Registration No. 3584019

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MORGAN STANLEY INTERNATIONAL LIMITED

Report and financial statements

31 December 2011

CONTENTS

DIRECTORS' REPORT

The Directors present their report and the consolidated financial statements of Morgan Stanley International Limited (the "Company" or "MSI"), and its subsidiary and associated undertakings (together the "Group"), together with the Company's balance sheet and related notes for the year ended 31 December 2011.

RESULTS AND DIVIDENDS

The Group's profit for the year, after tax and minority interest, was $1,109 million (2010: $1,041 million).

During the year, the Company paid an interim dividend of $2,000 million to the holders of its ordinary shares (2010: $1,000 million). No final dividend is proposed (2010: $nil).

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions. There have not been any significant changes in the Group's principal activities in the year under review and no significant change in the Group's principal business is expected. Certain of the Group's subsidiaries are authorised and regulated by the Financial Services Authority ("FSA") or by other financial services regulatory authorities.

The Group operates in the Europe, Middle East and Africa ("EMEA"), Americas and Asia markets. The Group operates branches in the Dubai International Financial Centre, France, Germany, Greece, Italy, Korea, Luxembourg, Netherlands, New Zealand, Poland, the Qatar International Financial Centre and Switzerland. A branch in Greece was closed post year end.

The Group's ultimate parent undertaking and controlling entity is Morgan Stanley, which, together with the Group and Morgan Stanley's other subsidiary undertakings, form the "Morgan Stanley Group".

The Morgan Stanley Group is a global financial services firm that maintains significant market positions in each of its business segments - Institutional Securities, Global Wealth Management Group and Asset Management. The Morgan Stanley Group provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. As a key contributor to the execution of the Morgan Stanley Group's Institutional Securities strategy in EMEA, the Group provides capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

BUSINESS REVIEW

During 2011, global and market economic conditions were negatively impacted by concerns about the sovereign debt crisis in Europe, the United States ("US") federal debt ceiling and slower economic growth leading to volatility on the global equity markets.

In Europe, real gross domestic product growth remained moderate in 2011. Major European equity market indices ended 2011 lower compared with the beginning of the year, primarily due to adverse economic developments, including investors' growing concerns about the sovereign debt crisis, especially in Greece, Ireland, Italy, Portugal and Spain (the "European Peripherals"), and the sovereign debt exposures in the European banking system. The euro area unemployment rate increased to 10.4% at 31 December 2011 from 10.0% a year ago. At 31 December 2011, the European Central Bank's ("ECB") benchmark interest rate was 1.00%, and the Bank of England's ("BOE") benchmark interest rate was 0.50%, both of which were unchanged from a year ago. In 2011, the BOE increased the size of its quantitative easing program by £75 billion to £275 billion in order to inject further monetary stimulus into the economy in the United Kingdom ("UK"). To stabilise the European banking system during the sovereign debt crisis, the ECB initiated a number of actions during the fourth quarter of 2011. The ECB made longer-term loans available to banks in exchange for posting of adequate collateral in October and December of 2011 for maturities up to 13 months, ensuring that European banks have unlimited financing into 2013. Starting in November 2011, the ECB also bought €40 billion in European bank bonds backed by mortgages and other assets, known as covered bonds, a key source of funds for banks. On 27 October 2011, leaders of 17 European Union countries announced a financial relief plan that involves a write-off of certain sovereign debt by European banks and other measures aimed to resolve the European sovereign debt crisis. In December 2011, European leaders agreed to sign an inter-government treaty that would require them to enforce stricter fiscal and financial discipline in their future budgets. In January and February 2012, rating agencies downgraded the credit ratings for several euro-zone countries.

BUSINESS REVIEW (CONTINUED)

The consolidated profit and loss account for the year is set out on page 15. The Group's profit after tax and minority interest for the year increased by $68 million to $1,109 million compared to the year ended 31 December 2010.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Net gains on fixed asset investments', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Despite the challenging market conditions noted above, aggregate revenues marginally increased by $151 million to $5,791 million, compared to $5,640 million in 2010. Revenues within equity sales and trading improved year on year mostly offset by lower fixed income sales and trading revenues. Aggregate revenues in 2011 include approximately $600 million primarily related to the release of credit valuation adjustments upon the restructuring of certain derivative transactions which decreased the Group's exposure to certain European countries. In addition, aggregate revenues for the year exclude net gains of $279 million, compared to $45 million in 2010, not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data. The results also include positive revenues of $128 million (2010: $1 million loss) due to the impact of the widening of Morgan Stanley's debt-related credit spreads on borrowings that are measured at fair value.

Other expenses have increased by 1% to $4,282 million from $4,225 million in 2010. The UK bank levy charge of $46 million has been reported within other expenses. Staff costs were consistent with 2010 levels.

The Group's effective tax rate for the year ended 31 December 2011 was 28% compared to 26% for the year ended 31 December 2010, driven by a non-UK capital gains tax provision offset by the release of certain tax reserves. Further details are provided in note 9 of the consolidated financial statements.

The consolidated balance sheet presented on pages 17 and 18 reflects increases in the Group's total assets and total liabilities of $74,419 million and $70,380 million respectively, an increase of 15% and 14% respectively, as at 31 December 2011 when compared to 31 December 2010. The increase in total assets is driven by an increase in financial assets held for trading, driven by fair value movement in derivative instruments held for trading as a result of market volatility. Excluding derivative assets held for trading, total assets have decreased by $45,213 million, driven by decreases in corporate equities, corporate and other debt and government debt securities held for trading. Excluding derivative liabilities held for trading, total liabilities have decreased by $43,951 million, driven by decreases in stock loan and repurchase agreements within financial liabilities at amortised cost.

The performance of the Group is included in the results of the Morgan Stanley Group which are disclosed in the Morgan Stanley Group's Annual Report on Form 10-K to the United States Securities and Exchange Commission. The Morgan Stanley Group manages its key performance indicators on a global basis but in consideration of individual legal entities. For this reason, the Company's Directors believe that providing further performance indicators for the Group itself would not enhance an understanding of the development, performance or position of the business of the Group.

The risk management section below sets out the Group's and the Morgan Stanley Group's policies for the management of liquidity and cash flow risk and other significant business risks.

Risk management

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group's business activities. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its activities on a global basis, in accordance with defined policies and procedures and in consideration of the individual legal entities. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group. Note 28 to the consolidated financial statements provides qualitative and quantitative disclosures about the Group's management and exposure to financial risks and note 34 describes the Morgan Stanley Group and the Group's policies for managing capital.

Risk management (continued)

Credit risk

Credit risk refers to the risk of loss arising from borrower or counterparty default when a borrower, counterparty or obligor does not meet its obligations.

The Morgan Stanley Group manages credit risk exposure on a global basis as well as giving consideration to each individual legal entity, by ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit, escalating risk concentrations to appropriate senior management and mitigating credit risk through the use of collateral and other arrangements.

Country risk exposure

The Morgan Stanley Group and the Group have exposure to country risk. Country risk exposure is the risk that events within a country, such as currency crises, regulatory changes and other political events, will adversely affect the ability of the sovereign government and/or obligors within the country to honour their obligations to the Group.

Country risk exposure is measured in accordance with the Morgan Stanley Group and the Group’s internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Morgan Stanley Group and the Group actively manages country risk exposure through a comprehensive risk management framework that combines credit and market fundamentals as well as scenario analysis, and allows the Group to effectively identify, monitor and limit country risk. Country risk exposure before and after hedges are monitored and managed, with stress testing and scenario analysis conducted on a continuous basis, to identify exposure concentrations, wrong way risk and the impact of idiosyncratic events. In addition, indirect exposures are captured and monitored through regular stress testing and counterparty, market and systemic vulnerability analysis. The Group reduces its country risk exposure through the effect of risk mitigants, such as netting agreements with counterparties that permit the Group to offset receivables and payables with such counterparties, obtaining collateral from counterparties, and by hedging.

The Group’s country risk exposure as at 31 December 2011, including the effect of the risk mitigants is shown across the following two tables. The basis for determining the domicile of the exposure is based on the country of jurisdiction for the obligor or guarantor, factors such as physical location of operations or assets, location and source of cash flows / revenues, and location of collateral (if applicable). Credit Default Swaps (“CDSs”) are incorporated in the exposure where protection is both purchased and sold.

The Group’s sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures comprise exposures to corporations, clearing houses and financial institutions.

Select European Countries

In connection with certain of its Institutional Securities business segment activities, the Group has country risk exposure to many foreign countries. During 2011, the European Peripherals and France experienced varying degrees of credit deterioration due to weaknesses in their economic and fiscal situations.

The Morgan Stanley Group has established a Eurozone Crisis Planning Group to formulate strategy, planning and execution associated with the European sovereign debt crisis and focus on the associated legal and operational issues. This planning group has directed a number of focused risk management reviews to ensure the Morgan Stanley Group is prepared in the case of a Eurozone country default or exit.

On 22 December 2011 the Group executed certain derivative restructuring amendments which settled post year end on 3 January 2012. Upon settlement of these, the exposure before hedges and net exposure for Italy decreased from $5,493 million to $2,214 million and $4,649 million to $1,368 million respectively, and the exposure before hedges and net exposure for European Peripherals, including Italy, decreased from $6,823 million and $5,736 million to $3,544 million and $2,455 million, respectively.

The following table shows the Group’s country risk exposure to European Peripherals and France at 31 December 2011. The majority of the financial instruments included in the table below are classified as held for trading and measured at fair value or are collateralised borrowings or lendings. As a result the Group does not have any recognised impairment on the financial instruments included in its country risk exposure to European Peripherals and France. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

Risk management (continued)

Select European Countries (continued)

Country Risk Exposure to European Peripherals and France

Country	Net Inventory [(1)]	Net Counterparty Exposure [(2)]	Funded Lending	Unfunded Commitments	CDS Adjustments[(3)]	Exposure Before Hedges	Hedges [(4)]	Net Exposure
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Greece:								
Sovereigns	25	-	-	-	10	35	-	35
Non-sovereigns	(4)	1	86	-	-	83	(34)	49
Total Greece	21	1	86	-	10	118	(34)	84
Ireland:								
Sovereigns	85	1	-	-	4	90	-	90
Non-sovereigns	82	19	-	-	1	102	-	102
Total Ireland	167	20	-	-	5	192	-	192
Italy [(5)]:								
Sovereigns	80	4,164	-	-	159	4,403	(583)	3,820
Non-sovereigns	(44)	445	242	363	84	1,090	(261)	829
Total Italy [(5)]	36	4,609	242	363	243	5,493	(844)	4,649
Spain:								
Sovereigns	(266)	(1)	-	-	496	229	123	352
Non-sovereigns	160	370	25	225	139	919	(161)	758
Total Spain	(106)	369	25	225	635	1,148	(38)	1,110
Portugal:								
Sovereigns	(409)	97	-	-	23	(289)	(109)	(398)
Non-sovereigns	(75)	90	126	-	20	161	(62)	99
Total Portugal	(484)	187	126	-	43	(128)	(171)	(299)
Sovereigns	(485)	4,261	-	-	692	4,468	(569)	3,899
Non-sovereigns:	119	925	479	588	244	2,355	(518)	1,837
Total European Peripherals [(6)]	**(366)**	**5,186**	**479**	**588**	**936**	**6,823**	**(1,087)**	**5,736**
France:								
Sovereigns	(1,760)	225	-	-	-	(1,535)	(47)	(1,582)
Non-sovereigns	(390)	1,537	78	1,362	10	2,597	(655)	1,942
Total France	(2,150)	1,762	78	1,362	10	1,062	(702)	360

(1) Net inventory representing exposure to both long and short single name positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).

(2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.

(3) CDS adjustment represents credit protection purchased from European peripheral banks on European peripheral sovereign and financial institution risk, or French banks on French sovereign and financial institution risk. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) Represents CDS hedges on net counterparty exposure and funded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(5) On 22 December 2011 the Group executed certain derivative restructuring amendments which settled on 3 January 2012. Upon settlement of the amendments, the exposure before hedges and net exposure for Italy decreased to $2,214 million and $1,368 million respectively, and the exposure before hedges and net exposure for European Peripherals decreased to $3,544 million and $2,455 million, respectively.

(6) In addition, as at 31 December 2011, the Group had European Peripherals and French exposure for overnight deposits with banks of approximately $12 million and $9 million, respectively.

Risk management (continued)

Non-UK country risk exposure

The following table shows the Group's significant non-UK country risk exposure at 31 December 2011, excluding select European countries disclosed above. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

Country	Net Inventory (1)	Net Counterparty Exposure(2)	Funded Lending	Unfunded Commitments	Exposure Before Hedges	Hedges (3)	Net Exposure(4)
	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Australia:							
Sovereigns	(171)	-	-	-	(171)	-	(171)
Non-sovereigns	599	320	-	-	919	-	919
Total Australia	428	320	-	-	748	-	748
China:							
Sovereigns	158	170	-	-	328	-	328
Non-sovereigns	411	177	155	30	773	(47)	726
Total China	569	347	155	30	1,101	(47)	1,054
Netherlands:							
Sovereigns	(133)	6	-	-	(127)	(229)	(356)
Non-sovereigns	76	927	-	-	1,003	-	1,003
Total Netherlands	(57)	933	-	-	876	(229)	647
United States:							
Sovereigns	(609)	4	-	-	(605)	-	(605)
Non-sovereigns	(680)	1,912	16	33	1,281	(88)	1,193
Total United States	(1,289)	1,916	16	33	676	(88)	588
Republic of Korea:							
Sovereigns	149	55	-	-	204	-	204
Non-sovereigns	52	247	10	-	309	(5)	304
Total Republic of Korea	201	302	10	-	513	(5)	508

(1) Net inventory representing exposure to both long and short single name positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).

(2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.

(3) Represents CDS hedges on net counterparty exposure and funded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) In addition, as at 31 December 2011, the Group had exposure to these countries for overnight deposits with banks of approximately $2 billion.

Risk management (continued)

Liquidity and capital resources

Liquidity and funding risk refers to the risk that the Group will be unable to meet its funding obligations in a timely manner. Liquidity risk stems from the potential risk that the Group will be unable to obtain necessary funding through borrowing money at favourable interest rates or maturity terms, or selling assets in a timely manner and at a reasonable price.

The Morgan Stanley Group's senior management establishes the liquidity and capital policies of the Morgan Stanley Group. Through various risk and control committees, the Morgan Stanley Group's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Morgan Stanley Group's asset and liability position.

The primary goal of the Morgan Stanley Group's liquidity risk management framework is to ensure that the Morgan Stanley Group has access to adequate funding across a wide range of market conditions. The framework is designed to enable the Morgan Stanley Group to fulfil its financial obligations and support the execution of the Morgan Stanley Group's business strategies.

Morgan Stanley has taken transformative steps during this extremely difficult environment, including the de-risking of the balance sheet and those related to capital and liquidity outlined below.

Morgan Stanley continues to actively manage its capital and liquidity position to ensure adequate resources are available to support the activities of the Morgan Stanley Group, to enable the Morgan Stanley Group to withstand market stresses, and to meet regulatory stress testing requirements proposed by regulators globally.

Morgan Stanley's funding management policies are designed to provide for financings that are executed in a manner that reduces the risk of disruption to Morgan Stanley's operations. Morgan Stanley pursues a strategy of diversification of secured and unsecured funding sources (by product, by investor and by region) and attempts to ensure that the tenor of the Company's liabilities equals or exceeds the expected holding period of the assets being financed.

Morgan Stanley funds its balance sheet on a global basis through diverse sources. These sources may include the Company's equity capital, long-term debt, repurchase agreements, securities lending, deposits, commercial paper, letters of credit and lines of credit. Morgan Stanley has active financing programs for both standard and structured products targeting global investors and currencies.

In line with this active management, in June 2011, the Morgan Stanley Group's capital position was further strengthened by converting its outstanding Series B Non-Cumulative Non-Voting Perpetual Convertible Preferred Stock with a face value of $7.8 billion and a 10% dividend issued to Mitsubishi UFJ Financial Group Inc ("MUFG"), for 385,464,097 shares in Morgan Stanley's common stock.

During the latest Comprehensive Capital Analysis and Review performed by the Federal Reserve, Morgan Stanley Group exceeded the minimum capital ratio even under the most negative "stressed" scenario, which reaffirms the improvements done in recent years to reduce risk and overhauling the quality and quantity of the capital base.

During 2011, the Group has continued to review and actively manage its capital position. As part of this capital management, the Group received a capital contribution of $4,900 million from its parent undertaking, Morgan Stanley International Holdings Inc, and paid dividends of $2,000 million. During the year the Group complied with all regulatory capital requirements, ensuring sufficient Capital Resources were held.

Note 34 to the consolidated financial statements, provides additional information regarding the Group's capital position.

Credit ratings

The Morgan Stanley Group relies on external sources to finance a significant portion of its day-to-day operations. The cost and availability of financing generally is impacted by the Morgan Stanley Group's credit ratings. In addition, the Group's and Morgan Stanley's credit ratings can have an impact on certain trading revenues, particularly in those businesses where longer-term counterparty performance is a key consideration, such as OTC derivative transactions, including credit derivatives and interest rate swaps. Issuer specific factors that are important to the determination of the Group's and Morgan Stanley's credit ratings include governance, the level and quality of earnings, capital adequacy, funding and liquidity, risk appetite and management, asset quality, strategic direction and business mix. Additionally, the agencies look at other industry-wide factors such as regulatory or legislative changes, macro-economic environment, and perceived levels of government support.

Risk management (continued)

Credit ratings (continued)

On 21 June 2012, Moody's Investor Services, Inc. ("Moody's") downgraded the ratings of 15 banks on review for downgrade in the context of a broad review of global banks with capital markets operations. Morgan Stanley's, Morgan Stanley & Co. International plc's and Morgan Stanley Bank International Limited's long-term and short-term debt ratings were lowered two notches to Baa1/P-2 from A2/P-1.

As a result of the Moody's downgrade of Morgan Stanley's credit rating, the amount of additional collateral requirements or other payments that could be called by counterparties, exchanges or clearing organisations under the terms of certain OTC trading agreements and certain other agreements for the Group was approximately $2,471 million. Of this amount, $1,726 million cash collateral was called and posted by the Group as at 3 September 2012, since the 21 June 2012 downgrade.

While certain aspects of a credit ratings downgrade are quantifiable pursuant to contractual provisions, the impact it will have on the Group's business and results of operation in future periods is inherently uncertain and will depend on a number of inter-related factors, including among others, the magnitude of the downgrade, individual client behaviour and future mitigating actions the Group may take. The liquidity impact of additional collateral requirements is included in the Group's Liquidity Stress Tests.

Market risk

Market risk refers to the exposure of the Group to adverse changes in the values of its portfolios and financial instruments due to changes in market prices or rates. Generally, the Group is exposed to market risk as a result of trading, investing and client facilitation activities, mainly within the Institutional Securities business segment where the substantial majority of the Group's Value-at-Risk ("VaR") for market risk exposures is generated. The Group uses VaR as one of a range of risk management tools.

During the current year, the Group has seen the average VaR for the Primary Risk Categories decline from $65 million in 2010 to $48 million in 2011. This has been driven by reduced risk taking in fixed income products that occurred during the second half of the year, and this is also the reason behind the reduction in the year-end VaR from $60 million at 31 December 2010 to $29 million at 31 December 2011. The credit portfolio VaR has increased on an average basis from $18 million during 2010 to $23 million during 2011, primarily due to higher exposure during 2011, although this had decreased at year end.

Operational risk

Operational risk refers to the risk of financial or other loss, or damage to the Group's or the Morgan Stanley Group's reputation, resulting from inadequate or failed internal processes, people, resources, systems or from other internal or external events (e.g. internal or external fraud, legal and compliance risks, damage to physical assets, etc.). Legal and compliance risk is included in the scope of operational risk and is discussed below under "Legal and regulatory risk".

The Group's business is highly dependent on the ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies. In general, the transactions processed are increasingly complex. The Group relies on the ability of the Morgan Stanley Group's employees, its internal systems, and systems at technology centres operated by third parties to process a high volume of transactions.

The Group also faces the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries it uses to facilitate securities transactions. In the event of a breakdown or improper operation of the Group's or a third party's systems or improper action by third parties or employees, the Group could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions or damage to its reputation.

Risk management (continued)

Operational risk (continued)

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and may be vulnerable to unauthorised access, mishandling or misuse, computer viruses and other events that could have a security impact on such systems. If one or more of such events occur, this potentially could jeopardise the Group's or the Group's clients' or counterparties' personal, confidential, proprietary or other information processed and stored in, and transmitted through, the Group's computer systems. Furthermore, such events could cause interruptions or malfunctions in the operations of the Group, its clients, its counterparties or third parties, which could result in reputational damage, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, or otherwise adversely affect the business, financial condition or results of operations.

The Morgan Stanley Group has established an operational risk management process which operates on a global and regional basis to identify, measure, monitor and control risk. Effective operational risk management is essential to reducing the impact of operational risk incidents and mitigating legal, regulatory and reputational risks.

Legal and regulatory risk

Legal and regulatory risk includes the risk of exposure to fines, penalties, judgements, damages and / or settlements in conjunction with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements or litigation. Legal risk also includes contractual risk such as the risk that a counterparty's performance obligations will be unenforceable. In the current environment of rapid and possibly transformational regulatory change, the Morgan Stanley Group also views regulatory change as a component of legal risk.

The Morgan Stanley Group has established procedures based on legal and regulatory requirements on a worldwide basis that are designed to foster compliance with applicable statutory and regulatory requirements. The Morgan Stanley Group, principally through the Legal and Compliance Division, also has established procedures that are designed to require that the Morgan Stanley Group's policies relating to conduct, ethics and business practices are followed globally. In connection with its businesses, the Morgan Stanley Group has and continuously develops various procedures addressing issues such as regulatory capital requirements, sales and trading practices, new products, potential conflicts of interest, structured transactions, use and safekeeping of customer funds and securities, credit granting, money laundering, privacy and recordkeeping. In addition, the Morgan Stanley Group has established procedures to mitigate the risk that a counterparty's performance obligations will be unenforceable, including consideration of counterparty legal authority and capacity, adequacy of legal documentation, the permissibility of a transaction under applicable law and whether applicable bankruptcy or insolvency laws limit or alter contractual remedies. The legal and regulatory focus on the financial services industry presents a continuing business challenge for the Morgan Stanley Group.

Significant changes in the way that major financial services institutions are regulated are occurring in the UK, Europe, the US and worldwide. The reforms being discussed and, in some cases, already implemented, include several that contemplate comprehensive restructuring of the regulation of the financial services industry. Such measures will likely lead to stricter regulation of financial institutions generally, and heightened prudential requirements for systemically important firms in particular. Such measures could include reforms of the over-the-counter ("OTC") derivatives markets, such as mandated exchange trading and clearing, position limits, margin, capital and registration requirements. Changes in tax legislation in the UK and worldwide, such as taxation of financial transactions, liabilities and employee compensation, are also possible.

Many of these changes, if enacted, may materially affect the Group's and the Morgan Stanley Group's business, financial condition, results of operations and cash flows in the future.

Basel II Pillar 3 disclosures

The disclosures for the Group made in order to comply with the FSA's rules, which implement in the UK the EU Directives underlying the revised capital adequacy framework, are incorporated in the Pillar 3 disclosures of MSI, which are available on the Morgan Stanley website.

Continuing market uncertainty

During the year the Group has been exposed to the deteriorating economic and financial conditions in selected Eurozone countries. Although there has been a significant reduction in the Group's exposure to certain Eurozone countries, there is still the risk of sovereign defaults, including contagion risk, and potential for the economic environment to worsen. The Morgan Stanley Group regularly performs stress testing to ensure both the Morgan Stanley Group and the Group have sufficient resources at their disposal to absorb losses associated with certain stressed scenarios. The global regulatory environment is continually changing and it remains difficult to assess the full impact on the Group. It is likely that there will be further material changes in the way major financial institutions are regulated and we are continually assessing the impact of these changes.

These conditions present difficulties and uncertainty for the business outlook which may adversely impact the financial performance of the Group in the future.

Going Concern

Business risks associated with the uncertain market and economic conditions are being monitored and managed by the Morgan Stanley Group and the Group. Retaining sufficient liquidity and capital to withstand these market pressures remains central to the Morgan Stanley Group's and the Group's strategy and steps have been taken to strengthen both the Morgan Stanley Group and the Group's capital positions. In particular, the Morgan Stanley Group's capital is deemed sufficient to exceed the minimum capital ratio under the most negative stressed scenario reviewed by the US Federal Reserve. The Morgan Stanley Group and the Group remain committed to maintaining a strong capital position. As explained in the credit ratings section above, the impact of the Group's credit rating downgrade is not considered to have a material impact on its liquidity and funding position.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the annual report and financial statements.

DIRECTORS

The following Directors held office throughout the year and to the date of approval of this report (except where otherwise shown):

P Bailas	(appointed 8 March 2011; ceased to be a director on 18 September 2012)
M C Bowe	(resigned 27 July 2011)
C D S Bryce	
W A Chammah	(resigned 3 March 2011)
L G P M Francois	(resigned 19 March 2012)
T C Kelleher (Chairman)	(appointed 26 April 2011)
G G Lynch	(resigned 21 March 2011)
N S Nandra	(appointed 7 April 2011)
F R Petitgas	
I Plenderleith	(appointed 1 December 2011)
R P Rooney	
D Russell	(appointed 23 May 2011)
C E Woodman	

DIRECTORS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance is taken out by Morgan Stanley, the Company's ultimate parent undertaking, for the benefit of the Directors of the Company.

QUALIFYING THIRD PARTY INDEMNITY PROVISIONS

Qualifying third party indemnity provisions (as defined in section 234 of the Companies Act 2006) were in force during the year and at the date of the Directors' report for the benefit of all the Directors of the Company.

EMPLOYEES

Both the Group and the Morgan Stanley Group place considerable value on the investment in their employees and have continued their practice of keeping employees informed on matters affecting them. Employees are encouraged to present their suggestions and views on Morgan Stanley Group’s performance to management and employees participate directly in the success of the business through Morgan Stanley Group’s various compensation incentive plans.

Every effort is also made to ensure that disabled applicants, or those existing employees that are disabled or may have become disabled, are treated as fairly as possible on terms comparable with those of other employees.

Appropriate training is arranged for disabled persons, including retraining for alternative work for employees who become disabled, to promote their career development within the organisation.

CHARITABLE CONTRIBUTIONS

During the year subsidiaries of the Company made donations to various charities totalling $2.2 million (2010: $4.2 million) of which $1.5 million was donated to Morgan Stanley International Foundation (2010: $1.3 million).

POST BALANCE SHEET EVENTS

There have been no significant events since the balance sheet date.

POLICY AND PRACTICE ON PAYMENT OF CREDITORS

The Group's and the Company's trade creditors balances are comprised primarily of unsettled securities transactions with exchanges, clearing houses, market counterparties, individual investors and other Morgan Stanley Group undertakings. It is the Company’s policy that these transactions are settled in accordance with the standard terms of the relevant exchange or market and disclosure of creditor days is not considered a relevant measure.

AUDIT COMMITTEE

The Company has an Audit Committee to assist the Board of the Company itself and the Boards of other MSI regulated subsidiaries in meeting their responsibilities in ensuring an effective system of internal control and compliance, and in meeting their external financial reporting obligations. The Audit Committee meets regularly and reports to the Board of the Company on a quarterly basis.

AUDITORS

Deloitte LLP have expressed their willingness to continue in office as auditors of the Company and, under sections 485 to 488 of the Companies Act 2006, will be deemed to be reappointed.

Statement as to disclosure of information to auditor

Each of the persons who are Directors of the Company at the date when this report is approved confirms that:

- so far as each of the Directors is aware, there is no relevant audit information (being information needed by the Group’s auditors in connection with preparing their report) of which the Group’s auditors are unaware; and
- each of the Directors has taken all the steps that he / she ought to have taken as a Director to make himself / herself aware of any relevant audit information and to establish that the Group's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

DIRECTORS' REPORT (CONTINUED)

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that year. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Approved by the Board and signed on its behalf by CE WOODMAN

Director

26 September 2012

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY INTERNATIONAL LIMITED

Year ended 31 December 2011

We have audited the Group and Company financial statements (the "financial statements") of Morgan Stanley International Limited for the year ended 31 December 2011 which comprise the consolidated profit and loss account, the consolidated statement of total recognised gains and losses, the consolidated and Company balance sheets and the related notes 1 to 35 for the Group financial statements and the related notes 1 to 11 for the Company financial statements. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditors

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's and the Company's affairs as at 31 December 2011 and of the Group's profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Robert Topley (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London
26 September 2012

MORGAN STANLEY INTERNATIONAL LIMITED

CONSOLIDATED PROFIT AND LOSS ACCOUNT

Year ended 31 December 2011

	Note	2011 $millions	2010 $millions
Net gains on financial instruments classified as held for trading		4,621	4,628
Net gains on financial instruments designated at fair value through profit or loss		275	318
Net gains on fixed asset investments:			
- Available-for-sale financial assets	2	1	61
Interest income	3	4,271	4,137
Interest expense	4	(4,781)	(4,577)
Other income	5	1,404	1,073
Other expense	6	(4,282)	(4,225)
Gain on disposal of subsidiaries	24	5	-
Gain on disposal of joint venture	12	21	-
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		1,535	1,415
Tax on profit on ordinary activities	9	(425)	(367)
PROFIT FOR THE FINANCIAL YEAR		1,110	1,048
Minority interest	24	(1)	(7)
PROFIT ATTRIBUTABLE TO SHAREHOLDERS OF THE COMPANY FOR THE FINANCIAL YEAR		1,109	1,041

All operations were continuing in the current and prior year.

A reconciliation of the movement in shareholders' funds is disclosed in note 24 to the accounts.

The notes on pages 19 to 86 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
Year ended 31 December 2011

	Note	2011 $millions	2010 $millions
PROFIT FOR THE FINANCIAL YEAR		1,110	1,048
Foreign currency revaluation reserve:			
- Foreign currency translation differences on foreign operations	24	(11)	(100)
- Foreign currency reclassification on disposal of subsidiaries	24	(5)	-
Fair value reserve:			
- Net change in fair value of available-for-sale financial assets recognised directly in equity	12	50	13
- Net amount transferred to profit and loss account		-	(3)
Pension reserve:			
- Actuarial loss recognised on post-retirement benefit plans	26	(9)	(9)
Net current and deferred tax on items taken directly to equity		9	2
TOTAL RECOGNISED GAINS AND LOSSES RELATING TO THE YEAR		1,144	951

The notes on pages 19 to 86 form an integral part of the financial statements.

MORGAN STANLEY INTERNATIONAL LIMITED
Registration No. 3584019

CONSOLIDATED BALANCE SHEET
As at 31 December 2011

	Note	2011 $millions	2010 $millions
FIXED ASSETS			
Intangible assets	10	-	10
Tangible assets	11	699	790
Investments:			
- Available-for-sale financial assets	12	196	151
- Joint venture	12	-	7
		895	958
CURRENT ASSETS			
Financial assets classified as held for trading (of which $37,643 million (2010: $55,504 million) were pledged to various parties)	13	361,018	285,378
Financial assets designated at fair value through profit or loss	14	8,691	9,363
Loans and receivables			
- Cash at bank	15	11,999	11,255
- Debtors	16	201,019	202,275
Other assets	17	605	579
		583,332	508,850
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities held for trading	13	(333,157)	(227,888)
Financial liabilities designated at fair value through profit or loss	14	(10,902)	(12,456)
Financial liabilities at amortised cost	19	(204,286)	(233,621)
Other creditors	20	(1,310)	(1,543)
		(549,655)	(475,508)
NET CURRENT ASSETS		33,677	33,342
TOTAL ASSETS LESS CURRENT LIABILITIES		34,572	34,300
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit or loss	14	(2,903)	(4,135)
Financial liabilities at amortised cost	19	(13,477)	(15,984)
PROVISIONS FOR LIABILITIES AND CHARGES	21	(70)	(97)
NET ASSETS EXCLUDING PENSION LIABILITIES		18,122	14,084
Pension liabilities	26	(6)	(7)
NET ASSETS INCLUDING PENSION LIABILITIES		18,116	14,077

CONSOLIDATED BALANCE SHEET (CONTINUED)
As at 31 December 2011

	Note	2011 $millions	2010 $millions
CAPITAL AND RESERVES			
Called up share capital	23	1,614	1,614
Capital redemption reserve	24	1,400	1,400
Foreign currency revaluation reserve	24	(534)	(541)
Capital contribution reserve	24	6,041	3,141
Fair value reserve	24	28	(22)
Pension reserve	24	(116)	(107)
Profit and loss account	24	9,589	8,476
EQUITY SHAREHOLDERS' FUNDS		18,022	13,961
MINORITY INTEREST	24	94	116
TOTAL EQUITY		18,116	14,077

These financial statements were approved by the Board and authorised for issue on 26 September 2012.

Signed on behalf of the Board CE WOODMAN

Director

The notes on pages 19 to 86 form an integral part of the financial statements.

1. ACCOUNTING POLICIES

The Group's principal accounting policies are summarised below and have been applied consistently throughout the year and preceding year.

a. Basis of preparation

The Group financial statements are prepared under the historical cost convention, modified by the inclusion of financial instruments at fair value as described in note 1(e) below, and in accordance with applicable United Kingdom company law and accounting standards. Certain limited format changes have been made to prior year amounts to conform to the current year presentation.

The consolidated financial statements of the Group comprise the financial statements of the Company and its subsidiaries prepared up to 31 December 2011. The financial statements for consolidated subsidiaries are prepared for the same reporting period as the Group, using consistent accounting policies. The financial statements of subsidiaries which are presented in currencies other than US dollars are translated into US dollars as described in note 1(d). Subsidiaries are consolidated from the date that the Group gains control until the date that control ceases. All subsidiaries have been included in the consolidation.

Intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions are eliminated in preparing the consolidated financial statements.

Minority interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Group and are presented separately in the consolidated profit and loss account and within equity in the consolidated balance sheet, separately from parent shareholders' equity. Acquisitions of minority interests are accounted for using the parent entity extension method, whereby the difference between the consideration paid and the fair value of the share of the net assets acquired is recognised in consolidated equity.

b. The going concern assumption

The Group's business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Business Review section of the Directors' report on pages 3 to 13. In addition, the notes to the financial statements include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments; and its exposures to credit risk and liquidity risk.

As set out in the Directors' report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Group's strategy and steps have been taken to strengthen the Morgan Stanley Group capital position and ensure that the Group's capital position is satisfactory.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

c. Functional currency

Items included in the financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Company operates. All currency amounts in the Directors' report and the financial statements are rounded to the nearest million US dollars, except when otherwise indicated.

1. ACCOUNTING POLICIES (CONTINUED)

d. Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the balance sheet date. Assets and liabilities of the overseas branches and subsidiaries are translated into US dollars using the closing rate method. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Translation differences arising from the net investments in the foreign operations are taken to the foreign currency revaluation reserve and all other translation differences are taken through the consolidated profit and loss account, with the exception of non-monetary financial investments classified as available-for-sale, where foreign exchange differences and the related tax amounts are recorded in the fair value reserve in equity until the investment is sold. Exchange differences recognised in the consolidated profit and loss account are presented in 'Other income' or 'Other expense', except where noted in 1(e) below.

On disposal of a foreign operation, the related cumulative gain or loss in the 'Foreign currency revaluation reserve' attributable to the equity holders of the Company is reclassified to the consolidated profit and loss account as a gain or loss on disposal of subsidiary. On liquidation of a foreign operation, the related cumulative gain or loss in the 'Foreign currency revaluation reserve' is reclassed to retained earnings.

e. Financial instruments

The Group classifies its financial assets into the following categories on initial recognition: financial assets classified as held for trading; financial assets designated at fair value through profit or loss; available-for-sale fixed asset investments; investments in joint ventures and loans and receivables.

The Group classifies its financial liabilities into the following categories on initial recognition: financial liabilities classified as held for trading, financial liabilities designated at fair value through profit or loss and financial liabilities at amortised cost.

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

With the exception of loans, financial instruments classified as held for trading, including all derivatives, are initially recorded on trade date at fair value (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the consolidated profit and loss account in 'Net gains/ (losses) on financial instruments classified as held for trading'.

For loans classified as held for trading, from the date a loan is entered into (trade date), until settlement date, the Group recognises any unrealised fair value changes in the loan as financial instruments classified as held for trading. On settlement date, the fair value of consideration given or received is recognised as a financial instrument classified as held for trading. All subsequent changes in fair value, foreign exchange differences and interest are reflected in the consolidated profit and loss account in 'Net gains / (losses) from financial instruments classified as held for trading'.

For all financial instruments classified as held for trading, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated profit and loss account in 'Other expense'.

ii) Financial instruments designated at fair value through profit or loss

The Group has designated certain financial assets and financial liabilities at fair value through profit or loss when either:

- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation at fair value eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments (continued)

ii) Financial instruments designated at fair value through profit or loss (continued)

From the date the transaction in a financial instrument designated at fair value is entered into (trade date) until settlement date, the Group recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the consolidated profit and loss account in 'Net gains / (losses) on financial instruments designated at fair value through profit or loss'. Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated profit and loss account in 'Other expense'.

iii) Available-for-sale fixed assets investments

Financial assets classified as available-for-sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories of financial instruments.

Financial assets classified as available-for-sale are recorded on trade date and are initially recognised and subsequently measured at fair value (see note 1(f) below).

For debt instruments, interest calculated using the effective interest method (see note 1(e)(iv) below), impairment losses and reversals of impairment losses and foreign exchange differences on the amortised cost of the asset are recorded in the profit and loss account in 'Net gains/ losses on fixed asset investments in available-for-sale financial assets'. For equity instruments, dividend income and impairment losses are recorded in the profit and loss account in 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'. All other gains and losses on debt and equity instruments classified as available-for-sale are recognised in the 'Fair value reserve' within equity.

Transaction costs that are directly attributable to the acquisition of the available-for-sale financial asset are added to the fair value on initial recognition.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the 'Fair value reserve' is transferred to and recognised in the profit and loss account and reported in 'Net gains/ losses on fixed asset investments in available-for-sale financial assets'.

iv) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the consolidated profit and loss account in 'Interest income', using the effective interest rate method as described below. Transaction costs that are directly attributable to the acquisition of the financial asset are added to or deducted from the fair value on initial recognition. Impairment losses and reversals of impairment losses on financial assets classified as loans and receivables are recognised in the consolidated profit and loss account in 'Other expense'.

Financial liabilities held at amortised cost are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost. Interest is recognised in the profit and loss account in 'Interest expense' using the effective interest rate method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments (continued)

iv) Loans and receivables and financial liabilities at amortised cost (continued)

The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the expected life of the financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate a shorter period) to the carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and financial liability. The calculation of the effective interest rate includes all fees and commissions paid or received, transaction costs and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

In the course of financing its business and as part of its trading activities, the Group enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given. Cash collateral balances repayable and accrued interest arising under repurchase agreements and securities lending arrangements are classified as ‘Financial liabilities at amortised cost’ and the related securities, where owned by the Group, are included in ‘Financial assets classified as held for trading’. Cash collateral balances receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as ‘Loans and receivables’. Securities received by the Group under resale arrangements and securities borrowing arrangements are generally not recognised on the balance sheet.

The redeemable preference shares issued by the Group are classified as financial liabilities at amortised cost in accordance with the substance of the contractual arrangement. Dividends on these redeemable preference shares are recognised in the profit and loss account in ‘Interest expense’ using the effective interest rate method.

f. Fair value of financial instruments

Fair value measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e. the “exit price”) in an orderly transaction between market participants at the measurement date.

In determining fair value, the Group uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximises the use of relevant observable inputs and minimises the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Group. Unobservable inputs are inputs that reflect the Group’s assumptions about the assumptions other market participants would use in pricing the asset or liability, developed based on the best information available in the circumstances.

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgement.

The Group uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments.

1. ACCOUNTING POLICIES (CONTINUED)

f. Fair value of financial instruments (continued)

Valuation techniques

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity), as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk. Adjustments for liquidity risk adjust model-derived valuations of financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trader activity, broker quotes or other external third party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Group's and the counterparty's credit standing is considered when measuring fair value.

In determining the expected exposure the Group simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap ("CDS") spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Group also considers collateral held and legally enforceable master netting agreements that mitigate the Group's exposure to each counterparty. Adjustments for model uncertainty are taken for positions where underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible.

The Group generally subjects all valuations and models to a review process initially and on a periodic basis thereafter. The Group may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

Fair value is a market-based measure considered from the perspective of a market participant rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Group's own assumptions are set to reflect those that the Group believes market participants would use in pricing the asset or liability at the measurement date.

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises a gain or loss on inception of the transaction.

When unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial change in fair value indicated by the valuation technique as at the transaction date is not recognised immediately in the consolidated profit and loss account and is recognised instead when the market data becomes observable.

1. ACCOUNTING POLICIES (CONTINUED)

g. Impairment of financial assets

At each balance sheet date, an assessment is made as to whether there is any objective evidence of impairment in the value of financial assets classified as available-for-sale fixed asset investments, other fixed asset investments or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale fixed asset investments are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. When a decline in the fair value of an available-for-sale financial asset has been recognised through the statement of total recognised gains and losses and there is evidence that the asset is impaired, the cumulative loss that had been recognised through the statement of total recognised gains and losses is removed from reserves and recognised in the consolidated profit and loss account within 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'.

Impairment losses on loans and receivables carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the consolidated profit and loss account within 'Other expenses' and are reflected against the carrying amount of the impaired asset on the consolidated balance sheet. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the statement of total recognised gains and losses and not separately identified as an impairment reversal. For all other financial assets, if in a subsequent year, the amount of the estimated impairment loss decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed as detailed by financial asset in note 1(e)(iii) and (iv). Any reversal is limited to the extent that the value of the asset may not exceed the original amortised cost of the asset had no impairment occurred.

h. Fees and commissions

Fees and commissions classified within 'Other income' in the consolidated profit and loss account include account servicing fees, investment management fees, sales commissions, placement fees, advisory fees and syndication fees.

Fees and commissions classified within 'Other expense' include transaction and service fees. These amounts are recognised as the related services are performed or received respectively.

i. Tangible fixed assets

Tangible fixed assets are stated at cost net of depreciation and any provision for impairment in value, which is included within 'Other expense' in the consolidated profit and loss account. For assets in the course of construction, interest that is directly attributable to the construction of the qualifying asset is capitalised as a cost of the asset. The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

For premises held under operating leases, a reinstatement provision is recognised for the estimated cost to reinstate the premises at the end of the lease period. When the reinstatement provision is established and included within 'Provisions for liabilities' in the consolidated balance sheet, an equivalent asset is recognised and included in the cost of leasehold improvements at the initial present value of any reinstatement obligations. The discount effect included in the reinstatement provision is reversed over time using a constant effective yield method and included within 'Interest expense' in the consolidated profit and loss account. The reinstatement asset is depreciated over the useful economic life of the relevant leasehold improvement asset and this depreciation is included within 'Other expense'.

1. ACCOUNTING POLICIES (CONTINUED)

i. Tangible fixed assets (continued)

Depreciation is provided on tangible fixed assets at rates calculated to write off the cost of the assets on a straight-line basis over their expected useful lives as follows:

Freehold property	- three to 39 years
Leasehold improvements, including reinstatement assets	- shorter of remaining lease term and 39 years
Fixtures, fittings and equipment	- three to eight years

Freehold land is not depreciated. Assets in the course of construction are not depreciated until the construction is complete and the asset is ready for use. The asset is then transferred to leasehold improvements or fixtures, fittings and equipment, where it is depreciated at the relevant rate.

j. Operating leases

Rentals payable under operating leases are charged to ‘Other expense’ in the consolidated profit and loss account on a straight line basis over the lease term. Lease incentives are recognised as a reduction of rentals payable and are allocated on a straight line basis over the shorter of the lease term and a period ending on a date from which it is expected the market rent will be payable.

Rentals receivable under operating leases are credited to ‘Other income’ in the consolidated profit and loss account on a straight-line basis over the lease term. Lease incentives are recognised as a reduction of rentals receivable and are allocated on a straight-line basis over the shorter of the lease term and a period ending on a date from which it is expected the market rent will be receivable.

k. Taxation

UK corporation tax is provided at amounts expected to be paid / recovered using the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Full provision has been made for deferred tax assets and liabilities arising from timing differences. Deferred tax is measured using the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

Current tax assets are offset against current tax liabilities when there is a legally enforceable right to offset current tax assets against current tax liabilities and when they relate to taxes levied by the same taxation authority and the Group intends to settle its current tax assets and current tax liabilities on a net basis. Deferred tax assets are offset against deferred tax liabilities to the extent that they relate to taxes levied by the same tax authority and arise in the same taxable entity.

l. Intangible fixed assets

Purchased goodwill, being the difference between the purchase consideration and the fair value of net assets acquired, is amortised over a period of between five to 20 years in respect of subsidiary undertakings, being the periods for which the Directors expect the values of the underlying businesses acquired to exceed the value of the underlying net assets. Goodwill is assessed for impairment if events or changes in circumstances indicate that its carrying value may not be recoverable in full.

1. ACCOUNTING POLICIES (CONTINUED)

m. Employee compensation plans

(i) Equity-settled share-based compensation plans

Morgan Stanley operates equity-settled share-based compensation plans on behalf of the Group and, in relation to which, the Group pays Morgan Stanley in consideration of the procurement of the transfer of shares or cash payment to employees.

The cost of equity settled transactions with employees is measured based on the fair value of the equity instruments at grant date. Fair value of stock unit awards is based on the market price of Morgan Stanley shares and fair value of stock option awards is estimated using the Black-Scholes option pricing model, which takes into account the option's exercise price, its expected term, the risk free interest rate and the expected volatility of the market price of Morgan Stanley shares. Non-market vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting over time the number of equity instruments included in the measurement of the transaction such that the amount ultimately recognised reflects the number that actually vest. The expense for Financial Reporting Standard ("FRS") 20 *Share-based payment* ("FRS 20") purposes is taken directly to 'Other expense' in the consolidated profit and loss account; the corresponding credit to reserves is reduced to the extent that payments are due to Morgan Stanley in respect of these awards.

(ii) Other deferred compensation plans

Morgan Stanley also maintains deferred compensation plans for the benefit of certain employees that provide a return to the participating employees based upon the performance of various referenced investments. Liabilities for these awards, which are included within 'Other creditors' in the consolidated balance sheet, are measured at fair value and recognised over time in accordance with the awards' vesting conditions. The related expense is recorded within 'Staff costs' in 'Other expense'. The Group economically hedges the exposure created by these deferred compensation plans by entering into derivative transactions with other Morgan Stanley undertakings. The derivatives are recognised within financial instruments classified as held for trading and the related gains and losses are recorded within 'Net gains / loss on financial instruments classified as held for trading' in the consolidated profit and loss account.

n. Retirement benefits

The Group operates both defined benefit and defined contribution plans.

Contributions due in relation to the Group's defined contribution plans are recognised in 'Other expense' in the consolidated profit and loss account when payable.

For the Group's defined benefit Plan, liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the Plan liabilities. Plan assets are measured at their fair value. A surplus of Plan assets over liabilities is recognised in the balance sheet as an asset where recoverable. Where Plan liabilities exceed Plan assets, the deficit is recognised in the balance sheet as a liability. The current service cost and any past service costs are charged to 'Other expense'. The expected return on Plan assets and the unwinding of the discount on the Plan liabilities are presented net and recognised within either 'Interest income' or 'Interest expense'. Actuarial gains and losses are recognised in full in the period in which they occur in the consolidated statement of total recognised gains and losses.

Details of the plans are given in note 26 of the consolidated financial statements.

o. Cash flow statement

The Group's ultimate parent undertaking, Morgan Stanley, produces consolidated financial statements in which the Group is included and which are publicly available. Accordingly, the Group, which is wholly owned by Morgan Stanley, has elected to avail itself of the exemption provided in Financial Reporting Standard 1 (Revised 1996), *Cash Flow Statements*, and has not presented a cash flow statement.

p. Subsidiaries and significant holdings

Details of the Group's and the Company's investments in subsidiaries and other significant holdings, including the name, country of incorporation, and proportion of ownership are given in note 3 to the Company's separate financial statements.

2. NET GAINS ON INVESTMENTS IN AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2011 $millions	2010 $millions
Net fair value gains transferred from equity on disposal of assets	-	3
Dividends receivable	1	58
	1	61

3. INTEREST INCOME

	2011 $millions	2010 $millions
Interest income from loans to other Morgan Stanley Group undertakings	1,547	1,909
Other interest income	2,724	2,228
	4,271	4,137

Other interest income includes $11 million (2010: $8 million) of interest income accrued on impaired loans and receivables.

4. INTEREST EXPENSE

	2011 $millions	2010 $millions
Interest expense on bank loans	7	4
Interest expense on loans from other Morgan Stanley Group undertakings	3,067	3,239
Net pension plan finance cost	-	2
Other interest expense	1,708	1,332
	4,782	4,577
Less: Interest capitalised on assets in the course of construction	(1)	-
	4,781	4,577

5. OTHER INCOME

	2011 $millions	2010 $millions
Fee and commission income	1,045	945
Operating lease rentals received	48	54
Non-UK capital gains tax recoverable	149	-
Other	162	74
	1,404	1,073

Non-UK capital gains tax recoverable represents the expected reimbursement from clients on certain equity transactions. Contractually the clients are bound to reimburse the Group for any tax, levy, impost duty, charge, assessment or fee, directly or indirectly, in connection with or arising from these equity transactions.

6. OTHER EXPENSE

	2011 $millions	2010 $millions
Staff costs (note 7)	1,245	1,215
Management recharges relating to staff costs borne by other Morgan Stanley Group undertakings	896	906
Management recharges from other Morgan Stanley Group undertakings relating to other services	73	76
Bank levy	46	-
Bank payroll tax	-	271
Impairment loss on loans and receivables (note 28)	3	22
Reversal of impairment loss on loans and receivables (Note 28)	(32)	(48)
Realised losses on loans and receivables	-	1
Operating lease rentals	68	68
Depreciation on property, plant and equipment (note 11)	135	137
Amortisation of goodwill (note 10)	10	14
Auditor's remuneration:		
- Audit of subsidiaries' financial statements	4	5
Foreign exchange losses	28	3
Brokerage fee and commission expense	665	562
Business development and corporate services	432	394
Other operating expense	709	599
	4,282	4,225

Included within both staff costs and management recharges relating to staff costs borne by other Morgan Stanley Group undertakings is an amount of $291 million (2010: $264 million) in relation to equity-settled share-based payment transactions. These costs reflect the amortisation of equity-based awards granted to employees over the last three years and are therefore not directly aligned with other staff costs in the current year.

Fees payable to the Company's auditors for the audit of the Company's annual accounts are $124,000 (2010:$125,000). Fees payable to the Company's auditors for non-audit services are $300,000 (2010: $308,000).

7. STAFF COSTS

The average number of employees of the Group including the Directors, is analysed below:

	2011 $millions	2010 $millions
Company and institutional securities infrastructure	2,876	2,925
Business units and other	1,329	1,308
	4,205	4,233

The costs of the staff including Directors, are analysed below:

	2011 $millions	2010 $millions
Wages and salaries	1,078	1,048
Social security costs	119	120
Pension costs	48	47
	1,245	1,215

8. DIRECTORS' BENEFITS

	2011 $millions	2010 $millions
Total emoluments of all Directors:		
Aggregate emoluments excluding pension contributions	10	16
Long-term incentive plans	3	6
Group contributions to pension plans	-	1
	13	23
Disclosures in respect of the highest paid Director:		
Aggregate emoluments	2	5
Long-term incentive plans	1	3
Aggregate emoluments paid to Directors for loss of office	-	3

Directors’ emoluments have been calculated as the sum of cash, bonuses, and benefits in kind.

All Directors who are employees of the Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Group’s equity based long-term incentive plans. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares or share options awarded, nor the gains made on exercise of share options. During the year no Directors exercised share options awarded under these incentive plans, including the highest paid Director (2010: none).

The value of assets (other than shares or share options) awarded under other long-term incentive plans has been included in the above disclosures when the awards vest, which is generally within three years from the date of the award.

There are nine Directors to whom retirement benefits were accruing under a money purchase plan (2010: eight). Three Directors have retirement benefits accruing under defined benefits plans (2010: four).

9. TAX ON PROFIT ON ORDINARY ACTIVITIES

Analysis of charge in the year

	2011 $millions	**2010 $millions**
UK corporation tax at 26.49% (2010: 28%)		
- Current year charge	232	379
- Adjustment in respect of prior years	(28)	(123)
	204	256
Double taxation relief		
- Current year credit	(87)	(76)
- Adjustment in respect of prior years	(45)	(13)
Foreign Tax		
- Current year charge	193	199
- Adjustment in respect of prior years	146	4
Total current tax	411	370
Deferred taxation		
- Current year charge	13	(7)
- Adjustment in respect of prior years	(6)	-
- Impact of change in the UK corporation tax rate	7	4
Total deferred tax	14	(3)
Tax on profit on ordinary activities	425	367

Current tax expense for the year includes an amount of $143 million that represents a potential non-UK capital gains tax liability that may arise on equity investments made by the Group to hedge client positions.

Tax on recognised gains and losses not included in the profit and loss account:

	2011 $millions	**2010 $millions**
Net current and deferred tax		
Tax on currency translation differences on foreign currency net investments		
- current year	5	2
- adjustments in respect of prior years	4	-
Net current and deferred tax recognised in the statement of total recognised gains and losses	9	2

9. TAX ON PROFIT ON ORDINARY ACTIVITIES (CONTINUED)

Factors affecting the tax charge for the year

The current year UK taxation charge is higher (2010: lower) than that resulting from applying the standard UK corporation tax rate of 26.49% (2010: 28%). The main differences are explained below:

	2011 $millions	2010 $millions
Profit on ordinary activities before tax	1,535	1,415
Profit on ordinary activities multiplied by the standard rate of corporation tax in the UK of 26.49% (2010: 28%)	407	396
Effects of:		
Adjustments to the tax charge in respect of prior periods	41	(29)
Currency translation on tax	(9)	-
Depreciation for the year in excess of / (lower than) capital allowances	1	(1)
Expenses not deductible for tax purposes	14	12
(Lower) / higher rate taxes on overseas earnings	(3)	7
Net Group relief surrendered / (received) for nil consideration from / to associated UK companies	-	(10)
Non deductible UK bank levy	12	-
Non deductible bank payroll tax	-	74
(Non taxable gain) / non deductible loss on disposal of fixed asset investments	(12)	5
Non deductible interest expense	2	2
Other timing difference	(8)	(10)
Other	4	6
(Reversal) / origination of timing differences relating to compensation	(19)	30
Tax expensed	(40)	-
Tax reserves movement relating to prior periods	31	(102)
Utilisation of tax losses	(10)	(6)
Withholding tax rebate	-	(4)
Current tax charge for the year	411	370

Finance (No. 2) Act 2010 enacted a 1% reduction in the UK corporation tax rate to 27% with effect from April 2011. Finance Act 2011 enacted a further 1% reduction in the rate of UK corporation tax to 26% from April 2011. The combined 2% reduction in the tax rate impacted the current tax charge in 2011.

Finance Act 2011 enacted an additional 1% reduction to the UK corporation tax rate to 25% with effect from April 2012. In the Budget announcement on 21 March 2012, this reduction was increased to 2% and was substantively enacted on 26 March 2012. The combined 2% reduction in the tax rate to 24% from 1 April 2012 will impact the current tax charge in 2012.

Withholding tax credits are generated by the Group from its equity trading activities as an integral component of net revenues, but are offset against the current year tax charge in accordance with FRS 16 *Current tax*.

10. INTANGIBLE FIXED ASSETS

Purchased goodwill	$millions
Cost	
At 31 December 2010 and 31 December 2011	151
Amortisation	
At 31 December 2010	(141)
Charge for the year	(10)
At 31 December 2011	(151)
Net book value	
At 31 December 2011	-
At 31 December 2010	10

11. TANGIBLE FIXED ASSETS

	Freehold land and property $millions	Leasehold improve-ments $millions	Assets in the course of construction $millions	Fixtures, fittings and equipment $millions	Total $millions
Cost					
At 1 January 2011	3	870	16	761	1,650
Additions	-	23	15	9	47
Disposals	-	-	-	(280)	(280)
Transfers	-	-	(3)	3	-
Foreign exchange revaluation on assets held in overseas subsidiaries	-	(1)	-	(2)	(3)
At 31 December 2011	3	892	28	491	1,414
Depreciation					
At 1 January 2011	-	246	-	614	860
Charge for the year	-	68	-	67	135
Disposals	-	-	-	(280)	(280)
At 31 December 2011	-	314	-	401	715
Net book value					
At 31 December 2010	3	624	16	147	790
At 31 December 2011	3	578	28	90	699

Interest capitalised on assets in the course of construction included within additions during the year amounted to $1 million (2010: $nil million). The cumulative amount of interest capitalised in the total cost of tangible fixed assets amounts to $23 million (2010: $22 million). The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

12. FIXED ASSETS INVESTMENTS

Fixed asset investments classified as available-for-sale:

Fixed asset investments that are categorised as available-for-sale are summarised in the table below:

	2011 $millions	2010 $millions
Corporate equities	196	151
	196	151

Movements in fixed asset investments categorised as available-for-sale during the year are as follows:

	2011 $millions	2010 $millions
Fair value		
At 1 January	151	163
Additions	-	7
Disposals and other settlements	(1)	(24)
Changes in fair value recognised in the 'fair value reserve'	50	13
Foreign exchange revaluation	(4)	(8)
At 31 December	196	151

Included in 'Available-for-sale financial assets' are listed investments of $98 million (2010: $75 million).

All available-for-sale financial assets are expected to be held for a period of more than twelve months.

Fixed assets investment in a joint venture

During the year, the Group sold its interest in Tarvos Investments GmbH ("Tarvos"), a limited liability company incorporated in Germany. The Group had contributed 50% of the capital in the company and accounted for the investment using the equity method of accounting as the majority of the risks and rewards of the company were absorbed by entities outside the Group.

The sale of Tarvos resulted in a net gain of $21 million reported in the consolidated profit and loss account, calculated as the difference between the proceeds of $28 million and the carrying value of the investment at disposal of $7 million.

13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES HELD FOR TRADING

Financial assets and financial liabilities classified as held for trading are summarised in the table below:

	2011		2010	
	Assets $millions	**Liabilities $millions**	**Assets $millions**	**Liabilities $millions**
Fair value				
Derivative financial instruments (listed and OTC):				
- Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	224,566	217,825	110,951	108,841
- Foreign exchange forward contracts and options	26,270	26,535	16,327	16,546
- Equity securities contracts (including equity swaps, warrants and options)	45,522	48,165	42,383	46,063
- Commodity forwards, options and swaps	13,960	13,743	21,025	20,487
	310,318	306,268	190,686	191,937
Government debt securities	10,500	10,164	17,983	15,105
Corporate equities	26,420	14,182	52,633	16,119
Corporate and other debt	13,780	2,543	24,076	4,727
Total financial instruments classified as held for trading	361,018	333,157	285,378	227,888

There are no terms and conditions of any financial asset or liability classified as held for trading that may individually significantly affect the amount, timing and certainty of future cash flows for the Group.

14. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial instruments designated at fair value through profit or loss consist primarily of the following financial assets and financial liabilities:

Prepaid over the counter (“OTC”) contracts: The risk on these financial instruments, both financial assets and financial liabilities, is primarily hedged using financial instruments classified as held for trading including equity securities and interest rate swaps. These prepaid OTC contracts are designated at fair value as such contracts, as well as the financial instruments with which they are hedged, are risk managed on a fair value basis as part of the Group’s trading portfolio and the risk is reported to key management personnel on this basis.

Issued structured notes: These relate to financial liabilities which arise from selling structured products generally in the form of notes or certificates. These structured notes are designated at fair value as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group’s trading portfolio and the risk is reported to key management personnel on this basis.

Corporate loans: Certain loans to customers are designated at fair value because either the risks of the loans have been matched with other fair valued financial instrument contracts and such a designation reduces an accounting mismatch; or as part of a documented risk management strategy the risks of the loan are managed on a fair value basis as part of the Group’s trading portfolio and the risk is reported to key management personnel on this basis; or because the loan contract itself contains an embedded derivative that must otherwise be separated and measured at fair value.

Other financial assets and liabilities: These include financial assets and liabilities such as those that arise upon the consolidation of certain special purpose entities and those that arise as a result of continuing recognition of certain financial assets and the simultaneous recognition of an associated financial liability. These financial assets and liabilities are designated at fair value as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group’s trading portfolio and the risk is reported to key management personnel on this basis.

	2011		2010	
	Assets $millions	**Liabilities $millions**	**Assets $millions**	**Liabilities $millions**
Fair value				
Prepaid OTC contracts	3,264	2,676	4,909	3,708
Structured notes	-	1,099	-	492
Corporate loans	1,442	-	-	-
Other financial assets and liabilities	3,985	10,030	4,454	12,391
Total financial instruments designated at fair value through profit or loss	8,691	13,805	9,363	16,591

The maximum exposure to credit risk of loans and receivables designated at fair value through profit or loss at the end of the year is $1,442 million (2010: $nil). The cumulative change in fair value of loans attributable to changes in credit risk amounts to a gain of $85 million (2010: $nil). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

Included within financial liabilities designated at fair value is an amount of $2,903 million (2010: $4,135 million) that is expected to be settled after more than 12 months.

The carrying amount of financial liabilities designated at fair value through profit or loss is $144 million lower than the contractual amount due at maturity (2010: $8 million lower).

The change in fair value recognised through the consolidated income statement attributable to own credit risk is a gain of $128 million (2010: $1 million loss) and cumulatively is $249 million gain (2010: $121 million gain). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

There are no terms and conditions of any financial asset or liability designated at fair value through profit or loss that may individually significantly affect the amount, timing and certainty of future cash flows for the Group.

15. CASH AT BANK

Included within 'Cash at bank' is an amount of $8,173 million (2010: $7,241 million) which represents segregated client money, held in accordance with the FSA's Client Money Rules, and an amount of $8 million (2010: $40 million) which represents other client money.

16. DEBTORS

	2011 $millions	2010 $millions
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	53,606	47,103
- Morgan Stanley Group undertakings	17,646	10,672
Securities purchased under agreements to resell and cash collateral on stocks borrowed:		
- External counterparties	79,250	93,176
- Morgan Stanley Group undertakings	44,729	43,116
Corporate loans	2,129	4,443
Other amounts due from Morgan Stanley Group undertakings	1,620	1,109
Other debtors classified within loans and receivables	2,039	2,656
	201,019	202,275

Amounts falling due after more than one year included above are as follows:

	2011 $millions	2010 $millions
Corporate loans:		
- between one and five years	2,044	4,320
- over five years	85	123
	2,129	4,443

17. OTHER ASSETS

	2011 $millions	2010 $millions
Deferred taxation (see note 18)	160	132
Corporation tax recoverable	78	191
Other tax recoverable	144	146
Prepayments and accrued income	223	110
	605	579

18. DEFERRED TAX

Deferred tax has been fully recognised and is analysed as follows:

	2011		2010	
	Asset $millions	**Liability $millions**	**Asset[(1)] $millions**	**Liability[(1)] $millions**
Accelerated capital allowances	18	(37)	16	(38)
Amounts not recognised due to unobservable market data	11	-	14	-
Deferred compensation	126	(1)	146	-
Hedges of forecast currency transactions	(3)	(5)	-	(6)
Other timing differences	5	(2)	6	(1)
Revaluation of available-for-sale financial assets	-	(1)	-	(1)
Tax losses carried forward	3	-	-	-
Unrealised (gains) / losses	-	(1)	2	(6)
	160	(47)	184	(52)

(1) Deferred tax presented as a net $132 million deferred tax asset as at 31 December 2010

The movement in the provision for deferred tax asset and liability during the year is analysed as follows:

	2011		2010	
	Asset $millions	**Liability $millions**	**Asset $millions**	**Liability $millions**
At 1 January 2011	184	(52)	184	(54)
Amounts recognised in the consolidated profit and loss account:				
- Current year timing differences	(16)	3	3	4
- Prior year timing differences	6	-	-	-
Amounts recognised in equity through the statement of recognised gains and losses:				
- Current year timing differences	(2)	(1)	(2)	-
Foreign exchange revaluation	(1)	-	4	(3)
Impact of change in UK corporation tax rate	(11)	3	(5)	1
At 31 December 2011	160	(47)	184	(52)

As at 31 December 2011, a total deferred tax asset of $20 million (2010: $62 million) in respect of losses carried forward at nil value has not been recognised due to uncertainty of the recoverability of the asset.

Finance Act 2011 enacted a 1% reduction to the UK corporation tax rate to 25% with effect from April 2012. This rate reduction to 25% has had an impact on the Group's deferred tax balance as indicated above.

As part of the Budget announcements on 21 March 2012, a further 1% reduction in the rate of UK corporation tax to 24% was announced and substantively enacted on 26 March 2012. A further announcement to reduce the UK corporation tax rate to 23% and 22% from April 2013 and April 2014 respectively was also made. However, as these reductions were not substantively enacted as at 31 December 2011, the effect of these subsequent rate reductions has not been applied to the valuation of the Group's deferred tax assets and liabilities.

19. FINANCIAL LIABILITIES AT AMORTISED COST

	2011 $millions	2010 $millions
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	762	580
Trade creditors:		
- External counterparties	65,850	55,027
- Morgan Stanley Group undertakings	22,363	13,150
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	42,382	72,983
- Morgan Stanley Group undertakings	56,194	68,990
Corporate deposits	4,451	6,883
Other amounts owing to Morgan Stanley Group undertakings	9,495	12,753
Other financial liabilities	2,789	3,255
	204,286	233,621

Included in other amounts owing to Morgan Stanley Group undertakings are amounts of $9,205 million (2010: $6,763 million) representing cash collateral received as security for open trading positions held with other Morgan Stanley Group undertakings.

	2011 $millions	2010 $millions
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	10,569	10,571
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	1,654	2,200
Other amounts owing to Morgan Stanley Group undertakings	1,254	3,213
	13,477	15,984
Total financial liabilities at amortised cost	217,763	249,605

Total financial liabilities at amortised cost of $11,622 million (2010: $11,647 million), included in the above, fall due for payment after five years from the balance sheet date. Of this, $nil (2010: $nil) is payable by instalments.

19. FINANCIAL LIABILITIES AT AMORTISED COST (CONTINUED)

Subordinated loans

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment Date	Interest rate	2011 $millions	2010 $millions
Morgan Stanley International Holdings Inc.	31 July 2019	3 month LIBOR plus 1.25%	388	389
Morgan Stanley International Finance S.A.	30 October 2020	3 month LIBOR plus 1.25%	-	820
Morgan Stanley UK Financing I LP	31 October 2025	3 month LIBOR plus 1.25%	820	-
Morgan Stanley International Holdings Inc.	31 October 2021	6 month LIBOR plus 1.25%	-	1,300
Morgan Stanley UK Financing II LP	31 October 2021	6 month LIBOR plus 1.25%	1,300	-
Morgan Stanley International Holdings Inc.	15 December 2021	3 month LIBOR plus 1.25%	155	156
Morgan Stanley International Finance S.A.	31 October 2025	3 month LIBOR plus 1.25%	-	7,906
Morgan Stanley UK Financing I LP	31 October 2025	3 month LIBOR plus 1.25%	7,906	-
			10,569	10,571

All amounts outstanding under subordinated loan agreements are repayable at any time at the borrower's option, subject to two business days' notice to the lender and at least one month notice to the Financial Services Authority ("FSA"), which has the right under the agreement to refuse consent to repayment.

A change in subordinated loan agreements counterparties was effective on 16 December 2011 as follows:

- Morgan Stanley International Finance S.A. novated $820 million subordinated debt issued by Morgan Stanley Group (Europe) to Morgan Stanley UK Financing I LP;
- Morgan Stanley International Holdings Inc. novated $1,300 million subordinated debt issued by MSI to Morgan Stanley UK Financing II LP; and
- Morgan Stanley International Finance S.A. novated $7,906 million subordinated debt issued by Morgan Stanley & Co. International plc to Morgan Stanley UK Financing I LP.

The Group has not defaulted on principal, interest or made any other breaches with respect to its subordinated loans during the year.

20. OTHER CREDITORS

	2011 $millions	2010 $millions
Amounts falling due within one year		
Corporation tax payable	108	283
Deferred taxation (see note 18)	47	-
Other taxes and social security costs	332	321
Accruals and deferred income	823	939
	1,310	1,543

21. PROVISIONS FOR LIABILITIES AND CHARGES

	Property $millions	Litigation $millions	Total $millions
At 1 January 2011	69	28	97
Additional provisions	1	6	7
Provisions utilised	(8)	(26)	(34)
Effect of unwind discount rate	3	-	3
Change in accounting estimates	(1)	-	(1)
Unused provision reversed	-	(3)	(3)
Foreign exchange movements	-	1	1
At 31 December 2011	64	6	70

Property

Property provisions represent the net present value of expected future costs of excess office space and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term that are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Tangible fixed assets' (see note 11).

Litigation matters

In the normal course of business, the Group has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and / or punitive damages or claims for indeterminate amounts of damages. While the Group has identified below any individual proceedings where the Group believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been notified to the Group or are not yet determined to be probable or possible and reasonably estimable.

On 25 August 2008, the Morgan Stanley Group, the Group and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance (the "Cheyne SIV"). The case is styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* and is pending in the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. On 2 September 2009, the court dismissed all of the claims against the Morgan Stanley Group and the Group except for plaintiffs' claims for common law fraud. On 15 June 2010, the court denied plaintiffs' motion for class certification. On 20 July 2010, the court granted plaintiffs leave to replead their aiding and abetting common law fraud claims against the Morgan Stanley Group and the Group, and those claims were added in an amended complaint filed on 5 August 2010. On 27 December 2011, the court permitted plaintiffs to reinstate their causes of action for negligent misrepresentation and breach of fiduciary duty against the Morgan Stanley Group and the Group. The Morgan Stanley Group and the Group moved to dismiss these claims on 10 January 2012. On 5 January 2012, the court permitted plaintiffs to amend their Complaint and assert a negligence claim against the Morgan Stanley Group and the Group. The amended complaint was filed on 9 January 2012 and the Morgan Stanley Group and the Group moved to dismiss the negligence claim on 17 January 2012. On 23 January 2012, the Morgan Stanley Group and the Group moved for summary judgment with respect to the fraud and aiding and abetting fraud claims. There are 15 plaintiffs in this action asserting claims related to approximately $983 million of securities issued by the Cheyne SIV. Plaintiffs have not alleged the amount of their alleged investments and are seeking, among other things, unspecified compensatory and punitive damages. Based on currently available information, the Morgan Stanley Group and the Group believes that the defendants could incur a loss up to the amount of plaintiffs' claimed compensatory damages, once specified, related to their alleged purchase of approximately $983 million of securities issued by the Cheyne SIV plus pre- and post-judgment interest, fees and costs.

21. PROVISIONS FOR LIABILITIES AND CHARGES (CONTINUED)

Litigation matters (continued)

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Morgan Stanley Group, which is styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al.* and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a $275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Morgan Stanley Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Morgan Stanley Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately $228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional $12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court presiding over this action denied the Morgan Stanley Group's motion to dismiss the complaint. On 21 March 2011, the Morgan Stanley Group appealed the order denying its motion to dismiss the complaint. On 7 July 2011, the appellate court affirmed the lower court's decision denying the motion to dismiss. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately $240 million plus pre- and post-judgment interest, fees and costs.

On 25 September 2009, the Group was named as a defendant in a lawsuit styled *Citibank, N.A. v. Morgan Stanley & Co. International, PLC,* which was pending in the United States District Court for the SDNY. The lawsuit relates to a credit default swap referencing the Capmark VI CDO ("Capmark"), which was structured by Citibank, N.A. ("Citi N.A."). At issue is whether, as part of the swap agreement, Citi N.A. was obligated to obtain the Group's prior written consent before it exercised its rights to liquidate Capmark upon the occurrence of certain contractually-defined credit events. Citi N.A. is seeking approximately $245 million in compensatory damages plus interest and costs. On 8 October 2010, the court issued an order denying Citi N.A.'s motion for judgment on the pleadings as to the Group's counterclaim for reformation and granting Citi N.A.'s motion for judgment on the pleadings as to the Group's counterclaim for estoppel. On 25 May 2011, the court issued an order denying the Group's motion for summary judgment and granting Citi N.A.'s cross motion for summary judgment. On 27 June 2011, the court entered a judgment in favour of Citi N.A. for $269 million plus post-judgment interest and costs, and the Group filed a notice of appeal with the United States Court of Appeals for the Second Circuit, which appeal is now pending. Based on currently available information, the Group believes it could incur a loss of up to approximately $269 million plus post-judgment interest. In compliance with the intra-group policies, revenues and costs related to the Capmark deal referenced above, including any potential litigation costs, are transferred to other Morgan Stanley Group undertakings outside the Group.

In addition to the above the Group has identified the following proceeding.

On 10 June 2010, the Morgan Stanley Group and the Group was named as a new defendant in a pre-existing purported class action related to securities issued by a SIV called Rhinebridge plc ("Rhinebridge SIV"). The case is styled *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.* and is pending in the SDNY. The complaint asserts claims for common law fraud and aiding and abetting common law fraud and alleges, among other things, that the ratings assigned to the securities issued by the SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime RMBS held by the SIV. On 15 July 2010, the Morgan Stanley Group and the Group moved to dismiss the complaint. That motion was denied on 29 October 2010. On 27 December 2011, the court permitted plaintiffs to amend their complaint and assert causes of action for negligence, negligent misrepresentation, and breach of fiduciary duty against the Morgan Stanley Group and the Group. The amended complaint was filed on 10 January 2012 and the Morgan Stanley Group and the Group moved to dismiss the negligence, negligent misrepresentation, and breach of fiduciary duty claims on 31 January 2012. The case is pending before the same judge presiding over the litigation concerning the Cheyne SIV, described above. While reserving their ability to act otherwise, plaintiffs have indicated that they do not currently plan to file a motion for class certification. Plaintiffs have not alleged the amount of their alleged investments, and are seeking, among other relief, unspecified compensatory and punitive damages.

22. COMMITMENTS AND CONTINGENCIES

At 31 December 2011 and 31 December 2010, the Group had the following outstanding commitments and contingent liabilities arising from off-balance sheet financial instruments:

Contingent liabilities	**2011 $millions**	**2010 $millions**
Financial guarantees	47	17
Contingent commitments	3,058	1,246
	3,105	1,263

Commitments	**2011 $millions**	**2010 $millions**
Lease commitments	77	93
Loan commitments	3,196	2,344
Underwriting commitments	156	128
Unsettled reverse repurchase agreements	22,448	29,784
	25,877	32,349

During the following year, the Group is committed to pay $77 million (2010: $93 million) in respect of operating leases as follows:

	Land and buildings 2011 $millions	**Land and buildings 2010 $millions**
Maturity of lease:		
- Within one year	1	1
- In two to five years	19	30
- Over five years	57	62
	77	93

23. CALLED UP SHARE CAPITAL

	2011 $millions	**2010 $millions**
Allotted and fully paid:		
Equity shares		
2 ordinary shares of £1 each	-	-
1,614,167,000 ordinary shares of $1 each	1,614	1,614
	1,614	1,614

All ordinary shares are recorded at the rate of exchange ruling at the date the shares were paid up.

24. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital	Capital redemption reserve	Foreign currency revaluation reserve	Capital contribution reserve	Fair value reserve	Pension reserve	Profit and loss account	Minority Interest	Total
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Balance at 1 January 2010	1,614	1,400	(387)	141	(32)	(98)	8,119	2,079	12,836
Reclassification adjustment net of income tax	-	-	(45)	-	-	-	45	-	-
Profit for the year	-	-	-	-	-	-	1,041	7	1,048
Recognised (losses) / gains for the year	-	-	(100)	-	10	-	-	-	(90)
Reclassification adjustment on disposal of foreign operation	-	-	(11)	-	-	-	11	-	-
Actuarial losses on defined benefit pension plans	-	-	-	-	-	(9)	-	-	(9)
Income tax arising on transitional accounting adjustments	-	-	2	-	-	-	-	-	2
Total comprehensive income	-	-	(154)	-	10	(9)	1,097	7	951
Share-based payments	-	-	-	-	-	-	2	-	2
Capital contribution by parent company	-	-	-	3,000	-	-	-	-	3,000
Dividends to equity holders of the Company	-	-	-	-	-	-	(1,000)	-	(1,000)
Capital infusion by minority interest into preference shares	-	-	-	-	-	-	-	20	20
Repayment of capital to minority interest	-	-	-	-	-	-	258	(1,990)	(1,732)
Balance at 1 January 2011	1,614	1,400	(541)	3,141	(22)	(107)	8,476	116	14,077
Profit for the year	-	-	-	-	-	-	1,109	1	1,110
Recognised (losses) / gains for the year	-	-	(8)	-	50	-	-	(3)	39
Foreign currency reclassification on liquidation of subsidiary	-	-	11	-	-	-	(11)	-	-
Foreign currency reclassification on disposal of subsidiaries	-	-	(5)	-	-	-	-	-	(5)
Actuarial losses on defined benefit pension plans	-	-	-	-	-	(9)	-	-	(9)
Income tax relating to components of other comprehensive income	-	-	9	-	-	-	-	-	9
Total comprehensive income	-	-	7	-	50	(9)	1,098	(2)	1,144
Share-based payments	-	-	-	-	-	-	15	-	15
Capital contribution by parent company	-	-	-	4,900	-	-	-	-	4,900
Dividends to equity holders of the Company	-	-	-	(2,000)	-	-	-	-	(2,000)
Repayment of capital to minority interest	-	-	-	-	-	-	-	(20)	(20)
Balance at 31 December 2011	1,614	1,400	(534)	6,041	28	(116)	9,589	94	18,116

24. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES (CONTINUED)

Capital redemption reserve

The 'capital redemption reserve' represents transfers in prior years from retained earnings in accordance with relevant company legislation.

Foreign currency revaluation reserve

The 'foreign currency revaluation reserve' comprises all foreign exchange differences arising from the translation of the net assets of foreign operations denominated in currencies other than US dollars.

The Group hedges foreign exchange exposure arising from its investments in foreign branch operations by utilising forward foreign currency exchange contracts (synthetic hedges) effected through intercompany accounts with the ultimate parent company, Morgan Stanley.

During the year, the Group disposed of its wholly owned subsidiary Morgan Stanley Norton Investments Limited, and materially all of its interest in Archimedes Investments Cooperatieve U.A, which were non-US dollar functional entities. As a consequence of the disposal, accumulated foreign exchange gains amounting to $5 million were reclassified from the 'foreign currency revaluation reserve' to the consolidated profit and loss account.

During the year, the Group liquidated a number of wholly owned, non-US dollar functional subsidiaries. As a consequence, the net assets of the liquidated subsidiaries were distributed to their respective parent companies, which are also non-US dollar functional subsidiaries. Accumulated foreign exchange losses amounting to $11 million were transferred from the 'foreign currency revaluation reserve' to 'retained earnings' as a reclassification adjustment within reserves.

Capital contribution reserve

The 'capital contribution reserve' comprises contributions of capital from the Group's parent company, Morgan Stanley International Holdings Inc.

During 2011 the Company's immediate parent undertaking Morgan Stanley International Holdings Inc, made a cash capital contribution of $4,900 million (2010: $3,000 million) to capitalise Group operations. The 'capital contribution reserve' is classified as a distributable reserve in accordance with relevant company legislation.

Fair value reserve

The 'fair value reserve' includes the cumulative net change in the fair value of available-for-sale financial assets held at the reporting date. The tax effect of these movements is also included in the 'Fair value reserve'.

25. SEGMENTAL REPORTING

Segment information is presented in respect of the Group's business and geographical segments. The business segments and geographical segments are based on the Group's management and internal reporting structure. Transactions between business segments are on normal commercial terms and conditions.

Business segments

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

The Group has one reportable business segment, Institutional Securities, which includes the following activities: capital raising, financial advisory services; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

Selected financial information to reconcile segment information to the Group's consolidated information is presented below.

2011 **Consolidated profit and loss information**	**Institutional Securities $millions**	**Other $millions**	**Total $millions**
Net gains on financial instruments held for trading	4,537	84	4,621
Net gains on financial instruments designated at fair value through profit or loss	275	-	275
Net gains on available-for-sale financial assets	1	-	1
Net interest (expense) / income	(515)	5	(510)
Other income	1,069	335	1,404
External revenues net of interest expense	5,367	424	5,791
Other expense	(3,948)	(334)	(4,282)
Net gains on disposal of subsidiaries and disposal of joint venture	26	-	26
Profit on ordinary activities before taxation	1,445	90	1,535
Balance sheet information			
Net assets	18,039	77	18,116

2010 **Consolidated profit and loss information**	**Institutional Securities $millions**	**Other $millions**	**Total $millions**
Net gains on financial instruments held for trading	4,517	111	4,628
Net gains on financial instruments designated at fair value through profit or loss	316	2	318
Net gains on available-for-sale financial assets	61	-	61
Net interest expense	(435)	(5)	(440)
Other income	721	352	1,073
External revenues net of interest expense	5,180	460	5,640
Other expense	(3,889)	(336)	(4,225)
Profit on ordinary activities before taxation	1,291	124	1,415
Balance sheet information			
Net assets	13,885	192	14,077

25. SEGMENTAL REPORTING (CONTINUED)

Geographical segments

The group operates in three geographic regions as listed below:

- Europe, Middle East and Africa ("EMEA")
- Americas
- Asia

The following table presents selected profit and loss account and balance sheet information by geographic area. The external revenues (comprising 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Interest income', 'Interest expense' and 'Other income') and total assets disclosed in the following table reflect the regional view of the Group's operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

2011

Consolidated profit and loss information	EMEA $millions	Americas $millions	Asia $millions	Total $millions
Net gains on financial instruments held for trading	4,365	104	152	4,621
Net gains on financial instruments designated at fair value through profit or loss	275	-	-	275
Net gains on available-for-sale financial assets	1	-	-	1
Net interest (expense) / income	(506)	(1)	(3)	(510)
Other income	1,193	14	197	1,404
External revenues net of interest expense	5,328	117	346	5,791
Other expense	(4,099)	(41)	(142)	(4,282)
Net gains on disposal of subsidiaries and disposal of joint venture	26	-	-	26
Profit on ordinary activities before taxation	1,255	76	204	1,535
Balance sheet information				
Net assets	14,548	2,052	1,516	18,116

External revenues and profit on ordinary activities before taxation for the Asia geographic segment includes other income of $149 million representing the expected reimbursement from clients on certain equity positions, as discussed in note 5.

2010

Consolidated profit and loss information	EMEA $millions	Americas $millions	Asia $millions	Total $millions
Net gains on financial instruments held for trading	4,597	29	2	4,628
Net gains on financial instruments designated at fair value through profit or loss	314	4	-	318
Net gains on available-for-sale financial assets	61	-	-	61
Net interest (expense) / income	(441)	1	-	(440)
Other income	634	401	38	1,073
External revenues net of interest expense	5,165	435	40	5,640
Other expense	(3,813)	(400)	(12)	(4,225)
Profit on ordinary activities before taxation	1,352	35	28	1,415
Balance sheet information				
Net assets	11,246	1,701	1,130	14,077

26. RETIREMENT BENEFITS

The Group operates both defined benefit and defined contribution plans for its employees. Details of the plans are below.

Defined contribution plans

The Group operates or contributes to the following defined contribution plans:

- the Morgan Stanley UK Group Pension Plan (the "Plan") and the Morgan Stanley UK Group Top-Up Pension Plan (the "Top-Up Plan"), which require contributions to be made to funds held in trust, separate from the assets of the Company, under the control of a trustee company
- the Morgan Stanley Investment Management (Athens Branch) Group Insurance Policy
- the Morgan Stanley Investment Management Luxembourg Branch Supplementary Pension Scheme
- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- Morgan Stanley & Co International Plc (Greece Branch) Group Insurance Policy
- MSII Offshore Retirement Benefit Plan IV, Dubai Section
- Morgan Stanley Asia Limited Retirement Benefit Plan
- Paschi Previdenza (a Milan multi employer defined contribution scheme)

The Group pays fixed contribution to the plans, with no legal or constructive obligation to pay further contributions.

The defined contribution pension charge for the year was $39 million (2010: $37 million) of which $nil was accrued at 31 December 2011 (2010: $nil).

Defined benefit Plan

Morgan Stanley UK Group Defined Benefit Pension Plan

The Morgan Stanley UK Group Pension Plan has both a defined benefit and defined contribution section. The defined benefit section of the Plan has been closed to new members since 1996. Under the Morgan Stanley UK Group's defined benefit Plan, the amount of pension benefit that a member is entitled to receive on retirement is dependent on years of service and salary. The Plan was previously open to permanent employees employed in the UK and, with the consent of the Trustees, other Morgan Stanley employees employed outside the UK who at some point had been members of the Plan.

The Plan assets relating to the defined benefits section of the Plan are held in a separate Trustee-administered fund to meet long-term pension liabilities. The Trustee of the Plan is required to act in the best interest of the Plan's beneficiaries. The appointment of Trustee Directors to the Plan is determined by the Plan's trust documentation. The Company has a policy that one third of Trustee Directors should be nominated by members of the fund.

The most recent full formal actuarial valuation of the defined benefit section of the Plan was carried out at 31 December 2009 and updated by a qualified actuary at 31 December 2011. Annual updates of this formal valuation are made for changes in the market conditions and actuarial assumptions. The liabilities of the Plan are measured by discounting the best estimate of future cash flows to be paid out by the plan using the projected unit method. The projected unit method is an accrued benefits valuation method in which the Plan liabilities make allowance for projected earnings. The accumulated benefit obligation is an actuarial measure of the present value of benefits for service already rendered but differs from the projected unit method in that it includes no assumption for future salary increases, given that the plan is closed to future accrual with no salary linkage. At the balance sheet date the accumulated benefit obligation was $183 million (2010: $145 million).

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

Defined benefit Plan expense

The amounts recognised in profit or loss in respect of the defined benefit Plan is as follows:

	2011 $millions	2010 $millions
Expected return on Plan assets	(8)	(6)
Interest on obligation	8	8
Total defined benefit Plan expense	-	2

Of the charge for the year, $nil (2010: $2 million) has been included in 'Interest expense'. Actuarial losses after the impact of the surplus cap of $9 million (2010: $8 million) have been recognised in the 'Statement of total recognised gains and losses'. The amount comprises any gains or losses on the Plan assets and obligations, as well as the impact of foreign exchange rate changes during the period, and movement in the Plan surplus.

The cumulative amount of actuarial losses recognised in the 'Statement of total recognised gains and losses' is $115 million (2010: $105 million). The surplus cap restricts the surplus recognised on the balance sheet to the amount recoverable by the Group.

Retirement benefit asset

The following table provides a reconciliation of the present value of Plan liabilities and fair value of Plan assets included in the consolidated balance sheet, as well as a summary of the funded status of the Plan:

	2011 $millions	2010 $millions
Present value of funded defined benefit obligation	(183)	(145)
Fair value of Plan assets	229	167
	46	22
Adjustment for ceiling	(46)	(22)
Retirement benefit asset recognised in the balance sheet	-	-

Contributions for the year to the closed defined benefit section of the Plan totalled $10 million (2010: $9 million), of which $nil was accrued at 31 December 2011 (2010: $nil). The Group expects to contribute $10 million (2010: $10 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

Following the actuarial valuation of the defined benefit Plan as at 31 December 2010, the Group's monthly contributions rate increased, with effect from 1 April 2011, from £500,000 to £541,667. The Group will monitor funding levels on an annual basis. The Group considers that the contribution rates agreed with trustees are sufficient to eliminate the deficit over the agreed period and that regular contributions, which are based on service costs, will not increase significantly.

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

Changes in the present value of the defined benefit Plan obligations were as follows:

	2011 $millions	2010 $millions
Reconciliation of defined benefit obligations		
Defined benefit obligation at 1 January	145	148
Interest cost	8	8
Actuarial loss / (gain)	34	(2)
Benefits paid	(3)	(3)
Foreign exchange rate changes	(1)	(6)
Defined benefit obligation at 31 December	183	145

Changes in the fair value of Plan assets were as follows:

	2011 $millions	2010 $millions
Reconciliation of fair value of Plan assets		
Fair value of Plan assets at 1 January	167	151
Expected return on Plan assets	8	6
Actuarial gain	49	9
Employer contributions	10	9
Benefits paid	(3)	(3)
Foreign exchange rate changes	(2)	(5)
	229	167
Actual return on fund assets	57	15

The major categories of Plan assets as a percentage of total Plan assets and the expected rates of return are as follows:

	Expected return		Fair value of assets	
	2011 %	2010 %	2011 $millions	2010 $millions
Equity securities	7.0	7.0	2	3
Fixed income securities	3.2	4.3	227	164
			229	167

In conjunction with the Trustee, during 2008 the Group conducted an asset-liability review for its major plans. These studies are used to assist the Trustee and the Group to determine the optimal long-term asset allocation with regard to the structure of liabilities within the plan. The results of the study are used to assist the Trustee in managing the volatility in the underlying investment performance and risk of a significant increase in the plan deficit by providing information used to determine the pension plan’s investment strategy.

Historically, non vesting Group contribution arising as a result of plan members who leave the defined contribution section of the plan with less than two years service have been treated as part of the defined benefit section’s assets. Since April 2006, the non vesting Group contributions have arisen as a result either of plan members who leave with less than three months’ service or those with less than two years’ service who do not transfer their benefit to their own plan. Consequently the defined benefits section has a small holding in a range of global and regional equity funds. Assets are managed on both an active and passive basis, relative to widely used industry benchmarks.

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

The expected long-term rate of return on assets represents the Group's best estimate of the long-term return on Plan assets and generally was estimated by computing a weighted average return of the underlying long-term expected returns on the different asset classes, based on the target asset allocations. The expected long-term return on assets is a long-term assumption that generally is expected to remain the same from one year to the next unless there is a significant change in the target asset allocation, the fees and expenses paid by the Plan or market conditions.

The Group, in consultation with its independent investment consultants and actuaries, determined the asset allocation targets based on its assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors, including industry practices, long-term historical and prospective capital market returns, were also considered.

The return objectives provide long-term measures for monitoring the investment performance against growth in the pension obligations. The overall allocation is expected to help protect the Plan's funded status while generating sufficiently stable real returns (net of inflation) to help cover current and future benefit payments.

Both the equity and fixed income portions of the asset allocation use a combination of active and passive investment strategies and different investment styles. The fixed income asset allocation consists of longer duration fixed income securities in order to help reduce Plan exposure to interest rate variation and to better correlate assets with obligations. The longer duration fixed income allocation is expected to help stabilize Plan contributions over the long run.

The following table presents the principal actuarial assumptions at the balance sheet date:

	2011	**2010**
Pre retirement discount rate	4.6%	5.6%
Post retirement discount rate	3.6%	4.3%
Rate of increase in pensions in deferment	2.4%	3.6%
Inflation assumption	3.1%	3.6%
Expected long-term rate of return on Plan assets:		
Bonds	3.2%	4.3%
Equities	7.0%	7.0%

The mortality assumptions used give the following life expectations at 65:

	Life expectancy at age 65 for a male member currently:		**Life expectancy at age 65 for a female member currently:**	
	Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
31 December 2011				
UK	89.3	92.2	91.9	94.8
31 December 2010				
UK	89.2	92.1	91.7	94.7

The sensitivities regarding the principal assumptions used to measure the Plan liabilities are as follows:

Assumption	**Change in assumption**	**Impact on Plan liabilities**
Discount rate	Increase / decrease by 0.25%	Decrease / increase by 8.2%/ 9.1%
Inflation assumption	Increase / decrease by 0.25%	Increase / decrease by 4.8%/ 4.4%
Rate of mortality	Increase by 1 year	Increase by 2.5%

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

The five-year history of experience adjustments is as follows:

	2011 $millions	2010 $millions	2009 $millions	2008 $millions	2007 $millions
Present value of defined benefit obligation	(183)	(145)	(148)	(132)	(170)
Fair value of Plan assets	229	167	151	149	195
Surplus	46	22	3	17	25
Experience adjustments on Plan liabilities:					
- Amount ($ millions)	2	(10)	-	-	(6)
- Percentage of Plan liabilities (%)	1%	(7)%	-	-	3%
Experience adjustments on Plan assets					
- Amount ($ millions)	(49)	(9)	27	-	3
- Percentage of Plan assets (%)	(20)%	(5)%	18%	-	(2)%

Other defined benefit Plans in the Group

In addition to the Morgan Stanley UK Group Pension Plan, the Group also operates several other defined benefits plans, which provide post employment benefits dependent on factors such as years of service and salary. The Group's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The defined benefits plans are as follows:

- Morgan Stanley Bank International Ltd German Branch DC Plan
- Morgan Stanley Bank International Ltd German Branch General Plan
- Morgan Stanley Bank International Ltd Milan Branch Termination Indemnity Plan
- Morgan Stanley Bank International Ltd Milan Branch Leaving Indemnity Plan
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan
- Morgan Stanley & Co. International plc Paris Branch IFC (Indemnites de Fin de Carriere)
- Morgan Stanley France (SAS) Leaving Indemnity Plan (Indemnites de Fin de Carriere)
- Morgan Stanley & Co. International plc Athens Branch Retirement Indemnity
- Morgan Stanley Investment Management Ltd Athens Branch Retirement Indemnity
- Morgan Stanley Asia (Taiwan) Limited Retirement Scheme
- Morgan Stanley Asia (Taiwan) Limited Book Reserve Plan
- Morgan Stanley & Co International plc Dubai Branch End of Service Gratuity Plan

Disclosures in respect of the above plans have been made on an aggregated basis.

The Group also operated the Morgan Stanley Bank International Limited Korean Branch Severance Pay Plan and the Morgan Stanley & Co International Plc Seoul Branch Severance Pay Plan until 1 October 2010 when the Plans closed and liabilities were either settled in cash or transferred to defined contribution plans.

26. RETIREMENT BENEFITS (CONTINUED)

Other defined benefit plans in the Group (continued)

During 2010, Bank Morgan Stanley AG transferred its institutional securities business to the Morgan Stanley Bank International Limited – Zurich Branch but its employees remained in the same Personalvorsorgestiftung der bank Morgan Stanley AG Plan, together with all remaining Bank Morgan Stanley AG employees. The Plan was considered transferred into the Zurich Branch with the difference between assets and liabilities at initial recognition recorded as a receivable forming part of the consideration for the transfer of the Zurich Branch to the Group.

Defined benefit plans expense

The amounts recognised in profit or loss in respect of these defined benefit plans are as follows:

	2011 $millions	2010 $millions
Current service cost	3	3
Past service cost	(1)	-
Expected return on plan assets	(1)	(1)
Interest on obligation	1	1
Foreign exchange rate changes	-	1
Total defined benefit plan expense	2	4

Of the charge for the year, $2 million (2010: $3 million) has been included in staff costs within 'Other expense'. Actuarial losses of $nil (2010: $1 million) have been recognised in the 'Statement of total recognised gains and losses'. The cumulative amount of actuarial losses recognised in the 'Statement of total recognised gains and losses' is $1 million (2010: $1 million).

Retirement benefit liability

The following table provides a reconciliation of the present value of plan liabilities and fair value of plan assets included in the balance sheet, as well as a summary of the funded status of the plans in the Group, excluding the MSUK Group Pension Plan:

	2011 $millions	2010 $millions
Present value of funded defined benefit obligation	(19)	(16)
Fair value of plan assets	17	13
	(2)	(3)
Present value of unfunded defined benefit obligation	(6)	(5)
Deficit	(8)	(8)
Related deferred tax asset	2	1
Retirement benefit liability recognised in the balance sheet	(6)	(7)

Contributions for the year to the Group's defined benefit plans totalled $2 million (2010: $9 million), of which $nil was accrued at 31 December 2011 (2010: $nil). The Group expects to contribute $1 million (2010: $1 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

26. RETIREMENT BENEFITS (CONTINUED)

Other defined benefit Plans in the Group (continued)

Changes in the present value of the defined benefit Plans' obligations were as follows:

	2011 $millions	2010 $millions
Reconciliation of defined benefit obligations		
Defined benefit obligation at 1 January	21	13
Current service cost	3	3
Past service cost	(1)	-
Interest cost	1	1
Actuarial loss	-	1
Net transfer in	2	12
Benefits paid	(1)	-
Liabilities extinguished on settlements	-	(10)
Foreign exchange rate changes	-	1
Defined benefit obligation at 31 December	25	21

Changes in the fair value of plan assets were as follows:

	2011 $millions	2010 $millions
Reconciliation of fair value of plan's assets		
Fair value of plan assets at 1 January	13	4
Expected return on plan assets	1	1
Net transfer in	2	9
Employer contributions	2	9
Benefits paid	(1)	-
Assets distributed on settlements	-	(10)
Fair value of plan assets at 31 December	17	13
Actual return on plan assets	1	-

The major categories of plan assets as a percentage of total plan assets and the expected rates of return are as follows:

	Expected return		Fair value of assets	
	2011 %	2010 %	2011 $millions	2010 $millions
Equity securities	5.6 - 6.9	5.4 - 8.4	4	4
Fixed income securities	0.9 - 1.8	1.5 - 1.9	7	5
Insurance deposit	-	-	1	-
Other – primarily cash	1.3 - 2.3	2.0 - 2.1	5	4
			17	13

26. RETIREMENT BENEFITS (CONTINUED)

Other defined benefit Plans in the Group (continued)

The following table presents the principle actuarial assumptions at the balance sheet date:

	2011	**2010**
Discount rate	1.75 - 4.70%	2.75 - 6.25%
Rate of increase in salaries	2.00 - 7.00%	3.50 - 6.00%
Inflation assumption	1.50 - 2.00%	1.50 - 2.00%
Expected long-term rate of return on plan assets	2.25 - 4.10%	4.10 - 5.50%

The mortality assumptions used give the following life expectations at age 65:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
31 December 2011					
Germany	Huebeck RT 2005 G	83.5	84.0	87.6	88.8
Switzerland	Swiss BVG 2010, Static Mortality Table	84.7	84.7	87.0	87.0
31 December 2010					
Germany	Huebeck RT 2005 G	83.3	83.0	87.4	88.1
Switzerland	Unadjusted BVG 2005 Mortality Table	82.9	82.9	86.0	86.0

The five-year history of experience adjustments is as follows:

	2011 $millions	**2010 $millions**	**2009 $millions**	**2008 $millions**	**2007 $millions**
Present value of defined benefit obligation	(25)	(21)	(13)	(10)	(14)
Fair value of plan assets	17	13	4	4	4
Deficit	(8)	(8)	(9)	(6)	(10)
Experience adjustments on plan liabilities:					
- Amount ($millions)	-	1	(1)	(2)	-
- Percentage of plan liabilities (%)	(72)% - 39%	(174)% - 33.75%	0% - 25%	(135)% - 45%	(18)% - 10%
Experience adjustments on plan assets					
- Amount ($millions)	-	-	-	-	-
- Percentage of plan assets (%)	(3)% - 1%	(1)% - 0%	(8)% - 6%	(7)% - 1%	(2)% - 4%

27. EMPLOYEE COMPENSATION PLANS

Deferred stock awards

Morgan Stanley has made deferred stock awards pursuant to equity-based compensation plans. The plans provide for the deferral of a portion of certain key employees' discretionary compensation with awards made in the form of a right to receive unrestricted shares of common stock in the future ("restricted stock units"). Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be cancelled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards generally have voting rights and receive dividend equivalents.

Equity-settled share-based awards

During the year Morgan Stanley granted 3,738,574 units of restricted common stock to employees of the Group with a weighted average fair value per unit of $29.44 (2010: 4,967,719 units, weighted average fair value $29.13), based on the market value of Morgan Stanley shares at grant date.

Cash-settled share-based awards

Certain equity-settled awards in respect of 498,860 restricted stock units were modified during 2010 such that the Group will pay the cash value of the awards to the employees at settlement date. No difference was attributed between the grant date fair value of the original equity-settled award and the modified award hence no profit or loss was recognised on modification date.

As a result of the modification, the cash-settled awards are held at the fair value of the equivalent stock unit award determined at each reporting date based on the market price of Morgan Stanley shares. At 31 December 2011, the total carrying amount of liabilities arising from the cash-settled share-based awards was $4 million (2010: $14 million) of which $2 million (2010: $1 million) had vested. The Group recognised total expenses of $1 million (2010: $5 million) arising from these cash settled share-based payment transactions during the year.

Stock option awards

Morgan Stanley has also made stock option awards in the form of stock options on Morgan Stanley's common stock. The stock options generally have an exercise price of not less than the fair value of Morgan Stanley's common stock on the date of grant and generally become exercisable over a three year period, expiring 10 years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are similar to those in deferred stock awards.

The weighted average fair value of options granted during the year was $30.01 (2010: none, no options were granted). The fair value of options granted has been determined using the Black-Scholes Merton pricing model and utilising the following weighted average assumptions:

	2011
Weighted average share price	$8.24
Weighted average exercise price	$8.24
Risk-free interest rate	2.1%
Expected option life in years	5.0
Expected stock price volatility	32.7%

The expected option life has been determined based upon historical experience and the expected stock price volatility has been implied from options traded on Morgan Stanley stock.

27. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Stock option awards (continued)

The following table shows activity relating to the Morgan Stanley Group's stock option awards for employees of the Company:

	2011		2010	
	Number of options millions	Weighted average exercise price $	Number of options millions	Weighted average exercise price $
Options outstanding at 1 January	5	50.41	6	52.01
Granted during the year	-	30.01	-	-
Forfeited during the year	-	-	-	66.73
Expired during the year	(1)	49.98	(1)	57.48
Options outstanding at 31 December	4	50.55	5	50.41
Options exercisable at end of year	4	50.55	5	50.41

There were no stock options exercised during the year (2010: none).

The following table presents information relating to the stock options outstanding:

	2011			2010		
Range of Exercise Prices	Number of options millions	Weighted average exercise price $	Weighted average remaining life in years	Number of options millions	Weighted average exercise price $	Weighted average remaining life in years
$30.00 - $39.99	1	34.66	2.18	1	36.18	1.91
$40.00 - $49.99	2	46.98	1.88	3	47.47	2.13
$50.00 - $59.99	-	56.97	4.67	-	55.91	1.26
$60.00 - $69.99	1	66.73	4.92	1	66.54	5.65
Total	4			5		

Other deferred compensation plans

The Group has granted deferred compensation awards to certain of its key employees. The plans provide for the deferral of a portion of the employees' discretionary compensation with awards that provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which is normally two to three years from the date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

During the year, the Group granted awards with a value of $147 million (2010: $129 million) to employees, and has recognised an expense of $192 million (2010: $103 million) within 'Staff costs' in 'Other expense' in the consolidated profit and loss account in relation to awards outstanding. The liability to employees at the end of the year, reported within 'Other creditors' in the consolidated balance sheet, is $262 million (2010: $219 million).

The Group economically hedges the exposure created by these deferred compensation plans by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation plans is $14 million (2010: $11 million) and held within 'Financial liabilities classified as held for trading' is $25 million (2010: $1 million). The related profit and loss recorded within 'Net gains/ losses on financial instruments classified as held for trading' for the year is $2 million loss (2010: $10 million gain).

28. FINANCIAL RISK MANAGEMENT

Risk management procedures

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group. 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 Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group.

As disclosed in the Directors' report, the Group has exposure to European peripheral countries, which are defined as Portugal, Ireland, Italy, Greece and Spain. The Group's exposure is included within the credit risk and the market risk disclosures below consistent with how the financial instrument is managed. Significant risks faced by the Group resulting from its trading, financing and investment activities are set out below.

Credit risk

Credit risk refers to the risk of loss arising from a borrower or counterparty default.

The Morgan Stanley Group manages credit risk exposure on a global basis, but in consideration of each individual legal entity, including those of the 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 Group are consistent with those of the Morgan Stanley Group and include escalation to appropriate key management personnel of the Group.

The Group incurs credit risk exposure to institutions and sophisticated investors with the risk arising from a variety of business activities, including, but not limited to, entering into swap or other derivative contracts under which the counterparties have obligations to make payments to the Group; extending credit to clients through various lending commitments; providing short-term or long-term funding that is secured, in whole or in part, by physical or financial collateral; and posting margin and / or collateral to clearing houses, clearing agencies, exchanges, banks, securities firms and other financial counterparties. The Group also incurs credit risk in traded securities and loan pools, whereby the value of these assets may fluctuate based on realised or expected defaults on the underlying obligations or loans.

Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the Group from losses resulting from its business activities, the Group analyses all material lending and derivative transactions and ensures that the creditworthiness of the Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. The Group assigns obligor credit ratings to its counterparties and borrowers which reflect an assessment of a counterparty's probability of default. For lending transactions, the Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. Where applicable, the Group also considers collateral arrangements and other structural elements of the particular transaction. The Group has credit guidelines that limit potential credit exposure to any one borrower or counterparty and to aggregates of borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2011, credit exposure was concentrated in North America and Western European countries. In addition, the 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.

The Group also reviews its credit exposure and risk to types of customers. At 31 December 2011, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Collateral and other credit enhancements

The amount and type of collateral required by the Group depends on an assessment of the credit risk of the counterparty. Collateral held is managed in accordance with the Group's guidelines and the relevant underlying agreements. The market value of securities received as collateral is monitored on a daily basis and securities received as collateral generally are not recognised on the statement of financial position.

Reverse repurchase agreements and securities borrowed

The Group manages credit exposure arising from reverse repurchase agreements and securities borrowed transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Group, in the event of a counterparty default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. Under these reverse repurchase agreements and securities borrowed transactions, the Group receives collateral, including US government and agency securities, other sovereign government obligations, corporate and other debt and corporate equities. The Group also monitors the fair value of the underlying securities compared to the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralised.

Derivatives

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size and maturity. The Group actively hedges its derivatives exposure through various financial instruments that may include single name, portfolio and structured credit derivatives. Additionally, the Group may enter into master netting agreements and collateral arrangements with counterparties. These master netting agreements and collateral arrangements may provide the Group with the ability to offset a counterparty's rights and obligations, to request additional collateral when necessary and / or to liquidate the collateral in the event of counterparty default. The Group monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 31 December 2011 is disclosed below, based on the carrying amounts of the financial assets the Group believes are subject to credit risk. Exposure arising from financial instruments not recognised on the consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. This table does not include receivables arising from pending securities transactions with market counterparties. Where the Group enters into credit enhancements, such as cash and security as collateral and master netting agreements, to manage the credit exposure on these financial instruments the financial effect of the credit enhancements is also disclosed below. The credit exposure remaining after the effect of the credit enhancements is disclosed as the net credit exposure. The "unrated" balance represents the pool of counterparties that either do not require a rating or are under review in accordance with the Morgan Stanley Group's rating policies. These counterparties individually generate no material credit exposure and this pool is highly diversified, monitored and subject to limits.

Financial assets classified as held for trading, excluding derivatives, are subject to traded credit risk through exposure to the issuer of the financial asset; the Group manages this issuer credit risk through its market risk management infrastructure and this traded credit risk is incorporated within the VaR-based risk measures included in the market risk disclosure.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

	2011			2010		
	Gross credit exposure (1)	**Credit enhancements**	**Net credit exposure (2)**	**Gross credit exposure (1)**	**Credit enhancements**	**Net credit exposure (2)**
	$millions	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**
Loans and receivables:						
Cash at bank	11,999	-	11,999	11,255	-	11,255
Trade debtors[3]:						
- External counterparties	33,566	-	33,566	26,717	-	26,717
- Morgan Stanley Group undertakings	12,483	-	12,483	5,449	-	5,449
Securities purchased under agreements to resell and cash collateral on stocks borrowed:						
- External counterparties	79,250	(77,300)	1,950	93,176	(90,709)	2,467
- Morgan Stanley Group undertakings	44,729	(43,049)	1,680	43,116	(41,398)	1,718
Corporate loans	2,129	-	2,129	2,684	-	2,684
Other amounts due from Morgan Stanley Group undertakings	1,620	-	1,620	1,109	-	1,109
Other debtors	2,039	-	2,039	2,656	-	2,656
Financial assets classified as held for trading:						
- OTC Derivatives	291,099	(268,725)	22,374	175,380	(150,720)	24,660
Financial assets designated at fair value through profit or loss	8,691	(7,477)	1,214	9,363	(9,182)	181
	487,605	(396,551)	91,054	370,905	(292,009)	78,896
Unrecognised financial instruments						
Contingent commitments	3,058	-	3,058	1,246	-	1,246
Financial guarantees	47	-	47	17	-	17
Loan commitments	3,196	-	3,196	2,344	-	2,344
Underwriting commitments	156	-	156	128	-	128
Unsettled reverse repurchase agreements (4)	22,448	-	22,448	29,784	-	29,784
	516,510	(396,551)	119,959	404,424	(292,009)	112,415

(1) The carrying amount recognised in the consolidated statement of financial position best represents the Group's maximum exposure to credit risk.

(2) Of the residual net credit exposure, intercompany cross-product netting arrangements are in place which would allow for an additional $4,032 million (2010: $3,893 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade debtors primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within financial liabilities classified as held for trading in the consolidated balance sheet.

(4) For unsettled reverse repurchase agreements, collateral in the form of securities will be received at the point of settlement. Since the value of collateral is determined at a future date it is currently unquantifiable and not included in the table.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Maximum exposure to credit risk by credit rating [1]

Credit rating	Gross credit exposure 2011 $millions	Gross credit exposure 2010 $millions
AAA	22,288	10,557
AA	81,540	118,926
A	333,495	223,290
BBB	50,569	22,996
BB	7,523	7,402
B	10,332	5,959
CCC	3,623	7,984
Unrated	7,140	7,310
Total	516,510	404,424

(1) Internal credit rating derived using methodologies generally consistent with those used by external rating agencies.

At 31 December 2011, there were no loans and receivables past due but not impaired (2010: None). The carrying amount of renegotiated loans that would otherwise be past due or impaired totalled $nil (2010: $nil).

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Loans and receivables individually impaired

The breakdown of the carrying amount of individually impaired loans and receivables by class are as follows:

2011

Corporate loans	2011 $millions	2010 $millions
Carrying value before deducting impairment	219	285
Impairment loss	(66)	(106)
Carrying value after deducting impairment loss	153	179

The main considerations for the impairment assessment include whether there are any known difficulties in the cash flows of counterparties, credit rating downgrades, or infringement of the original terms of the contract. The Group determines the allowance appropriate for each individually significant loan and receivable on an individual basis. Items considered when determining the allowance amount include the sustainability of the counterparty's business plan, the counterparty's ability to improve performance once a financial difficulty has arisen, the realisable value of collateral, and the timing of expected cash flows. The impairment losses are evaluated at least at each reporting date.

Movement in impairment losses on loans and receivables

Allowances for impairment	2011 $millions	2010 $millions
Balance at 1 January	106	146
Charge for the year	3	22
Reversal of impairment losses	(32)	(48)
Amounts written off	(9)	(8)
Foreign exchange revaluation	(2)	(6)
Balance at 31 December	66	106

At 31 December 2011, the carrying value of 'Financial assets individually impaired' which were secured by the assets of the borrower was $143 million (2010: $173 million).

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk

Liquidity risk is the risk that the entity may encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The Morgan Stanley Group's senior management establishes the liquidity and capital policies of the Morgan Stanley Group. Through various risk and control committees, the Morgan Stanley Group's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Morgan Stanley Group's asset and liability position.

The primary goal of the Morgan Stanley Group's liquidity risk management framework is to ensure that the Morgan Stanley Group has access to adequate funding across a wide range of market conditions. The framework is designed to enable the Morgan Stanley Group to fulfil its financial obligations and support the execution of the Morgan Stanley Group's business strategies.

Liquidity management policies

The core components of the Morgan Stanley Group's and the Group's liquidity management framework, are the Contingency Funding Plan ("CFP"), Liquidity Stress Test and Global Liquidity Reserves. These elements support the Morgan Stanley Group's, as well as the Group's, target liquidity profile.

Contingency Funding Plan. The CFP describes the data and information flows, limits and triggers, escalation procedures, roles and responsibilities, and available mitigating actions in the event of a liquidity stress. The CFP assesses current and future funding sources and uses and establishes a plan for monitoring and managing a potential liquidity stress event. A set of escalation triggers identifies early signs of stress and activates a response plan.

Liquidity Stress Tests. The Morgan Stanley group uses Liquidity Stress Tests to model liquidity outflows across multiple scenarios over a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events.

The assumptions underpinning the Liquidity Stress Tests include, but not limited to, the following: (i) no government support; (ii) no access to unsecured debt markets; (iii) repayment of all unsecured debt maturing within one year; (iv) higher haircuts and significantly lower availability of secured funding; (v) additional collateral that would be required by trading counterparties and certain exchanges and clearing organisations related to multi-notch credit rating downgrades; (vi) additional collateral that would be required due to collateral substitutions, collateral disputes and uncalled collateral; (vii) discretionary unsecured debt buybacks; (viii) drawdowns on unfunded commitments provided to third parties; (ix) client cash withdrawals and reduction in customer short positions that fund long positions; (x) limited access to the foreign exchange swap markets; (xi) return of securities borrowed on an uncollateralised basis; and (xii) maturity roll-off of outstanding letters of credit with no further issuance.

The Liquidity Stress Tests are produced at the Morgan Stanley Group and major operating subsidiary, level, including the Group, as well as major currency levels, to capture specific cash requirements and cash availability at various legal entities. The Liquidity Stress Tests assume that subsidiaries, including Group, will use their own liquidity first to fund their obligations before drawing liquidity from Morgan Stanley. It is also assumed that Morgan Stanley does not have access to cash that may be held at certain subsidiaries that are subject to regulatory, legal or tax constraints.

The CFP and Liquidity Stress Tests are evaluated on an on-going basis and reported to the Firm Risk Committee, Asset / Liability Management committee, and other appropriate risk committees including the Morgan Stanley International Limited Board Risk Committee.

Global Liquidity Reserves. The Morgan Stanley Group and the Group maintain sufficient liquidity reserves ("the Global Liquidity Reserve") to cover daily funding needs and meet strategic liquidity targets sized by the CFP and Liquidity Stress Tests. These liquidity targets are based on the Morgan Stanley Group's risk tolerance, statement of financial position level and composition, subsidiary funding needs, and upcoming debt maturities, which are subject to change dependent on market and firm-specific events.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Liquidity management policies (continued)

Global Liquidity Reserves (continued)

The Global Liquidity Reserve is held within Morgan Stanley and the Morgan Stanley Group's major operating subsidiaries and consists of highly liquid and diversified cash and cash equivalents and unencumbered securities (including US government securities, US agency securities, US agency mortgage-backed securities, FDIC-guaranteed corporate debt and non US government securities). In addition to the global liquidity reserve, the Group maintains a locally managed liquidity reserve which consists of cash and cash equivalents and central bank eligible unencumbered securities. In addition to the liquidity reserve held by the Group, the Group has access to the global liquidity reserve.

Funding management policies

The Morgan Stanley Group's funding management policies are designed to provide for financings that are executed in a manner that reduces the risk of disruption to the Morgan Stanley Group's and the Group's operations. The Morgan Stanley Group pursues a strategy of diversification of secured and unsecured funding sources (by product, by investor and by region) and attempts to ensure that the tenor of the Morgan Stanley Group's, and the Group's, liabilities equals or exceeds the expected holding period of the assets being financed.

The Morgan Stanley Group funds its statement of financial position on a global basis through diverse sources. These sources may include the Morgan Stanley Group's equity capital, long-term debt, repurchase agreements, securities lending, deposits, commercial paper, letters of credit and lines of credit. The Morgan Stanley Group has active financing programmes for both standard and structured products targeting global investors and currencies.

In managing both the Morgan Stanley Group's and the Group's funding risk the composition and size of the entire statement of financial position, not just financial liabilities, is monitored and evaluated. A substantial portion of the Morgan Stanley Group's total assets consist of highly liquid marketable securities and short-term collateralised receivables arising from its Institutional Securities sales and trading activities. The liquid nature of these assets provides the Morgan Stanley Group and the Group with flexibility in financing and managing its business.

Maturity analysis

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group's trading activities are disclosed as on demand and presented at fair value, consistent with how these financial liabilities are managed. Derivatives not held as part of the Group's trading activities and financial liabilities designated at fair value through profit and loss are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 31 December 2011. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis (continued)

31 December 2011	On demand $millions	Less than one month $millions	More than one month but less than three months $millions	More than three months but less than one year $millions	More than one year but less than five years $millions	More than five years $millions	Total $millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	762	-	-	-	-	-	762
Trade Creditors:							
- External counterparties	65,850	-	-	-	-	-	65,850
- Group undertakings	22,363	-	-	-	-		22,363
Securities sold under agreements to repurchase and cash collateral on stocks loaned:							
- External counterparties	2,785	14,828	14,779	10,041	1,660	-	44,093
- Group undertakings	56,194	-	-	-	-	-	56,194
Other amounts owing to Morgan Stanley Group undertakings	5,193	-	-	4,302	201	1,053	10,749
Corporate deposits	4,451	-	-	-	-	-	4,451
Other financial liabilities	2,789	-	-	-	-	-	2,789
Subordinated debt	-	16	32	145	774	12,055	13,022
Financial liabilities classified as held for trading:							
Derivatives	306,268	-	-	-	-	-	306,268
Other	26,889	-	-	-	-	-	26,889
Financial liabilities designated at fair value through profit or loss	10,066	53	280	503	2,177	726	13,805
Total financial liabilities	503,610	14,897	15,091	14,991	4,812	13,834	567,235
Unrecognised financial instruments							
Contingent commitments	3,058	-	-	-	-	-	3,058
Financial guarantees	47	-	-	-	-	-	47
Lease commitments	-	-	-	1	19	57	77
Loan commitments	3,196	-	-	-	-	-	3,196
Underwriting commitments	100	-	-	56	-	-	156
Unsettled reverse repurchase agreements	22,448	-	-	-	-	-	22,448
Total unrecognised financial instruments	28,849	-	-	57	19	57	28,982

The Group does not expect that all of the cash flows associated with financial guarantees, letters of credits and loan commitments will be required.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis (continued)

	On demand	Less than one month	More than one month but less than three months	More than three months but less than one year	More than one year but less than five years	More than five years	Total
31 December 2010	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	580	-	-	-	-	-	580
Trade Creditors:							
- External counterparties	55,027	-	-	-	-	-	55,027
- Group undertakings	13,150	-	-	-	-	-	13,150
Securities sold under agreements to repurchase and cash collateral on stocks loaned:							
- External counterparties	12,696	34,228	16,219	9,892	2,202	-	75,237
- Group undertakings	68,990	-	-	-	-	-	68,990
Other amounts owing to Morgan Stanley Group undertakings	822	-	-	11,931	2,137	1,076	15,966
Corporate deposits	6,883	-	-	-	-	-	6,883
Other financial liabilities	3,255	-	-	-	-	-	3,255
Subordinated debt	-	14	27	123	658	12,161	12,983
Financial liabilities classified as held for trading:							
Derivatives	191,937	-	-	-	-	-	191,937
Other	35,951	-	-	-	-	-	35,951
Financial liabilities designated at fair value through profit or loss	10,890	627	208	732	3,131	1,003	16,591
Total financial liabilities	400,181	34,869	16,454	22,678	8,128	14,240	496,550
Unrecognised financial instruments							
Contingent commitments	1,246	-	-	-	-	-	1,246
Financial guarantees	17	-	-	-	-	-	17
Lease commitments	-	-	-	1	30	62	93
Loan commitments	2,344	-	-	-	-	-	2,344
Underwriting commitments	-	-	128	-	-	-	128
Unsettled reverse repurchase agreements	29,784	-	-	-	-	-	29,784
Total unrecognised financial instruments	33,391	-	128	1	30	62	33,612

The Group does not expect that all of the cash flows associated with financial guarantees, letters of credits and loan commitments will be required.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as liquidity, will result in losses for a position or portfolio.

Sound market risk management is an integral part of the Group's and the Morgan Stanley Group's culture. The Group is responsible for ensuring that market risk exposures are well-managed and prudent and more broadly 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 Morgan Stanley Group monitors the market risk of the firm against limits on aggregate risk exposures, performs a variety of risk analyses, routinely reports risk summaries and maintains the Value at Risk ("VaR") system. These limits are designed to control price and market liquidity risk. Market risk is monitored through various measures: statistically (using VaR and related analytical measures); by measures of position sensitivity; and through routine stress testing and scenario analyses. The material risks identified by these processes are summarised and reported to senior management.

The Group is managed within the Morgan Stanley Group's global framework. The market risk management policies and procedures of the Group are consistent with those of the Morgan Stanley Group, including reporting of material risks identified to appropriate key management personnel of the Group.

Risk and capital management initiative

The Group frequently enhances its market and credit risk management framework to address severe stresses that are observed in global markets during economic downturns. During 2011, 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 continues to be 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.

Primary market risk exposures and market risk management

During the year ended 31 December 2011, the Group had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices - and the associated implied volatilities and spreads - related to the global markets in which it conducts its trading activities.

The Group is exposed to interest rate and credit spread risk as a result of its market-making activities and other trading in interest rate-sensitive financial instruments (e.g., risk arising from changes in the level or implied volatility of interest rates, the timing of mortgage prepayments, the shape of the yield curve and credit spreads). The activities from which those exposures arise and the markets in which the Group is active include, but are not limited to, the following: corporate and government debt across both developed and emerging markets and asset-backed debt (including mortgage-related securities).

The Group is exposed to equity price and implied volatility risk as a result of making markets in equity securities and derivatives and maintaining other positions (including positions in non-public entities). Positions in non-public entities may include, but are not limited to, exposures to private equity, venture capital, private partnerships, real estate funds and other funds. Such positions are less liquid, have longer investment horizons and are more difficult to hedge than listed equities.

The Group is exposed to foreign exchange rate and implied volatility risk as a result of making markets in foreign currencies and foreign currency derivatives, from maintaining foreign exchange positions and from holding non-US dollar-denominated financial instruments.

The Group is exposed to commodity price and implied volatility risk as a result of market-making activities and maintaining positions in physical commodities (such as crude and refined oil products, natural gas, electricity and precious and base metals) and related derivatives. Commodity exposures are subject to periods of high price volatility as a result of changes in supply and demand. These changes can be caused by weather conditions; physical production, transportation and storage issues; or geopolitical and other events that affect the available supply and level of demand for these commodities.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

The Group, as part of the Morgan Stanley Group's global market risk management framework manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that are being hedged. The Group manages the market risk associated with its trading activities on a Group basis, on an entity-wide basis, on a worldwide trading division level and on an individual product strategy level. The Group manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Group believes is well-diversified in the aggregate with respect to market risk factors and that reflects the aggregate risk tolerance of key entities within the Group as established by the Group's senior management. Aggregate market risk limits have been approved for the Group and major trading divisions globally. Additional market risk limits are assigned to trading desks and, as appropriate, products and regions. Trading division risk managers, desk risk managers, traders and the market risk department monitor market risk measures against limits in accordance with policies set by senior management.

VaR

The 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 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 risk factors; and information on the current sensitivity of the portfolio values to these market risk factor changes. The Group's VaR model uses four years of historical data to characterise potential changes in market risk factors. The 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 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. The model also takes into account linear exposures to implied volatility risks for all asset classes and non-linear exposures to implied volatility risks for equity, commodity and foreign exchange referenced products. 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 but are not limited to: 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. A small proportion of market risk generated by trading positions is not included in VaR. The modelling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures.

28 FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR methodology, assumptions and limitations (continued)

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 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 Group levels.

The 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 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 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.

Since the reported VaR statistics are estimates based on historical data, VaR should not be viewed as predictive of the Group's future revenues or financial performance or of its ability to monitor and manage risk. There can be no assurance that the 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 for a 95% / one-day VaR. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

Trading VaR for the year ended 31 December 2011

The table below presents VaR for the Group's Trading portfolio, on a year-end, annual average and annual high and low basis (see table below) for 31 December 2011 and 31 December 2010.

The Credit Portfolio VaR is disclosed as a separate category from the Primary Risk Categories. The Credit Portfolio VaR includes the mark-to-market relationship lending exposures and associated hedges as well as counterparty credit valuation adjustments and related hedges.

The table below presents 95% / one-day VaR for each of the Group's primary market risk categories and on an aggregate basis.

95% Total VaR	**95% one-day VaR 2011**				**95% one-day VaR 2010**			
	Period End $'m	**Average $'m**	**High $'m**	**Low $'m**	**Period End $'m**	**Average $'m**	**High $'m**	**Low $'m**
Market risk category								
Interest rate and credit spread	30	41	59	27	49	59	77	42
Equity price	16	22	35	14	24	21	53	12
Foreign exchange rate	5	5	13	2	8	9	17	3
Commodity price	3	5	12	2	2	3	9	2
Less: diversification benefit (1)(2)	(25)	(25)	N/A	N/A	(23)	(27)	N/A	N/A
Primary risk categories VAR	29	48	73	29	60	65	93	48
Credit portfolio VaR	22	23	29	19	21	18	27	11
Less: diversification benefit (1)(2)	(9)	(10)	N/A	N/A	(8)	(9)	N/A	N/A
Total trading VaR	42	61	82	40	73	74	106	54

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.

2. N/A - Not Applicable. The minimum and maximum VaR values for the total VaR and each of the component VaRs might have occurred on different days during the year and therefore the diversification benefit is not an applicable measure.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Trading VaR for the year ended 31 December 2011 (continued)

The Group's average trading VaR for the Primary Risk Categories for 2011 was $48 million compared with $65 million for 2010. Reduced risk taking in fixed income products was the primary driver of the decrease. The reduction in period-end trading VaR from $73 million for 2010 to $42 million for 2011 more clearly demonstrates the reduced risk taking in fixed income products that occurred at the end of the third quarter of 2011 that continued through the fourth quarter of 2011.

The average Credit Portfolio VaR for 2011 was $23 million compared with $18 million for 2010. The increase in the average VaR over the year was from increased counterparty exposure during 2011, although this had decreased at year end.

The average Total Trading VaR for 2011 was $61 million compared with $74 million for 2010.

Non-trading risks for the year ended 31 December 2011

The Group believes that sensitivity analysis is an appropriate representation of the Group's non-trading risks. Reflected below is this analysis, which covers substantially all of the non-trading risk in the Group's portfolio.

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net gain or loss of approximately $4.9 million as at 31 December 2011, compared to a net gain or loss of $2.5 million as at 31 December 2010.

Counterparty Exposure Related to the Group's Own Spread

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure corresponds to a change in value of approximately $2 million and $3 million for each 1 basis point movement in the Group's credit spread level for 31 December 2011 and 31 December 2010, respectively.

Structured Notes

The credit spread risk sensitivity of the Group's mark-to-market structured notes corresponded to change in value of approximately $0.4 million for each 1 basis point movement in the Group's credit spread level at both 31 December 2011 and 31 December 2010.

Available-for-sale Financial Assets

The Group makes investments in both public and private companies. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues associated with a 10% decline in investment values.

10% sensitivity	**2011 $millions**	**2010 $millions**
Private equity and infrastructure funds	19.6	15.1

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

The Group has foreign currency exposure arising from foreign operations. The majority of this foreign currency risk has been hedged by other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising forward foreign currency exchange contracts.

The analysis below details the foreign currency exposure for the Group, by foreign currency, and calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency against the US dollar, with all other variables held constant. This analysis does not take into account the effect of the any foreign currency hedges held by the Group or by other members of the Morgan Stanley Group.

	2011			2010		
		Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)	
	Foreign currency exposure	Percentage change applied	Total recognised gain or loss	Foreign currency exposure	Percentage change applied	Total recognised gain or loss
	$millions	**%**	**$millions**	**$millions**	**%**	**$millions**
Australian Dollar	(6)	27%	2	(6)	27%	2
British Pound	2,216	29%	643	2,025	29%	587
Chinese Yuan	205	8%	16	185	8%	15
Euro	553	7%	38	522	7%	37
New Taiwan Dollar	66	8%	5	60	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Russian Rouble	322	24%	77	273	24%	66
Singapore Dollar	-	9%	-	4	9%	-
South Korean Won	433	42%	182	425	42%	179
Swedish Krona	15	23%	3	15	23%	3
Swiss Franc	8	10%	1	5	10%	1
	3,814			3,510		

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change over a four-year period from 1 December 2007 to 31 December 2011. Thus the percentage change applied may not be the same percentage change in the currency rate for the year.

The Group also has foreign currency exposure arising from its trading activities / assets and liabilities in currencies other than US dollars, which it actively manages by hedging with other Morgan Stanley Group undertakings. The residual currency risk for the Group from this activity is not material.

29. TRANSFERS OF FINANCIAL ASSETS, INCLUDING PLEDGES OF COLLATERAL

In the ordinary course of business, the Group enters into various transactions that result in the transfer of financial assets to third parties, which for accounting purposes may not give rise to full derecognition of the financial assets.

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes do not qualify for derecognition and continue to be recognised in the consolidated balance sheet.

	2011 $millions	2010 $millions
Government debt securities	7,592	14,238
Corporate equities	21,706	42,082
Corporate and other debt	17,155	12,760
	46,453	69,080

The majority of financial assets that do not qualify for derecognition arise from repurchase agreements and securities lending arrangements. Under these types of transactions, the Group generally retains substantially all risks and rewards of the transferred assets including credit risk, settlement risk, country risk and market risk.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for open derivative transactions, as well as certain sales of securities with related transactions, such as derivatives, that result in the Group either retaining substantially all the risks and rewards of the financial assets transferred, or not retaining substantially all the risks and rewards but retaining control of those financial assets.

These transactions are mostly conducted under standard agreements used by financial market participants and are undertaken with counterparties subject to the Group's normal credit risk control processes. The resulting credit exposures are controlled by daily monitoring and collateralisation of the positions. The carrying amount of the associated liabilities related to financial assets transferred that continue to be recognised approximate the carrying amount of those transferred assets.

30. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Group accepts financial assets as collateral which, dependent on the terms of the arrangement, the Group is allowed to sell or repledge. The majority of the financial assets accepted as collateral are received as part of reverse repurchase agreements or securities borrowing and are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under such arrangements as at 31 December 2011 was $180,797 million (2010: $199,601 million). Of this amount $143,365 million (2010: $168,166 million) has been sold or repledged to third parties in connection with financing activities, or to comply with commitments under short sale transactions.

31. SPECIAL PURPOSE ENTITIES

The Group is involved with various entities in the normal course of business that may be deemed to be special purpose entities ("SPEs"). The Group's interests in SPEs include debt and equity interests and derivative instruments, and these interests primarily arise from trading activity and structured transactions. Consolidation of SPEs is determined in accordance with the Group's accounting policies. As at 31 December 2011 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are $212 million (2010: $135 million) and the Group's maximum exposure to loss relating to such SPEs is $174 million (2010: $59 million). The Group's consolidated balance sheet includes $2,904 million of assets arising from consolidated SPEs (2010: $4,252 million). The Group's maximum exposure to loss relating to these assets is $1,279 million (2010: $2,036 million).

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy

Financial instruments recognised at fair value are broken down for disclosure purposes into a three level fair value hierarchy based on the observability of inputs as follows:

- *Quoted prices (unadjusted) in an active market for identical assets or liabilities (Level 1)* - valuations based on quoted prices in active markets for identical assets or liabilities that the Morgan Stanley Group has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuations of these products do not entail a significant degree of judgement.
- *Valuation techniques using observable inputs (Level 2)* - valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- *Valuation techniques with significant non-observable inputs (Level 3)* - valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Fair value control processes

The Group employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Morgan Stanley Group personnel with relevant expertise who are independent from the trading desks.

Additionally, groups independent from the trading divisions within the financial control, market risk and credit risk management departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and liabilities recognised at fair value

The following table presents the carrying value of the Group's financial assets and liabilities, recognised at fair value, classified according to the fair value hierarchy described above:

2011	Level 1 $millions	Level 2 $millions	Level 3 $millions	Total $millions
Financial assets classified as held for trading:				
- Government debt securities	5,792	4,707	1	10,500
- Corporate equities	18,475	7,775	170	26,420
- Corporate and other debt	3	11,228	2,549	13,780
- Derivatives	535	303,898	5,885	310,318
Total financial assets classified as held for trading	24,805	327,608	8,605	361,018
Financial assets designated at fair value through profit or loss	-	8,661	30	8,691
Fixed asset investments: Available-for-sale financial assets	98	-	98	196
Total financial assets measured at fair value	24,903	336,269	8,733	369,905
Financial liabilities classified as held for trading:				
- Government debt securities	6,994	3,170	-	10,164
- Corporate equities	12,082	2,095	5	14,182
- Corporate and other debt	3	2,467	73	2,543
- Derivatives	360	298,403	7,505	306,268
Total financial liabilities classified as held for trading	19,439	306,135	7,583	333,157
Financial liabilities designated at fair value through profit or loss	-	13,424	381	13,805
Total financial liabilities measured at fair value	19,439	319,559	7,964	346,962

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and liabilities recognised at fair value (continued)

2010	**Level 1 $millions**	**Level 2 $millions**	**Level 3 $millions**	**Total $millions**
Financial assets classified as held for trading:				
- Government debt securities	12,369	5,614	-	17,983
- Corporate equities	51,345	1,136	152	52,633
- Corporate and other debt	110	20,294	3,672	24,076
- Derivatives	972	187,281	2,433	190,686
Total financial assets classified as held for trading	64,796	214,325	6,257	285,378
Financial assets designated at fair value through profit or loss	-	8,834	529	9,363
Fixed asset investments: Available-for-sale financial assets	75	-	76	151
Total financial assets measured at fair value	64,871	223,159	6,862	294,892
Financial liabilities classified as held for trading:				
- Government debt securities	11,944	3,161	-	15,105
- Corporate equities	15,683	423	13	16,119
- Corporate and other debt	-	4,695	32	4,727
- Derivatives	928	187,097	3,912	191,937
Total financial liabilities classified as held for trading	28,555	195,376	3,957	227,888
Financial liabilities designated at fair value through profit or loss	-	15,736	855	16,591
Total financial liabilities measured at fair value	28,555	211,112	4,812	244,479

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

The Group's valuation approach and fair value hierarchy categorisation for certain significant classes of financial instruments recognised at fair value is as follows:

Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets

Government debt securities

The fair value of sovereign government obligations are valued using quoted prices in active markets when available. To the extent quoted prices are not available, fair value is determined based on a valuation model that has as inputs interest rate yield curves, cross-currency basis index spreads, and country credit spreads for structures similar to the bond in terms of issuer, maturity and seniority. These bonds are generally categorised in Levels 1 or 2 of the fair value hierarchy.

Corporate equities

Exchange-Traded Equity Securities. Exchange traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied and they are categorised in Level 1 of the fair value hierarchy; otherwise, they are categorised in Level 2 or Level 3 of the fair value hierarchy.

Investments. The Group investments include direct investments in equity securities as well as investments in private equity funds, real estate funds and hedge funds, which include investments made in connection with certain employee deferred compensation plans. Initially, the transaction price is generally considered by the Group as the exit price and is the Group's best estimate of fair value.

After initial recognition, in determining the fair value of internally and externally managed funds, the Group generally considers the net asset value of the fund provided by the fund manager to be the best estimate of fair value. For non-exchange-traded investments either held directly or held within internally managed funds, fair value after initial recognition is based on an assessment of each underlying investment, considering rounds of financing third party transactions, discounted cash flow analyses and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. Exchange-traded direct equity investments are generally valued based on quoted prices from the exchange.

Exchange-traded direct equity investments that are actively traded are categorised in Level 1 of the fair value hierarchy. Non-exchange-traded direct equity investments and investments in private equity and real estate funds are generally categorised in Level 3 of the fair value hierarchy. Investments in hedge funds that are redeemable at the measurement date or in the near future, are categorised in Level 2 of the fair value hierarchy; otherwise they are categorised in level 3 of the fair value hierarchy.

Corporate and other debt

Residential Mortgage-Backed Securities ("RMBS"), Commercial Mortgage-Backed Securities ("CMBS"), and other Asset-Backed Securities ("ABS"). RMBS, CMBS and other ABS may be valued based on external price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and / or analysing expected credit losses, default and recover rates. In evaluating the fair value of each security, the Group considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Issac Corporation ("FICO") scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are generally categorised in Level 2 of the fair value hierarchy. If external prices or spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs, then RMBS, CMBS and ABS are categorised in Level 3 of the fair value hierarchy.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets (continued)

Corporate and other debt (continued)

Corporate Bonds. The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads obtained from independent external parties such as vendors and brokers adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data is not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorised in Level 2 of the fair value hierarchy; in instances where prices, spreads or any other of the aforementioned key inputs are unobservable, they are categorised in Level 3 of the fair value hierarchy.

Collateralised Debt Obligations ("CDOs"). The Group holds CDOs that typically reference a tranche of an underlying synthetic portfolio of single name credit default swaps. The collateral is usually ABS or other corporate bonds. Credit correlation, a primary input used to determine the fair value of a cash CDO, is usually unobservable and derived using a benchmarking technique. The other model inputs such as credit spreads, including collateral spreads, and interest rates are observable. CDOs are categorised in Level 2 of the fair value hierarchy when the correlation input is insignificant. In instances where the correlation input is deemed to be significant, these instruments are categorised in Level 3 of the fair value hierarchy.

Derivatives

Listed Derivative Contracts. Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorised in Level 1 of the fair value hierarchy. Listed derivatives that are not actively traded are valued using the same approaches as those applied to OTC derivatives; they are generally categorised in Level 2 of the fair value hierarchy.

OTC Derivative Contracts. OTC derivative contracts include forward, swap and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices or commodity prices.

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modelled using a series of techniques, and model inputs from comparable benchmarks, including closed-form analytic formulas, such as the Black-Scholes option-pricing model, and simulation models or a combination thereof. Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgement, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swaps, certain option contracts and certain credit default swaps. In the case of more established derivative products, the pricing models used by the Group are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued using pricing models fall into this category and are categorised within Level 2 of the fair value hierarchy.

Other derivative products, including complex products that have become illiquid, require more judgement in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes certain types of interest rate derivatives with both volatility and correlation exposure and credit derivatives including mortgage-related CDO securities, certain types of ABS credit default swaps, basket credit default swaps and CDO-squared positions where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorised in Level 3 of the fair value hierarchy.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets (continued)

Derivatives (continued)

OTC Derivative Contracts (continued)

Derivative interests in complex mortgage-related CDOs and ABS credit default swaps, for which observability of external price data is limited, are valued based on an evaluation of the market and model input parameters sourced from similar positions as indicated by primary and secondary market activity. Each position is evaluated independently taking into consideration available comparable market levels as well as cash-synthetic basis, or the underlying collateral performance and pricing, behaviour of the tranche under various cumulative loss and prepayment scenarios, deal structures (e.g., non-amortising reference obligations, call features) and liquidity. While these factors may be supported by historical and actual external observations, the determination of their value as it relates to specific positions nevertheless requires significant judgement.

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap or position and is benchmarked to standardised proxy baskets for which correlation data are available. The other model inputs such as credit spread, interest rates and recovery rates are observable. In instances where the correlation input is deemed to be significant, these instruments are categorised in Level 3 of the fair value hierarchy; otherwise, the instruments are categorised in Level 2 of the fair value hierarchy.

The Group trades various derivative structures with commodity underlyings. Depending on the type of structure, the model inputs generally include interest rate yield curves, commodity underlier price curves, implied volatility of the underlying commodities and, in some cases, the implied correlation between these inputs. The fair value of these products is estimated using executed trades and broker and consensus data to provide values for the aforementioned inputs. Where these inputs are unobservable, relationships to observable commodities and data points, based on historic and / or implied observations, are employed as a technique to estimate the model input values. Commodity derivatives are generally categorised in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorised in Level 3 of the fair value hierarchy.

Financial assets and financial liabilities designated at fair value through profit or loss

Prepaid OTC contracts and issued structured notes designated as fair value through profit or loss

The Group issues structured notes and trades prepaid OTC derivatives that have coupons or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. The fair value of structured notes and prepaid OTC derivatives is determined using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices that the notes are linked to, interest rate yield curves, option volatility and currency, commodity or equity rates. Independent, external and traded prices for the notes are also considered. The impact of own credit spreads is also included based on observed secondary bond market spreads. Most structured notes and prepaid OTC derivatives are categorised in Level 2 of the fair value hierarchy.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and financial liabilities designated at fair value through profit or loss (continued)

Corporate loans

Corporate loans and lending commitments. The fair value of corporate loans is estimated using recently executed transactions, market prices quotations (where observable), implied yields from comparable debt and market observable credit default swap spread levels obtained from independent external parties such as vendors or brokers adjusted for any basis difference between cash and derivative instruments, along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate lending commitments is determined by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of loans and lending commitments also takes into account fee income that is considered an attribute of the contract.

Corporate loans and lending commitments are generally categorised in Level 2 of the fair value hierarchy except in instances where prices or significant spread inputs are unobservable, in which case they are categorised in Level 3 of the fair value hierarchy.

b. Changes in Level 3 assets and liabilities measured at fair value

The following tables present the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the year ended 31 December 2011. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains (losses) on hedging instruments that have been classified by the Group within the Level 1 and / or Level 2 categories.

Additionally, both observable and unobservable inputs may be used to determine the fair value of positions that the Group has classified within the Level 3 category. As a result, the unrealised gains (losses) during the period for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value during the period that were attributable to both observable (e.g., changes in market interest rates) and unobservable (e.g., changes in unobservable long-dated volatilities) inputs.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 financial assets and liabilities measured at fair value (continued)

2011 $millions	Balance at 1 January 2011	Total gains or (losses) recognised in profit or loss	Total gains or (losses) recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 31 December 2011	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2011 (2)
Financial assets classified as held for trading:										
- Government debt securities	-	-	-	1	-	-	-	-	1	-
- Corporate equities	152	(24)	-	150	(107)	-	-	(1)	170	(24)
- Corporate and other debt	3,672	(102)	-	838	(2,252)	-	(5)	398	2,549	(142)
Total financial assets classified as held for trading	3,824	(126)	-	989	(2,359)	-	(5)	397	2,720	(166)
Financial assets designated at fair value through profit or loss	529	-	-	30	-	-	-	(529)	30	-
Available-for-sale financial assets:										
- Corporate equities	76	-	26	-	(4)	-	-	-	98	-
Total financial assets measured at fair value	4,429	(126)	26	1,019	(2,363)	-	(5)	(132)	2,848	(166)
Financial liabilities classified as held for trading:										
- Government debt securities	-	-	-	-	-	-	-	-	-	-
- Corporate equities	(13)	(1)	-	12	(3)	-	-	-	(5)	-
- Corporate and other debt	(32)	(2)	-	9	(67)	-	1	18	(73)	3
- Net derivative contracts(3)	(1,479)	173	-	323	-	(1,704)	721	346	(1,620)	522
Total financial liabilities classified as held for trading	(1,524)	170	-	344	(70)	(1,704)	722	364	(1,698)	525
Financial liabilities designated at fair value through profit or loss	(855)	75	-	-	-	(101)	78	422	(381)	75
Total financial liabilities measured at fair value	(2,379)	245	-	344	(70)	(1,805)	800	786	(2,079)	600

(1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the year, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the year.

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2011 related to assets and liabilities still outstanding at 31 December 2011.

(3) Net derivative contracts represent Financial assets classified as held for trading – derivative contracts net of Financial liabilities classified as held for trading – derivative contracts.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 financial assets and liabilities measured at fair value (continued)

2010 $millions	Balance at 1 January 2010	Total gains or (losses) recognised in profit or loss	Total gains or (losses) recognised in other comprehe-nsive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 31 December 2010	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2010 (2)
Financial assets classified as held for trading:										
- Government debt securities	2	-	-	-	-	-	-	(2)	-	-
- Corporate equities	112	42	-	126	(177)	-	-	49	152	27
- Corporate and other debt	3,594	92	-	1,508	(1,761)	-	(137)	376	3,672	27
Total financial assets classified as held for trading	3,708	134	-	1,634	(1,938)	-	(137)	423	3,824	54
Financial assets designated at fair value through profit or loss	1,411	-	-	527	-	-	-	(1,409)	529	-
Available-for-sale financial assets:										
- Corporate equities	163	-	1	7	(24)	-	-	(71)	76	-
Total financial assets measured at fair value	5,282	134	1	2,168	(1,962)	-	(137)	(1,057)	4,429	54
Financial liabilities classified as held for trading:										
- Government debt securities	-	-	-	-	-	-	-	-	-	-
- Corporate equities	(4)	1	-	-	(48)	-	49	(11)	(13)	1
- Corporate and other debt	(38)	4	-	-	(86)	-	79	9	(32)	-
- Net derivative contracts(3)	(1,531)	(33)	-	-	-	-	72	13	(1,479)	(313)
Total financial liabilities classified as held for trading	(1,573)	(28)	-	-	(134)	-	200	11	(1,524)	(312)
Financial liabilities designated at fair value through profit or loss	(892)	(167)	-	-	121	(105)	39	149	(855)	(258)
Total financial liabilities measured at fair value	(2,465)	(195)	-	-	(13)	(105)	239	160	(2,379)	(570)

(1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the year, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the year.

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2010 related to assets and liabilities still outstanding at 31 December 2010.

(3) Net derivative contracts represent Financial assets classified as held for trading – derivative contracts net of Financial liabilities classified as held for trading – derivative contracts. All cash flows on derivative contracts are presented in settlements.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 financial assets and liabilities measured at fair value (continued)

The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the above table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in the Group.

During the year ended 31 December 2011, the Group reclassified approximately $529 million (2010: $1,409 million) of certain financial assets designated at fair value through profit and loss from Level 3 to Level 2. The Group reclassified these hybrid contracts as external prices became observable and the remaining unobservable inputs were deemed insignificant to the overall measurement.

c. Significant transfers between Level 1 and Level 2 of the fair value hierarchy

During the year, the Group reclassified approximately $1,027 million of Government Debt security assets and approximately $1,778 million of Government Debt security liabilities from Level 1 to Level 2. These reclassifications primarily related to certain European peripheral government bonds as these securities traded with a high degree of pricing volatility, dispersion and wider bid-ask spreads. The Group continues to mark these securities to observable market price quotations.

d. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives

All financial instruments are valued in accordance with the techniques outlined in the fair value hierarchy disclosure above. Some of these techniques, including those used to value instruments categorised in Level 3 of the fair value hierarchy, are dependent on unobservable parameters and the fair value for these financial instruments has been determined using parameters appropriate for the valuation methodology based on prevailing market evidence. It is recognised that the unobservable parameters could have a range of reasonably possible alternative values.

In estimating the change in fair value, the unobservable parameters were varied to the extremes of the ranges of reasonably possible alternatives using statistical techniques, such as dispersion in comparable observable external inputs for similar asset classes, historic data or judgement if a statistical technique is not appropriate. Where a financial instrument has more than one unobservable parameter, the sensitivity analysis reflects the greatest reasonably possible increase or decrease to fair value by varying the assumptions individually. It is unlikely that all unobservable parameters would be concurrently at the extreme range of possible alternative assumptions and therefore the sensitivity shown below is likely to be greater than the actual uncertainty relating to the financial instruments.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 31 December 2011 to reasonably possible alternative assumptions.

2011		**Effect of reasonably possible alternative assumptions**	
	Fair value $millions	**Increase in fair value $millions**	**Decrease in fair value $millions**
Financial assets classified as held for trading:			
- Government debt securities	1	-	-
- Corporate equities	170	6	(15)
- Corporate and other debt	2,549	49	(47)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Structured notes	-	-	-
- Other	30	1	(1)
Available-for-sale financial assets:			
- Corporate equities	98	9	(9)
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	5	-	-
- Corporate and other debt	72	-	-
- Net derivatives contracts(1)	(1,620)	141	(139)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	111	8	(8)
- Structured notes	5	-	-
- Other	265	2	(2)

(1) Net derivative contracts represent Financial assets classified as held for trading (derivative contracts) net of Financial liabilities classified as held for trading (derivative contracts).

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

2010	Fair value $millions	Effect of reasonably possible alternative assumptions: Increase in fair value $millions	Effect of reasonably possible alternative assumptions: Decrease in fair value $millions
Financial assets classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	152	3	(3)
- Corporate and other debt	3,672	223	(222)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Structured notes	-	-	-
- Other	529	11	(6)
Available-for-sale financial assets:			
- Corporate equities	76	11	(6)
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	(13)	-	(1)
- Corporate and other debt	(32)	1	(1)
- Net derivatives contracts(1)	(1,479)	128	(148)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(3)	-	-
- Structured notes	-	-	-
- Other	(852)	8	(8)

(1) Net derivative contracts represent Financial assets classified as held for trading (derivative contracts) net of Financial liabilities classified as held for trading (derivative contracts).

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

The amounts not recognised in the consolidated profit and loss account relating to the difference between the fair value at initial recognition (the transaction price) and the amounts determined at initial recognition using valuation techniques are as follows:

	2011 $millions	2010 $millions
At 1 January	260	215
New transactions	310	94
Amounts recognised in the consolidated profit and loss account during the year	(31)	(49)
At 31 December	539	260

The balance above predominantly relates to derivatives.

The balance sheet categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value', and 'Available-for-sale financial assets' include financial instruments whose fair value is based on valuation techniques using unobservable market data. However, the balance above for the Group predominantly relates to derivatives classified as held for trading.

33. FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

For all financial assets and financial liabilities not recognised at fair value, the carrying amount is considered to be a reasonable approximation of fair value due to the short term nature of these financial assets and liabilities, except for the following:

31 December 2011	Carrying value $millions	Fair value $millions	Unrecognised gain $millions
Financial liabilities			
Subordinated loans	10,569	7,814	2,755

As at 31 December 2011 Securities purchased under agreements to resell, Corporate loans and Securities sold under agreements to repurchase carrying value was considered to be a reasonable approximation of fair value.

31 December 2010	Carrying value $millions	Fair value $millions	Unrecognised gain / (loss) $millions
Financial assets			
Securities purchased under agreements to resell	71,990	72,016	26
Corporate Loans	3,200	3,235	35
Financial liabilities			
Subordinated loans	10,571	8,551	2,020
Securities sold under agreements to repurchase	72,147	72,151	(4)

The fair value for subordinated loans has been determined based on the assumption that all subordinated loans are held to the latest repayment date, although the amounts outstanding are repayable at any time at the Group's option, subject to two business days' notice to the lender and at least one month notice to the Financial Services Authority ("FSA"), which has the right under the agreement to refuse consent to repayment.

34. CAPITAL MANAGEMENT

The Morgan Stanley Group manages its capital on a global basis with consideration for its legal entities. The capital managed by the Morgan Stanley Group broadly includes ordinary share capital, preference share capital, subordinated loans and reserves.

The Morgan Stanley Group's capital estimate is based on the Required Capital Framework, an internal capital adequacy measure. The framework is a risk-based internal use of capital measure, which is compared with the Morgan Stanley Group's regulatory capital to help ensure the Morgan Stanley Group maintain an amount of risk-based going concern capital after absorbing potential losses from extreme stress events at a point in time. The difference between the Morgan Stanley Group's regulatory capital and aggregate Required Capital is the Morgan Stanley Group's Parent capital.

Tier 1 capital and common equity attribution to the business segments is based on capital usage calculated by Required Capital. In principle, each business segment is capitalised as if it were an operating entity with limited diversification benefit between the business segments. Required Capital is assessed at each business segment and further attributed to product lines. The process is intended to align capital with the risks in each business segment in order to allow senior management to evaluate returns on a risk-adjusted basis.

The Required Capital Framework will evolve over time in response to changes in the business and regulatory environment and to incorporate enhancements in modelling techniques.

The Morgan Stanley Group actively manages its consolidated capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses.

The Morgan Stanley Group also aims to adequately capitalise at a legal entity level whilst safeguarding that entity's ability to continue as a going concern and ensuring that it meets all regulatory capital requirements, so that it can continue to provide returns for the Morgan Stanley Group.

The Group is regulated by the Financial Services Authority ("FSA") and as such is subject to minimum capital requirements. The Group's capital is monitored on an ongoing basis to ensure compliance with the rules within the FSA's General Prudential Sourcebook. At a minimum, the Group must ensure that Capital Resources (share capital, subordinated debt, audited profit and loss and eligible reserves) are greater than the Capital Resource Requirement covering credit, market and operational risk. The Group complied with all of its regulatory capital requirements during the year.

In December 2010, the Basel Committee on Banking Supervision published the final rules text on a comprehensive set of reform measures, developed to strengthen the regulation, supervision and risk management of the banking sector ("the Basel III Framework"). In July 2011, the European Commission published draft legislation to implement these measures in Europe with an expected effective date of 1 January 2013.

The Basel III Framework covers both microprudential and macroprudential elements. It sets out requirements for higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. The Morgan Stanley Group is currently working to ensure compliance with these new regulatory standards as they are implemented from 2013 onwards.

In addition to the Basel III Framework, new standards relating to market risk capital requirements were implemented with effect from 31 December 2011.

34. CAPITAL MANAGEMENT (CONTINUED)

During 2011, the Group has continued to review and actively manage its capital position. As part of this capital management, the Group received a capital contribution of $4,900 million (2010: $3,000 million), and paid ordinary dividends of $2,000 million (2010: $1,000 million). The movement in subordinated loan agreements during the year relate to the foreign currency translation of non US dollar loans into US Dollars.

The Group considers the below to be its managed capital:

	2011 $millions	2010 $millions
Ordinary share capital	1,614	1,614
Subordinated loans	10,569	10,571
Reserves	16,408	12,347
	28,591	24,532

35. RELATED PARTY TRANSACTIONS

The Group is exempt from the requirement to disclose transactions with fellow wholly owned Morgan Stanley Group undertakings under paragraph 3(c) of FRS 8 *Related Party Disclosures.*

There were no other related party transactions requiring disclosure.

MORGAN STANLEY INTERNATIONAL LIMITED
Registration No. 3584019

COMPANY BALANCE SHEET
As at 31 December 2011

	Note	2011 $millions	2010 $millions
FIXED ASSETS			
Investments	3	9,013	4,113
CURRENT ASSETS			
Debtors	4	2,591	8,396
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR	5	(1,477)	(5,247)
NET CURRENT ASSETS / (LIABILITIES)		1,114	3,149
TOTAL ASSETS LESS CURRENT LIABILITIES		10,127	7,262
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR	6	(1,322)	(1,322)
		8,805	5,940
CAPITAL AND RESERVES			
Called up share capital	7	1,614	1,614
Capital contribution reserve	8	6,038	3,138
Profit and loss account	8	1,153	1,188
EQUITY SHAREHOLDERS' FUNDS		8,805	5,940

These financial statements were approved by the Board and authorised for issue on 26 September 2012.

Signed on behalf of the Board CE WOODMAN

Director

The notes on pages 88 to 93 form an integral part of the financial statements.

1. ACCOUNTING POLICIES

The Company's principal accounting policies are summarised below and have been applied consistently throughout the year and preceding year.

a) Basis of preparation

The financial statements are prepared under the historical cost convention and in accordance with applicable United Kingdom company law and accounting standards.

b) The going concern assumption

The Company's business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Directors' report on pages 3 to 13.

As set out in the Directors' report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy and steps have been taken to strengthen the Morgan Stanley Group capital position and ensure that the Company's capital position is satisfactory. The Company is parent to a group of companies with a significant level of capital and resources, and operates within the global liquidity management framework of the Morgan Stanley Group.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Company will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

c) Functional currency

Items included in the financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Company operates.

All currency amounts in the Company accounts and the notes to the Company accounts are rounded to the nearest million US dollars.

d) Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the balance sheet date. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Foreign exchange differences on monetary fixed asset investments are taken through the profit and loss account and are presented in 'Net gains/ losses from fixed asset investments'. All other translation differences are taken through the profit and loss account and are presented in 'Other income' or 'Other expense'.

e) Recognition of income and expense

i) Interest income and expense

Interest income and interest expense are recognised on an accruals basis within 'Interest income' and 'Interest expense' in the profit and loss account.

ii) Dividend income

Dividend income from fixed asset investments is recognised when the Company's right to receive payment is established.

f) Fixed asset investments

Fixed asset investments are stated at cost, less provision for any impairment.

Details of the Company's investments in subsidiaries, including the name, country of incorporation, and proportion of ownership are given in note 3.

1. ACCOUNTING POLICIES (CONTINUED)

g) Taxation

UK corporation tax is provided at amounts expected to be paid / recovered using the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Full provision has been made for deferred tax assets and liabilities arising from timing differences. Deferred tax is measured using the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

Current tax assets are offset against current tax liabilities when there is a legally enforceable right to offset current tax assets against current tax liabilities and when they relate to taxes levied by the same taxation authority and the Company intends to settle its current tax assets and current tax liabilities on a net basis. Deferred tax assets are offset against deferred tax liabilities to the extent that they relate to taxes levied by the same tax authority and arise in the same taxable entity.

h) Cash flow statement

The Company's ultimate parent undertaking produces consolidated cash flow statements in which the Company is included and which are publicly available. Accordingly, the Company, which is a wholly-owned subsidiary, has elected to avail itself of the exemption provided in FRS 1 (Revised 1996) *Cash flow statements* and not present a cash flow statement.

2. PROFIT FOR THE YEAR

The Company has taken advantage of the exemption, as permitted by section 408 of the Companies Act 2006, from presenting its own profit and loss account and related notes. The Company's loss after taxation for the year ended 31 December 2011 was $35 million (2010: $1,840 million profit). During the year an interim dividend of $2,000 million was paid to the holders of the ordinary shares out of the capital contribution reserve (2010: $1,000 million out of retained earnings). A net loss after dividends of $35 million has been carried to reserves (2010: $840 million profit carried to reserves).

3. FIXED ASSET INVESTMENTS

The Company's investments in subsidiary undertakings are as follows:

	$millions
Cost and net book value	
At 1 January 2011	4,113
Addition	4,907
Disposal	(7)
At 31 December 2011	9,013

During 2011 the Company made a cash capital contribution of $4,900 million to its wholly-owned subsidiary Morgan Stanley Group (Europe) to capitalise Group operations. The capital contribution has been accounted for as an addition to the Company's investment in the subsidiary.

The principal subsidiary undertakings of the Company are as follows:

Name of company	Country of incorporation	Proportion of shares held	Type of shares held	Proportion of voting rights	Nature of business
Morgan Stanley & Co. International plc	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley & Co. Limited	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley Bank International Limited	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley Equity Finance (Malta) Limited	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley Group (Europe)	England and Wales	100%	Ordinary shares	100%	Intermediate holding company
Morgan Stanley Investment Management Limited	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley Securities Limited	England and Wales	100%	Ordinary shares*	100%	Financial services
Morgan Stanley Strategic Funding Limited	England and Wales	100%	Ordinary shares	100%	Funding company
Morgan Stanley UK Group	England and Wales	100%	Ordinary shares*	100%	Service company
Morgan Stanley UK Limited	England and Wales	100%	Ordinary shares*	100%	Service company
OOO Morgan Stanley Bank	Russian Federation	100%	Participation shares*	100%	Financial services

An * denotes shareholdings attributed to the Company which are held indirectly by the Company.

A full list of the Company's subsidiary and associate undertakings will be annexed to the Company's next Annual Return and filed with the Registrar of Companies.

4. DEBTORS

	2011 $millions	2010 $millions
Amounts due from Morgan Stanley Group undertakings	19	1,494
Amounts due from Group undertakings	2,572	6,902
	2,591	8,396

5. OTHER CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2011 $millions	2010 $millions
Amounts owing to Morgan Stanley Group undertakings	83	567
Amounts owing to Group undertakings	1,394	4,680
	1,477	5,247

6. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	2011 $millions	2010 $millions
Subordinated loan agreements	1,300	1,300
Amounts due to Group undertakings		
- Long term loan	22	22
	1,322	1,322

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment date	Interest rate	2011 $millions	2010 $millions
Morgan Stanley International Holdings Inc.	31 October 2021	6 month LIBOR plus 1.25%	-	1,300
Morgan Stanley UK Financing II LP	31 October 2021	6 month LIBOR plus 1.25%	1,300	-
			1,300	1,300

All amounts outstanding under subordinated loan agreements are repayable at any time at the Company's option, subject to two business days' notice to the lender and at least one month notice to the Financial Services Authority ("FSA"), which has the right under the agreement to refuse consent to repayment.

On 16 December 2011 Morgan Stanley International Holdings Inc. novated the subordinated debt issued by the Company to Morgan Stanley UK Financing II LP.

The Company has not had any defaults of principal, interest or other breaches with respect to its subordinated loans during the year.

7. CALLED UP SHARE CAPITAL

	2011 $millions	2010 $millions
Allotted and fully paid:		
Equity shares		
2 ordinary shares of £1 each	-	-
1,614,167,000 ordinary shares of $1 each	1,614	1,614
	1,614	1,614

All ordinary shares are recorded at the rate of exchange ruling at the date the shares were paid up.

8. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital $millions	Capital contribution reserve $millions	Profit and loss account $millions	Total $millions
At 1 January 2010	1,614	138	348	2,100
Profit for the year	-	-	1,840	1,840
Capital contribution from parent company	-	3,000	-	3,000
Dividends paid	-	-	(1,000)	(1,000)
At 31 December 2010	1,614	3,138	1,188	5,940
Loss for the year	-	-	(35)	(35)
Capital contribution from parent company	-	4,900	-	4,900
Dividends paid	-	(2,000)	-	(2,000)
At 31 December 2011	1,614	6,038	1,153	8,805

Capital contribution reserve

The 'capital contribution reserve' comprises contributions of capital from the Company's parent company, Morgan Stanley International Holdings Inc.

During 2011 the Company's immediate parent undertaking Morgan Stanley International Holdings Inc, made a cash capital contribution of $4,900 million (2010: $3,000 million) to capitalise Group operations. The 'capital contribution reserve' is classified as a distributable reserve in accordance with relevant company legislation.

9. COMMITMENTS AND CONTINGENCIES

The Company has provided a letter of financial support to two Morgan Stanley Group undertakings. In addition, these undertakings have letters of support from the Group's ultimate parent. This support has not been called upon. It is considered unlikely that the letters of support would be called upon as these undertakings are funded by short-term loans from other Morgan Stanley Group undertakings. The maximum amount of support potentially required by the Company is $12,800 million, before taking into account the support provided to these entities by the Group's ultimate parent Morgan Stanley.

10. RELATED PARTY TRANSACTIONS

The Company is exempt from the requirement to disclose transactions with fellow wholly owned Morgan Stanley undertakings under paragraph 3(c) of FRS 8 *Related Party Disclosures.* There were no other related party transactions requiring disclosure.

11. PARENT UNDERTAKINGS

The Company's ultimate parent undertaking and controlling entity, and the largest group of which the Company is a member and for which group financial statements are prepared, is Morgan Stanley. The Company's immediate controlling party is Morgan Stanley International Holdings Inc. Both Morgan Stanley and Morgan Stanley International Holdings Inc are registered and incorporated in Delaware, the United States of America and copies of their financial statements can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA.