MORGAN STANLEY INTERNATIONAL LIMITED

Morgan Stanley

Pillar 3 *Regulatory Disclosure (UK)*

As at 31 December 2010

1. BASEL II ACCORD 2

2. BACKGROUND TO PILLAR 3 DISCLOSURES 2

3. APPLICATION OF THE PILLAR 3 FRAMEWORK 3

4. MORGAN STANLEY INTERNATIONAL LIMITED 3

5. CAPITAL RESOURCES 3

6. REGULATORY CAPITAL REQUIREMENTS 4

7. APPLICATION OF THE PILLAR 2 FRAMEWORK 4

8. RISK MANAGEMENT OBJECTIVES AND POLICIES 4

9. VALUATION AND ACCOUNTING POLICIES 5

10. CREDIT RISK 5

10.1 Credit Exposure 5
10.2 Counterparty and Credit Risk Capital Component ("CRCC") 5
10.3 Internal Ratings-Based Approach 5
10.4 Securitisation 7
10.5 Standardised Approach 7
10.6 Credit Exposure Breakdown Tables 8
10.7 Credit Risk Mitigation 8
10.8 Collateral Downgrades 10
10.9 Wrong Way Risk 10

11. MARKET RISK 11

11.1 Market Risk Capital Component 11
11.2 Value-at-Risk (VaR) 11
11.3 VaR for the Year Ended 31 December 2010 12
11.4 Stress Testing 13
11.5 Interest Rate Risk in the Non-Trading Book 13

1. BASEL II ACCORD

The Basel II Accord, as detailed in "International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version" June 2006, has been implemented in the European Union via the Banking Consolidation Directive and the Capital Adequacy Directive collectively known as the Capital Requirements Directive ("CRD").

The framework consists of three "pillars." Pillar 1 of the new standards sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors are required to assess the appropriateness of the Pillar 1 level of capital that Morgan Stanley International Limited and its subsidiaries (the "MSI Group") require, taking into account risks not covered in Pillar 1, and must take action accordingly. The aim of Pillar 3 is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess certain specified information in relation to capital adequacy, particular risk exposures and risk management processes.

2. BACKGROUND TO PILLAR 3 DISCLOSURES

The MSI Group's ultimate parent undertaking and controlling entity is Morgan Stanley, a Delaware corporation, which, together with its consolidated subsidiaries, form the Morgan Stanley Group ("Morgan Stanley Group"). Morgan Stanley is a "Financial Holding Company" as defined by the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System.

Morgan Stanley currently calculates its capital ratios and risk-weighted assets in accordance with the capital adequacy standards for financial holding companies adopted by the Federal Reserve, which are based upon a framework described in the "International Convergence of Capital Measurement and Capital Standards," July 1988, as amended, also referred to as "Basel I." U.S. banking regulators are in the process of incorporating the Basel II Accord into the existing risk-based capital requirements and Morgan Stanley is working with its regulators accordingly to transition to these requirements.

Morgan Stanley is listed on the New York Stock Exchange and is required, by the U.S. Securities and Exchange Commission ("SEC"), to file public disclosures, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

These disclosures can be found at **http://www.morganstanley.com/about/ir/sec_filings.html.**

The MSI Group is a wholly owned sub-group of the Morgan Stanley Group. Whilst the MSI Group is a material sub-group, the information disclosed in this document is not necessarily indicative of the Morgan Stanley Group as a whole, nor is it comprehensively representative of the Morgan Stanley Group's activity in any particular region. Investors, stakeholders, creditors or other users seeking information on capital adequacy, risk exposure and risk management policies should consult the public disclosures of Morgan Stanley Group, as this will provide a more comprehensive view.

Public disclosures, including those required under Pillar 3 by the Financial Services Authority ("FSA"), will continue to evolve over time. The qualitative and quantitative information contained in this document represents the position of the MSI Group as at 31 December 2010. Amendments to the MSI Group's operating model and risk management procedures that have occurred following this date are not discussed in this document.

The majority of the numerical disclosures in this document are calculated by reference to FSA's methodology and are not necessarily the primary exposure measures used by internal management. The calculation of exposure in this document is based on the calculation methodology for regulatory risk exposure prescribed by the FSA. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

This document does not constitute a set of financial statements. The MSI Group financial statements are prepared in accordance with applicable United Kingdom ("UK") company law and accounting standards ("UK GAAP"). Information disclosed in the financial statements will not necessarily be consistent with information disclosed in this document. Trading Book and Non-Trading Book definitions used in this document refer to the regulatory view and may differ from the accounting definitions.

3. APPLICATION OF THE PILLAR 3 FRAMEWORK

This document represents the annual public Pillar 3 qualitative and quantitative disclosures required by the FSA prudential sourcebook rules for Banks, Building Societies and Investment Firms ("BIPRU") in relation to the MSI Group.

The basis of consolidation for prudential purposes is materially the same as consolidation for accounting purposes. The MSI Group completes its prudential consolidation in compliance with BIPRU, Section 8. The principal subsidiary undertakings of the MSI Group are listed in the annual financial statements of the MSI Group, Company disclosures note 3. The most significant of these subsidiaries is Morgan Stanley & Co. International plc ("MSIP"), the results of which are material to the MSI Group. The risk profile of MSIP is materially the same as the MSI Group and risk management policies and procedures are applied consistently. Therefore, separate disclosure of MSIP individually is not provided.

The MSI Group has a policy in place to assess the appropriateness of its Pillar 3 disclosures, including their verification and frequency.

4. MORGAN STANLEY INTERNATIONAL LIMITED

The Morgan Stanley Group structures its business segments primarily based upon the nature of the financial products and services provided to customers and the Morgan Stanley Group's internal management structure. The MSI Group's own business segments are consistent with those of the Morgan Stanley Group.

The principal activity of the MSI Group is the provision of financial services to corporations, governments and financial institutions. There have not been any significant changes in the MSI Group's principal activity in the period under review and no other significant changes in the MSI Group's principal activity is expected.

As at 31 December 2010, the following entities within the MSI Group were regulated by the FSA:

- Morgan Stanley & Co. International plc
- Morgan Stanley Bank International Limited
- Morgan Stanley Securities Limited
- Morgan Stanley & Co. Limited
- Morgan Stanley Capital Group Limited (Dormant)
- Morgan Stanley Investment Management Limited
- Morgan Stanley Investment Management (ACD) Limited

The FSA regulated MSI Group includes all the entities that form part of the accounting consolidation group with the exception of two entities which do not meet the requirements under BIPRU, Section 8, for inclusion in the prudential consolidation group. As at 31 December 2010, there were no entities which were deducted from the MSI Group's capital resources.

The MSI Group calculates capital requirements in accordance with the regulatory capital requirements of the FSA and, in turn, with guidelines described under the Basel II Accord.

5. CAPITAL RESOURCES

Under FSA supervision, the MSI Group is required to maintain a minimum ratio of total capital resources to capital requirements. As at 31 December 2010, the MSI Group was in compliance with the FSA capital requirements as defined by BIPRU. The FSA handbook can be found at **http://fsahandbook.info/FSA/html/handbook/BIPRU.** All capital resources included in Tier 1, 2 or 3 are of standard form and the main terms and conditions of the capital instruments disclosed below are disclosed in the MSI Group financial statements. See note 19 for subordinated debt disclosures and note 25 for share capital disclosures.

The table below shows the financial resources that the MSI Group had as at 31 December 2010 based upon the audited financial statements:

Capital Resources

As at 31 December	2010 $millions	2009 $millions
Permanent Share Capital	1,614	1,614
Profit and loss account and other reserves	11,906	10,795
Less: Intangible assets	(55)	(64)
Less: Net losses on equities held in the available-for-sale financial assets category	(21)	(32)
Tier 1 capital resources	**13,444**	**12,313**
Tier 2 capital resources	**6,722**	**6,156**
Less: Expected losses and other negative amounts	(311)	(135)
Tier 1 plus tier 2 capital after deductions	**19,855**	**18,334**
Tier 3 capital resources	**3,849**	**4,435**
Less: Deductions from total capital	(62)	(45)
Total Capital Resources, Net of Deductions	23,642	22,724

Permanent share capital and subordinated loans included in financial resources are consistent with MSI Group financial statements. The General Prudential sourcebook ("GENPRU") sections 1 and 2 define the items that are included or deducted from the profit and loss account and other reserves to arrive at total financial resources. As a result, the profit and loss account and other reserves balance noted above will differ from the MSI financial statements.

There are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the MSI Group and its subsidiary undertakings.

Management reviews capital levels on an ongoing basis in light of changing business needs and the external environment. The level of capital as at 31 December 2010 was 4% higher than 2009 and in line with historical levels.

Management ensures that appropriate levels of capital are maintained to support business needs whilst remaining in compliance with the target operating range established by the relevant governing bodies and applicable regulatory requirements.

6. REGULATORY CAPITAL REQUIREMENTS

The MSI Group calculates Pillar 1 capital requirements in accordance with the regulatory capital requirements of the FSA. As at 31 December 2010 and 31 December 2009, the MSI Group had the following capital requirements:

Regulatory Capital Requirements

As at 31 December	2010 $millions	2009 $millions
Credit risk capital component	660	1,036
Counterparty risk capital component	4,004	2,969
Market risk capital component	4,317	4,286
Concentration risk capital component	2,766	1,554
Operational risk—Basic Indicator Approach	780	1,098
Total Capital Requirements	12,527	10,943

Credit and counterparty risk capital components reflect capital charges attributable to the risk of loss arising from a borrower or counterparty failing to meet its financial obligations. Risk-weighted exposures are determined using either an Internal Ratings Based ("IRB") approach, which reflects the MSI Group's internal estimate of a borrower or counterparty's credit worthiness, or a standardised approach. For a further discussion, see section 10 Credit Risk.

The market risk capital component reflects capital charges attributable to the risk of loss resulting from adverse changes in market prices and other factors. The market risk capital of the MSI Group comprises capital associated with the FSA's approved models-based approach that is associated with the standardised approach. For a further discussion, see section 11 Market Risk.

Operational risk capital charges are designed to account for the risk of losses due to inadequate or failed internal processes, people and systems, or external events and take into account legal risk. Capital requirements for operational risk are currently calculated under the Basic Indicator Approach.

The risk capital calculations will evolve over time as the MSI Group enhances its risk management strategy and incorporates improvements in modeling techniques while maintaining compliance with the regulatory requirements. The firm received permission from the FSA in 2011 to utilise the internal model method for calculating its Credit and Counterparty risk exposure, in accordance with BIPRU 13.6.

7. APPLICATION OF THE PILLAR 2 FRAMEWORK

The MSI Group employs a Required Capital framework in order to meet its obligations under BIPRU 2.2 "Internal capital adequacy standards," whereby additional capital for stress losses is calculated and held. Note the Required Capital framework is consistent with the Morgan Stanley Group Required Capital framework.

The Required Capital framework is used to ensure that the MSI Group carries, or has access to, sufficient capital to support all material risks residing within the MSI Group, and is based on regional management's own risk assessment. The MSI Group's UK Required Capital framework has been reviewed by the FSA.

8. RISK MANAGEMENT OBJECTIVES AND POLICIES

Risk is an inherent part of MSI Group's business activity and is managed by the MSI Group within the context of the Morgan Stanley Group global framework. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The MSI Group's own risk management objectives, policies and procedures are consistent with those of the Morgan Stanley Group.

As noted previously, Morgan Stanley is required to make quarterly filings with the SEC. For further discussion of Morgan Stanley's risk management objectives, policies and procedures, see pages 96-118 of Morgan Stanley's 31 December 2010 Form 10-K.

9. VALUATION AND ACCOUNTING POLICIES

The MSI Group's financial statements are prepared in accordance with applicable UK company law and accounting standards ("UK GAAP"). The MSI Group relies on its policies, procedures and systems to determine adequacy of valuation. For capital purposes, valuation adjustments are applied as per the applicable accounting standards and UK company law with additional adjustments made to comply with the requirements of GENPRU 1.3. Further information regarding the accounting policies of the MSI Group, including measurement considerations, can be found in note 1 of the MSI Group's financial statements.

10. CREDIT RISK

10.1 Credit Exposure

The Morgan Stanley Group manages credit risk exposure on a global basis, but in consideration of each individual legal entity, including those of MSI Group. The credit risk management policies and procedures of the Morgan Stanley Group include ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit and escalating risk concentrations to appropriate senior management. Credit risk management policies and procedures for the MSI Group are consistent with those of the Morgan Stanley Group and include escalation to appropriate key management personnel of the MSI Group.

The MSI Group is exposed primarily to single-name credit risk, requiring credit analysis of specific counterparties, both initially and on an ongoing basis. Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the MSI Group from losses resulting from its business activities, the MSI Group analyses all material lending and derivative transactions and ensures that the creditworthiness of the MSI Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. For lending transactions, the MSI Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. The MSI Group also considers collateral arrangements and other structural elements of the particular transaction. The MSI Group has credit guidelines that limit potential credit exposure to any one borrower or counterparty and to groups of connected borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

Credit risk exposure is managed by Credit Risk Management together with various risk committees. The Credit Limits Framework is one of the primary tools used to evaluate and manage credit risk levels and is calibrated within the Morgan Stanley Group's risk tolerance. The Credit Limits Framework includes single-name limits and portfolio concentration limits by country, industry and product type. Credit Risk Management is responsible for ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit, and escalating risk concentrations to appropriate senior management.

10.2 Counterparty and Credit Risk Capital Component ("CRCC")

The credit risk capital component reflects capital requirements attributable to the risk of loss arising from a borrower or counterparty failing to meet its obligations. Risk-weighted exposures are determined using either an IRB approach, which reflects the MSI Group's internal estimate of a borrower or counterparty's credit worthiness, or the standardised approach.

The table below shows the counterparty and credit risk capital component for the MSI Group as at 31 December 2010, for each industry type, as per the classifications set out in BIPRU:

CRCC Summary

As at 31/12/2010	IRB approach $millions	Standardised approach $millions	Total CRCC $millions
Sovereigns	208	73	281
Institutions	1,277	20	1,297
Corporates	2,699	175	2,874
Other	149	63	212
Total	4,333	331	4,664

10.3 Internal Ratings-Based Approach

The MSI Group has been granted a waiver by the FSA to use the Foundation Internal Ratings-Based ("FIRB") approach for the calculation of counterparty credit risk capital requirements. The permission covers exposures generated by the Institutional Securities business which includes all material portfolios and is applicable to

all exposures to central governments, central banks, institutions and corporates.

The Morgan Stanley Group leverages the IRB process for its own internal economic capital assessment and for internal risk management processes.

Rating Process

The credit department expresses the creditworthiness of each counterparty by assigning it a rating; on a scale from AAA to D. Counterparty ratings establish the probability of default ("PD") "through the cycle." Each rating is linked to an exposure limit. To monitor the credit risk of the portfolio, the MSI Group uses quantitative models to estimate various risk parameters related to each counterparty and/or facility.

Credit professionals rate counterparties based on analysis of all qualitative and quantitative factors relevant to credit standing in that industry or sector. The rating process typically includes analysis of the counterparty's financial statements, evaluation of its market position, strategy, management, legal and environmental issues, and consideration of industry dynamics affecting its performance. Credit professionals also consider security prices and other financial data reflecting a market view of the counterparty, and carry out due diligence with the counterparty's management as needed.

The credit department assigns counterparty ratings at the highest level in the counterparty's corporate structure. Subsidiaries of the holding company will often carry the same rating as the holding company, but a subsidiary's rating may vary based on a variety of factors considered and documented during the rating process.

Where a parent guarantee has been received for a counterparty and the guarantee meets our internal requirements for PD Substitution, then the rating of the guarantor is assigned to the counterparty.

Ratings for Special Purpose Vehicles ("SPVs") reflect the credit department's assessment of the risk that the SPV will default. The rating therefore incorporates the Morgan Stanley Group's relative position in the counterparty's payment structure as well as the default risk associated with the underlying assets. Ratings are often "tranche specific" (e.g., the AAA-rated senior tranche or the BBB subordinated tranche).

The credit department will not approve exposure to a counterparty if the analyst has inadequate information to set a rating. If counterparty information is incomplete, the credit professional will apply a conservative rating to reflect uncertainty arising from the missing information.

Control Mechanisms for the Rating System

The performance of the rating system is validated on a quarterly basis. This includes a review of key performance measures including comparison of internal ratings versus agency ratings, ratings of defaulted parties, transitions across grades and comparisons versus credit spreads.

For credit risk capital and risk management purposes, the credit department maps PDs to Standard and Poor's ("S&P") PDs and makes minor adjustments such as preserving the monotonic relationship among rating grade PDs and maintaining the Basel II regulatory floor of 0.03%. The use of external data in the Morgan Stanley Group's PD quantification approach is a conservative alternative to the use of internally sourced data given the statistical insignificance of internal losses.

Morgan Stanley Group confirms, through an internal validation process, that the PD values it uses are prudent when compared to actual Morgan Stanley Group default experience.

The table below shows a breakdown of the IRB-related exposure amounts for the MSI Group as at 31 December 2010, for each credit quality step as defined in BIPRU 3:

IRB Exposures[1]

PD Band As at 31/12/2010	Total Gross Exposure $millions	Exposure value after credit risk mitigation $millions	Outstanding Loans $millions	Exposure value of undrawn commitments $millions	Exposure weighted average risk weight
Sovereigns					
1 0.03%–0.08%	19,009	2,944	0	0	0.11
2 0.07%–0.17%	13,409	4,864	0	0	0.38
3 0.17%–0.41%	3,394	583	0	0	0.37
4 0.53%–1.65%	1,036	114	0	0	1
5 1.92%–100%	2	2	0	0	2.43
Institutions					
1 0.03%–0.08%	111,964	19,203	0	0	0.13
2 0.07%–0.17%	211,596	37,444	0	0	0.25
3 0.17%–0.41%	21,321	4,618	0	0	0.45
4 0.53%–1.65%	5,371	1,124	0	0	1.06
5 1.92%–100%	256	54	0	0	2.5
Corporates					
1 0.03%–0.08%	39,445	8,968	0	150	0.2
2 0.07%–0.17%	183,324	44,111	813	1,275	0.28
3 0.17%–0.41%	23,262	7,232	710	782	0.55
4 0.53%–1.65%	67,418	9,823	951	742	1.15
5 1.92%–100%	9,430	1,721	78	8	2.06
Other		600	600		2.43
Total	710,837	143,405	2,552	2,957	

[1] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

Equity Exposure Outside the Trading Book

The approach assigned for equity exposures falling outside of the trading book is as defined in the IRB section of BIPRU. For the purposes of risk weighting these equity exposures, the MSI Group applies the simple risk weight approach.

Non-trading book exposure in equities excludes any investments MSI Group holds in other Morgan Stanley Group undertakings. Total non-trading book equity exposure is immaterial (0.4% of total Exposure At Default ("EAD")).

Retail Exposures

The MSI Group does not have IRB exposure to retail clients.

10.4 Securitisation

MSI Group's securitised IRB risk-weighted exposures calculated in accordance with BIPRU 9 represents 0.8% of total EAD. No further disclosure has been made as these positions are immaterial for the MSI Group.

10.5 Standardised Approach

A standardised approach is used for certain asset categories, including receivables (e.g., fees and interest), unsettled trades and other assets.

The table below shows the exposures for the MSI Group as at 31 December 2010, calculated using the standardised approach for each industry type:

Standardised Approach Exposures[2]

As at 31/12/2010	Total gross exposure $millions	Exposure value after credit risk mitigation $millions
Sovereigns	1,084	1,084
Institutions	413	413
Corporates	2,110	2,110
Other	790	790
Total	4,397	4,397

[2] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

10.6 Credit Exposure Breakdown Tables

The table below shows the gross credit exposures for the MSI Group as at 31 December 2010:

Gross Credit Exposures[1]

As at 31/12/2010	Gross credit exposure prior to credit mitigation $millions	Total exposure value covered by eligible financial collateral $millions	Total exposure value covered by guarantees $millions	Net credit exposure $millions
Sovereigns	37,934	25,646	0	9,591
Institutions	350,921	214,873	0	62,856
Corporates	324,989	169,846	1,659	73,965
Other	1,390	0	0	1,390
Total	715,234	410,365	1,659	147,802

[1] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

"Exposure value covered by eligible financial collateral," represents the positive market value against which collateral has been received and for which an enforceable legal netting agreement exists in order to enable collateral to be applied. Net credit exposure is the EAD calculated under the rules prescribed in BIPRU upon which regulatory capital charges are calculated.

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the MSI Group also reviews its credit exposure and risk to geographic regions.

The table below shows the geographical distribution of credit exposures for the MSI Group as at 31 December 2010:

Geographical Breakdown of Exposures[2]

As at 31/12/2010	Americas $millions	EMEA $millions	Asia $millions	Total $millions
Sovereigns	349	8,257	984	9,591
Institutions	22,825	33,212	6,819	62,856
Corporates	33,612	36,640	3,714	73,965
Other	0	1,390	0	1,390
Total	56,786	79,499	11,517	147,802

[2] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

As at 31 December 2010, credit exposure was concentrated in North America and Western Europe. In addition, the MSI Group pays particular attention to smaller exposures in emerging markets given their higher risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

MSI Group also reviews its credit exposure and risk to industry categories. As at 31 December 2010, the Morgan Stanley Group's material credit exposure was to corporate entities and institutions.

10.7 Credit Risk Mitigation

The MSI Group applies a number of credit risk mitigation techniques, including netting, collateral and hedging of risk through use of credit derivatives. Management of MSI Group's own credit portfolio is centralised through a global risk management function.

Netting

The Morgan Stanley Group has policies and procedures in place for recording netting agreements with clients, including the review of the legal enforceability of these agreements. In instances where there is doubt over the legal enforceability of an agreement, the benefit of netting is not applied. See IRB exposure table (10.3) and gross credit exposure table (10.6) for the impact of netting and collateral.

Collateral

The amount and type of collateral required by MSI Group depends on an assessment of the credit risk of the counterparty. Collateral held is managed in

accordance with MSI Group's guidelines and the relevant underlying agreements.

The Morgan Stanley Group actively manages its credit exposure through the application of collateral arrangements and readily available market instruments such as credit derivatives. The use of collateral in managing OTC derivative risk is standard in the market place, and is governed by appropriate documentation, for example, the Credit Support Annex to the ISDA documentation. In line with these standards, the Morgan Stanley Group generally accepts only cash and G7 government bonds, corporate debt and main index equities as eligible collateral. Other securities may be accepted in securities lending, repo and prime brokerage, subject to conservative haircuts based on assessments of collateral volatility and liquidity. There is an established and robust infrastructure to manage, maintain and value collateral on a daily basis.

For specific transactions or counterparties, the MSI Group will accept letters of credit and guarantees following an appropriate level of due diligence. In such instances, the exposure is assumed to be to the provider of the letter of credit or guarantee.

The tables below show residual maturity breakdown of exposures by industry type, for fully collateralized, partially collateralized and unsecured funding businesses:

Residual Maturity Breakdown of Exposures[1]

1. Collateralised business (comprising: PWM, PB, stockloan/repo)

As at 31/12/2010	less than 1 yr (incl. 1 yr) $millions	over 1 yr to less than 5 yrs $millions	5 yrs and above $millions	No Maturity $millions	Total $millions
Sovereigns	2,531	0	0	0	2,531
Institutions	21,176	849	31	0	22,055
Corporates	19,065	49	0	0	19,114
Other	0	0	0	0	0
Total	42,772	898	31	0	43,700

2. Partially collateralised (comprising mainly OTC)

As at 31/12/2010	less than 1 yr (incl. 1 yr) $millions	over 1 yr to less than 5 yrs $millions	5 yrs and above $millions	No Maturity $millions	Total $millions
Sovereigns	37	54	26	0	117
Institutions	6,591	15,765	4,680	0	27,036
Corporates	8,190	17,897	3,653	0	29,740
Other	0	0	0	0	0
Total	14,818	33,716	8,359	0	56,893

3. Unsecured (comprising mainly OTC and loans)

As at 31/12/2010	less than 1 yr (incl. 1 yr) $millions	over 1 yr to less than 5 yrs $millions	5 yrs and above $millions	No Maturity $millions	Total $millions
Sovereigns	2,040	291	4,613	0	6,943
Institutions	11,522	1,565	678	0	13,765
Corporates	11,281	8,794	4,943	94	25,111
Other	0	0	0	1,390	1,390
Total	24,843	10,650	10,234	1,484	47,209
Grand Total	82,433	45,264	18,624	1,484	147,802

[1] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

Derivative credit exposure

The table below shows the trading book gross positive fair value of derivative contracts, netting benefits, netted current credit exposure and collateral held as at 31 December 2010 for the MSI Group:

Derivative Credit Exposures[1]

As at 31/12/2010	Market Value $millions
Gross positive fair value of contracts	190,686
Netting Benefits	156,246
Gross positive fair value after netting	34,440
Collateral held	36,331
Net derivatives credit exposure (after netting and collateral)	13,200

[1] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure.

Gross positive fair value represents any long market value on derivative transactions before netting benefits are applied but after any regulatory eliminations and exemptions are applied.

Collateral held represents the market value of collateral received, irrespective of enforceability or utilization after regulatory eliminations and exemptions are applied.

The table below shows the EAD and current exposure calculated on derivative contracts as at 31 December 2010:

Derivative Contracts EAD and Current Exposure[2]

As at 31/12/2010	EAD $millions	Current Exposure $millions
Sovereigns	5,662	4,390
Institutions	31,303	14,759
Corporates	47,832	15,291
Total	84,797	34,440

[2] The calculation of exposures in this table is based on the calculation methodology for regulatory risk exposure prescribed by the FSA in BIPRU. As at 31 December 2010, the firm had not received permission to use advanced exposure calculations, e.g., IMM as set out in BIPRU, and therefore exposures above will be materially different from those used internally and in other external risk disclosures by the firm, including those presented in the MSI Group's Financial Statements. In general, the regulatory risk exposures are based on notional with prescribed haircuts rather than risk factors measured in accordance with up-to-date market pricing. These exposures include intra-group exposures that form a sizeable proportion of the total exposure. Net replacement cost is used as a measure of current exposure.

Derivative contracts

The table below shows the notional values of derivative contracts for the MSI Group as at 31 December 2010:

Notional Values of Derivative Contracts

As at 31/12/2010	Notional Amounts $millions
Foreign exchange	1,602,504
Interest rate	9,487,616
Credit Derivatives	836,500
Equity and Stock index	1,406,576
Commodities	333,098
Total	13,666,294

The notional values above are reported based on the regulatory reporting data and are before netting and regulatory exemptions and eliminations as defined in BIPRU 3 and 4.

Where a market in credit derivatives exists, the MSI Group may choose to purchase default protection in the form of a credit derivative from a third party. The counterparty risk to the third-party protection provider is monitored and managed by the credit department.

10.8 Collateral Downgrades

The level of incremental collateral which would be required by derivative counterparties in the event of a Morgan Stanley ratings downgrade is monitored daily. Collateral triggers are maintained by the collateral management department and vary by counterparty. As at 31 December 2010, a downgrade would have resulted in the following additional collateral requirements for MSI Group:

- One notch downgrade—$323 million
- Two notch downgrade—$485 million[3]

See page 89 of Morgan Stanley's 31 December 2010 Form 10-K for details of Morgan Stanley Group collateral downgrade information.

10.9 Wrong Way Risk

Specific wrong way risk arises when a transaction is structured in such a way that the exposure to the counterparty is positively correlated with the probability of default of the counterparty. For example, a counterparty writing put options on its own stock or a counterparty collateralised by its own or related party stocks. Morgan Stanley Group considers these matters when approving transactions. General wrong way risk

[3] Non-cumulative impact of a two notch downgrade.

arises when the counterparty probability of default is correlated, for non-specific reasons, with the market or macroeconomic factors that affect the value of the counterparty's trades. The credit assessment process looks to identify these correlations and monitor accordingly.

11. MARKET RISK

The Morgan Stanley Group has a global Value-at-Risk ("VaR") model and has regulatory permission to use it for the MSI Group's consolidated market risk capital calculations.

Sound market risk management is an integral part of the Group's culture. The various business units and trading desks are responsible for ensuring that market risk exposures are well-managed and prudent. The control groups help ensure that these risks are measured and closely monitored and are made transparent to senior management. The Market Risk Department is responsible for ensuring transparency of material market risks, monitoring compliance with established limits, and escalating risk concentrations to appropriate senior management. To execute these responsibilities, the Market Risk Department monitors the Group's risk against limits on aggregate risk exposures, performs a variety of risk analyses, routinely reports risk summaries, and maintains the Company's VaR and scenario analysis systems. These limits are designed to control price and market liquidity risk. Market risk is also monitored through various measures: statistically (using VaR and related analytical measures); by measures of position sensitivity; and through routine stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors, and scenario analyses conducted by the Market Risk Department in collaboration with the business units. The material risks identified by these processes are summarized in reports produced by the Market Risk Department that are circulated to and discussed with senior management.

11.1 Market Risk Capital Component

The market risk capital component of the MSI Group comprises capital associated with the VaR methodology in accordance with FSA's approved models and that associated with the standardised approach. The VaR-based capital is determined on a 60-day average of 99% ten-day VaR.

The table below shows the total market risk capital charge categorised by component type:

Market Risk Capital Component

As at 31/12/2010	Market Risk Capital Component Calculated in Accordance with the VaR Methodology[1] $millions	Market Risk Capital Component Calculated in Accordance with the Standardized Approach $millions	Total Market Risk Capital Component $millions
Interest Rate and Credit Spread	2,144	764	2,908
Equity Price	994	79	1,073
Foreign Exchange Rate	239	589	828
Commodity Price	40	51	91
Less: Diversification Benefits[2]	(582)		(582)
Total	2,835	1,483	4,318

[1] Other related regulatory buffers are included.

[2] Diversification benefit equals the difference between total VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories may occur on different days; similar diversification benefits also are taken into account within each category.

11.2 Value-at-Risk (VaR)

The MSI Group uses the statistical technique known as VaR as one of the tools used to measure, monitor and review the market risk exposures of its trading portfolios. The Market Risk Department calculates and distributes daily VaR-based risk measures to various levels of management.

VaR methodology, assumptions and limitations

The MSI Group estimates VaR using a model based on historical simulation for major market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. Historical simulation involves constructing a distribution of hypothetical daily changes in the value of trading portfolios based on two sets of inputs: historical observation of daily changes in key market indices or other market factors; and information on the sensitivity of the portfolio values to these market risk factor changes. The MSI Group's VaR model uses four years of historical data to characterise potential changes in market risk factors. The MSI Group's 95%/one-day VaR corresponds to the

unrealised loss in portfolio value that, based on historically observed market risk factor movements, would have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

The MSI Group's VaR model generally takes into account linear and non-linear exposures to equity and commodity price risk, interest rate risk, credit spread risk and foreign exchange rates as well as linear exposures to implied volatility risks. The VaR model also captures certain implied correlation risks associated with portfolio credit derivatives as well as certain basis risks (e.g., corporate debt and related credit derivatives).

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks and portfolio assets. One key element of the VaR model is that it reflects risk reduction due to portfolio diversification or hedging activities. However, VaR risk measures should be interpreted carefully in light of the methodology's limitations, which include the following: past changes in market risk factors may not always yield accurate predictions of the distributions and correlations of future market movements; changes in portfolio value in response to market movements (especially for complex derivative portfolios) may differ from the responses calculated by a VaR model; VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day; the historical market risk factor data used for VaR estimation may provide only limited insight into losses that could be incurred under market conditions that are unusual relative to the historical period used in estimating the VaR; and published VaR results reflect past trading positions while future risk depends on future positions. VaR is most appropriate as a risk measure for trading positions in liquid financial markets and will understate the risk associated with severe events, such as periods of extreme illiquidity. The MSI Group is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. As explained above, this process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, and control at the trading desk, division and the MSI Group levels.

The MSI Group's VaR models evolve over time in response to changes in the composition of trading portfolios and to improvements in modelling techniques and systems capabilities. The MSI Group is committed to continuous review and enhancement of VaR methodologies and assumptions in order to capture evolving risks associated with changes in market structure and dynamics. As part of regular process improvement, additional systematic and name-specific risk factors may be added to improve the VaR model's ability to more accurately estimate risks to specific asset classes or industry sectors. Additionally, the MSI Group continues to evaluate enhancements to the VaR model to make it more responsive to more recent market conditions while maintaining a longer-term perspective.

The methodology, assumptions and limitations of the MSI Group's VaR model are consistent with those of the Morgan Stanley Group. For a further discussion see pages 98 to 105 of Morgan Stanley's 31 December 2010 Form 10-K.

11.3 VaR for the Year Ended 31 December 2010

The MSI Group's Trading, Non-Trading and Aggregate VaR for each of the MSI Group's primary market risk exposures at 31 December 2010 is shown below, incorporating substantially all financial instruments generating market risk that are managed by the MSI Group's trading businesses. This measure of VaR incorporates most of the MSI Group's trading-related market risks. However, a small proportion of trading positions generating market risk is not included in VaR, and the modelling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce different VaR results from those produced using more precise measures.

The counterparty portfolio, which reflects adjustments, net of hedges, relating to counterparty credit risk and other market risks, was reclassified from Non-Trading VaR into Trading VaR as at 1 January 2010. This reclassification reflects regulatory considerations surrounding the Morgan Stanley Group's conversion to a financial holding company, and the trading book nature of the MSI Group's counterparty risk-hedging activities that the MSI Group follows. Aggregate VaR was not affected by this change.

Since the VaR statistics reported below are estimates based on historical position and market data, VaR should not be viewed as predictive of the MSI Group's future revenues or financial performance or of its ability to monitor and manage risk. There can be no assurance that the MSI Group's actual losses on a particular day will not exceed the VaR amounts indicated below or that such losses will not occur more than five times in 100 trading days. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

The table below presents 95%/one-day VaR as at 31 December 2010 for each of the MSI Group's primary market risk categories and on an aggregate basis:

95% Total VaR

As at 31/12/2010	Aggregate $millions	Trading $millions	Non-Trading $millions
Interest rate and credit spread	65	61	12
Equity price	25	26	1
Foreign exchange rate	10	10	3
Commodity price	2	2	
Subtotal	102	99	16
Less diversification benefit[1]	(23)	(26)	(3)
Total VaR	79	73	13

[1] Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

The MSI Group views average trading VaR over the fiscal year as more representative of trends in the business than VaR at any single point in time. The table below, which presents the high, low and average 95%/one-day trading VaR during the year to 31 December 2010, represents substantially all of the MSI Group's trading activities:

95% One-day high/low/average trading VaR

As at 31/12/2010	High $millions	Low $millions	Average $millions
Interest rate and credit spread	86	54	69
Equity price	53	13	22
Foreign exchange rate	17	3	9
Commodity price	9	2	3
Subtotal	165	72	103
Less diversification benefit[2]	(59)	(18)	(29)
Trading VaR	106	54	74

[2] Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

11.4 Stress Testing

During 2010, the Group continued to enhance its market and credit risk management framework to address the severe stresses observed in global markets during the economic downturn. The Group expanded and improved its risk measurement processes, including stress tests and scenario analysis, and further refined its market and credit risk limit framework. Stress Value-at-Risk ("S-VaR"), a proprietary methodology that comprehensively measures the Group's market and credit risks, was further refined and is now an important metric used in establishing the Group's risk appetite and its capital allocation framework. S-VaR simulates many stress scenarios based on more than 25 years of historical data and attempts to capture the different liquidities of various types of general and specific risks. Additionally, S-VaR captures event and default risks that are particularly relevant for credit portfolios.

11.5 Interest Rate Risk in the Non-Trading Book

Morgan Stanley Group activities are split into trading book and non-trading book, by legal entity, for the purpose of defining Pillar 1 capital adequacy requirements. The guidelines defining the non-trading book population are reviewed on an annual basis.

Interest rate risk refers to the risk that a change in interest rates will result in losses for a position or portfolio. The assessment of the impact of interest rate risk in the non-trading book is carried out at the MSI Group level.

Non-trading book transactions fall within three broad categories: corporate treasury related activities, business unit related activities and other.

Corporate treasury related activities include, funding transactions such as external money market loans, inter-company short-term and long-term loans, and intercompany subordinated debt borrowings and investments such as external money market deposits, deposits with clearing organisations and cash held at banks.

Business unit related activities include investments, distressed loans/debt for which a two-way market does not exist, fees due from advising and arranging and other non-trading exposures.

The table below shows the impact of a 1 basis point parallel shift in interest rates on the value of interest rate positions in the non-trading book including those captured in VaR and those that form part of Corporate Treasury activities:

Interest Rate Risk in non-trading book

As at 31/12/2010	Profit or loss of a+1bp parallel shift in interest rates $000	Profit or loss of a-1bp parallel shift in interest rates $000
USD	190	(190)
EUR	(79)	79
GBP	(43)	43
JPY	17	(17)
Other	114	(114)
Total	199	(199)