local D-SIBs (in addition to converging with MREL) Missing piece for banks to fine tune and implement total capital strategy (means more Tier 2 and other bail-inable debt) RTS published in July 2015, giving clarity on MREL
		7 Resolution Strategy/SRB	<ul style="list-style-type: none"> Next to SSM on supervision side, now have SRM/SRF on resolution side

United States

	Description and Expected Future Development		Description and Expected Future Development
1 Stress Testing	<ul style="list-style-type: none"> Anticipate relief for less complicated / smaller banks <ul style="list-style-type: none"> No relief for G-SIB's Expect limited relief for non-G-SIB banks >\$250Bn Process becoming year-round 	4 Net Stable Funding Ratio	<ul style="list-style-type: none"> U.S. proposal expected by the end of 2015 Expect super equivalent elements vs. Basel
2 Standardized Approach Revisions	<ul style="list-style-type: none"> Fed, FDIC and OCC have said that they will consider Basel proposals with application, if any, to internationally active banking organizations in the U.S. No current U.S. proposals 	5 Total Loss Absorbing Capital	<ul style="list-style-type: none"> Comments on Fed proposal due Feb. 1st, 2016 FSB final term sheet finalized and expected to be published on November 9th
3 Resolution Planning	<ul style="list-style-type: none"> Regulators increasingly focused on simplicity and resolvability and accordingly resolution planning has become a top priority Unsatisfactory resolution plan could impact CCAR capital actions 	6 M&A	<ul style="list-style-type: none"> Clearer line of sight toward M&A approval and more eligible buyers

Requirements Emerging Across Broad Spectrum of Metrics

Basel III Phase-in Arrangements							Markets asking for this today	
Phase	2013	2014	2015	2016	2017	2018	2019	
Capital	Leverage Ratio	Parallel run 1-Jan-13–1-Jan-17 Disclosure starts 1-Jan-17				Migration to Pillar 1		
	Minimum Common Equity Capital Ratio	3.5%	4.0%		4.5%		4.5%	
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
	Minimum Common Equity Plus Capital Conservation Buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
	Phase-in of Deductions from CET1 ⁽¹⁾		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.5%	5.5%		6.0%			6.0%
	Minimum Total Capital			8.0%				8.0%
	Minimum Total Capital Plus Conservation Buffer		8.0%		8.625%	9.25%	9.875%	10.5%
	Capital Instrument that No Longer Qualify as Non-core Tier 1 Capital or Tier 2 Capital	Phased out over 10 year horizon beginning 2013						
	Liquidity	Liquidity Coverage Ratio—Minimum Requirement			60%	70%	80%	90%
Net Stable Funding Ratio							Introduce minimum standard	

+ Pillar 2
+G-SIFI
Buffers

Transition Periods

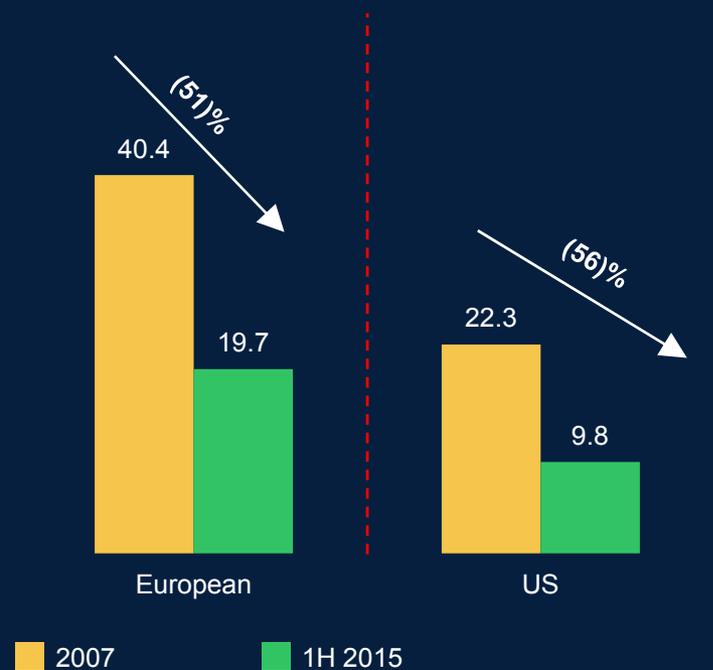
Source: Basel Committee on Banking Supervision (BCBS), Bank for International Settlements

Overall Regulatory Picture Is Clarifying. Are we 80-90% Done?...

Capital Strengthening

Leverage Ratio ⁽¹⁾

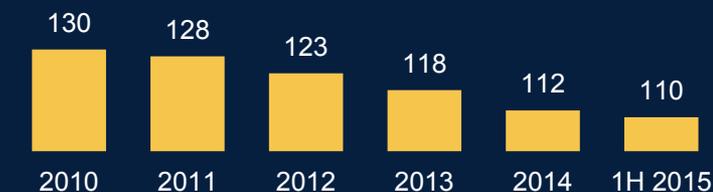
x



Source: Morgan Stanley Analysis

EU Average Loan to Deposit Ratio Evolution

%



Source: ECB

Conduct Charges—Past the Worst

\$ Bn



Source: Morgan Stanley Research

(1) Calculated as total assets over total equity. European peers includes: Barclays, CS, Deutsche Bank, UBS. US peers include: BAC, JPM, Citi, WFC, GS

(2) US peers include: BAC, JPM, Citi, WFC, GS

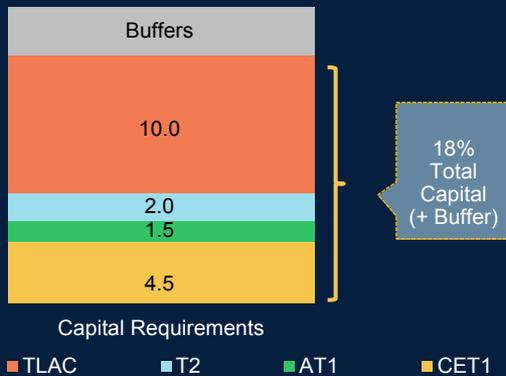
(3) Including Barclays, HSBC, Lloyds, RBS, STAN, Nationwide, Santander UK, CS, UBS, Julius Baer, Commerzbank, Deutsche Bank, BNPP, CASA, Natixis, SocGen, ING, Rabobank, Unicredit

...or Is There Still a Long Way to Go?

EU vs. US TLAC Deficits

EU Banks Capital Requirements

%



Eu G-SIB TLAC Deficits (€ Bn)

387

Source: MS IBD GCM

Top US Banks (1) Required Long Term Debt Issuance Assuming Fully Phased in TLAC Requirements

\$ Bn



Source: MS Research

EU Banks Announcing Capital Increases or CEO Changes Over the Last 2 Months



Deutsche Bank



CREDIT SUISSE



Total Assets (€ Tn)

4.9

More than 1/3 of EU GDP

Morgan Stanley

(1) Analysis based on Wells Fargo, Bank of America, JPM, State Street, Citigroup, Bank of New York Mellon

RoEs are Markedly Down...

RoE Evolution - GSIBs

GSIBs



Source: Oliver Wyman Analysis

RoE Evolution – All Other Banks

All other banks



Source: Oliver Wyman Analysis

... as Are Valuation Levels

Will Customers Pay for This? [Shareholders seem to have paid a lot...]

European Banks

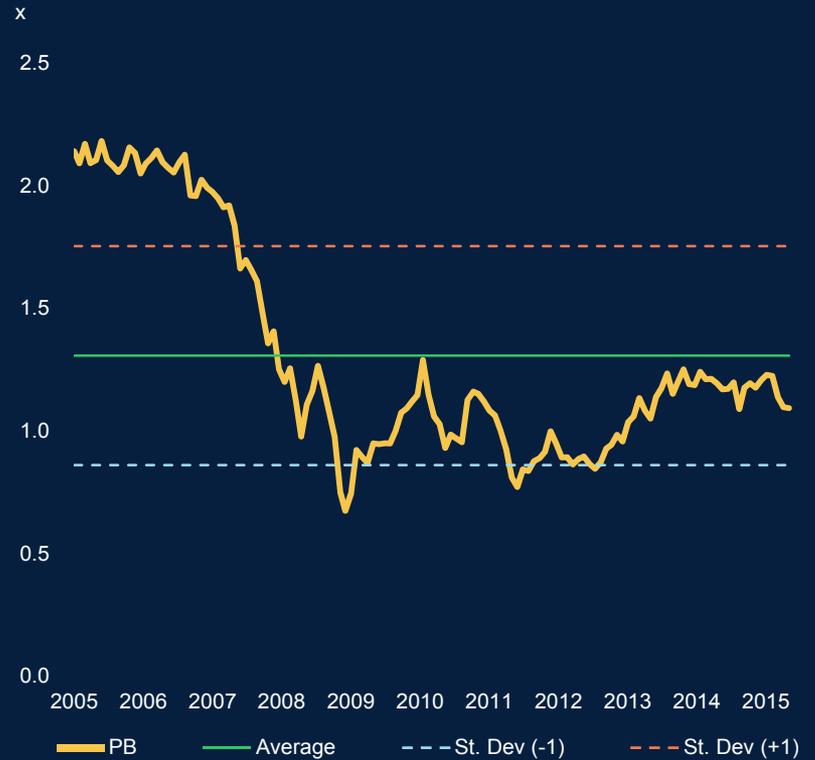
P/B Multiples 2005-2015



Source: Datastream, Morgan Stanley Research

US Banks

P/B Multiples 2005-2015

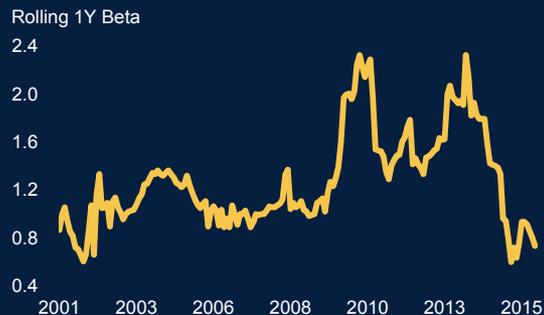


Source: Morgan Stanley Research

Lower Beta, Increasing Dividends and Improving EPS Prospects Helping to Stabilize the Sector

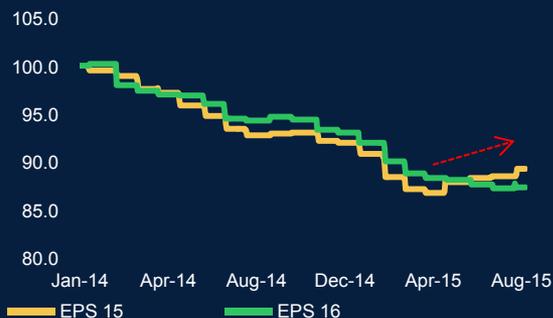
So What's in for the Real Economy?

European Banks Rolling Beta



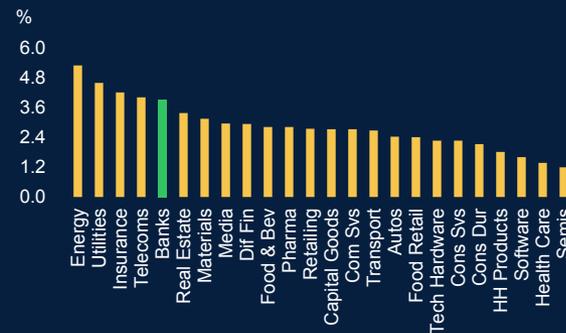
Source: MSCI, Morgan Stanley Research

European Banks - Consensus EPS Index



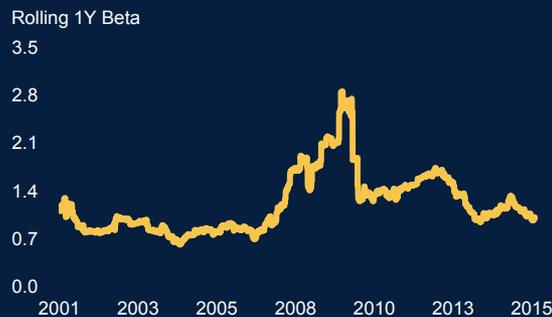
Source: SG Cross Asset Research/Equity

European Sectors: 2015 Consensus Dividend Yield



Source: Datastream, MSCI IBES, Morgan Stanley Research

US Banks Rolling Beta



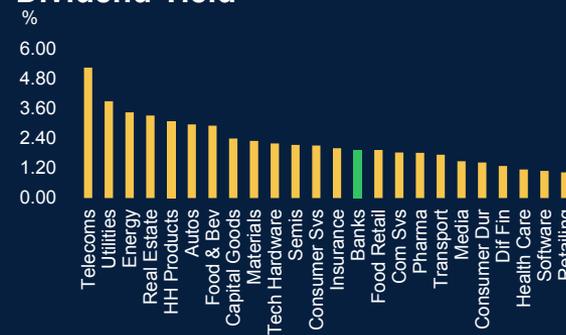
Source: Morgan Stanley Research, BBG

US Banks - Consensus EPS



Source: Morgan Stanley Research, BBG

US Sectors: 2015 Consensus Dividend Yield



Source: Morgan Stanley Research, BBG

A First Signs that Loans Growth is Picking Up

B ...but Little Correlation between Loan Growth and BS Strength

A Europe - Total Assets and Loans

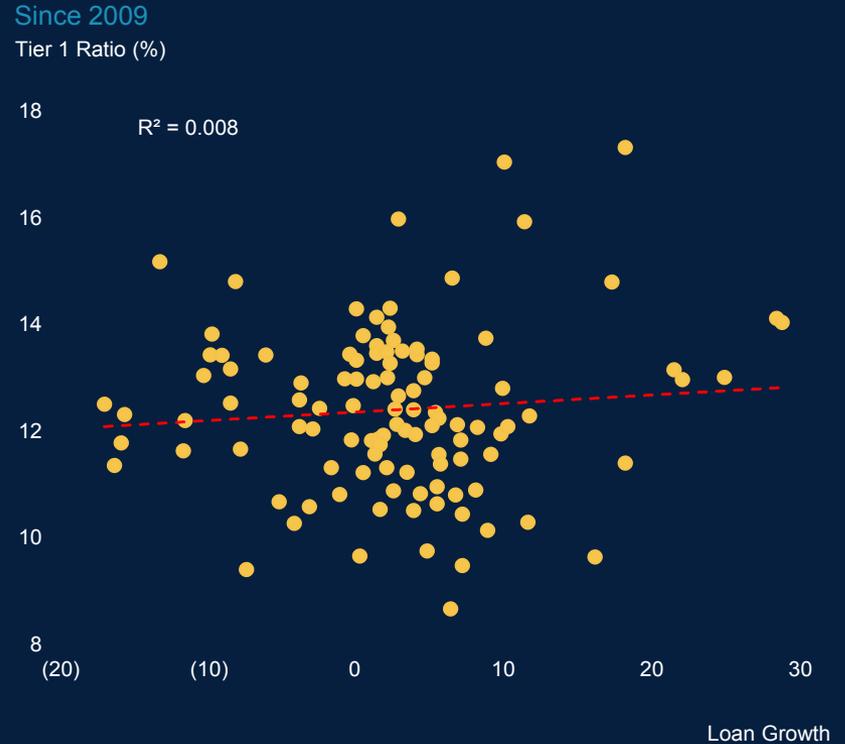


A US - Total Assets and Loans



Source: MS Research, ECB, Datastream

B Loan Growth vs. Tier 1 Ratio Regression



Source: Societe Generale Cross Asset Research

Question: Do We Need a Pause on New Regulation?

A Banks Balance Sheets are Stronger...

B ...but Liquidity in the Market Has Significantly Dried Down

A Primary Dealer Corporate Bond Inventory



Source: Market Axcess

B No. of Average Dealer Quotes Per Corporate Bond



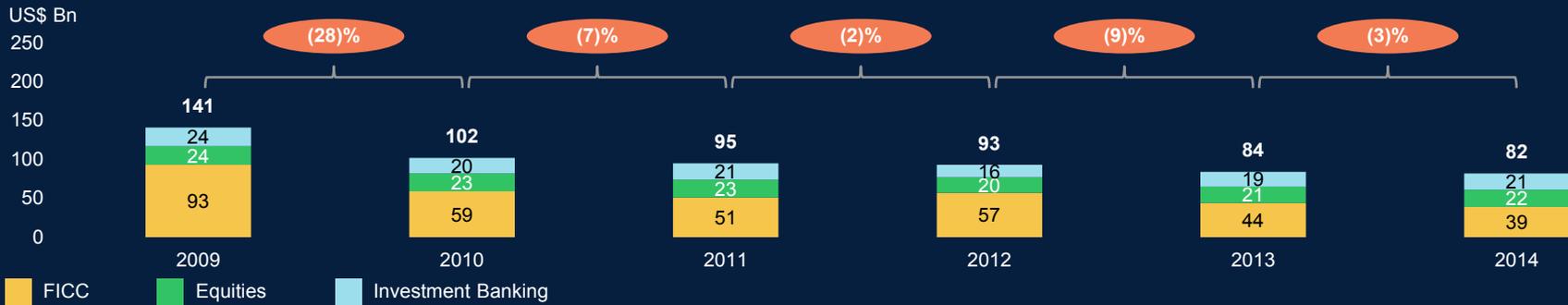
Source: MS Research

Question: Where is the Right Balance Between Risk and Liquidity?

A Reliance of Europe on Wholesale Banking is Decidedly Down...

B ...or Is Europe More Reliant on Non-EU Banks?

A EMEA Revenue Pools for Investment Banking, FICC and Equities



B Global Revenue Pool for Investment Banking, FICC and Equities

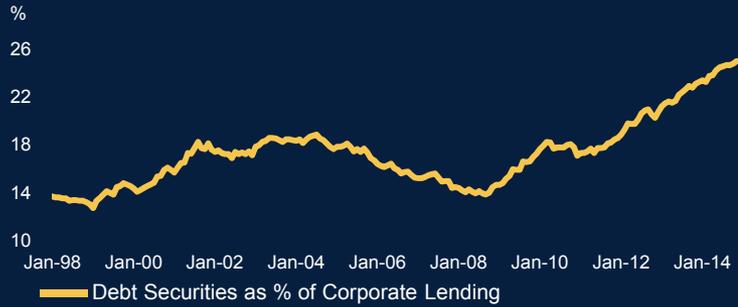


Question: Do We Need Stronger European Wholesale Banks?

A Debt Issuance Noticeably Up...

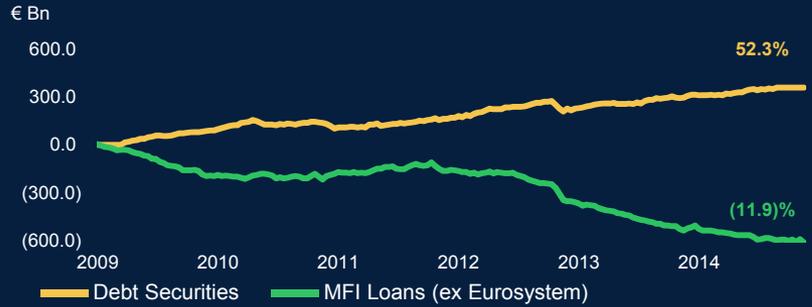
B ... Making Up for Reduced Banks Lending?

A Outstanding Debt Securities as % of Corporate Lending



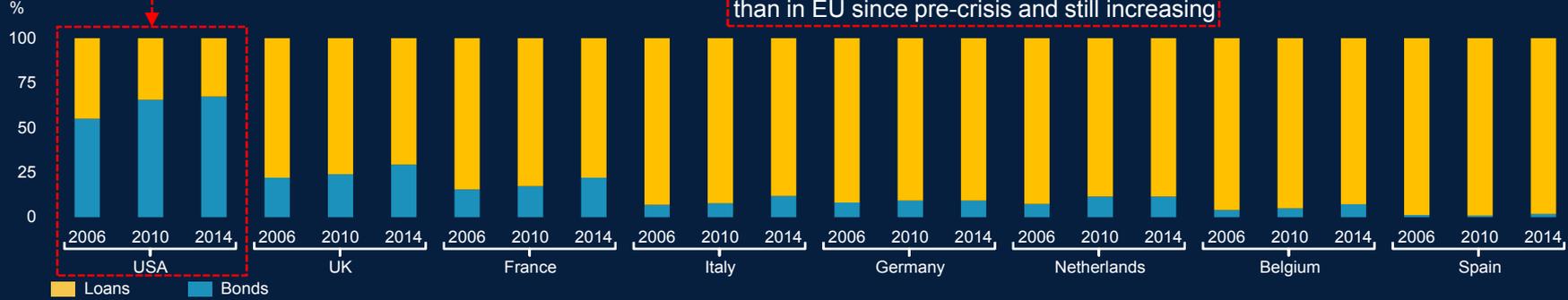
Source: Morgan Stanley Research, ECB

B Debt Securities vs. Bank Lending Evolution



Source: Morgan Stanley Research, ECB

A Corporate Funding (%), Selected Countries (2006–2014)



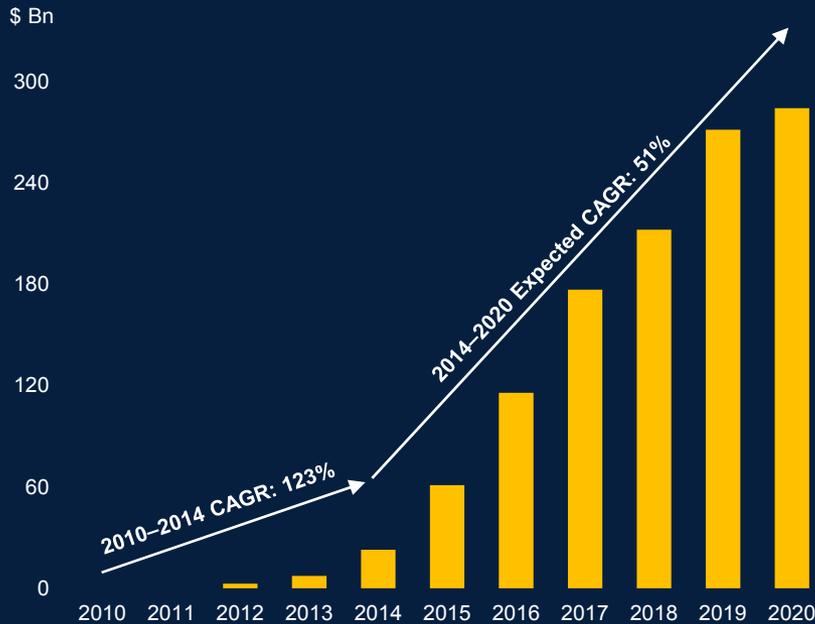
Source: S&P

Question: Are Public Markets Better than Banks in Pricing Risk?

A Reduced Banks' Lending Appetite Opened Opportunities for New Players...

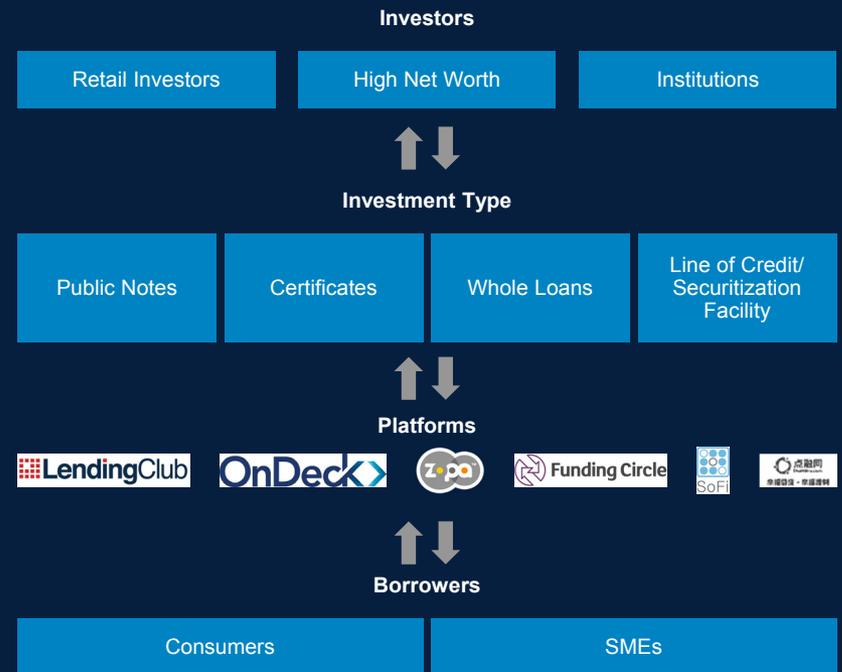
B ... Are These New Players Better at Estimating Risk?

A Global Marketplace Loan Issuance



Source: Morgan Stanley Research estimates

B How Marketplace Lending Works



Source: Morgan Stanley Research

Question(s): Who Are These New Players Lending to? Customers Rejected by Banks? Who Bears the Risk?

A Risk Profile Is Improving in Advanced Economies...

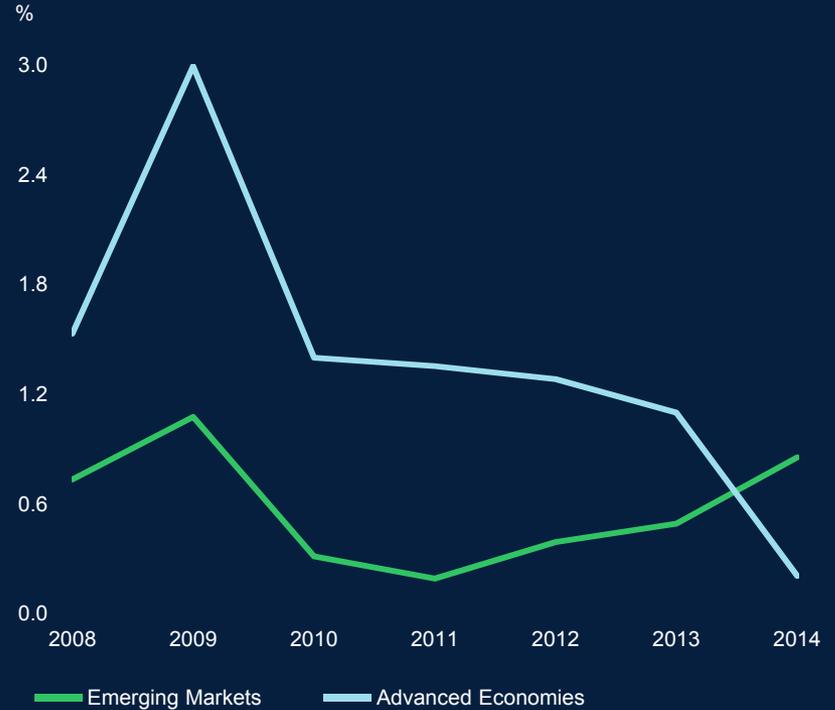
B ... Not so Much in Emerging Markets

A Corporate Debt to EBITDA



Source: S&P's Cap IQ, IMF Staff Calculation

B New Nonperforming Loans to Risk-Weighted Assets⁽¹⁾



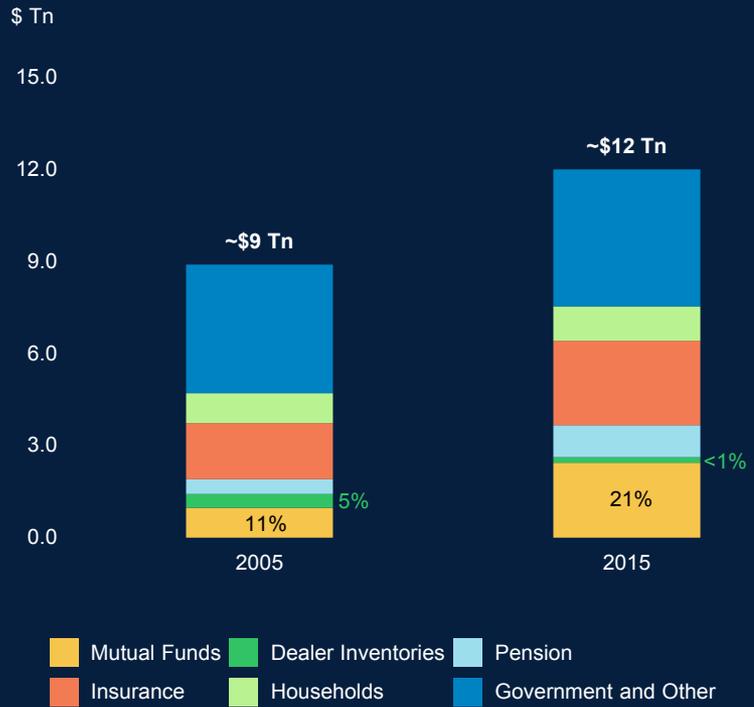
Source: Bankscope, IMF staff calculations

Question: Are We Just Moving the Problem Elsewhere?

A AMs Playing the Lending Game as Banks Less Willing to Do So...

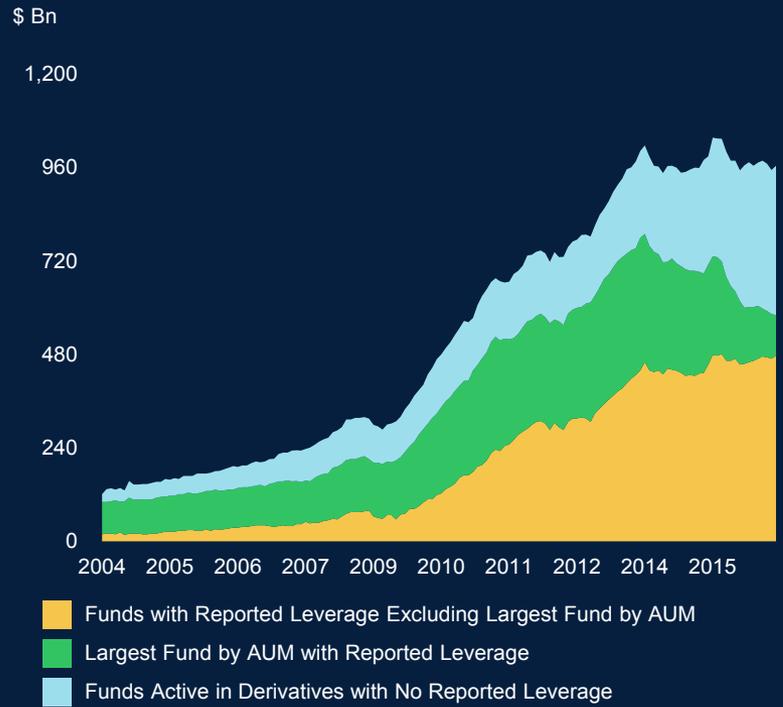
B ...But Low Rates Also Mean AMs Playing the Leverage Game

A US Corporate Credit Asset Ownership



Source: Federal Reserve, Oliver Wyman

B Assets under Management

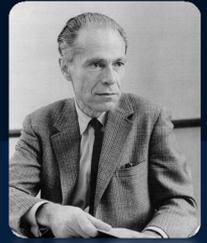


Source: IMF

Question: Is Risk in the Wealth Management Sector under Control? ...Financial Crisis Symbolically Started with European Money Market Funds Suspending Redemptions

(1) Includes government entities and other financial institutions

Regulation vs. Deregulation: Hirschman Dilemma



“There are two tragedies in life. One is not to get your heart’s desire. The other is to get it.” [Albert O. Hirschman 1982]

Regulation

▼

Effects

- Concentration
- Rigidity
- Monitored Market
- Public Interest



Deregulation

▼

Effects

- Enhanced Competition
- Flexibility
- Undisciplined Market
- Individualism Risk

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