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MORGAN STANLEY & CO. INTERNATIONAL plc

Half-yearly financial report

30 June 2018

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 2018. 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's profit for the six month period, after tax, was \$662 million (30 June 2017: \$695 million).

On 31 May 2018, the Directors approved a coupon payment on the Additional Tier 1 ("AT1") capital instruments of \$119 million (2017: \$119 million, see note 14). No other dividends were proposed or paid during the six months ended 30 June 2018 (2017: 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, the Netherlands, Poland, the Qatar Financial Centre, South Korea and Switzerland.

There have not been any changes in the Group's principal activity during the period and no significant change in the Group's principal activity is expected.

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

The Morgan Stanley Group is a global financial services firm that maintains significant market positions in each of its business segments: Institutional Securities, 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"). In addition, the company is a registered swap dealer and is regulated by the United States ("US") Commodity Futures Trading Commission ("CFTC").

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW

Global markets and economic conditions

After a strong recovery in 2017, global economic growth remained broadly stable above its long-term average in the first half of 2018, with GDP growth in the first quarter at 4.0% and the second quarter tracking at 3.9% for the year. In developed markets (“DMs”) sequential growth rebounded in the second quarter (due to the US and Japan) after a temporary softening in the first quarter. In emerging markets (“EMs”), growth remained strong at 5.1% in the first quarter before moderating slightly to 5.0% in the second quarter. In EM Asia, growth came in better than expected as China’s GDP growth remained broadly stable and India’s growth is expected to have accelerated, thereby offsetting a slowdown in other select EMs such as Brazil. Against a backdrop of solid growth and further tightening in labor markets, DM central banks continued to lean against accommodative financial conditions: the Federal Reserve remained on a hiking path, raising interest rates by 25bps each quarter, and the European Central Bank (“ECB”) decided that it will halve its net purchases to €15 billion per month between October and December, and discontinue Quantitative Easing (“QE”) in June 2019. In China, the Group believes that the policy stance has turned neutral from a tightening bias earlier in the year. More specifically, the reserve requirement ratio was cut twice in April and June and there was some easing of regulatory norms to support broader credit growth amid lingering trade tensions and credit risk. In Brazil and Russia, central banks cut rates in the first quarter. Meanwhile, the Reserve Bank of India (“RBI”) maintained its gradual hiking path. Trade tensions remained elevated, with the US administration taking up a series of tariff measures in the first half of 2018 which were met with similar responses from trade partners such as China and the euro area. The impact on global trade and GDP growth has been limited so far, but we continue to see downside risks, particularly if further tariffs, such as the proposed measures on \$200 billion of China imports, were to be implemented.

UK Withdrawal from the EU

On 23 June 2016, the UK electorate voted to leave the European Union (“EU”). On 29 March 2017, the UK formally invoked Article 50 of the Lisbon Treaty, which triggered a two-year period, subject to extension (which would need the unanimous approval of the EU Member States), during which the UK government is expected to negotiate its withdrawal agreement with the EU. Absent any extension, the UK is expected to leave the EU in March 2019. The terms and conditions of the anticipated withdrawal from the EU, and which of the several alternative models of relationship that the UK might ultimately negotiate with the EU, remain uncertain. However, the UK government has stated that the UK will leave the EU single market and will seek a phased period of implementation for the new relationship that may cover the legal and regulatory framework applicable to financial institutions with significant operations in Europe, such as Morgan Stanley. Since any transition or implementation periods and the eventual successor arrangements require agreement of both the UK and the EU, there is a risk that these arrangements may not be agreed by March 2019.

It is difficult to predict the future of the UK’s relationship with the EU, which uncertainty may increase the volatility in the global financial markets in the short- and medium-term. Potential effects of the UK exit from the EU and potential mitigation actions may vary considerably depending on the timing of withdrawal and the nature of any transition or successor arrangements. The Group is taking steps to make changes to European operations in an effort to ensure that it can continue to provide cross-border banking and investment services in EU Member States without the need for separate regulatory authorisations in each member state. These changes must be approved by the relevant regulatory authorities and therefore it is currently unclear what the final post-Brexit structure of European operations will be. Depending on the extent to which the Group may be required to make material changes to European operations beyond those currently planned, results of the Group’s operations and business prospects could be negatively affected.

Overview of 2018 Financial Results

The Group’s revenues are best reviewed across the aggregate of ‘Net trading income’, ‘Net income from other financial instruments held at fair value’, ‘Fee and commission income’, ‘Interest income’, ‘Interest expense’ and ‘Other revenue’ (“net revenues”).

Set out below is an overview of the Group’s financial results for the six month period ended 30 June 2018 and 30 June 2017.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT BUSINESS REVIEW (CONTINUED)

Overview of 2018 Financial Results (continued)

	Six months ended 30 June 2018	Six months ended 30 June 2017
	\$millions	\$millions
Net revenues	3,443	3,219
Staff related expenses	(1,036)	(884)
Non-staff related expenses	(1,432)	(1,338)
Impairment (loss)/gain	(5)	2
Non-Interest Expenses	(2,473)	(2,220)
Profit before tax	970	999
Income tax expense	(308)	(304)
Profit after tax	662	695
Total Assets	467,778	461,362
Total Liabilities	448,455	442,675
Total Equity	19,323	18,687

The condensed consolidated income statement for the six month period to 30 June 2018 is set out on page 20. The Group reported a profit after tax for the six month period to 30 June 2018 of \$662 million compared to a profit after tax of \$695 million for the six month period to 30 June 2017 as expenses increased faster than income for the period.

Net revenues for the six month period ended 30 June 2018 increased by 7% to \$3,443 million compared to \$3,219 million for the six month period ended 30 June 2017.

The increase in net revenues was primarily driven by increased revenues in Equities and Fixed Income. In addition, revenues increased as a result of the adoption of IFRS 15 which increased both revenues and expenses by \$53 million (refer to note 3 for further details).

The increase in Institutional Equities revenues was primarily driven by derivatives as a result of increased client activity linked to high market volatility and by gains from a number of individually-significant trades.

The increase in Fixed Income revenues was driven by increased trading activity due to increased volatility linked to global events.

Other expenses increased from \$2,222 million for the six months ended 30 June 2017 to \$2,468 million for the six month period ended 30 June 2018.

Staff related expenses increased by 17% from \$884 million for the six month period ended 30 June 2017 to \$1,036 million for the six months ended 30 June 2018. The increase was primarily driven by higher discretionary compensation due to the higher revenues, and the strengthening of the British pound against the US dollar.

Non-staff related expenses increased by 7% from \$1,338 million for the period ended 30 June 2017 to \$1,432 million for the period ended 30 June 2018. The increase in non-staff related costs included the impact from the adoption of IFRS 15 which increased both revenues and expenses by \$53 million (refer to note 3 for further details). In addition, there was an increase in brokerage expenses due to higher trading volumes, and other non-staff related expenses due to the strengthening of the British pound against the US dollar, partially offset by a decrease in UK indirect tax expense.

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INTERIM MANAGEMENT REPORT BUSINESS REVIEW (CONTINUED)

Overview of 2018 Financial Results (continued)

The Group's tax expense for the six month period ended 30 June 2018 was \$308 million compared to \$304 million for the six month period ended 30 June 2017. This represents an effective tax rate of 31.75% (30 June 2017: 30.43%) which is higher than the average standard rate of UK corporation tax (inclusive of the UK Banking surcharge) of 27% (30 June 2017: 27.25%). See note 7 for further details.

The condensed consolidated statement of financial position presented on page 23 reflects increases in the Group's total assets and total liabilities of \$6,416 million and \$5,780 million respectively, in each case representing increases of 1% as at 30 June 2018 when compared to 31 December 2017. The increase in total assets is driven by increases of \$7,085 million in 'cash and short-term deposits', \$4,407 million in 'trading financial assets' and \$4,606 million in 'trade and other receivables' which is partially offset by a decrease of \$9,700 million in 'secured financing'. The increase in total liabilities is driven by increases in 'trading financial liabilities' of \$4,299 million, and an increase in 'trade and other payables' of \$6,503 million, which were partially offset by a decrease in 'secured borrowing' of \$2,850 million and a decrease in 'debt and other borrowings' of \$1,995 million.

The increase in cash and short-term deposits reflects an increase in the liquidity reserve. The increase in trading financial assets was driven by an increase in derivative assets due to fair value movements, partially offset by a decrease in corporate equities as a result of changes in hedging strategy. The increase in trade receivables is driven by an increase in Prime Brokerage receivables. The decrease in secured financing was linked to changes in business and client financing activity.

The increase in trade and other payables is driven by an increase in Prime Brokerage payables. The increase in trading financial liabilities was driven by an increase in derivative assets due to fair value movements.

In addition, opening retained earnings as at 1 January 2018 increased by \$68 million as a result of the Group's adoption of IFRS 9 'Financial Instruments' ("IFRS 9") driven by the reclassification of the available-for-sale reserve to opening retained earnings.

The condensed consolidated statement of cash flows presented on page 24 shows an increase in cash and cash equivalents of \$6,515 million during the six month period to 30 June 2018 (six month period to 30 June 2017: net decrease of \$60 million). Net cash inflows from operating activities were \$8,660 million (six month period to 30 June 2017: \$1,108 million). This has been partially offset by net cash outflows from financing activities due to the repayment of \$2,000 million of subordinated loans, the payment of the AT1 capital instrument coupon of \$119 million (30 June 2017: \$119 million) and the payment of interest on subordinated loan liabilities of \$26 million (30 June 2017: \$103 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. For the risk information, refer to the Risk reporting and measurement section of the Risk Management section later in this report. Certain performance based metrics are shown below:

Profitability metrics

Return on ordinary shareholders equity: The Group's return on ordinary shareholders equity (profit/loss for the year attributable to the parent less dividends paid on AT1 instruments as a percentage of ordinary shareholders equity at the beginning of the year (total equity less AT1 Instruments and Non-controlling Interest)) was 3.3% for the six month period ended 30 June 2018 (six month period ended 30 June 2017: 3.9%).

Return on assets: The Group's return on assets for the period (profit/ loss for the period as a percentage of total assets at the beginning of the year) was 0.1% for the six month period ended 30 June 2018 (six month period ended 30 June 2017: 0.2%).

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Key performance indicators (continued)

Balance sheet assets

Total assets: Total assets of the Group continue to be closely monitored. The Group's total assets, as disclosed on page 23, increased by 1% from \$461,362 million at 31 December 2017 to \$467,778 million at 30 June 2018.

Capital

The Group monitors its, and the Company's capital position against a range of key metrics including the following:

Tier 1 regulatory capital: The Company's Tier 1 capital as calculated in accordance with PRA rules which are based on the fourth EU Capital Requirements Directive ("CRD") and EU Capital Requirements Regulation ("CRR"), collectively known as "CRD IV", was \$17,109 million as at 30 June 2018 (31 December 2017: \$16,971 million) and its Tier 1 capital ratio was 12.5% as at 30 June 2018 (31 December 2017: 12.8%), which is in excess of the required minimum regulatory ratio. Tier 1 capital ratio is defined as Tier 1 capital divided by risk-weighted assets ("RWAs").

Leverage ratio: CRD IV, as amended by the European Commission Delegated Act, compares Tier 1 capital to a measure of leverage exposure, defined as the sum of assets less Tier 1 capital deductions plus off-balance sheet exposures. As at 30 June 2018, the Company had a leverage ratio of 3.8% (31 December 2017: 3.8%), which is above the expected minimum regulatory ratio of 3% that will apply once European legislation has been finalised.

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. The risk management policy framework includes escalation to the Group's Board of Directors and to appropriate senior management of the Group as well as oversight through the Group's Board of Directors and through a dedicated Risk Committee of non-executive Directors that reports to the Board of Morgan Stanley International Limited, the Company's ultimate UK parent undertaking.

Pages 9 to 30 of the strategic report and note 27 to the consolidated financial statements for the year ended 31 December 2017 provide more detailed qualitative disclosures on the Group's exposure to financial risks. Note 17 to the condensed consolidated financial statements provides more detailed quantitative disclosures as well as qualitative information on the Group's expected credit loss ("ECL") measurement introduced from 1 January 2018 on transition to IFRS 9.

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

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities, correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

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

The Group uses the statistical technique known as VaR as one of the tools used to measure, monitor and review the market risk exposures of its trading portfolios. The Market Risk Department calculates and distributes daily VaR-based risk measures to various levels of management. The table on the following page shows the Group's VaR for primary risk categories and total Management VaR for the six month period ended 30 June 2018 and for the year ended 31 December 2017.

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INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Market risk (continued)

	95% / one-day VaR for the six months ended 30 June 2018		95% / one-day VaR for the year ended 31 December 2017	
	Period End \$millions	Average \$millions	Period End \$millions	Average \$millions
Primary Risk Categories	18	19	20	21
Credit Portfolio ⁽¹⁾	4	4	5	6
Less: Diversification benefit ⁽²⁾	(3)	(3)	(3)	(4)
Total Management VaR	19	20	22	23

(1) 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.

(2) Diversification benefit equals the difference between total management VaR and the sum of the VaRs for the Primary Risk Categories and the Credit Portfolio. This benefit arises because the simulated one-day losses for each of the component categories occur on different days; similar diversification benefits are also taken into account within each category.

The Group's average Management VaR for Primary Risk Categories for the six month period ended 30 June 2018 was \$19 million compared to \$21 million in 2017. The decrease in average Management VaR for Primary Market Risk Categories is spread across underlying risk factors, primarily equity price and foreign exchange risk.

The Group's average Credit Portfolio VaR for the six months ended 30 June 2018 was \$4 million, compared to \$6 million in 2017. This reduction was mainly due to parameter updates in Corporate Credit VaR models.

The Group's average Total Management VaR for the six months ended 30 June 2018 was \$20 million, compared to \$23 million for 2017.

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 country risk, which is further described below.

The Group primarily incurs credit risk exposure to institutions and sophisticated investors mainly through its Institutional Securities business segment. This risk may be incurred through a variety of activities, including, but not limited to, the following:

- entering into derivative contracts under which counterparties may 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 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.

Credit risk exposure is managed on a global basis and in consideration of each significant legal entity within the Morgan Stanley Group. The credit risk management policies and procedures establish the framework for identifying, measuring, monitoring and controlling credit risk whilst ensuring transparency of material credit risks, compliance with established limits and escalating risk concentrations to appropriate senior management.

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INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

For further information on the Group's credit risk management framework, monitoring and control, credit evaluation and risk mitigation procedures, refer to pages 19 to 23 of the strategic report in the consolidated financial statements for the year ended 31 December 2017.

The following table shows the Group's maximum exposure to credit risk and credit exposure for certain financial assets the Group believes are subject to credit risk and where the Group has entered into credit enhancements, including receiving cash and security as collateral and master netting agreements. The financial effect of the credit enhancements is also disclosed in the table. The net credit exposure represents the credit exposure remaining after the effect of the credit enhancements. Exposure to other Morgan Stanley Group undertakings is included in this table.

Exposure to credit risk by class

Class	30 June 2018			31 December 2017		
	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure \$millions	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure \$millions
Recognised financial instruments						
Secured financing	89,645	(87,145)	2,500	99,345	(95,075)	4,270
Trading financial assets:						
Derivatives	178,348	(170,098)	8,250	167,008	(159,176)	7,832
Unrecognised financial instruments						
Loan commitments	2,265	(30)	2,235	2,190	(105)	2,085
	<u>270,258</u>	<u>(257,273)</u>	<u>12,985</u>	<u>268,543</u>	<u>(254,356)</u>	<u>14,187</u>

(1) Gross credit exposure is the carrying amount which best represents the Group's maximum exposure to credit risk, and for recognised financial instruments is reflected in the condensed consolidated statement of financial position.

Country risk exposure

Country risk is the risk that events in, or affecting, a foreign country might adversely affect the Group. "Foreign country" means any country other than the UK. Sovereign Risk, by contrast, is the risk that a government will be unwilling or unable to meet its debt obligations, or renege on the debt it guarantees. Sovereign risk is single-name risk for a sovereign government, its agencies and guaranteed entities. For further information on how the Group identifies, monitors and manages country risk exposure refer to page 22 of the strategic report of the consolidated financial statements for the year ended 31 December 2017.

The Group's sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures consist of exposures primarily to corporations and financial institutions. The table on the next page shows the Group's five largest non-UK country net exposures. Exposure to other Morgan Stanley Group undertakings has been excluded from this table.

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INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Country risk exposure (continued)

Five largest non-UK country risk net exposures:

Country	Net Inventory ⁽¹⁾ \$millions	Net Counterparty Exposure ⁽²⁾ \$millions	Funded lending \$millions	Unfunded Commitments \$millions	Exposure Before Hedges \$millions	Hedges ⁽³⁾ \$millions	Net Exposure ⁽⁴⁾ \$millions
France							
Sovereigns	(269)	-	-	-	(269)	(50)	(319)
Non-sovereigns	(138)	1,835	4	1,242	2,943	(379)	2,564
Total France	(407)	1,835	4	1,242	2,674	(429)	2,245
Italy							
Sovereigns	1,194	(8)	-	-	1,186	52	1,238
Non-sovereigns	204	446	-	195	845	(33)	812
Total Italy	1,398	438	-	195	2,031	19	2,050
Germany							
Sovereigns	(68)	494	-	-	426	(457)	(31)
Non-sovereigns	246	1,898	-	49	2,193	(270)	1,923
Total Germany	178	2,392	-	49	2,619	(727)	1,892
United States							
Sovereigns	(1,037)	33	-	-	(1,004)	-	(1,004)
Non-sovereigns	891	1,471	21	587	2,970	(120)	2,850
Total United States	(146)	1,504	21	587	1,966	(120)	1,846
Japan							
Sovereigns	540	-	-	-	540	(36)	504
Non-sovereigns	64	1,280	-	-	1,344	(21)	1,323
Total Japan	604	1,280	-	-	1,884	(57)	1,827

(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 over the counter ("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. Amounts are based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) In addition, as at 30 June 2018, the Group had exposure to these countries for overnight deposits with banks of approximately \$3,047 million.

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INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Liquidity 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 (or perceived ability) to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern. Liquidity risk also encompasses the associated funding risks triggered by the market or idiosyncratic stress events that may cause unexpected changes in funding needs or an inability to raise new funding. Generally, the Group incurs liquidity and funding risk as a result of its trading, investing and client facilitation activities.

For a further discussion on the Group's liquidity risk refer to pages 24 to 27 of the strategic report in the consolidated financial statements for the year ended 31 December 2017.

Credit ratings

The Company relies on external sources to finance a significant portion of its daily operations. The cost and availability of financing generally are impacted by, among other variables, the Company's credit ratings. In addition, the Company's credit ratings can have an impact on certain trading revenues, particularly in those businesses where longer-term counterparty performance is a key consideration, such as OTC derivative transactions, including credit derivatives and interest rate swaps. When determining credit ratings, ratings agencies consider company-specific factors, other industry factors such as regulatory or legislative changes, and the macroeconomic environment, among other things.

Some rating agencies have stated that they currently incorporate various degrees of credit rating uplift from non-governmental third party sources of potential support.

At 30 June 2018, the Company's senior unsecured ratings were as follows:

	Short- Term Debt	Long- Term Debt	Rating Outlook
Moody's Investors Service, Inc ("Moody's")	P-1	A1	Stable
Standard & Poor's Rating Service ("S&P")	A-1	A+	Stable

Collateral impact of a downgrade

In connection with certain OTC trading agreements and certain other agreements where the Company is a liquidity provider to certain financing vehicles, the Company may be required to provide additional collateral or immediately settle any outstanding liability balances with certain counterparties or pledge additional collateral to certain exchanges and clearing organisations in the event of a future credit rating downgrade irrespective of whether the Company is in a net asset or net liability position.

The additional collateral or termination payments that may be called in the event of a future credit rating downgrade vary by contract and can be based on ratings by either or both of Moody's and S&P. As at 30 June 2018, the future potential collateral amounts and termination payments that could be called or required from the Company, by counterparties or exchanges and clearing organisations, in the event of one-notch or two-notch downgrade scenarios, from the lowest of Moody's or S&P ratings, based on the relevant contractual downgrade triggers, were \$241 million and an incremental \$252 million, respectively.

While certain aspects of a credit rating downgrade are quantifiable pursuant to contractual provisions, the impact it would have on the Company's business and results of operations in future periods is inherently uncertain and would depend on a number of interrelated factors, including, among others, the magnitude of the downgrade, the rating relative to peers, the rating assigned by the relevant agency pre-downgrade, individual client behaviour and future mitigating actions the Company might take. The liquidity impact of additional collateral requirements is included in the Group's Liquidity Stress Tests.

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INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Operational risk

Operational risk refers to the risk of loss, or of damage to the Group's reputation, resulting from inadequate or failed processes or systems, from human factors or from external events (e.g. fraud, theft, legal and compliance risks, cyber-attacks or damage to physical assets). Operational risk relates to the following risk event categories as defined by Basel Capital Standards: 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. The Group may incur operational risk across the full scope of its business activities, including revenue-generating activities (e.g. sales and trading) and support and control groups (e.g. information technology and trade processing). Legal and compliance risk is included in the scope of operational risk.

For further information on the Group's operational risk including conduct risk and legal, regulatory and compliance risk, refer to pages 27 to 30 of the strategic report in the consolidated financial statements for the year ended 31 December 2017.

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.

In line with Morgan Stanley Group's capital management policies, the Group actively manages its capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines. Therefore, in the future it may adjust its capital base to address the changing needs of its businesses. The appropriate level of capital is determined at a legal entity level to safeguard that entity's ability to continue as a going concern and ensure that it meets all regulatory capital requirements. The key components of the capital management framework used by the Group are set out in the Capital Management Policy and include a point in time risk and leverage based capital assessment, forward-looking capital projections and stress testing.

The Company's ultimate UK parent undertaking, Morgan Stanley International ("MSI") Group, conducts an Internal Capital Adequacy Assessment Process ("ICAAP") at least annually to meet its obligations under CRD IV and the requirements of the PRA. The ICAAP is one of the key tools used to inform the MSI Group's capital adequacy assessment, planning and management. The MSI Group ICAAP:

- Is designed to ensure the risks to which the MSI Group is exposed are appropriately capitalised and risk managed, including those risks that are either not captured, or not fully captured under Pillar 1;
- Uses stress testing to size a capital buffer aimed at ensuring the MSI Group will continue to operate above regulatory requirements under a range of severe but plausible stress scenarios; and
- Assesses capital adequacy under normal and stressed operating environments over the 3 year capital planning horizon to ensure the MSI Group maintains a capital position in line with pre- and post-stress minimum levels.

The key elements of the ICAAP are embedded in the MSI Group's day-to-day management processes and decision making culture.

The PRA reviews the ICAAP document through its Supervisory Review Process and issues an Individual Capital Guidance which establishes the minimum level of regulatory capital for the MSI Group. In addition, the PRA sets a buffer if required in addition to the Basel Combined Buffers, which is available to support the MSI Group in a stressed market environment.

MSI Group capital is managed to ensure risk and leverage based requirements assessed through the ICAAP and SREP are met. Internal capital ratio minima are set to ensure the MSI Group and its subsidiaries have sufficient capital to meet their regulatory requirements at all times.

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INTERIM MANAGEMENT REPORT CAPITAL MANAGEMENT (CONTINUED)

The capital managed by the Group broadly includes share capital, Additional Tier 1 capital instruments, subordinated debt and reserves. In order to maintain or adjust its capital structure, the Group may pay dividends, return capital to its shareholder, issue new shares, or issue or repay subordinated debt or Additional Tier 1.

REGULATORY REQUIREMENTS

Regulatory capital

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.

The Company is regulated by the FCA and the PRA and as such is subject to minimum capital requirements. The Company's capital is monitored on an ongoing basis to ensure compliance with these requirements. At a minimum, the Company must ensure that Capital Resources described in accordance with CRR as Own Funds, are greater than the Capital Resource Requirement covering credit, market and operational risk.

The Company complied with all of its regulatory capital requirements during the period.

Set out below are details of the Company's Capital Resources, described in accordance with CRR, as at 30 June 2018 and 31 December 2017:

	30 June 2018 \$millions	31 December 2017 \$millions
Common Equity Tier 1 ("CET 1")	15,809	15,671
Additional Tier 1 ("AT1")	1,300	1,300
Tier 1 Capital	17,109	16,971
Tier 2 Capital	5,000	7,000
Total Own Funds	22,109	23,971
RWAs	137,062	132,724
CET1 Ratio	11.5%	11.8%
Tier 1 Capital Ratio	12.5%	12.8%
Total Capital Ratio	16.1%	18.1%
Leverage Exposure	454,783	448,591
Leverage Ratio	3.8%	3.8%

Tier 2 capital decreased as a result of the repayment of subordinated debt of \$2 billion. Refer to note 12 for further detail.

On 23 August 2018, the Company issued Additional Tier 1 capital instruments (the "Instruments") with a value of \$2,200 million to Morgan Stanley International Limited, a UK incorporated indirect parent of the Company. For further detail, refer to note 22.

Leverage ratio framework

The Basel III framework introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The Basel Committee on Banking Supervision (the "Basel Committee") is of the view that a simple leverage ratio framework is critical and complementary to the risk-based capital framework and that a credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT REGULATORY REQUIREMENTS (CONTINUED)

Leverage ratio framework (continued)

Although there is no current binding leverage requirement under CRD IV, the MSI Group manages its risk of excessive leverage through the application of Business Unit leverage exposure limits and leverage ratio early warning trigger levels. Limits are calibrated in line with legal entity capacity and ensure that leverage exposure remains within the MSI Board's risk appetite. MSI Group and the Group's leverage exposures are calculated monthly and weekly, respectively, and reported to EMEA ALCO who monitor this, as well as maturity mismatches and Asset Encumbrance metrics, to ensure that any excessive risk is highlighted, assessed and mitigated appropriately. The MSIP Group leverage ratio was 3.8% as of 30 June 2018 (3.8% as at 31 December 2017).

Resolution and recovery planning

Both the Morgan Stanley Group and the MSI Group prepare, on an annual basis, a recovery plan which identifies mitigation tools available to both groups in times of severe stress.

The Morgan Stanley Group has developed a resolution plan in accordance with the requirements of Section 165(d) of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementation regulations adopted by the Federal Reserve Board and the Federal Deposit Insurance Corporation. The resolution plan presents the Firm's strategy for resolution of the Firm upon material financial distress or failure in a severely adverse macroeconomic environment. The Company is a Material Operating Entity of the Morgan Stanley Group and is within the scope of the single point of entry resolution strategy adopted by the Morgan Stanley Group.

The EU Bank Recovery and Resolution Directive ("BRRD") has established a recovery and resolution framework for EU credit institutions and investment firms, including the Company. The Company produces information required by the UK Resolution Authority in the form of a resolution pack and ad hoc regulatory submissions, as necessary under BRRD and UK regulatory requirements.

MiFID II

Following the global financial crisis, the European Commission reviewed the Markets in Financial Instruments framework. The Markets in Financial Instruments Regulation and a revision of the Markets in Financial Instruments Directive (together, "MiFID II"), became effective on 3 January 2018 and introduced comprehensive and new trading and market infrastructure reforms in the EU, including new trading venues, enhancements to pre- and post-trading transparency, and additional investor protection requirements, among others.

Derivatives regulation

The Group is subject to swap regulations under the Dodd-Frank Act, including requirements relating to public and regulatory reporting in the US, central clearing and mandatory trading on certain US exchanges. US and other global regulators, including the European Supervisory Authorities, have also finalised margin requirements for uncleared derivatives that apply to various entities in the Group, including the Company. Initial margin requirements are phasing in between September 2016 and September 2020 depending on the parties' trading activity, and variation margin requirements began applying to most in-scope counterparties on 1 March 2017.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT REGULATORY REQUIREMENTS (CONTINUED)

Expected Replacement of London Interbank Offered Rate

Central banks around the world have commissioned working groups of market participants and official sector representatives with the goal of finding suitable replacements for LIBOR based on observable market transactions. It is expected that a transition away from the widespread use of LIBOR to alternative rates will occur over the course of the next few years. The UK FCA ("FCA"), which regulates LIBOR, has announced that it has commitments from panel banks to continue to contribute to LIBOR through the end of 2021, but that it will not use its powers to compel contributions beyond such date. Accordingly, there is considerable uncertainty regarding the publication of such rates beyond 2021.

On April 3, 2018, the US Federal Reserve commenced publication of three reference rates based on overnight US Treasury repurchase agreement transactions, including the Secured Overnight Financing Rate ("SOFR"), which has been recommended as an alternative to US dollar LIBOR by the Alternative Reference Rates Committee. Further, the Bank of England has commenced publication of a reformed Sterling Overnight Index Average ("reformed SONIA"), comprised of a broader set of overnight Sterling money market transactions, as of 23 April 2018. Reformed SONIA has been recommended as the alternative to Sterling LIBOR by the Working Group on Sterling Risk-Free Reference Rates.

Although the full impact of such reforms and actions, together with any transition away from LIBOR, including the potential or actual discontinuance of LIBOR publication, remains unclear, these changes may have an adverse impact on the value of, return on and trading markets for a broad array of financial products, including any LIBOR-based securities, loans and derivatives that are included in our financial assets and liabilities. Such reforms and actions may also require extensive changes to the contracts that govern these LIBOR-based products, as well as our systems and processes.

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").

Liquidity Coverage Ratio: The LCR was developed to ensure banking organisations have sufficient high quality liquid assets to cover net cash outflows arising from significant stress over 30 calendar days. The standard's objective is to promote the short-term resilience of the liquidity risk profile of banking organisations. The Group was required to comply with LCR minimum standards from 1 October 2015. The Group is compliant with the minimum required LCR based on current interpretation. These minimum standards are increasing each year until 2018. The Group continues to evaluate the impact on its liquidity and funding requirements.

Net Stable Funding Ratio: The objective of the NSFR is to reduce funding risk over a one year horizon by requiring banking organisations to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress. In October 2014, the Basel Committee finalised revisions to the NSFR, which became effective on 1 January 2018. As part of the European Commission's comprehensive regulatory reform package the proposed NSFR rules are expected to be introduced in the EU in 2019 at the earliest, with Member States implementing the new rules in 2021 based on current estimates. The MSI Group continues to evaluate the NSFR and its potential impact on the Group's current liquidity and funding requirements.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT REGULATORY REQUIREMENTS (CONTINUED)

Finalising Basel III Reforms

On 7 December 2017, the Basel Committee released the final part of its Basel III reform package. The key amendments provide updates to the standardised measures for calculating capital requirements and include a risk-weighted (“RWA”) floor, calculated as 72.5% of total standardised RWA. These proposals will need to be transposed into national/EU law, however the timing of this is still uncertain.

European Financial Regulation Reform

In November 2016, the European Commission published a comprehensive regulatory reform package which aims to continue the reforms that the EU implemented in the wake of the financial crisis. The proposals seek to amend the existing prudential regime (CRR and CRD IV), including amendments to the risk-based capital, liquidity, leverage and large exposures regimes (known as “CRD5” and “CRR2”), the BRRD and the Single Resolution Mechanism (“SRM”).

The key amendments to the CRR include:

- A binding leverage ratio;
- A new standard on the total loss-absorbing capacity (“TLAC”) for globally systemically important institutions (“G-SIIs”) which will require those institutions to have more loss-absorbing and recapitalisation capacity, and to tackle interconnections in the global financial markets;
- A binding NSFR to establish how much stable, long-term sources of funding an institution needs to weather periods of market or funding stress;
- A new standardised approach for the calculation of counterparty credit exposures for derivatives;
- New standardised and advanced calculation approaches for market risk requirements.

Amongst key amendments to the CRD IV the following are worth noting:

- Provisions harmonising the application of the Pillar 2 framework by supervisors across the EU;
- Harmonisation of the calculation of the distributable amount (e.g., dividends) by introducing a common ‘stacking order’ for capital requirements calculated at different levels (such as Pillar 1 capital requirements, TLAC requirements, capital buffers);
- Modifications to the framework for Interest Rate Risk in the Banking book (“IRRBB”);
- Bringing certain holding companies directly in scope of the EU prudential framework;
- Introducing a requirement for certain large non-EU financial groups to set up EU Parent Intermediate Holding Companies (“EU IHC”) which will bring their EU-based regulated subsidiaries under common prudential consolidation groups. EU IHCs would be subject to direct supervision and authorisation by the European Central Bank (“ECB”) or the relevant national EU regulator.

Progress has been made by European policy-makers during 2018. The final stage of the legislative process (“trilogue”) has commenced and legislators are targeting completion by the end of 2018.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT 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 as required.

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 reports and Interim Financial Statements.

Approved by the Board and signed on its behalf by



C Castello

Director

20 September 2018

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 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 20 September 2018



C Castello
Director

Board of Directors:

J Bloomer	(appointed Chairman from 31 March 2018)
D O Cannon	
C Castello	
T Duhon	
L Guy	
J Horder	
A Kohli	
M C Phibbs	
I Plenderleith	(Chairman until resigned on 31 March 2018)
R P Rooney	(resigned on 5 September 2018)
D A Russell	
N P Whyte	(appointed 14 May 2018)
C Woodman	(appointed 5 September 2018)

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 2018, 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 22. 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 2018 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
Statutory Auditor
London
21 September 2018

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED INCOME STATEMENT

Six months ended 30 June 2018

		Six months ended 30 June 2018 \$millions (unaudited)	Six months ended 30 June 2017 \$millions (unaudited)
	Note		
Net trading income		2,945	2,838
Net income from other financial instruments held at fair value		150	(91)
Fee and commission income	4	1,294	1,241
Other revenue		15	5
Total non-interest revenues		<u>4,404</u>	<u>3,993</u>
Interest income	5	472	(31)
Interest expense	5	(1,433)	(743)
Net interest expense		<u>(961)</u>	<u>(774)</u>
Net revenues		<u>3,443</u>	<u>3,219</u>
Non-interest expenses:			
Other expense	6	(2,468)	(2,222)
Net impairment (loss)/gain on financial assets		(5)	2
PROFIT BEFORE TAX		<u>970</u>	<u>999</u>
Income tax expense	7	(308)	(304)
PROFIT FOR THE PERIOD		<u>662</u>	<u>695</u>

All profit for the current and prior period were attributable to owners of the parent.

All operations were continuing in the current and prior periods.

The notes on pages 25 to 81 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Six months ended 30 June 2018

	Six months ended 30 June 2018 \$millions (unaudited)	Six months ended 30 June 2017 \$millions (unaudited)
PROFIT FOR THE PERIOD	<u>662</u>	<u>695</u>
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Items that will not be reclassified subsequently to profit or loss:		
Remeasurement of net defined benefit liability	(1)	-
Changes in fair value attributable to own credit risk on financial liabilities designated at fair value	94	(19)
Items that may be reclassified subsequently to profit or loss:		
Currency translation reserve:		
Foreign currency translation differences arising on foreign operations during the period	(36)	62
Available-for-sale reserve:		
Net change in fair value of available-for-sale financial assets	-	2
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX	<u>57</u>	<u>45</u>
TOTAL COMPREHENSIVE INCOME	<u>719</u>	<u>740</u>
Attributable to:		
Owners of the parent	721	736
Non-controlling interests	(2)	4
TOTAL COMPREHENSIVE INCOME	<u>719</u>	<u>740</u>

The notes on pages 25 to 81 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 2018

	Equity instruments \$millions	Share premium \$millions	Currency translation reserve \$millions	Available-for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Other reserve \$millions	Debt valuation adjustment reserve \$millions	Retained earnings \$millions	Attributable to owners of the parent \$millions	Non-controlling interest \$millions	Total equity \$millions
Balance at 1 January 2018	13,765	513	98	63	3	1,400	-	(118)	2,904	18,628	59	18,687
Impact of adoption of new accounting standards (see note 3)	-	-	-	(63)	-	-	-	-	67	4	-	4
Profit for the period	-	-	-	-	-	-	-	-	662	662	-	662
Other comprehensive income for the period:												
Remeasurement of defined benefit liability	-	-	-	-	-	-	(1)	-	-	(1)	-	(1)
Changes in fair value attributable to own credit risk on financial liabilities designated at fair value	-	-	-	-	-	-	-	94	-	94	-	94
Foreign currency translation differences arising on foreign operations	-	-	(34)	-	-	-	-	-	-	(34)	(2)	(36)
Total comprehensive income	-	-	(34)	-	-	-	(1)	94	662	721	(2)	719
Transactions with owners:												
Dividends	-	-	-	-	-	-	-	-	(87)	(87)	-	(87)
Balance at 30 June 2018 (unaudited)	13,765	513	64	-	3	1,400	(1)	(24)	3,546	19,266	57	19,323

	Equity instruments \$millions	Share premium \$millions	Currency translation reserve \$millions	Available-for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Other reserve \$millions	Debt valuation adjustment reserve \$millions	Retained earnings \$millions	Attributable to owners of the parent \$millions	Non-controlling interest \$millions	Total equity \$millions
Balance at 1 January 2017	12,765	513	(6)	(5)	3	1,400	-	(45)	2,126	16,751	52	16,803
Profit for the period	-	-	-	-	-	-	-	-	695	695	-	695
Other comprehensive income for the year:												
Changes in fair value attributable to own credit risk on financial liabilities designated at fair value	-	-	-	-	-	-	-	(19)	-	(19)	-	(19)
Foreign currency translation differences arising on foreign operations	-	-	58	-	-	-	-	-	-	58	4	62
Net change in fair value on available-for-sale financial assets	-	-	-	2	-	-	-	-	-	2	-	2
Total comprehensive income	-	-	58	2	-	-	-	(19)	695	736	4	740
Transactions with owners:												
Dividends	-	-	-	-	-	-	-	-	(86)	(86)	-	(86)
Balance at 30 June 2017 (unaudited)	12,765	513	52	(3)	3	1,400	-	(64)	2,735	17,401	56	17,457

The notes on pages 25 to 81 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc
Registered Number: 02068222

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 30 June 2018

		30 June 2018	31 December 2017
		\$millions	\$millions
ASSETS			
Cash and short term deposits	15	32,546	25,461
Trading financial assets (of which \$54,762 million (2017: \$58,785 million) were pledged to various parties)	9	269,200	264,793
Secured financing	8	89,645	99,345
Loans and advances		504	476
Investment securities		154	161
Trade and other receivables		75,470	70,864
Current tax assets		161	139
Deferred tax assets		72	107
Prepayments and accrued income		16	6
Property, plant and equipment		8	8
Intangible assets		2	2
TOTAL ASSETS		467,778	461,362
LIABILITIES AND EQUITY			
Bank loans and overdrafts	15	12	123
Trading financial liabilities	9	222,276	217,977
Secured borrowing	8	84,336	87,186
Trade and other payables		103,723	97,220
Debt and other borrowings	12	37,943	39,938
Provisions		30	54
Current tax liabilities	7	33	28
Accruals and deferred income		96	144
Post employment benefit obligations		6	5
TOTAL LIABILITIES		448,455	442,675
EQUITY			
Share capital		13,765	13,765
Share premium account		513	513
Currency translation reserve		64	98
Available-for-sale reserve		-	63
Capital contribution reserve		3	3
Capital redemption reserve		1,400	1,400
Other reserve		(1)	-
Debt valuation adjustment reserve		(24)	(118)
Retained earnings		3,546	2,904
Equity attributable to owners of the parent		19,266	18,628
Non-controlling interest		57	59
TOTAL EQUITY		19,323	18,687
TOTAL LIABILITIES AND EQUITY		467,778	461,362

The notes on pages 25 to 81 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

As at 30 June 2018

		Six months ended 30 June 2018 \$millions (unaudited)	Six months ended 30 June 2017 \$millions (unaudited)
	Note		
NET CASH FLOWS FROM OPERATING ACTIVITIES	15	8,660	1,108
INVESTING ACTIVITIES			
Purchase of property, plant and equipment		-	(1)
Purchase of investment securities		-	(40)
Proceeds from sale of investment securities		-	1
NET CASH FLOWS USED IN INVESTING ACTIVITIES		<u>-</u>	<u>(40)</u>
FINANCING ACTIVITIES			
Dividends paid		(119)	(119)
Repayment of subordinated loans	12	(2,000)	(5,906)
Issuance of subordinated loans		-	5,000
Interest on subordinated loan liabilities		(26)	(103)
NET CASH FLOWS USED IN FINANCING ACTIVITIES		<u>(2,145)</u>	<u>(1,128)</u>
NET INCREASE/ (DECREASE) IN CASH AND CASH EQUIVALENTS		6,515	(60)
Currency translation differences on foreign currency cash balances		681	(708)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD		<u>25,338</u>	<u>20,321</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD		<u>32,534</u>	<u>19,553</u>

The notes on pages 25 to 81 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 2018

1. BASIS OF PREPARATION

a. General information

These Interim Financial Statements do not constitute statutory accounts within the meaning of Section 435 of the United Kingdom Companies Act 2006 ("Companies Act").

Statutory accounts for the year ended 31 December 2017 were approved by the Board of Directors on 19 April 2018 and 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 2016. Other comparative information for the six months ended 30 June 2017 is included in certain instances.

b. Accounting policies

The Group has prepared its annual consolidated financial statements in accordance with IFRSs issued by the International Accounting Standards Board ("IASB") as adopted by the EU, Interpretations issued by the IFRS Interpretations Committee ("IFRIC") and the Companies Act 2006. 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 2017, except for those included in note 2 in the 'Summary of new or amended accounting policies'.

New standards and interpretations adopted during the period

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

IFRS 9 was issued by the IASB in November 2009, reissued in October 2010, amended in November 2013, and revised and reissued by the IASB in July 2014. IFRS 9 is applicable retrospectively, except where otherwise prescribed by transitional provisions of the standard, and is effective for annual periods beginning on or after 1 January 2018. The Group early adopted the requirements relating to the presentation of fair value movements due to changes in credit risk on financial liabilities designated at fair value through profit or loss ("FVPL"), and has adopted the remaining requirements of IFRS 9 from 1 January 2018.

A further amendment to IFRS 9, relating to the accounting treatment of financial instruments with prepayment features including negative compensation, was issued by the IASB in October 2017. The amendment is applicable retrospectively, except where otherwise prescribed by transitional provisions of the amendment, and is effective for annual periods beginning on or after 1 January 2019. The amendment was endorsed by the EU in March 2018. The Group has early adopted this amendment from 1 January 2018.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

New standards and interpretations adopted during the period (continued)

The main aspects of IFRS 9 which impact the Group are its requirements relating to:

- Classification and measurement of financial assets

The classification and measurement of financial assets is determined based upon how these financial assets are managed and their contractual cash flow characteristics. Measurement will be either at amortised cost, fair value through other comprehensive income ("FVOCI") or FVPL.

- Impairment of financial instruments

The impairment requirements are based on expected credit losses ("ECL") and apply to financial assets measured at amortised cost and FVOCI, and lease receivables and certain loan commitments and financial guarantee contracts.

The Group has completed a project to implement IFRS 9. As part of this project, the Group performed an evaluation of its business models and a review of the contractual terms of financial assets.

As a result of this evaluation, certain financial assets have moved from amortised cost and designated at FVPL under IAS 39 '*Financial instruments: Recognition and measurement*' ("IAS 39") to mandatorily at FVPL under IFRS 9. Equity investments previously held at available-for-sale have moved to FVPL with a consequent transfer of the accumulated available-for-sale reserve to retained earnings. Additionally, certain financial liabilities have changed classification from amortised cost to being designated at FVPL as they are part of a group of financial assets and financial liabilities which are managed on a fair value basis. The impact of these changes on retained earnings as at 1 January 2018 was \$68 million.

For lending products and other debt financial instruments, a model-based approach has been adopted, the key aspects of which are:

- The impairment allowance is based on ECLs associated with the lifetime cash shortfalls that will result if a default occurs in the twelve months after the reporting date (the 'twelve month ECL'), unless there has been a significant increase in credit risk ("SICR") since origination, in which case the ECL is based on all possible defaults over the total expected life of the instrument (the 'lifetime ECL');
- Identifying whether assets have experienced a SICR since origination. When determining whether credit risk has increased significantly since initial recognition, the Group considers both quantitative and qualitative information and analysis, based on the Group's historical experience and expert credit risk assessment, including forward-looking information;
- Estimating ECL, reflecting an unbiased and the probability-weighted impact of multiple future economic scenarios. ECLs are calculated using three main components: probability of default ("PD"), the expected loss given default ("LGD") and an estimated exposure at default ("EAD"). These parameters are generally derived from internally-developed statistical models, combined with historical, current and forward-looking customer and macro-economic data.

For trade receivables, a simplified approach has been adopted, as permitted by IFRS 9, whereby an allowance is recognised for the lifetime ECLs of the instrument. Practical expedients have been employed to calculate the ECLs for trade receivables. For some portfolios of financial assets, ECLs have been estimated to be close to zero, reflecting the short term nature of the portfolio and the benefit of collateral or other credit mitigants.

The impact of the implementation of the ECL impairment approach on retained earnings as at 1 January 2018 was not material to the Group.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

New standards and interpretations adopted during the period (continued)

The impact to the Group's Tier 1 capital as at 1 January 2018 as a result of the transition to IFRS 9 was not material. The Group did not make use of the transitional arrangements introduced by Regulation (EU) 2017/2395 relating to the effects of ECL for mitigating the impact of the introduction of IFRS 9 on own funds and the treatment of certain large exposures.

Under the transitional provisions of the Standard, the Group's opening balance sheet at the date of initial application (1 January 2018) has been restated, with no restatement of comparative periods. However, the Group has updated the presentation of its primary statements on transition to IFRS 9 to provide more relevant information to the users of the consolidated financial statements. The comparative period has been re-presented to align to the new format in the condensed consolidated financial statements.

Note 2 provides the new accounting policies under IFRS 9 applicable from 1 January 2018.

To reflect the differences between IFRS 9 and IAS 39, IFRS 7 '*Financial Instruments: Disclosures*' was updated by the IASB and the Group adopted the updated IFRS 7, for the year beginning 1 January 2018. The updated requirements include transition disclosures shown in note 3, in addition to qualitative and quantitative information about the ECL as set out in note 17.

An amendment to IFRS 2 '*Classification and Measurement of Share-based Payment Transactions*' was issued by the IASB in June 2016, for application in accounting periods beginning on or after 1 January 2018. Early application is permitted. The amendment was endorsed by the EU in February 2018.

IFRS 15 '*Revenue from Contracts with Customers*' ("IFRS 15") was issued by the IASB in May 2014 for retrospective application in annual periods beginning on or after 1 January 2018. In addition, amendments relating to clarifications to IFRS 15 were issued by the IASB in April 2016 requiring application in accounting periods beginning on or after 1 January 2018. The standard and amendments were endorsed by the EU in October 2016. Refer to note 3 for further information.

As part of the 2014-2016 Annual Improvements Cycle published in December 2016, the IASB made amendments to the following standard that are relevant to the Group's operations: IAS 28 '*Investments in Associates*', for application in accounting periods beginning on or after 1 January 2018. The amendments were endorsed by the EU in February 2018.

IFRIC 22 '*Foreign Currency Transactions and Advance Consideration*' was issued by the IASB in December 2016 for application in accounting periods beginning on or after 1 January 2018 and was endorsed by the EU in April 2018.

There were no other standards, amendments to 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, amendments to standards and interpretations relevant to the Group's operations were issued by the IASB but not mandatory for accounting periods beginning 1 January 2018. Except where otherwise stated, the Group does not expect that the adoption of the following standards, amendments to standards and interpretations will have a material impact on the Group's consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

New standards and interpretations not yet adopted (continued)

IFRS 16 '*Leases*' ("IFRS 16") was issued by the IASB in January 2016, for modified retrospective application in accounting periods beginning on or after 1 January 2019. The principal impact of adopting IFRS 16 is the recognition of additional right of use assets and lease liabilities for leases that were previously accounted for as operating leases under IAS 17. The consolidated income statement will also be affected because the total expense is typically higher in the earlier years of a lease and lower in later years, whereas under IAS 17, expense was recognised on a straight-line basis over the life of the lease, although these impacts are not expected to be material to the Group. The Group is currently assessing the impact of IFRS 16 on its consolidated financial statements. The standard was endorsed by the EU in November 2017.

An amendment to IAS 19 '*Plan Amendment, Curtailment or Settlement*' was issued by the IASB in February 2018, for retrospective application to plan amendments, curtailments or settlements occurring on or after 1 January 2019.

As part of the 2015-2017 Annual Improvements Cycle published in December 2017, the IASB made amendments to the following standards that are relevant to the Group's operations: IAS 12 '*Income Taxes*' ("IAS 12") and IAS 23 '*Borrowing Costs*', for application in accounting periods beginning on or after 1 January 2019. The amendment to IAS 12 will affect the presentation of tax benefits relating to the coupon payments on the Additional Tier 1 capital instruments, which will be presented within the income tax expense in the consolidated income statement rather than the consolidated statement of changes in equity.

IFRIC 23 '*Uncertainty over Income Tax Treatments*' was issued by the IASB in June 2017 for application in accounting periods beginning on or after 1 January 2019.

c. Critical judgements in applying the Group's accounting policies

In applying the Group's accounting policies, the judgements made by management other than those involving estimations noted below, that have the most significant effect on the amounts recognised in the consolidated financial statements are regarding the recognition of deferred tax balances, and the consolidation of structured entities. The Group believes that the judgements utilised in preparing the consolidated financial statements are reasonable, relevant and reliable. For further details on these, refer to notes 3(d), 6, 7, 15, and 31 in the Group's financial statements for the year ended 31 December 2017.

d. Key sources of estimation uncertainty

The preparation of the Group's consolidated financial statements requires management to apply judgement to estimations and assumptions made regarding the valuation of certain financial instruments, impairment of assets, tax balances, pension obligations, the outcome of litigation, and other matters that affect the consolidated financial statements and related disclosures. For further detail, see accounting policy note 3(o) and note 19 in the consolidated financial statements for the year ended 31 December 2017.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES

The accounting policies below in relation to Financial Instruments and Revenue Recognition are those which are new or amended as a result of IFRS 9 and IFRS 15, and apply only from 1 January 2018. All other accounting policies for the current period, and all policies for the prior period, are consistent with those in note 3 in the Group's consolidated Financial Statement for the year ended 31 December 2017.

a. Financial instruments

i) Financial instruments mandatorily at fair value through profit and loss

Trading financial instruments

Trading financial instruments include government debt securities, corporate and other debt, traded loans and corporate equities where the Group acquires the financial asset or financial liability for the purpose of selling or repurchasing in the near term or is part of a portfolio for which there is evidence of short term profit taking, and all derivative contracts.

Purchases and sales of non-derivative financial instruments classified as trading are initially recognised on settlement date at fair value, including regular way securities transactions. For purchases of non-derivative financial instruments classified as trading, from the date that the terms are agreed (trade date) until the settlement date, the Group recognises any unrealised fair value in the consolidated statement of financial position as 'Trading financial instruments' with corresponding profit or loss recognised within the consolidated income statement in 'Net trading income'. For sales of non-derivative financial instruments unrealised fair value changes are no longer recognised in the consolidated income statement from trade date. Upon settlement date the resulting financial instrument is recognised or de-recognised from the consolidated statement of financial position.

Derivatives are initially recognised on trade date at fair value. All subsequent changes in fair value are reflected in the consolidated income statement in 'Net trading income'.

All changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net trading income'. When interest is included as a component of an instrument's fair value, interest is also reflected in the income statement in 'Net trading income', otherwise, it is included within 'Interest income' or 'Interest expense'.

For all trading financial instruments, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

Non-trading financial assets at fair value through profit or loss

Non-trading financial assets at FVPL are principally financial assets where the Group makes decisions based upon the assets' fair values and are generally recognised on settlement date at fair value, since they are neither regular way nor are they derivatives. From the date the terms are agreed (trade date), until the financial asset is funded (settlement date), the Group recognises any unrealised fair value changes in the financial asset as non-trading financial assets at FVPL. On settlement date, the fair value of consideration given is recognised as a non-trading financial asset at FVPL. All subsequent changes in fair value, foreign exchange differences and unrealised interest are reflected in the consolidated income statement in 'Net income from other financial instruments held at fair value'.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES (CONTINUED)

a. Financial instruments (continued)

i) Financial instruments mandatorily at fair value through profit and loss (continued)

Non-trading financial assets at fair value through profit or loss (continued)

For all non-trading financial assets at FVPL, transaction costs are excluded from the initial fair value measurement of the financial assets. These costs are recognised in the consolidated income statement in 'Other expense'.

Non-trading financial assets at FVPL include secured financing transactions such as cash collateral on securities borrowed and securities purchased under agreements to resell, prepaid OTC contracts and financial assets arising upon consolidation of certain special purpose entities as well as certain investment securities (unlisted equities).

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

The Group has designated certain financial liabilities at FVPL where:

- the financial liability forms part of a group of financial assets or financial liabilities or both which are managed, evaluated and reported internally on a fair value basis; or
- the financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

For further information, see note 8.

iii) Financial assets and financial liabilities at amortised cost

Financial assets are recognised at amortised cost when the Group's business model objective is to collect the contractual cash flows of the assets and where these cash flows are solely payments of principal and interest ("SPPI") on the principal amount outstanding until maturity. Such assets are recognised when the Group becomes a party to the contractual provisions of the instrument. The instruments are initially measured at fair value and subsequently measured at amortised cost less ECL allowance. Interest is recognised in the consolidated income statement in 'Interest income', using the effective interest rate method as described on the next page. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. Transaction costs that are directly attributable to the acquisition of the financial asset are added to the fair value on initial recognition. ECL and reversals thereof are recognised in the consolidated income statement in 'Net impairment (loss)/gain on financial assets'.

Financial assets at amortised cost include cash and short-term deposits, certain trade and other receivables and certain loans and advances.

Financial liabilities at amortised cost include certain bank loans and overdrafts and certain secured borrowings, trade and other payables and debt and other borrowings.

b. Secured financing and secured borrowings

In the course of financing its business and part of its trading activities, the Group enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES (CONTINUED)

b. Secured financing and secured borrowings (continued)

Securities received by the Group under resale arrangements and securities borrowing arrangements are generally not recognised on the consolidated statement of financial position. Where cash collateralised, the resulting cash collateral receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as 'Non-trading at FVPL' as they are managed on a fair value basis.

Securities pledged or sold by the Group under sale and repurchase agreements and securities lending arrangements are generally not derecognised from the consolidated statement of financial position. Where cash collateralised, the resulting cash collateral payable and accrued interest arising are designated at FVPL where the financial liability forms part of a group of financial assets or financial liabilities or both, which is managed, evaluated and reported internally of a fair value basis; or at amortised cost if not so designated.

c. Impairment of financial instruments

The Group recognises loss allowances for ECL for the following financial instruments that are not measured at FVPL:

- financial assets measured at amortised cost;
- loan commitments, except those that can be net settled in cash or with another financial instrument; and
- financial guarantees

Measurement of ECL

For financial assets, ECLs are the present value of cash shortfalls (i.e. the difference between contractual and expected cash flows) over the expected life of the financial instrument, discounted at the asset's effective interest rate ("EIR").

Where a financial asset is credit-impaired at the reporting date, the ECL is measured as the difference between the asset's gross carrying amount and the present value of future cash flows, discounted at the original effective interest rate.

For in-scope loan commitments, ECLs are the present value of the cash shortfalls (i.e. the difference between contractual and expected cash flows), assuming that the loan is drawn down.

For a financial guarantee contract, the ECLs are the present value of the cash shortfalls based on the expected payments to reimburse the holder for a credit loss that it may incur when a debtor fails to make payment when due.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES (CONTINUED)

c. Impairment of financial instruments (continued)

Measurement of ECL (continued)

The Group applies a three stage approach to measuring ECLs based on the change in credit risk since initial recognition:

- Stage 1: if the credit risk of the financial instrument at the reporting date has not increased significantly since initial recognition ("SICR"), then the loss allowance is calculated as the lifetime cash shortfalls that will result if a default occurs in the next 12 months, weighted by the probability of that default occurring.
- Stage 2: if there has been a SICR since initial recognition, the loss allowance is calculated as the ECL over the remaining life of the financial instrument. If it is subsequently determined that there has no longer been a SICR since initial recognition, then the loss allowance reverts to reflecting 12 month expected losses.
- Stage 3: if there has been a SICR since initial recognition and the financial instrument is deemed credit-impaired (see next page for definition of credit-impaired), the loss allowance is calculated as the ECL over the remaining life of the financial instrument. If it is subsequently determined that there has no longer been a SICR since initial recognition, then the loss allowance reverts to reflecting 12 month expected losses.

Notwithstanding the above, for trade receivables, a lifetime ECL is always calculated, without considering whether a SICR has occurred.

The Group's accounting policy is to not use the 'low' credit risk practical expedient. As a result, the Group monitors all financial instruments which do not have a significant financing component that are subject to impairment for SICR.

In general, ECLs are measured so that they reflect:

- A probability-weighted range of possible outcomes;
- the time value of money, and
- relevant information relating to past, current and future economic conditions.

When measuring ECLs, the Group considers multiple scenarios, except where practical expedients are used to determine ECLs. Practical expedients are used where they are consistent with the principles described above. ECLs on certain trade receivables are calculated using a 'matrix' approach which reflects the previous history of credit losses on these financial assets, applying different provision levels based on the age of the receivable. Alternatively where there is a history of no credit losses, and where this is expected to persist into the future for structural or other reasons, such as collateral or other credit enhancement, in which case it is determined that the ECL for a financial instrument is *de minimis* (highly immaterial) and it may not be necessary to recognise the ECL.

The Group measures ECL on an individual asset basis and has no purchased or originated credit-impaired financial assets.

If a financial asset has been the subject of modification which does not lead to its derecognition, SICR is assessed by comparing the risk of default of the financial instrument, based on the modified terms at the reporting date, with the risk of default of the financial instrument at inception, based on the financial instrument's original, unmodified, terms.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES (CONTINUED)

c. Impairment of financial instruments (continued)

Measurement of ECL (continued)

Where the modification of contractual cash flows of a financial asset leads to its derecognition and the recognition of a new asset, the date of modification is treated as the date of initial recognition for the new financial asset when determining whether a SICR has occurred for that modified financial asset. In rare circumstances, after modification, the new asset is considered to be credit impaired, in which case it is treated as an asset which was credit-impaired at origination.

More information on measurement of ECLs is provided in note 17 Credit Risk Management.

Presentation of ECL

ECL is recognised in the consolidated income statement within 'Net impairment (loss)/gain on financial assets'. ECLs on financial assets measured at amortised cost are presented as an ECL allowance. The allowance reduces the net carrying amount on the face of the consolidated statement of financial position. Where the financial asset is measured at FVOCI, the loss allowance is recognised as an accumulated impairment amount in other comprehensive income and does not reduce the carrying amount of the financial asset on the consolidated statement of financial position. ECLs on loan commitments and financial guarantee contracts are presented as a provision in the consolidated statement of financial position, i.e. as a liability.

Credit-impaired financial instruments

In assessing the impairment of financial instruments under the ECL model, the Group defines credit-impaired financial instruments in accordance with Credit Risk Management Department's policies and procedures. A financial instrument is credit-impaired when, based on current information and events, it is probable that the Group will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the agreement.

Definition of Default

In assessing the impairment of financial instruments under the ECL model, the Group defines default in accordance with Credit Risk Management Department's policies and procedures. This considers whether the borrower is unlikely to pay its credit obligations to the Group in full and takes into account qualitative indicators, such as breaches of covenants. The definition of default also includes a presumption that a financial asset which is more than 90 days past due ("DPD") has defaulted.

Write-offs

Loans and debt securities are written off (either partially or in full) when they are deemed uncollectible which generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted. Such determination is based on an indication that the borrower can no longer pay the obligation, or that the proceeds from collateral will not be sufficient to pay the loan. Partial write-offs are made when a portion of the loan is uncollectable. Financial assets that are written off could still be subject to enforcement activities for recoveries of amounts due. If the amount to be written off is greater than the accumulated loss allowance, the difference is reflected directly in the consolidated income statement within 'Net impairment (loss)/gain on financial assets' and is not recognised in the loss allowance account. Any subsequent recoveries are credited to 'Net impairment (loss)/gain on financial assets' within the consolidated income statement.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

2. SUMMARY OF NEW OR AMENDED ACCOUNTING POLICIES (CONTINUED)

d. Revenue recognition and contract assets and liabilities

Revenues are recognised when the promised goods or services are delivered to the Group's customers, in an amount that is based on the consideration the Group expects to receive in exchange for those goods or services when such amounts are not probable of significant reversal.

Investment banking

Revenue from investment banking activities consists of revenues earned from underwriting primarily equity and fixed income securities and advisory fees for mergers, acquisitions, restructuring and advisory assignments.

Underwriting revenues are generally recognised on trade date, if there is no uncertainty or contingency related to the amount to be paid. Underwriting costs are deferred and are recognised when the related underwriting revenues are recorded.

Advisory fees are recognised as advice is provided to the client based on the estimated progress of work and when the revenue is not probable of a significant reversal. Advisory expenses are recognised as incurred, including when reimbursed.

Fee and commission income

Fee and commission income results from transaction-based arrangements in which the client is charged a fee for the execution of transactions. Such revenues primarily arise from transactions in equity securities; services related to sales and trading activities; futures, insurance products and options. Fee and commission income is recognised on trade date when the performance obligation is satisfied.

Fee and commission income in the consolidated income statement includes investment management fees, sales commissions, placement fees, advisory fees and syndication fees.

Other items

Receivables from contracts with customers are recognised within 'Trade and other receivables' in the consolidated statement of financial position when the underlying performance obligations have been satisfied and the Group has the right per the contract to bill the customer. Contract assets are recognised when the Group has satisfied its performance obligations, however, customer payment is conditional, and are presented within 'Prepayments and accrued income'. Contract liabilities are recognised when the Group has collected payment from a customer based on the terms of the contract, but the underlying performance obligations are not yet satisfied, and are presented within 'Accruals and deferred income'.

Incremental costs to obtain the contract are expensed as incurred. Revenues are not discounted when payment is expected within one year.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

3. TRANSITION TO IFRS 9 AND IFRS 15

As discussed in note 1, the Group adopted two new standards from 1 January 2018, IFRS 9 and IFRS 15, which have resulted in cumulative adjustments to retained earnings at the date of adoption of \$67 million. Of the total cumulative adjustment, \$63 million was due to the transfer of the balance of the available-for-sale reserve to retained earnings. An analysis is shown in the condensed consolidated statement of changes in equity.

The disclosures below set out the impact of adopting IFRS 9 on the condensed consolidated statement of financial position and retained earnings, including the effect of replacing IAS 39's incurred credit loss models with the ECL framework under IFRS 9.

The following table shows the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities as at 1 January 2018 in accordance with the Group's updated accounting policies on the classification of financial instruments under IFRS 9 as set out in note 2.

1 January 2018	Note	Original classification under IAS 39	New classification under IFRS 9	Original carrying amount under IAS 39 \$millions	New carrying amount under IFRS 9 \$millions
Financial assets					
Cash and short term deposits		Loans and receivables	Financial assets at amortised cost	25,461	25,461
Trading financial assets		FVPL	FVPL (trading)	264,793	264,793
Secured financing	a	Loans and receivables	FVPL (non-trading)	88,567	88,572
Secured financing	a	FVPL (designated)	FVPL (non-trading)	10,778	10,778
Loans and advances	b	Loans and receivables	Financial assets at amortised cost	472	472
Loans and advances	b	Loans and receivables	FVPL (non-trading)	4	2
Investment securities	c	Available for sale	FVPL (non-trading)	161	161
Trade and other receivables	a	FVPL (designated)	FVPL (non-trading)	718	718
Trade and other receivables	a	Loans and receivables	FVPL (non-trading)	9	9
Trade and other receivables		Loans and receivables	Financial assets at amortised cost	70,036	70,036
Total financial assets				460,999	461,002

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

3. TRANSITION TO IFRS 9 AND IFRS 15 (CONTINUED)

1 January 2018	Note	Original classification under IAS 39	New classification under IFRS 9	Original carrying amount under IAS 39 \$millions	New carrying amount under IFRS 9 \$millions
Financial liabilities					
Bank loans and overdrafts		Financial liabilities at amortised cost	Financial liabilities at amortised cost	123	123
Trading financial liabilities		FVPL	FVPL (trading)	217,977	217,977
Secured borrowing	d	Financial liabilities at amortised cost	Financial liabilities at amortised cost	49,207	49,207
Secured borrowing	d	Financial liabilities at amortised cost	FVPL (designated)	20,436	20,434
Secured borrowing	d	FVPL (designated)	FVPL (designated)	17,543	17,543
Trade and other payables		Financial liabilities at amortised cost	Financial liabilities at amortised cost	96,087	96,087
Trade and other payables		FVPL (designated)	FVPL (designated)	898	898
Trade and other payables	b	n/a (unfunded loan commitments)	FVPL (designated)	6	6
Debt and other borrowings		Financial liabilities at amortised cost	Financial liabilities at amortised cost	36,080	36,080
Debt and other borrowings		FVPL (designated)	FVPL (designated)	3,858	3,858
Total financial liabilities				442,215	442,213

The application of these policies resulted in the reclassifications set out in the table above and explained below.

- a. Secured financing transactions and certain other financial assets are reclassified as non-trading at FVPL as they are held within a business model in which they are managed and their performance is evaluated on a fair value basis.
- b. Loans and advances to customers are classified as either:
 - Financial assets at amortised cost where they are in a held to collect business model and their contractual terms are SPPI; or
 - Non-trading at FVPL when they are held within a business model in which they are managed and their performance is evaluated on a fair value basis. Unfunded loan commitments related to these loans are designated at FVPL.
- c. Equity investments are required to be non-trading at FVPL since the Group has not chosen to elect them at FVOCI.
- d. Secured borrowing transactions are classified either as:
 - Designated at FVPL where the financial liability forms part of a group of financial assets or financial liabilities or both, which is managed, evaluated and reported internally on a fair value basis; or
 - Financial liabilities at amortised cost.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2018

3. TRANSITION TO IFRS 9 AND IFRS 15 (CONTINUED)

The following table reconciles the carrying amount under IAS 39 to the carrying amounts under IFRS 9 on transition to IFRS 9 on 1 January 2018 by showing where there has been a presentation reclassification and/or a carrying amount remeasurement.

	IAS 39 carrying amount 31 December 2017 \$millions	Reclass- ification \$ millions	Remeas- urement \$millions	IFRS 9 carrying amount 1 January 2018 \$millions	Retained earnings effect 1 January 2018 \$millions
Financial assets					
Amortised cost					
Cash and short term deposits:					
Secured financing:	25,461	-	-	25,461	-
To FVPL (non-trading)	88,567	(88,567)	-	-	-
Loans and advances:					
To FVPL (non-trading)	476	(4)	-	472	-
Trade and other receivables:					
To FVPL	70,045	(9)	-	70,036	-
Total amortised cost	<u>184,549</u>	<u>(88,580)</u>	<u>-</u>	<u>95,969</u>	<u>-</u>
Available for sale					
Investment securities:					
To FVPL (non-trading)	161	(161)	-	-	-
Financial assets at FVPL (trading)					
FVPL (trading)	<u>264,793</u>	<u>-</u>	<u>-</u>	<u>264,793</u>	<u>-</u>
FVPL (non-trading)					
Secured financing:					
From amortised cost	-	88,567	5	88,572	5
From FVPL designated	-	10,778	-	10,778	-
Closing balance	<u>-</u>	<u>99,345</u>	<u>5</u>	<u>99,350</u>	<u>5</u>
Loans and advances:					
From amortised cost	-	4	(2)	2	(2)
Trade and other receivables:					
From FVTPL (designated)	-	718	-	718	-
From amortised cost	-	9	-	9	-
Closing balance	<u>-</u>	<u>731</u>	<u>(2)</u>	<u>729</u>	<u>(2)</u>
Investment securities:					
From available-for-sale	-	161	-	161	-
Total FVPL (non-trading)	<u>-</u>	<u>100,237</u>	<u>3</u>	<u>100,240</u>	<u>3</u>
FVPL (designated)					
Trade and other receivables:					
To FVTPL (non-trading)	718	(718)	-	-	-
Secured financing:					
To FVTPL (non-trading)	10,778	(10,778)	-	-	-
Total FVPL (designated)	<u>11,496</u>	<u>(11,496)</u>	<u>-</u>	<u>-</u>	<u>-</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

3. TRANSITION TO IFRS 9 AND IFRS 15 (CONTINUED)

	IAS 39 carrying amount 31 December 2017	Reclass- ification	Remeas- urement	IFRS 9 carrying amount 1 January 2018	Retained earnings effect 1 January 2018
	\$ millions	\$ millions	\$ millions	\$ millions	\$ millions
Financial liabilities					
Amortised cost					
Bank loans and overdrafts	123	-	-	123	-
Secured borrowing:					
To FVPL (designated)	69,643	(20,436)	-	49,207	-
Debt and other borrowings:	36,080	-	-	36,080	-
Trade and other payables:	96,087	-	-	96,087	-
Total amortised cost	<u>201,933</u>	<u>(20,436)</u>	<u>-</u>	<u>181,497</u>	<u>-</u>
Financial liabilities at FVPL (trading)					
FVPL (trading)	217,977	-	-	217,977	-
Unfunded loan commitments					
Trade and other payables:					
To FVPL (designated)	6	(6)	-	-	-
FVPL (designated)					
Debt and other borrowings:	3,858	-	-	3,858	-
Trade and other payables:	898	6	-	904	-
Secured financing:	-	-	-	-	-
Opening balance	17,543	-	-	17,543	-
From amortised cost	-	20,436	(2)	20,434	2
Total FVPL (designated)	<u>22,299</u>	<u>20,442</u>	<u>(2)</u>	<u>42,739</u>	<u>2</u>

The table on the following page analyses the impact, net of tax, of transition to IFRS 9 on reserves and retained earnings. The impact relates to the available-for-sale reserve and retained earnings. There is no impact on other components of equity.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2018

3. TRANSITION TO IFRS 9 AND IFRS 15 (CONTINUED)

Impact of adopting IFRS 9	Available-for-sale reserve	Retained Earnings
\$millions		
Closing balance under IAS 39 (31 December 2017)	63	2,904
Reclassification of investment securities (equity) from available-for-sale to FVPL	(63)	63
Remeasurement of secured financing and loans and advances from amortised cost to FVPL and secured borrowing balances from amortised cost to FVPL (designated)	-	5
Recognition of ECL under IFRS 9	-	-
Opening balance under IFRS 9 (1 January 2018)	<u>-</u>	<u>2,972</u>

IFRS 9: Expected credit losses

The closing impairment allowance for financial assets in accordance with IAS 39 and the opening ECL allowance determined in accordance with IFRS 9 as at 1 January 2018 were both \$41 million. The total provisions for loan commitments and financial guarantee contracts in accordance with IAS 37 as at 31 December 2017 and in accordance with IFRS 9 as at 1 January 2018 were both nil. There was no reclassification or remeasurement impact on ECLs as a result of the adoption of IFRS 9.

IFRS 15

At 1 January 2018, the Group adopted IFRS 15, in accordance with the transition provisions therein. The Group has applied the provisions of IFRS 15 retrospectively only to contracts that were not completed as at 1 January 2018, the date of initial application. Prior periods have not been restated. A cumulative loss, net of tax, of \$1 million was recorded as of 1 January 2018, reflecting the deferral in timing of the recognition of Investment Banking revenues. As a result of adopting IFRS 15, the accounting for certain transactions has changed, resulting in certain transactions now being presented on a gross basis within both 'fee and commission income' and 'other expense' of \$53 million.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

4. FEE AND COMMISSION INCOME

	30 June 2018	30 June 2017
	\$millions	\$millions
Trust and other fiduciary activities	85	52
Investment banking ¹	632	646
Commission income	453	415
Other fee and commission income	124	128
Total fee and commission income	1,294	1,241
<i>Of which, revenue from contracts with customers</i>	<i>1,356</i>	<i>1,234</i>

Total fee and commission income is stated after the adjustment for certain arrangements which do not relate to contracts with customers, including revenues totalling \$63 million transferred to other Morgan Stanley Group undertakings, as a result of intra-group policies which ensure that revenues and related costs are matched.

Revenue from contracts with customers

Performance obligations

The following table presents revenues in the current period. The Group had no unsatisfied performance obligations from contracts with customers with original expected durations exceeding 1 year.

	Current contract revenues
	30 June 2018
	\$millions
Investment banking ¹	695
Trust and other fiduciary activities	85
Commission income	453
Other revenue from contracts with customers	123
Total revenue from contracts with customers	1,356

1. Includes advisory and underwriting revenues.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

5. INTEREST INCOME AND INTEREST EXPENSE

'Interest income' represents total interest generated from financial assets whilst 'Interest expense' represents total interest arising on financial liabilities with the exception that:

- when interest is included as a component of the financial instrument's fair value, interest is reflected in 'Net trading income'; and
- interest expense otherwise arising on trading financial liabilities 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 undertaken to cover customers' short positions.

Certain currencies, in which the Group's trades are denominated, may at times have negative interest rates, of which a current example is the Euro. When financial assets and financial liabilities are denominated in such currencies with negative interest rates, this results in negative 'Interest income' and positive 'Interest expense' being recognised.

No gains or losses have been recognised in respect of financial assets measured at amortised cost other than those disclosed as 'Interest income', impairment losses and reversals of impairment losses disclosed in 'Net impairment loss on financial instruments', and foreign exchange differences included within 'Other revenue'.

No gains or losses have been recognised in respect of financial liabilities measured at amortised costs other than those disclosed as 'Interest expense', and foreign exchange differences included within 'Other revenue'.

The table below presents interest income and expense by accounting classification. Interest income and expense is calculated using the effective interest rate method for financial assets and financial liabilities measured at amortised cost.

	30 June 18 \$ millions	30 June 17 \$ millions
Financial assets measured at amortised cost	580	-
Loans and receivables	-	(31)
Financial assets not measured at FVPL	580	(31)
Trading financial assets	44	-
Non-trading financial assets at FVPL ¹	(152)	-
Financial assets measured at FVPL	(108)	-
Total interest income	472	(31)
Financial liabilities measured at amortised cost	1,514	743
Financial liabilities designated at FVPL ¹	(81)	-
Total interest expense	1,433	743

1. Relates to interest on secured financing and borrowing transactions which were classified as loans and receivables and financial liabilities at amortised cost under IAS 39. The equivalent figures for the period to 30 June 2017 are \$(242) million and \$(302) million respectively.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

6. OTHER EXPENSE

	30 June 2018	30 June 2017
	\$millions	\$millions
Direct staff costs	73	71
Management charges from other Morgan Stanley Group undertakings relating to staff costs	963	813
Management charges from other Morgan Stanley Group undertakings relating to other services	554	423
Brokerage fees	352	328
Administration and corporate services	48	122
Professional services	73	103
Other taxes	334	330
Other	71	32
	<u>2,468</u>	<u>2,222</u>

The increase in 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' was primarily driven by an increase in discretionary compensation and strengthening of the British pound against the US dollar.

The increase in 'Management charges from other Morgan Stanley Group undertakings relating to other services', and the decreases in 'Administration and corporate services fees' and 'Professional services' were principally as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing policy during 2017.

The increase in 'Other' expenses occurred as a result of the recognition of expenses previously treated as a reduction of income, following adoption of IFRS 15 (refer to note 3), and due to strengthening of the British Pound against the US dollar, partially offset by a decrease in UK indirect tax expenses.

7. INCOME TAX EXPENSE

The Group's tax expense has been accrued based on the expected annual 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 UK Bank Levy (the "Levy") is an annual charge on a financial institution's balance sheet. It is applied to chargeable liabilities and equity of the Group and other Morgan Stanley UK tax-resident entities and their overseas subsidiaries. Under IFRIC 21, 'Levies' the Levy is not recognised in the Interim Financial Statements since the Levy's obligating event has not yet arisen. However, for the purposes of calculating the effective tax rate in accordance with IAS 34, an adjustment has been made for the forecast Levy (since it is non-deductible for UK corporation tax purposes). As such, the Levy impacts the annual effective tax rate and the tax expense for the six months ended 30 June 2018.

Finance (No.2) Act 2015 enacted reductions in the rate at which the Levy is applied from 0.21% to 0.10% over the period 2016-2021, which, in the absence of any other change would reduce the impact of the Levy on the Group's net income and effective tax rate. The forecast Levy at 30 June 2018 is similar to the 2017 liability and therefore the impact to the effective tax rate is expected to be materially unchanged.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

7. INCOME TAX EXPENSE (CONTINUED)

The Group's forecast tax rate is sensitive to the non-deductibility of certain expenses (including the Levy forecast) for tax purposes, the geographic mix of profits and tax rates in non-UK jurisdictions and the additional 8% UK Banking Surcharge.

During the period the UK statutory rate, excluding the banking surcharge, was 19%. A further reduction to 17% has been enacted and will be effective from 1 April 2020.

The Group's effective tax rate for the six months ended 30 June 2018 is 31.75% (six months ended 30 June 2017: 30.43%), which is higher than the standard rate of corporation tax (inclusive of the UK Banking Surcharge) in the UK of 27%. The main reasons for the higher effective tax rate are the effect of overseas taxes and non-deductible expenses.

8. FINANCIAL ASSETS AND LIABILITIES BY MEASUREMENT CATEGORY

The following table analyses financial assets and financial liabilities as at 30 June 2018 presented in the consolidated statement of financial position by IFRS 9 classifications.

30 June 2018	FVPL (mandatorily) \$millions	FVPL (designated) \$millions	Amortised cost \$millions	Total \$millions
Cash and short term deposits	-	-	32,546	32,546
Trading financial assets	269,200	-	-	269,200
Secured financing:				
Cash collateral on securities borrowed	22,353	-	-	22,353
Securities purchased under agreements to resell	58,671	-	-	58,671
Other secured financing	8,621	-	-	8,621
Loans and advances	29	-	475	504
Investment securities	154	-	-	154
Trade and other receivables	639	-	74,674	75,313
Total financial assets	359,667	-	107,695	467,362
Bank loans and overdrafts	-	-	12	12
Trading financial liabilities	222,276	-	-	222,276
Secured borrowings	-	34,443	49,893	84,336
Trade and other payables	-	446	102,777	103,223
Debt and other borrowings	-	4,927	33,016	37,943
Total financial liabilities	222,276	39,816	185,698	447,790

The table on the next page analyses financial assets and financial liabilities as at 31 December 2017 presented in the consolidated statement of financial position by IAS 39 classifications.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

8. FINANCIAL ASSETS AND LIABILITIES BY MEASUREMENT CATEGORY (CONTINUED)

31 December 2017	FVPL (trading) \$millions	FVPL (designated) \$millions	Available- for-sale \$millions	Loans and receivables \$millions	Financial liabilities at amortised cost \$millions	Total \$millions
Cash and short term deposits	-	-	-	25,461	-	25,461
Trading financial assets	264,793	-	-	-	-	264,793
Secured financing:						
Cash collateral on securities borrowed	-	-	-	17,828	-	17,828
Securities purchased under agreements to resell	-	-	-	70,739	-	70,739
Other secured financing	-	10,778	-	-	-	10,778
Loans and advances	-	-	-	476	-	476
Investment securities	-	-	161	-	-	161
Trade and other receivables	-	718	-	70,045	-	70,763
Total financial assets	264,793	11,496	161	184,549	-	460,999
Bank loans and overdrafts					123	123
Trading financial liabilities	217,977	-	-	-	-	217,977
Secured borrowings	-	17,543	-	-	69,643	87,186
Trade and other payables	-	898	-	-	96,093	96,991
Debt and other borrowings	-	3,858	-	-	36,080	39,938
Total financial liabilities	217,977	22,299	-	-	201,939	442,215

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2018

8. FINANCIAL ASSETS AND LIABILITIES BY MEASUREMENT CATEGORY (CONTINUED)

Financial assets and financial liabilities designated at FVPL

The following table analyses financial assets and financial liabilities designated at FVPL as at 30 June 2018 and 31 December 2017 presented in the consolidated statement of financial position by IFRS 9 classifications.

	30 June 2018		31 December 2017	
	Assets \$millions	Liabilities \$millions	Assets \$millions	Liabilities \$millions
Secured financing				
Other secured financing	-	-	10,778	-
Loans and advances				
Corporate loans	-	-	276	-
Trade and other receivables				
Prepaid OTC contracts	-	-	442	-
Secured borrowing				
Cash collateral on securities loaned	-	532	-	-
Securities sold under agreements to repurchase	-	11,489	-	-
Other financial liabilities	-	22,422	-	17,543
Trade and other payables				
Prepaid OTC contracts	-	436	-	898
Unfunded loan commitments ¹	-	10	-	-
Debt and other borrowings				
Issued structured notes	-	4,927	-	3,858
	<u>-</u>	<u>39,816</u>	<u>11,496</u>	<u>22,299</u>

1. Related to loans which are on balance sheet as non-trading at FVPL.

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Six months ended 30 June 2018

9. TRADING FINANCIAL ASSETS AND LIABILITIES

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

	30 June 2018	30 June 2018	31 December 2017	31 December 2017
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Government debt securities	15,910	18,957	11,956	22,834
Corporate and other debt	11,394	3,946	9,756	2,864
Corporate equities	63,548	26,454	76,073	23,053
Derivatives (see note 10)	178,348	172,919	167,008	169,226
	<u>269,200</u>	<u>222,276</u>	<u>264,793</u>	<u>217,977</u>

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

10. DERIVATIVES

	30 June 2018			
	Bilateral OTC	Cleared OTC	Listed derivative contracts	Total
	\$millions	\$millions	\$millions	\$millions
Derivative assets:				
Interest rate contracts	69,027	1,122	1	70,150
Credit contracts	3,759	71	-	3,830
Foreign exchange and gold contracts	65,505	1,876	-	67,381
Equity contracts	27,608	-	6,802	34,410
Commodity contracts	2,431	-	146	2,577
	<u>168,330</u>	<u>3,069</u>	<u>6,949</u>	<u>178,348</u>
Derivative liabilities:				
Interest rate contracts	64,512	621	-	65,133
Credit contracts	3,542	48	-	3,590
Foreign exchange and gold contracts	62,770	1,819	1	64,590
Equity contracts	30,691	-	6,341	37,032
Commodity contracts	2,488	-	86	2,574
	<u>164,003</u>	<u>2,488</u>	<u>6,428</u>	<u>172,919</u>

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Six months ended 30 June 2018

10. DERIVATIVES (CONTINUED)

	31 December 2017			
	Bilateral OTC \$millions	Cleared OTC \$millions	Listed derivative contracts \$millions	Total \$millions
Derivative assets:				
Interest rate contracts	71,726	1,143	7	72,876
Credit contracts	4,227	94	-	4,321
Foreign exchange and gold contracts	54,731	801	-	55,532
Equity contracts	26,590	-	5,301	31,891
Commodity contracts	2,224	-	164	2,388
	<u>159,498</u>	<u>2,038</u>	<u>5,472</u>	<u>167,008</u>
Derivative liabilities:				
Interest rate contracts	65,223	654	3	65,880
Credit contracts	4,608	53	-	4,661
Foreign exchange and gold contracts	56,287	1,007	-	57,294
Equity contracts	34,063	-	4,953	39,016
Commodity contracts	2,353	-	22	2,375
	<u>162,534</u>	<u>1,714</u>	<u>4,978</u>	<u>169,226</u>

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

11. INTEREST IN STRUCTURED ENTITIES

The Group is involved with various special purpose entities (“SPE”) in the normal course of business. In most cases, these entities are considered to be structured entities.

Information on certain types of structured entities is provided in the consolidated financial statements for the year ended 31 December 2017. The information below is limited to quantitative information and should be read in conjunction with note 15 of the consolidated financial statements for the year ended 31 December 2017.

Consolidated structured entities

As at 30 June 2018 and 31 December 2017, the Group did not consolidate any significant structured entities.

Unconsolidated structured entities

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

The table below shows certain non-consolidated structured entities in which the Group had an interest at 30 June 2018 and 31 December 2017. 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 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.

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
30 June 2018					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	8,935	6,863	540	2,421	18,759
Maximum exposure to loss:					
Debt and equity interests	504	174	420	-	1,098
Derivative and other contracts	-	-	120	2,419	2,539
Total maximum exposure to loss	504	174	540	2,419	3,637
Carrying value of exposure to loss - assets ⁽¹⁾ :					
Debt and equity interests	504	174	419	-	1,097
Derivative and other contracts	-	-	42	65	107
Total carrying value of exposure to loss - assets	504	174	461	65	1,204
Carrying value of exposure to loss - liabilities ⁽¹⁾ :					
Derivatives and other contracts	-	-	78	34	112
Total carrying value of exposure to loss - liabilities	-	-	78	34	112

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

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11. INTEREST 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
31 December 2017					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	6,998	5,365	856	2,302	15,521
Maximum exposure to loss:					
Debt and equity interests	441	142	755	-	1,338
Derivative and other contracts	-	-	101	1,450	1,551
Total maximum exposure to loss	441	142	856	1,450	2,889
Carrying value of exposure to loss - assets ⁽¹⁾ :					
Debt and equity interests	441	142	755	-	1,338
Derivative and other contracts	-	-	40	132	172
Total carrying value of exposure to loss - assets	441	142	795	132	1,510
Carrying value of exposure to loss - liabilities ⁽¹⁾ :					
Derivatives and other contracts	-	-	61	4	65
Total carrying value of exposure to loss - liabilities	-	-	61	4	65

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

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 are generally non-recourse to the Group. Where notional amounts are used 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 use 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.

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11. INTEREST IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

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 which were retained in connection with transfers of assets by the Group totalled \$288 million at 30 June 2018 (31 December 2017: \$392 million). Details of the type of securities retained are shown in the table below.

	30 June 2018 \$millions	31 December 2017 \$millions
<i>Securities backed by:</i>		
Residential mortgage loans	138	222
Commercial mortgage loans	10	26
CDOs or other CLOs	113	106
Other consumer loans	27	38
	<u>288</u>	<u>392</u>

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 Trading financial assets – 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 financially, any unconsolidated structured entity.

Sponsored unconsolidated structured entities

Details of when the Group considers itself the sponsor of certain non-consolidated structured entities are provided in note 15 of the consolidated financial statements for the year ended 31 December 2017.

In some sponsored entities, 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 Group has no interest in these entities as at 30 June 2018 (31 December 2017: \$nil).

The gain related to sponsored entities during the six month period to 30 June 2018 was \$3.8 million (31 December 2017: loss of \$1.5 million). Gains or losses are reported under 'Net trading income' in the condensed consolidated income statement. \$1,157 million of assets were transferred to sponsored structured entities during the six months ended 30 June 2018. (year ended 31 December 2017: \$nil).

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12. DEBT AND OTHER BORROWINGS

	30 June 2018	31 December 2017
	\$'millions	\$'millions
Debt and other borrowings (amortised cost)		
Subordinated debt	5,000	7,000
Other borrowings	28,016	29,080
	<u>33,016</u>	<u>36,080</u>
Debt and other borrowings (designated at FVPL)		
Issued structured notes	4,927	3,858
	<u>37,943</u>	<u>39,938</u>

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

Counterparty	Repayment date	Interest rate	30 June 2018		31 December 2017	
			Accrued Interest	Balance	Accrued Interest	Balance
			\$millions	\$millions	\$millions	\$million
Morgan Stanley Investments (UK)	21-Dec-25	OBFR ⁽¹⁾ plus 2.3%	128	5,000	30	5,000
Morgan Stanley International Finance S.A.	31-Oct-25	LIBOR ⁽²⁾ plus 1.475%	-	-	10	2,000
			<u>128</u>	<u>5,000</u>	<u>40</u>	<u>7,000</u>

(1) Overnight Bank Funding Rate ("OBFR")

(2) London Interbank Offered Rate ("LIBOR")

All amounts outstanding under subordinated loan agreements are repayable at any time at the Group's option, subject to two business days' notice to the lender and at least one month's notice to the PRA.

The Group has not defaulted on principal, interest or breached any terms of its subordinated loans during the year.

On 24 May 2018 the subordinated loan of \$2,000 million from Morgan Stanley International Finance S.A. was repaid.

13. LITIGATION MATTERS

In addition to the matters 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 are in financial distress.

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13. LITIGATION MATTERS (CONTINUED)

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 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's future legal expenses may fluctuate from period to period, 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 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 financial condition 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 will continue to be the subject of elevated claims for damages and other relief and, while the Group has identified below certain proceedings 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.

On 27 June 2018, the Group and another Morgan Stanley Group affiliate in *China Development Industrial Bank ("CDIB") v. Morgan Stanley & Co. Incorporated et al.* filed a motion for summary judgment and spoliation sanctions against CDIB.

On 17 May 2018, the hearing for the parties' final submissions was held in the case styled *Banco Popolare Società Cooperativa v. Morgan Stanley & Co. International plc & others.*

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13. LITIGATION MATTERS (CONTINUED)

On 30 March 2018, the Group filed its defence to the claim brought by the public prosecutor for the Court of Accounts for the Republic of Italy in the matter styled *Case number 2012/00406/MNV*. A hearing was held on 19 April 2018. On 15 June 2018, the Court of Accounts for the Republic of Italy issued a decision declining jurisdiction and dismissing the claim against the Group. On 24 July 2018, the Group was served with an appeal by the public prosecutor.

On 26 April 2018, the District Court in Amsterdam issued a decision in matters styled *Case number 15/3637* and *Case number 15/4353* dismissing the Dutch Tax Authority's claims. On 4 June 2018, the Dutch Tax Authority filed an appeal against the decision issued by the District Court in Amsterdam.

On 8 June 2018, the City Court of Copenhagen, Denmark ordered that the matters styled *Case number BS 99-6998/2017* and *Case number B-2073-16* be heard together before the High Court of Eastern Denmark. On 29 June 2018, the Group filed its defence to the matter styled *Case number B-2073-16*.

14. DIVIDENDS

On 31 May 2018, the Directors approved a coupon payment on the Additional Tier 1 capital instruments of \$118,625,000 (2017: \$118,625,000) out of reserves available for distribution at 31 December 2017. The coupon was paid on 31 May 2018 and has a related tax benefit of \$32,028,750 (2017: \$33,121,579).

The Directors have not proposed the payment of an interim dividend out of reserves available at 30 June 2018 (2017: \$nil).

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15. ADDITIONAL CASH FLOW INFORMATION

	Six months ended 30 June 2018 \$millions	Six months ended 30 June 2017 \$millions
Profit for the period	662	695
Adjustments for:		
Impairment loss on financial assets	5	6
Difference between pension contributions paid and amounts recognised in the consolidated income statement	(1)	-
Interest income	(472)	31
Interest expense	1,433	743
Income tax expense	308	304
Operating cash flows before changes in operating assets and liabilities	<u>1,935</u>	<u>1,779</u>
Change in operating assets		
Decrease in secured financing	9,700	1,359
Increase in loans and advances	(28)	(225)
Decrease in investment securities	7	-
Increase in trade and other receivables	(4,381)	(10,775)
Increase in trading financial assets	(4,406)	(7,050)
Increase in other operating assets	(69)	11
	<u>823</u>	<u>(16,680)</u>
Change in operating liabilities		
Increase in trading financial liabilities	4,299	(19,306)
Decrease in secured borrowing	(2,849)	10,544
Increase in trade and other payables	6,214	671
Increase in debt and other borrowings	98	23,974
Decrease in provisions	(24)	40
Decrease in other operating liabilities	(43)	(114)
	<u>7,695</u>	<u>15,809</u>
Interest received	242	(213)
Interest paid	(1,118)	(261)
Income taxes paid	(204)	(96)
Effect of foreign exchange movements	(713)	770
Net cash flows used in operating activities	<u><u>8,660</u></u>	<u><u>1,108</u></u>

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16. SEGMENT REPORTING

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

Business segments

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

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

Geographical segments

The Group operates in three geographic regions, being Europe, Middle East and Africa ("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 external 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 attribution of 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 2018 \$millions	30 June 2017 \$millions	30 June 2018 \$millions	30 June 2017 \$millions	30 June 2018 \$millions	30 June 2017 \$millions	30 June 2018 \$millions	30 June 2017 \$millions
External revenues net of interest	2,787	2,539	125	214	531	466	3,443	3,219
Profit before income tax	788	745	42	125	140	129	970	999
	30 June 2018 \$millions	31 Dec 2017 \$millions	30 June 2018 \$millions	31 Dec 2017 \$millions	30 June 2018 \$millions	31 Dec 2017 \$millions	30 June 2018 \$millions	31 Dec 2017 \$millions
Total assets	355,447	337,863	55,092	58,299	57,239	65,200	467,778	461,362

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17. FINANCIAL RISK MANAGEMENT

Risk management procedures

The Group's risk management procedures are consistent with those disclosed in the Group's consolidated financial statements for the year ended 31 December 2017. This disclosure is limited to quantitative data for each risk category, other than credit risk which includes qualitative information on the Group's ECL measurement implemented from 1 January 2018 on transition to IFRS 9, and should be read in conjunction with the risk management procedures detailed in the strategic report and note 27 of the consolidated financial statements for the year ended 31 December 2017.

Market risk

Sensitivity analysis

VaR for the six month period ended 30 June 2018

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 2018 and 31 December 2017 as a comparative.

	95% / one-day VaR for the six months ended 30 June 2018				95% / one-day VaR for the year ended 31 December 2017			
	Period end \$millions	Average \$millions	High \$millions	Low \$millions	Period end \$millions	Average \$millions	High \$millions	Low \$millions
<i>Market Risk Category:</i>								
Interest rate and credit spread	15	16	21	12	15	15	22	10
Equity price	10	11	18	8	9	12	18	8
Foreign exchange rate	3	3	8	2	2	5	9	2
Commodity price	1	1	2	1	1	1	2	-
Less: Diversification benefit ⁽¹⁾⁽²⁾	(11)	(12)	N/A	N/A	(7)	(12)	N/A	N/A
Primary Risk Categories	18	19	27	15	20	21	29	15
Credit Portfolio ⁽³⁾	4	4	6	3	5	6	8	4
Less: Diversification benefit ⁽¹⁾⁽²⁾	(3)	(3)	N/A	N/A	(3)	(4)	N/A	N/A
Total Management VaR	19	20	30	16	22	23	31	16

(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.

(3) 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 Group's average VaR for Primary Risk Categories for the six month period to 30 June 2018 was \$19 million, compared with \$21 million for the year to 31 December 2017. The decrease in average Management VaR for Primary Market Risk Categories is spread across underlying risk factors, primarily equity price and foreign exchange risk.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Sensitivity analysis (continued)

The average Credit Portfolio VaR for the six month period to 30 June 2018 was \$4 million compared with \$6 million for the year to 31 December 2017. This reduction was mainly due to parameter updates in Corporate Credit VaR models.

The average total Management VaR for the six months ended 30 June 2018 was \$20 million compared with \$23 million for the year to 31 December 2017.

Non-trading risks for the six month period ended 30 June 2018

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, with the exception of counterparty credit valuation adjustments, which are covered in the previous section.

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application to these positions of a parallel increase or decrease in interest rates of 200 basis points would result in a net gain or loss, respectively, of approximately \$47.6 million as at 30 June 2018, compared to a net gain or loss of \$20.8 million as at 31 December 2017.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately \$3.6 million and \$1.8 million for each 1 basis point widening in the Group's credit spread level for 30 June 2018 and 31 December 2017, respectively.

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 listed and private equities classified as investment securities. 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.

	30 June 2018 \$millions	31 December 2017 \$millions
Investment securities	<u>15</u>	<u>16</u>

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

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 2018			31 December 2017		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure Smillions	Percentage change applied %	Other comprehensive income Smillions	Foreign currency exposure Smillions	Percentage change applied %	Other comprehensive income Smillions
Euro	668	14%	94	648	14%	91
Taiwan New Dollar	81	8%	6	82	8%	7
Polish Zloty	5	17%	1	5	17%	1
South Korean Won	230	11%	25	234	11%	26
Swedish Krona	12	21%	3	13	21%	3
Swiss Franc	20	12%	2	17	12%	2
	<u>1,016</u>		<u>131</u>	<u>999</u>		<u>130</u>

Credit Risk

Credit Risk management

Refer to pages 8 to 10 of the interim management report and to pages 19 to 23 of the strategic report in the consolidated financial statements for the year ended 31 December 2017.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 30 June 2018 is disclosed on the following page, based on the carrying amounts of the financial assets and the maximum amount that the Group could have to pay in relation to unrecognised financial instruments, which the Group believes are subject to credit risk. Within the table financial instruments subject to accounting ECLs are distinguished from those that are not. Those financial instruments that bear credit risk but are not subject to ECLs are subsequently measured at fair value.

Trading financial assets 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.

Collateral and other credit enhancements

The Group employs a range of policies and practices to mitigate credit risk, the most common being acceptance of collateral for funds advanced. The main types of collateral held are cash or similar highly-liquid assets. The Group has internal policies on the acceptability of specific classes of collateral or credit risk mitigation. There has been no change in the collateral policy of the Group during the period.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Collateral and other credit enhancements

The Group closely monitors collateral held for financial assets considered to be credit-impaired, as in such cases it is considered more likely that the Group will take possession of collateral to mitigate potential credit losses.

Exposure to credit risk by product

Class	30 June 2018		
	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure ⁽²⁾ \$millions
Subject to ECL:			
Cash and short term deposits	32,546	-	32,546
Loans and advances	475	-	475
Trade and other receivables ⁽³⁾	74,674	-	74,674
Not subject to ECL⁽⁴⁾:			
Trading financial assets			
Derivatives	178,348	(170,098)	8,250
Secured financing	89,645	(87,145)	2,500
Loans and advances	29	-	29
Trade and other receivables ⁽³⁾	639	(481)	158
	<u>376,356</u>	<u>(257,724)</u>	<u>118,632</u>
Unrecognised financial instruments			
Subject to ECL:			
Loan commitments	1,542	-	1,542
Guarantees	1	-	1
Central counterparty clearing ("CCP")-related secured financing	922	-	922
Not subject to ECL⁽⁴⁾:			
Loan commitments ⁽⁵⁾	723	(30)	693
Guarantees	1	-	1
Unsettled securities purchased under agreements to resell ⁽⁶⁾	49,220	-	49,220
Total unrecognised financial instruments	<u>52,409</u>	<u>(30)</u>	<u>52,379</u>
	<u>428,765</u>	<u>(257,754)</u>	<u>171,011</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 \$3,412 million to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade and other receivables primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within trading financial liabilities in the condensed consolidated statement of financial position.

(4) Financial assets measured at FVPL are not subject to ECL.

(5) Loan commitments measured at FVPL are not subject to ECL.

(6) 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.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Collateral and other credit enhancements (continued)

Maximum exposure to credit risk for 2017 is presented as follows, reflecting the balance sheet categories used in 2017.

	31 December 2017		
	Gross credit exposure ⁽¹⁾	Credit enhancements	Net credit exposure ⁽²⁾
	\$millions	\$millions	\$millions
Cash and short-term deposits	25,461	-	25,461
Trading financial assets:			
Derivatives	167,008	(159,176)	7,832
Secured financing	99,345	(95,075)	4,270
Loans and advances	476	-	476
Trade and other receivables ⁽³⁾	69,835	(520)	69,315
	362,125	(254,771)	107,354
Unrecognised financial instruments			
Loan commitments	2,190	(105)	2,085
Unsettled securities purchased under agreements to resell ⁽⁴⁾	28,480	-	28,480
Guarantees	2	-	2
Total unrecognised financial instruments	30,672	(105)	30,567
	392,797	(254,876)	137,921

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

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$5,364 million of an available \$29,930 million to be offset in the ordinary course of business and/or in the event of default.

(3) Trade receivables primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within trading financial liabilities in the consolidated statement of financial position.

(4) For unsettled securities purchased under agreements 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 disclosed in note 18.

Expected credit loss ("ECL") measurement

a. Assessment of significant increase in credit risk ("SICR")

As explained in note 2c, to assess whether an instrument is subject to a 12 month ECL or to a lifetime ECL, and therefore its appropriate staging, the Group determines whether there has been a SICR for the instrument since initial recognition.

When making this assessment, the Group considers both quantitative and qualitative information and analysis based on the Group's historical experience and expert credit risk assessment, including forward-looking information.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Expected credit loss ("ECL") measurement (continued)

The PD is derived from internal credit rating grades (based on available information about the borrower) and multiple forward-looking macroeconomic scenarios which are probability weighted. Credit risk is considered to have increased significantly if the PD has significantly increased at the reporting date relative to the PD of the facility, at the date of initial recognition. The assessment of whether a change in PD is "significant" is based both on a consideration of the relative change in PD and on qualitative indicators of the credit risk of the facility, which indicate whether a loan is performing or in difficulty. In addition, as a backstop, the Group considers that SICR has occurred in all cases when an asset is more than 30 days past due.

b. Calculation of ECLs

ECLs are calculated using three main components:

- PD: for accounting purposes, the 12 month and lifetime PD represent the expected point-in-time probability of a default over the next 12 months and over the remaining lifetime of the financial instrument respectively, based on conditions existing at the balance sheet date and future economic conditions.
- LGD: the LGD represents expected loss conditional on default, taking into account the mitigating effect of collateral, including the expected value of the collateral when realised and the time value of money.
- EAD: this represents the expected EAD, taking into account the expected repayment of principal and interest from the balance sheet date to the default event together with any expected drawdowns of the facility over that period.

These parameters are generally derived from internally developed statistical models, incorporating historical, current and forward-looking macro-economic data.

The 12 month ECL is equal to the sum over the next 12 months of quarterly PD multiplied by LGD and EAD, with such expected losses being discounted at the effective interest rate. Lifetime ECL is calculated using the discounted present value of total quarterly PDs multiplied by LGD and EAD, over the full remaining life of the facility.

c. Incorporation of forward looking information

The Group uses internal macro-economic research and country risk expert judgement to support the calculation of ECL. The macro-economic scenarios are reviewed quarterly.

There have been no changes made to estimation techniques or significant assumptions for estimating impairment, during the period.

Exposure to credit risk by internal rating grades

Internal credit ratings are derived using methodologies generally consistent with those used by external agencies.

a. Recognised and unrecognised financial instruments subject to ECL

The following table provides an analysis of the credit risk exposure by ECL stage per class of recognised and unrecognised financial instrument subject to ECL, based on the following internal credit rating grades:

Investment grade: internal grades AAA - BBB

Non-investment grade: internal grades BB - CCC

Default: internal grades D

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Exposure to credit risk by internal rating grades (continued)

a. Recognised and unrecognised financial instruments subject to ECL (continued)

	ECL staging			Total
	Stage 1	Stage 2	Stage 3	
	12-month	Lifetime	Lifetime	
	ECL	ECL	ECL	
30 June 2018	\$millions	\$millions	\$millions	\$millions
Cash:				
Credit grade				
Investment grade	31,948	-	-	31,948
Non-investment grade	319	-	-	319
Unrated	279	-	-	279
Carrying amount	32,546	-	-	32,546
Loans and Advances:				
Credit grade				
Investment grade	160	-	-	160
Non-investment grade	12	-	-	12
Unrated	303	-	-	303
Carrying amount	475	-	-	475
Trade and other receivables⁽¹⁾:				
Credit grade				
Investment grade	316	61,717	20	62,053
Non-investment grade	-	8,674	9	8,683
Default	-	-	10	10
Unrated	62	3,832	73	3,967
Gross carrying amount	378	74,223	112	74,713
Loss allowance	-	9	30	39
Carrying amount	378	74,214	82	74,674

(1) The \$378 million in stage 1 relates entirely to other assets. There are no trade receivables at stage 1, as the Group's accounting policy is to measure lifetime credit losses on trade receivables under the simplified approach. Refer to Note 2(c) for further detail on the accounting policy.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Exposure to credit risk by internal rating grades (continued)

a. Recognised and unrecognised financial instruments subject to ECL (continued)

	ECL staging			Total \$millions
	Stage 1	Stage 2	Stage 3	
	12- month	Lifetime	Lifetime	
	ECL	ECL	ECL	
	\$millions	\$millions	\$millions	\$millions
Loan commitments⁽²⁾				
Credit grade				
Investment grade	1,398	-	-	1,398
Non-investment grade	116	29	-	145
Total amount committed	1,514	29	-	1,543

(2) Loan commitments include guarantees

CCP-related secured financing

Credit grade

Investment grade	922	-	-	922
Total amount financing receivables	922	-	-	922

b. Financial assets measured at FVPL

Maximum exposure to credit risk by credit rating⁽¹⁾

Credit rating	Gross credit exposure	
	30 June 2018	
	\$millions	
AAA	8,899	
AA	40,390	
A	147,279	
BBB	54,990	
BB	11,624	
B	4,584	
CCC	669	
Unrated	226	
Total	268,661	

(1) The above table excludes \$90,852 million of trading corporate debt and equities as well as \$154 million of investment securities. For debt instruments, credit risk is managed through the market risk management infrastructure and incorporated into VaR.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Exposure to credit risk by internal rating grades (continued)

c. Unrecognised financial instruments measured at fair value

Maximum exposure to credit risk by credit rating

Credit rating	Gross credit exposure
	30 June 2018
	\$millions
AAA	860
AA	29,629
A	7,105
BBB	9,507
BB	2,695
B	124
CCC	-
Unrated	24
Total	<u>49,944</u>

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk

Maturity analysis

30 June 2018	On demand \$millions	Less than 1 month \$millions	Equal to or more than 1 month but less than 3 months \$millions	Equal to or more than 3 months but less than 1 year \$millions	Equal to or more than 1 year but less than 5 years \$millions	Equal to or more than 5 years \$millions	Total \$millions
Financial liabilities							
Bank loans and overdrafts	12	-	-	-	-	-	12
Trading financial liabilities:							
Derivatives	172,919	-	-	-	-	-	172,919
Other	49,357	-	-	-	-	-	49,357
Secured borrowing	57,000	9,413	7,513	5,219	5,241	-	84,386
Trade and other payables	102,668	14	12	233	29	296	103,252
Debt and other borrowings	1,831	79	193	851	25,634	13,053	41,641
Total financial liabilities	383,787	9,506	7,718	6,303	30,904	13,349	451,567
Unrecognised financial instruments							
Guarantees	564	-	-	-	2	-	566
Letters of credit	-	-	-	-	1	-	1
Loan commitments	2,265	-	-	-	-	-	2,265
CCP-related secured financing	922	-	-	-	-	-	922
Unsettled securities purchased under agreements to resell ⁽¹⁾	48,832	388	-	-	-	-	49,220
Total unrecognised financial instruments	52,583	388	-	-	3	-	52,974

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 30 June 2018 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 30 June 2018, \$48,832 million settled within three business days.

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17. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding 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
31 December 2017	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities							
Bank loans and overdrafts	123	-	-	-	-	-	123
Trading financial liabilities:							
Derivatives	169,226	-	-	-	-	-	169,226
Other	48,752	-	-	-	-	-	48,752
Secured borrowing	54,191	15,145	4,603	7,088	6,205	-	87,232
Trade and other payables	96,043	298	9	221	75	373	97,019
Debt and other borrowings	1,875	34	75	618	26,864	14,144	43,610
Total financial liabilities	370,210	15,477	4,687	7,927	33,144	14,517	445,962
Unrecognised financial instruments							
Guarantees	575	-	-	-	2	-	577
Letters of credit	-	-	-	-	1	-	1
Loan commitments	2,190	-	-	-	-	-	2,190
Underwriting commitments	-	-	-	336	-	-	336
Unsettled securities purchased under agreements to resell ⁽¹⁾	28,246	234	-	-	-	-	28,480
Total unrecognised financial instruments	31,011	234	-	336	3	-	31,584

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2017 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2017, \$28,246 million settled within three business days.

18. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING

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 assets 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 a master netting arrangements, collateral agreements and other credit enhancements, on the Group's exposure to credit risk is disclosed in note 17. The information below is limited to quantitative information and should be read in conjunction with note 30 of the consolidated financial statements for the year ended 31 December 2017.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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18. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING
(CONTINUED)

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ^{(2),(3)}	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(4),(5),(6),(7)}		Net exposure ⁽⁸⁾
	\$millions	\$millions	\$millions	Financial instruments \$millions	Cash collateral \$millions	\$millions
30 June 2018						
Assets						
Secured financing:						
Cash collateral on securities borrowed	31,080	(8,727)	22,353	(21,530)	-	823
Securities purchased under agreement to resell	153,648	(94,977)	58,671	(56,994)	-	1,677
Trading financial assets:						
Derivatives	230,011	(51,663)	178,348	(146,449)	(23,604)	8,295
TOTAL	414,739	(155,367)	259,372	(224,973)	(23,604)	10,795
Liabilities						
Secured borrowing:						
Cash collateral on securities loaned	31,817	(8,727)	23,090	(22,560)	-	530
Securities sold under agreement to repurchase	133,803	(94,977)	38,826	(36,255)	-	2,571
Trading financial liabilities:						
Derivatives	224,010	(51,091)	172,919	(142,629)	(19,403)	10,887
TOTAL	389,630	(154,795)	234,835	(201,444)	(19,403)	13,988

(1) Amounts include \$364 million of cash collateral on securities borrowed, \$1,620 million of securities purchased under agreements to resell, \$2,823 million of trading financial assets - derivatives, \$529 million of cash collateral on securities loaned, \$1,912 million of securities sold under agreements to repurchase and \$3,145 million of trading financial liabilities- 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 the 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 \$4,262 million and \$3,691 million of cash collateral related to trading financial assets – derivatives and trading financial liabilities – derivatives, respectively, recognised in amounts offset in the condensed consolidated statement of financial position.

(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 not offset is recognised in the condensed consolidated statement of financial position within secured financing and secured borrowing respectively.

(6) In addition to the balances disclosed in the table above, certain secured financing and secured borrowing have legally enforceable master netting arrangements in place. As a result \$3,004 million of netting is included within the condensed consolidated statement of financial position.

(7) In addition to the balances disclosed in the table above, \$7 million not presented net of certain trade and other receivables and trade and other payables have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.

(8) Intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$3,412 million of the total condensed consolidated statement of financial position, to be offset in the ordinary course of business and/ or in the event of default. The additional amounts for offset would include a portion of the residual net exposure.

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**18. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING
(CONTINUED)**

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ^{(2),(3)}	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(4),(5),(6)}		Net exposure ⁽⁷⁾
				Financial instruments	Cash collateral	
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
31 December 2017						
Assets						
Secured financing:						
Cash collateral on securities borrowed	28,639	(10,811)	17,828	(17,410)	-	418
Securities purchased under agreement to resell	140,530	(69,791)	70,739	(66,887)	-	3,852
Trading financial assets:						
Derivatives	216,599	(49,591)	167,008	(136,287)	(22,844)	7,877
TOTAL	385,768	(130,193)	255,575	(220,584)	(22,844)	12,147
Liabilities						
Secured borrowing:						
Cash collateral on securities loaned	28,299	(10,812)	17,487	(17,208)	-	279
Securities sold under agreement to repurchase	121,947	(69,792)	52,155	(48,380)	-	3,775
Trading financial liabilities:						
Derivatives	215,199	(45,973)	169,226	(133,480)	(24,038)	11,708
TOTAL	365,445	(126,577)	238,868	(199,068)	(24,038)	15,762

(1) Amounts include \$134 million of cash collateral on securities borrowed, \$3,581 million of securities purchased under agreements to resell, \$2,103 million of trading financial assets - derivatives, \$271 million of cash collateral on securities loaned, \$3,362 million of securities sold under agreements to repurchase and \$2,465 million of trading financial liabilities- 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 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 \$6,418 million and \$2,800 million of cash collateral related to trading financial assets- derivatives recognised in amounts offset in the 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 consolidated statement of financial position.

(5) The cash collateral not offset is recognised in the 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. As a result, \$1,760 million of netting is included within the consolidated statement of financial position. \$32 million not presented net within the 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) Intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$5,364 million of the total consolidated statement of financial position, to be offset in the ordinary course of business and/ or in the event of default. The additional amounts for offset would include a portion of the residual net exposure.

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19. 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. With the exception of financial instruments moving to FVPL or FVOCI on transition to IFRS 9 (refer to note 2), the information below is limited to quantitative information and should be read in conjunction with note 27 of the consolidated financial statements for the year ended 31 December 2017.

30 June 2018

	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
Trading financial assets:				
Government debt securities	12,157	3,750	3	15,910
Corporate and other debt	-	11,014	380	11,394
Corporate equities	63,134	300	114	63,548
Derivatives:				
Interest rate contracts	-	68,971	1,179	70,150
Credit contracts	-	3,723	107	3,830
Foreign exchange and gold contracts	-	67,355	26	67,381
Equity contracts	267	32,176	1,968	34,410
Commodity contracts	123	2,438	15	2,577
Total trading financial assets	75,681	189,727	3,792	269,200
Secured financing				
Cash collateral on securities borrowed	-	22,353	-	22,353
Securities purchased under agreements to resell	-	58,671	-	58,671
Other secured financing	-	8,621	-	8,621
Total secured financing	-	89,645	-	89,645
Loans and advances:				
Corporate loans	-	12	17	29
Total loans and advances	-	12	17	29
Investment securities:				
Corporate equities	22	-	132	154
Total investment securities	22	-	132	154
Trade and other receivables:				
Prepaid OTC contracts	-	315	105	420
Margin loans	-	172	47	219
Total trade and other receivables	-	487	152	639
Total financial assets measured at fair value	75,703	279,871	4,093	359,667
Trading financial liabilities:				
Government debt securities	16,451	2,506	-	18,957
Corporate and other debt	-	3,946	-	3,946
Corporate equities	26,401	32	21	26,454
Derivatives:				
Interest rate contracts	7	64,482	644	65,133
Credit contracts	-	3,433	157	3,590
Foreign exchange and gold contracts	1	64,533	56	64,590
Equity contracts	336	34,149	2,547	37,032
Commodity contracts	62	2,487	25	2,574
Total trading financial liabilities	43,258	175,568	3,450	222,276
Secured borrowing:				
Cash collateral on securities loaned	-	532	-	532
Securities sold under agreements to repurchase	-	11,489	-	11,489
Other secured borrowing	-	22,422	-	22,422
Total secured borrowing	-	34,443	-	34,443
Trade and other payables:				
Prepaid OTC contracts	-	198	238	436
Unfunded loan commitments	-	10	-	10
Total trade and other payables	-	208	238	446
Debt and other borrowings:				
Issued structured notes	-	4,540	387	4,927
Total debt and other borrowings	-	4,540	387	4,927
Total financial liabilities measured at fair value	43,258	214,759	4,075	262,092

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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19. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 2017

	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
Trading financial assets:				
Government debt securities	8,150	3,805	1	11,956
Corporate and other debt	-	9,355	401	9,756
Corporate equities	75,722	274	77	76,073
Derivatives:				
Interest rate contracts	6	71,701	1,169	72,876
Credit contracts	-	4,155	166	4,321
Foreign exchange and gold contracts	-	55,469	63	55,532
Equity contracts	297	29,726	1,868	31,891
Commodity contracts	104	2,273	11	2,388
Total trading financial assets	84,279	176,758	3,756	264,793
Secured financing	-	10,778	-	10,778
Investment securities:				
Corporate equities	26	42	93	161
Trade and other receivables:				
Prepaid OTC contracts	-	336	106	442
Margin loans	-	47	229	276
Total trade and other receivables	-	383	335	718
Total financial assets measured at fair value	84,305	187,961	4,184	276,450
Trading financial liabilities:				
Government debt securities	21,231	1,603	-	22,834
Corporate and other debt	-	2,864	-	2,864
Corporate equities	22,966	72	15	23,053
Derivatives:				
Interest rate contracts	4	65,218	658	65,880
Credit contracts	-	4,474	187	4,661
Foreign exchange and gold contracts	-	57,210	84	57,294
Equity contracts	384	36,196	2,436	39,016
Commodity contracts	13	2,355	7	2,375
Total trading financial liabilities	44,598	169,992	3,387	217,977
Secured borrowing:	-	17,543	-	17,543
Trade and other payables:				
Prepaid OTC contracts	-	729	169	898
Debt and other borrowings:				
Issued structured notes	-	3,497	361	3,858
Total financial liabilities measured at fair value	44,598	191,761	3,917	240,276

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

19. 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 financial instruments is described in note 27 of the consolidated financial statements for the year ended 31 December 2017. As a result of the adoption of IFRS 9, certain additional financial instruments are measured at fair value; refer to transition note 3 for additional detail. The Group's valuation approach and fair value hierarchy categorisation for the financial instruments now measured at FVPL as a result of the transition to IFRS 9 is as follows;

Asset and Liability / Valuation Technique	Valuation Hierarchy Classification
<i>Securities purchased under agreements to resell, Securities sold under agreements to repurchase, Cash collateral on securities borrowed/securities loaned and other secured financing</i>	
<ul style="list-style-type: none"> Fair value is computed using a standard cash flow discounting methodology. <p>The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks, interest rate yield curves and option volatilities.</p>	<ul style="list-style-type: none"> Generally Level 2 Level 3 – in instances where the unobservable inputs are deemed significant

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 2018. During 2017, the Group reclassified approximately \$1,200 million of European government debt securities assets and \$968 million of European government debt securities liabilities from Level 2 to Level 1 due to increased market activity in these instruments.

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 2018 and for the year ended 31 December 2017. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. The realised and unrealised gains/ (losses) for assets and liabilities within the Level 3 category presented in the following tables do not reflect the related realised and unrealised gains or losses on hedging instruments that have been classified by the Group within the Level 1 and / or Level 2 categories.

Unrealised gains/ (losses) during the period for assets and liabilities within the Level 3 category presented in the following tables may include changes in fair value during the period that were attributable to both observable and unobservable 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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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2018

19. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

c. Changes in Level 3 assets and liabilities measured at fair value on a recurring basis (continued)
30 June 2018

	Balance at 1 January 2018	Impact of adopting IFRS 9	Total gains or (losses) recognised in condensed consolidated income statement ⁽¹⁾	Total gains or (losses) recognised in condensed consolidated other comprehensive income ⁽¹⁾	Purchases	Sales and issuances ⁽²⁾	Settlements	Net transfers in and / or out of Level 3 ⁽³⁾	Balance at 30 June 2018	Unrealised gains or (losses) for level 3 assets/liabilities outstanding as at 30 June 2018 ⁽⁴⁾
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Trading financial assets:										
Government debt securities	1	-	-	-	3	(1)	-	-	3	-
Corporate and other debt	401	(17)	(17)	-	150	(133)	-	(4)	380	1
Corporate equities	77	-	(6)	-	30	(26)	-	39	114	(5)
Total trading financial assets	479	(17)	(23)	-	183	(160)	-	35	497	(4)
Loans and advances:										
Corporate loans	-	17	-	-	-	-	-	-	17	-
Investment securities:										
Corporate equities	93	-	3	-	-	(2)	-	38	132	3
Trade and other receivables:										
Prepaid OTC contracts	106	-	-	-	3	(4)	-	-	105	-
Margin loans	229	-	(3)	-	-	(1)	-	(178)	47	(3)
Total trade and other receivables	335	-	(3)	-	3	(5)	-	(178)	152	(3)
Total financial assets measured at fair value	907	-	(23)	-	186	(167)	-	(105)	798	(4)
Trading financial liabilities:										
Corporate equities	15	-	6	-	(3)	14	-	1	21	1
Net derivative contracts ⁽⁵⁾	95	-	120	-	(1,258)	1,764	(243)	(104)	134	162
Total trading financial liabilities	110	-	126	-	(1,261)	1,778	(243)	(103)	155	163
Trade and other payables:										
Prepaid OTC contracts	169	-	-	-	-	78	(9)	-	238	-
Debt and other borrowings:										
Issued structured notes	361	-	6	(17)	-	35	(31)	45	387	20
Total financial liabilities measured at fair value	640	-	132	(17)	(1,261)	1,891	(283)	(58)	780	183

(1) The total gains or (losses) are recognised in the condensed consolidated income statement and the condensed consolidated statement of comprehensive income for the six months ended 30 June 2018, as detailed in the Financial instruments accounting policy (note 3(c)) in the Group's consolidated financial statements for the year ended 31 December 2017.

(2) Amounts related to entering into Net derivative contracts, issued structured notes and prepaid OTC contracts (within trade and other payables) represent issuances. Amounts for other line items represent sales.

(3) 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.

(4) 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 for the six months ended 30 June 2018, as detailed in the financial instruments accounting policy (note 3(c)) in the Group's consolidated financial statements for the year ended 31 December 2017.

(5) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Six months ended 30 June 2018

19. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 2017

	Balance at 1 January 2017	Total gains or (losses) recognised in consolidated income statement ⁽¹⁾	Total gains or (losses) recognised in consolidated comprehensive income ⁽¹⁾	Purchases	Sales and issuances ⁽²⁾	Settlements	Net transfers in and / or (out) of Level 3 ⁽³⁾	Balance at 31 December 2017	Unrealised gains or (losses) for level 3 assets/liabilities outstanding as at 31 December 2017 ⁽⁴⁾
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Trading financial assets:									
Government debt securities	4	-	-	-	(3)	-	-	1	-
Corporate and other debt	218	14	-	329	(146)	-	(14)	401	-
Corporate equities	61	(6)	-	45	(53)	-	30	77	(5)
Total trading financial assets	283	8	-	374	(202)	-	16	479	(5)
Secured financing:	15	-	-	-	(15)	-	-	-	-
Investment securities:									
Corporate equities	29	-	40	40	-	-	(16)	93	40
Trade and other receivables:									
Prepaid OTC contracts	11	4	-	94	-	-	(3)	106	4
Margin loans	152	26	-	-	(60)	-	111	229	25
Total trade and other receivables	163	30	-	94	(60)	-	108	335	29
Total financial assets measured at fair value	490	38	40	508	(277)	-	108	907	64
Trading financial liabilities:									
Corporate and other debt	5	-	-	(5)	-	-	-	-	-
Corporate equities	28	1	-	(8)	4	-	(8)	15	-
Net derivative contracts ⁽⁵⁾	804	(162)	-	(705)	928	(1,171)	77	95	(100)
Total trading financial liabilities	837	(161)	-	(718)	932	(1,171)	69	110	(100)
Secured borrowing:	15	-	-	-	-	(15)	-	-	-
Trade and other payables:									
Prepaid OTC contracts	11	5	-	-	154	(2)	11	169	5
Debt and other borrowings:									
Issued structured notes	242	(16)	(12)	-	181	(42)	(48)	361	(16)
Total financial liabilities measured at fair value	1,105	(172)	(12)	(718)	1,267	(1,230)	32	640	(111)

(1) The total gains or (losses) are recognised in the consolidated income statement and the consolidated statement of comprehensive income, as detailed in the financial instruments accounting policy (note 3(c)) in the financial statements for the year ended 31 December 2017.

(2) Amounts related to entering into Net derivative contracts and Financial liabilities designated at fair value through profit or loss represent issuances. Amounts for other line items represent sales.

(3) 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.

(4) 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 consolidated income statement or consolidated statement of comprehensive income, as detailed in the financial instruments accounting policy in the Group's annual financial statements for the year ended 31 December 2017.

(5) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

There were no material transfers from Level 2 to Level 3 or Level 3 to Level 2 of the fair value hierarchy during the period (2017: \$nil).

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

19. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

The following disclosures 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 following table provides information on the valuation techniques, significant unobservable inputs and their ranges and averages for each material category of assets and liabilities measured at fair value on a recurring basis.

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 group's in the financial services industry because of diversity in the types of products included in each group's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs. There are no predictable relationships between multiple significant unobservable inputs attributable to a given valuation technique. A single amount is disclosed when there is no significant difference between the minimum, maximum and average (weighted average or similar average / median).

30 June 2018	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽¹⁾ (Weighted averages or simple averages/median) ⁽²⁾
ASSETS			
Trading financial assets:			
- Corporate and other debt:			
- Mortgage- and asset-backed securities	99	Comparable pricing	
		Comparable bond price	1 to 102 pts (56 pts)
- Corporate bonds	223	Comparable pricing	
		Comparable bond price	69 to 112 pts (95 pts)
- Loans and lending commitments	58	Comparable pricing	
		Comparable loan price	26 to 100 pts (69 pts)
- Corporate equities	114	Comparable pricing	
		Comparable equity price	100% (100%)
Investment securities:			
- Corporate equities	132	Comparable pricing	
		Comparable equity price	96% to 100% (97%)
Trade and other receivables:			
- Prepaid OTC contracts	105	Discounted cash flow	
		Recovery rate	18% (18%)
- Margin loans	47	Option Model	
		Volatility skew	-1%(-1%)

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19. 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 2018	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽¹⁾ (Weighted averages or simple averages/median) ⁽³⁾
LIABILITIES			
Trading financial liabilities:			
- Net derivatives contracts: ^{(1),(4),(5)}			
- Interest rate	535	Option model	
		Inflation volatility	25.5% to 65.5% (45.8%/42.5%)
		Interest rate-foreign exchange correlation	52.7% to 56.6% (55.4%/55.1%)
		Interest rate curve correlation	41.6% to 88.5% (70%/71%)
		Inflation curve	1.60% to 1.63% (1.61%/1.61%)
		Interest rate volatility skew	29.4% to 92.7% (33.3%/41.4%)
		Interest rate – inflation correlation	-49% to -33% (-37.2%/-33%)
- Credit	(50)	Comparable pricing	
		Credit spread	457bps (457bps)
		Comparable bond price	1 to 139 pts (43 pts)
		Funding spread	105 to 161 bps (149 bps)
		Correlation model	
		Credit correlation	43% to 60% (49.45%)
- Foreign exchange and gold	(31)	Option model	
		Interest rate-foreign exchange correlation	52.7% to 56.6% (55.4%/55.1%)
		Interest rate volatility skew	29.4% to 92.7% (33.3%/41.4%)
		Foreign exchange volatility skew	-52.8% to -9.3% (-21.7%/-16.0%)
		Interest rate curve correlation	24.6% to 94.5% (78.7%/83.5%)
- Equity	(578)	Option model	
		At the money volatility	5% to 56% (22%)
		Volatility skew	-3% to 0% (-1%)
		Equity-equity correlation	5% to 98% (81%)
		Equity-foreign exchange correlation	-95% to 55% (-57%)
- Commodity	(10)	Comparable pricing	
		Comparable price	\$603 to \$1,530 (\$1,120)
Debt and other borrowings:			
- Issued structured notes	(387)	Option model	
		At the money volatility	5% to 28% (25%)
		Volatility skew	-1% to 0% (0%)
		Equity-equity correlation	46% to 98% (80%)
		Equity-foreign exchange correlation	-55% to 13% (-21%)
Trade and other payables:			
- Prepaid OTC contracts	(238)	Option model	
		At the money volatility	4% to 30% (13%)

(1) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

(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 equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided when more relevant.

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

(5) 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 2018

19. 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 2017	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽²⁾ (Weighted averages or simple averages/median) ⁽³⁾
ASSETS			
Trading financial assets:			
- Corporate and other debt:			
- Mortgage and asset-backed securities	151	Comparable pricing	
		Comparable bond price	0 to 100 pts (35 pts)
- Corporate bonds	213	Comparable pricing	
		Comparable bond price	65 to 134 pts (70 pts)
- Loans and lending commitments	36	Comparable pricing	
		Comparable loan price	78.5 to 100 pts (92.59 pts)
- Corporate equities	77	Comparable pricing	
		Comparable equity price	100% (100%)
Trade and other receivables:			
- Margin loans	229	Option model	
		Volatility skew	-1% (-1%)
- Prepaid OTC contracts	106	Discounted cash flow	
		Recovery rate	15% (15%)
Investment securities:			
- Corporate equities	93	Comparable pricing	
		Comparable equity price	100% (100%)

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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19. 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 if significant unobservable inputs (continued)

31 December 2017			Range ⁽¹⁾
	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	(Weighted averages or simple averages/median) ⁽⁴⁾
LIABILITIES			
Trading financial liabilities:			
- Net derivatives contracts: ⁽¹⁾⁽⁴⁾⁽⁵⁾			
- Interest rate	511	Option model	
		Inflation volatility	23% to 63% (44%/41%)
		Interest rate-foreign exchange correlation	54% to 57% (56%/56%)
		Interest rate curve correlation	55% to 90% (75%/76%)
		Inflation curve	2% to 2% (2%/2%)
		Interest rate volatility skew	31% to 99% (42%/45%)
- Credit	(21)	Comparable pricing	
		Funding spreads	93bps to 96bps (96bps)
		Comparable bond price	1 to 140 pts (40 pts)
		Credit spreads	150bp (150 bp)
- Foreign exchange and gold	(21)	Option model	
		Interest rate-foreign exchange correlation	54% to 57% (56%/56%)
		Interest rate volatility skew	31% to 99% (42%/45%)
		Deal execution probability	95% to 100% (96%/95%)
- Equity	(568)	Option model	
		At the money volatility	5% to 53% (32%)
		Volatility skew	-2% to 0% (-1%)
		Equity-equity correlation	25% to 99% (73%)
		Equity-foreign exchange Correlation	-60% to 40% (26%)
- Commodity	4	Comparable pricing	
		Comparable price	\$557 to \$1,552 (\$1,233)
Debt and other borrowings:			
- Issued structured notes	(361)	Option model	
		At the money volatility	5% to 35% (25%)
		Volatility skew	-1% to 0% (0%)
		Equity-equity correlation	46% to 86% (68%)
		Equity-foreign exchange correlation	-60% to 10% (4%)
- Prepaid OTC contracts	(169)	Discounted cash flow	
		Recovery rate	15% (15%)

(1) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

(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 equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided when more relevant.

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

(5) 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 2018

19. 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 if significant unobservable inputs (continued)

A description of the significant unobservable inputs and qualitative sensitivity included in the table above for all major categories of assets and liabilities is included within note 31 of the consolidated financial statements for the year ended 31 December 2017.

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

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. The information below is limited to quantitative information and should be read in conjunction with note 31 of the Group's consolidated financial statements for the year ended 31 December 2017.

30 June 2018

	Effect of reasonably possible alternative assumptions		
	Fair value \$millions	Increase in fair value \$millions	Decrease in fair value \$millions
Trading financial assets:			
Corporate and other debt	380	10	(15)
Corporate equities	114	8	(23)
Trade and other receivables:			
Prepaid OTC contracts	105	141	(61)
Margin loans	47	-	-
Investment securities:			
Corporate equities	132	41	(59)
Trading financial liabilities:			
Net derivatives contracts ⁽¹⁾⁽²⁾	134	46	(43)
Trade and other payables:			
Prepaid OTC contracts	238	141	(61)
Debt and other borrowings:			
Issued structured notes	387	4	(2)

(1) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – 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 2018

19. 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)

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

31 December 2017

	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Trading financial assets:			
Corporate and other debt	401	15	(19)
Corporate equities	77	5	(15)
Trade and other receivables:			
Prepaid OTC contracts	106	135	(58)
Margin loans	229	-	-
Investment securities:			
Corporate equities	93	32	(45)
Trading financial liabilities:			
Net derivatives contracts ⁽¹⁾⁽²⁾	95	9	(5)
Trade and other payables:			
Prepaid OTC contracts	169	135	(58)
Debt and other borrowings:			
Issued structured notes	361	2	(1)

(1) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – 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 2018

19. 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 2018 \$millions	31 December 2017 \$millions
At 1 January	330	245
New transactions	40	211
Amounts recognised in the condensed consolidated income statement during the period/year	(101)	(126)
At 30 June 2018 / 31 December 2017	269	330

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.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2018

20. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE

The table below presents 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.

	Carrying value \$millions	Fair value \$millions	Fair value measurement using:		
			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
30 June 2018					
Financial liabilities					
Subordinated loans	5,000	5,281	-	5,281	-
Subordinated loans at 31 December 2017	7,000	7,310	-	7,310	-

Also included in the condensed consolidated statement of financial position is \$30,277 million of other payables where the carrying value is a reasonable approximation of fair 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.

21. 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 arm's length pricing.

The Group receives and incurs management charges to and from other Morgan Stanley Group undertakings for infrastructure services, including the provision of staff and office facilities. For the six month period ended 30 June 2018 'management charges from other Morgan Stanley Group undertakings relating to staff costs' were \$963 million (30 June 2017: \$813 million) and 'management charges from other Morgan Stanley Group undertakings relating to other services' were \$554 million (30 June 2017: \$423 million). See note 6 for further details.

22. EVENTS AFTER THE REPORTING PERIOD

On 23 August 2018, the Company issued Additional Tier 1 capital instruments (the "Instruments") with a value of \$2,200 million to Morgan Stanley International Limited, a UK incorporated indirect parent of the Company. The Instruments include a trigger mechanism whereby if the Common Equity Tier 1 capital ratio of the Company falls below a pre-determined level, the Company will write down the outstanding principal amount of the Instruments, together with any accrued interest coupon. In this situation, Morgan Stanley International Limited would have no further rights against the Company in respect of the Instruments. The Instruments have no defined maturity, are callable at the Company's discretion from 30th November 2023 and are subordinated to senior creditors and subordinated loan creditors of the Company. The Instruments are not entitled to any participation in the residual net assets of the Company. Coupons on the Instruments are non-cumulative and payable at a fixed rate of 7.5% per annum. Payment of the coupon is wholly at the discretion of the Company.