Registration No. 3584019

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MORGAN STANLEY INTERNATIONAL LIMITED

Report and financial statements

31 December 2012

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 2012.

RESULTS AND DIVIDENDS

The Group's profit for the year, after tax and minority interest, was $311 million (2011: $1,109 million).

No dividend was paid or declared during the year (2011: $2,000 million dividend was paid to the holders of ordinary shares). No final dividend is proposed (2011: $nil).

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions.

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.

Certain of the Group's subsidiaries are authorised and regulated by the Financial Services Authority ("FSA") or by other financial services regulatory authorities. From 1 April 2013, the FSA was replaced by two separate regulatory authorities and therefore from this date certain of the Group's subsidiaries are authorised by the Prudential Regulatory Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA.

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.

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 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 2012, global market and economic conditions improved modestly as European policymakers became more determined in combating the region's debt crisis and central bankers around the globe took a number of actions to stimulate the economic recovery. Despite these improvements, global market and economic conditions in 2012 were challenged by concerns about the ongoing European sovereign debt crisis, the United States ("US") "fiscal cliff" (i.e., the combination of expiring tax cuts and spending cuts on or after 1 January 2013), the US federal debt ceiling and its potential adverse impact on the US economy, and slowing economic growth in emerging markets.

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

In Europe, major equity market indices ended 2012 higher compared with the beginning of the year, primarily due to investors' optimism about Europe's progress in addressing its sovereign debt crisis, especially in Greece, Ireland, Italy, Portugal and Spain (the "European Peripherals"), and the sovereign debt exposures in the European banking system. In the euro-area, gross domestic product declined in 2012 and the unemployment rate increased to 11.7% at 31 December 2012 from 10.4% at 31 December 2011. At 31 December 2012, the European Central Bank's ("ECB") benchmark interest rate was 0.75% (2011: 0.5%). The Bank of England's ("BOE") benchmark interest rate was 0.5% and was unchanged from a year ago. To inject further monetary stimulus into the economy in the United Kingdom ("UK"), the BOE increased the size of its quantitative easing programme on two separate occasions in 2012.

BUSINESS REVIEW (CONTINUED)

In 2012, the ECB conducted its second three-year refinancing operation and widened the pool of eligible collateral for refinancing operations to ease funding conditions for euro-area banks. In addition, EU leaders agreed on a new bailout and debt-restructuring agreement designed to reduce Greece's debt and reached another agreement to ease the recapitalisation of struggling European banks. In September 2012, the ECB outlined the details of a plan to buy euro-area government bonds and reiterated its pledge to preserve the euro. In December 2012, EU finance ministers reached an agreement to bring many of the continent's banks under a single supervisor. Despite these actions, several major rating agencies downgraded the credit ratings for some euro-zone countries, and some EU member countries, such as Italy and Spain, entered into a technical recession (two consecutive quarters of negative change in gross domestic product) in 2012.

In response to the ongoing uncertainties in Europe the Group has continued to reduce its net exposure to European Peripherals. At 31 December 2012, exposure before hedges to European peripheral countries was $4,723 million (2011: $6,823 million) and the net exposure after hedges was $4,069 million (2011: $5,736 million). Details of the country risk exposures to European Peripherals are provided on page 7 of the Directors' Report.

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 decreased by $798 million to $311 million, a decrease of 72% compared to the year ended 31 December 2011.

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 available-for-sale financial assets', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the year declined by $649 million to $5,142 million, a decrease of 11% compared to the year ended 31 December 2011.

Equity sales and trading revenues decreased during the year compared to 2011 due to decreased core and portfolio products revenues, a decrease in the accrual for expected reimbursement from clients on certain equity transactions (see note 5) and due to negative revenues related to changes in the fair value of net derivative contracts and borrowings that are measured at fair value attributable to the tightening of Morgan Stanley's credit default swap spreads. These decreases were partially offset by an increase in equity derivative products revenues.

Fixed income and commodities sales and trading revenues decreased during the year compared to 2011 due to reduced credit derivative and non-core fixed income product revenues and due to negative revenues from the impact of the tightening of Morgan Stanley's credit default swap spreads on borrowings that are measured at fair value. This was partially offset by increased revenues in interest rate, foreign exchange, corporate debt, securitised and commodity products.

The reductions in equity and fixed income sales and trading revenues were partially offset by increased investment banking and asset management revenues.

Other expense increased by $336 million from $4,282 million in 2011 to $4,618 million in 2012, mainly driven by increased management charges from other Morgan Stanley Group undertakings relating to other services, which increased by $345 million. The increase in management charges was mainly due to increased investment banking related transfer pricing and increased asset management sub-advisory costs.

The Group's effective tax rate for the year was 37% (2011: 28%) with the deviation from the UK statutory rate of 24.5% driven by the impact of higher rate taxes on overseas earnings and certain non-deductible expenses for tax purposes, see note 9 for further details.

The consolidated balance sheet presented on page 17 reflects decreases in the Group's total assets and total liabilities of $13,398 million and $13,902 million respectively, decreases of 2% as at 31 December 2012 when compared to 31 December 2011. The decrease in total assets is mainly driven by decreases in financial assets classified as held for trading of $9,783 million and in debtors of $3,037 million. The decrease in total liabilities is driven by a decrease in financial liabilities classified as held for trading of $17,588 million, partially offset by an increase in financial liabilities at amortised cost of $4,752 million. The decreases in financial assets and liabilities held for trading is primarily due to reduced derivatives positions.

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.

BUSINESS REVIEW (CONTINUED)

For this reason, the Group'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.

Note 28 to the consolidated balance sheet provides qualitative and quantitative disclosures about the Group's management of and exposure to financial risks.

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.

The Morgan Stanley Group manages the market risk associated with its trading activities on a global basis, at both a trading division and an individual product level, which includes consideration of market risk for each individual legal entity.

The Group has enhanced its VaR model during 2012 to make it more responsive to current market conditions while maintaining a longer-term perspective. This enhancement is consistent with regulatory requirements. The current VaR model estimates are lower than the VaR estimates produced under the previously used model because the prior model places more emphasis on the large market moves experienced during the 2008 financial crisis, while the current model places more emphasis on more recent volatility, which has been generally lower.

Under the current VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $25 million compared with $33 million under the previous model. The period end VaR was $22 million while it was $27 million under the previous model. The average Credit Portfolio VaR for 2012 was $15 million compared with $18 million under the previous model. The average total trading VaR for 2012 was $32 million compared with $40 million under the previous model.

Under the previous VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $33 million compared with $48 million for 2011. The decrease in average VaR for Primary Risk Categories is primarily due to reduced risk taking in fixed income products. The average Credit Portfolio VaR for 2012 was $18 million compared with $23 million for 2011. The decrease in the average VaR over the year was from decreased counterparty exposure during 2012. The average total trading VaR for 2012 was $40 million compared with $61 million for 2011.

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.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

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 manage 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 is monitored and managed, with stress testing and scenario analysis conducted on a continuous basis, to identify exposure concentrations, wrong way risk (the risk that occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty) and the impact of idiosyncratic events. In addition, indirect exposures are identified through the Group's counterparty credit analysis as having a vulnerability or exposure to another country or jurisdiction. Examples of such counterparties include: mutual funds that invest in a single country, offshore companies whose assets reside in another country to that of the offshore jurisdiction and finance company subsidiaries of corporations. The outcome of such identification can result in a reclassification of country risk, amendment of counterparty limits or exposure mitigation. 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 2012, 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 the year ended 31 December 2012, the European Peripherals and France continued to experience varying degrees of credit deterioration due to weaknesses in their economic and fiscal situations.

The following table shows the Group's country risk exposure to European Peripherals and France at 31 December 2012. The majority of the financial instruments included in the table below are classified as held for trading and are 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.

BUSINESS REVIEW (CONTINUED)

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(5)
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Greece:								
Sovereigns	5	-	-	-	-	5	-	5
Non-sovereigns	52	-	3	-	-	55	(3)	52
Total Greece	57	-	3	-	-	60	(3)	57
Ireland:								
Sovereigns	82	7	-	-	5	94	-	94
Non-sovereigns	62	16	-	-	1	79	-	79
Total Ireland	144	23	-	-	6	173	-	173
Italy:								
Sovereigns	(21)	288	-	-	320	587	(154)	433
Non-sovereigns	369	436	223	727	84	1,839	(195)	1,644
Total Italy	348	724	223	727	404	2,426	(349)	2,077
Portugal:								
Sovereigns	(38)	32	-	-	31	25	(71)	(46)
Non-sovereigns	66	31	98	-	27	222	(30)	192
Total Portugal	28	63	98	-	58	247	(101)	146
Spain:								
Sovereigns	61	1	-	-	458	520	(75)	445
Non-sovereigns	301	284	34	559	119	1,297	(126)	1,171
Total Spain	362	285	34	559	577	1,817	(201)	1,616
Sovereigns	89	328	-	-	814	1,231	(300)	931
Non-sovereigns:	850	767	358	1,286	231	3,492	(354)	3,138
Total European Peripherals	**939**	**1,095**	**358**	**1,286**	**1,045**	**4,723**	**(654)**	**4,069**
France:								
Sovereigns	(898)	13	-	-	-	(885)	(15)	(900)
Non-sovereigns	(320)	1,750	120	1,676	11	3,237	(269)	2,968
Total France	(1,218)	1,763	120	1,676	11	2,352	(284)	2,068

(1) Net inventory representing exposure to both long and short single-name and index 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 (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(5) In addition, as at 31 December 2012, the Group had European peripherals and French exposure for overnight deposits with banks of approximately $2.2 million and $23 million, respectively.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Non-UK country risk exposure

The following table shows the Group's significant non-UK country risk exposure at 31 December 2012, 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
Germany:							
Sovereigns	4,622	593	-	-	5,215	(696)	4,519
Non-sovereigns	(59)	2,158	74	44	2,217	7	2,224
Total Germany	4,563	2,751	74	44	7,432	(689)	6,743
United States:							
Sovereigns	(243)	69	-	-	(174)	-	(174)
Non-sovereigns	(481)	2,591	6	8	2,124	(88)	2,036
Total United States	(724)	2,660	6	8	1,950	(88)	1,862
Russian Federation:							
Sovereigns	66	25	-	-	91	(87)	4
Non-sovereigns	1,011	302	225	-	1,538	(255)	1,283
Total Russian Federation	1,077	327	225	-	1,629	(342)	1,287
Japan:							
Sovereigns	(100)	-	-	-	(100)	-	(100)
Non-sovereigns	41	819	-	-	860	-	860
Total Japan	(59)	819	-	-	760	-	760
China:							
Sovereigns	249	10	-	-	259	-	259
Non-sovereigns	193	113	140	2	448	(48)	400
Total China	442	123	140	2	707	(48)	659

(1) Net inventory represents exposure to both long and short single-name and index 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 (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) In addition, as at 31 December 2012, the Group had exposure to these countries for overnight deposits with banks of approximately $1.1 billion.

BUSINESS REVIEW (CONTINUED)

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 primary goal of the Morgan Stanley Group's liquidity risk management framework is to ensure that the Morgan Stanley Group, including the Group, have access to adequate funding across a wide range of market conditions. The framework is designed to enable the Group to fulfil its financial obligations and support the execution of the Group's business strategies. The Group's capital management framework is further described in note 34.

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, including the Group, to enable the Morgan Stanley Group to withstand market stresses, and to meet regulatory stress testing requirements proposed by regulators globally. 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.

On 21 June 2012, Moody's Investor Services announced the conclusion of an industry-wide reassessment and revised ratings for 15 global capital markets banks. The Morgan Stanley Group's long- and short- term debt ratings were lowered two notches to Baa1/P-2 from A2/P-1, and a negative outlook was assigned.

While certain aspects of a credit ratings downgrade are quantifiable pursuant to contractual provisions, the impact it will have on the Morgan Stanley 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 Morgan Stanley Group may take. The liquidity impact of additional collateral requirements is included in the Morgan Stanley Group's Liquidity Stress Tests.

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.

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.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Legal, regulatory and compliance risk

Legal risk includes the risk of exposure to fines, penalties, judgements, damages and/or settlements in connection with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements and standards or litigation. Legal risk also includes contractual and commercial risk such as the risk that a counterparty's performance obligations will be unenforceable. The Morgan Stanley Group is generally subject to extensive regulation in the different jurisdictions in which it conducts its business. 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 business conduct, ethics and 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, information barriers, potential conflicts of interest, structured transactions, use and safekeeping of customer funds and securities, lending and credit granting, anti-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 employees compensation, are also possible.

In December 2010, the Basel Committee reached an agreement on Basel III. In June 2013 the Capital Requirement Directive and Regulation ("CRD") was finalised implementing Basel III in Europe. These rules contain new capital standards that raise the capital requirements and strengthen counterparty credit risk capital requirements, through, for example, new requirements to capture Counterparty Valuation Adjustment risk. The CRD also requires banking organisations, including the Group, to maintain both a capital conversion buffer and, if deployed, a countercyclical capital buffer, above the minimum risk based capital ratios. Failure to maintain such buffers will result in restrictions on the banking organisation's ability to make capital distributions and pay discretionary bonuses to executive officers. The CRD also subjects banking organisations, including the Group, to a minimum leverage ratio of 3%.

The Group will become subject to the CRD beginning on 1 January 2014, with the requirements being phased in over several years.

Basel II Pillar 3 disclosures

The Group publishes Pillar 3 disclosures which allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms required by the UK implementation of Basel II. The 2011 Pillar 3 disclosure can be found in the investor relations section at www.morganstanley.com.

BUSINESS REVIEW (CONTINUED)

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. 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. With respect to the Group, its capital position is also expected to be in excess of regulatory minimums under both a normal and stressed market environment in the foreseeable future.

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	(ceased to be a director on 18 September 2012)
C D S Bryce	
D O Cannon	(appointed 1 June 2013)
L Francois	(resigned 19 March 2012)
Sir E J W Gieve	(appointed 1 October 2012)
T C Kelleher (Chairman)	
N S Nandra	(resigned 16 April 2013)
F R Petitgas	
M C Phibbs	(appointed 1 May 2013)
I Plenderleith	
R P Rooney	
D A Russell	
C E Woodman	

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

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

DIRECTORS' INDEMNITY

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

AUDIT COMMITTEE

The Company has an Audit Committee to assist the Boards of the Company, other Group regulated subsidiaries and certain other Morgan Stanley Group undertakings 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 is chaired by a non-executive director and the majority of its members are non-executive directors. The Audit Committee meets regularly and reports to the Board of the Company on a quarterly basis.

EMPLOYEES

Both the Company 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 who 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 $2.3 million (2011: $2.2 million) of which $1.6 million was donated to Morgan Stanley International Foundation (2011: $1.5 million).

POLICY AND PRACTICE ON PAYMENT OF CREDITORS

It is the Group's and the Company's policy that payments to suppliers are made in accordance with those terms and conditions agreed between the Group or the Company and its suppliers, providing that all trading terms and conditions have been complied with.

The Group's and the Company's trade creditors balance is comprised primarily of unsettled securities transactions with exchanges, clearing houses, market counterparties, individual investors and other Morgan Stanley Group undertakings. It is the Group's and 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.

AUDITOR

Deloitte LLP have expressed their willingness to continue in office as auditor of the Group and, under sections 485 to 488 of the Companies Act 2006, will be deemed to be re-appointed.

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 auditor is 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 auditor is 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' 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

C E Woodman

Director

25 September 2013

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

Year ended 31 December 2012

We have audited the Group and Company financial statements (the "financial statements") of Morgan Stanley International Limited for the year ended 31 December 2012 which comprise the consolidated profit and loss account, the consolidated statement of total recognised gains and losses, the consolidated and Company balance sheet and the related notes 1 to 35 for the Group financial statements and the related notes 1 to 12 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 Group'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 Group's members those matters we are required to state to them in an auditor's 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 Group and the Group's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditor

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 Group's and 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 2012 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
25 September 2013

CONSOLIDATED PROFIT AND LOSS ACCOUNT

Year ended 31 December 2012

	Note	2012 $millions	2011 $millions
Net gains on financial instruments classified as held for trading		3,805	4,621
Net gains on financial instruments designated at fair value through profit or loss		97	275
Net gains on fixed asset investments:			
- Available-for-sale financial assets	2	61	1
Interest income	3	2,728	4,271
Interest expense	4	(3,123)	(4,781)
Other income	5	1,574	1,404
Other expense	6	(4,618)	(4,282)
Net currency translation (loss)/ gain on disposal of subsidiaries	12	(30)	5
Gain on disposal of joint venture	12	-	21
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		494	1,535
Tax on profit on ordinary activities	9	(182)	(425)
PROFIT FOR THE FINANCIAL YEAR		312	1,110
Minority interest	24	(1)	(1)
PROFIT ATTRIBUTABLE TO SHAREHOLDERS OF THE COMPANY FOR THE FINANCIAL YEAR		311	1,109

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 91 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
Year ended 31 December 2012

	Note	2012 $millions	2011 $millions
PROFIT FOR THE FINANCIAL YEAR		312	1,110
Currency translation reserve:			
Foreign currency translation differences on foreign operations	24	175	(11)
Reclassification of foreign currency translation differences on disposal of operations to profit and loss account	24	30	(5)
Available-for-sale reserve:			
Net change in fair value of available-for-sale financial assets	11	46	50
Reclassification of amounts relating to available-for-sale financial assets to profit and loss account	2	(53)	-
Pension reserve:			
Actuarial loss on post employment benefit schemes	26	(9)	(9)
Net current and deferred tax: on items taken directly to equity		-	9
TOTAL RECOGNISED GAINS AND LOSSES RELATING TO THE YEAR		501	1,144

The notes on pages 19 to 91 form an integral part of the financial statements.

MORGAN STANLEY INTERNATIONAL LIMITED
Registration No. 3584019

CONSOLIDATED BALANCE SHEET
As at 31 December 2012

	Note	2012 $millions	2011 $millions
FIXED ASSETS			
Tangible assets	10	623	699
Investments:			
- Available-for-sale financial assets	11	76	196
		699	895
CURRENT ASSETS			
Financial assets classified as held for trading (of which $47,183 million (2011: $37,643 million) were pledged to various parties)	13	351,235	361,018
Financial assets designated at fair value through profit or loss	14	7,668	8,691
Loans and receivables			
- Cash at bank	15	12,408	11,999
- Debtors	16	197,982	201,019
Other assets	17	837	605
		570,130	583,332
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities classified as held for trading	13	(315,569)	(333,157)
Financial liabilities designated at fair value through profit or loss	14	(6,603)	(10,902)
Financial liabilities at amortised cost	19	(204,370)	(204,286)
Other creditors	20	(1,377)	(1,310)
		(527,919)	(549,655)
NET CURRENT ASSETS		42,211	33,677
TOTAL ASSETS LESS CURRENT LIABILITIES		42,910	34,572
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit or loss	14	(5,987)	(2,903)
Financial liabilities at amortised cost	19	(18,145)	(13,477)
PROVISIONS FOR LIABILITIES	21	(153)	(70)
NET ASSETS EXCLUDING PENSION LIABILITIES		18,625	18,122
Pension liabilities	26	(5)	(6)
NET ASSETS INCLUDING PENSION LIABILITIES		18,620	18,116

CONSOLIDATED BALANCE SHEET (CONTINUED)
As at 31 December 2012

	Note	2012 $millions	2011 $millions
CAPITAL AND RESERVES			
Called up share capital	23	1,614	1,614
Capital redemption reserve	24	1,400	1,400
Currency translation reserve	24	(332)	(534)
Capital contribution reserve	24	6,041	6,041
Available-for-sale reserve	24	21	28
Pension reserve	24	(125)	(116)
Profit and loss account	24	9,903	9,589
EQUITY SHAREHOLDERS' FUNDS		18,522	18,022
MINORITY INTEREST	24	98	94
TOTAL EQUITY		18,620	18,116

These financial statements were approved by the Board and authorised for issue on 25 September 2013.

Signed on behalf of the Board

CE Woodman

Director

The notes on pages 19 to 91 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 2012. 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.

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 Group operates.

All currency amounts in the financial statements and Directors' report are rounded to the nearest million US dollars, except when otherwise indicated.

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 financial assets classified as available-for-sale are recorded in the 'Available-for-sale reserve' in equity, with the exception of translation differences on the amortised cost of monetary available-for-sale assets, which are recognised through the consolidated profit and loss account. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Translation differences arising from net investments in foreign operations are taken to the 'Foreign currency revaluation reserve'. All other translation differences are taken through the consolidated profit and loss account. 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.

1. ACCOUNTING POLICIES (CONTINUED)

d. Foreign currencies (continued)

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 Group is reclassified to the consolidated profit and loss account and recorded within gain or loss on disposal.

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 assets; 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's terms are agreed (trade date), until the loan is funded (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 is recognised as a financial asset 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.

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'.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments (continued)

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).

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.

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 consolidated 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 consolidated 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 'Available-for-sale reserve' within equity.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the 'Available-for-sale reserve' is reclassified to the consolidated 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.

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.

1. ACCOUNTING POLICIES (CONTINUED)

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 product. 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 considers 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.

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.

1. ACCOUNTING POLICIES (CONTINUED)

f. Fair value of financial instruments (continued)

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.

Valuation process

The Valuation Review Group ("VRG") within the Financial Control Group is responsible for the Group's fair value valuation policies, processes and procedures. VRG is independent of the business units and reports to the Chief Financial Officer ("CFO"), who has final authority over the valuation of the Group's financial instruments. VRG implements valuation control processes to validate the fair value of the Group's financial instruments measured at fair value including those derived from pricing models. These control processes are designed to ensure 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 ensure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable.

The Group's control processes apply to all financial instruments, unless otherwise noted. These control processes include:

Model Review. VRG, in conjunction with the Market Risk Department and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer, independently review valuation models' theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VRG reviews the appropriateness of the proposed valuation methodology to ensure it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilised in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit's valuation model. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Group's valuation models are subject to an independent annual VRG review.

Independent Price Verification. The business units are responsible for determining the fair value of financial instruments using approved valuation models and valuation methodologies. Generally on a monthly basis, VRG independently validates the fair values of financial instruments determined using valuation models by determining the appropriateness of the inputs used by the business units and by testing compliance with the documented valuation methodologies approved in the model review process described above.

VRG uses recently executed transactions, other observable market data such as exchange data, broker/dealer quotes, third-party pricing vendors and aggregation services for validating the fair values of financial instruments generated using valuation models. VRG assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources are evaluated using a number of approaches; for example, by corroborating the external sources' prices to executed trades, by analysing the methodology and assumptions used by the external source to generate a price and/or by evaluating how active the third-party pricing source (or originating sources used by the third-party pricing source) is in the market. Based on this analysis, VRG generates a ranking of the observable market data to ensure that the highest-ranked market data source is used to validate the business unit's fair value of financial instruments.

For financial instruments where the fair value is based on unobservable inputs, VRG reviews the business unit's valuation techniques to ensure these are consistent with market participant assumptions.

1. ACCOUNTING POLICIES (CONTINUED)

f. Fair value of financial instruments (continued)

The results of this independent price verification and any adjustments made by VRG to the fair value generated by the business units are presented to management of the Morgan Stanley Group's three business segments (i.e., Institutional Securities, Global Wealth Management Group and Asset Management), the CFO and the Chief Risk Officer on a regular basis.

Review of Transactions where the valuation is based on unobservable inputs. VRG reviews the models and valuation methodology used to price all new material Level 3 transactions and both the Financial Control Group and Market Risk Department management must approve the fair value of the trade that is initially recognised.

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.

g. Derecognition of financial assets and liabilities

The Group derecognises a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risk and rewards of ownership of the asset.

The Group derecognises financial liabilities when the Group's obligations are discharged, cancelled or they expire.

h. 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 loans and receivables, financial assets classified as available-for-sale fixed asset investments and other fixed asset investments. 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 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 expense' and are recognised 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.

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

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the 'Available-for-sale reserve' through the consolidated 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 (v). 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.

1. ACCOUNTING POLICIES (CONTINUED)

i. 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.

j. 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'.

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.

k. 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.

l. 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.

1. ACCOUNTING POLICIES (CONTINUED)

l. Taxation (continued)

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.

m. Employee compensation plans

(i) Equity-settled share-based compensation plans

Morgan Stanley operates equity based compensation plans on behalf of the Group, in relation to which the Group pays Morgan Stanley in consideration of the procurement of the transfer of shares to employees. The cost of equity based 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 the 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 FRS 20 Share-based payment ("FRS 20") purposes is recorded within 'Staff costs' in 'Other expense' in the consolidated profit and loss account; corresponding credit to the consolidated profit and loss account 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/ (losses) on financial instruments classified as held for trading' in the consolidated profit and loss account.

n. Retirement benefits

The Group operates defined contribution schemes and defined benefit pension schemes.

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

For the Group's defined benefit schemes, 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 scheme liabilities. Scheme assets are measured at their fair value. A surplus of scheme assets over liabilities is recognised in the balance sheet as an asset where recoverable. Where scheme liabilities exceed scheme assets, the deficit is recognised in the consolidated balance sheet as a liability. The current service cost and any past service costs are charged to 'Other expense'. The expected return on scheme assets and the unwinding of the discount on the scheme 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 schemes are given in note 26 of the consolidated financial statements.

1. ACCOUNTING POLICIES (CONTINUED)

o. Cash flow statement

The Group's ultimate parent undertaking produces consolidated financial statements in which the Group is included and which are publicly available. Accordingly, the Group, which is wholly-owned subsidiary, has elected to avail itself of the exemption provided in FRS 1 (Revised 1996) *Cash Flow Statements* and 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

	2012 $millions	2011 $millions
Dividend income	8	1
Net fair value gains reclassified from the available-for-sale reserve on disposal of asset	53	-
	61	1

3. INTEREST INCOME

	2012 $millions	2011 $millions
Interest income from loans to other Morgan Stanley Group undertakings	1,318	1,547
Other interest income	1,410	2,724
	2,728	4,271

Other interest income includes $3 million (2011: $11 million) of interest income accrued on impaired loans and receivables.

4. INTEREST EXPENSE

	2012 $millions	2011 $millions
Interest expense on bank loans	4	7
Interest expense on loans from other Morgan Stanley Group undertakings	1,734	3,067
Net pension scheme finance cost	1	-
Other interest expense	1,384	1,708
	3,123	4,782
Less: Interest capitalised on assets in the course of construction	-	(1)
	3,123	4,781

5. OTHER INCOME

	2012 $millions	2011 $millions
Fee and commission income	1,361	1,045
Non-UK capital gains tax recoverable	2	149
Other	211	210
	1,574	1,404

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. Such tax incurred by the Group in relation to these equity transactions is included in ‘Income tax expense’ in the consolidated profit and loss account (see note 9).

6. OTHER EXPENSE

	2012 $millions	2011 $millions
Fee and commission expense:		
Brokerage fee and commission expense	651	665
Staff costs (note 7)	1,274	1,245
Management charges from other Morgan Stanley Group undertakings relating to staff costs	841	896
Management charges from other Morgan Stanley Group undertakings relating to other services	668	323
Bank levy:		
- Current year expense	38	46
- Prior year over provision	(11)	-
Impairment losses on loans and receivables (note 28)	35	3
Reversal of impairment losses on loans and receivables (note 28)	(29)	(32)
Realised losses on loans and receivables	38	16
Operating lease rentals	73	68
Depreciation on property, plant and equipment (note 10)	105	135
Amortisation of goodwill	-	10
Auditor's remuneration - audit of Company's subsidiaries	6	4
Net foreign exchange losses	-	28
Administration and corporate services	490	432
Other expenses	439	443
	4,618	4,282

Included within both staff costs and management charges from other Morgan Stanley Group undertakings relating to staff costs is an amount of $176 million (2011: $291 million) in relation to equity-settled share-based compensation plans, granted to employees of the Group. 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 auditor for the audit of the Company's annual accounts are $130,000 (2011: $124,000). Fees payable to the Company's auditor for non-audit services are $323,000 (2011: $300,000).

7. STAFF COSTS

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

	2012	2011
Company and institutional securities infrastructure	2,773	2,876
Business units and other	1,352	1,329
	4,125	4,205

The cost of staff including Directors is analysed below:

	2012 $millions	2011 $millions
Wages and salaries	1,089	1,078
Social security costs	140	119
Pension costs	45	48
	1,274	1,245

8. DIRECTORS' BENEFITS

	2012 $millions	2011 $millions
Total emoluments of all Directors:		
Aggregate emoluments	6	10
Long term incentive schemes	15	3
	21	13
Disclosures in respect of the highest paid Director:		
Aggregate emoluments	2	2
Long-term incentive schemes	4	1

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

All Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group’s equity based long-term incentive schemes. 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 schemes, including the highest paid Director (2011: none).

The value of assets (other than shares or share options) awarded under other long-term incentive schemes 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 eight Directors to whom retirement benefits are accruing under a money purchase scheme (2011: nine). The Morgan Stanley UK Group Pension Plan operated a defined benefit pension scheme, which closed in September 1996. Two Directors have deferred defined benefits under the scheme (2011: three).

9. TAX ON PROFIT ON ORDINARY ACTIVITIES

Analysis of expense in the year

	2012 $millions	2011 $millions
UK corporation tax at 24.50% (2011: 26.49%)		
- Current year	102	232
- Adjustment in respect of prior years	(1)	(28)
	101	204
Double taxation relief		
- Current year	(54)	(87)
- Adjustment in respect of prior years	7	(45)
Foreign Tax		
- Current year	167	193
- Adjustment in respect of prior years	9	146
Total current tax	230	411
Deferred taxation		
- Current year	(57)	13
- Adjustment in respect of prior years	1	(6)
- Impact of change in the UK corporation tax rate	8	7
Total deferred tax	(48)	14
Tax on profit on ordinary activities	182	425

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

	2012 $millions	2011 $millions
Net current and deferred tax		
Tax on currency translation differences on foreign currency net investments		
- current year	2	5
- unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	(3)	-
- adjustments in respect of prior years	1	4
Net current and deferred tax recognised in the statement of total recognised gains and losses	-	9

9. TAX ON PROFIT ON ORDINARY ACTIVITIES (CONTINUED)

Factors affecting the tax expense for the year

The current year UK taxation charge is higher (2011: higher) than that resulting from applying the standard UK corporation tax rate of 24.50% (2011: 26.49%). The main differences are explained below:

	2012 $millions	2011 $millions
Profit on ordinary activities before tax	494	1,535
Profit on ordinary activities multiplied by the standard rate of corporation tax in the UK of 24.50% (2011: 26.49%)	121	407
Effects of:		
Expenses not deductible for tax purposes:		
UK bank levy	7	12
Interest expense	2	2
Other	10	14
Carried forward/(utilisation) of tax losses	4	(10)
Group relief received for no cash consideration	(5)	-
Depreciation in the year in excess of capital allowances	1	1
Non taxable gain on disposal of fixed asset investments	(14)	(12)
Reversal of timing differences relating to compensation	(1)	(19)
Currency translation on tax	-	(9)
Higher/(lower) rate taxes on overseas earnings	28	(3)
Deferred interest	48	-
Other timing difference	2	(8)
Tax expensed	-	(40)
Tax reserves movement relating to previous years	15	31
Adjustments to the tax charge in respect of previous years	(1)	41
Other	13	4
Current tax expense for the year	230	411

Finance Act 2011 enacted a reduction to the UK corporation tax rate to 25% with effect from April 2012. Finance Act 2012 increased the reduction by a further 1%. The combined reduction in the rate to 24% from April 2012 impacted the current tax charge in 2012.

Finance Act 2012 also enacted an additional reduction of 1% in the UK corporation tax rate to 23% with effect from April 2013. This further reduction in the tax rate will impact the current tax charge in 2013.

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. 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 2012	3	892	28	491	1,414
Additions	-	29	-	-	29
Disposals	-	-	-	(2)	(2)
Transfers	-	-	(24)	24	-
Foreign exchange revaluation on assets held in overseas subsidiaries	-	1	-	2	3
At 31 December 2012	3	922	4	515	1,444
Depreciation					
At 1 January 2012	-	314	-	401	715
Charge for the year	-	56	-	49	105
Disposals	-	-	-	(1)	(1)
Foreign exchange revaluation on assets held in overseas subsidiaries	-	1	-	1	2
At 31 December 2012	-	371	-	450	821
Net book value					
At 31 December 2011	3	578	28	90	699
At 31 December 2012	3	551	4	65	623

Interest capitalised on assets in the course of construction included within additions during the year amounted to $nil (2011: $1 million). The cumulative amount of interest capitalised in the total cost of tangible fixed assets amounts to $23 million (2011: $23 million). The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

11. 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:

	2012 $millions	2011 $millions
Corporate equities	76	196
	76	196

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

	2012 $millions	2011 $millions
Fair value		
At 1 January	196	151
Additions	2	-
Changes in fair value recognised in the 'Available-for-sale reserve'	46	50
Foreign exchange revaluation	-	(4)
Disposals and other settlements	(168)	(1)
At 31 December	76	196

Included in 'Available-for-sale financial assets' are listed investments of $2 million (2011: $98 million).

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

12. DISPOSAL OF SUBSIDIARY AND JOINT VENTURE

a) Disposal of subsidiaries

During the year the Group disposed of two wholly-owned subsidiaries (2011: two), Morgan Stanley Euro Financing (Luxembourg) and Morgan Stanley Moselle S.à r.l. to another Morgan Stanley Group undertaking outside of the Group. The subsidiaries that were disposed of were non-US dollar functional currency entities. The subsidiaries were sold for consideration equal to their net book value, however, as a consequence of the sale, accumulated foreign currency translation losses amounting to $30 million (2011: $5 million gain) were reclassified from the "Currency translation reserve" to the consolidated profit and loss account within "Net currency (loss)/ gain on disposal of subsidiaries". This reclassification did not have an impact on the net assets of the Group.

The carrying value of the net assets of these subsidiaries at the date of disposal was as follows:

	2012 At disposal $millions	2011 At disposal $millions
ASSETS		
Trade receivables	1,920	-
	1,920	-
Total consideration received	1,920	-
Reclassification of net cumulative currency translation (losses)/gains	(30)	5
(Loss)/ gain on disposals	(30)	5

12. DISPOSAL OF SUBSIDIARY AND JOINT VENTURE (CONTINUED)

b) Disposal of Joint Venture

During 2011, 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 Tarvos and accounted for the investment using the equity method of accounting as the majority of the risks and rewards of Tarvos 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:

	2012		2011	
	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	230,392	222,329	224,566	217,825
- Foreign exchange forward contracts and options	9,389	9,142	26,270	26,535
- Equity securities contracts (including equity swaps, warrants and options)	37,354	41,269	45,522	48,165
- Commodity forwards, options and swaps	4,445	4,652	13,960	13,743
	281,580	277,392	310,318	306,268
Government debt securities	19,410	17,043	10,500	10,164
Corporate and other debt	11,264	2,095	13,780	2,543
Corporate equities	38,981	19,039	26,420	14,182
Total financial instruments classified as held for trading	351,235	315,569	361,018	333,157

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 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.

Customer 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.

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.

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.

Financial assets and financial liabilities designated at fair value through profit or loss are summarised in the table below:

	2012		2011	
	Assets $millions	**Liabilities $millions**	**Assets $millions**	**Liabilities $millions**
Fair value				
Prepaid OTC contracts	4,311	3,174	3,264	2,676
Customer loans	1,193	-	1,442	-
Issued structured notes	-	1,390	-	1,099
Other financial assets and liabilities	2,164	8,026	3,985	10,030
Total financial instruments designated at fair value through profit or loss	7,668	12,590	8,691	13,805

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 $1,193 million (2011: $1,442 million). The cumulative change in fair value of loans attributable to changes in credit risk amounts to a gain of $4 million (2011: $4 million). 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.

The change in fair value of financial liabilities designated at fair value through profit or loss recognised through the consolidated income statement attributable to own credit risk is a loss of $187 million (2011: $128 million gain) and cumulatively is $62 million gain (2011: $249 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. The carrying amount of financial liabilities designated at fair value through profit or loss is $59 million higher than the contractual amount due at maturity (2011: $144 million lower).

Included within financial liabilities designated at fair value through profit or loss is an amount of $3,865 million (2011: $2,903 million) that is expected to be settled after more than 12 months.

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 $7,520 million (2011: $8,173 million) which represents segregated client money, held in accordance with the FSA's Client Money Rules, and an amount of $405 million (2011: $8 million) which represents other client money.

16. DEBTORS

	2012 $millions	2011 $millions
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	50,704	53,606
- Morgan Stanley Group undertakings	18,782	17,646
Securities purchased under agreements to resell and cash collateral on securities borrowed:		
- External counterparties	72,340	79,250
- Morgan Stanley Group undertakings	53,998	44,729
Corporate loans	1,669	2,129
Other amounts due from Morgan Stanley Group undertakings	484	1,620
Other debtors classified within loans and receivables	5	2,039
	197,982	201,019

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

	2012 $millions	2011 $millions
Corporate loans:		
- between one and five years	1,608	2,044
- over five years	61	85
	1,669	2,129

17. OTHER ASSETS

	2012 $millions	2011 $millions
Deferred taxation (see note 18)	201	160
Corporation tax recoverable	215	78
Other tax recoverable	148	144
Prepayments and accrued income	273	223
	837	605

18. DEFERRED TAX

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

	2012		2011	
	Asset $millions	Liability $millions	Asset $millions	Liability $millions
Accelerated capital allowances	20	(34)	18	(37)
Tax losses carried forward	3	-	3	-
Deferred compensation	112	-	126	(1)
Deferred interest	45	-	-	-
Revaluation of available-for-sale financial assets	-	(1)	-	(1)
Other timing differences	13	(2)	5	(2)
Amounts not recognised due to unobservable market data	8	-	11	-
Hedges of forecast currency transactions	-	(6)	(3)	(5)
Unrealised gains	-	-	-	(1)
	201	(43)	160	(47)

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

	2012		2011	
	Asset $millions	Liability $millions	Asset $millions	Liability $millions
At 1 January	160	(47)	184	(52)
Amounts recognised in the consolidated profit and loss account:				
- Current year timing differences	54	4	(16)	3
- Prior year timing differences	2	(3)	6	-
Amounts recognised in equity through the consolidated statement of recognised gains and losses:				
- Current year timing differences	(2)	-	(2)	(1)
Impact of change in UK corporation tax rate	(14)	3	(11)	3
Foreign exchange revaluation	1	-	(1)	-
At 31 December	201	(43)	160	(47)

As at 31 December 2012, a total deferred tax asset of $22 million (2011: $20 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 2012 enacted further reductions in the rate of UK corporation tax to 24% with effect from April 2012 and 23% with effect from April 2013. This overall rate reduction to 23% has had an impact on the Group’s deferred tax balance as indicated above.

Finance Act 2013 enacted reductions in the UK corporation tax to 21% with effect from April 2014 and 20% with effect from April 2015. However, as neither rate reduction was substantively enacted as at 31 December 2012, their effect has not been applied to the valuation of the Group’s deferred tax assets and liabilities.

19. FINANCIAL LIABILITIES AT AMORTISED COST

	2012 $millions	2011 $millions
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	588	762
Trade creditors:		
- External counterparties	73,830	65,850
- Morgan Stanley Group undertakings	13,958	22,363
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	50,218	42,382
- Morgan Stanley Group undertakings	57,784	56,194
Corporate deposits	1,820	4,451
Other amounts owing to Morgan Stanley Group undertakings	6,066	9,495
Other financial liabilities	106	2,789
	204,370	204,286
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	10,595	10,569
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	3,516	1,654
- Morgan Stanley Group undertakings	809	-
Corporate deposits	2	-
Other amounts owing to Morgan Stanley Group undertakings	3,223	1,254
	18,145	13,477
Total financial liabilities at amortised cost	222,515	217,763

Total financial liabilities at amortised cost of $14,136 million (2011: $11,622 million), included in the above, fall due for payment after five years from the balance sheet date. This consists of securities sold under agreements to repurchase with external counterparties of $324 million (2011: $nil), subordinated loans of $10,595 million (2011: $10,569 million) and other loan amounts owing to Morgan Stanley Group undertakings of $3,217 million (2011: $1,053 million). Details of terms relating to the loans are set out in the table below. Of this, $nil (2011: $nil) is payable by instalments.

19. FINANCIAL LIABILITIES AT AMORTISED COST (CONTINUED)

Loans repayable after five years

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

Counterparty	Maturity date	Interest rate	2012 $millions	2011 $millions
Morgan Stanley International Holdings Inc (1)	31 July 2019	3 month LIBOR plus 1.25%	406	388
Morgan Stanley UK Financing I LP (1)	31 October 2025	3 month LIBOR plus 1.25%	820	820
Morgan Stanley UK Financing II LP (1)	31 October 2021	6 month LIBOR plus 1.25%	1,300	1,300
Morgan Stanley International Holdings Inc. (1)	15 December 2021	3 month LIBOR plus 1.25%	163	155
Morgan Stanley UK Financing I LP (1)	31 October 2025	3 month LIBOR plus 1.25%	7,906	7,906
Great St. Helen Finance Limited	31 May 2020	Canadian dollar proxy related rate (2)	1,076	1,053
Morgan Stanley UK Financing III LP	31 December 2030	US dollar proxy related rate (2)	2,141	-
			13,812	11,622

(1) All amounts outstanding under subordinated loan agreements 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 FSA, which has the right under the agreement to refuse consent to repayment.

(2) Proxy interest rates are established by the Morgan Stanley Group Treasury function for all entities within the Morgan Stanley Group and approximate the market rate of interest that Morgan Stanley Group incurs in funding its business.

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

20. OTHER CREDITORS

	2012 $millions	2011 $millions
Amounts falling due within one year		
Corporation tax payable	264	108
Deferred taxation (see note 18)	43	47
Other taxes and social security costs	337	332
Accruals and deferred income	733	823
	1,377	1,310

21. PROVISIONS FOR LIABILITIES AND CHARGES

	Property $millions	Litigation $millions	Total $millions
At 1 January 2012	64	6	70
Additional provisions	12	87	99
Provisions utilised	(10)	(9)	(19)
Effect of unwinding discount rate	4	-	4
Unused provision reversed	-	(5)	(5)
Foreign exchange movements	4	-	4
At 31 December 2012	74	79	153

21. PROVISIONS FOR LIABILITIES AND CHARGES (CONTINUED)

Property provisions

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions 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' (note 10).

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. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress. These actions have included, but are not limited to, residential mortgage and credit crisis related matters. Over the last several years, the level of litigation and investigatory activity focused on residential mortgage and credit crisis related matters has increased materially in the financial services industry. As a result, the Group may become the subject of increased claims for damages and other relief regarding residential mortgages and related securities in the future and, 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 losses.

The Group is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Group's business and involving, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

The Group contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the consolidated financial statements and the Group can reasonably estimate the amount of that loss, the Group accrues the estimated loss by a charge to income. In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. In addition, even where loss is possible or an exposure to loss exists in excess of the liability already accrued with respect to a previously recognized loss contingency, it is not always possible to reasonably estimate the size of the possible loss or range of loss.

For certain legal proceedings, the Group cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

For certain other legal proceedings, the Group can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Group's consolidated financial statements as a whole, other than the matters referred to in the following paragraphs.

21. PROVISIONS FOR LIABILITIES AND CHARGES (CONTINUED)

Litigation matters (continued)

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 plc and Cheyne Finance LLC (together, 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 United States District Court for 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, including because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. The plaintiffs currently assert allegations of aiding and abetting fraud and negligent misrepresentation relating to approximately $852 million of securities issued by the Cheyne SIV. The plaintiffs' motion for class certification was denied in June 2010. The court denied the Morgan Stanley Group's and the Group's motion for summary judgment on the aiding and abetting fraud claim in August 2012. On 30 November 2012, the Morgan Stanley Group and the Group filed a motion for summary judgment on the negligent misrepresentation claim. On 24 April 2013, the parties reached an agreement to settle this matter. On 26 April 2013, the court dismissed the action with prejudice. The settlement does not cover claims that were previously dismissed. On 23 May 2013, certain parties in this matter filed a notice of appeal as to certain claims dismissed from the matter prior to the settlement by the remaining parties.

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 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 1 July 2013, the European Commission ("EC") issued a Statement of Objections ("SO") addressed to twelve financial firms (including the Group), the International Swaps and Derivatives Association, Inc. ("ISDA") and Markit Group Limited ("Markit") and various affiliates alleging that, between 2006 and 2009, the recipients breached EU competition law by taking and refusing to take certain actions in an effort to prevent the development of exchange traded CDS products. The SO indicates that the EC plans to impose remedial measures and fines on the recipients. The Group and the other recipients have been given an opportunity to respond to the SO. An affiliate of the Group and others have also responded to an ongoing investigation by the Antitrust Division of the United States Department of Justice related to the CDS market.

In addition, 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 and Rhinebridge LLC (together the "Rhinebridge SIV"). The case is styled *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.* and is pending in the SDNY before the same judge presiding over the litigation concerning the Cheyne SIV, described above. The complaint 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. The court dismissed plaintiffs' claims for breach of fiduciary duty and negligence on 4 May 2012. On 7 September 2012 the Morgan Stanley Group and the Group moved for summary judgment with respect to the remaining claims for fraud, negligent misrepresentation and aiding and abetting fraud. On 3 January 2013 the court granted the motion for summary judgment with respect to the fraud and negligent misrepresentation claims and denied it with respect to the aiding and abetting fraud claim. On 24 April 2013, the parties reached an agreement to settle this matter. On 26 April 2013, the court dismissed the action with prejudice.

21. PROVISIONS FOR LIABILITIES AND CHARGES (CONTINUED)

Litigation matters (continued)

In addition to the matters disclosed above, on 2 October 2012, the United States Court of Appeals for the Second Circuit affirmed the 27 June 2011 judgment of the SDNY in *Citibank, N.A. v. Morgan Stanley & Co. International plc* in favour of Citibank, N.A. for $269 million plus post-judgment interest and costs. The Group has satisfied the judgment. In compliance with certain intra-group policies of the Morgan Stanley Group, all costs related to this matter were transferred to other Morgan Stanley Group undertakings outside of the Group.

22. COMMITMENTS AND CONTINGENCIES

At 31 December 2012 and 31 December 2011, the Group had the following outstanding commitments and contingent liabilities arising from off-balance sheet financial instruments:

Contingent liabilities	**2012 $millions**	**2011 $millions**
Financial guarantees	19	47
Contingent commitments	2,212	3,058
	2,231	3,105

Commitments	**2012 $millions**	**2011 $millions**
Lease commitments	97	77
Loan commitments	4,448	3,196
Underwriting commitments	44	156
Unsettled reverse repurchase agreements	25,370	22,448
	29,959	25,877

Leases

During the next year, the Group is committed to pay $97 million (2011: $77 million) in respect of operating leases as follows:

	Land and buildings 2012 $millions	**Land and buildings 2011 $millions**
Annual commitments under operating leases expiring:		
- Within one year	2	1
- In two to five years	28	19
- After more than five years	67	57
	97	77

Contingent liability relating to tax

The tax position of a subsidiary undertaking of the Group is currently under review by the Dutch tax authorities. The review has not progressed sufficiently to determine the timings of resolution or the amount of any outflow. The current estimate of the maximum amount payable, if any, arising from this review is Euro 124 million.

23. CALLED UP SHARE CAPITAL

	2012 $millions	2011 $millions
Allotted and fully paid:		
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 rates 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	Currency translation reserve	Capital contribution reserve	Available-for-sale reserve	Pension reserve	Profit and loss account	Minority Interest	Total
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
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
Reclassification of foreign currency translation differences on liquidation of subsidiary	-	-	11	-	-	-	(11)	-	-
Reclassification of foreign currency translation differences on disposal of subsidiaries	-	-	(5)	-	-	-	-	-	(5)
Actuarial losses on defined benefit pension schemes	-	-	-	-	-	(9)	-	-	(9)
Income tax relating to components of other comprehensive income	-	-	9	-	-	-	-	-	9
Total recognised gains and losses	-	-	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)
Capital infusion by minority interest into preference shares	-	-	-	-	-	-	-	-	-
Repayment of capital to minority interest	-	-	-	-	-	-	-	(20)	(20)
Balance at 1 January 2012	1,614	1,400	(534)	6,041	28	(116)	9,589	94	18,116
Profit for the year	-	-	-	-	-	-	311	1	312
Recognised gains for the year	-	-	172	-	46	-	-	3	221
Reclassification of amounts relating to available for sale financial assets to the profit and loss account	-	-	-	-	(53)	-	-	-	(53)
Reclassification of foreign currency translation differences on disposal of subsidiaries	-	-	30	-	-	-	-	-	30
Actuarial losses on defined benefit pension schemes	-	-	-	-	-	(9)	-	-	(9)
Total comprehensive income	-	-	202	-	(7)	(9)	311	4	501
Share-based payments	-	-	-	-	-	-	3	-	3
Balance at 31 December 2012	1,614	1,400	(332)	6,041	21	(125)	9,903	98	18,620

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

Reserves

Capital redemption reserve

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

Currency translation reserve

The 'Currency translation reserve' comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations with functional 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 accumulated foreign exchange losses totalling $30 million were reclassified from the 'currency translation reserve' to the consolidated profit and loss account (see note 12).

Capital contribution reserve

The 'Capital contribution reserve' comprises contributions of capital from the Group's parent company, Morgan Stanley International Holdings Inc. This reserve is classified as a distributable reserve in accordance with relevant company legislation.

Available-for-sale reserve

The 'Available-for sale 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 'Available-for sale 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 two reportable business segments; Institutional securities and Asset management. Institutional securities include the following activities: financial advisory and capital raising 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. Asset management includes a range of alternative investment, real estate investing and merchant banking products for institutional investors and high net worth individuals.

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

2012

Consolidated profit and loss information	**Institutional securities $millions**	**Asset management $millions**	**Other $millions**	**Total $millions**
Net gains on financial instruments held for trading	3,805	-	-	3,805
Net gains on financial instruments designated at fair value through profit or loss	97	-	-	97
Net gains on available-for-sale financial assets	61	-	-	61
Net interest	(398)	(1)	4	(395)
Other income	940	619	15	1,574
External revenues net of interest expense	4,505	618	19	5,142
Other expense	(4,026)	(577)	(15)	(4,618)
Net loss on disposal of subsidiaries	(30)	-	-	(30)
Profit on ordinary activities before taxation	449	41	4	494
Balance sheet information				
Net assets	17,883	91	646	18,620

25. SEGMENTAL REPORTING (CONTINUED)

Business segments (continued)

2011

Consolidated profit and loss information	Institutional securities $millions	Asset management $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	(515)	(1)	6	(510)
Other income	1,069	325	10	1,404
External revenues net of interest expense	5,367	408	16	5,791
Other expense	(3,948)	(322)	(12)	(4,282)
Net gains on disposal of subsidiaries and disposal of joint venture	26	-	-	26
Profit on ordinary activities before taxation	1,445	86	4	1,535
Balance sheet information				
Net assets	18,039	67	10	18,116

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 revenues net of interest expense balance presented is based on the origin of the income, which is not materially different to revenues net of interest expense based on the destination of income.

2012

Consolidated profit and loss information	EMEA $millions	Americas $millions	Asia $millions	Total $millions
Net gains on financial instruments held for trading	3,751	13	41	3,805
Net gains on financial instruments designated at fair value through profit or loss	97	-	-	97
Net gains on available-for-sale financial assets	61	-	-	61
Net interest	(422)	(11)	38	(395)
Other income	1,384	168	22	1,574
External revenues net of interest expense	4,871	170	101	5,142
Other expense	(4,278)	(245)	(95)	(4,618)
Net loss on disposal of subsidiaries	(30)	-	-	(30)
Profit on ordinary activities before taxation	563	(75)	6	494
Balance sheet information				
Net assets	14,194	3,061	1,365	18,620

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	(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

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:

- Morgan Stanley UK Group Pension Plan and the Morgan Stanley UK Group Top-Up Pension Plan
- Morgan Stanley Investment Management (Athens Branch) Group Insurance Policy
- Morgan Stanley Flexible Company Pension Plan (Amsterdam Branch)
- Morgan Stanley Investment Management Luxembourg Branch Supplementary Pension Scheme
- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- MSII Offshore Retirement Benefit Plan IV, Dubai Section
- Morgan Stanley Asia Limited Retirement Benefit Plan (Taiwan)
- Paschi Previdenza (a Milan multi employer defined contribution scheme)
- Morgan Stanley Bank International Ltd Seoul Branch Defined Contribution plan (a Korean multi employer defined contribution plan)

During the year, the Athens Branch of Morgan Stanley & Co. International plc was closed along with its associated defined contribution plan (the Morgan Stanley & Co. International plc (Greece Branch) Group Insurance Policy). At the time of closure, there were no outstanding contributions.

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

The defined contribution pension charge recognised within ‘Staff costs’ in ‘Other expense’ in the consolidated profit and loss account was $42 million for the year (2011: $39 million) of which $nil was accrued at 31 December 2012 (2011: $nil).

Defined benefit Plan

Morgan Stanley UK Group Defined Benefit Pension Plan

The Morgan Stanley UK Group Pension Plan (the “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 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 are held in a separate Trustee-administered fund to meet long-term pension liabilities. The Trustees of the fund are required to act in the best interest of the fund’s beneficiaries. The appointment of Trustees to the Plan is determined by the Plan’s trust documentation. The Morgan Stanley UK Group has a policy that one third of Trustees should be nominated by members of the fund.

The most recent full 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 2012. 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. Under this method, each participant’s benefits under the Plan are attributed to years of service, taking into consideration future salary increases (if applicable) and the Plan’s benefit allocation formula. For the defined benefit section of the Plan, accrual of future benefits ceased in 1996 and no further benefit has been attributed to service during subsequent reporting periods. The accumulated benefit obligation is therefore 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. At the balance sheet date the accumulated benefit obligation was $206 million (2011: $183 million).

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan expense

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

	2012 $millions	2011 $millions
Expected return on Plan assets	8	8
Interest on obligation	(9)	(8)
Total defined benefit Plan expense	(1)	-

Of the charge for the year, $1 million (2011: $nil) has been included in 'Interest expense'. Actuarial losses, including the impact of the surplus cap, of $8 million (2011: $9 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 arising from changes in actuarial assumptions, the impact of foreign exchange rate changes on Plan assets and liabilities and the movement in the Plan surplus cap.

The cumulative amount of actuarial losses recognised in the 'Statement of total recognised gains and losses', including the effect of the surplus cap, is $124 million (2011: $116 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 balance sheet, as well as a summary of the funded status of the Plan:

	2012 $millions	2011 $millions
Present value of funded defined benefit obligation	(206)	(183)
Fair value of Plan assets	250	229
	44	46
Adjustment for ceiling	(44)	(46)
Retirement benefit asset recognised in the consolidated balance sheet	-	-

Contributions for the year to the closed defined benefit section of the Plan totalled $10 million (2011: $10 million), of which $nil was accrued at 31 December 2012 (2011: $nil). The Group expects to contribute $11 million (2011: $10 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)

Defined benefit Plan (continued)

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

	2012 $millions	2011 $millions
Defined benefit obligation at 1 January	183	145
Interest cost	9	8
Actuarial loss	10	34
Benefits paid	(4)	(3)
Foreign exchange rate changes	8	(1)
Defined benefit obligation at 31 December	206	183

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

	2012 $millions	2011 $millions
Fair value of Plan assets at 1 January	229	167
Expected return on Plan assets	8	8
Actuarial (loss)/gain	(3)	49
Employer contributions	10	10
Benefits paid	(4)	(3)
Foreign exchange rate changes	10	(2)
Fair value of Plan assets at 31 December	250	229
Actual return on Plan assets	5	57

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	
	2012 %	2011 %	2012 $millions	2011 $millions
Equity securities	7.0	7.0	1	2
Fixed income securities	3.4	3.2	249	227
			250	229

In conjunction with the Trustees, during 2008 the Group conducted an asset-liability review for its major plans. These studies are used to assist the Trustees 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 Trustees in managing the volatility in the underlying investment performance and risk of a significant increase in the Plan obligations by providing information used to determine the pension Plan’s investment strategy.

Assets are managed on both an active and passive basis, relative to widely used industry benchmarks.

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.

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

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 stabilise Plan contributions over the long run.

The change in the proportion of equity securities is as a result of the relative investment returns of equities compared to fixed income securities rather than a change in investment strategies.

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

	2012	**2011**
Pre-retirement discount rate	3.8%	4.6%
Post-retirement discount rate	4.0%	3.6%
Rate of increase in pensions in deferment	2.3%	2.4%
Inflation assumption	3.0%	3.1%
Expected long-term rate of return on Plan assets:		
- Equity securities	7.0%	7.0%
- Fixed income securities	3.4%	3.2%

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 2012				
UK	89.5	92.3	92.0	95.0
31 December 2011				
UK	89.3	92.2	91.9	94.8

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 8.04%/8.91%
Inflation assumption	Increase / decrease by 0.25%	Increase / decrease by 4.81%/ 4.50%
Rate of mortality	Increase by 1 year	Increase by 2.37%

26. RETIREMENT BENEFITS (CONTINUED)

Defined benefit Plan (continued)

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

	2012	2011	2010	2009	2008
Present value of defined benefit obligation ($millions)	(206)	(183)	(145)	(148)	(132)
Fair value of Plan assets ($millions)	250	229	167	151	149
Surplus ($millions)	44	46	22	3	17
Experience adjustments on Plan liabilities:					
- Amount ($millions)	(2)	2	(10)	-	-
- Percentage of Plan liabilities (%)	1%	1%	(7)%	-	-
Experience adjustments on Plan assets					
- Amount ($millions)	(3)	(49)	(9)	27	-
- Percentage of Plan assets (%)	1%	(20)%	(5)%	18%	-

Other defined benefit plans in the Group

In addition to the Morgan Stanley UK Group Pension Plan, the Group operates several other defined benefit 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 benefit 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 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 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

During the year, the Athens Branch of Morgan Stanley & Co. International plc was closed along with its associated defined benefit plan (the Morgan Stanley & Co. International plc (Athens Branch) Retirement Indemnity). At the time of closure, there were no assets or outstanding obligations.

The Group also operated the Morgan Stanley Bank International Limited Milan Branch Termination Indemnity Plan until July 2012 at which time the plan closed and all liabilities were settled in cash in August 2012. As such there are no further obligations.

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

26. RETIREMENT BENEFITS (CONTINUED)

Other defined benefit plans in the Group (continued)

Defined benefit plans expense

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

	2012 $millions	2011 $millions
Current service cost	(2)	(3)
Past service cost	-	1
Expected return on plan assets	1	1
Interest on obligation	(1)	(1)
Total defined benefit plan expense	(2)	(2)

Of the charge for the year, $2 million (2011: $2 million) has been included in 'Other expense'. Actuarial losses of $1 million (2011: $nil) 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 $2 million (2011: $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 consolidated balance sheet, as well as a summary of the funded status of the plans in the Group, excluding the MSUK Group Pension Plan:

	2012 $millions	2011 $millions
Present value of funded defined benefit obligation	(20)	(19)
Fair value of plan assets	17	17
	(3)	(2)
Present value of unfunded defined benefit obligation	(4)	(6)
Deficit	(7)	(8)
Related deferred tax asset	2	2
Retirement benefit liability recognised in the consolidated balance sheet	(5)	(6)

Contributions for the year to the Group's defined benefit plans totalled $5 million (2011: $2 million), of which $nil was accrued at 31 December 2012 (2011: $nil). The Group expects to contribute $1 million (2011: $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 plan obligations were as follows:

	2012 $millions	2011 $millions
Reconciliation of defined benefit obligations		
Defined benefit obligation at 1 January	25	21
Current service cost	2	3
Past service cost	-	(1)
Interest cost	1	1
Actuarial loss	1	-
Net transfer (out)/in	(3)	2
Benefits paid	(1)	(1)
Plan participants' contributions	1	-
Liabilities extinguished on settlements	(3)	-
Foreign exchange rate changes	1	-
Defined benefit obligation at 31 December	24	25

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

	2012 $millions	2011 $millions
Reconciliation of fair value of plan assets		
Fair value of plan assets at 1 January	17	13
Expected return on plan assets	1	1
Net transfer (out)/in	(3)	2
Employer contributions	5	2
Plan participants' contributions	1	-
Benefits paid	(2)	(1)
Assets distributed on settlements	(3)	-
Foreign exchange rate changes	1	-
Fair value of plan assets at 31 December	17	17
Actual return on plan assets	1	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	
	2012 %	2011 %	2012 $millions	2011 $millions
Equity securities	6.1	5.6 - 6.9	5	4
Fixed income securities	1.1	0.9 - 1.8	7	7
Property	6.1	6.1	1	1
Other – primarily cash	1.3 - 2.3	1.3 - 2.3	4	5
			17	17

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:

	2012	2011
Discount rate	1.50% - 4.30%	1.75 - 4.70%
Rate of increase in salaries	1.50% - 4.00%	2.00 - 7.00%
Inflation assumption	1.50% - 2.00%	1.50 - 2.00%
Expected long-term rate of return on plan assets	2.25% - 3.85%	2.25 - 4.10%

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 2012					
Germany	Huebeck RT 2005 G	83.6	84.1	87.7	88.9
Switzerland	Swiss BVG 2010, Static Mortality Table	86.3	88.1	88.8	90.5
31 December 2011					
Germany	Huebeck RT 2005 G	83.5	84.0	87.6	88.8
Switzerland	Unadjusted BVG 2005 Mortality Table	84.7	84.7	87.0	87.0

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

	2012 $millions	2011 $millions	2010 $millions	2009 $millions	2008 $millions
Present value of defined benefit obligation	(24)	(25)	(21)	(13)	(10)
Fair value of plan assets	17	17	13	4	4
Deficit	(7)	(8)	(8)	(9)	(6)
Experience adjustments on plan liabilities:					
- Amount ($millions)	-	-	1	(1)	(2)
- Percentage of plan liabilities (%)	(25)% - 8%	(72)% - 39%	(174)% - 33.75%	0% - 25%	(135)% - 45%
Experience adjustments on plan assets					
- Amount ($millions)	-	-	-	-	-
- Percentage of plan assets (%)	0% - 3%	(3)% - 1%	(1)% - 0%	(8)% - 6%	(7)% - 1%

27. EMPLOYEE COMPENSATION PLANS

Equity-settled share-based compensation plans

- *Deferred stock awards*

Morgan Stanley has made deferred stock awards pursuant to several 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.

During the year, Morgan Stanley granted 5,594,126 units of restricted stock units to employees of the Group with a weighted average fair value per unit of $18.25 (2011: 3,738,574 units, weighted average fair value of $29.44), based on the market value of Morgan Stanley shares at grant date.

- *Stock option awards*

Morgan Stanley has also granted stock option awards in the form of stock options on Morgan Stanley's common stock. There were no options granted during the year (2011: 303,000). 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 ten 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 $nil (2011: $30.01). 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
Expected stock price volatility	32.7%
Expected dividend yield	1.5%

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)

Equity-settled share-based compensation plans (continued)

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

	2012		2011	
	Number of options millions	Weighted average exercise price $	Number of options millions	Weighted average exercise price $
Options outstanding at 1 January	4	49.04	5	50.41
Granted during the year	-	-	-	30.01
Expired during the year	(1)	39.86	(1)	49.98
Options outstanding at 31 December	3	52.26	4	49.04
Options exercisable at 31 December	3	53.83	4	50.55

There were no options exercised during the year (2011: nil).

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

	2012			2011		
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	-	31.42	3.92	1	34.66	2.18
\$40.00 - \$49.99	2	46.93	0.98	2	46.98	1.88
\$50.00 - \$59.99	-	56.97	3.67	-	56.97	4.67
\$60.00 - \$69.99	1	66.73	3.93	1	66.73	4.92
Total	3			4		

Other deferred compensation plans

The Group has granted non-equity based 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 normally ranges from six months 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.

Awards with a value of \$186 million (2011: \$193 million) have been granted to employees during the year and an expense of \$211 million (2011: \$192 million) has been recognised 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 'Accruals and deferred income' in the consolidated balance sheet is \$191 million (2011: \$262 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 fair value of the derivative balance held at the end of the year in relation to these deferred compensation plans recognised within 'Financial assets classified as held for trading' is \$17 million (2011: \$14 million), and recognised within 'Financial liabilities classified as held for trading' is \$25 million (2011: \$25 million). The related profit and loss recorded within 'Net gains/ (losses) on financial instruments classified as held for trading' for the year is \$6 million gain (2011: \$2 million loss).

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.

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 when a borrower, counterparty or issuer does not meet its financial obligations.

The Morgan Stanley Group manages credit risk exposure on a global consolidated basis and in consideration of individual legal entities. The credit risk management policies and procedures of the Morgan Stanley Group include ensuring transparency of material credit risks, ensuring compliance with established limits 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 primarily incurs credit risk exposure to institutions and individuals mainly through the Institutional securities business segment. The Group may incur credit risk in the Institutional Securities business segment through a variety of activities, including, but not limited to, entering into swap or other derivative contracts under which 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 by physical or financial collateral whose value may at times be insufficient to fully cover the loan repayment amount; posting margin and/ or collateral to clearing houses, clearing agencies, exchanges, banks, securities firms and other financial counterparties; and investing or trading in securities and loan pools, whereby the value of these assets may fluctuate based on realised or expected defaults on the underlying obligations or loans.

In order to protect the Group from losses, the Credit Risk Management Department establishes company-wide practices to evaluate, monitor and control credit risk exposure at the transaction, obligor and portfolio levels. The Credit Risk Management Department approves extensions of credit, evaluates the creditworthiness of the Group's counterparties and borrowers on a regular basis, and ensures that credit exposure is actively monitored and managed. The evaluation of counterparties and borrowers includes an assessment of the probability that an obligor will default on its financial obligations and any losses that may occur when an obligor defaults.

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 2012, credit exposure was concentrated in Asian and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their unique 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 2012, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

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 consolidated balance sheet.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

- *Securities purchased under agreements to resell and securities borrowed*

The Group manages credit exposure arising from securities purchased under agreements to resell 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 securities purchased under agreements to resell 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 as compared with 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, including collateral provisions, guarantees and hedges. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Group actively hedges its derivatives exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. 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 demand collateral, as well as to liquidate collateral and offset receivables and payables covered under the same master netting agreement 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 2012 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 balance sheet 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, including receiving 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 net credit exposure represents the credit exposure remaining after the effect of the credit enhancements. The "unrated" balance in the 'Maximum exposure to credit risk by credit rating' 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.

Certain 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 Value at Risk ("VaR") -based risk measures included in the market risk disclosure.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

	2012			2011		
	Gross credit exposure (1) $millions	Credit enhancements $millions	Net credit exposure (2) $millions	Gross credit exposure (1) $millions	Credit enhancements $millions	Net credit exposure (2) $millions
Loans and receivables:						
Cash at bank	12,408	-	12,408	11,999	-	11,999
Trade debtors(3):						
- External counterparties	37,249	-	37,249	33,566	-	33,566
- Morgan Stanley Group undertakings	12,911	-	12,911	12,483	-	12,483
Securities purchased under agreements to resell and cash collateral on stocks borrowed:						
- External counterparties	72,340	(71,034)	1,306	79,250	(77,300)	1,950
- Morgan Stanley Group undertakings	53,998	(53,484)	514	44,729	(43,049)	1,680
Corporate loans	1,669	-	1,669	2,129	-	2,129
Other amounts due from Morgan Stanley Group undertakings	484	-	484	1,620	-	1,620
Other debtors classified within loans and receivables	5	-	5	2,039	-	2,039
Financial assets classified as held for trading:						
- OTC Derivatives	265,515	(251,288)	14,227	291,099	(268,725)	22,374
Financial assets designated at fair value through profit or loss	7,668	(6,250)	1,418	8,691	(7,477)	1,214
	464,247	(382,056)	82,191	487,605	(396,551)	91,054
Unrecognised financial instruments						
Contingent commitments	2,212	-	2,212	3,058	-	3,058
Financial guarantees	19	-	19	47	-	47
Loan commitments	4,448	-	4,448	3,196	-	3,196
Underwriting commitments	44	-	44	156	-	156
Unsettled reverse repurchase agreements(4)	25,370	-	25,370	22,448	-	22,448
	496,340	(382,056)	114,284	516,510	(396,551)	119,959

(1) The carrying amount recognised in the consolidated balance sheet 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 $9,897 million (2011: $4,032 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 2012 $millions**	**Gross credit exposure 2011 $millions**
AAA	19,491	22,288
AA	111,810	81,540
A	282,762	333,495
BBB	52,741	50,569
BB	14,740	7,523
B	6,851	10,332
CCC	3,871	3,623
D	339	-
Unrated	3,735	7,140
Total	496,340	516,510

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

At 31 December 2012, there were no financial assets past due but not impaired (2011: $nil). The carrying amount of renegotiated loans that would otherwise be past due or impaired totalled $nil (2011: $nil).

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Financial assets individually impaired

Loans and receivables	2012 $millions	2011 $millions
Carrying value before deducting impairment loss [(1)]	302	219
Impairment loss	(62)	(66)
Carrying value after deducting impairment loss	240	153

(1) $232 million (2011: $143 million) of this balance was secured by the assets of the borrower.

Movement in impairment losses on financial assets

Loans and receivables	2012 $millions	2011 $millions
Balance at 1 January	66	106
Charge for the year	35	3
Reversal of impairment losses	(29)	(32)
Amounts written off	(8)	(9)
Foreign exchange revaluation	(2)	(2)
Balance at 31 December	62	66

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 financial asset on an individual and portfolio 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, and the realisable value of collateral and the timing of expected cash flows. The impairment losses are evaluated at least at each reporting date.

Management is required to exercise significant judgement in determining whether there is objective evidence that an impairment loss has occurred, and in the determination of impairment losses where such objective evidence of impairment exists. Historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. The exercise of judgment requires the use of assumptions which are highly subjective and very sensitive to various risk factors, including changes in economic and credit conditions, changes in laws and regulations, the level of interest rates, and other influences on the borrower's performance. It is possible that the actual realised loans and advances could differ from the amounts recognised.

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 overall liquidity and funding policies of the Morgan Stanley Group and the liquidity risk management policies and procedures conducted within the Group are consistent with those of the Morgan Stanley Group. The Morgan Stanley Group's liquidity and funding risk management policies are designed to mitigate the potential risk that entities within the Morgan Stanley Group, including the Group, may be unable to access adequate financing to service their financial liabilities when they become payable without material, adverse franchise or business impact. The key objective of the liquidity and funding risk management framework is to support the successful execution of both the Morgan Stanley Group's and the Group's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of stressed market conditions.

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, which 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, targets, operating environment indicators, escalation procedures, roles and responsibilities, and available mitigating actions in the event of a liquidity stress. The CFP also sets forth the principal elements of the Morgan Stanley Group's and the Group's liquidity stress testing which identifies stress events of different severity and duration, assesses current funding sources and uses and establishes a plan for monitoring and managing a potential liquidity stress event.

Liquidity Stress Tests. The Morgan Stanley Group uses Liquidity Stress Tests to model liquidity outflows across multiple scenarios over a range of time horizons.

The assumptions underpinning the Liquidity Stress Tests include, but not are limited to, the following: (i) no government support; (ii) no access to unsecured debt markets; (iii) repayment of all unsecured debt maturing within the stress horizon; (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 for Morgan Stanley and the major operating subsidiaries, including the Group, as well as at major currency levels, to capture specific cash requirements and cash availability at various legal entities. The Liquidity Stress Tests assume that subsidiaries, including the 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.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Liquidity management policies (continued)

Global Liquidity Reserve. 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. The size of the Global Liquidity Reserve is actively managed by the Morgan Stanley Group and the Group. The following components are considered in sizing the Global Liquidity Reserve: unsecured debt maturity profile, balance sheet size and composition, funding needs in a stressed environment inclusive of contingent cash outflows and collateral requirements and additional reserve, which is primarily a discretionary surplus based on the Morgan Stanley Group's and the Group's risk tolerance and is subject to change dependent on market and firm-specific events.

The Global Liquidity Reserve is held within Morgan Stanley and the Morgan Stanley Group's major operating subsidiaries and is composed of diversified cash and cash equivalents and highly liquid unencumbered securities (including US government securities, US agency securities, US agency mortgage-backed securities, Federal Deposit Insurance Corporation - guaranteed corporate debt, non-US government securities and other highly liquid investment grade 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 manages its funding in a manner that reduces the risk of disruption to the Morgan Stanley Group's and the Company'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 balance sheet on a global basis through diverse sources, which includes consideration of the funding risk of each legal entity. These sources may include the Morgan Stanley Group's equity capital, long-term debt, securities sold under agreements to repurchase, securities lending, deposits, commercial paper, letters of credit and lines of credit. The Morgan Stanley Group has active financing programs 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 balance sheet, not just financial liabilities, is monitored and evaluated. A substantial portion of the Morgan Stanley Group's total assets consists of liquid marketable securities and short-term collateralised receivables arising from its Institutional Securities business segment's sales and trading activities. The liquid nature of these assets provides the Morgan Stanley Group and the Group with flexibility in funding and managing their 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 2012. 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)

	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 2012	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	588	-	-	-	-	-	588
Trade Creditors:							
- External counterparties	73,830	-	-	-	-	-	73,830
- Morgan Stanley Group undertakings	13,958	-	-	-	-	-	13,958
Securities sold under agreements to repurchase and cash collateral on stocks loaned:							
- External counterparties	14,735	10,387	10,956	14,140	3,192	324	53,734
- Morgan Stanley Group undertakings	37,224	18,666	1,617	277	809	-	58,593
Other amounts owing to Morgan Stanley Group undertakings	4,903	1	3	2,381	63	4,160	11,511
Corporate deposits	1,820	-	-	-	2	-	1,822
Other financial liabilities	106	-	-	-	-	-	106
Subordinated debt	-	-	-	200	1,164	13,452	14,816
Financial liabilities classified as held for trading:							
Derivatives	277,392	-	-	-	-	-	277,392
Other	38,177	-	-	-	-	-	38,177
Financial liabilities designated at fair value through profit or loss	8,004	69	81	571	3,257	608	12,590
Total financial liabilities	470,737	29,123	12,657	17,569	8,487	18,544	557,117
Unrecognised financial instruments							
Contingent commitments (1)	2,212	-	-	-	-	-	2,212
Financial guarantees (1)	19	-	-	-	-	-	19
Lease commitments	-	8	16	73	-	-	97
Loan commitments (1)	4,448	-	-	-	-	-	4,448
Underwriting commitments	44	-	-	-	-	-	44
Unsettled reverse repurchase agreements	20,648	4,722	-	-	-	-	25,370
Total unrecognised financial instruments	27,371	4,730	16	73	-	-	32,190

(1) The Group does not expect that all of the cash flows associated with contingent commitments, financial guarantees 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 2011	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	762	-	-	-	-	-	762
Trade Creditors:							
- External counterparties	65,850	-	-	-	-	-	65,850
- Morgan Stanley 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
- Morgan Stanley 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 (1)	3,058	-	-	-	-	-	3,058
Financial guarantees (1)	47	-	-	-	-	-	47
Lease commitments	-	-	-	1	19	57	77
Loan commitments (1)	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

(1) The Group does not expect that all of the cash flows associated with contingent commitments, financial guarantees 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 VaR and scenario systems. These limits are designed to control price and market liquidity risk. Market risk is also monitored through various measures: using statistics (including 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 Morgan Stanley Group frequently enhances its market and credit risk management framework to address severe stresses that are observed in global markets during economic downturns. During 2012, the Morgan Stanley 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 ("SVaR"), 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 2012, 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, 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 commodity positions in physical commodities base metals) and related derivatives.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

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.

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 is being hedged. The Group manages the market risk associated with its trading activities on an entity-wide basis, on a worldwide trading division level and on an individual product strategy. The Company 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 Group's aggregate risk tolerance, as established by the Group's senior management.

Aggregate market risk limits have been approved for the Group, and major trading divisions worldwide, as well as for the firm 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 has enhanced its VaR model during 2012 to make it more responsive to current market conditions while maintaining a longer-term perspective. This enhancement is consistent with regulatory requirements. The current VaR model has been approved by the Group's regulators for use in regulatory capital calculations.

The Group estimates VaR using a model based on volatility adjusted historical simulation for general market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. The model constructs a distribution of hypothetical daily changes in the value of trading portfolios based on the following: historical observation of daily changes in key market indices or other market risk factors; and information on the sensitivity of the portfolio values to these market risk factor changes. The Group's current VaR model uses four years of historical data with a volatility adjustment to reflect current market conditions. The Group's prior VaR model also uses four years of historical data, but does not make any volatility adjustments and is therefore less responsive to current market conditions. 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.

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 has various strengths and limitations, which include but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behaviour or reflect the historical distribution of results beyond the 95% confidence interval; and reporting of losses in a single day, which does not reflect the risk of positions that cannot be liquidated or hedged in one day. A small proportion of market risk generated by trading positions is not included in VaR.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR (continued)

The modeling 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. 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, entity and global levels.

The Group's VaR model evolves 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.

Since the VaR statistics reported below 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.

Sensitivity analysis

VaR for the year ended 31 December 2012

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 2012 and 31 December 2011.

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 primary market risk category (previous model)	**95% one-day VaR 2012**				**95% one-day VaR 2011**			
	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	23	26	41	20	30	41	59	27
Equity price	16	21	42	16	16	22	35	14
Foreign exchange rate	4	4	10	2	5	5	13	2
Commodity price	2	3	4	1	3	5	12	2
Less diversification benefit [(1)(2)]	(18)	(21)	N/A	N/A	(25)	(25)	N/A	N/A
Primary Risk Categories VAR	27	33	50	26	29	48	73	29
Credit Portfolio	17	18	25	13	22	23	29	19
Less diversification benefit [(1)(2)]	(7)	(11)	N/A	N/A	(9)	(10)	N/A	N/A
Total trading VaR	37	40	61	30	42	61	82	40

(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)

Sensitivity analysis (continued)

Under the previous VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $33 million compared with $48 million for 2011. The decrease in average VaR for Primary Risk Categories is primarily due to reduced risk taking in fixed income products from reduced exposure to interest rates and credit spread. The reduction in period end VaR from $42 million to $37 million more clearly demonstrates this.

The average Credit Portfolio VaR for 2012 was $18 million compared with $23 million for 2011. The decrease in the average VaR over the year was from decreased counterparty exposure during 2012.

The average total trading VaR for 2012 was $40 million compared with $61 million for 2011.

95% Total VaR primary market risk category	95% one-day VaR for the nine months ended 31 December 2012 (Current Model)				95% one-day VaR for the 12 months ended 31 December 2012 (Previous Model)			
	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	18	19	29	15	23	26	41	20
Equity price	13	16	28	12	16	21	42	16
Foreign exchange rate	3	3	7	2	4	4	10	2
Commodity price	1	2	4	1	2	3	4	1
Less diversification benefit (1)(2)	(13)	(15)	N/A	N/A	(18)	(21)	N/A	N/A
Primary Risk Categories VAR	22	25	42	20	27	33	50	26
Credit Portfolio	14	15	19	13	17	18	25	13
Less diversification benefit (1)(2)	(7)	(8)	N/A	N/A	(7)	(11)	N/A	N/A
Total trading VaR	29	32	53	23	37	40	61	30

(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.

The current VaR model estimates are lower than the VaR estimates produced under the previously used model because the prior model places more emphasis on the large market moves experienced during the 2008 financial crisis, while the current model places more emphasis on more recent volatility, which has been generally more benign.

Under the current VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $25 million compared with $33 million under the previous model. The period end VaR was $22 million while it was $27 million under the previous model.

The average Credit Portfolio VaR for 2012 was $15 million compared with $18 million under the previous model.

The average total trading VaR for 2012 was $32 million compared with $40 million under the previous model.

Non-trading risks for the year ended 31 December 2012

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.

28. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

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 $5.8 million as at 31 December 2012, compared to a net gain or loss of $4.9 million as at 31 December 2011.

Counterparty exposure related to own spreads

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure is managed separately from VaR. The credit spread risk sensitivity of this exposure corresponds to an increase in value of approximately $2.7 million and $2 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2012 and 31 December 2011.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately $0.7 million and $0.4 million for each 1 basis point widening in the Group's credit spread level at both 31 December 2012 and 31 December 2011.

Equity investment price risk

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 asset values as shown in the table below.

	31 December 2012 10% sensitivity $millions	31 December 2011 10% sensitivity $millions
Private equity and infrastructure funds	7.6	19.6

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 with other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising both forward foreign currency exchange contracts and non-US dollar denominated debt.

The analysis below details the foreign currency exposure for the Group, by foreign currency, and calculates the impact on total recognised gains and losses 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 foreign currency hedges held by other members of the Morgan Stanley Group.

	2012			2011		
		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	(16)	27%	(4)	(6)	27%	2
British Pound	2,457	29%	713	2,216	29%	643
Chinese Yuan	215	8%	17	205	8%	16
Euro	616	7%	43	553	7%	38
Polish Zloty	2	16%	-	-	16%	-
New Taiwan Dollar	62	8%	5	66	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Russian Rouble	343	24%	82	322	24%	77
South Korean Won	476	42%	200	433	42%	182
Swedish Krona	16	23%	4	15	23%	3
Swiss Franc	10	10%	1	8	10%	1
	4,183			3,814		

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change over a five-year period from 1 December 2007 to 31 December 2012 (2011: 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 and 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

Transferred financial assets that are not derecognised in their entirety

In the ordinary course of business, the Group enters into various arrangements including selling securities under agreements to repurchase, purchasing securities under agreements to resell, securities borrowed and securities loaned to, amongst other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Group's inventory positions.

The Group pledges certain financial instruments to collateralise repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as financial instruments classified as held for trading (pledged to various parties) in the consolidated balance sheet. The Group has determined that it retains substantially all the risks and rewards of these financial instruments including credit risk, settlement risk, country risk and market risk, and therefore has not derecognised them. In addition, it recognises a financial liability in respect of the consideration received.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for derivative transactions or otherwise, as well as certain sales of securities with related transactions, such as derivatives, that result in the Group retaining substantially all the risks and rewards of the financial assets transferred. In addition, it recognises a financial liability in respect of the consideration received.

All of 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 financial liabilities related to financial assets transferred that continue to be recognised approximate the carrying amount of those transferred assets.

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes remain recognised on the consolidated balance sheet.

	2012 $millions	2011 $millions
Financial assets classified as held for trading		
Government debt securities	20,267	7,592
Corporate and other debt	11,431	17,155
Corporate equities	27,287	21,706
	58,985	46,453

30. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Group's policy is generally to take possession of securities received as collateral, securities purchased under agreements to resell and securities borrowed. The Group monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralised. Where deemed appropriate, the Group's agreements with third parties specify its rights to request additional collateral. These transactions are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under these arrangements as at 31 December 2012 was $209,851million (2011: $180,797 million). Of this amount $171,914 million (2011: $143,365 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 2012 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are $378 million (2011: $212 million) and the Group's maximum exposure to loss relating to such SPEs is $147 million (2011: $174 million). The Group's consolidated balance sheet includes $1,933 million of assets arising from consolidated SPEs (2011: $2,904 million). The Group's maximum exposure to loss relating to these assets is $1,413 million (2011: $1,279 million).

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy disclosure

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, valuation of these products does 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 unobservable 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:

2012	**Quoted prices in active market (Level 1) $millions**	**Valuation techniques using observable inputs (Level 2) $millions**	**Valuation techniques with significant unobservable inputs (Level 3) $millions**	**Total $millions**
Financial assets classified as held for trading:				
- Government debt securities	15,084	4,324	2	19,410
- Corporate and other debt	1	10,072	1,191	11,264
- Corporate equities	38,100	768	113	38,981
- Derivatives	474	278,036	3,070	281,580
Total financial assets classified as held for trading	53,659	293,200	4,376	351,235
Financial assets designated at fair value through profit or loss	-	7,091	577	7,668
Fixed asset investments: Available-for-sale financial assets	2	-	74	76
Total financial assets measured at fair value	**53,661**	**300,291**	**5,027**	**358,979**
Financial liabilities classified as held for trading:				
- Government debt securities	14,638	2,405	-	17,043
- Corporate and other debt	4	2,056	35	2,095
- Corporate equities	18,605	431	3	19,039
- Derivatives	433	272,660	4,299	277,392
Total financial liabilities classified as held for trading	33,680	277,552	4,337	315,569
Financial liabilities designated at fair value through profit or loss	-	12,282	308	12,590
Total financial liabilities measured at fair value	**33,680**	**289,834**	**4,645**	**328,159**

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and liabilities recognised at fair value (continued)

2011	**Quoted prices in active market (Level 1) $millions**	**Valuation techniques using observable inputs (Level 2) $millions**	**Valuation techniques with significant unobservable inputs (Level 3) $millions**	**Total $millions**
Financial assets classified as held for trading:				
- Government debt securities	5,792	4,707	1	10,500
- Corporate and other debt	3	11,228	2,549	13,780
- Corporate equities	18,475	7,775	170	26,420
- 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 and other debt	3	2,467	73	2,543
- Corporate equities	12,082	2,095	5	14,182
- 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)

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*

US Treasury Securities. US Treasury Securities are valued using quoted market prices. Valuation adjustments are not applied. Accordingly, US Treasury securities are generally categorised in Level 1 of the fair value hierarchy.

US Agency Securities. US Agency Securities are composed of three main categories consisting of agency issued debt, agency mortgage pass-through pool securities and collateralised mortgage obligations. Non-callable agency issued debt securities are generally valued using quoted market prices. Callable agency issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. The fair value of agency mortgage pass-through pool securities is model driven based on spreads of the comparable to-be-announced security. Collateralised mortgage obligations are valued using quoted market prices and trade data adjusted by subsequent changes in related indices for identical or comparable securities. Actively traded non-callable agency issued debt securities are categorised in Level 1 of the fair value hierarchy. Callable agency issued debt securities, agency mortgage pass-through pool securities and collateralised mortgage obligations are generally categorised in Level 2 of the fair value hierarchy.

Non-US 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 and other debt*

US State and Municipal Securities. The fair value of state and municipal securities is determined using recently executed transactions, market price quotations and pricing models that factor in, where applicable, interest rates, bond or credit default swap spreads and volatility. These bonds are generally categorised in Level 2 of the fair value hierarchy.

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 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 recovery 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 Isaac 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 also 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 significant 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 other ABS are categorised in Level 3 of the fair value hierarchy.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

- *Corporate and other debt (continued)*

Corporate Bonds. The fair value of corporate bonds is determined 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 do not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are 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 of the other 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.

Corporate Loans and Lending Commitments. The fair value of corporate loans is determined 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 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.

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, the Group estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilises the capital structure and credit spreads of recent comparable securitisation transactions. Mortgage loans valued based on observable market data for identical or comparable instruments are categorised in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are categorised in Level 3 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.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

- *Corporate equities (continued)*

Investments (other than investments in other Morgan Stanley Group undertakings). The Group's 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 non-exchange-traded 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 and 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. Exchanged-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.

Equity investments in other Morgan Stanley Group undertakings. Where the Group has equity investments in other Morgan Stanley Group undertakings that are neither subsidiaries nor associates, the Group's share of the net asset value of the undertaking is considered the best representation of fair value for the investment. These investments are included in Level 3 of the fair value hierarchy because net asset value amounts are not considered observable.

- *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 in 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)

- *Derivatives (continued)*

Derivative interests in credit default swaps on certain mortgage-backed or asset-backed securities, 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, these 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 determined 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 at 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 to which the notes are linked, interest rate yield curves, option volatility and currency, commodity or equity prices. 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.

- *Customer Loans*

Corporate Loans and Lending commitments. The fair value of corporate loans is determined 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 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.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

- *Customer loans (continued)*

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, the Group estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilises the capital structure and credit spreads of recent comparable securitisation transactions. Mortgage loans valued based on observable market data for identical or comparable instruments are categorised in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans 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 2012. 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.

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 below 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.

32. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2012 $millions	Balance at 1 January 2012	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 2012	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2012[(2)]
Financial assets classified as held for trading:										
- Government debt securities	1	-	-	-	-	-	-	1	2	-
- Corporate and other debt	2,549	(35)	-	436	(533)	-	(1,110)	(116)	1,191	(39)
- Corporate equities	170	3	-	45	(40)	-	-	(65)	113	6
Total financial assets classified as held for trading	2,720	(32)	-	481	(573)	-	(1,110)	(180)	1,306	(33)
Financial assets designated at fair value through profit or loss	30	-	-	267	-	-	(31)	311	577	-
Available-for-sale financial assets										
- Corporate equities	98	46	(6)	2	(7)	-	(59)	-	74	-
Total financial assets measured at fair value	**2,848**	**14**	**(6)**	**750**	**(580)**	**-**	**(1,200)**	**131**	**1,957**	**(33)**
Financial liabilities classified as held for trading:										
- Government debt securities	-	-	-	-	-	-	-	-	-	-
- Corporate and other debt	73	-	-	(44)	29	-	(3)	(20)	35	13
- Corporate equities	5	(2)	-	(1)	(2)	-	-	3	3	(1)
- Net derivative contracts[(3)]	1,620	357	-	(378)	-	135	43	(548)	1,229	(172)
Total financial liabilities classified as held for trading	1,698	355	-	(423)	27	135	40	(565)	1,267	(160)
Financial liabilities designated at fair value through profit or loss	381	(55)	-	-	-	-	(18)	-	308	55
Total financial liabilities measured at fair value	**2,079**	**300**	**-**	**(423)**	**27**	**135**	**22**	**(565)**	**1,575**	**(105)**

(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 2012 related to assets and liabilities still outstanding at 31 December 2012. The unrealised gains or (losses) are recognised in the consolidated profit and loss account or consolidated statement of total recognised gains and losses as detailed in the financial instruments accounting policy (note 1e).

(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)

2011 $millions	**Balance at 1 January 2011**	**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 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 and other debt	3,672	(102)	-	838	(2,252)	-	(5)	398	2,549	(142)
- Corporate equities	152	(24)	-	150	(107)	-	-	(1)	170	(24)
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 and other debt	32	2	-	(9)	67	-	(1)	(18)	73	3
- Corporate equities	13	1	-	(12)	3	-	-	-	5	-
- 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. The unrealised gains or (losses) are recognised in the consolidated profit and loss account or consolidated statement of total recognised gains and losses as detailed in the financial instruments accounting policy (note 1e).

(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)

During the year, the Group reclassified approximately $1,604 million of derivative assets (2011: $529 million) and $2,152 million of derivative liabilities (2011: $nil) from Level 3 to Level 2. These reclassifications were primarily related to hybrid contracts for which external prices became observable and the remaining unobservable inputs were deemed insignificant to the overall measurement.

There were no significant transfers from Level 2 to Level 3 of the fair value hierarchy during the year (2011:$nil).

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

During the year, the Group reclassified approximately $2,700 million of derivative assets and approximately $1,981 million of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the year, the Group reclassified approximately $302 million of derivative assets from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

During 2011, 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 2012 to reasonably possible alternative assumptions.

2012		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	2	-	-
- Corporate and other debt	1,191	97	(63)
- Corporate equities	113	4	(4)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	14	-	(13)
- Other	563	-	-
Available-for-sale financial assets:			
- Corporate equities	74	8	(21)
Financial liabilities classified as held for trading:			
- Corporate and other debt	35	-	-
- Corporate equities	3	-	-
- Net derivatives contracts(1)	(1,229)	138	(117)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	134	2	(2)
- Structured notes	1	-	-
- Other	173	-	-

(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)

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 and other debt	2,549	49	(47)
- Corporate equities	170	6	(15)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Other	30	1	(1)
Available-for-sale financial assets:			
- Corporate equities	98	9	(9)
Financial liabilities classified as held for trading:			
- Corporate and other debt	72	-	-
- Corporate equities	5	-	-
- 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)

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:

	2012 $millions	2011 $millions
At 1 January	539	260
New transactions	141	310
Amounts recognised in the consolidated profit and loss account during the year	(121)	(31)
At 31 December	559	539

The balance above predominantly relates to derivatives.

Although the consolidated 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, the balance above 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 2012	Carrying value $millions	Fair value $millions	Unrecognised (loss)/gain $millions
Corporate loans	1,669	1,625	(44)
Subordinated loans	(10,595)	(8,810)	1,785

31 December 2011	Carrying value $millions	Fair value $millions	Unrecognised (loss)/gain $millions
Corporate loans	2,129	1,976	(153)
Subordinated loans	(10,569)	(7,814)	2,755

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 prior consent from the FSA.

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 required capital estimation 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 maintains an amount of risk-based going concern capital after absorbing potential losses from extreme stress events where applicable, 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.

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.

In order to maintain or adjust the capital structure as described above, the Group may adjust the amount of dividends paid, return capital to shareholders, issue new shares, issue or repay subordinated debt or sell assets to reduce debt.

The Group is authorised and regulated by the 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 prepares an Internal Capital Adequacy Assessment Process ("ICAAP") document in order to meet its obligations under BIPRU 2.2 "Internal Capital Adequacy Standards". The Group's Required Capital Framework captures risks not adequately covered under Pillar 1 and calculates an additional capital buffer required to absorb stress losses. The framework is based on regional management's own risk assessment and is broadly consistent with the Morgan Stanley Group's Required Capital framework. It is used to ensure that the Group carries, or has access to, sufficient capital to support all material risks residing within it.

The Group's ICAAP identifies and measures material risks, sets and assesses internal capital adequacy operating targets and limits that relate directly to risk through the Required Capital framework and the risk appetite defined by UK Group Governing Bodies and assesses current and future capital adequacy under normal and stressed operating environments over the capital planning horizon.

The FSA reviews the ICAAP document through its Supervisory Review Process and issues an Individual Capital Guidance which sets the minimum level of regulatory capital for the Group. In addition, the FSA sets a capital planning buffer which is available to support the Group in a stressed market environment.

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 June 2013 the Capital Requirement Directive and Regulation ("CRD") was finalised implementing Basel III in Europe with effect from 1 January 2014.

34. CAPITAL MANAGEMENT (CONTINUED)

The Basel III Framework covers both microprudential and macroprudential elements. It sets out requirements for higher and better-quality capital, improved 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 2014 onwards.

New standards relating to market risk capital requirements, referred to as Basel 2.5, were implemented with effect from 31 December 2011.

The Group manages the following items as capital:

	2012 $millions	**2011 $millions**
Ordinary share capital	1,614	1,614
Subordinated loans	10,595	10,569
Reserves	16,908	16,408
	29,117	28,591

Basel II Pillar 3 disclosures

The Group publishes Pillar 3 disclosures which allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms required by the UK implementation of Basel II. The 2011 Pillar 3 disclosure can be found in the investor relations section at www.morganstanley.com.

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 2012

	Note	2012 $millions	2011 $millions
FIXED ASSETS			
Investments	3	9,032	9,013
CURRENT ASSETS			
Debtors	4	1,401	2,591
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR	5	(288)	(1,477)
NET CURRENT ASSETS		1,113	1,114
TOTAL ASSETS LESS CURRENT LIABILITIES		10,145	10,127
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR	6	(1,322)	(1,322)
		8,823	8,805
CAPITAL AND RESERVES			
Called up share capital	7	1,614	1,614
Capital contribution reserve	8	6,038	6,038
Profit and loss account	8	1,171	1,153
SHAREHOLDERS' FUNDS		8,823	8,805

These financial statements were approved by the Board and authorised for issue on 25 September 2013.

Signed on behalf of the Board

C E Woodman

Director

The notes on pages 93 to 98 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 Business Review section of 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.

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

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

Fixed asset investments are stated at cost, less provision for any impairment. Monetary fixed asset investments denominated in currencies other than US dollars are revalued to US dollars at the rates ruling at the balance sheet date, as described in note 1(d) above. Non-monetary items in a foreign currency are not retranslated.

Interest, dividend income, impairment losses and reversal of impairment losses on fixed asset investments, and foreign exchange differences on monetary fixed asset investments are reported in the profit and loss account in 'Net gains/ (losses) on fixed asset investments'.

At each balance sheet date, an assessment is made as to whether there is any objective evidence that the carrying amount of the fixed asset investment may not be recoverable.

1. ACCOUNTING POLICIES (CONTINUED)

f) Fixed asset investments (continued)

If it is determined that the carrying amount of the fixed asset investment is not recoverable then an impairment loss is recognised within the profit and loss account in 'Net gains/ (losses) on fixed asset investments' and is reflected against the carrying amount of the impaired asset on the balance sheet.

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.

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 Financial Reporting Standard ("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 profit after taxation for the year ended 31 December 2012 was $18 million (2011: $35 million loss). During the year an interim dividend of $nil was paid to the holders of the ordinary shares (2011: $2,000 million out of retained earnings). A net profit of $18 million has been carried to reserves (2011: $35 million loss 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 2012	9,013
Additions	19
At 31 December 2012	9,032

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 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
Morgan Stanley Bank International (China) Limited	China	100%	Ordinary shares*	100%	Financial services
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

	2012 $millions	2011 $millions
Amounts due from Morgan Stanley Group undertakings	97	19
Amounts due from Group undertakings	1,303	2,572
Other debtors	1	-
	1,401	2,591

5. OTHER CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2012 $millions	2011 $millions
Amounts owing to Morgan Stanley Group undertakings	6	83
Amounts owing to Group undertakings	282	1,394
	288	1,477

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

	2012 $millions	2011 $millions
Subordinated loan agreements	1,300	1,300
Amounts due to Group undertakings		
- Long term loan	22	22
	1,322	1,322

Subordinated loans

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

Counterparty	Repayment date	Interest rate	2012 $millions	2011 $millions
Morgan Stanley UK Financing II LP	31 October 2021	6 month LIBOR plus 1.25%	1,300	1,300

All subordinated loans are repayable at any time at the option of the Company, subject to two business days' notice to the lender and with prior written consent of the FSA, which has the right under the agreement to refuse consent to repayment.

Long term loan

Details of the long term loan are shown below:

Counterparty	Repayment date	Interest rate	2012 $millions	2011 $millions
Morgan Stanley Finance (C.I.) Limited	13 months notice by the Company	LIBOR-related managed rate	22	22

7. CALLED UP SHARE CAPITAL

	2012 $millions	2011 $millions
Allotted and fully paid:		
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 2011	1,614	3,138	1,188	5,940
Loss for the year	-	-	(35)	(35)
Capital contribution from parent company	-	4,900	-	4,900
Dividends	-	(2,000)	-	(2,000)
At 31 December 2011	1,614	6,038	1,153	8,805
Profit for the year	-	-	18	18
At 31 December 2012	1,614	6,038	1,171	8,823

Capital contribution reserve

The 'capital contribution reserve' comprises contributions of capital from the Company's immediate parent company, Morgan Stanley International Holdings Inc ("MSIH"). During 2012 $nil cash capital contribution was received from MSIH (2011: $4,900 million).

9. COMMITMENTS AND CONTINGENCIES

The Company has provided a letter of financial support to two Group undertakings, Morgan Stanley Longcross Limited and Morgan Stanley Langton Limited. 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 $12,400 million (2011: $12,800 million), before taking into account the support provided to these entities by the Group's ultimate parent Morgan Stanley.

The Company has provided a guarantee to Morgan Stanley & Co. International plc ("MSIP") in relation to payments falling due on OTC derivative contracts that certain Morgan Stanley undertakings ("the Affiliates") have entered into with MSIP. The total amount payable by the Affiliates to MSIP as at 31 December 2012 was $5,330 million (2011: $5,491 million). To date no amounts have become payable under this guarantee.

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. POST BALANCE SHEET EVENTS

FSA Core Group

In accordance with the FSA's Core Group regulations, on 27 March 2013, the Company, in conjunction with certain other Morgan Stanley Group undertakings, known collectively as the Contributing Entities, entered into a Deed of Agreement ("the agreement") to provide additional capital resources to certain Morgan Stanley Group undertakings registered with the FSA (collectively the 'Authorised Firms') if required in compliance with the regulatory requirements applicable to the members of a core UK group.

In the event that the capital resources of any Authorised Firm falls below its capital requirements, as determined by the FSA, the agreement gives the Authorised Firms the unilateral right to demand a contribution of capital resources from the Company.

The amount of the contribution is limited to the Company's surplus capital, to the extent that such capital is not required to repay the Company's liabilities, as defined in the agreement. The capital resources may be provided in the form of a subscription and purchase of shares or other capital instruments; to the extent legally permissible through payment of dividends or other distributions of capital resources or through such other legally permissible means as may be determined to be appropriate.

Entering in to the agreement did not result in any adjustments to the Company's balance sheet at 31 December 2012. The agreement will remain in force while the Company is a Contributing Entity in Morgan Stanley's UK core group, as determined for regulatory purposes, subject to earlier termination in certain circumstances.

12. PARENT UNDERTAKINGS

The 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. Morgan Stanley is incorporated in the state of Delaware, the United States of America and copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

The Company's immediate controlling party is Morgan Stanley International Holdings Inc., which is registered in Delaware, the United States of America. Copies of its financial statements can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA.