

**Registered Number: 02068222**  
**Registered Office:**  
**25 Cabot Square**  
**Canary Wharf**  
**London E14 4QA**

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**Half-yearly financial report**

**30 June 2015**

# **MORGAN STANLEY & CO. INTERNATIONAL plc**

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# **MORGAN STANLEY & CO. INTERNATIONAL plc**

## **INTERIM MANAGEMENT REPORT**

The Directors present their interim management report and the condensed consolidated financial statements (“Interim Financial Statements”) of Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary undertakings (together the “Group”), for the six month period ended 30 June 2015. This interim management report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary undertakings when viewed as a whole.

The interim management report contains certain forward-looking statements. These statements are made by the Directors in good faith based on the information available at the time of their approval of this report and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information.

### **RESULTS AND DIVIDENDS**

The Group made a profit after tax in the six month period to 30 June 2015 of \$548 million (30 June 2014: \$234 million). A payment of coupon interest on the Additional Tier 1 capital instruments of \$15 million was made on 30 January 2015 (see note 8) (30 June 2014: \$nil). No interim dividends have been declared (30 June 2014: \$nil).

### **PRINCIPAL ACTIVITY**

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

The Company operates branches in the Dubai International Financial Centre, France, South Korea, the Netherlands, Poland, the Qatar Financial Centre and Switzerland.

There have not been any changes in the Group’s principal activity in the period under review and no significant change in the Group’s principal activity is expected. During the period under review the Institutional Securities business of Morgan Stanley Securities Limited (“MSSL”), a Morgan Stanley Group undertaking incorporated in the United Kingdom (“UK”), was transferred to the Group, with completion on 31 May 2015. This transferred business did not have a significant impact on the Group’s net profit after tax. Further details are provided within the business review section below.

In addition, on 11 May 2015 a definitive agreement was entered into between Morgan Stanley and Castleton Commodities International LLC to sell Morgan Stanley Group’s global oil merchanting unit of the commodities division. The sale is expected to close during the second half of 2015. As part of this transaction the oil merchanting unit operated within the Group will be sold. During the period under review the Group recognised a \$33 million charge related to the estimated cost to sell the business (see note 4).

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, Wealth Management and Investment 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 Europe, the Middle East and Africa (“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.

### **REGULATION**

The Company is authorised by the Prudential Regulation Authority (“PRA”) and regulated by the PRA and the Financial Conduct Authority (“FCA”).

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW

#### Global market and economic conditions

In the first quarter of 2015, global growth decelerated, as slower domestic demand growth in the US and in major emerging market economies was partly offset by indications of improving growth in Europe and Japan, a divergence consistent with relative regional equity market performance. Much lower energy prices also resulted in lower inflation in much of the world. Central banks globally responded with over 30 additional easing measures since the start of 2015, including the central banks of Switzerland, Sweden and Denmark moving to negative central bank policy rates to join the European Central Bank (“ECB”).

In the second quarter of 2015, global growth was supported by a rebound in the US and firmer growth in the euro zone and the UK, which was partially offset by continued sluggishness in major emerging market economies, including China and Brazil, and slower growth in Japan after a strong first quarter of 2015. Prior declines in energy prices kept developed economies’ market inflation running near 0% in the second quarter of 2015 but with a move up from slightly negative to slightly positive annual rates in the US, euro zone and the UK. China continued to experience entrenched producer price index deflation, while other emerging market economies showed mixed inflation trends. Global equity markets showed little change in the aggregate during the second quarter of the year but with mixed trends across regions.

In Europe, favourable financial conditions were aided by the ECB quantitative easing (“QE”) program. A weaker euro supported continued improvement in growth during the six month period ended 30 June 2015, led by Germany, but protracted negotiations over extending the Greece bailout increased uncertainties in late June 2015. The STOXX Europe 600 index fell 4% in the second quarter of 2015 after rising 16% in the first quarter of 2015 and peaking in April 2015. The 10-year German Bund yield rose to 0.76% on 30 June 2015 after reaching a record low of 0.07% in April 2015, as expectations for how long ECB QE and near zero short-term interest rates would be maintained were paired with the move in euro zone inflation from a slightly negative annual rate to slightly positive.

#### Overview of 2015 interim financial results

The condensed consolidated income statement for the six month period to 30 June 2015 is set out on page 13. The Group reported a profit after tax for the six month period to 30 June 2015 of \$548 million compared to a profit after tax of \$234 million for the six month period to 30 June 2014.

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’, ‘Interest income’, ‘Interest expense’ and ‘Other income’ (“aggregate revenues”). Aggregate revenues for the six month period ended 30 June 2015 increased by 8% to \$2,717 million compared to \$2,512 million for the six month period ended 30 June 2014.

The biggest drivers of the increased revenues were within fixed income and commodities sales and trading and investment banking. Fixed income revenues rose due to increased interest rate product revenues generated from increased client activity, partially offset by reduced credit and securitised products revenues. Commodities revenues rose due to improved oil related business, partially reduced by lower electricity and natural gas revenues. Investment banking revenues increased as a result of stronger advisory revenues.

Equity sales and trading revenues fell slightly compared to the six month period ended 30 June 2014. There was a reduction compared to the prior period in the value of day one gains released during the current period from the unwind of trades where valuation techniques include unobservable market data (see note 14e). This reduction was partially offset by increased revenues generated from the transfer of MSSL to the Group during the period, in particular within cash equities and prime brokerage.

Other expense decreased by 12% from \$2,150 million for the six month period ended 30 June 2014 to \$1,886 million for the six month period ended 30 June 2015. The decrease mainly reflects a reduction in ‘management recharges from other Morgan Stanley Group undertakings relating to other services’ due to a reimbursement of \$213 million of net costs which were previously recharged from certain UK incorporated Morgan Stanley Group undertakings following the implementation of the new UK accounting framework, which had reduced aggregate costs recorded by those undertakings, partially offset by a recharge of \$33 million related to the Group’s share of the estimated cost to sell Morgan Stanley’s global oil merchanting

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Overview of 2015 interim financial results (continued)

business. For 2014, 'management recharges from other Morgan Stanley Group undertakings relating to other services' includes an adjustment made to the recharge of relationship lending costs relating to prior periods (see note 4).

The Group's tax expense for the six month period ended 30 June 2015 was \$283 million compared to \$128 million for the six month period ended 30 June 2014. This represents an effective tax rate of 34.1% (June 2014: 35.4%) which is higher than the average standard rate of UK corporation tax of 20.25% (30 June 2014: 21.49%). The 2015 tax charge includes the recognition of a provision against certain withholding tax reclaim balances recognised in prior periods.

The condensed consolidated statement of financial position presented on page 16 reflects decreases in the Group's total assets and liabilities of \$17,249 million and \$17,756 million respectively, representing decreases of 4% for each as at 30 June 2015 when compared to total assets and liabilities at 31 December 2014. The decrease in total assets is driven by a decrease of \$22,278 million in financial assets classified as held for trading, partially offset by increases in securities purchased under agreements to resell of \$2,529 million and trade receivables of \$1,363 million. The decrease in total liabilities is driven by a decrease in financial liabilities classified as held for trading of \$19,668 million, partially offset by an increase in cash collateral on securities loaned of \$4,768 million.

The decrease in financial assets classified as held for trading was due to a decrease of \$38,135 million in derivative assets, partially offset by increases in corporate equities of \$13,067 million and government debt securities of \$4,001 million (see note 6). The key driver of the derivative asset decrease is a decrease in fixed income derivatives mainly due to fair value movements in Euro and British Pound positions. The increase in corporate equities reflects the transfer of positions from MSSL to the Group during the period under review and the increase in government debt securities was mainly due to increased client activity.

The decrease in financial liabilities classified as held for trading was due to a decrease of \$32,583 million in derivative liabilities, partially offset by increases in corporate equities of \$8,201 million and government debt securities of \$5,383 million (see note 6). The key drivers of these movements are consistent with the movements in financial assets classified as held for trading noted above.

The condensed consolidated statement of cash flows presented on page 17 shows a net increase in cash and cash equivalents of \$860 million during the six month period to 30 June 2015 (six month period to 30 June 2014: net decrease of \$546 million). Net cash flows from operating activities were \$939 million (six month period to 30 June 2014: net cash flows used in operating activities were \$479 million). Interest paid on subordinated debt was \$68 million (six month period to 30 June 2014: \$68 million). Excluding segregated client funds, the net increase in cash and cash equivalents for the six month period to 30 June 2015 was \$100 million (six month period to 30 June 2014: net decrease of \$1,365 million).

#### Key performance indicators

The Board of Directors monitors the results of the Group by reference to a range of performance and risk based metrics, including, but not limited to the following:

*Profitability metrics* – The Group's operating margin (defined as profit before tax as a percentage of aggregate revenues) was 30.6% for the six month period ended 30 June 2015 (30 June 2014: 14.4%). Its return on equity (profit for the period as a percentage of total equity at the beginning of the period) was 3.3% for the six month period ended 30 June 2015 (six month period ended 30 June 2014: 1.5%) and its return on assets (profit for the period as a percentage of total assets at the end of the period) was 0.1% for the six month period ended 30 June 2015 (six month period ended 30 June 2014: 0%).

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Key performance indicators (continued)

*Total assets* – Reducing the Group’s total assets continued to be a focus of the Group during the period. The Group’s total assets, as disclosed on page 16, decreased by 4% from \$448,526 million at 31 December 2014 to \$431,277 million at 30 June 2015.

*Capital* – The Group continues to closely manage its capital position in light of the implementation of Basel III during 2014 and of leverage rules which are being phased in over future years. The Group’s managed capital was \$24,535 million as at 30 June 2015 (31 December 2014: \$24,023 million) which consists of the Group’s ordinary share capital, Additional Tier 1 capital, subordinated loans and reserves.

*Market risk* – The Group uses Value at Risk (“VaR”) measures as a useful indicator of possible trading losses resulting from adverse daily market movements. The Group’s average total VaR for risk management purposes (“Management VaR”) for the six month period to 30 June 2015 was \$24 million compared with \$19 million for the year ended 31 December 2014 and was below internal risk management targets.

#### Risk management

Risk is an inherent part of the Group’s business activity. The 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 has developed its own risk management policy framework, which leverages the risk management policies and procedures of the Morgan Stanley Group, and includes escalation to the Group’s Board of Directors and to appropriate senior management personnel of the Group.

Set out below is an overview of the Group’s policies for the management of financial risk and other significant business risks.

Note 11 to the condensed consolidated financial statements provides more detailed qualitative and quantitative disclosures about the Group’s management of, and exposure to, financial risks.

The nature of the principal risks that the Group is exposed to has not materially changed since the prior year and the Group does not anticipate a material change during the remaining six months of the financial year, although the Group continues to closely monitor and manage all of its principal risks and exposures, in particular in light of ongoing developments in Greece, Russia and Ukraine. The Group’s net exposure to these countries is limited. As at 30 June 2015 the country net exposure to Greece was \$2 million (see page 7), to Russia was \$115 million and to Ukraine was \$5 million.

#### Market risk

Market risk refers to the risk of losses for a position or portfolio due to changes in rates, foreign exchange, equities, implied volatilities, correlations or other market factors.

Market risk management policies and procedures for the Group are consistent with those of the Morgan Stanley Group and include escalation to the Group’s Board of Directors and appropriate key management personnel.

The Group manages the market risk associated with its trading activities at both a trading division and an individual product level, and includes consideration of market risk at the legal entity level.

The Group’s Management VaR is a useful indicator of possible trading losses resulting from adverse daily market movements. The average VaR for the Primary Risk Categories for the first six months ended 30 June 2015 was \$22 million compared to \$17 million for 2014, with the increase being mainly due to increased exposure to interest rate and equity price risk. The average Credit Portfolio VaR for the six months ended 30 June 2015 was \$6 million, unchanged compared to 2014. The average total Management VaR for the six months ended 30 June 2015 was \$24 million compared to \$19 million for 2014.

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## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Risk management (continued)

##### *Credit risk*

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Group. Credit risk includes the risk that economic, social and political conditions and events in a foreign country will adversely affect an obligor's ability and willingness to fulfil their obligations. The Group primarily incurs credit risk exposure to institutions and sophisticated investors mainly through its Institutional Securities business segment. Credit risk management policies and procedures for the Group are consistent with those of the Morgan Stanley Group and include escalation to the Group's Board of Directors and appropriate key management personnel.

The Group manages credit risk exposure on a consolidated basis and also for each significant legal entity within the Group. Its credit risk management policies and procedures establish the framework for identifying, measuring, monitoring and controlling credit risk whilst ensuring transparency of material credit risks, ensuring compliance with established limits and escalating risk concentrations to appropriate senior management.

##### *Country risk exposure*

Country risk exposure is the risk that events in, or affecting, a foreign country (any country other than the UK) might adversely affect the Group.

Country risk exposure is measured in accordance with the Group's internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Group actively manages country risk exposure through a comprehensive risk management framework that combines credit and market fundamentals and allows the Group to effectively identify, monitor and limit country risk. Country risk exposure before and after hedges is monitored and managed.

The Group's obligor credit evaluation process may also identify indirect exposures whereby an obligor has vulnerability or exposure to another country or jurisdiction. Examples of indirect exposures 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. Indirect exposures identified through the credit evaluation process may result in a reclassification of country of risk.

The Group conducts periodic stress testing that seeks to measure the impact on the Group's credit and market exposures of shocks stemming from negative economic or political scenarios. When deemed appropriate by the Group's risk managers, the stress test scenarios include possible contagion effects. Second order risks such as the exposure of core European banks to Peripheral European countries (Greece, Ireland, Italy, Spain and Portugal) may also be considered. The Group also conducts legal and documentation analysis of its exposures to obligors in Peripheral jurisdictions to identify the risk that such exposures could be redenominated into new currencies or subject to capital controls in the case of country exit from the Eurozone. This analysis, and the results of the stress tests, may result in the amendment of limits or exposure mitigation.

The Group's sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures primarily consist of exposures to corporations and financial institutions. The following table shows the Group's five largest non-UK country net exposures, excluding exposures to European Peripherals which are disclosed separately. Exposure to other Morgan Stanley Group undertakings has been excluded from the tables below.

Each reference entity within an index is allocated to that reference entity's country of risk. Index exposures are allocated to the underlying reference entities in proportion to the notional weighting of each reference entity in the index, adjusted for any fair value receivable/payable for that reference entity. Where credit risk crosses multiple jurisdictions, for example, a credit default swap ("CDS") purchased from an issuer in a specific country that references bonds issued by an entity in a different country, the fair value of the CDS is reflected in the Net Counterparty Exposure column based on the country of the CDS issuer. Further, the notional amount of the CDS adjusted for the fair value of the receivable/ payable is reflected in the Net Inventory column based on the country of the underlying reference entity.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Risk management (continued)

Country risk exposure (continued)

Five largest non-UK country risk net exposures, excluding exposures to European Peripherals:

Country	Net inventory <sup>(1)</sup> \$millions	Net counterparty exposure <sup>(2)</sup> \$millions	Funded lending \$millions	Unfunded commitments \$millions	Exposure before hedges \$millions	Hedges <sup>(3)</sup> \$millions	Net exposure <sup>(4)</sup> \$millions
United States:							
Sovereigns	1,449	201	-	-	1,650	-	1,650
Non-sovereigns	2,162	1,333	-	-	3,495	(11)	3,484
Total United States	3,611	1,534	-	-	5,145	(11)	5,134
France:							
Sovereigns	279	-	-	-	279	-	279
Non-sovereigns	114	2,177	-	1,223	3,514	(770)	2,744
Total France	393	2,177	-	1,223	3,793	(770)	3,023
People's Republic of China:							
Sovereigns	533	328	-	-	861	-	861
Non-sovereigns	788	339	-	-	1,127	(8)	1,119
Total People's Republic of China	1,321	667	-	-	1,988	(8)	1,980
Germany:							
Sovereigns	868	106	-	-	974	(948)	26
Non-sovereigns	(46)	2,364	19	65	2,402	(767)	1,635
Total Germany	822	2,470	19	65	3,376	(1,715)	1,661
United Arab Emirates:							
Sovereigns	30	719	-	-	749	(5)	744
Non-sovereigns	(27)	166	-	-	139	(10)	129
Total United Arab Emirates	3	885	-	-	888	(15)	873

(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). As a market maker, the Group transacts in these CDS positions to facilitate client trading.

(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 30 June 2015, the Group had exposure to these countries for overnight deposits with banks of approximately \$932 million.



# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Risk management (continued)

Country risk exposure (continued)

Country risk exposure to European Peripherals:

Country	Net inventory <sup>(1)</sup> \$millions	Net counterparty exposure <sup>(2)</sup> \$millions	Funded lending \$millions	Unfunded commitments \$millions	CDS adjustments <sup>(3)</sup> \$millions	Exposure before hedges \$millions	Hedges <sup>(4)</sup> \$millions	Net exposure <sup>(5)</sup> \$millions
Greece:								
Sovereigns	-	-	-	-	-	-	(14)	(14)
Non-sovereigns	16	-	-	-	-	16	-	16
Total Greece	16	-	-	-	-	16	(14)	2
Ireland:								
Sovereigns	245	2	-	-	5	252	-	252
Non-sovereigns	252	53	-	-	-	305	-	305
Total Ireland	497	55	-	-	5	557	-	557
Italy:								
Sovereigns	164	(20)	-	-	130	274	16	290
Non-sovereigns	514	566	-	444	26	1,550	(85)	1,465
Total Italy	678	546	-	444	156	1,824	(69)	1,755
Portugal:								
Sovereigns	120	1	-	-	-	121	-	121
Non-sovereigns	109	19	-	-	19	147	(2)	145
Total Portugal	229	20	-	-	19	268	(2)	266
Spain:								
Sovereigns	323	11	-	-	4	338	-	338
Non-sovereigns	(67)	273	2	86	-	294	(95)	199
Total Spain	256	284	2	86	4	632	(95)	537
Total European Peripherals:								
Sovereigns	852	(6)	-	-	139	985	2	987
Non-sovereigns	824	911	2	530	45	2,312	(182)	2,130
Total European Peripherals	1,676	905	2	530	184	3,297	(180)	3,117

- (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). As a market maker, the Group transacts in these CDS positions to facilitate client trading.
- (2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) takes into consideration legally enforceable master netting agreements and collateral.
- (3) CDS adjustment represents credit protection purchased from European Peripherals' banks on European Peripherals' 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 30 June 2015, the Group had European Peripherals exposure for overnight deposits with banks of approximately \$6 million.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### Risk management (continued)

##### *Liquidity and funding risk*

Liquidity and funding risk refers to the risk that the Group will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the Group's ability to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern.

The primary goal of the Group's liquidity and funding risk management framework is to ensure that the Group has 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 its business strategies. The Group's key components of liquidity and funding risk management include its Contingency Funding Plan ("CFP"), Liquidity Stress Testing and its Liquidity Reserve, which are further described in note 11.

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

##### *Operational risk*

Operational risk refers to the risk of loss, or of damage to the Group's reputation, resulting from inadequate or failed processes, people and systems or from external events (e.g. fraud, theft, legal and compliance risks, cyber-attacks or damage to physical assets). Operational risk includes information security, supplier management and outsourcing risk. Operational risk relates to the following risk event categories as defined by Basel III: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; business disruption and system failure; damage to physical assets; and execution, delivery and process management.

Operational risk may be incurred across the Group's full scope of business activities, including revenue-generating activities (e.g. sales and trading) and support control functions.

The Group has established an operational risk framework to identify, measure, monitor and control risk in the context of an approved risk tolerance appetite, set by the Board. Effective operational risk management is essential to reducing the impact of operational risk incidents and mitigating legal and reputational risks.

The Group has implemented operational risk data and assessment systems to monitor and analyse internal and external operational risk events, business environment and internal control factors and to perform scenario analysis. The collected data elements are incorporated in the operational risk capital model which encompasses both quantitative and qualitative elements.

Conduct risk refers to the risk that the Group's actions or behaviours do not adequately consider the impact on the firm's clients, expected market users or the markets. Conduct risk within the Group is managed and owned across the businesses and control functions through policies, process and controls within a designed framework.

##### *Legal, regulatory and compliance risk*

The Group is exposed to legal, regulatory and compliance risks, which include the risk of legal or regulatory sanctions, material financial loss; such as fines, penalties, judgements, damages and/ or settlements or loss to reputation the Group may suffer as a result of failure to comply with laws, regulations, rules, self-regulatory organisation standards and codes of conduct applicable to business activities. Legal risks also include contractual and commercial risks in the event that a counterparty's performance obligations will be unenforceable. The 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 changes, the Group also views regulatory changes as a component of legal risk.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

### BUSINESS REVIEW (CONTINUED)

#### **Risk management (continued)**

##### *Legal, regulatory and compliance risk (continued)*

The Group has established procedures designed to foster compliance with applicable statutory and regulatory requirements. The Group, principally through the Legal and Compliance Division, also has established procedures that are designed to require that the Group's policies relating to business conduct, ethics and practices are followed globally. In connection with its businesses, the Group 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 Group has established procedures to mitigate the risk that 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 Group.

##### *Culture, Values and Conduct of Employees*

All employees of the Morgan Stanley Group have accountability for risk management. The Morgan Stanley Group strives to establish a culture of effective risk management through its defined core values, governance framework, management oversight, training and development programs, policies, procedures, and defined roles and responsibilities within the Morgan Stanley Group. The actions and conduct of each employee are essential to risk management. The Morgan Stanley Group's Code of Conduct (the "Code") has been established to provide a framework and standards for employee conduct that further reinforces the Morgan Stanley Group's commitment to integrity and high ethical standards. Every new hire and every employee annually must certify to their understanding of and adherence to the Code. The employee annual review process includes evaluation of adherence to the Code. The Global Incentive Compensation Discretion Policy sets forth standards that specifically provide that managers must consider whether the employee effectively managed and supervised the risk control practices of his/ her employee reports during the performance year. The Morgan Stanley Group has several mutually reinforcing processes to identify incidents of employee conduct that may have an impact on the employment status, current year compensation or prior year compensation. The Morgan Stanley Group's clawback and cancellation provisions permit recovery of deferred incentive compensation where, for example, an employee's act or omission (included with respect to direct supervisory responsibilities) causes a restatement of the Morgan Stanley Group's consolidated financial results, constitutes a violation of the Morgan Stanley Group's global risk management principles, policies and standards, or causes a loss of revenue associated with a position on which the employee was paid and the employee operated outside of internal control policies.

#### **Capital management**

The Group views capital as an important source of financial strength. It actively manages and monitors its capital in line with established policies and procedures and in compliance with local regulatory requirements. During the period under review the Group issued ordinary share capital of \$1 million to Morgan Stanley Investments (UK), its immediate parent undertaking (see note 7).

#### **Going concern**

Business risks associated with the uncertain market and economic conditions are being actively monitored and managed by the Group. Retaining sufficient liquidity and capital to withstand these market pressures remains central to the Group's strategy. In particular, the Group's capital and liquidity is deemed sufficient to exceed regulatory minimums under both a normal and in a stressed market environment for the foreseeable future. Additionally, the Group has access to further Morgan Stanley Group capital and liquidity if required.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**INTERIM MANAGEMENT REPORT**

**BUSINESS REVIEW (CONTINUED)**

**Going concern (continued)**

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 interim management report and Interim Financial Statements.

Approved by the Board and signed on its behalf by



C Castello

Director

24 August 2015

# MORGAN STANLEY & CO. INTERNATIONAL plc

## DIRECTORS' RESPONSIBILITY STATEMENT

The Directors, the names of whom are set out below, confirm that to the best of their knowledge:

- (a) the condensed set of Interim Financial Statements has been prepared in accordance with International Accounting Standard ("IAS") 34 '*Interim Financial Reporting*' as adopted by the European Union ("EU"), give a true and fair view of the assets, liabilities, financial position and result of the Group; and
- (b) the interim management report includes a fair review of the information required by DTR4.2.7R of the Disclosure and Transparency Rules, being an indication of the important events that have occurred during the period and their impact on the condensed set of interim financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year.

By order of the Board on 24 August 2015



C Castello

Director

Board of Directors:

D O Cannon

C Castello

Sir E J W Gieve

L Guy

T C Kelleher

M C Phibbs

I Plenderleith (Chairman)

R Rooney

D A Russell

C E Woodman

# **INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc**

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six month period ended 30 June 2015 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 17. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Company in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Company those matters we are required to state to them in an independent review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company, for our review work, for this report, or for the conclusions we have formed.

## **Directors' responsibilities**

The half-yearly financial report is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union. The condensed set of interim financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34 "*Interim Financial Reporting*", as adopted by the European Union.

## **Our responsibility**

Our responsibility is to express to the Company a conclusion on the condensed set of interim financial statements in the half-yearly financial report based on our review.

## **Scope of review**

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical procedures and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

## **Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of interim financial statements in the half-yearly financial report for the six month period ended 30 June 2015 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.



Deloitte LLP  
Chartered Accountants and Statutory Auditor  
London  
24 August 2015

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED INCOME STATEMENT**  
**Six months ended 30 June 2015**

		<b>Six months ended 30 June 2015</b>	<b>Restated Six months ended 30 June 2014</b>
	<b>Note</b>	<b>\$millions (unaudited)</b>	<b>\$millions (unaudited)</b>
Net gains on financial instruments classified as held for trading		2,258	1,786
Net gains on financial instruments designated at fair value through profit or loss		81	147
Interest income	2	36	220
Interest expense	2	(314)	(355)
Other income	3	656	714
Other expense	4	(1,886)	(2,150)
<b>PROFIT BEFORE INCOME TAX</b>		<u>831</u>	<u>362</u>
Income tax expense	5	(283)	(128)
<b>PROFIT FOR THE PERIOD</b>		<u><u>548</u></u>	<u><u>234</u></u>
Attributable to:			
Owners of the parent		548	233
Non-controlling interests		-	1
<b>PROFIT FOR THE PERIOD</b>		<u><u>548</u></u>	<u><u>234</u></u>

All operations were continuing in the current and prior periods.

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

Details of the restatement are provided in note 1.

**MORGAN STANLEY & CO. INTERNATIONAL plc****CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME****Six months ended 30 June 2015**

	<b>Six months ended 30 June 2015 \$millions (unaudited)</b>	<b>Six months ended 30 June 2014 \$millions (unaudited)</b>
<b>PROFIT FOR THE PERIOD</b>	<u>548</u>	<u>234</u>
<b>OTHER COMPREHENSIVE INCOME, NET OF TAX</b>		
<b>Items that will not be reclassified subsequently to profit or loss:</b>		
Actuarial losses on defined benefit plans	(1)	-
<b>Items that may be reclassified subsequently to profit or loss:</b>		
Currency translation reserve:		
Foreign currency translation differences arising on foreign operations during the period	(27)	15
Available-for-sale reserve:		
Net change in fair value of available-for-sale financial assets	(2)	1
<b>OTHER COMPREHENSIVE (LOSS)/ INCOME AFTER INCOME TAX FOR THE PERIOD</b>	<u>(30)</u>	<u>16</u>
<b>TOTAL COMPREHENSIVE INCOME FOR THE PERIOD</b>	<u>518</u>	<u>250</u>
Attributable to:		
Owners of the parent	523	249
Non-controlling interests	(5)	1
<b>TOTAL COMPREHENSIVE INCOME FOR THE PERIOD</b>	<u>518</u>	<u>250</u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.



**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**

**Six months ended 30 June 2015**

Note	Equity instruments \$millions	Share premium \$millions	Currency translation reserve \$millions	Available-for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Pension reserve \$millions	Retained earnings \$millions	Attributable to owners of the parent \$millions	Non-controlling interest \$millions	Total equity \$millions
<b>Balance at 1 January 2015</b>	12,764	513	27	6	3	1,400	2	1,402	16,117	71	16,188
Total comprehensive income	-	-	(22)	(2)	-	-	(1)	548	523	(5)	518
<b>Transactions with owners:</b>											
Issue of ordinary shares	7	1	-	-	-	-	-	-	1	-	1
Coupon interest on Additional Tier 1 capital	8	-	-	-	-	-	-	(12)	(12)	-	(12)
<b>Balance at 30 June 2015 (unaudited)</b>	12,765	513	5	4	3	1,400	1	1,938	16,629	66	16,695

	Equity instruments \$millions	Share premium \$millions	Currency translation reserve \$millions	Available - for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Pension reserve \$millions	Retained earnings \$millions	Attributable to owners of the parent \$millions	Non-controlling interest \$millions	Total equity \$millions
<b>Balance at 1 January 2014</b>	11,464	513	78	4	3	1,400	-	2,118	15,580	79	15,659
Total comprehensive income	-	-	15	1	-	-	-	233	249	1	250
<b>Balance at 30 June 2014 (unaudited)</b>	11,464	513	93	5	3	1,400	-	2,351	15,829	80	15,909

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

**CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION**  
**As at 30 June 2015**

		<b>30 June 2015</b>	<b>31 December 2014</b>
		<b>\$millions</b>	<b>\$millions</b>
<b>ASSETS</b>	<b>Note</b>	<b>(unaudited)</b>	
<b>ASSETS</b>			
Loans and receivables:			
Cash and short term deposits	9	12,320	11,671
Cash collateral on securities borrowed		19,912	20,691
Securities purchased under agreements to resell		61,253	58,724
Trade receivables		56,307	54,944
Other receivables		2,458	3,317
		<u>152,250</u>	<u>149,347</u>
Financial assets classified as held for trading (of which approximately \$47,020 million (2014: \$43,572 million) were pledged to various parties)	6	273,120	295,398
Financial assets designated at fair value through profit or loss		5,566	3,360
Available-for-sale financial assets		40	42
Current tax assets		175	217
Deferred tax assets		79	86
Prepayments and accrued income		44	72
Property, plant and equipment		3	4
<b>TOTAL ASSETS</b>		<u><u>431,277</u></u>	<u><u>448,526</u></u>
<b>LIABILITIES AND EQUITY</b>			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	9	13	15
Cash collateral on securities loaned		22,267	17,499
Securities sold under agreements to repurchase		41,358	45,911
Trade payables		79,220	83,561
Subordinated loans		7,906	7,906
Other payables		17,514	14,134
		<u>168,278</u>	<u>169,026</u>
Financial liabilities classified as held for trading	6	238,160	257,828
Financial liabilities designated at fair value through profit or loss		7,716	5,131
Provisions		45	43
Current tax liabilities		166	105
Deferred tax liabilities		18	1
Accruals and deferred income		193	199
Post employment benefit obligations		6	5
<b>TOTAL LIABILITIES</b>		<u><u>414,582</u></u>	<u><u>432,338</u></u>
<b>EQUITY</b>			
Equity instruments	7	12,765	12,764
Share premium account		513	513
Currency translation reserve		5	27
Available-for-sale-reserve		4	6
Capital contribution reserve		3	3
Capital redemption reserve		1,400	1,400
Pension reserve		1	2
Retained earnings		1,938	1,402
<b>Equity attributable to owners of the parent</b>		<u>16,629</u>	<u>16,117</u>
<b>Non-controlling interest</b>		<u>66</u>	<u>71</u>
<b>TOTAL EQUITY</b>		<u><u>16,695</u></u>	<u><u>16,188</u></u>
<b>TOTAL LIABILITIES AND EQUITY</b>		<u><u>431,277</u></u>	<u><u>448,526</u></u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**Six months ended 30 June 2015**

		<b>Six months ended 30 June 2015 \$millions (unaudited)</b>	<b>Six months ended 30 June 2014 \$millions (unaudited)</b>
<b>NET CASH FLOWS FROM/ (USED IN) OPERATING ACTIVITIES</b>	9(b)	939	(479)
<b>INVESTING ACTIVITIES</b>			
Purchase of available-for-sale financial assets		(1)	-
Proceeds from sale of available-for-sale financial assets		1	1
<b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>		<u>-</u>	<u>1</u>
<b>FINANCING ACTIVITIES</b>			
Issue of share capital	7	1	-
Coupon interest on Additional Tier 1 capital	8	(12)	-
Interest on subordinated loan liabilities		(68)	(68)
<b>NET CASH FLOWS USED IN FINANCING ACTIVITIES</b>		<u>(79)</u>	<u>(68)</u>
<b>NET INCREASE/ (DECREASE) IN CASH AND CASH EQUIVALENTS</b>		860	(546)
Currency translation differences on foreign currency cash balances		(209)	(6)
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>		<u>11,656</u>	<u>12,228</u>
<b>CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD</b>	9(a)	<u>12,307</u>	<u>11,676</u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 1. BASIS OF PREPARATION

#### a. General information

The information in this interim report does not constitute statutory accounts within the meaning of Section 435 of the United Kingdom Companies Act 2006 ("Companies Act").

The comparative information for the year ended 31 December 2014 does not constitute statutory accounts as defined in section 434 of the Companies Act. A copy of the statutory accounts for that year has been delivered to the Registrar of Companies. The auditor's report on those accounts was not qualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act.

#### b. Accounting policies

The Group prepares its annual consolidated financial statements in accordance with IFRSs issued by the International Accounting Standards Board ("IASB") as adopted by the European Union ("EU"), Interpretations issued by the IFRS Interpretations Committee ("IFRIC") and the Companies Act. The Interim Financial Statements have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and in accordance with IAS 34 '*Interim Financial Reporting*', as adopted by the EU.

In preparing these Interim Financial Statements the Group has applied consistently the accounting policies and methods of computation used in the Group's annual consolidated financial statements for the year ended 31 December 2014, except where noted below.

#### New standards and interpretations adopted during the period

The following amendments to standards relevant to the Group's operations were adopted during the period. These amendments to standards did not have a material impact on the Group's condensed consolidated financial statements.

An amendment to IAS 19 '*Employee benefits on defined benefit plans*' ("IAS 19") was issued by the IASB in November 2013, for retrospective application in annual periods beginning on or after 1 July 2014. The amendment was endorsed by the EU in December 2014.

As part of the December 2013 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 2 '*Share-based payment*', IFRS 3 '*Business combinations*', IFRS 8 '*Operating segments*' ("IFRS 8"), IFRS 13 '*Fair value measurement*', IAS 16 '*Property, plant and equipment*' ("IAS 16"), IAS 24 '*Related party disclosures*' and IAS 38 '*Intangible assets*' ("IAS 38") (for application in accounting periods beginning on or after 1 July 2014). The improvements were endorsed by the EU in December 2014.

There were no other standards or interpretations relevant to the Group's operations which were adopted during the period.

#### New standards and interpretations not yet adopted

At the date of authorisation of these condensed consolidated financial statements, the following standards and amendments to standards relevant to the Group's operations were in issue by the IASB but not yet mandatory. Except where otherwise stated, the Group does not expect that the adoption of the following standards and amendments to standards will have a material impact on the Group's consolidated financial statements.

An amendment to IAS 1 '*Disclosure initiative*' was issued by the IASB in December 2014, for application in annual periods beginning on or after 1 January 2016.

Amendments to IAS 16 and IAS 38 were issued by the IASB in May 2014, for prospective application in annual periods beginning on or after 1 January 2016.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**1. BASIS OF PREPARATION**

**New standards and interpretations not yet adopted (continued)**

IFRS 9 '*Financial instruments*' ("IFRS 9") was issued by the IASB in November 2009, amended in November 2013, and revised and reissued by the IASB in July 2014. IFRS 9 is applicable retrospectively, except where otherwise prescribed by the transitional provisions of the standard, and is effective for annual periods beginning on or after 1 January 2018. Early adoption, either in full or relating to own credit in isolation, is permitted. Although there are expected to be significant changes to the presentation of financial instruments by the Group, there is not expected to be a significant impact on net assets.

Amendments to IFRS 10 and IAS 28 '*Sale or contribution of assets between an investor and its associate or joint venture*' were issued by the IASB in September 2014 for prospective application to transactions occurring in annual periods beginning on or after 1 January 2016.

Amendments to IFRS 10, IFRS 12 and IAS 28 '*Investment entities: Applying the consolidation exemption*' were issued by the IASB in December 2014 for retrospective application in annual periods beginning on or after 1 January 2016.

An amendment to IFRS 11 '*Joint arrangements*' was issued by the IASB in May 2014, for prospective application in annual periods beginning on or after 1 January 2016.

IFRS 15 '*Revenue from Contracts with Customers*' was issued by the IASB in May 2014 for retrospective application in annual periods beginning on or after 1 January 2017.

As part of the September 2014 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 7 '*Financial instruments: Disclosures*', IAS 19 and IAS 34 '*Interim financial reporting*' (for application in accounting periods beginning on or after 1 January 2016).

**c. Restatement of comparative amounts**

'Other income' for the six months ended 30 June 2014 has been revised primarily to include underwriting fees. Underwriting fees were previously presented in the 30 June 2014 condensed consolidated financial statements within 'Net gains on financial instruments classified as held for trading'. This revision has been performed to enhance comparability with the current year presentation (see note 3). Note 10 has also been revised as a result of this restatement. The classification of underwriting fees within 'other income' is consistent with the presentation within the Group's annual consolidated financial statements for the year ended 31 December 2014.

**d. Use of estimates and sources of uncertainty**

The preparation of the Group's condensed consolidated financial statements requires management to make judgements, estimates and assumptions regarding the valuation of certain financial instruments, deferred tax balances, pension obligations, the outcome of litigation and other matters that affect the Interim Financial Statements and related disclosures. The Group believes that the estimates utilised in preparing the Interim Financial Statements are reasonable, relevant and reliable. Actual results could differ from these estimates.

For further details on the judgements used in determining whether the Group should consolidate a structured entity and in determining fair value of certain assets and liabilities see note 13 and note 14 respectively.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 2. INTEREST INCOME AND INTEREST EXPENSE

‘Interest income’ represents total interest generated from financial assets whilst ‘interest expense’ represents total interest generated from financial liabilities with the exception that interest expense generated from financial liabilities classified as held for trading is reported as a reduction in ‘interest income’.

‘Interest income’ also includes fees paid on securities borrowed transactions and ‘interest expense’ includes fees received on securities loaned balances and from prime brokerage customers for stock loan transactions incurred to cover customers’ short positions.

### 3. OTHER INCOME

	30 June 2015	Restated <sup>(1)</sup> 30 June 2014
	\$millions	\$millions
Fee and commission income:		
Advisory fees	237	196
Underwriting fees	376	415
Trust and other fiduciary activities	12	5
Management charges to other Morgan Stanley Group undertakings	13	37
Other	18	61
	<u>656</u>	<u>714</u>

(1) Details of the restatement are provided in note 1.

### 4. OTHER EXPENSE

	30 June 2015	30 June 2014
	\$millions	\$millions
Direct staff costs	80	92
Management recharges relating to staff costs borne by other Morgan Stanley Group undertakings	977	1,017
Management recharges from other Morgan Stanley Group undertakings relating to other services <sup>(1)</sup>	98	330
Brokerage fees	283	274
Administration and corporate services	171	169
Professional services	173	181
Operating lease rentals	4	4
Depreciation on property, plant and equipment	1	2
Impairment losses on loans and receivables	9	2
Reversal of impairment losses on loans and receivables	(3)	(2)
Net foreign exchange losses	2	4
Other	91	77
	<u>1,886</u>	<u>2,150</u>

(1) Included within ‘Management recharges from other Morgan Stanley Group undertakings relating to other services’ for 2015 is a reimbursement of \$213 million of net costs which were previously recharged from certain UK incorporated Morgan Stanley Group undertakings following the implementation of the new UK accounting framework, which had reduced aggregate costs recorded by those undertakings; partially offset by a recharge of \$33 million related to the Group’s share of the estimated cost to sell Morgan Stanley’s global oil merchanting business. For 2014, ‘Management recharges from other Morgan Stanley Group undertakings relating to other services’ includes an adjustment made to the recharge of relationship lending costs relating to prior periods.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 5. INCOME TAX EXPENSE

The Group's tax expense has been accrued based on the expected tax rate that takes into account current expectations concerning the allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates.

The Group's effective tax rate for the six month period ended 30 June 2015 is 34.1%, which is higher than that resulting from applying the average standard rate of corporation tax in the UK of 20.25%. The main reason for the higher effective tax rate is the recognition of a provision against certain withholding tax reclaim balances recognised in prior periods.

### 6. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

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

	30 June 2015	30 June 2015	31 December 2014	31 December 2014
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
<b>Fair value</b>				
Government debt securities	14,882	14,306	10,881	8,923
Corporate and other debt	10,040	1,550	11,251	2,219
Corporate equities	51,060	23,632	37,993	15,431
Derivatives	197,138	198,672	235,273	231,255
	<u>273,120</u>	<u>238,160</u>	<u>295,398</u>	<u>257,828</u>

### 7. EQUITY INSTRUMENTS

	Ordinary shares of \$1 each	Ordinary shares of £1 each	Class A ordinary shares of \$1 each	Additional Tier 1 capital	Total equity instruments
	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Issued and fully paid:</b>					
At 1 January 2014 and 30 June 2014	9,934	30	1,500	-	11,464
Issued in the year:					
Additional Tier 1 capital	-	-	-	1,300	1,300
At 31 December 2014	<u>9,934</u>	<u>30</u>	<u>1,500</u>	<u>1,300</u>	<u>12,764</u>
At 1 January 2015	9,934	30	1,500	1,300	12,764
Issued in the period:					
Ordinary shares of \$1 each <sup>(1)</sup>	1	-	-	-	1
At 30 June 2015	<u>9,935</u>	<u>30</u>	<u>1,500</u>	<u>1,300</u>	<u>12,765</u>
<b>Voting rights at 30 June 2015</b>	99.7% <sup>(2)</sup>	0.3% <sup>(2)</sup>	Non-voting	Non-voting	100%

(1) On 20 January 2015 1,000,000 ordinary shares of \$1 each were issued, at par, to the Company's immediate parent undertaking for cash consideration.

(2) Ordinary shares are pari passu with each other regardless of currency and together carry 100% of the vote (31 December 2014: 100%).

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 7. EQUITY INSTRUMENTS (CONTINUED)

#### Equity instruments

The equity instruments remain unchanged from the terms disclosed in the Group's annual consolidated financial statements for the year ended 31 December 2014.

### 8. DIVIDENDS

On 22 January 2015 the Directors approved a coupon payment on the Additional Tier 1 capital instruments of \$14,850,694 out of reserves available for distribution at 31 December 2014. The coupon was paid on 30 January 2015, and resulted in a tax benefit of \$3,103,649.

The Directors have not proposed the payment of an interim dividend out of reserves available at 30 June 2015 (30 June 2014: \$nil).

### 9. ADDITIONAL CASH FLOW INFORMATION

#### a. Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances which have less than three months maturity from the date of acquisition:

	<b>30 June 2015</b>	<b>30 June 2014</b>
	<b>\$millions</b>	<b>\$millions</b>
Cash and short-term deposits	12,320	11,751
Bank loans and overdrafts	(13)	(75)
	<u>12,307</u>	<u>11,676</u>

Included within 'Cash and short term deposits' is \$9,155 million (30 June 2014: \$8,719 million) of segregated client money, held in accordance with the FCA's Client Money Rules, and an amount of \$527 million (30 June 2014: \$747 million) which represents other client money, that is not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.



**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**9. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)**

**b. Reconciliation of cash flows from operating activities**

	<b>Six months ended 30 June 2015 \$millions</b>	<b>Six months ended 30 June 2014 \$millions</b>
Profit for the period	548	234
Adjustments for:		
Depreciation on property, plant and equipment	1	2
Movement in impairment losses for loans and receivables	6	-
Interest income	(36)	(220)
Interest expense	314	355
Income tax expense	283	128
Operating cash flows before changes in operating assets and liabilities	<u>1,116</u>	<u>499</u>
Change in operating assets		
Increase in loans and receivables, excluding cash and short term deposits	(2,437)	(19,061)
Decrease in financial assets classified as held for trading	22,278	65,443
(Increase)/ decrease in financial assets designated at fair value through profit or loss	<u>(2,206)</u>	<u>1,688</u>
	<u>17,635</u>	<u>48,070</u>
Change in operating liabilities		
(Decrease)/ increase in financial liabilities at amortised cost, excluding bank loans and overdrafts	(709)	3,826
Decrease in financial liabilities classified as held for trading	(19,668)	(52,385)
Increase/ (decrease) in financial liabilities designated at fair value through profit or loss	2,585	(560)
Increase/ (decrease) in provisions	2	(1)
	<u>(17,790)</u>	<u>(49,120)</u>
Interest received	40	(62)
Interest paid	(211)	207
Income taxes paid	(33)	(91)
Effect of foreign exchange movements	182	18
<b>Net cash flows from/ (used in) operating activities</b>	<u><u>939</u></u>	<u><u>(479)</u></u>

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 10. SEGMENT REPORTING

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

#### Business segments

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

The Group has one reportable business segment, Institutional Securities, for the period ended 30 June 2015. The Group had two reportable business segments, being Institutional Securities and Investment Management, for the period ended 30 June 2014. Investment Management was not reported as a separate business segment for the period ended 30 June 2015 as it did not meet the quantitative thresholds defined under IFRS 8 that requires it to be reported as a separate business segment, however, it did meet the thresholds for the period ended 30 June 2014.

Institutional Securities provides 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. Investment Management provides a broad array of investment strategies that span the risk/ return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients.

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

<b>Condensed consolidated income statement information</b>	<b>Institutional Securities</b>	<b>Investment Management</b>	<b>Total</b>
<b>Six months ended 30 June 2014</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>
Net gains on financial instruments classified as held for trading (restated) <sup>(1)</sup>	1,778	8	1,786
Net gains on financial instruments designated at fair value through profit or loss	147	-	147
Net interest expense	(134)	(1)	(135)
Other income (restated) <sup>(1)</sup>	707	7	714
<b>External revenues net of interest</b>	<b>2,498</b>	<b>14</b>	<b>2,512</b>
Other expense	(2,117)	(33)	(2,150)
<b>Profit/ (loss) before tax</b>	<b>381</b>	<b>(19)</b>	<b>362</b>
Income tax (expense)/credit	(132)	4	(128)
<b>Profit/ (loss) for the period</b>	<b>249</b>	<b>(15)</b>	<b>234</b>

(1) Details of the restatement are provided in note 1.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 10. SEGMENT REPORTING (CONTINUED)

#### Geographical segments

The Group operates in three geographic regions being EMEA, the Americas and Asia.

The following table presents selected condensed consolidated income statement and condensed consolidated statement of financial position information of the Group's operations by geographic area. The aggregate revenues (net of interest expense) and total assets disclosed in the following table reflect the regional view of the Group's operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

Geographical Segments	EMEA		Americas		Asia		Total	
	30 June 2015	30 June 2014	30 June 2015	30 June 2014	30 June 2015	30 June 2014	30 June 2015	30 June 2014
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Aggregate revenues net of interest expense	2,626	2,410	29	40	62	62	2,717	2,512
Profit before income tax	801	332	1	8	29	22	831	362
	30 June 2015	31 Dec 2014	30 June 2015	31 Dec 2014	30 June 2015	31 Dec 2014	30 June 2015	31 Dec 2014
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Total assets	305,813	306,460	70,919	89,042	54,545	53,024	431,277	448,526

### 11. FINANCIAL RISK MANAGEMENT

#### Risk management procedures

Risk is an inherent part of the Group's business activity. The 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 has developed its own risk management policy framework, which leverages the risk management policies and procedures of the Morgan Stanley Group and includes escalation to the Group's Board of directors and to appropriate senior management personnel of the 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 to the Group. Credit risk includes the risk that economic, social and political conditions and events in a foreign country will adversely affect an obligor's ability and willingness to fulfil their obligations.

The Group's credit risk management policies and procedures establish the framework for ensuring transparency of material credit risks, ensuring compliance with established limits and escalation of risk concentrations to appropriate senior management.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

The Group may incur credit risk in its Institutional Securities business segment through a variety of activities, including, but not limited to, the following:

- entering into derivative contracts under which counterparties have obligations to make payments to the Group;
- extending credit to clients through lending commitments;
- providing short 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;
- placing funds on deposit at other financial institutions to support the Group's clearing and settlement obligations; 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.

*Monitoring and control*

In order to help protect the Group from losses, the Group's Credit Risk Management Department establishes firm-wide practices to evaluate, monitor and control credit risk exposure at the transaction, obligor and portfolio levels. The Group's Credit Risk Management Department approves extensions of credit, evaluates the creditworthiness of the Group's obligors on a regular basis, and ensures that credit exposure is actively monitored and managed. The evaluation of obligors includes an assessment of the probability that an obligor will default on its financial obligations and any subsequent losses that may occur when an obligor defaults. In addition, credit risk exposure is actively managed by credit professionals and committees within the Group's Credit Risk Management Department and through various risk committees, whose membership includes individuals from the Group's Credit Risk Management Department. A comprehensive and global Credit Limits Framework is utilised to manage credit risk levels across the Group. The Credit Limits Framework is calibrated within the Group's risk tolerance and includes single-name limits and portfolio concentration limits by country, industry and product type. The Credit Risk Management Department ensures transparency of material credit risks, compliance with established limits and escalation of risk concentrations to appropriate senior management.

The Credit Risk Management Department also works closely with the Market Risk Department and applicable business units to monitor risk exposures and to perform stress tests to identify, analyse and control credit risk concentrations arising in the Group's lending and trading activities. The stress tests shock market factors (e.g., interest rates, commodity prices, credit spreads), risk parameters (e.g., default probabilities and loss given default), recovery rates and expected losses in order to assess the impact of stresses on exposures, profit and loss and the Company's capital position. Stress and scenario tests are conducted in accordance with established Group's policies and procedures and comply with methodologies outlined in the Basel regulatory framework.

*Credit evaluation* – The evaluation of corporate and institutional counterparties includes assigning obligor credit ratings, which reflect an assessment of an obligor's probability of default and loss given default. Credit evaluations typically involve the assessment of financial statements, leverage, liquidity, capital strength, asset composition and quality, market capitalisation, access to capital markets, the adequacy of collateral, if applicable, and in the case of certain loans, cash flow projections and debt service requirements. The Group's Credit Risk Management Department also evaluates strategy, market position, industry dynamics, management and other factors that could affect the obligor's risk profile. Additionally, the Group's Credit Risk Management Department evaluates the relative position of the Group's exposure in

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

*Monitoring and control (continued)*

the borrower's capital structure and relative recovery prospects, as well as adequacy of collateral (if applicable) and other structural elements of the particular transaction.

In addition to assessing and monitoring its credit exposure and risk at the individual obligor level, the Group also reviews its credit exposure and risk to geographic regions. As at 30 June 2015, credit exposure was concentrated in North America, Western Europe and Asia. 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 30 June 2015, the Group's material credit exposure was to central clearing counterparties, corporate entities, sovereign-related entities and financial institutions.

*Risk Mitigation* – The Credit Risk Management Department may seek to mitigate credit risk from its lending and trading activities in multiple ways, including collateral provisions, guarantees and hedges. At the transaction level, the Credit Risk Management Department seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Group actively hedges its lending and derivatives exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. Additionally, the Group may sell, assign or syndicate funded loans and lending commitments in the primary and secondary loan market. In connection with its derivatives trading activities, the Group generally enters into master netting agreements and collateral arrangements with counterparties. These agreements 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 agreement in the event of a counterparty default.

- *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 agreements with counterparties that provide the Group, in the event of a counterparty default, with the right to net a counterparty's rights and obligations under such agreement and liquidate and set off collateral held by the Group against the net amount owed by the counterparty. 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 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 documentation, 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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

*Exposure to credit risk*

The maximum exposure to credit risk (“gross credit exposure”) of the Group as at 30 June 2015 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 condensed consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. Where the Group enters into credit enhancements, including receiving cash and securities 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 Group’s rating policies. These counterparties individually generate no material credit exposure and this pool is highly diversified, monitored and subject to limits.

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

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 11. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Credit risk (continued)

*Exposure to credit risk by class*

Class	30 June 2015			31 December 2014		
	Gross credit exposure <sup>(1)</sup>	Credit enhancements	Net credit exposure <sup>(2)</sup>	Gross credit exposure <sup>(1)</sup>	Credit enhancements	Net credit exposure <sup>(2)</sup>
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Loans and receivables:						
Cash and short term deposits	12,320	-	12,320	11,671	-	11,671
Cash collateral on securities borrowed	19,912	(18,643)	1,269	20,691	(19,770)	921
Securities purchased under agreements to resell	61,253	(59,591)	1,662	58,724	(57,640)	1,084
Trade receivables <sup>(3)</sup>	56,307	-	56,307	54,944	-	54,944
Other receivables	1,581	-	1,581	2,702	-	2,702
Financial assets classified as held for trading:						
Derivatives	197,138	(185,956)	11,182	235,273	(224,980)	10,293
Financial assets designated at fair value through profit or loss	5,566	(5,318)	248	3,360	(1,760)	1,600
	<u>354,077</u>	<u>(269,508)</u>	<u>84,569</u>	<u>387,365</u>	<u>(304,150)</u>	<u>83,215</u>
<b>Unrecognised financial instruments</b>						
Contingent commitments	987	-	987	962	-	962
Letters of credit	2	-	2	1	-	1
Loan commitments	1,825	-	1,825	1,815	-	1,815
Underwriting commitments	3,215	(665)	2,550	290	-	290
Unsettled securities purchased under agreements to resell <sup>(4)</sup>	27,001	-	27,001	24,797	-	24,797
	<u>387,107</u>	<u>(270,173)</u>	<u>116,934</u>	<u>415,230</u>	<u>(304,150)</u>	<u>111,080</u>

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

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$4,372 million (2014: \$2,928 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade receivables 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 condensed consolidated statement of financial position.

(4) For unsettled securities purchased under agreement to resell, 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.

The impact of master netting arrangements and similar agreements on the Group's ability to offset financial assets and financial liabilities is further disclosed in note 12.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 11. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Credit risk (continued)

*Maximum exposure to credit risk by credit rating <sup>(1)</sup>*

Credit rating	Gross credit exposure	
	30 June 2015 \$millions	31 December 2014 \$millions
AAA	12,458	14,895
AA	72,690	72,747
A	220,623	246,673
BBB	54,457	54,410
BB	13,381	15,736
B	5,607	3,849
CCC	2,433	2,671
Unrated	5,458	4,249
<b>Total</b>	<b>387,107</b>	<b>415,230</b>

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

*Financial assets past due but not impaired:*

At 30 June 2015, \$2,279 million of financial assets included in loans and receivables in the condensed consolidated statement of financial position were past due but not impaired (31 December 2014: \$1,005 million). The balance as at 31 December 2014 has been revised to reflect additional trading related balances which are generally not past due by more than 30 days.

*Financial assets individually impaired:*

	30 June 2015 \$millions	31 December 2014 \$millions
Loans and receivables:		
Trade receivables	31	22
Other receivables	-	24
	<u>31</u>	<u>46</u>

#### Liquidity and funding risk

Liquidity and funding risk refers to the risk that the Group will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the Group's ability to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern.

The Group's liquidity and funding risk management policies and procedures are consistent with those of the Morgan Stanley Group. The Board of directors of the Group is ultimately responsible for establishing the liquidity risk tolerance and ensuring the Group's liquidity risk is appropriately managed. In addition to the internal liquidity risk management framework, the Group is locally subject to the liquidity regulations prescribed by the PRA. The Group has daily monitoring and reporting processes in place to ensure compliance with its regulatory requirements.

The primary goal of the Group's liquidity and funding risk management framework is to ensure that the Group has 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.



**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity and funding risk (continued)**

The following principles guide the Group's liquidity and funding risk management framework:

- Sufficient liquid assets should be maintained to cover maturing liabilities and other planned and contingent outflows;
- Maturity profile of assets and liabilities should be aligned, with limited reliance on short-term funding;
- Source, counterparty, currency, region, and term of funding should be diversified; and
- Contingency Funding Plan ("CFP") should anticipate, and account for, periods of limited access to funding.

The core components of the Group's liquidity and funding risk management framework are the CFP, Liquidity Stress Tests and the Liquidity Reserve (as defined below), which support the Group's target liquidity profile.

*Contingency Funding Plan*

A CFP is prepared for the UK Defined Liquidity Group ("DLG") which consists of the Company, and two other UK Morgan Stanley Group undertakings, being MSSL, whose institutional securities business was transferred to the Group in the period, and Morgan Stanley Bank International Limited. The Company is the largest component of the DLG. 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 DLG'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 DLG, uses liquidity stress tests to model liquidity outflows across multiple scenarios over a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events.

The assumptions underpinning the Liquidity Stress Tests include, but are not limited to, the following:

- No government support;
- No access to equity and unsecured debt markets;
- Repayment of all unsecured debt maturing within the stress horizon;
- Higher haircuts and significantly lower availability of secured funding;
- Additional collateral that would be required by trading counterparties, certain exchanges and clearing organisations related to credit rating downgrades;
- Additional collateral that would be required due to collateral substitutions, collateral disputes and uncalled collateral;
- Discretionary unsecured debt buybacks;
- Drawdowns on unfunded commitments provided to third parties;
- Client cash withdrawals and reduction in customer short positions that fund long positions;
- Limited access to the foreign exchange swap markets; and
- Maturity roll-off of outstanding letters of credit with no further issuance.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity and funding risk (continued)**

*Liquidity Stress Tests (continued)*

Stress Tests are produced for the DLG, as well as at major currency levels, to capture specific cash requirements and cash availability across the DLG. The Liquidity Stress Tests assume that a legal entity will use its own liquidity first to fund its obligations before drawing liquidity from its ultimate parent undertaking, Morgan Stanley. Morgan Stanley will support its subsidiaries and will not have access to subsidiaries' liquidity reserves that are subject to any regulatory, legal or tax constraints.

At 30 June 2015, the Group, through the DLG, maintained sufficient liquidity to meet current and contingent funding obligations as modeled in its Liquidity Stress Tests.

*Liquidity Reserve*

The Group maintains sufficient liquidity reserves ("Liquidity Reserve") to cover daily funding needs and to meet strategic liquidity targets sized by the CFP and Liquidity Stress Tests. The size of the Liquidity Reserve is actively managed by the Group. The following components are considered in sizing the 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. Additionally, the Group's Liquidity Reserve includes an additional reserve, which is primarily a discretionary surplus based on the Group's risk tolerance and is subject to change dependent on market and entity-specific events.

The Group holds its own Liquidity Reserve which is composed of diversified cash and cash equivalents and highly liquid unencumbered securities. Eligible unencumbered highly liquid securities include primarily US government securities in addition to non-US government securities and other highly liquid investment grade securities.

*Basel Liquidity Framework*

The Basel Committee has developed two standards intended for use in liquidity risk supervision: the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"). The Group will be subject to both ratios under the local adoption of Basel III regulations, which will be implemented in phases starting October 2015.

*Funding Management*

The Group manages its funding in a manner that reduces the risk of disruption to the Group's operations. The 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 Group's liabilities equals or exceeds the expected holding period of the assets being financed.

The Group funds itself through diverse sources. These sources may include the Group's equity capital, long-term debt, repurchase agreements and securities lending. The Group has an active financing program for structured products targeting global investors and currencies.

*Secured Financing.* A substantial portion of the Group's total assets consists of liquid marketable securities. The liquid nature of these assets provides the Group with flexibility in funding these assets with secured financing. The Group's goal is to achieve an optimal mix of durable secured and unsecured financing. Secured financing investors principally focus on the quality of the eligible collateral posted. Accordingly, the Group actively manages its secured financing book based on the quality of the assets being funded.

The Group utilises shorter-term secured financing only for highly liquid assets and has established longer tenor limits for less liquid asset classes, for which funding may be at risk in the event of a market disruption. The Group defines highly liquid assets as those that are consistent with the standards of the Liquidity Reserve, and less liquid assets as those that do not meet these standards. To further minimise the refinancing risk of secured financing for less liquid assets, the Group has established concentration limits to

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity and funding risk (continued)**

*Funding Management (continued)*

diversify its investor base and reduce the amount of monthly maturities for secured financing of less liquid assets. Furthermore, the Group obtains spare capacity, or term secured funding liabilities in excess of less liquid inventory, as an additional risk mitigant to replace maturing trades in the event that secured financing markets or our ability to access them become limited. Finally, in addition to the above risk management framework, the Group holds a portion of its Liquidity Reserve against the potential disruption to its secured financing capabilities.

*Unsecured Financing.* The Group views long-term debt as a stable source of funding. The Group's unsecured financings include structured borrowings, whose payments and redemption values are based on the performance of certain underlying assets, including equity, credit, foreign exchange, interest rates and commodities. When appropriate, the Group may use derivative products to conduct asset and liability management and to make adjustments to the Group's interest rate and structured borrowings risk profile.

*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 presented at fair value, consistent with how these financial liabilities are managed, and disclosed as on demand. Derivatives not held as part of the Group's trading activities and financial liabilities designated at fair value through profit or 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 30 June 2015 and 31 December 2014. 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.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk (continued)**

*Maturity analysis (continued)*

	On demand	Less than 1 month	Equal to or more than 1 month but less than 3 months	Equal to or more than 3 months but less than 1 year	Equal to or more than 1 year but less than 5 years	Equal to or more than 5 years	Total
30 June 2015	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	13	-	-	-	-	-	13
Cash collateral on securities loaned	20,216	125	1,362	564	-	-	22,267
Securities sold under agreements to repurchase	20,335	7,699	2,782	6,443	4,148	-	41,407
Trade payables	79,220	-	-	-	-	-	79,220
Other payables	4,030	6	12	10,115	278	3,617	18,058
Subordinated loans	-	-	-	139	994	9,867	11,000
Financial liabilities classified as held for trading:							
Derivatives	198,672	-	-	-	-	-	198,672
Other	39,488	-	-	-	-	-	39,488
Financial liabilities designated at fair value through profit or loss							
	5,295	81	48	885	767	640	7,716
<b>Total financial liabilities</b>	<b>367,269</b>	<b>7,911</b>	<b>4,204</b>	<b>18,146</b>	<b>6,187</b>	<b>14,124</b>	<b>417,841</b>
<b>Unrecognised financial instruments</b>							
Contingent commitments	987	-	-	-	-	-	987
Lease commitments	-	1	1	5	23	2	32
Letters of credit	-	-	-	1	-	1	2
Loan commitments	1,825	-	-	-	-	-	1,825
Underwriting commitments	279	665	865	1,406	-	-	3,215
Unsettled securities purchased under agreements to resell <sup>(1)</sup>	26,805	196	-	-	-	-	27,001
<b>Total unrecognised financial instruments</b>	<b>29,896</b>	<b>862</b>	<b>866</b>	<b>1,412</b>	<b>23</b>	<b>3</b>	<b>33,062</b>

(1) The Group enters into forward starting unsettled securities purchased under agreements to resell (agreements which have a trade date at or prior to 30 June 2015 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 30 June 2015, \$26,805 million settled within three business days.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk (continued)**

*Maturity analysis (continued)*

<b>31 December 2014</b>	<b>On demand</b>	<b>Less than 1 month</b>	<b>Equal to or more than 1 month but less than 3 months</b>	<b>Equal to or more than 3 months but less than 1 year</b>	<b>Equal to or more than 1 year but less than 5 years</b>	<b>Equal to or more than 5 years</b>	<b>Total</b>
	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>
<b>Financial liabilities</b>							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	15	-	-	-	-	-	15
Cash collateral on securities loaned	15,687	826	525	461	-	-	17,499
Securities sold under agreements to repurchase	21,210	10,692	4,551	6,430	3,092	-	45,975
Trade payables	83,561	-	-	-	-	-	83,561
Subordinated loans	-	-	-	145	1,088	9,785	11,018
Other payables	4,277	6	13	6,483	306	3,722	14,807
Financial liabilities classified as held for trading:							
Derivatives	231,255	-	-	-	-	-	231,255
Other	26,573	-	-	-	-	-	26,573
Financial liabilities designated at fair value through profit or loss							
	2,007	461	111	690	1,119	743	5,131
<b>Total financial liabilities</b>	<b>384,585</b>	<b>11,985</b>	<b>5,200</b>	<b>14,209</b>	<b>5,605</b>	<b>14,250</b>	<b>435,834</b>
<b>Unrecognised financial instruments</b>							
Contingent commitments	962	-	-	-	-	-	962
Lease commitments	-	1	1	5	22	5	34
Letters of credit	-	-	-	-	-	1	1
Loan commitments	1,815	-	-	-	-	-	1,815
Underwriting commitments	-	-	290	-	-	-	290
Unsettled securities purchased under agreements to resell <sup>(1)</sup>	24,333	464	-	-	-	-	24,797
<b>Total unrecognised financial instruments</b>	<b>27,110</b>	<b>465</b>	<b>291</b>	<b>5</b>	<b>22</b>	<b>6</b>	<b>27,899</b>

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2014 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2014, \$24,333 million settled within three business days.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk**

Market risk refers to the risk of losses for a position or portfolio due to changes in rates, foreign exchange, equities, implied volatilities, correlations or other market factors.

Sound market risk management is an integral part of the Group's culture. The Group is responsible for ensuring that market risk exposures are well-managed and monitored. The Group also ensures transparency of material market risks, monitors compliance with established limits, and escalates risk concentrations to appropriate senior management.

To execute these responsibilities, the Group monitors its market risk against limits on aggregate risk exposures, performs a variety of risk analyses, routinely reports risk summaries and maintains the VaR and scenario analysis methodologies. These limits are designed to control market 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.

*Primary market risk exposures and market risk management*

During the period, the Group had exposures to a wide range of interest rate and credit spread risk, equity prices, foreign exchange rates and commodity prices and the associated implied volatilities and correlations, 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 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, 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 market making activities in equity securities and derivatives and maintaining other positions (including positions in non-public entities). Positions in non-public entities may include, but are not limited to, exposures to private equity, venture capital, private partnerships, real estate funds, and other funds. Such positions are less liquid, have longer investment horizons and are more difficult to hedge than listed equities.

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

The Group 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 in all circumstances 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 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 Board of Directors.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**11. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk (continued)**

*Primary market risk exposures and market risk management (continued)*

Aggregate market risk limits have been approved for the Group. Additional market risk limits are assigned to trading desks. 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 the Board of directors.

*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 Management VaR-based risk measures to various levels of management.

*VaR methodology, assumptions and limitations*

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 VaR model uses four years of historical data with a volatility adjustment to reflect current market conditions. A set of internal processes and controls ensure that all trading positions booked by the Group are being included in VaR. The Group's Management VaR is the internal management VaR metric set up at a 95% level of confidence over a one day time horizon, which is a useful indicator of possible trading losses resulting from adverse daily market moves. The Group's 95%/one-day VaR corresponds to the potential 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 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 modelled into VaR. In addition, 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. 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.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 11. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Market risk (continued)

##### *VaR methodology, assumptions and limitations (continued)*

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 six months ended 30 June 2015*

The table below presents the Management VaR for the Group's Trading portfolio on a period-end, six month average as well as the high and low basis for 30 June 2015 and one year to 31 December 2014 as a comparative.

The Credit Portfolio VaR is disclosed as a separate category from the Primary Risk Categories and includes loans that are carried at fair value 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% VaR	95% / one-day VaR for the six months ended 30 June 2015				95% / one-day VaR for the year ended 31 December 2014			
	Period		High \$million	Low \$million	Period		High \$million	Low \$million
Market Risk Category	End \$million	Average \$million			End \$million	Average \$million		
Interest rate and credit spread	14	14	20	11	12	12	16	9
Equity price	11	15	38	10	13	12	15	10
Foreign exchange rate	6	6	10	3	4	3	6	2
Commodity price	2	2	3	-	1	1	4	-
Less: Diversification benefit <sup>(1)(2)</sup>	(13)	(15)	N/A	N/A	(12)	(11)	N/A	N/A
<b>Primary Risk Categories VaR</b>	<b>20</b>	<b>22</b>	<b>42</b>	<b>17</b>	<b>18</b>	<b>17</b>	<b>21</b>	<b>14</b>
Credit Portfolio VaR	6	6	8	5	6	6	8	4
Less: Diversification benefit <sup>(1)(2)</sup>	(3)	(4)	N/A	N/A	(3)	(4)	N/A	N/A
<b>Total Management VaR</b>	<b>23</b>	<b>24</b>	<b>43</b>	<b>19</b>	<b>21</b>	<b>19</b>	<b>24</b>	<b>15</b>

(1) Diversification benefit equals the difference between total trading 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 are also 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 period and therefore the diversification benefit is not an applicable measure.



# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 11. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Market risk (continued)

##### *Sensitivity analysis (continued)*

The Group's average Management VaR for Primary Risk Categories for the first six months of 2015 was \$22 million compared with \$17 million for the year ended 31 December 2014. The increase in average VaR for Primary Risk Categories is primarily due to increased exposure to interest rate and equity price risk.

The average Credit Portfolio VaR for the first six months of 2015 was \$6 million, unchanged compared to the year ended 31 December 2014.

The average total Management VaR for the first six months of 2015 was \$24 million compared with \$19 million for the year ended 31 December 2014.

##### *Non-trading risks for the six months ended 30 June 2015*

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

##### *Interest rate risk*

The Group's VaR excludes certain funding liabilities and money market transactions and other non-trading risks. 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 \$3.1 million as of 30 June 2015 compared to a net gain or loss of \$2.7 million as at 31 December 2014.

##### *Counterparty exposure related to own spreads*

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure has been managed within VaR since February 2015. As at 31 December 2014, the credit spread risk sensitivity of this exposure corresponds to an increase in value of approximately \$2.7 million for each 1 basis point widening in the Group's credit spread level.

##### *Funding liabilities*

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately \$0.3 million for each 1 basis point widening in the Group's credit spread level as at 30 June 2015 (\$0.1 million as at 31 December 2014).

##### *Equity investments price risk*

The Group is exposed to equity price risk as a result of changes in the fair value of its investments in both exchange traded equity securities and private equities classified as available-for-sale financial assets. 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.

	<b>30 June 2015</b>	<b>31 December 2014</b>
	<b>10% sensitivity</b>	<b>10% sensitivity</b>
	<b>\$millions</b>	<b>\$millions</b>
Available-for-sale financial assets	<u>4</u>	<u>4</u>

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 11. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Market risk (continued)

##### *Currency risk*

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

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

The analysis below details the foreign currency exposure for the Group, by foreign currency, relating to the retranslation of its non-US dollar denominated branches and subsidiaries. The analysis calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency in relation to 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.

	30 June 2015			31 December 2014		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions
Australian Dollar	(44)	14%	(6)	(52)	14%	(7)
British Pound	(87)	6%	(5)	(29)	6%	(2)
Euro	307	12%	37	264	12%	32
New Taiwan Dollar	71	8%	6	67	8%	6
Polish Zloty	3	17%	1	3	17%	1
South Korean Won	187	8%	15	205	8%	17
Swedish Krona	13	21%	3	14	21%	3
Swiss Franc	11	12%	1	9	12%	1
	<u>461</u>		<u>52</u>	<u>481</u>		<u>51</u>

The reasonably possible percentage change in the currency rate in relation to US dollars has been calculated based on the greatest annual percentage change over the period from 1 January 2010 to 30 June 2015. Thus, the percentage change applied may not be the same percentage as the actual change in the currency rate for the six month period to 30 June 2015, or for the year ended 31 December 2014.

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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING**

In order to manage credit exposure arising from its business activities, the Group applies various credit risk management policies and procedures, see Note 11 for further details. Primarily in connection with securities purchased under agreements to resell and securities sold under agreements to repurchase, securities borrowed and securities loaned transactions and derivative transactions, the Group enters into master netting arrangements and collateral arrangements with its counterparties. These agreements provide the Group with the right, in the ordinary course of business and/ or in the event of a counterparty default (such as bankruptcy or a counterparty's failure to pay or perform), to net a counterparty's rights and obligations under such agreement and, in the event of counterparty default, set off collateral held by the Group against the net amount owed by the counterparty. However, in certain circumstances, the Group may not have such an agreement in place; the relevant insolvency regime (which is based on type of counterparty entity and the jurisdiction of organisation of the counterparty) may not support the enforceability of the agreement; or the Group may not have sought legal advice to support the enforceability of the agreement. In cases where the Group has not determined an agreement to be enforceable, the related amounts are not offset in the tabular disclosures. The Group's policy is generally to take possession of securities purchased under agreements to resell and securities borrowed, and to receive securities and cash posted as collateral (with rights of rehypothecation), although in certain cases the Group may agree for such collateral to be posted to a third party custodian under a tri-party arrangement that enables the Group to take control of such collateral in the event of a counterparty default. The enforceability of the master netting agreement is taken into account in the Group's risk management practices and application of counterparty credit limits. 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 as provided under the applicable agreement to ensure such transactions are adequately collateralised.

In the condensed consolidated statement of financial position, financial assets and financial liabilities are only offset and presented on a net basis where there is a current legally enforceable right to set off the recognised amounts and an intention to either settle on a net basis or to realise the asset and the liability simultaneously. In the absence of such conditions, financial assets and financial liabilities are presented on a gross basis.

The following tables present information about the offsetting of financial instruments and related collateral amounts. The tables do not include information about financial instruments that are subject only to a collateral agreement. The effect of master netting arrangements, collateral agreements and other credit enhancements, on the Group's exposure to credit risk is disclosed in note 11.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts <sup>(1)</sup> \$millions	Amounts offset in the condensed consolidated statement of financial position <sup>(2)(3)</sup> \$millions	Net amounts presented in the condensed consolidated statement of financial position \$millions	Amounts not offset in the condensed consolidated statement of financial position <sup>(4) (5) (6)</sup>		Net exposure <sup>(7)</sup> \$millions
				Financial instruments \$millions	Cash collateral \$millions	
<b>30 June 2015</b>						
<b>Assets</b>						
Loans and receivables:						
Cash collateral on securities borrowed	33,334	(13,422)	19,912	(18,643)	-	1,269
Securities purchased under agreements to resell	85,953	(24,700)	61,253	(59,591)	-	1,662
Financial assets classified as held for trading:						
Derivatives	250,279	(53,141)	197,138	(163,374)	(22,582)	11,182
<b>TOTAL</b>	<b>369,566</b>	<b>(91,263)</b>	<b>278,303</b>	<b>(241,608)</b>	<b>(22,582)</b>	<b>14,113</b>
<b>Liabilities</b>						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	35,689	(13,422)	22,267	(21,934)	-	333
Securities sold under agreements to repurchase	66,058	(24,700)	41,358	(37,727)	-	3,631
Financial liabilities classified as held for trading:						
Derivatives	242,669	(43,997)	198,672	(161,933)	(22,179)	14,560
<b>TOTAL</b>	<b>344,416</b>	<b>(82,119)</b>	<b>262,297</b>	<b>(221,594)</b>	<b>(22,179)</b>	<b>18,524</b>

- (1) Amounts include \$900 million of cash collateral on securities borrowed, \$1,290 million of securities purchased under agreements to resell, \$4,864 million of financial assets classified as held for trading - derivatives, \$197 million of cash collateral on securities loaned, \$2,735 million of securities sold under agreements to repurchase and \$4,867 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the condensed consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts include \$9,393 million and \$249 million of cash collateral receivable and payable related to financial assets classified as held for trading - derivatives recognised in amounts offset in the condensed consolidated statement of financial positions for assets and liabilities respectively.
- (4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the condensed consolidated statement of financial position.
- (5) The cash collateral related to held for trading derivatives not offset is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (6) In addition to the balances disclosed in the table certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the condensed consolidated statement of financial position. \$3 million not presented net within the condensed consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.
- (7) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$4,372 million to be offset in the ordinary course of business and/ or in the event of default.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts <sup>(1)</sup>	Amounts offset in the condensed consolidated statement of financial position <sup>(2)(3)</sup>	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position <sup>(4)(5)(6)</sup>		Net exposure <sup>(7)</sup>
	\$millions	\$millions	\$millions	Financial instruments \$millions	Cash collateral \$millions	\$millions
<b>31 December 2014</b>						
<b>Assets</b>						
Loans and receivables:						
Cash collateral on securities borrowed	39,701	(19,010)	20,691	(19,770)	-	921
Securities purchased under agreements to resell	86,595	(27,871)	58,724	(57,640)	-	1,084
Financial assets classified as held for trading:						
Derivatives	296,542	(61,269)	235,273	(194,201)	(30,717)	10,355
<b>TOTAL</b>	<b>422,838</b>	<b>(108,150)</b>	<b>314,688</b>	<b>(271,611)</b>	<b>(30,717)</b>	<b>12,360</b>
<b>Liabilities</b>						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	36,509	(19,010)	17,499	(17,415)	-	84
Securities sold under agreements to repurchase	73,782	(27,871)	45,911	(42,344)	-	3,567
Financial liabilities classified as held for trading:						
Derivatives	284,398	(53,143)	231,255	(195,083)	(24,015)	12,157
<b>TOTAL</b>	<b>394,689</b>	<b>(100,024)</b>	<b>294,665</b>	<b>(254,842)</b>	<b>(24,015)</b>	<b>15,808</b>

- (1) Amounts include \$697 million of cash collateral on securities borrowed, \$1,080 million of securities purchased under agreements to resell, \$4,602 million of financial assets classified as held for trading - derivatives, \$60 million of cash collateral on securities loaned, \$3,359 million of securities sold under agreements to repurchase and \$3,920 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the condensed consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts include \$9,272 million and \$1,153 million of cash collateral receivable and payable related to financial assets classified as held for trading - derivatives recognised in amounts offset in the condensed consolidated statement of financial positions for assets and liabilities respectively.
- (4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the condensed consolidated statement of financial position.
- (5) The cash collateral related to held for trading derivatives not offset is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (6) In addition to the balances disclosed in the table certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the condensed consolidated statement of financial position. \$2 million not presented net within the condensed consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.
- (7) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$2,928 million to be offset in the ordinary course of business and / or in the event of default.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**13. INTERESTS IN STRUCTURED ENTITIES**

The Group is involved with various special purpose entities in the normal course of business. In most cases, these entities are deemed to be structured entities.

A structured entity is an entity that has been designed such that voting or similar rights are not the dominant factor in deciding who controls the entity. The party that consolidates the structured entity is the investor that controls the structured entity. An investor controls a structured entity when it is exposed, or has the rights, to variable returns from its involvement with the structured entity and has the ability to affect those returns through its power over the structured entity. The Group consolidates structured entities it controls.

The Group's interests in structured entities include certain debt and equity interests, commitments, guarantees, derivative instruments and certain fees arrangements. The Group's involvement with structured entities arises primarily from:

- Loans made to and investments in structured entities that hold debt, equity, real estate or other assets;
- Interests purchased in connection with market-making activities and retained interests held as a result of securitisation activities;
- Structuring of asset-repackaged notes designed to meet the investment objectives of clients; and
- Certain derivatives entered into with structured entities.

The Group determines whether it controls, and therefore should consolidate, a structured entity upon its initial involvement with the structured entity and reassesses whether it should continue to consolidate on an ongoing basis as long as it has any continuing involvement with the structured entity. This determination is based upon an analysis of the design of the structured entity, including the entity's structure and activities; assessment of the significance of the powers to make economic decisions which are held by the Group and its related parties and whether such powers may be used to affect its investor returns; and consideration of the significance of direct and indirect interests in the structured entity which are held by the Group and its related parties.

The power to make the most significant economic decisions may take a number of different forms. The Group considers servicing or collateral management decisions as generally representing the power to make the most significant economic decisions in transactions such as securitisations or collateralised debt obligations ("CDOs"). As a result, the Group does not consolidate securitisations or CDOs for which it does not act as the servicer or collateral manager unless it holds certain other rights to replace the servicer or collateral manager or to require the liquidation of the entity. In fund structures, the power to appoint or direct the fund manager is generally the most significant power.

For certain structured entities, such as entities which issued Credit Linked Notes ('CLNs') and other asset-repackaged notes, there are no significant economic decisions made on an ongoing basis. In these cases, the Group focuses its analysis on decision making powers relating to liquidation of the entity or unwinding or termination of the transaction structure. Based upon factors, which include an analysis of the nature of the assets, including whether the assets were issued in a transaction sponsored by the Group and the extent of the information available to the Group and to investors, the number, nature and involvement of investors, other rights held by the Group and investors, the standardisation of the legal documentation and the level of the continuing involvement by the Group, including the amount and type of interests owned by the Group and by other investors, the Group concluded in some of these transactions that decisions made prior to the initial closing were shared between the Group and the initial investors. The Group focused its control decision on any right held by the Group or investors related to the termination of the structured entity. Many CLNs and other asset repackaged notes have no such termination rights.

The assets owned by many consolidated structured entities cannot be removed unilaterally by the Group and are not generally available to the Group. The related liabilities issued by many consolidated structured entities are non-recourse to the Group. In certain other consolidated structured entities, the Group has the unilateral right to remove assets or provide additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**13. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)**

The Group accounts for the assets held by structured entities primarily in ‘Financial assets classified as held for trading – corporate and other debt’ and the liabilities of the structured entities as ‘Financial liabilities designated at fair value’ in the consolidated statement of financial position.

The usage of structured entities is described below.

*Securitisation Activities.* In a securitisation transaction, the Group transfers assets (generally commercial or residential mortgage loans) to a structured entity, sells to investors most of the beneficial interests, such as notes or certificates, issued by the structured entity, and in many cases, retains other beneficial interests. The purchase of the transferred assets by the structured entity is financed through the sale of these interests. In many securitisations, particularly those involving residential mortgage loans, the Group also enters into derivative transactions, primarily interest rate swaps or interest rate caps with a senior payment priority, with the structured entity.

*Credit Protection Purchased through CLNs.* In a CLN transaction, the Group transfers reference assets (generally high-quality securities or money market investments) to a structured entity, enters into a derivative transaction in which the structured entity writes protection on an unrelated reference asset or group of assets, through a credit default swap, a total return swap or similar instrument, and sells to investors the securities issued by the structured entity. In some transactions, the Group may also enter into interest rate or currency swaps with the structured entity. The purchase of the transferred assets by the structured entity is financed through the sale of the securities issued. Upon the occurrence of a credit event related to the reference asset, the structured entity will deliver collateral securities as the payment to the Group. The Group is generally exposed to price changes on the collateral securities in the event of a credit event and subsequent sale. These transactions are designed to provide investors with exposure to certain credit risk on the reference asset. The structure of the transaction determines the accounting treatment. In some transactions, the assets and liabilities of the structured entity are recognised in the Group’s consolidated financial statements. In other transactions, the transfer of the collateral securities is accounted for as a sale of assets, and the structured entity is not consolidated. CLNs are included in Other in the tables below.

*Collateralised Loan and Debt Obligations.* A collateralised loan obligation (“CLO”) or a CDO is a structured entity that purchases a pool of assets, consisting of corporate loans, corporate bonds, asset-backed securities or synthetic exposures on similar assets through derivatives, and issues multiple tranches of debt and equity securities to investors. The purchase of the assets by the structured entity is financed through the issuance of the tranches of securities. The Group underwrites the securities issued in CLO transactions on behalf of unaffiliated sponsors and provides advisory services to these unaffiliated sponsors. The Group sells corporate loans to many of these structured entities, in some cases representing a significant portion of the total assets purchased. If necessary, the Group may retain unsold securities issued in these transactions. Although not obligated, the Group generally makes a market in the securities issued by structured entities in these transactions. These beneficial interests are included in Financial assets classified as held for trading.

*Equity-Linked Notes.* In an equity-linked note transaction the Group typically transfers to a structured entity either a note issued by the Group, the payments on which are linked to the performance of a specific equity security, equity index or other index, or debt securities issued by other companies and a derivative contract, the terms of which will relate to the performance of a specific equity security, equity index or other index. These transactions are designed to provide investors with exposure to certain risks related to the specific equity security, equity index or other index.

The purchase of the transferred note or debt securities by the structured entity is financed through the sale of equity interests to investors. Equity-linked notes are included in “Other” in the tables below.

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**Six months ended 30 June 2015**

**13. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)**

*Fund Investments.* In a fund investment structure the Group provides clients with indirect access to specified underlying investments through total return swaps. The investments are purchased and held by a structured entity in which the Group holds an interest. The structured entity is financed through the sale of notes to investors.

**Consolidated structured entities**

As at 30 June 2015 and at 31 December 2014, the Group did not have any structured entities that it consolidated.

**Unconsolidated structured entities**

The Group has interests in structured entities that the Group does not control and are therefore not consolidated.

The Group's transactions with unconsolidated structured entities primarily include securitisations, credit protection purchased through CLNs, other structured financings and collateralised loan and debt obligations. The Group's interests in structured entities that it does not consolidate can include ownership of retained interests in Group-sponsored transactions, interests purchased in the secondary market (both for Group-sponsored transactions and transactions sponsored by third parties), and certain derivatives with securitisation structured entities. The risks associated with derivatives entered into with structured entities are essentially the same as similar derivatives with non-structured entity counterparties and are managed as part of the Group's overall exposure.

The tables below show certain non-consolidated structured entities in which the Group had an interest at 30 June 2015 and 31 December 2014. The tables include all structured entities in which the Group has determined that its maximum exposure to loss is greater than specific thresholds or meets certain other criteria. Most of the structured entities included in the tables below are sponsored by unrelated parties; the Group's involvement generally is the result of the Group's secondary market-making activities.



**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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**13. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)**

**Unconsolidated structured entities (continued)**

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
<b>30 June 2015</b>					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	16,330	1,560	2,688	85	20,663
Maximum exposure to loss:					
Debt and equity interests	851	59	-	16	926
Derivative and other contracts	-	-	2,688	52	2,740
<b>Total maximum exposure to loss</b>	<b>851</b>	<b>59</b>	<b>2,688</b>	<b>68</b>	<b>3,666</b>
Carrying value of exposure to loss - assets <sup>(1)</sup> :					
Debt and equity interests	851	59	-	16	926
Derivative and other contracts	-	-	1	-	1
<b>Total carrying value of exposure to loss - assets</b>	<b>851</b>	<b>59</b>	<b>1</b>	<b>16</b>	<b>927</b>
Carrying value of exposure to loss - liabilities <sup>(1)</sup> :					
Derivatives and other contracts	-	-	3	19	22
<b>Total carrying value of exposure to loss - liabilities</b>	<b>-</b>	<b>-</b>	<b>3</b>	<b>19</b>	<b>22</b>

(1) Amounts are recognised in the condensed consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**13. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)**

**Unconsolidated structured entities (continued)**

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
<b>31 December 2014</b>					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	18,375	4,106	2,576	95	25,152
Maximum exposure to loss:					
Debt and equity interests	922	124	-	16	1,062
Derivative and other contracts	-	-	2,576	35	2,611
<b>Total maximum exposure to loss</b>	<b>922</b>	<b>124</b>	<b>2,576</b>	<b>51</b>	<b>3,673</b>
Carrying value of exposure to loss – assets <sup>(1)</sup> :					
Debt and equity interests	922	124	-	16	1,062
Derivative and other contracts	-	-	-	-	-
<b>Total carrying value of exposure to loss - assets</b>	<b>922</b>	<b>124</b>	<b>-</b>	<b>16</b>	<b>1,062</b>
Carrying value of exposure to loss – liabilities <sup>(1)</sup> :					
Derivatives and other contracts	-	-	13	2	15
<b>Total carrying value of exposure to loss - liabilities</b>	<b>-</b>	<b>-</b>	<b>13</b>	<b>2</b>	<b>15</b>

(1) Amounts are recognised in the condensed consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**13. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)**

**Unconsolidated structured entities (continued)**

The Group's maximum exposure to loss often differs from the carrying value of the interests held by the Group. The maximum exposure to loss is dependent on the nature of the Group's interest in the structured entities and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Group has made in the structured entities. Liabilities issued by structured entities generally are non-recourse to the Group. Where notional amounts are utilised in quantifying maximum exposure related to derivatives, such amounts do not reflect fair value write downs already recorded by the Group.

The Group's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Group may utilise to hedge these risks associated with the Group's interests. In addition, the Group's maximum exposure to loss is not reduced by the amount of collateral held as part of a transaction with the structured entity or any party to the structured entity directly against a specific exposure to loss.

Securitisation transactions generally involve structured entities. Primarily as a result of its secondary market-making activities, the Group owned additional securities issued by securitisation structured entities for which the maximum exposure to loss is less than specific thresholds. These additional securities totalled \$589 million at 30 June 2015 (31 December 2014: \$513 million). These securities were retained in connection with transfers of assets by the Group. Securities issued by securitisation structured entities consist of \$361 million of securities backed primarily by residential mortgage loans (31 December 2014: \$262 million), \$59 million of securities backed by commercial mortgage loans (31 December 2014: \$86 million), \$144 million of securities backed by collateralised debt obligations or collateralised loan obligations (31 December 2014: \$100 million) and \$25 million backed by other consumer loans (31 December 2014: \$65 million). The Group's primary risk exposure is to the securities issued by the structured entity owned by the Group, with the risk highest on the most subordinate class of beneficial interests. These securities generally are included in financial assets classified as held for trading – corporate and other debt. The Group does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees or similar derivatives. The Group's maximum exposure to loss generally equals the fair value of the securities owned.

The Group has not provided financial support to, or otherwise agreed to be responsible for, supporting any unconsolidated structured entity financially.

**Sponsored unconsolidated structured entities**

The Group considers itself the sponsor of certain non-consolidated structured entities where it was primarily involved in the establishment of a structured entity and additionally where the Group has been involved in the transfer of assets; servicer of the assets; ability to access the assets; marketing; managing activities; purchasing protection or providing explicit guarantees; when the Group's name is associated with the structured entity or where market participants may generally expect the Group to be associated with the structured entity.

For some sponsored entities, the Group has no interest at 30 June 2015, however the Group has been involved with the structured entity through establishing the structured entity, marketing of products associated with the structured entity in its own name, and/ or through involvement in the design of the structured entity.

The income generated related to sponsored entities issuing equity linked notes during the six month period to 30 June 2015 was \$1.4 million (30 June 2014: loss of \$4 million). Gains or losses are reported under 'Net gains on financial instruments classified as held for trading' in the condensed consolidated income statement. During the current period and prior year, no assets were transferred to the sponsored entities.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

#### a. Financial assets and liabilities recognised at fair value on a recurring basis

The following tables present the carrying value of the Group's financial assets and financial liabilities recognised at fair value on a recurring basis, classified according to the fair value hierarchy.

30 June 2015

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	10,523	4,350	9	14,882
- Corporate and other debt	-	9,552	488	10,040
- Corporate equities	50,370	509	181	51,060
- Derivatives	725	193,202	3,211	197,138
Total financial assets classified as held for trading	61,618	207,613	3,889	273,120
Financial assets designated at fair value through profit or loss	-	5,214	352	5,566
Available-for-sale financial assets:				
- Corporate equities	3	-	37	40
<b>Total financial assets measured at fair value</b>	<b>61,621</b>	<b>212,827</b>	<b>4,278</b>	<b>278,726</b>
Financial liabilities classified as held for trading:				
- Government debt securities	12,479	1,827	-	14,306
- Corporate and other debt	-	1,549	1	1,550
- Corporate equities	23,472	56	104	23,632
- Derivatives	1,421	193,095	4,156	198,672
Total financial liabilities classified as held for trading	37,372	196,527	4,261	238,160
Financial liabilities designated at fair value through profit or loss	-	7,574	142	7,716
<b>Total financial liabilities measured at fair value</b>	<b>37,372</b>	<b>204,101</b>	<b>4,403</b>	<b>245,876</b>

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

**31 December 2014**

	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	7,350	3,492	39	10,881
- Corporate and other debt	1	10,754	496	11,251
- Corporate equities	37,192	682	119	37,993
- Derivatives	381	230,723	4,169	235,273
Total financial assets classified as held for trading	44,924	245,651	4,823	295,398
Financial assets designated at fair value through profit or loss	-	2,044	1,316	3,360
Available-for-sale financial assets:				
- Corporate equities	2	-	40	42
<b>Total financial assets measured at fair value</b>	<b>44,926</b>	<b>247,695</b>	<b>6,179</b>	<b>298,800</b>
Financial liabilities classified as held for trading:				
- Government debt securities	7,094	1,829	-	8,923
- Corporate and other debt	-	2,213	6	2,219
- Corporate equities	15,351	77	3	15,431
- Derivatives	252	226,000	5,003	231,255
Total financial liabilities classified as held for trading	22,697	230,119	5,012	257,828
Financial liabilities designated at fair value through profit or loss	-	5,062	69	5,131
<b>Total financial liabilities measured at fair value</b>	<b>22,697</b>	<b>235,181</b>	<b>5,081</b>	<b>262,959</b>

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

The Group's valuation approach and fair value hierarchy categorisation for certain significant classes of financial instruments recognised at fair value on a recurring basis 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 ("TBA") 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.* Non-US Sovereign Government obligations are valued using quoted prices in active markets when available. These bonds are generally categorised in Level 1 of the fair value hierarchy. If the market is less active or prices are dispersed, these bonds are categorised in Level 2 of the fair value hierarchy. In instances where the inputs are unobservable, these bonds are categorised in Level 3 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 and/ or applying discounted cash flow techniques. 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 considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are generally categorised in Level 2 of the fair value hierarchy. If external prices or significant spread inputs are unobservable or if the comparability assessment involves significant

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

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

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.

*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, at the money volatility and/ or volatility skew 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 and Loan Obligations.* The Group holds cash collateralised debt obligations (“CDOs”)/CLOs that typically reference a tranche of an underlying synthetic portfolio of single name credit default swaps collateralised by corporate bonds (“credit-linked notes”) or cash portfolio of asset-backed securities/loans (“asset-backed CDOs/CLOs”). Credit correlation, a primary input used to determine the fair value of credit-linked notes, is usually unobservable and derived using a benchmarking technique. The other credit-linked note model inputs such as credit spreads, including collateral spreads, and interest rates are typically observable. Asset-backed CDOs/CLOs 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 asset-backed CDO/CLO position is evaluated independently taking into consideration available comparable market levels, underlying collateral performance and pricing, deal structures and liquidity. Cash CDOs/CLOs are categorised in Level 2 of the fair value hierarchy when either the credit correlation input is insignificant or comparable market transactions are observable. In instances where the credit correlation input is deemed to be significant or comparable market transactions are unobservable, cash CDOs/CLOs 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 price quotations (where observable), implied yields from comparable debt, and market observable credit default swap spread levels obtained from independent external parties such as vendors and 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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

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

- *Corporate Equities*

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

*Investments (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. Exchange-traded direct equity investments are generally valued based on quoted prices from the exchange.

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

*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.



**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

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

• *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 by the Group 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 credit default swaps on certain mortgage-backed or asset-backed securities, basket credit default swaps and CDO-squared positions (a CDO-squared position is a special purpose vehicle that issues interests, or tranches, that are backed by tranches issued by other CDOs) 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.

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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)**

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

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 contracts that have coupons or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. Fair value of structured notes and prepaid OTC contracts is determined using valuation models for the derivative and debt portions of the notes and the prepaid OTC contracts. 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, and commodity or equity prices. Independent, external and traded prices for the notes are considered as well. The impact of own credit spreads is also included based on observed secondary bond market spreads. Most structured notes and prepaid OTC contracts are categorised in Level 2 of the fair value hierarchy.

- *Customer Loans*

*Corporate Loans.* The fair value of corporate loans is determined using recently executed transactions, market price quotations (where observable), implied yields from comparable debt, and market observable credit default swap spread levels obtained from independent external parties such as vendors and 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 valuation of loans also takes into account fee income that is considered an attribute of the contract. Corporate loans 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.

**b. Transfers between Level 1 and Level 2 of the fair value hierarchy for financial assets and liabilities recognised at fair value on a recurring basis**

There were no material transfers between Level 1 and Level 2 of the fair value hierarchy during the six month period to 30 June 2015 and for the year to 31 December 2014.

**c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis**

The following tables present the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the six months ended 30 June 2015 and the year ended 31 December 2014. 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.

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**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)**

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.

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**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)**  
**30 June 2015**

	Balance at 1 January 2015	Total gains/ (losses) recognised in condensed consolidated income statement	Total gains/ (losses) recognised in condensed consolidated statement of comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and/or out of Level 3 <sup>(1)</sup>	Balance at 30 June 2015	Unrealised gains or (losses) for level 3 assets/ liabilities outstanding as at 30 June 2015 <sup>(2)</sup>
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Financial assets classified as held for trading:										
- Government debt securities	39	(1)	-	4	(29)	-	-	(4)	9	-
- Corporate and other debt	496	59	-	292	(326)	-	(12)	(21)	488	22
- Corporate equities	119	34	-	62	(69)	3	-	32	181	13
<b>Total financial assets classified as held for trading</b>	<b>654</b>	<b>92</b>	<b>-</b>	<b>358</b>	<b>(424)</b>	<b>3</b>	<b>(12)</b>	<b>7</b>	<b>678</b>	<b>35</b>
Financial assets designated at fair value through profit or loss										
	1,316	6	-	-	-	70	(831)	(209)	352	6
Available-for-sale financial assets:										
- Corporate equities	40	-	(2)	-	(1)	-	-	-	37	-
<b>Total financial assets measured at fair value</b>	<b>2,010</b>	<b>98</b>	<b>(2)</b>	<b>358</b>	<b>(425)</b>	<b>73</b>	<b>(843)</b>	<b>(202)</b>	<b>1,067</b>	<b>41</b>
Financial liabilities classified as held for trading:										
- Corporate and other debt	6	3	-	(4)	-	-	-	2	1	-
- Corporate equities	3	(25)	-	(74)	3	-	100	47	104	17
- Net derivative contracts <sup>(3)</sup>	834	(205)	-	(1,822)	-	4	1,243	481	945	146
<b>Total financial liabilities classified as held for trading</b>	<b>843</b>	<b>(227)</b>	<b>-</b>	<b>(1,900)</b>	<b>3</b>	<b>4</b>	<b>1,343</b>	<b>530</b>	<b>1,050</b>	<b>163</b>
Financial liabilities designated at fair value through profit or loss										
	69	(10)	-	-	-	101	(38)	-	142	(10)
<b>Total financial liabilities measured at fair value</b>	<b>912</b>	<b>(237)</b>	<b>-</b>	<b>(1,900)</b>	<b>3</b>	<b>105</b>	<b>1,305</b>	<b>530</b>	<b>1,192</b>	<b>153</b>

- (1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the period, 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 period.
- (2) Amounts represent unrealised gains or (losses) for the period related to assets and liabilities still outstanding as at the end of the period. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of comprehensive income as detailed in the financial instruments accounting policy in the Group's annual consolidated financial statements for the year ended 31 December 2014.
- (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.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)**

**31 December 2014**

	Balance at 1 January 2014	Total gains/ (losses) recognised in condensed consolidated income statement	Total gains/ (losses) recognised in condensed consolidated statement of comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 <sup>(1)</sup>	Balance at 31 December 2014	Unrealised gains or (losses) for level 3 assets/ liabilities outstanding as at 31 December 2014 <sup>(2)</sup>
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Financial assets classified as held for trading:										
- Government debt securities	8	1	-	37	(7)	-	-	-	39	-
- Corporate and other debt	714	27	-	262	(315)	-	(209)	17	496	(1)
- Corporate equities	68	19	-	65	(72)	-	-	39	119	(2)
<b>Total financial assets classified as held for trading</b>	<b>790</b>	<b>47</b>	<b>-</b>	<b>364</b>	<b>(394)</b>	<b>-</b>	<b>(209)</b>	<b>56</b>	<b>654</b>	<b>(3)</b>
Financial assets designated at fair value through profit or loss										
1,598	(12)	-	935	-	-	(1,333)	128	1,316	(11)	
Available-for-sale financial assets:										
- Corporate equities	58	-	(5)	-	(13)	-	-	-	40	-
<b>Total financial assets measured at fair value</b>	<b>2,446</b>	<b>35</b>	<b>(5)</b>	<b>1,299</b>	<b>(407)</b>	<b>-</b>	<b>(1,542)</b>	<b>184</b>	<b>2,010</b>	<b>(14)</b>
Financial liabilities classified as held for trading:										
- Corporate and other debt	47	(11)	-	(23)	11	-	-	(40)	6	(2)
- Corporate equities	7	2	-	(55)	51	-	-	2	3	2
- Net derivative contracts <sup>(3)(4)</sup>	530	(22)	-	(1,029)	-	946	395	(30)	834	(4)
<b>Total financial liabilities classified as held for trading</b>	<b>584</b>	<b>(31)</b>	<b>-</b>	<b>(1,107)</b>	<b>62</b>	<b>946</b>	<b>395</b>	<b>(68)</b>	<b>843</b>	<b>(4)</b>
Financial liabilities designated at fair value through profit or loss										
257	-	-	-	-	-	70	(247)	(11)	69	1
<b>Total financial liabilities measured at fair value</b>	<b>841</b>	<b>(31)</b>	<b>-</b>	<b>(1,107)</b>	<b>62</b>	<b>1,016</b>	<b>148</b>	<b>(79)</b>	<b>912</b>	<b>(3)</b>

- (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 2014 related to assets and liabilities still outstanding at 31 December 2014. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of comprehensive income as detailed in the financial instruments accounting policy in the Group's annual consolidated financial statements for the year ended 31 December 2014.
- (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.
- (4) During the year, the Group incurred a charge of approximately \$273 million related to the implementation of FVA, which was recognised within 'net gains on financial instruments classified as held for trading' in the consolidated income statement as detailed in the Group's annual financial statements for the year ended 31 December 2014.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**c. Changes in Level 3 assets and liabilities measured at fair value on a recurring basis (continued)**

There were no material transfers from Level 2 to Level 3 or from Level 3 to Level 2 of the fair value hierarchy during the period (2014: \$nil).

**d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis**

The disclosures below provide information on the sensitivity of fair value measurements to key inputs and assumptions.

**i. Quantitative information about and qualitative sensitivity of significant unobservable inputs**

The table below provides information on the valuation techniques, significant unobservable inputs and their ranges and averages for each major category of assets and liabilities measured at fair value on a recurring basis with a significant Level 3 balance.

The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across firms in the financial services industry because of diversity in the types of products included in each firm's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

#### i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

30 June 2015

	Fair value \$millions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range <sup>(2)</sup>	Averages
<b>ASSETS</b>					
<b>Financial assets classified as held for trading:</b>					
- Corporate equities	181	Comparable pricing Market Approach	Comparable equity price / (A) EBITDA Multiple / (A)	100% 8 to 10 times	100% 9 times
- Corporate and other debt:					
- Residential Mortgage backed securities	76	Comparable pricing	Comparable bond price / (A)	4 to 99 points	32 points
- Commercial mortgage backed securities	40	Comparable pricing	Comparable bond price / (A)	5 to 28 points	5 points
- Asset backed securities	104	Comparable pricing	Comparable bond price / (A)	9 to 100 points	77 points
- Corporate bonds	116	Option Model Option Model Comparable pricing	At the money volatility / (C) / (D) Volatility skew / (C) / (D) Comparable bond price / (A)	7% to 45% -2% to 0% 1 to 106 points	21% -1% 69 points
- Collateralised debt obligations	98	Comparable pricing	Comparable loan price / (A)	65 to 102 points	91 points
- Other debt	48	Comparable pricing Option Model Option Model	Comparable bond price / (A) At the money volatility / (C) / (D) Volatility skew / (C) / (D)	120 to 124 points 6% to 44% -1% to 0%	122 points 29% 0%
- Available-for-sale financial assets					
- Corporate equities	37	Comparable pricing	Comparable equity price / (A)	100%	100%
<b>Financial assets designated at fair value through profit or loss:</b>					
- Prepaid OTC contracts	51	Option Model Option Model	At the money volatility / (C) / (D) Volatility skew / (C) / (D)	6% to 24% -1% to 0%	24% 0%
- Customer loans	301	Margin Loan Model Margin Loan Model Margin Loan Model Option Model	Credit spread / (C) / (D) Volatility skew / (C) / (D) Comparable price / (A) / (D) Volatility skew / (C)	513 bps 23% to 29% 80% to 120% 0%	513 bps 26% 103% 0%

#### Sensitivity of the fair value to changes in the unobservable inputs:

- (A) Significant increase/ (decrease) in the unobservable input in isolation would result in a significantly higher/ (lower) fair value measurement.
- (B) Significant changes in credit correlation may result in a significantly higher or lower fair value measurement. Increasing/ (decreasing) correlation drives a redistribution of risk within the capital structure such that junior tranches become less/ (more) risky and senior tranches become more/ (less) risky.
- (C) Significant increase/ (decreases) in the unobservable input in isolation would result in a significantly lower/ (higher) fair value measurement.
- (D) There are no predictable relationships between the significant unobservable inputs.

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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

#### i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

LIABILITIES	Fair value \$millions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range <sup>(2)</sup>	Averages
<b>Financial liabilities classified as held for trading:</b>					
- Corporate equities	(104)	Comparable pricing	Comparable equity price / (A)	55%	55%
- Net derivative contracts: <sup>(1)</sup>					
- Credit	(236)	Correlation Model	Credit Correlation / (B)	42% to 86%	60%
		Comparable pricing	Comparable bond price / (C)	3 to 100 points	38 points
- Equity <sup>(5)</sup>	(740)	Option Model	At the money volatility / (C) / (D)	14% to 46%	29%
		Option Model	Volatility skew / (A) / (D)	-2% to 0%	-1%
		Option Model	Equity correlation / (C) / (D)	40% to 99%	67%
		Option Model	Equity FX correlation / (C) / (D)	-50% to 10%	-24%
- Interest rate <sup>(4)</sup>	(421)	Option Model	Inflation Volatility / (A) / (D)	61%	mean 61%; median 61%
		Option Model	Interest Rate / (A) / (D)	0% to 1%	mean 0%; median 0%
		Option Model	Interest rate - Foreign exchange correlation / (A) / (D)	28% to 62%	mean 44%; median 43%
		Option Model	Interest rate - Inflation correlation / (A) / (D)	-40% to -39%	mean -39%; median -39%
		Option Model	Interest Rate Curve Correlation / (C) / (D)	12% to 95%	mean 60%; median 73%
		Option Model	Interest rate quanto correlation / (A) / (D)	-14% to 35%	mean 2%; median -8%
		Option Model	Interest rate volatility skew / (A) / (D)	32% to 106%	mean 49%; median 52%
- Foreign exchange <sup>(4)(5)</sup>	453	Option Model	Interest Rate Curve / (A) / (D)	0% to 1%	mean 0%; median 0%
		Option Model	Interest rate - Foreign exchange correlation / (A) / (D)	28% to 62%	mean 44%; median 43%
		Option Model	Interest rate volatility skew / (A) / (D)	32% to 106%	mean 49%; median 52%
- Commodity	(1)	Option model	Cross commodity correlation (C)	33% to 100%	93%
<b>Financial liabilities designated at fair value through profit or loss:</b>					
- Prepaid OTC contracts	(78)	Option Model	At the money volatility / (A) / (D)	16% to 29%	29%
		Option Model	Volatility skew / (A) / (D)	-1% to 0%	0%
		Option Model	Cash synthetic basis / (A) / (D)	15 points	15 points
- Issued Structured Notes	(64)	Option Model	At the money volatility / (A) / (D)	16% to 45%	29%
		Option Model	Volatility skew / (A) / (D)	-1% to 0%	0
		Option Model	Equity correlation / (A) / (D)	42% to 97%	73%
		Option Model	Equity FX correlation / (C) / (D)	-49% to -7%	-40%

(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.

(2) The ranges of significant unobservable inputs are represented in points, percentages, basis points, times or megawatt hours. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point equals 1/100<sup>th</sup> of 1%; for example, 513 basis points would equal 5.13%.

(3) See below for a qualitative discussion of the wide unobservable input ranges for comparable bond prices and credit correlation.

(4) CVA and FVA are included in the fair value, but excluded from the valuation techniques and significant unobservable inputs in the table above. CVA is deemed to be a Level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

(5) See below for a qualitative discussion of the wide unobservable input ranges for comparable bond prices, interest rate volatility skew, interest rate quanto correlation and forward commercial paper rate-LIBOR basis.

(6) Includes derivative contracts with multiple risks (i.e. hybrid products).



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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

#### i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

31 December 2014

	Fair value \$millions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range <sup>(2)</sup>	Averages <sup>(3)</sup>
<b>ASSETS</b>					
<b>Financial assets classified as held for trading:</b>					
- Corporate equities	119	Comparable pricing Market Approach	Comparable equity price / (A) EBITDA Multiple / (A)	100% 7 to 9 times	100% 8 times
- Government debt securities	39	Comparable pricing	Comparable bond price / (A)	119% to 122%	120%, 121%
- Corporate and other debt:					
- Residential mortgage backed securities	100	Comparable pricing	Comparable bond price / (A)	3 to 96 points	22 points
- Commercial mortgage backed securities	44	Comparable pricing	Comparable bond price / (A)	3 to 5 points	4 points
- Asset backed securities	78	Comparable pricing	Comparable bond price / (A)	0 to 100 points	100 points
- Corporate bonds	140	Comparable pricing Option Model Option Model	Comparable bond price / (A) At the money volatility / (A) Volatility skew / (A)	1 to 117 points 15% to 54% -3% to 0%	64 points 26% -1%
- Collateralised debt obligations	109	Comparable pricing	Comparable loan price / (A)	71 to 100 points	91 points
<b>Financial assets designated at fair value through profit or loss:</b>					
- Customer loans	1,296	Margin Loan Model Margin Loan Model Margin Loan Model Option Model	Credit spread / (C)(D) Volatility skew / (C)(D) Comparable price / (A)(D) Volatility skew / (C)	353 to 451 bps 3% to 37% 80% to 120% -1%	402 bps 25% 100% -1%
<b>Available-for-sale financial assets</b>					
- Corporate equities	40	Comparable pricing	Comparable equity price / (A)	100%	100%

#### Sensitivity of the fair value to changes in the unobservable inputs:

- (A) Significant increase/ (decrease) in the unobservable input in isolation would result in a significantly higher/ (lower) fair value measurement.
- (B) Significant changes in credit correlation may result in a significantly higher or lower fair value measurement. Increasing/ (decreasing) correlation drives a redistribution of risk within the capital structure such that junior tranches become less/ (more) risky and senior tranches become more/ (less) risky.
- (C) Significant increase/ (decrease) in the unobservable input in isolation would result in a significantly lower/ (higher) fair value measurement.
- (D) There are no predictable relationships between the significant unobservable inputs.

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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

#### i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

LIABILITIES	Fair value \$millions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range <sup>(2)</sup>	Averages <sup>(3)</sup>
<b>Financial liabilities classified as held for trading:</b>					
- Net derivative contracts: <sup>(1)(4)</sup>					
- Credit	(6)	Correlation Model	Credit correlation / (B)	46% to 88%	61%
		Comparable pricing	Comparable bond price / (C)(D)	2 to 99 points	40 points
- Equity	(1,033)	Option Model	At the money volatility / (C)(D)	15% to 50%	29%
			Volatility skew / (C)(D)	-4% to 1%	-1%
			Equity correlation / (C)(D)	30% to 99%	70%
			Equity Foreign exchange correlation / (C)(D)	-40% to 10%	-16%
- Interest rate	25	Option Model	Inflation volatility / (A)(D)	69% to 71%	mean 70%; median 71%
			Interest rate curve / (A)(D)	0% to 2%	mean 1%; median 1%
			Interest rate - foreign exchange correlation / (C)(D)	28% to 62%	mean 44%; median 42%
			Interest rate - inflation correlation / (A)(D)	-44% to -40%	mean -42%; median -43%
			Interest rate curve correlation / (C)(D)	44% to 87%	mean 73%; median 80%
			Interest rate quanto correlation / (C)(D)	-9% to 35%	mean 6%; median -6%
			Interest rate volatility skew / (A)(D)	38% to 104%	mean 86%; median 60%
- Foreign exchange	228	Option Model	Interest rate curve / (A)(D)	0% to 2%	mean 1%; median 1%
			Interest rate - foreign exchange correlation / (C)(D)	28% to 62%	mean 44%; median 42%
			Interest rate curve correlation / (C)(D)	44% to 87%	mean 73%; median 80%
			Interest rate quanto correlation / (C)(D)	-9% to 35%	mean 6%; median -6%
			Interest rate volatility skew / (A)(D)	38% to 104%	mean 86%; median 60%
- Commodity	(48)	Option Model	Cross commodity correlation / (C)	33% to 100%	93%
<b>Financial liabilities designated at fair value through profit or loss:</b>					
- Prepaid OTC contracts	(52)	Option Model	At the money volatility / (C)(D)	6% to 33%	19%
			Cash synthetic basis / (C)(D)	15 points	15 points

(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. In addition, there are other derivative contracts with a fair value of \$7 million not included within one of the major derivative categories.

(2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point (bps) equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) See below for a qualitative discussion of the wide unobservable input ranges for comparable bond prices and credit correlation.

(4) CVA and FVA are included in the fair value, but excluded from the valuation techniques and significant unobservable inputs in the table above. CVA is deemed to be a Level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

(5) See below for a qualitative discussion of the wide unobservable input ranges for comparable bond prices, interest rate volatility skew, interest rate quanto correlation and forward commercial paper rate-LIBOR basis.

(6) Includes derivative contracts with multiple risks (i.e. hybrid products).

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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

##### i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

The following provides a description of significant unobservable inputs included in the table above for all major categories of assets and liabilities:

- *Cash synthetic basis* – the measure of the price differential between cash financial instruments (“cash instruments”) and their synthetic derivative-based equivalents (“synthetic instruments”). The range disclosed in the table above signifies the number of points by which the synthetic bond equivalent price is higher than the quoted price of the underlying cash bonds.
- *Comparable bond price* – a pricing input used when prices for the identical instrument are not available. Significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments. Valuation using comparable instruments can be done by calculating an implied yield (or spread over a liquid benchmark) from the price of a comparable bond, then adjusting that yield (or spread) to derive a value for the bond. The adjustment to yield (or spread) should account for relevant differences in the bonds such as maturity or credit quality. Alternatively, a price-to-price basis can be assumed between the comparable instrument and bond being valued in order to establish the value of the bond. Additionally, as the probability of default increases for a given bond (i.e., as the bond becomes more distressed), the valuation of that bond will increasingly reflect its expected recovery level assuming default. The decision to use price-to-price or yield/spread comparisons largely reflects trading market convention for the financial instruments in question. Price-to-price comparisons are primarily employed for CMBS, CDOs, mortgage loans and distressed corporate bonds. Implied yield (or spread over a liquid benchmark) is utilised predominately for non-distressed corporate bonds, loans and credit contracts.
- *Comparable equity price* – a price derived from equity raises, share buybacks and external bid levels, etc. A discount or premium may be included in the fair value estimate.
- *Correlation* – a pricing input where the payoff is driven by more than one underlying risk. Correlation is a measure of the relationship between the movements of two variables (i.e., how the change in one variable influences a change in the other variable). Credit correlation, for example, is the factor that describes the relationship between the probability of individual entities to default on obligations and the joint probability of multiple entities to default on obligations. The correlation ranges may be wide since any two underlying inputs may be highly correlated (either positively or negatively) or weakly correlated.
- *Credit spread* – the difference in yield between different securities due to differences in credit quality. The credit spread reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk. The credit spread of a particular security is often quoted in relation to the yield on a credit risk-free benchmark security or reference rate, typically either U.S. Treasury or LIBOR.
- *EBITDA multiple* – the ratio of the Enterprise Value to EBITDA, where the Enterprise Value is the aggregate value of equity and debt minus cash and cash equivalents. The EBITDA multiple reflects the value of the company in terms of its full-year EBITDA, whereas the exit multiple reflects the value of the company in terms of its full year expected EBITDA at exit. Either multiple allows comparison between companies from an operational perspective.
- *Funding spread* – the difference between the general collateral rate (which refers to the rate applicable to a broad class of U.S. Treasury issuances) and the specific collateral rate (which refers to the rate applicable to a specific type of security pledged as collateral, such as a municipal bond). Repurchase agreements and certain other secured financings are discounted based on collateral curves. The curves

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**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)**

**i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)**

*Funding spread (continued)*

are constructed as spreads over the corresponding overnight indexed swap (“OIS”) or LIBOR curves, with the short end of the curve representing spreads over the corresponding OIS curves and the long end of the curve representing spreads over LIBOR.

- *Interest rate curve* – the term structure of interest rates (relationship between interest rates and the time to maturity) and a market’s measure of future interest rates at the time of observation. An interest rate curve is used to set interest rate and foreign exchange derivative cash flows and is a pricing input used in the discounting of any OTC derivative cash flow.
- *Internal rate of return* – the discount factor required for the net present value of future cash flows to equal zero. The internal rate of return represents the minimum average annual return required for an investment.
- *Volatility* – the measure of the variability in possible returns for an instrument given how much that instrument changes in value over time. Volatility is a pricing input for options and, generally, the lower the volatility, the less risky the option. The level of volatility used in the valuation of a particular option depends on a number of factors, including the nature of the risk underlying that option (e.g., the volatility of a particular underlying equity security may be significantly different from that of a particular underlying commodity index), the tenor and the strike price of the option.
- *Volatility skew* – the measure of the difference in implied volatility for options with identical underliers and expiry dates but with different strikes. The implied volatility for an option with a strike price that is above or below the current price of an underlying asset will typically deviate from the implied volatility for an option with a strike price equal to the current price of that same underlying asset.

**ii. 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. 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, to provide information about the variability of the fair value measurement, 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.

The following tables present the sensitivity of the fair value of Level 3 financial assets and financial liabilities to reasonably possible alternative assumptions, providing quantitative information on the potential variability of the fair value measurement.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

**30 June 2015**

	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	9	-	-
- Corporate and other debt	488	21	(22)
- Corporate equities	181	2	(27)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	51	3	(2)
- Customer loans	301	4	(1)
Available-for-sale financial assets:			
- Corporate equities	37	9	(2)
Financial liabilities classified as held for trading:			
- Corporate and other debt	1	-	-
- Corporate equities	104	11	-
- Net derivative contracts <sup>(1)(2)</sup>	945	225	(200)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	78	2	(1)
- Structured notes	64	1	(1)

(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.

(2) CVA and FVA are included in the fair value, but excluded from the effect of reasonably possible alternative assumptions in the table above. CVA is deemed to be a level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

**31 December 2014**

	<b>Effect of reasonably possible alternative assumptions</b>		
	<b>Fair value \$millions</b>	<b>Increase in fair value \$millions</b>	<b>Decrease in fair value \$millions</b>
Financial assets classified as held for trading:			
- Government debt securities	39	-	-
- Corporate and other debt	496	19	(16)
- Corporate equities	119	2	(9)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	20	-	-
- Customer loans	1,296	2	(3)
Available-for-sale financial assets:			
- Corporate equities	40	9	(2)
Financial liabilities classified as held for trading:			
- Corporate and other debt	6	-	-
- Corporate equities	3	-	-
- Net derivatives contracts <sup>(1)(2)</sup>	834	152	(163)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	52	2	(1)
- Other	17	-	-

(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.

(2) CVA and FVA are included in the fair value, but excluded from the effect of reasonably possible alternative assumptions in the table above. CVA is deemed to be a level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

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## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015

### 14. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

#### e. Financial instruments valued using unobservable market data

The amounts not recognised in the condensed consolidated income statement 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:

	30 June 2015 \$millions	31 December 2014 \$millions
At 1 January	234	351
New transactions	25	26
Amounts recognised in the condensed consolidated income statement during the period	(48)	(143)
<b>At 30 June 2015 / 31 December 2014</b>	<u>211</u>	<u>234</u>

The condensed consolidated statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value through profit or loss', 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 derivative contracts.

#### f. Assets and liabilities measured at fair value on a non-recurring basis

Non-recurring fair value measurements of assets and liabilities are those which are required or permitted in the condensed consolidated statement of financial position in particular circumstances. There were no assets or liabilities measured at fair value on a non-recurring basis during the current or prior period.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2015**

**15. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE**

The tables below present the carrying value, fair value and fair value hierarchy category of certain financial assets and financial liabilities that are not measured at fair value in the condensed consolidated statement of financial position.

Financial assets and financial liabilities not measured at fair value for which the carrying value is considered a reasonable approximation of fair value are excluded from the table below.

**30 June 2015**

	Carrying value	Fair value	Fair value measurement using:		
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>					
Other payables	2,090	1,752	-	1,752	-

**31 December 2014**

	Carrying value	Fair value	Fair value measurement using:		
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>					
Subordinated loans	7,906	8,064	-	8,064	-
Other payables	3,166	2,845	-	2,845	-

The fair value of 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 PRA. As at 30 June 2015 the fair value of subordinated loans was approximate to its carrying value.

The fair value of other payables is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity. Also included in the condensed consolidated statement of financial position is \$15,424 million (31 December 2014: \$10,968 million) of other payables where the carrying value is a reasonable approximation of fair value.



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### **NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2015**

#### **16. RELATED PARTY DISCLOSURES**

The management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the six month period ended 30 June 2015, \$998 million of net revenues was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the condensed consolidated income statement (six month period to 30 June 2014: \$326 million).

#### **17. LITIGATION**

In addition to the matter described below, 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 in financial distress.

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, sales and trading activities, financial products or offerings sponsored, underwritten or sold by the Group, and 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 condensed 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. The Group expects future litigation accruals in general to continue to be elevated and the changes in accruals from period to period may fluctuate significantly, given the current environment regarding government investigations and private litigation affecting global financial services firms, including the Group.

In many proceedings and investigations, however, it is inherently difficult to determine whether any loss is probable or even possible, or to estimate the amount of any loss. The Group cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. 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 or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation. Subject to the foregoing, the Group believes, based on current knowledge and after consultation with counsel, that the outcome of such proceedings and investigations will not have a material adverse effect on the condensed consolidated financial position of the Group, although the outcome of such proceedings or investigations could be material to the Group's operating results and cash flows for a particular period depending on, among other things, the level of the Group's revenues or income for such period.

Over the last several years, the level of litigation and investigatory activity (both formal and informal) by government and self-regulatory agencies has increased materially in the financial services industry. As a result, the Group expects that it may become the subject of increased claims for damages and other relief and, while the Group has identified below a new matter that has occurred since previously reporting certain matters in the Group's annual financial statements for the year ended 31 December 2014 that the Group believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

The Group is responding to a number of regulatory and governmental inquiries in the UK, the US and elsewhere related to its foreign exchange business.