To Our Shareholders

Philip J. Purcell, Chairman & Chief Executive Officer (right);
John J. Mack, President & Chief Operating Officer

In the lives of most companies, there are very few events that can be described as truly momentous—even in an annual report, where hyperbole rarely is spared. For Morgan Stanley, Dean Witter, Discover & Co., there were two such events in 1997.

The first was our merger, which brought together two highly profitable, successful companies, creating a powerful new company—one with enormous financial strength, global scope, and an unmatched breadth of market leadership across a number of businesses. The combination

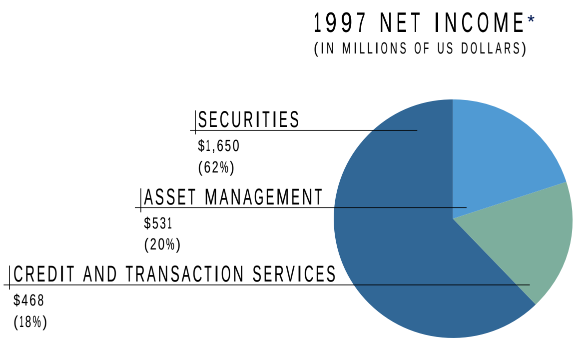
WE ACCOMPLISHED OUR TRANSITION TO ONE COMPANY IN REMARKABLY SHORT ORDER AND WITH A RATHER SIZABLE INCREASE IN REVENUES AND EARNINGS

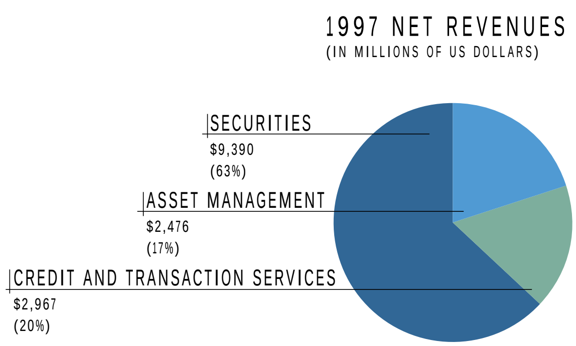
was widely heralded as raising the bar and dramatically affecting the competitive contours in the financial services marketplace. Our merger has been followed by many others as the wave of consolidation has continued, and it is clear at the beginning of 1998 that, by anticipating the trend, each of our companies gained a quality partner.

The second event—perhaps more an achievement than an event—was making the business decisions that would put the merger in place. This certainly was more difficult than the initial agreement and the formal consummation of the merger because when companies combine, there inevitably is the need to integrate certain functions, change old ways of doing things, and work together. We accomplished our transition to one company in remarkably short order, with very few distractions, and a rather sizable increase in revenues and earnings. In serving our customers

(DOLLARS IN MILLIONS, EXCEPT PER SHARE DATA)	FISCAL YEAR 1997	FISCAL YEAR 1996
NET REVENUES		
Securities	$ 9,390	$ 7,898
Asset Management	2,476	1,336
Credit and Transaction Services	2,967	2,789
Total	$ 14,833	$ 12,023
NET INCOME*		
Securities	$ 1,650	$ 1,269
Asset Management	531	277
Credit and Transaction Services	468	434
Total	$ 2,649	$ 1,980
Earnings per common share:		
Primary	$ 4.25	$ 3.22
Fully diluted	$ 4.15	$ 3.14
Total assets	$302,287	$238,860
Shareholders' equity	$ 13,956	$ 11,702
Return on average common shareholders' equity	22%	20%

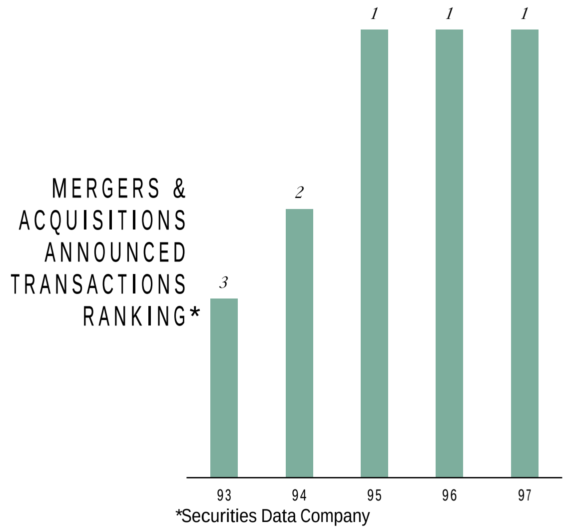
See accompanying financial statements and footnotes beginning on page 66.
*Excludes merger-related expenses aggregating $63 million net of tax in fiscal year 1997.





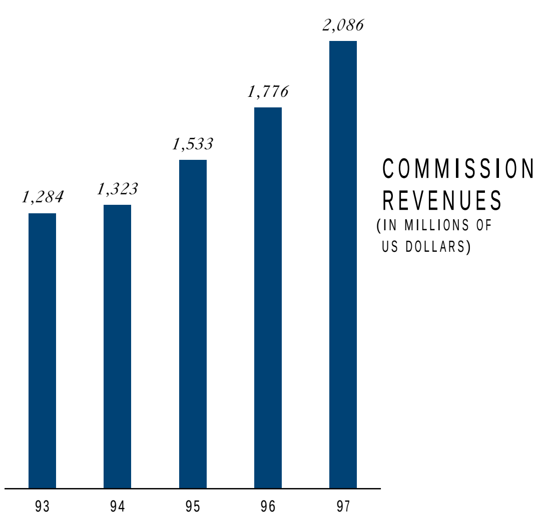
FISCAL YEAR[1] (DOLLARS IN MILLIONS, EXCEPT SHARE DATA)	1997	1996	1995	1994	1993
INCOME STATEMENT DATA:					
Revenues					
Investment banking	$ 2,694	$ 2,190	$ 1,556	$ 1,102	$ 1,642
Principal transactions:					
Trading	3,191	2,659	1,685	1,614	1,778
Investments	463	86	121	154	157
Commissions	2,086	1,776	1,533	1,323	1,284
Fees:					
Asset management, distribution and administration	2,505	1,732	1,377	1,317	1,074
Merchant and cardmember	1,704	1,505	1,135	940	771
Servicing	762	809	680	565	506
Interest and dividends	13,583	11,288	10,530	8,715	7,336
Other	144	126	115	127	104
Total revenues	27,132	22,171	18,732	15,857	14,652
Interest expense	10,806	8,934	8,190	6,697	5,620
Provision for consumer loan losses	1,493	1,214	722	530	433
Net revenues	14,833	12,023	9,820	8,630	8,599
Non-interest expenses					
Compensation and benefits	6,019	5,071	4,005	3,535	3,687
Other	4,466	3,835	3,464	3,133	2,737
Merger-related expenses	74	—	—	—	—
Relocation charge	—	—	59	—	—
Total non-interest expenses	10,559	8,906	7,528	6,668	6,424
Income before income taxes	4,274	3,117	2,292	1,962	2,175
Provision for income taxes	1,688	1,137	827	705	803
Net income	$ 2,586	$ 1,980	$ 1,465	$ 1,257	$ 1,372
Earnings applicable to common shares[2]	$ 2,520	$ 1,914	$ 1,400	$ 1,192	$ 1,317
PER SHARE DATA:[3]					
Earnings per common share					
Primary	$ 4.25	$ 3.22	$ 2.30	$ 1.96	$ 2.24
Fully diluted	4.15	3.14	2.25	1.93	2.20
Book value per common share	22.11	18.43	15.63	13.38	11.43
Dividends per common share	0.56	0.44	0.32	0.25	0.15
BALANCE SHEET AND OTHER OPERATING DATA:					
Total assets	$302,287	$238,860	$181,961	$159,477	$161,519
Consumer loans	20,033	21,262	19,733	14,731	11,091
Total capital[4]	33,577	31,152	24,644	20,933	15,112
Long-term borrowings[4]	19,621	19,450	14,636	12,352	7,702
Shareholders' equity	13,956	11,702	10,008	8,581	7,410
Return on average common shareholders' equity	22.0%	20.0%	16.4%	15.8%	21.7%
Average common and equivalent shares[2][3]	594,182,885	594,478,535	608,246,433	606,721,462	586,639,815

[1] Fiscal 1993 through fiscal 1996 represents the combination of Morgan Stanley's financial statements for the fiscal years ended November 30 with Dean Witter Discover's financial statements for the years ended December 31.
[2] Amounts shown are used to calculate primary earnings per common share.
[3] Per share data have been restated to reflect the Company's two-for-one stock split.
[4] Excludes the current portion of long-term borrowings and includes Capital Units.



OVER 400 OFFICES IN
28 COUNTRIES

3.5 MILLION
INDIVIDUAL
INVESTOR ACCOUNTS
AND $302 BILLION
IN INDIVIDUAL
CLIENT ASSETS



SECURITIES

Our securities business is built on two powerful franchises—Morgan Stanley and Dean Witter—the first primarily serving corporations, governments, and institutions and the second primarily focusing on individual investors.

The Morgan Stanley franchise is based on a long tradition of financial strength and quality that is carried out today by 10,000 investment bankers, sales and trading professionals, product specialists, research analysts, and support staff who serve both the providers and users of capital in markets around the world.

In 1997, we further strengthened our position of market leadership. We were once again ranked #1 in worldwide completed and announced M&A transactions. In underwriting, we again were in the top three in equity and equity-related issues, we rose to #2 in high-yield debt, and we maintained our strong position in US investment grade debt. We were selected as lead-manager or advisor for many of the year's most prominent transactions in all corners of the globe, including the proposed $23 billion merger of Union Bank of Switzerland and Swiss Bank Corporation, Unibanco's $1.2 billion global share offering—the largest ever by a Brazilian company, the $18 billion merger of Guinness and Grand Met in the UK, and Raytheon's $3 billion debt offering, a much sought-after mandate awarded to Morgan Stanley Dean Witter after competition among 19 firms.

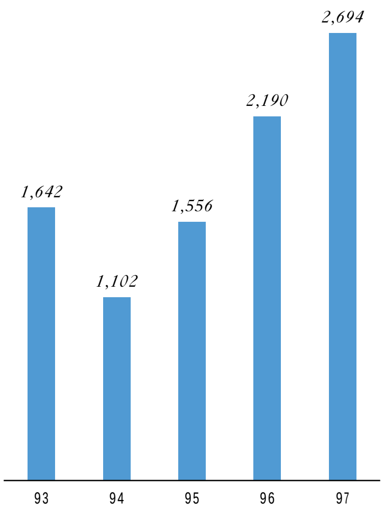
WE FURTHER STRENGTHENED OUR MARKET LEADERSHIP IN INVESTMENT BANKING

Our institutional equity sales and trading presence continued to grow its market share around the world. The quality of our equity franchise was recognized with awards in many categories of service, including "Equity House of the Year" and "Equity Derivatives House of the Year" by *International Financing Review*.

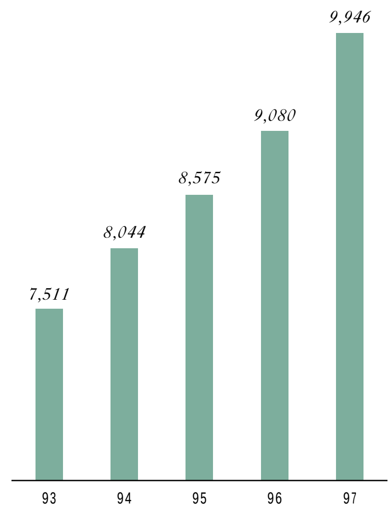
Morgan Stanley's prominence in investment banking is matched by the breadth, leadership, and skill of our sales and trading activities in global markets. Morgan Stanley Dean Witter is the firm of choice for many issuers because of the market knowledge we gain from our trading activities and our constant daily contact with investors and counterparties. Our corporate

SECURITIES

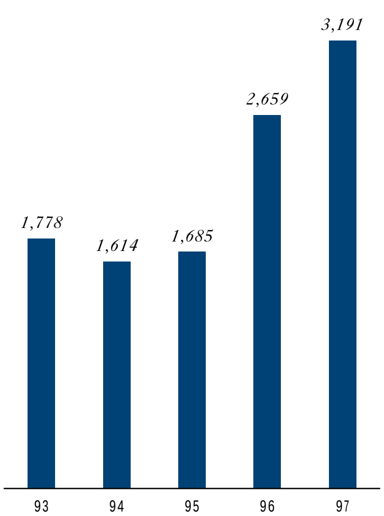
INVESTMENT BANKING REVENUES
(IN MILLIONS OF US DOLLARS)



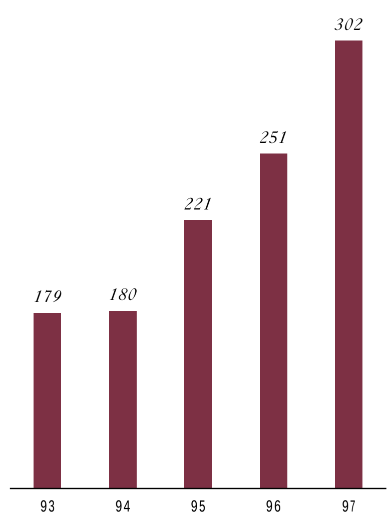
DEAN WITTER ACCOUNT EXECUTIVES



PRINCIPAL TRADING REVENUES
(IN MILLIONS OF US DOLLARS)



DEAN WITTER CLIENT ASSETS
(IN BILLIONS OF US DOLLARS)



finance professionals work closely with professionals on our trading floors—and now with the Dean Witter sales organization—to structure transactions designed to meet the goals of both issuers and investors.

One of our greatest strengths in serving both investors and issuers is our global equity research team, which includes 15 economists, 12 strategists, and 181 analysts covering more than 2,000 companies worldwide. The Morgan Stanley Dean Witter merger significantly enhanced our research capabilities and in 1997, we were ranked #1 in first team positions on the *Institutional Investor* All-America Research Team and #2 in total positions.

THE GLOBAL EQUITY RESEARCH GROUP WAS NAMED NUMBER ONE IN GLOBAL RESEARCH IN *INSTITUTIONAL INVESTOR*'S FIRST-EVER SURVEY ON GLOBAL RESEARCH

Our broad expertise and ability to execute transactions in today's global markets have placed us at the center of several large-scale economic trends. In 1997, we were the leading M&A advisor in the financial services sector as consolidation in this industry accelerated. As global competition in telecommunications intensified, we provided advisory services and arranged financing for a number of telecommunications companies in the US, Europe, and Asia. We also have been at the forefront of the global consolidation and the convergence activity in the energy and utilities industries. We continue to be the leader in research, financing, and advisory services for technology companies as this sector undergoes further rapid change. We also are leaders in helping to meet the infrastructure needs in developing countries and in this past year led four major infrastructure financings in China. As the US health-care system moved further toward "corporatization," we provided M&A advisory services, high-yield financing, senior debt, and securitization of assets for the formation of Multicare, a long-term health-care company.

Innovation continues to be one of our hallmarks. This past year we extended securitization to new markets and asset classes with Autolink's £231 million securitization of toll roads in

SALES AND TRADING

INVESTMENT BANKING

INDIVIDUAL INVESTOR BROKERAGE

SECURITIES RESEARCH AND ANALYSIS

Scotland, the Sino Commercial Properties Funding $300 million financing backed by commercial property in Hong Kong, Canary Wharf's £550 million securitization of commercial property leases, and the ground-breaking $3.6 billion rate reduction bonds for Pacific Gas and Electric and San Diego Gas and Electric. The firm applied its expertise as a world leader in the market for Collateralized Bond/Loan Obligations (CBOs/CLOs) and completed a $1.3 billion CLO transaction managed by Van Kampen American Capital, one of our mutual fund companies. We also expanded the global reach of the non-investment grade market by lead-managing four European currency high-yield offerings: a DM 175 million issue for Exide Holding Europe, a DM 140 million issue for Central European Media Enterprises, a FFr 500 million issue for Financière Néopost, and a dual-tranche offering for COLT Telecom plc (£50 million and DM 150 million).

Our second major franchise in the securities business is Dean Witter—led by our 9,946 professional account executives in 399 branches nationwide who provide financial advice to individual investors. Over the last five years, the number of Dean Witter account executives has grown by a greater amount than any of our major full-service competitors in the US. In

SINCE THE COMPLETION OF THE MERGER, NEW ISSUE SALES BY DEAN WITTER ACCOUNT EXECUTIVES HAVE INCREASED DRAMATICALLY

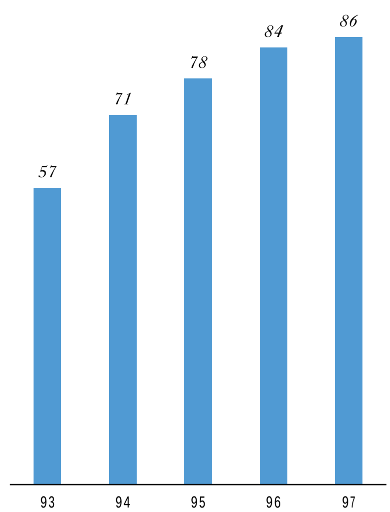
1997, we added 853 new account executives—giving us the highest number in our history. We also gained 700,000 new account relationships—another record, which brought the total number of accounts to 3.5 million. And we increased individual client assets entrusted to account executives by $51 billion to stand at $302 billion at the end of the fiscal year.

The strategic importance of our full-service individual investor securities business is underlined by the growth in recent years of the individual investor market, fueled in large part by the rapid increase in mutual fund assets. Sixty-four percent of financial assets in the US now are controlled by individual investors compared with 47% 10 years ago, and individual stocks and equity funds now have replaced real estate and bank deposits as the largest component of net worth for American households. As the financial services industry continues to consolidate, as product categories proliferate and become blurred, and as the sheer volume of financial information continues to expand, the financial advice of our account executives nationwide will play an increasingly important role in serving individual investors and will provide us with a key competitive advantage.

The strength of the Dean Witter franchise among individual investors already has had a very significant positive impact on our underwriting business, particularly on our ability to win mandates for preferred stock offerings, REITs, and large block trades. The successful distribution of $575 million of SunAmerica stock showed that our account executives can play a role in block transactions, which are becoming increasingly important for many corporate issuers. Our account executives also played a key role in the $2.5 billion secondary issue of First Union common shares, the largest secondary offering in history. More than 20,000 individual clients invested approximately $500 million in this issue through Dean Witter account executives.

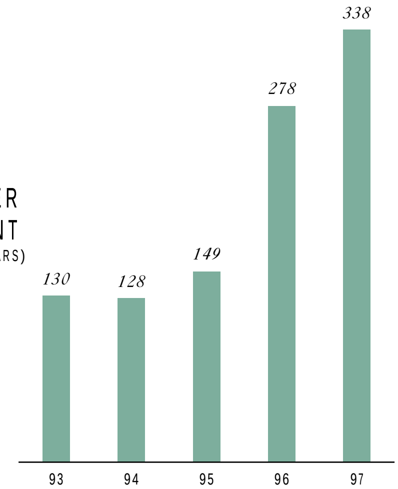
As 1997 drew to a close, our individual investor clients benefited from the expanded opportunities created by the merger, and corporate issuers benefited from the new company's expanded distribution strengths. In the financial services marketplace, two powerful franchises had become one: Morgan Stanley Dean Witter. We believe there is no better name in financial services than Morgan Stanley Dean Witter and no company with a more powerful combination of strengths to meet the needs and goals of our clients and customers around the world.

NUMBER OF TOP-RATED ANALYSTS WORLDWIDE*



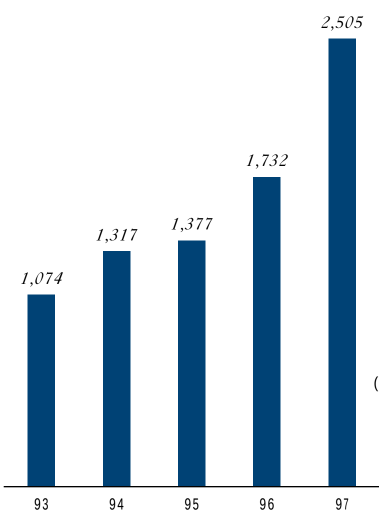
* *INSTITUTIONAL INVESTOR* 1997 RANKED ANALYSTS

TOTAL ASSETS UNDER MANAGEMENT
(IN BILLIONS OF US DOLLARS)



NET INCOME OF $531 MILLION

$338 BILLION ASSETS UNDER MANAGEMENT



TOTAL ASSET MANAGEMENT DISTRIBUTION AND ADMINISTRATION REVENUES
(IN MILLIONS OF US DOLLARS)

ASSET MANAGEMENT

Morgan Stanley Dean Witter managed $338 billion for institutional and individual investors at year-end 1997 to rank # 2 worldwide among domestic full-service securities firms. This business generated $531 million in net income in 1997, and we believe it is destined for significant growth in the next 5-10 years driven by increasing global demand for asset management products and services.

We have benefited from the remarkable growth of the US mutual fund business in recent years, with assets going from $789 billion in 1987 to $4.4 trillion today. We believe that the demand for asset management services will continue in the US and should accelerate dramatically in Europe, Asia, and Latin America as a result of four secular trends:

- An aging population in the developed world and a growing middle class in the developing world;
- Increased privatization of pension plans to meet shortfalls in government-sponsored plans;
- Increased control by individuals over retirement assets; and
- The movement away from savings and fixed income products to equities in order to meet long-term financial goals such as providing for retirement.

ASSET MANAGEMENT NET INCOME FOR THE YEAR WAS A RECORD $531 MILLION—92% AHEAD OF 1996

Morgan Stanley Dean Witter is in a strong position to take advantage of these trends. Our competitive advantages include: a broad base of both institutional and individual clients; a comprehensive product menu that can be tailored to meet particular client goals; a global presence; and the ability to differentiate ourselves in a crowded, but consolidating, marketplace.

In meeting the growing demand for asset management services, we have three well-established distribution channels: direct relationships with corporations, governments, universities, and other institutions through Morgan Stanley and Miller Anderson & Sherrerd products and services;

INSTITUTIONAL INVESTMENT MANAGEMENT

MORGAN STANLEY ASSET MANAGEMENT

Morgan Stanley Asset Management (MSAM) is a global provider of outstanding performing products and services for sophisticated institutional clients across traditional and alternative asset classes. MSAM operates with over 50 investment products spanning the risk/return spectrum that are managed in locations around the world. MSAM also manages a large family of domestic, international equity, and multi-class funds for institutional, high net worth, and retail investors.

MILLER ANDERSON & SHERRERD, LLP

Miller Anderson & Sherrerd (MAS) provides a variety of financial products and mutual funds with first class, long-term investment results and service to institutional clients. Blending strategic thinking with disciplined investment analysis, MAS has compiled an outstanding long-term performance record across a broad range of asset classes and investment styles. MAS' strength in fixed income and domestic equities complements the firm's long-standing strengths in global products.

INDIVIDUAL ASSET MANAGEMENT

VAN KAMPEN AMERICAN CAPITAL

Van Kampen American Capital (VKAC) is a top-tier retail non-proprietary mutual fund provider that has client relationships in several retail distribution channels for its broad range of domestic and international products. VKAC has over 60 open-end funds, 37 closed-end funds, and 2,500 series of tax exempt and equity unit investment trusts. Approximately 46% of VKAC's $51 billion in retail fund assets are in equity, and 54% are in fixed income. Its products are sold primarily through brokerage firms, banks, and financial planners.

DEAN WITTER INTERCAPITAL

Dean Witter InterCapital is adviser and administrator to the company's family of proprietary mutual funds for individual investors. InterCapital develops, markets, and manages a broad spectrum of funds, which are sold through Dean Witter account executives. There currently are 143 InterCapital funds and portfolios with more than $102 billion in assets and more than 2 million investors. Approximately 45% of the assets are in a variety of equity funds, which have been the fastest growing segment in recent years. InterCapital has provided Dean Witter clients with solid performance and exceptional customer service over the years.

direct relationships with more than 2 million individual investors who are Dean Witter clients; and relationships with millions of individual investors who purchase Van Kampen American Capital products through other brokerage firms, banks, and financial planners.

OUR ASSET MANAGEMENT BUSINESSES PROVIDE A WIDE RANGE OF PRODUCTS AND SERVICES FOR BOTH INSTITUTIONAL AND INDIVIDUAL CLIENTS

Morgan Stanley is recognized globally as a leader in institutional investment management. Our reputation has been built on a record of performance and a standard of professional service that is widely recognized. We had an outstanding year in 1997 in institutional fund performance. Our comprehensive set of products includes domestic and international equities, global fixed income, multi-asset class products, and alternative asset class products such as private equity, venture capital, real estate, and commodities funds. All are backed by strong research and sophisticated risk analysis. The mix of products for a particular client is determined by disciplined attention to the client's investment goals.

As a result of this approach, our institutional assets under management grew by $35 billion in 1997—with $12 billion coming from asset appreciation and a record $23 billion coming from net new business. Institutional assets managed by the Company have grown to $145 billion. In addition, our private investment products under the asset management umbrella enable clients to implement a diversified asset allocation strategy. We continue to grow this business, including adding a $300 million emerging markets private investment fund to our stable of private investment funds. Morgan Stanley now has raised over $8 billion of commitments for 12 funds that invest in controlling equity, buyout transactions, venture capital, real estate, and special situations. The funds in these fast-growing asset classes have historically delivered solid performance, providing the Company and its investors with superior long-term returns and a more diversified portfolio.

VAN KAMPEN AMERICAN CAPITAL

MORGAN STANLEY ASSET MANAGEMENT

MILLER ANDERSON & SHERRERD

DEAN WITTER INTERCAPITAL

Morgan Stanley Dean Witter's second key distribution channel is our full-service relationships with individual investors through Dean Witter's 9,946 professional account executives. Dean Witter was one of the first Wall Street firms to focus on asset management products for individual investors. Dean Witter InterCapital Inc. has grown from approximately $700 million in assets under management in 1978 to over $102 billion today. The focus on asset management has historically helped make Dean Witter's earnings less volatile than most other securities firms and continues to provide a stream of continuing revenues. This business now includes rapidly growing product areas such as variable annuities, wrap accounts, unit investment trusts, and asset-related lending products—all offered through Dean Witter account executives.

To fully leverage our company's reputation and capabilities in asset management, we will start in 1998 to market all of our proprietary funds for individuals under the Morgan Stanley Dean Witter brand. We also will adapt a number of the Morgan Stanley institutional funds for the

ONE OF THE COMPANY'S TOP PRIORITIES IS GLOBAL GROWTH OF OUR ASSET MANAGEMENT BUSINESS

individual investor market and offer them through Dean Witter account executives. A precursor of the potential synergies of this combination was a Morgan Stanley-advised fund, distributed through Dean Witter in October, which attracted $496 million in investments in the first month.

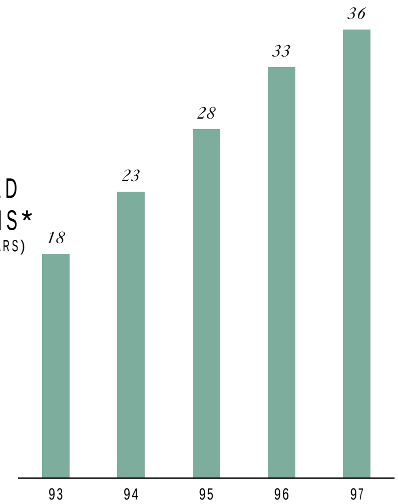
Our third major distribution channel is to offer Van Kampen American Capital asset management products to individuals through intermediaries such as other brokerage firms, banks, and financial planners. In addition to important distribution relationships, Van Kampen American Capital gives us a third strong brand, one with a reputation for quality service. It has won the

INVESTORS TRUST OUR ASSET MANAGEMENT SKILLS TO PROVIDE THEM WITH HIGH-QUALITY PRODUCTS AND SERVICES TO MAKE SOUND INVESTMENT DECISIONS

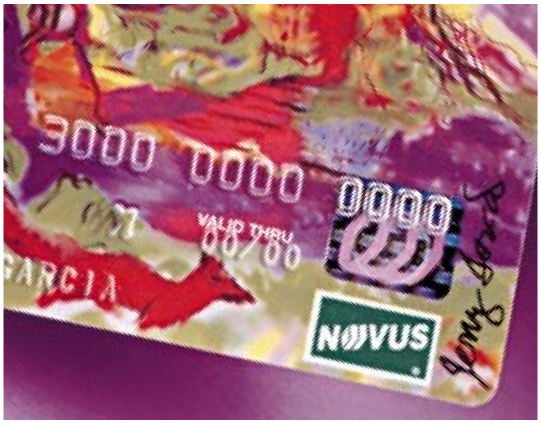
DALBAR Quality Tested Seal of Approval for the last eight years. In addition to mutual funds, Van Kampen American Capital offers unit investment trusts to individual investors through its multiple distribution relationships.

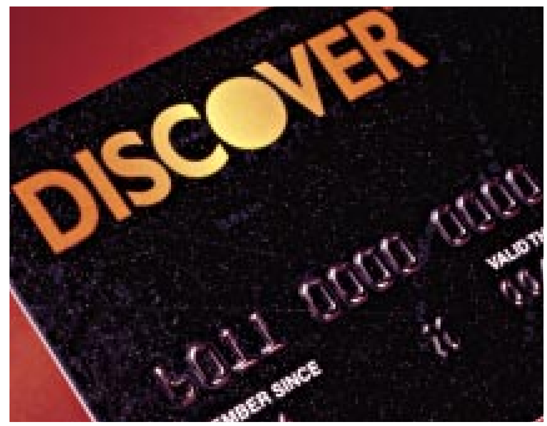
There clearly are complementary strengths in the Morgan Stanley Dean Witter asset management business that should lead to future growth. One obvious opportunity is in the still nascent markets outside the US, where we should be able to leverage the firm's global presence along with our considerable asset management expertise. About 90% of our asset management revenues come from US customers, but we already have a sizable presence in Japan—where we went from $3 billion to $5 billion in assets under management in 1997. We are committed to meeting the global need for asset management services and thereby hope to capture a large share of the growing global market.

MANAGED
CONSUMER LOANS*
(IN BILLIONS OF US DOLLARS)

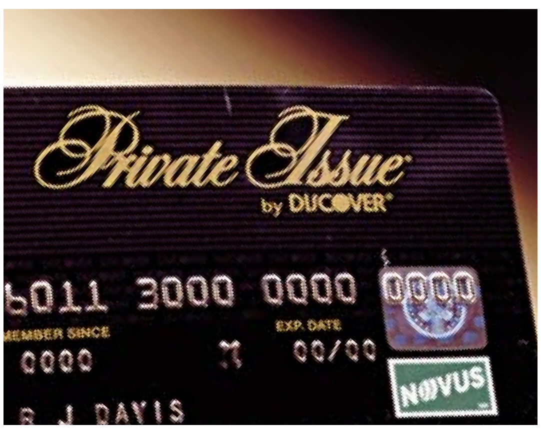


*As of November 30

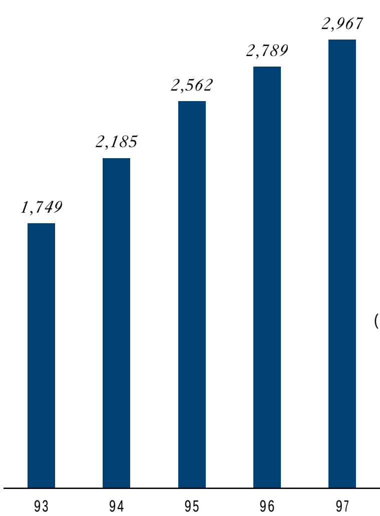




NUMBER ONE IN
CONSUMER SATISFACTION



40 MILLION GENERAL
PURPOSE CREDIT
CARD ACCOUNTS



CREDIT AND
TRANSACTION
SERVICES NET
REVENUES
(IN MILLIONS OF
US DOLLARS)

CREDIT SERVICES

Morgan Stanley Dean Witter is a company that is built on leading, well-established franchises, and one of our strongest is Discover Card, which is the flagship of our credit services business. Discover Card was started from ground zero in 1985 and marketed as the first value card—with no annual fee and a Cashback Bonus®. In 1997, credit services was the largest US issuer of general purpose credit cards, as measured by number of accounts. We reach roughly a third of the households in the US. Our credit services business has almost $36 billion in receivables and relationships with more than 3 million merchant locations across the US.

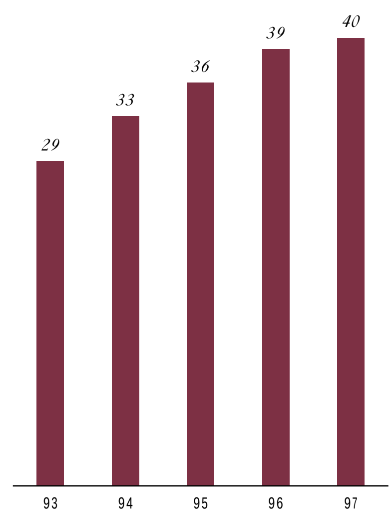
Our credit services business had a successful year in 1997, with earnings of $468 million—an 8% increase over 1996. We maintained the strength of our franchise and continued to extend it in a number of key areas. Credit card receivables, which provide a stream of continuing revenues, increased by 8% to $36 billion. We achieved significant growth with the addition of 400,000 new NOVUS® merchant locations that accept our credit cards, bringing us much closer to our goal of parity with VISA and MasterCard. Today, our cards are accepted at locations that account for a vast majority of credit card transactions in the US. In 1997, we also continued our initiative, through Discover Brokerage Direct, in the promising area of electronic commerce.

CREDIT AND TRANSACTION SERVICES ACHIEVED $468 MILLION IN NET INCOME, AN 8% INCREASE OVER LAST YEAR

We achieved these results in an environment that was difficult for many in the industry in two ways. First, delinquencies and personal bankruptcies continued to beleaguer the industry, resulting in continued high costs of write-offs for bad debt. Second, several years of fierce competition for new accounts have made it more difficult for many companies to achieve profitable growth, several major cards have faltered and industry-wide consolidation has intensified. We believe our size and strength have enabled us to withstand the worst effects of these trends, and we have been able to take action in response to them.

GENERAL PURPOSE CREDIT CARD ACCOUNTS

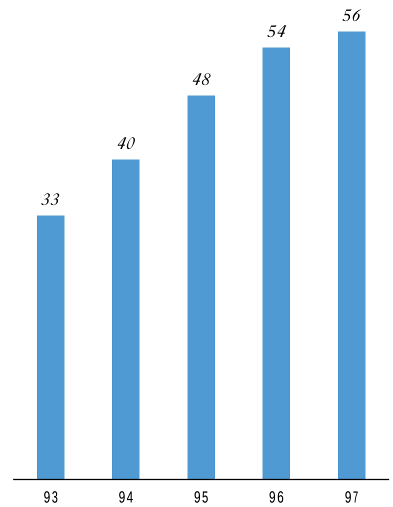
(IN MILLIONS)



In 1997, we continued to pursue a number of courses to deal with the trend of rising delinquencies, including tightened credit standards, increased collection efforts, and a number of repricing actions such as overlimit fees and increased fees for late payments. As a result of the repricing actions, we protected the profitability of the franchise during 1997—in fact, earnings have continued to grow despite $2.8 billion in write-offs over the past two years.

In early 1997, we initiated further steps to deal with the continuing problem of bad debts. The tightening of credit policies begun two years ago applied mostly to new account acquisition, but we now examine our entire portfolio (old and new accounts alike) to identify risks of future delinquencies, and we lower lines of credit and proactively revoke accounts based on current credit bureau information on the number of credit cards held by the cardmember and the cardmember's current total indebtedness. We look forward to the future results from this intensified focus on portfolio risk management.

GENERAL PURPOSE CREDIT CARD TRANSACTION VOLUME
(IN BILLIONS OF US DOLLARS)



Many industry observers have been predicting a slowing of growth in the credit card market for more than a decade—it was cited back in 1985 as the main reason the new Discover Card would never succeed. But credit cards continued to be a growth industry, attracting new entrants and fostering fierce competition. As a result, continued profitable growth has become more difficult for many companies. In 1997, Bank of New York exited the market, Advanta's growth stalled (its card portfolio was acquired by Fleet Financial), and AT&T put its Universal Card on the selling block (and found a buyer in Citibank).

Discover Card continues to have a large, successful consumer franchise, and we are responding to the competitive environment with increased focus on our strengths. Since it has become more difficult and expensive to gain profitable new accounts, we will give more emphasis to building revenues by playing to our strength: namely, our enormous base of existing cardholders. We plan to build revenues by offering new promotions, opportunities, and products to the many different segments of our customer base of 38 million accounts. We believe this customer base is an immense strength in a consolidating market.

As we mine the rich Discover Card account base, we are still in a position to opportunistically pursue additional growth in other segments of the credit card market. We plan to continue to grow the Private Issue card. We are pleased with the initial success of our NOVUS partnership (co-brand and affinity) programs, which have allowed us to broaden our customer base

THE NOVUS ACCOUNT BASE OF 38 MILLION GIVES US A SIGNIFICANT COMPETITIVE ADVANTAGE

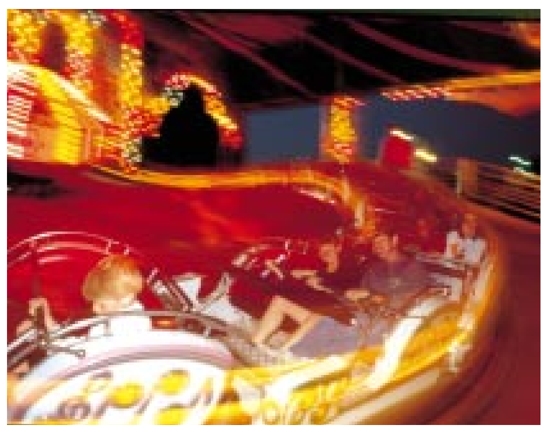
through our programs with various partners, including the Smithsonian Institution and Universal Studios. We will continue these efforts.

A long-term goal for Discover Card and the NOVUS Network is expansion overseas—into markets where there is still a significant undercapacity in credit cards. Since this expansion will entail relationships with financial and non-financial institutions, as well as foreign governments, Morgan Stanley's established presence in markets throughout the world is an obvious advantage.

The extension of the Discover brand also offers opportunities in a number of emerging, rapid growth businesses that cut across the traditional credit card market. One of the most promising is the realm of electronic commerce. In January 1997, Dean Witter Discover acquired Lombard Brokerage, Inc., a leading provider of online brokerage services. We renamed it Discover Brokerage Direct and have committed new resources to this enterprise, with the long-term goal of offering a wide range of financial services to the growing number of customers who want alternatives to traditional brokerage channels.

DISCOVER® CARD

PRIVATE ISSUE® CARD



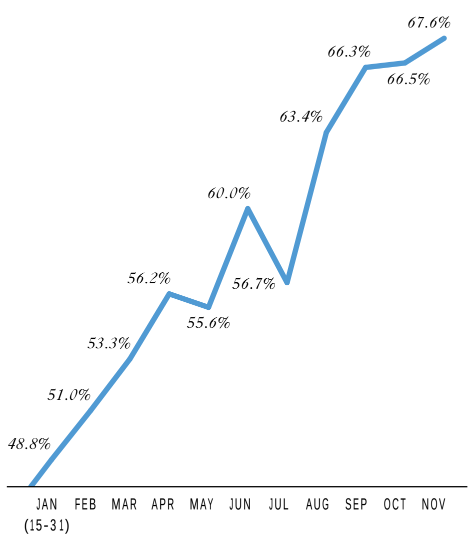
CO-BRAND/AFFINITY CARDS

DISCOVER BROKERAGE DIRECT

WE BELIEVE DISCOVER BROKERAGE DIRECT HAS TREMENDOUS GROWTH POTENTIAL IN THE ELECTRONIC FINANCIAL SERVICES MARKET

We believe the emerging electronic financial services market has tremendous growth potential. Forrester Research has predicted that online accounts will grow from approximately 3 million today to more than 14 million by 2002 and that those accounts will control more than $500 billion in assets. Discover Brokerage Direct is participating in this growth as shown by the increase in the percentage of our trades processed through the Internet.

DISCOVER BROKERAGE DIRECT INTERNET TRADES AS A PERCENT OF TOTAL TRADES
(JAN. 1996—6.2%)



Discover Brokerage Direct permits customers to invest three ways—through its Internet site, via an automated touch-tone telephone system, or with a core group of registered representatives. Our user-friendly services include detailed account information; real-time securities quotes; stock, options, bonds, and mutual fund executions; and third-party research data. In April 1997, Discover Brokerage Direct was named the best overall online broker by *Barron's* for the second consecutive year and in February 1998 was named the #1 online brokerage firm overall by *SmartMoney* magazine. Discover Brokerage Direct also has recently redesigned its Web site (www.discoverbrokerage.com) and launched a new advertising campaign with the theme "You Are Not Alone." We are enthusiastic about building Discover Brokerage Direct into a leading financial services firm for self-directed consumers worldwide, providing them with direct access to financial data and the capability to execute value-priced transactions.

INTRODUCTION

THE COMPANY

On May 31, 1997, Morgan Stanley Group Inc. ("Morgan Stanley") was merged with and into Dean Witter, Discover & Co. ("Dean Witter Discover") (the "Merger"). At that time, Dean Witter Discover changed its corporate name to Morgan Stanley, Dean Witter, Discover & Co. (the "Company"). In conjunction with the Merger, each share of Morgan Stanley common stock then outstanding was converted into 1.65 shares of the Company's common stock (the "Exchange Ratio"), and each share of Morgan Stanley preferred stock was converted into one share of a corresponding series of preferred stock of the Company. The Merger was treated as a tax-free exchange.

The Company is a pre-eminent global financial services firm that maintains leading market positions in each of its businesses—Securities and Asset Management, and Credit and Transaction Services. The Company combines three well-recognized brands in the financial services industry: Morgan Stanley, Dean Witter and Discover® Card. The Company also combines global strengths in investment banking (including in the origination of quality underwritten public offerings and mergers and acquisitions advice) and institutional sales and trading, with strengths in providing investment and global asset management services to its customers and in providing quality consumer credit products primarily through its Discover® Card brand.

BASIS OF FINANCIAL INFORMATION

The Company's consolidated financial statements give retroactive effect to the Merger in a transaction accounted for as a pooling of interests. The pooling of interests method of accounting requires the restatement of all periods presented as if Dean Witter Discover and Morgan Stanley always had been combined. The consolidated statement of changes in shareholders' equity reflects the accounts of the Company as if the additional preferred and common stock had been issued during all of the periods presented.

Prior to the consummation of the Merger, Dean Witter Discover's year ended on December 31 and Morgan Stanley's fiscal year ended on November 30. Subsequent to the Merger, the Company adopted a fiscal year-end of November 30. In recording the pooling of interests combination, Dean Witter Discover's financial statements for the years ended December 31, 1996 and 1995 were combined with Morgan Stanley's financial statements for the fiscal years ended November 30, 1996 and 1995 (on a combined basis, "fiscal 1996" and "fiscal 1995," respectively). The Company's results for the twelve months ended November 30, 1997 ("fiscal 1997") include the results of Dean Witter Discover that were restated to conform to the new fiscal year-end date. The Company's results of operations for fiscal 1997 and fiscal 1996 include the month of December 1996 for Dean Witter Discover.

Certain reclassifications have been made to prior-year amounts to conform to the current presentation. All material intercompany balances and transactions have been eliminated.

RESULTS OF OPERATIONS

CERTAIN FACTORS AFFECTING RESULTS OF OPERATIONS*

The Company's results of operations may be materially affected by market fluctuations and by economic factors. In addition, results of operations in the past have been and in the future may continue to be materially affected by many factors of a global nature, including economic and market conditions; the availability of capital; the level and volatility of interest rates; currency values and other market indices; the availability of credit; inflation; and legislative and regulatory developments. Such factors also may have an impact on the Company's ability to achieve its strategic objectives, including (without limitation) continued profitable global expansion.

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*This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, as well as a discussion of some of the risks and uncertainties involved in the Company's businesses that could affect the matters referred to in such statements.

The Company's Securities and Asset Management business, particularly its involvement in primary and secondary markets for all types of financial products, including derivatives, is subject to substantial positive and negative fluctuations due to a variety of factors that cannot be predicted with great certainty, including variations in the fair value of securities and other financial products and the volatility and liquidity of trading markets. Fluctuations also occur due to the level of market activity, which, among other things, affects the flow of investment dollars into mutual funds and the size, number and timing of transactions or client assignments (including realization of returns from the Company's principal and merchant banking investments). In the Company's Credit and Transaction Services business, changes in economic variables may substantially affect consumer loan growth and credit quality. Such variables include the number of personal bankruptcy filings, the rate of unemployment and the level of consumer debt to income ratios.

The Company's results of operations also may be materially affected by competitive factors. In addition to competition from firms traditionally engaged in the securities business, there has been increased competition from other sources, such as commercial banks, insurance companies, mutual fund groups and other companies offering financial services both in the U.S. and globally. As a result of recent and pending legislative and regulatory initiatives in the U.S. to remove or relieve certain restrictions on commercial banks, competition in some markets that have traditionally been dominated by investment banks and retail securities firms has increased and may continue to increase in the near future. In addition, recent convergence and consolidation in the financial services industry will lead to increased competition from larger diversified financial services organizations. Fiscal 1997 was characterized by a record level of strategic alliances in the financial services industry which focused on expanding asset management capabilities and combining institutional and retail businesses, including product origination and distribution capabilities.

Such competition, among other things, affects the Company's ability to attract and retain highly skilled individuals. Competitive factors also affect the Company's success in attracting and retaining clients and assets through its ability to meet investors' saving and investment needs by consistency of investment performance and accessibility to a broad array of financial products and advice. In the credit services industry, competition centers on merchant acceptance of credit cards, credit card account acquisition and customer utilization of credit cards. Merchant acceptance is based on both competitive transaction pricing and the number of credit cards in circulation. Credit card account acquisition and customer utilization are driven by the offering of credit cards with competitive and appealing features such as no annual fees, low introductory interest rates and other customized features targeting specific consumer groups and by having broad merchant acceptance.

As a result of the above economic and competitive factors, net income and revenues in any particular period may not be representative of full-year results and may vary significantly from year to year and from quarter to quarter. The Company intends to manage its business for the long term and help mitigate the potential effects of market downturns by strengthening its competitive position in the global financial services industry through diversification of its revenue sources and enhancement of its global franchise. The Company's ability and success in maintaining high levels of profitable business activities, emphasizing fee-based assets that are designed to generate a continuing stream of revenues, managing risks in both the Securities and Asset Management and Credit and Transaction Services businesses, evaluating credit product pricing and monitoring costs will continue to affect its overall financial results. In addition, the complementary trends in the financial services industry of consolidation and globalization present, among other things, technological, risk management and other infrastructure challenges that will require effective resource allocation in order for the Company to remain competitive.

MARKET AND ECONOMIC CONDITIONS IN FISCAL 1997

The favorable market and economic conditions which characterized fiscal 1996 continued throughout much of fiscal 1997, contributing to higher industry-wide securities revenues and to record levels of net income and net revenues for the Company's Securities and Asset Management business. In addition, the Company's Securities and Asset Management business ended the fiscal year with record levels of account executives, customer accounts and assets, and assets under management and administration. The Company's Credit and Transaction Services business also recorded record levels of net income, net revenues, managed consumer loans and customer accounts despite difficult conditions in the industry which resulted in higher rates of credit card loan charge-offs.

Market conditions in the U.S. were favorable for much of fiscal 1997, as moderate economic growth, low levels of unemployment and continued growth in corporate profits generally prevailed. Despite these conditions, the level of inflation has remained relatively low. U.S. financial markets also experienced periods of increased volatility during fiscal 1997. In the first half of the year, bond markets were affected by fears of inflationary pressures due to consistently strong indicators of economic growth, which prompted the Federal Reserve Board to raise the overnight lending rate by .25% in March 1997. The bond markets rallied later in the year as interest rates fell across the yield curve. This decline in interest rates reflected the continuing stability of inflation and the Federal Reserve Board's interest rate policy. The market for U.S. government securities was particularly strong during the latter part of the year, as market instability in certain Asian markets increased investor demand for less risky investments. The performance of U.S. equity markets also was very positive in fiscal 1997, primarily resulting from strong corporate earnings, high levels of cash inflows into mutual funds, and a high volume of equity issuances. U.S. equity markets also experienced periods of increased volatility, particularly during the second and fourth fiscal quarters. During both of these periods, equity markets experienced sharp selloffs that were subsequently followed by strong recoveries.

In fiscal 1997, European financial markets provided investors with solid returns despite a slight downturn during the fourth quarter. The robust performance of these markets reflected strong corporate earnings and optimism that economic growth in the region will continue to remain solid. European financial markets also were impacted by the prospects of the approaching European Economic and Monetary Union ("EMU"). The EMU is scheduled to commence on January 1, 1999 when the European Currency Unit (the "ECU") will be replaced by the "Euro" at a conversion rate of 1:1. Those national currencies which are to participate in the EMU will ultimately cease to exist as separate currencies and will be replaced by the Euro. Throughout fiscal 1997, varying expectations regarding the probability and timing of the EMU often caused volatility in certain interest rates and currencies.

In the Far East, the conditions in Japanese financial markets were generally weak during the fiscal year, as the nation's rate of economic growth remained sluggish. Investors also have been concerned with the strength of Japan's financial system. The Japanese banking sector has been burdened by underperforming real estate loans, rising unemployment, an anemic stock market and fears regarding the potential impact of the economic crisis that began in fiscal 1997 in much of Asia. Financial markets in Southeast Asia also experienced difficult conditions, including the currency crisis that impacted the region, which impaired creditworthiness and undermined investor confidence in the region's highly leveraged banking sector. Conditions in these markets were particularly volatile in the third and fourth fiscal quarters, as increased investor concerns resulted in significant declines in certain Asian equity markets. The currencies of certain nations in the region also experienced sizable depreciation during this period.

The worldwide market for mergers and acquisitions continued to be robust during fiscal 1997, resulting in record levels of revenues by the Company's investment banking business. The need for economies of scale, location, financial capacity and the ability to compete globally contributed to an aggressive acquisition marketplace which was further stimulated by relatively low interest rates and the buoyant equity markets. The markets for the underwriting of securities also were robust, as corporations, like consumers, were capitalizing on low interest rates to refinance debt obligations. Primary markets also benefited from the continued flow of funds into the equity markets from mutual funds, asset allocation adjustments, the continued cross border flows of capital and a significant number of privatizations.

In fiscal 1997, consumer demand and retail sales continued to increase although at a slower rate than the prior year, favorably impacting credit card transaction volume and consumer loan growth. In fiscal 1997, the Company continued to invest in growth through the expansion of its NOVUS® Network and by increasing its marketing and solicitation activities. However, credit quality issues have continued to be a challenge for the credit services industry and the Company, as levels of consumer debt and personal bankruptcies continued to increase during fiscal 1997 with resulting continued increases in industry-wide credit card loan losses.

FISCAL 1997 AND 1996 RESULTS FOR THE COMPANY

The Company achieved net income of $2,586 million in fiscal 1997, a 31% increase from fiscal 1996. In fiscal 1996, net income increased 35% to $1,980 million from fiscal 1995. Primary earnings per common share increased 32% to $4.25 in fiscal 1997 and 40% to $3.22 in fiscal 1996. Fully diluted earnings per common share increased 32% to $4.15 in fiscal 1997 and 40% to $3.14 in fiscal 1996. The Company's return on average shareholders' equity was 22%, 20% and 16% in fiscal 1997, fiscal 1996 and fiscal 1995, respectively. The Company's fiscal 1997 net income includes $63 million of costs related to the Merger. These costs, which consisted primarily of proxy solicitation costs, severance costs, financial advisory and accounting fees, and legal and regulatory filing fees, were recorded by the Company during the second fiscal quarter.

The remainder of Results of Operations is presented on a business segment basis. With the exception of fiscal 1997's merger-related expenses, substantially all of the operating revenues and operating expenses of the Company can be directly attributed to its two business segments: Securities and Asset Management, and Credit and Transaction Services. Certain reclassifications have been made to prior-period amounts to conform to the current year's presentation.

SECURITIES AND ASSET MANAGEMENT STATEMENTS OF INCOME

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Revenues:			
Investment banking	$ 2,694	$ 2,190	$ 1,556
Principal transactions:			
Trading	3,191	2,659	1,685
Investments	463	86	121
Commissions	2,059	1,776	1,533
Asset management, distribution and administration fees	2,505	1,732	1,377
Interest and dividends	10,455	8,571	8,138
Other	132	122	113
Total revenues	21,499	17,136	14,523
Interest expense	9,633	7,902	7,265
Net revenues	11,866	9,234	7,258
Compensation and benefits	5,475	4,585	3,584
Occupancy and equipment	462	432	406
Brokerage, clearing and exchange fees	448	317	289
Information processing and communications	602	514	474
Marketing and business development	393	296	235
Professional services	378	282	203
Other	511	382	417
Relocation charge	–	–	59
Total non-interest expenses	8,269	6,808	5,667
Income before income taxes	3,597	2,426	1,591
Provision for income taxes	1,416	880	559
Net income	$ 2,181	$ 1,546	$ 1,032

SECURITIES AND ASSET MANAGEMENT

Securities and Asset Management provides a wide range of financial products, services and investment advice to individual and institutional investors. Securities and Asset Management business activities are conducted in the U.S. and throughout the world and include investment banking, research, institutional sales and trading, global asset management, and investment and asset management products and services for individual clients. At November 30, 1997, the Company's Dean Witter Reynolds Inc. ("DWR") account executives provided investment services to more than 3.5 million client accounts with assets of $302 billion. The Company had the third largest account executive sales organization in the U.S. with 9,946 professional account executives and 399 branches at November 30, 1997. With well-recognized brand names, including those associated with Dean Witter InterCapital Inc. ("ICAP"), Van Kampen American Capital, Inc. ("VKAC"), Morgan Stanley Asset Management and Miller Anderson & Sherrerd, LLP ("MAS"), the Company has one of the largest global asset management operations of any full-service securities firm, with total assets under management or supervision of $338 billion at November 30, 1997.

Securities and Asset Management achieved record net revenues and net income of $11,866 million and $2,181 million in fiscal 1997, increases of 29% and 41%, respectively, from fiscal 1996. In fiscal 1996, Securities and Asset Management net revenues and net income increased 27% and 50%, respectively, from fiscal 1995. The Company's fiscal 1997 and 1996 levels of net revenues and net income in its Securities and Asset Management business reflect a strong global market for mergers and acquisitions, as well as improved sales and trading results primarily driven by favorable economic conditions and increased customer trading volume and the positive accumulation and management of client assets. These results were partially offset in both years by increased costs for incentive-based compensation, as well as increased non-compensation expenses associated with the Company's higher level of global business activities.

The growth in net income in both years was impacted by favorable business environments and the Company's focus on accumulating client assets and building fee-based assets under management and administration.

Investment Banking

Investment banking revenues are derived from the underwriting of securities offerings and fees from advisory services. Investment banking revenues were as follows:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Advisory fees from merger, acquisition and restructuring transactions	$ 920	$ 848	$ 622
Equity underwriting revenues	888	722	503
Debt underwriting revenues	886	620	431
Total investment banking revenues	$2,694	$2,190	$1,556

Investment banking revenues increased 23% and attained record levels in fiscal 1997, surpassing the Company's previous level of record revenues that were recorded in fiscal 1996. Revenues in both fiscal 1997 and fiscal 1996 benefited from increased advisory fees from merger, acquisition and restructuring transactions, as well as increased revenues from underwriting debt and equity securities.

The worldwide merger and acquisition markets remained robust for the third consecutive year with more than $1.6 trillion of transactions (per Securities Data Company) announced during calendar year, 1997, including record volume in the U.S. The sustained growth of the merger and acquisition markets, coupled with the Company's global presence and strong market share, had a positive impact on advisory fees, which increased 8% in fiscal 1997. As was the case in fiscal 1996, merger and acquisition activity was diversified across many industries in the Company's client base. In fiscal 1997, the health care, banking and other financial services, telecommunications, technology and energy sectors contributed the greatest level of activity. Advisory fees from real estate transactions were also higher as compared with the prior year, benefiting from a stable financing environment, favorable economic conditions and a strong real estate market, including accelerated consolidation activity among real estate investment trusts ("REITS"). The 36% increase in advisory fees in 1996 was primarily due to high transaction volumes that were propelled in part by rising stock prices, as well as the Company's strong global presence and broad client base.

Equity underwriting revenues increased 23% in fiscal 1997, primarily due to a higher volume of equity offerings and an increased market share, particularly in Europe, as compared with the prior year. The primary market for equity issuances continued to benefit from the high volume of cash inflows into equity mutual funds, as well as from a favorable economic environment. Equity underwriting revenues increased 44% in fiscal 1996 and were positively affected by a strong primary calendar as new issuances were readily absorbed by the increased flows of money into the equity markets. Additionally, reduced concerns regarding inflation and lower interest rates positively affected the demand for new equity issuances.

Revenues from debt underwriting increased 43% in fiscal 1997. The increase was primarily attributable to higher revenues from high-yield debt issuances, as the favorable market conditions which existed for much of fiscal 1997 enabled certain high-yield issuers to obtain attractive rates of financing. Issuers in the telecommunications sector were particularly active in the high-yield debt market. Debt financing revenues also were impacted by higher revenues from securitized debt issuances, resulting from the Company's continued focus on this business sector and an increase in the number of asset-backed transactions. In fiscal 1996, revenues from debt financing activity increased 44% and were positively affected by a relatively stable interest rate environment as the Federal Reserve Board maintained short-term interest rates at a constant level subsequent to a modest decrease in the Federal Funds rate in January 1996. Fiscal 1996 debt underwriting revenues reflected a continued demand for corporate new issues as interest rates remained relatively low, an increased level of high-yield issuance activity and increased revenues from securitized debt transactions.

Principal Transactions
Principal transactions include revenues from customers' purchases and sales of securities in which the Company acts as principal and gains and losses on securities held for resale. Principal trading revenues were as follows:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Equities	$1,310	$1,181	$ 728
Fixed income	1,187	1,172	710
Foreign exchange	500	169	177
Commodities	194	137	70
Total principal trading revenues	$3,191	$2,659	$1,685

Equity trading revenues increased 11% to record levels in fiscal 1997, reflecting favorable market conditions that contributed to strong customer demand and high trading volumes. The increased revenues were primarily from trading in equity cash products, as the strong rates of return generated by many global equity markets contributed to higher customer trading volumes and the continuance of high levels of cash inflows into mutual funds. Revenues also benefited from the strong performance of many foreign equity markets, particularly in Europe, which led to higher trading volumes as U.S. investors sought to increase their positions in these markets. Equity trading revenues increased 62% in fiscal 1996, reflecting increased customer trading activity, particularly in the U.S., as the strong market was driven by low inflation, a moderately growing economy and relatively low interest rates. Equity cash products were positively affected as individual investors infused money into equity mutual funds at a high level. Revenues from equity derivative products increased as the Company expanded its proprietary trading activities to capitalize on increased levels of volatility, particularly in the U.S. options and futures markets.

Fixed income trading revenues increased 1% in fiscal 1997. Revenues from trading in fixed income products were positively affected by high levels of customer trading volumes, a large amount of new debt issuances and increased demand for credit sensitive fixed income products. Revenues from trading in high-yield debt securities and fixed income derivative products were particularly favorably impacted by these developments. Securitized debt trading revenues also increased, as the Company continued to focus on this market segment by expanding its level of activity in several key areas. Trading revenues benefited from higher revenues from trading in commercial whole loans and mortgage swaps, coupled with increased securitization volumes and innovative structures. These increases were offset by lower revenues from trading in government and investment grade corporate securities. Fixed income trading revenues increased 65% in fiscal 1996, primarily due to higher revenues from high-yield, emerging market, swaps and securitized debt trading. High-yield trading revenues benefited from increased volumes as positive corporate earnings increased investor demand for high-yield issues. Emerging market revenues increased, in part, due to higher levels of volatility in Russian securities, as well as the strengthening of Latin American markets, specifically in developing countries such as Mexico, Argentina and Brazil. Swaps trading revenue increased significantly, benefiting from an increased customer base, significant increases in volume and a favorable interest rate environment. Securitized debt trading revenues increased substantially as the Company increased its focus on this market segment by expanding its level of activity in securitized debt products. Revenues from trading in mortgage-backed securities and commercial whole loans contributed significantly to the overall revenue increase as securitizations increased and innovative structures were created.

Revenues from foreign exchange trading increased 196% to record levels in fiscal 1997, primarily resulting from the Company's increased client market share and from high levels of volatility in the foreign exchange markets. The U.S. dollar appreciated against many currencies throughout the year due to the strong growth of the U.S. economy and continued low levels of inflation. In addition, many European currencies experienced periods of increased volatility due to uncertainty regarding the timing of the EMU and the strength of the Euro, while the performance of the yen was affected by sluggish economic growth in Japan. Other Asian currencies were particularly volatile during the latter half of fiscal 1997, primarily due to the depreciation of certain currencies, including Thailand's baht. Higher trading volumes and an increasing customer base also contributed to the increase in revenues. Foreign exchange trading revenues declined 5% in fiscal 1996, primarily due to decreased volatility in the foreign exchange markets due to the narrowing of the differences in inflation rates among certain European nations.

Commodities trading revenues increased 42% and reached record levels in fiscal 1997, benefiting from higher revenues from trading in energy products, including the Company's increased presence in the electricity markets, precious metals and natural gas. Volatility in these products was high during most of the year due to fluctuating levels of customer demand and inventory. In both fiscal 1997 and fiscal 1996, commodities trading revenues benefited from the expansion of the customer base for commodity-related products, including derivatives, and the use of such products for risk management purposes. Revenues from commodities trading increased 96% in fiscal 1996, benefiting from volatile markets that were buoyed by low inventories, robust demand and the industry's expectation for much of fiscal 1996 that Iraq would re-enter the world crude oil market. In fiscal 1996, revenues from energy-related products increased significantly due to increased volatility as the prices of natural gas, crude oil and heating oil increased to their highest levels since the early 1990s.

Principal transaction investment revenues aggregating $463 million were recognized in fiscal 1997 as compared with $86 million in fiscal 1996. Fiscal 1997 revenues reflect a record level of revenues from the Company's merchant banking business. The higher revenues primarily reflect increases in the carrying value of certain of the Company's merchant banking investments, including an increase related to the Company's holdings of Fort James Corporation, the entity created from the merger of Fort Howard Corporation and James River Corporation of Virginia, as well as realized gains on certain positions that were sold during the year. Higher revenues from certain real estate and venture capital investment gains also contributed to the increase. Fiscal 1996 revenues also reflect increases in the carrying value of certain of the Company's merchant banking investments, as well as revenues from other principal investments, including real estate investments.

Commissions

Commission revenues primarily arise from agency transactions in listed and over-the-counter equity securities and sales of mutual funds, futures, insurance products and options. Commission revenues increased 16% in fiscal 1997, primarily reflecting high customer trading volumes, particularly in the third and fourth fiscal quarters when the New York Stock Exchange experienced some of the highest trading volume in its history. The strong returns posted by many global equity markets encouraged an increased investor demand for equity securities and resulted in high levels of cash inflows into mutual funds. Commission revenues also benefited from an increase in the Company's market share and from the continued strength in the market for equity issuances. In fiscal 1996, the 16% increase in commission revenues primarily reflected increased market participation by investors resulting from favorable market conditions and a strong primary calendar, particularly in the U.S., and an increase in sales of mutual fund and insurance products. In addition, commission revenues improved as institutional investors purchased more foreign and emerging market issuances.

Net Interest

Interest and dividend revenues and expense are a function of the level and mix of total assets and liabilities, including financial instruments owned, reverse repurchase and repurchase agreements, customer margin loans and the prevailing level, term structure and volatility of interest rates. Interest and dividend revenues and expense should be viewed in the broader context of principal trading results. Decisions relating to principal transactions in securities are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes an assessment of the potential gain or loss associated with a trade, the interest income or expense associated with financing or hedging the Company's positions, and potential underwriting, commission or other revenues associated with related primary or secondary market sales. Net interest revenues increased 23% in fiscal 1997, reflecting higher levels of trading activities and retail customer financing activity, including margin interest. Net interest revenues decreased 23% in fiscal 1996, partly attributable to changes in the mix of the Company's fixed income inventory, coupled with the general trend in interest rates. In both fiscal 1997 and fiscal 1996, net interest revenues reflected increased financing costs associated with higher average levels of balance sheet usage, particularly in equity-related businesses.

Asset Management, Distribution and Administration Fees

Asset management, distribution and administration fees include revenues from asset management services, including fund management fees which are received for investment management and for promoting and distributing mutual funds ("12b-1 fees"), other administrative fees and non-interest revenues earned from correspondent clearing and custody services. Fund management fees arise from investment management services the Company provides to registered investment companies (the "Funds") pursuant to various contractual arrangements. The Company receives management fees based upon each Fund's average daily net assets. The Company receives 12b-1 fees for services it provides in promoting and distributing certain open-ended Funds. These fees are based on either the average daily Fund net asset balances or average daily aggregate net Fund sales and are affected by changes in the overall level and mix of assets under management and administration. The Company also receives fees from investment management services provided to segregated customer accounts pursuant to various contractual arrangements.

Asset management, distribution and administration fees were as follows:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Asset management, distribution and administration fees	$2,505	$1,732	$1,377

The Company's customer assets under management or supervision and global assets under custody were as follows:

(DOLLARS IN BILLIONS)	1997	1996	1995
Customer assets under management or supervision (at fiscal year-end)	$ 338	$ 278	$ 149
Global assets under custody (at fiscal year-end)	$ 377	$ 144	$ 111

In fiscal 1997, asset management, distribution and administration fees increased 45%, reflecting the Company's continuing strategic emphasis on the asset management business. The increase also reflects revenues from VKAC, which was acquired by the Company on October 31, 1996. Fiscal 1997 revenues benefited from higher levels of fund management fees and increased revenues from international equity, emerging market and U.S. domestic equity and fixed income products and continued growth in customer assets under management or supervision. Revenues also were positively impacted by the Company's acquisition of the institutional global custody business of Barclays Bank PLC ("Barclays") on April 3, 1997. In fiscal 1996, the 26% increase in asset management, distribution and administration fees reflected growth in both asset management activities, including the acquisition of MAS, and global clearing and custody services. Higher revenues from 12b-1 fees also contributed to the increase in fiscal 1996.

As of November 30, 1997, assets under management or supervision had increased significantly as compared with fiscal year-end 1996. The increase in assets under management or supervision in both fiscal 1997 and fiscal 1996 reflected continued inflows of customer assets as well as appreciation in the value of customer portfolios, particularly in equity funds, and growth in international equity and domestic fixed income funds. In fiscal 1997, approximately 50% of the increase in assets under management or supervision was attributable to the acquisition of net new assets, while the remaining 50% reflected market appreciation.

Global assets under custody also increased significantly in fiscal 1997. Approximately $204 billion of the increase is attributable to the Company's acquisition of Barclays, and approximately $150 billion of these assets remain subject to current clients of Barclays agreeing to become clients of the Company. In both fiscal 1997 and fiscal 1996, global assets under custody also increased due to additional assets placed under custody with the Company, as well as appreciation in the value of customer portfolios.

Non-Interest Expenses

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Compensation and benefits	$5,475	$4,585	$3,584
Occupancy and equipment	462	432	406
Brokerage, clearing and exchange fees	448	317	289
Information processing and communications	602	514	474
Marketing and business development	393	296	235
Professional services	378	282	203
Other	511	382	417
Relocation charge	–	–	59
Total non-interest expenses	$8,269	$6,808	$5,667

Fiscal 1997's total non-interest expenses increased 21% to $8,269 million. Within that category, employee compensation and benefits expense increased 19%, reflecting increased levels of incentive compensation based on record fiscal 1997 revenues and earnings. Excluding compensation and benefits expense, non-interest expenses increased $571 million, including $266 million of operating costs related to VKAC and the global institutional custody business of Barclays. Occupancy and equipment expenses increased 7%, principally reflecting the occupancy costs of VKAC and increased office space in London and Hong Kong. Brokerage, clearing and exchange fees increased 41%, primarily reflecting the acquisitions of VKAC and the institutional global custody business of Barclays, as well as higher levels of trading volume in the global securities markets. Information processing and communications costs increased 17% due to higher data services costs related to an increased number of employees, incremental costs related to VKAC and continued enhancements to the Company's information technology infrastructure. Marketing and business development expenses increased 33%, reflecting higher travel and entertainment costs relating to increased levels of business activity associated with active financial markets. Additional advertising costs associated with VKAC's retail mutual funds also contributed to the increase. Professional services expenses increased 34%, reflecting higher consulting costs as a result of information technology initiatives and the increased level of overall business activity. Other expenses increased 34%, which includes goodwill amortization of $43 million associated with the acquisitions of VKAC and Barclays, as well as the impact of a higher level of business activity on various operating expenses.

Fiscal 1996's total non-interest expenses increased 20% to $6,808 million. Within that category, employee compensation and benefits expense increased 28%, reflecting increased levels of incentive compensation based on higher fiscal 1996 revenues and earnings, the impact of salaries and benefits relating to additional personnel hired during the year or joining the Company as the result of the MAS and VKAC acquisitions, and higher costs related to training new account executives. Excluding compensation and benefits expense, non-interest expenses increased $199 million (excluding fiscal 1995's relocation charge), including $48 million of operating costs related to MAS and VKAC. Occupancy and equipment expenses increased 6%, principally reflecting costs associated with the relocation of Morgan Stanley's New York offices, new leased office space in Tokyo, and the occupancy costs of MAS and VKAC. Brokerage, clearing and exchange fees increased 10%, reflecting increased trade volumes, both in the U.S. and in Europe, and the continued growth in the international component of the Company's sales and trading activities. Information processing and communications costs increased 8% in fiscal 1996 due to continued emphasis on technology initiatives. Marketing and business development and professional services expenses increased 32% in fiscal 1996, reflecting significantly higher travel and entertainment, consulting and advertising costs as a result of the increased level of the Company's global business activities. Other expenses decreased 8% in fiscal 1996, which primarily reflects a reduction in legal expenses partially offset by the amortization of goodwill related to the acquisitions of MAS and VKAC.

CREDIT AND TRANSACTION SERVICES

Credit and Transaction Services, which had approximately 40 million general purpose credit card accounts at November 30, 1997, was the largest single issuer of general purpose credit cards in the United States as measured by number of accounts and cardmembers. Consumers use general purpose credit cards to purchase goods and services and obtain cash advances. Credit and Transaction Services proprietary general purpose credit cards are offered principally by the Company's NOVUS Services business unit, which operates the NOVUS® Network. These include the Discover Card, the Private Issue® Card, and co-branded and affinity program cards. The Prime Option℠ MasterCard® is a co-branded general purpose credit card issued by NationsBank of Delaware, N.A., and serviced by Prime Option Services. SPS Transaction Services, Inc. ("SPS") is a 74% owned, publicly held subsidiary. Services provided by SPS include electronic transaction processing, consumer private label credit card program administration, commercial accounts receivable processing and call center teleservices. Discover Brokerage Direct offers discount trading services, principally to individual investors, through its Internet site, an automated telephone system and a core group of registered representatives, and is an example of the Company's efforts to satisfy the demand for financial services outside the traditional full-service brokerage channel.

CREDIT AND TRANSACTION SERVICES STATEMENTS OF INCOME

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Fees:			
Merchant and cardmember	$1,704	$1,505	$1,135
Servicing	762	809	680
Commissions	27	–	–
Other	12	4	2
Total non-interest revenues	2,505	2,318	1,817
Interest revenue	3,128	2,717	2,392
Interest expense	1,173	1,032	925
Net interest income	1,955	1,685	1,467
Provision for consumer loan losses	1,493	1,214	722
Net credit income	462	471	745
Net revenues	2,967	2,789	2,562
Compensation and benefits	544	486	421
Occupancy and equipment	64	61	48
Brokerage, clearing and exchange fees	12	–	–
Information processing and communications	478	482	415
Marketing and business development	786	731	639
Professional services	73	52	49
Other	259	286	289
Total non-interest expenses	2,216	2,098	1,861
Income before income taxes	751	691	701
Provision for income taxes	283	257	268
Net income	$ 468	$ 434	$ 433

In fiscal 1997, Credit and Transaction Services net income increased 8% to $468 million. Fiscal 1997 net income was positively impacted by higher average levels of consumer loans, credit card fees and interest revenue enhancements introduced in fiscal 1996 and higher general purpose credit card transaction volume, partially offset by increased consumer credit losses and higher non-interest expenses. In fiscal 1996, Credit and Transaction Services net income of $434 million remained level compared with fiscal 1995, as revenues from higher levels of transaction volume and average loans and increased credit card fees were offset by a higher rate of consumer credit losses.

Due to the Company's recent adoption of a November 30 fiscal year-end and the seasonality of the credit card business, certain information for November 30, 1996 is presented in order to provide a more meaningful comparison with the November 30, 1997 balances (see also "Seasonal Factors" herein).

Credit and Transaction Services statistical data was as follows:

FISCAL YEAR (DOLLARS IN BILLIONS)	1997	NOV. 30, 1996	1996	1995
Consumer loans:				
Owned	$20.9	$20.1	$22.1	$20.4
Managed	$36.0	$33.3	$35.3	$30.3
General Purpose Credit Card transaction volume	$55.8	$53.1	$53.6	$47.5

Merchant and Cardmember Fees

Merchant and cardmember fees include revenues from fees charged to merchants on credit card sales, late payment fees, overlimit fees, insurance fees, cash advance fees, the administration of credit card programs and transaction processing services.

Merchant and cardmember fees increased 13% in fiscal 1997 and 33% in fiscal 1996. The increase in both fiscal years was primarily the result of higher revenues from overlimit fees, late payment fees and merchant fees. Overlimit fees were implemented in March 1996, and the amount of the fee was increased in the fourth quarter of fiscal 1996. The increase in overlimit fees in fiscal 1997 was due to a higher incidence of overlimit occurrences. The increase in late payment fee revenues in both fiscal years was due to an increase in the incidence of late payments and higher levels of delinquent accounts. In both fiscal years, higher merchant fee revenues were primarily the result of continued growth in the level of general purpose credit card transaction volume. Fiscal 1996 revenues also benefited from increases in credit insurance fees, primarily due to higher enrollments and favorable loss experience rebates.

Servicing Fees

Servicing fees are revenues derived from consumer loans which have been sold to investors through asset securitizations. Cash flows from the interest yield and cardmember fees generated by securitized loans are used to pay investors in these loans a predetermined fixed or floating rate of return on their investment, to reimburse the investors for losses of principal through charged off loans and to pay the Company a fee for servicing the loans. Any excess cash flows remaining are paid to the Company. The servicing fees and excess net cash flows paid to the Company are reported as servicing fees in the consolidated statements of income. The sale of consumer loans through asset securitizations therefore has the effect of converting portions of net credit income and fee income to servicing fees.

The table below presents the components of servicing fees:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Merchant and cardmember fees	$ 436	$ 307	$ 137
Interest revenue	2,116	2,025	1,647
Interest expense	(829)	(792)	(681)
Provision for consumer loan losses	(961)	(731)	(423)
Servicing fees	$ 762	$ 809	$ 680

Servicing fees are affected by the level of securitized loans, the spread between the interest yield on the securitized loans and the yield paid to the investors, the rate of credit losses on securitized loans and the level of cardmember fees earned from securitized loans. Servicing fees also include the effects of interest rate contracts entered into by the Company as part of its interest rate risk management program. Servicing fees decreased 6% in fiscal 1997 and increased 19% in fiscal 1996. The decline in fiscal 1997 servicing fees was attributable to higher credit losses, partially offset by higher merchant and cardmember fees and net interest revenues. The increased revenues in fiscal 1996 were primarily due to higher net interest cash flows and cardmember fees from securitized loans, partially offset by increased credit losses from securitized loans. The increased net interest cash flows in fiscal 1996 were due to higher average levels of securitized loans.

Net Interest Income

Net interest income is equal to the difference between interest revenue derived from Credit and Transaction Services consumer loans and short-term investment assets and interest expense incurred to finance those assets. Credit and Transaction Services assets, consisting primarily of consumer loans, earn interest revenue at both fixed rates and market indexed variable rates. The Company incurs interest expense at fixed and floating rates. Interest expense also includes the effects of interest rate contracts entered into by the Company as part of its interest rate risk management program. This program is designed to reduce the volatility of earnings resulting from changes in interest rates and is accomplished primarily through matched financing, which entails matching the repricing schedules of consumer loans and the related financing.

The following tables present analyses of Credit and Transaction Services average balance sheets and interest rates in fiscal 1997, fiscal 1996 and fiscal 1995 and changes in net interest income during those fiscal years:

AVERAGE BALANCE SHEET ANALYSIS

FISCAL YEAR (DOLLARS IN MILLIONS)	1997			1996			1995		
	AVERAGE BALANCE	RATE	INTEREST	AVERAGE BALANCE	RATE	INTEREST	AVERAGE BALANCE	RATE	INTEREST
ASSETS									
Interest earning assets:									
General purpose credit card loans	$19,512	14.03%	$2,738	$17,083	13.99%	$2,391	$14,691	14.75%	$2,167
Other consumer loans	1,773	15.73	279	1,766	14.25	252	1,312	13.48	177
Investment securities	176	5.45	10	234	5.38	13	195	5.85	11
Other	1,680	6.06	101	1,078	5.60	61	578	6.03	37
Total interest earning assets	23,141	13.52	3,128	20,161	13.47	2,717	16,776	14.25	2,392
Allowance for loan losses	(828)			(669)			(598)		
Non-interest earning assets	1,726			1,352			1,221		
Total assets	$24,039			$20,844			$17,399		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Interest bearing deposits									
Savings	$ 963	4.27%	$ 41	$ 1,021	4.58%	$ 47	$ 1,050	4.71%	$ 49
Brokered	4,589	6.66	306	3,418	6.93	237	3,222	7.21	232
Other time	2,212	6.12	135	1,921	6.05	116	1,278	6.41	83
Total interest bearing deposits	7,764	6.21	482	6,360	6.29	400	5,550	6.55	364
Other borrowings	11,371	6.07	691	10,307	6.11	632	8,312	6.75	561
Total interest bearing liabilities	19,135	6.13	1,173	16,667	6.18	1,032	13,862	6.67	925
Shareholder's equity/other liabilities	4,904			4,177			3,537		
Total liabilities and shareholders' equity	$24,039			$20,844			$17,399		
Net interest income			$1,955			$1,685			$1,467
Net interest margin[1]			8.45%			8.36%			8.74%
Interest rate spread[2]		7.39%			7.29%			7.58%	

[1] Net interest margin represents net interest income as a percentage of total interest earning assets.
[2] Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

RATE/VOLUME ANALYSIS

FISCAL YEAR (DOLLARS IN MILLIONS)	1997 VS. 1996			1996 VS. 1995		
INCREASE/(DECREASE) DUE TO CHANGES IN:	VOLUME	RATE	TOTAL	VOLUME	RATE	TOTAL
INTEREST REVENUE						
General purpose credit card loans	$339	$ 8	$347	$353	$(129)	$224
Other consumer loans	1	26	27	61	14	75
Investment securities	(3)	–	(3)	3	(1)	2
Other	33	7	40	29	(5)	24
Total interest revenue	400	11	411	482	(157)	325
INTEREST EXPENSE						
Interest bearing deposits						
Savings	(3)	(3)	(6)	(1)	(1)	(2)
Brokered	81	(12)	69	15	(10)	5
Other time	18	1	19	41	(8)	33
Total interest bearing deposits	88	(6)	82	53	(17)	36
Other borrowings	64	(5)	59	136	(65)	71
Total interest expense	151	(10)	141	188	(81)	107
Net interest income	$249	$ 21	$270	$294	$ (76)	$218

Net interest income increased 16% in fiscal 1997 and 15% in fiscal 1996. The increases in both years were due to higher average levels of consumer loans outstanding, partially offset by the effects of higher charge-offs on interest revenue. The impact of higher charge-offs in fiscal 1997 was mitigated by pricing actions implemented in the fourth quarter of fiscal 1996. In both years, the effects of changes in interest rates on the Company's variable rate loan portfolio were substantially offset by comparable changes in the Company's cost of funds for the related financing. Fiscal 1997's revenues also were impacted by the pricing actions implemented in the fourth quarter of fiscal 1996. The Company believes that the effect of changes in market interest rates on net interest income were mitigated as a result of its liquidity and interest rate risk policies.

The supplemental table below provides average managed loan balance and rate information which takes into account both owned and securitized loans:

SUPPLEMENTAL AVERAGE MANAGED LOAN INFORMATION

FISCAL YEAR (DOLLARS IN MILLIONS)	1997		1996		1995	
	AVERAGE BALANCE	RATE	AVERAGE BALANCE	RATE	AVERAGE BALANCE	RATE
Consumer loans	$34,619	14.83%	$31,459	14.83%	$25,897	15.41%
General purpose credit card loans	32,176	14.72	29,021	14.81	23,970	15.41
Total interest earning assets	36,475	14.38	32,770	14.46	26,670	15.14
Total interest bearing liabilities	32,469	6.17	29,277	6.22	23,756	6.75
Consumer loan interest rate spread		8.66		8.61		8.66
Interest rate spread		8.21		8.24		8.39
Net interest margin		8.89		8.90		9.12

Provision for Consumer Loan Losses

The provision for consumer loan losses is the amount necessary to establish the allowance for loan losses at a level that the Company believes is adequate to absorb estimated losses in its consumer loan portfolio at the balance sheet date. The Company's allowance for loan losses is regularly evaluated by management for adequacy on a portfolio-by-portfolio basis and was $884 million at fiscal year-end 1997 and $802 million at fiscal year-end 1996.

The provision for consumer loan losses, which is affected by net charge-offs, loan volume and changes in the amount of consumer loans estimated to be uncollectable, increased 23% in fiscal 1997 and 68% in fiscal 1996. In both fiscal 1997 and fiscal 1996, the increase was primarily due to higher net charge-offs, which resulted from an increase in the percentage of consumer loans charged off and a higher level of average consumer loans outstanding. In fiscal 1996, the effect of an increase in the Company's estimate of the allowance for loan losses, primarily in the fourth quarter of fiscal 1996, was partially offset by a lower provision for losses for consumer loans intended to be securitized. The increases in both years in the Company's net charge-off rate were consistent with the industry-wide trend of increasing credit loss rates that the Company believes is related, in part, to increased consumer debt levels and bankruptcy rates. The Company believes this trend may continue and the Company may experience a higher net charge-off rate in fiscal 1998. In fiscal 1996, the Company took steps to reduce the impact of this trend, including raising credit quality standards for new accounts, selectively reducing credit limits and increasing collection activity. The Company continued to implement similar measures in fiscal 1997, including a more stringent screening of new cardmembers, tightened overlimit authorization procedures, and the closing of certain high risk accounts. The Company believes these measures, designed to improve credit quality, had a minimal impact in fiscal 1997 due to the period of time necessary for such measures to have a meaningful effect on portfolio credit quality, but believes they may have an increased effect in fiscal 1998. The Company's expectations about future charge-off rates and credit quality are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that influence the level and direction of consumer loan delinquencies and charge-offs include changes in consumer spending and payment behaviors, bankruptcy trends, the seasoning of the Company's loan portfolio, interest rate movements and their impact on consumer behavior, and the rate and magnitude of changes in the Company's consumer loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio.

Consumer loans are considered delinquent when interest or principal payments become 30 days past due. Consumer loans are charged off when they become 180 days past due, except in the case of bankruptcies and fraudulent transactions, where loans are charged off earlier. Loan delinquencies and charge-offs are primarily affected by changes in economic conditions and may vary throughout the year due to seasonal consumer spending and payment behaviors. The Company believes that changes in its consumer loan delinquency rates in fiscal 1997 and 1996 were related to the industry-wide credit conditions discussed previously.

From time to time, the Company has offered and may continue to offer cardmembers with accounts in good standing the opportunity to skip the minimum monthly payment, while continuing to accrue periodic finance charges, without being considered to be past due ("skip-a-payment"). The comparison of delinquency rates at any particular point in time may be affected depending on the timing of the "skip-a-payment" program. The delinquency rate for consumer loans 30-89 days past due at November 30, 1997 was favorably impacted by a skip-a-payment offer allowing certain cardmembers to skip their October 1997 monthly payment. The following table presents delinquency and net charge-off rates with supplemental managed loan information:

ASSET QUALITY

FISCAL YEAR (DOLLARS IN MILLIONS)	1997		NOVEMBER 30, 1996		1996		1995	
	OWNED	MANAGED	OWNED	MANAGED	OWNED	MANAGED	OWNED	MANAGED
Consumer loans at period-end	$20,917	$35,950	$20,085	$33,316	$22,064	$35,261	$20,442	$30,340
Consumer loans contractually past due as a percentage of period-end consumer loans:								
30 to 89 days	3.96%	3.91%	4.45%	4.49%	4.42%	4.41%	4.19%	4.19%
90 to 179 days	3.11%	3.07%	2.78%	2.78%	2.89%	2.82%	2.16%	2.14%
Net charge-offs as a percentage of average consumer loans	6.78%	6.95%	5.29%	5.43%	5.45%	5.59%	3.69%	3.92%

Non-Interest Expenses

Total non-interest expenses increased 6% to $2,216 million in fiscal 1997 and 13% to $2,098 million in fiscal 1996.

Employee compensation and benefits expense increased 12% in fiscal 1997 and 15% in fiscal 1996. The increases in both years were due to higher headcount and employment costs associated with processing increased credit card transaction volume and servicing additional NOVUS Network merchants and active credit card accounts, including collection activities.

Brokerage, clearing and exchange fees of $12 million were recorded in fiscal 1997. These expenses relate to the trading volume recorded by Discover Brokerage Direct, the Company's provider of electronic brokerage services that was acquired in January 1997.

Information processing and communications expense decreased 1% in fiscal 1997 and increased 16% in fiscal 1996. In both fiscal years, there were higher costs associated with processing increased transaction volume, servicing additional NOVUS Network merchants and active credit card accounts, and developing the systems supporting the Company's multi-card strategy. In fiscal 1997, such increases were offset by an adjustment resulting from the sale of the Company's indirect interest in one of the Company's transaction processing vendors.

Marketing and business development expense increased 8% in fiscal 1997 and 14% in fiscal 1996. In both years, the increase was primarily attributable to higher cardmember rewards expense. Cardmember rewards expense includes the Cashback Bonus® award, pursuant to which the Company annually pays Discover cardmembers and Private Issue cardmembers electing this feature a percentage of their purchase amounts ranging up to one percent (up to 2% for the Private Issue card) based upon a cardmember's level of annual purchases. Cardmember rewards expense increased due to continued growth in credit card transaction volume and increased cardmember qualification for higher award levels. Both years' expenses also were impacted by higher marketing and promotional costs associated with the growth of new and existing credit card brands.

Professional services expense increased 40% in fiscal 1997 and remained relatively level in fiscal 1996. The increase in fiscal 1997 was primarily due to higher expenditures for consumer credit counseling and collections services.

Other non-interest expenses decreased 9% in fiscal 1997 and remained relatively level in fiscal 1996. Other expenses primarily include fraud losses, credit inquiry fees and other administrative costs. The decrease in fiscal 1997 was due to a continuing decline in the level of fraud losses. In fiscal 1995, the Company began implementing several measures designed to reduce fraud losses. Since the Company began implementing these measures, fraud losses as a percentage of transaction volume have declined.

Seasonal Factors

The credit card lending activities of Credit and Transaction Services are affected by seasonal patterns of retail purchasing. Historically, a substantial percentage of credit card loan growth occurs in the fourth calendar quarter, followed by a flattening or decline of consumer loans in the subsequent first calendar quarter. Merchant fees, therefore, have historically tended to increase in the first fiscal quarter, reflecting higher sales activity in the month of December. Additionally, higher cardmember rewards expense is accrued in the fiscal first quarter, reflecting seasonal growth in retail sales volume.

LIQUIDITY AND CAPITAL RESOURCES

The Balance Sheet

The Company's total assets increased to $302.3 billion at November 30, 1997 from $238.9 billion at fiscal year-end 1996, primarily reflecting growth in financial instruments owned, reverse repurchase agreements, and securities borrowed. Due to the favorable operating conditions throughout fiscal 1997, the Company operated with a larger balance sheet as compared with fiscal 1996, as well as higher levels of balance sheet leverage. The growth is primarily attributable to the Company's fixed income activities, most notably corporate debt, foreign sovereign government obligations and reverse repurchase agreements used in both financing activities and the Company's fixed income matched book activities. The Company was positioned to capitalize on favorable conditions in the global fixed income markets, particularly in the global high-yield and sovereign debt markets. Securities borrowed also rose during fiscal 1997, reflecting an increase in collateralized lending to facilitate higher levels of customer activity, as well as increases related to the Company's proprietary trading activities. A substantial portion of the Company's total assets consists of highly liquid marketable securities and short-term receivables arising principally from securities transactions. The highly liquid nature of these assets provides the Company with flexibility in financing and managing its business.

Funding and Capital Policies

The Company's senior management establishes the overall funding and capital policies of the Company, reviews the Company's performance relative to these policies, monitors the availability of sources of financing, reviews the foreign exchange risk of the Company, and oversees the liquidity and interest rate sensitivity of the Company's asset and liability position. The primary goal of the Company's funding and liquidity activities is to ensure adequate financing over a wide range of potential credit ratings and market environments.

Many of the Company's businesses are capital-intensive. Capital is required to finance, among other things, the Company's securities inventories, underwriting, principal investments, merchant banking activities, consumer loans and investments in fixed assets. As a policy, the Company attempts to maintain sufficient capital and funding sources in order to have the capacity to finance itself on a fully collateralized basis at all times, including periods of financial stress. Currently, the Company believes that it has sufficient capital to meet its needs. In addition, the Company attempts to maintain total equity, on a consolidated basis, at least equal to the sum of all of its subsidiaries' equity. Subsidiary equity capital requirements are determined by regulatory requirements (if applicable), asset mix, leverage considerations and earnings volatility.

The Company views return on equity to be an important measure of its performance, in the context of both the particular business environment in which the Company is operating and its peer group's results. In this regard, the Company actively manages its consolidated capital position based upon, among other things, business opportunities, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and therefore may, in the future, expand or contract its capital base to address the changing needs of its businesses. The Company also had returned internally generated equity capital which was in excess of the needs of its businesses through common stock repurchases and dividends.

The Company's liquidity policies emphasize diversification of funding sources. The Company also follows a funding strategy which is designed to ensure that the tenor of the Company's liabilities equals or exceeds the expected holding period of the assets being financed. Short-term funding generally is obtained at rates related to U.S., Euro or Asian money market rates for the currency borrowed. Repurchase transactions are effected at negotiated rates. Other borrowing costs are negotiated depending upon prevailing market conditions (see Notes 5 and 6 to the consolidated financial statements). Maturities of both short-term and long-term financings are designed to minimize exposure to refinancing risk in any one period.

The volume of the Company's borrowings generally fluctuates in response to changes in the amount of repurchase transactions outstanding, the level of the Company's securities inventories and consumer loans receivable, and overall market conditions. Availability and cost of financing to the Company can vary depending upon market conditions, the volume of certain trading activities, the Company's credit ratings and the overall availability of credit. The Company, therefore, maintains a surplus of unused short-term funding sources at all times to withstand any unforeseen contraction in credit capacity. In addition, the Company attempts to maintain cash and unhypothecated marketable securities equal to at least 110% of its outstanding short-term unsecured borrowings. The Company has in place a contingency funding strategy which provides a comprehensive one-year action plan in the event of a severe funding disruption.

The Company views long-term debt as a stable source of funding for core inventories, consumer loans and illiquid assets and therefore maintains a long-term debt-to-capitalization ratio at a level appropriate for the current composition of its balance sheet. In general, fixed assets are financed with fixed rate long-term debt, and securities inventories and all current assets are financed with a combination of short-term funding, floating rate long-term debt, or fixed rate long-term debt swapped to a floating basis. Both fixed rate and variable rate long-term debt (in addition to sources of funds accessed directly by the Company's Credit and Transaction Services business) are used to finance the Company's consumer loan portfolio. Consumer loan financing is targeted to match the repricing characteristics of the loans financed. The Company uses derivative products (primarily interest rate and currency swaps) to assist in asset and liability management, reduce borrowing costs and hedge interest rate risk (see Note 6 to the consolidated financial statements).

The Company's reliance on external sources to finance a significant portion of its day-to-day operations makes access to global sources of financing important. The cost and availability of financing generally are dependent on the Company's short-term and long-term debt ratings. In addition, the Company's debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as over-the-counter derivative transactions.

As of January 31, 1998, the Company's credit ratings were as follows:

	COMMERCIAL PAPER	SENIOR DEBT
Moody's Investors Service	P-1	A1
Standard & Poor's	A-1	A+
Thomson BankWatch	TBW-1	AA
Dominion Bond Rating Service	R-1 (middle)	n/a
Duff & Phelps	D-1+	AA–
Fitch–IBCA, Inc.	F1+	AA–
Japan Bond Research Institute	n/a	AA–

As the Company continues its global expansion and as revenues are increasingly derived from various currencies, foreign currency management is a key element of the Company's financial policies. The Company benefits from operating in several different currencies because weakness in any particular currency often is offset by strength in another currency. The Company closely monitors its exposure to fluctuations in currencies and, where cost-justified, adopts strategies to reduce the impact of these fluctuations on the Company's financial performance. These strategies include engaging in various hedging activities to manage income and cash flows denominated in foreign currencies and using foreign currency borrowings, when appropriate, to finance investments outside the U.S.

Principal Sources of Funding

The Company funds its balance sheet on a global basis. The Company's funding for its Securities and Asset Management business is raised through diverse sources. These sources include the Company's capital, including equity and long-term debt; repurchase agreements; U.S., Canadian, Euro and French commercial paper; letters of credit; unsecured bond borrows; German Schuldschein loans; securities lending; buy/sell agreements; municipal reinvestments; master notes; and committed and uncommitted lines of credit. Repurchase agreement transactions, securities lending and a portion of the Company's bank borrowings are made on a collateralized basis and therefore provide a more stable source of funding than short-term unsecured borrowings.

The funding sources utilized for the Company's Credit and Transaction Services business include the Company's capital, including equity and long-term debt, asset securitizations, commercial paper, deposits, asset-backed commercial paper, Fed Funds and short-term bank notes. The Company sells consumer loans through asset securitizations using several transaction structures. Riverwoods Funding Corporation ("RFC"), an entity included in the consolidated financial statements of the Company, issues asset-backed commercial paper.

The Company's bank subsidiaries solicit deposits from consumers, purchase Fed Funds and issue short-term bank notes. Interest bearing deposits are classified by type as savings, brokered and other time deposits. Savings deposits consist primarily of money market deposits and certificate of deposit accounts sold directly to cardmembers and savings deposits from DWR clients. Brokered deposits consist primarily of certificates of deposit issued by the Company's bank subsidiaries. Other time deposits include institutional certificates of deposit. The Company, through Greenwood Trust Company, an indirect subsidiary of the Company, sells notes under a short-term bank note program.

The Company maintains borrowing relationships with a broad range of banks, financial institutions, counterparties and others from which it draws funds in a variety of currencies.

In November 1997, the Company replaced the predecessor Dean Witter Discover and Morgan Stanley holding company senior revolving credit agreements with a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the "MSDWD Facility"). Under the terms of the MSDWD Facility, the banks are committed to provide up to $6.0 billion. The MSDWD Facility contains restrictive covenants which require, among other things, that the Company maintain shareholders' equity of at least $8.3 billion at all times. The Company believes that the covenant restrictions will not impair the Company's ability to pay its current level of dividends. At November 30, 1997, no borrowings were outstanding under the MSDWD Facility.

The Company maintains a master collateral facility that enables Morgan Stanley & Co. Incorporated ("MS&Co."), one of the Company's U.S. broker-dealer subsidiaries, to pledge certain collateral to secure loan arrangements, letters of credit and other financial accommodations (the "MS&Co. Facility"). As part of the MS&Co. Facility, MS&Co. also maintains a secured committed credit agreement with a group of banks that are parties to the master collateral facility under which such banks are committed to provide up to $1.5 billion. The credit agreement contains restrictive covenants which require, among other things, that MS&Co. maintain specified levels of consolidated shareholders' equity and Net Capital, each as defined. In January 1998, this facility was renewed, and the amount of the commitment was increased to $1.875 billion. At November 30, 1997, no borrowings were outstanding under the MS&Co. Facility.

The Company also maintains a revolving committed financing facility that enables Morgan Stanley & Co. International Limited ("MSIL") to secure committed funding from a syndicate of banks by providing a broad range of collateral under repurchase agreements (the "MSIL Facility"). Such banks are committed to provide up to an aggregate of $1.85 billion available in 12 major currencies. The facility agreements contain restrictive covenants which require, among other things, that MSIL maintain specified levels of Shareholders' Equity and Financial Resources, each as defined. At November 30, 1997, no borrowings were outstanding under the MSIL Facility.

RFC maintains a senior bank credit facility which supports the issuance of asset-backed commercial paper. In fiscal 1997, RFC renewed this facility and increased its amount to $2.55 billion from $2.1 billion. Under the terms of the asset-backed commercial paper program, certain assets of RFC were subject to a lien in the amount of $2.6 billion at November 30, 1997. RFC has never borrowed from its senior bank credit facility.

The Company anticipates that it will utilize the MSDWD Facility, the MS&Co. Facility or the MSIL Facility for short-term funding from time to time (see Note 5 to the consolidated financial statements).

Fiscal 1997 and Subsequent Activity

During fiscal 1997, the Company took several steps to extend the maturity of its liabilities, reduce its reliance on unsecured short-term funding and increase its capital. These steps contributed to a net increase in capital of $2,425 million to $33,577 million at November 30, 1997. The additions to capital included net issuances of senior notes and subordinated debt aggregating $2,655 million.

During fiscal 1997, the Company and Morgan Stanley Finance plc, a U.K. subsidiary ("MS plc"), issued 8.03% Capital Units in an aggregate amount of $134 million. Each Capital Unit consists of (a) a Subordinated Debenture of MS plc guaranteed by the Company, and (b) a related Purchase Contract issued by the Company requiring the holder to purchase one Depositary Share representing shares (or fractional shares) of the Company's 8.03% Cumulative Preferred Stock.

During fiscal 1997, the Company redeemed all 975,000 shares of its 8.88% Cumulative Preferred Stock at a redemption price of $201.632 per share, which reflects the stated value of $200 per share together with an amount equal to all dividends accrued and unpaid to, but excluding, the redemption date. During fiscal 1997, the Company also redeemed all 750,000 shares of its 8-¾% Cumulative Preferred Stock at a redemption price of $200 per share, which was equal to the stated value of $200 per share.

During fiscal 1997, the Company repurchased shares of its common stock at an aggregate cost of $124 million and an average cost per share of $34.22. Prior to the consummation of the Merger, both Morgan Stanley and Dean Witter Discover rescinded any outstanding share repurchase authorizations.

Between November 30, 1997 and January 31, 1998, additional debt obligations aggregating approximately $1,659 million were issued. These notes have maturities from 1998 to 2004.

At November 30, 1997, certain assets of the Company, such as real property, equipment and leasehold improvements of $1.7 billion, and goodwill and other intangible assets of $1.4 billion, were illiquid. In addition, certain equity investments made in connection with the Company's merchant banking and other principal investment activities, high-yield debt securities, emerging market debt, and certain collateralized mortgage obligations and mortgage-related loan products are not highly liquid. In connection with its merchant banking and other principal investment activities, the Company has equity investments (directly or indirectly through funds managed by the Company) in privately and publicly held companies. As of November 30, 1997, the aggregate carrying value of the Company's equity investments in privately held companies (including direct investments and partnership interests) was $128 million, and its aggregate investment in publicly held companies was $547 million.

The Company acts as an underwriter of and as a market-maker in mortgage-backed pass-through securities, collateralized mortgage obligations and related instruments, and as a market-maker in commercial, residential and real estate loan products. In this capacity, the Company takes positions in market segments in which liquidity can vary greatly from time to time. The carrying value of the portion of the Company's mortgage-related portfolio at November 30, 1997 traded in markets that the Company believed were experiencing lower levels of liquidity than traditional mortgage-backed pass-through securities approximated $2,697 million.

In addition, at November 30, 1997, the aggregate value of high-yield debt securities and emerging market loans and securitized instruments held in inventory was $2,188 million (a substantial portion of which was subordinated debt) with not more than 4%, 14% and 16% of all such securities, loans and instruments attributable to any one issuer, industry or geographic region, respectively. Non-investment grade securities generally involve greater risk than investment grade securities due to the lower credit ratings of the issuers, which typically have relatively high levels of indebtedness and are, therefore, more sensitive to adverse economic conditions. In addition, the market for non-investment grade securities and emerging market loans and securitized instruments has been, and may in the future be, characterized by periods of volatility and illiquidity. The Company has in place credit and other risk policies and procedures to control total inventory positions and risk concentrations for non-investment grade securities and emerging market loans and securitized instruments.

The Company also has commitments to fund certain fixed assets and other less liquid investments, including at November 30, 1997 approximately $150 million in connection with its merchant banking and other principal investment activities. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit to clients.

The Company may, from time to time, also provide financing or financing commitments to companies in connection with its investment banking and merchant banking activities. The Company may provide extensions of credit to leveraged companies in the form of senior or subordinated debt, as well as bridge financing on a selective basis (which may be in connection with the Company's commitment to the Morgan Stanley Bridge Fund, LLC). At November 30, 1997, the Company had one such loan of $355 million outstanding in connection with its securitized debt underwriting activities.

The Company also engages in senior lending activities, including origination, syndication and trading of senior secured loans of non-investment grade companies. Such companies are more sensitive to adverse economic conditions than investment grade issuers, but the loans are generally made on a secured basis and are senior to the non-investment grade securities of these issuers that trade in the capital markets. At November 30, 1997, the aggregate value of senior secured loans and positions held by the Company was $738 million, and aggregate senior secured loan commitments were $325 million.

The gross notional and fair value amounts of derivatives used by the Company for asset and liability management and as part of its trading activities are summarized in Notes 6 and 8, respectively, to the consolidated financial statements (see also "Derivative Financial Instruments" herein).

Year 2000 and EMU

Many of the world's computer systems currently record years in a two-digit format. Such computer systems will be unable to properly interpret dates beyond the year 1999, which could lead to business disruptions in the U.S. and internationally (the "Year 2000" issue). The potential costs and uncertainties associated with the Year 2000 issue will depend on a number of factors, including software, hardware and the nature of the industry in which a company operates. Additionally, companies must coordinate with other entities with which they electronically interact, such as customers, creditors and borrowers.

To ensure that the Company's computer systems are Year 2000 compliant, a team of information technology professionals began preparing for the Year 2000 issue in 1995. Since then, the Company has been reviewing each of its systems and programs to identify those that contain two-digit year codes. The Company is assessing the amount of programming required to upgrade or replace each of the affected programs with the goal of completing all relevant internal software remediation and testing by the end of 1998 with continuing Year 2000 compliance efforts through 1999. In addition, the Company is actively working with all of its major external counterparties and suppliers to assess their compliance efforts and the Company's exposure to them.

Based upon current information, the Company believes that its Year 2000 expenditures for 1998 and through the project's completion will be approximately $125 million. Costs incurred relating to this project are being expensed by the Company during the period in which they are incurred. The Company's expectations about future costs associated with the Year 2000 issue are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that could influence the amount and timing of future costs include the success of the Company in identifying systems and programs that contain two-digit year codes, the nature and amount of programming required to upgrade or replace each of the affected programs, the rate and magnitude of related labor and consulting costs, and the success of the Company's external counterparties and suppliers in addressing the Year 2000 issue.

Modifications to the Company's computer systems and programs are also being made in order to prepare for the upcoming EMU. The EMU, which will ultimately result in the replacement of certain European currencies with the "Euro," will primarily impact the Company's Securities and Asset Management business. Costs associated with the modifications necessary to prepare for the EMU are also being expensed by the Company during the period in which they are incurred.

Preparation relating to the Year 2000 issue and the EMU transition will also create additional resource allocation challenges that the Company and other international financial institutions will need to address.

Regulatory Capital Requirements

DWR and MS&Co. are registered broker-dealers and registered futures commission merchants and, accordingly, are subject to the minimum net capital requirements of the Securities and Exchange Commission ("SEC"), the New York Stock Exchange and the Commodity Futures Trading Commission. MSIL, a London-based broker-dealer subsidiary, is regulated by the Securities and Futures Authority ("SFA") in the United Kingdom and, accordingly, is subject to the Financial Resources Requirements of the SFA. Morgan Stanley Japan Limited ("MSJL"), a Tokyo-based broker-dealer, is regulated by the Japanese Ministry of Finance with respect to regulatory capital requirements. DWR, MS&Co., MSIL and MSJL have consistently operated in excess of their respective regulatory requirements (see Note 10 to the consolidated financial statements).

Certain of the Company's subsidiaries are Federal Deposit Insurance Corporation ("FDIC") insured financial institutions. Such subsidiaries are therefore subject to the regulatory capital requirements adopted by the FDIC. These subsidiaries have consistently operated in excess of these and other regulatory requirements.

Certain other U.S. and non-U.S. subsidiaries are subject to various securities, commodities and banking regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. These subsidiaries have consistently operated in excess of their applicable local capital adequacy requirements. In addition, Morgan Stanley Derivative Products Inc., a triple-A rated subsidiary through which the Company conducts some of its derivative activities, has established certain operating restrictions which have been reviewed by various rating agencies.

Effects of Inflation and Changes in Foreign Exchange Rates

Because the Company's assets to a large extent are liquid in nature, they are not significantly affected by inflation. However, inflation may result in increases in the Company's expenses, which may not be readily recoverable in the price of services offered. To the extent inflation results in rising interest rates and has other adverse effects upon the securities markets, on the value of financial instruments and upon the markets for consumer credit services, it may adversely affect the Company's financial position and profitability.

A portion of the Company's business is conducted in currencies other than the U.S. dollar. Non-U.S. dollar assets typically are financed by direct borrowing or swap-based funding in the same currency. Changes in foreign exchange rates affect non-U.S. dollar revenues as well as non-U.S. dollar expenses. Those foreign exchange exposures that arise and are not hedged by an offsetting foreign currency exposure are actively managed by the Company to minimize risk of loss due to currency fluctuations.

Derivative Financial Instruments

The Company actively offers to clients and trades for its own account a variety of financial instruments described as "derivative products" or "derivatives." These products generally take the form of futures, forwards, options, swaps, caps, collars, floors, swap options and similar instruments which derive their value from underlying interest rates, foreign exchange rates, or commodity or equity instruments and indices. All of the Company's trading-related divisions use derivative products as an integral part of their respective trading strategies, and such products are used extensively to manage the market exposure that results from a variety of proprietary trading activities (see Note 8 to the consolidated financial statements). In addition, as a dealer in certain derivative products, most notably interest rate and currency swaps, the Company enters into derivative contracts to meet a variety of risk management and other financial needs of its clients. Given the highly integrated nature of derivative products and related cash instruments in the determination of overall trading division profitability and the context in which the Company manages its trading areas, it is not meaningful to allocate trading revenues between the derivative and underlying cash instrument components. Moreover, the risks associated with the Company's derivative activities, including market and credit risks, are managed on an integrated basis with associated cash instruments in a manner consistent with the Company's overall risk management policies and procedures (see "Risk Management" following Management's Discussion and Analysis of Financial Condition and Results of Operations). It should be noted that while particular risks may be associated with the use of derivatives, in many cases derivatives serve to reduce, rather than increase, the Company's exposure to market, credit and other risks.

The total notional value of derivative trading contracts outstanding at November 30, 1997 was $2,529 billion (as compared with $1,317 billion at fiscal year-end 1996). While these amounts are an indication of the degree of the Company's use of derivatives for trading purposes, they do not represent the Company's market or credit exposure and may be more indicative of customer utilization of derivatives. The Company's exposure to market risk relates to changes in interest rates, foreign currency exchange rates or the fair value of the underlying financial instruments or commodities. The Company's exposure to credit risk at any point in time is represented by the fair value of such contracts reported as assets. Such total fair value outstanding as of November 30, 1997 was $17.1 billion. Approximately $14.2 billion of that credit risk exposure was with counterparties rated single-A or better (see Note 8 to the consolidated financial statements).

The Company also uses derivative products (primarily interest rate, currency and equity swaps) to assist in asset and liability management, reduce borrowing costs and hedge interest rate risk (see Notes 5 and 6 to the consolidated financial statements).

The Company believes that derivatives are valuable tools that can provide cost-effective solutions to complex financial problems and remains committed to providing its clients with innovative financial products. The Company established Morgan Stanley Derivative Products Inc. to offer derivative products to clients who will enter into derivative transactions only with triple-A rated counterparties. In addition, the Company, through its continuing involvement with regulatory, self-regulatory and industry activities such as the International Swaps and Derivatives Association Inc. (ISDA), the Securities Industry Association, the Group of 30 and the U.S. securities firms' Derivatives Policy Group, provides leadership in the development of policies and practices in order to maintain confidence in the markets for derivative products, which is critical to the Company's ability to assist clients in meeting their overall financial needs.

RISK MANAGEMENT

RISK MANAGEMENT POLICY AND CONTROL STRUCTURE

Risk is an inherent part of the Company's business and activities. The extent to which the Company properly and effectively identifies, assesses, monitors and manages each of the various types of risk involved in its activities is critical to its soundness and profitability. The Company's broad-based portfolio of business activities helps reduce the impact that volatility in any particular area or related areas may have on its net revenues as a whole. The Company seeks to identify, assess, monitor and manage, in accordance with defined policies and procedures, the following principal risks involved in the Company's business activities: market risk, credit risk, operational risk, legal risk and funding risk. Funding risk is discussed in the Liquidity and Capital Resources section of Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 36.

Risk management at the Company is a multi-faceted process with independent oversight which requires constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administrative and business functions to assist in the identification, assessment and control of various risks. In recognition of the increasingly varied and complex nature of the global financial services business, the Company's risk management policies and procedures are evolutionary in nature and are subject to ongoing review and modification.

The Management Committee, composed of the Company's most senior officers, establishes the overall risk management policies for the Company and reviews the Company's performance relative to these policies. The Management Committee has created several Risk Committees to assist it in monitoring and reviewing the Company's risk management practices. These Risk Committees, among other things, review the general framework, levels and monitoring procedures relating to the Company's market and credit risk profile, general sales practice policies, pricing of consumer loans and reserve adequacy, legal enforceability and operational and systems risks. The Controllers, Treasury, Law, Compliance and Governmental Affairs and Market Risk Departments, which are all independent of the Company's business units, assist senior management and the Risk Committees in monitoring and controlling the Company's risk profile. In addition, the Internal Audit Department, which also reports to senior management, evaluates the Company's operations and control environment through periodic examinations of business operational areas. The Company continues to be committed to employing qualified personnel with appropriate expertise in each of its various administrative and business areas to implement effectively the Company's risk management and monitoring systems and processes.

The following is a discussion of the Company's risk management policies and procedures for its principal risks (other than funding risk). The discussion focuses on the Company's securities trading (primarily its institutional trading activities) and consumer lending and related activities. The Company believes that these activities generate a substantial portion of its principal risks. This discussion and the estimated amounts of the Company's market risk exposure generated by the Company's statistical analyses are forward looking statements. However, the analyses used to assess such risks are not projections of future events, and actual results may vary significantly from such analyses due to actual events in the markets in which the Company operates and certain other factors described below.

MARKET RISK

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, volatilities, correlations or other market factors, such as liquidity, will result in losses for a specified position or portfolio. For a discussion of the Company's currency exposure relating to its net monetary investments in non-U.S. dollar functional currency subsidiaries, see Note 10 to the consolidated financial statements.

TRADING AND RELATED ACTIVITIES

Primary Market Risk Exposures and Market Risk Management

During fiscal 1997, the Company had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices — and associated volatilities and spreads — related to a broad spectrum of global markets in which it conducts its trading activities. The Company is exposed to interest rate risk as a result of maintaining market making and proprietary positions and trading in interest rate sensitive financial instruments (e.g., risk arising from changes in the level or volatility of interest rates, the timing of mortgage prepayments, the shape of the yield curve and credit spreads for corporate bonds and emerging market debt). The Company is exposed to equity price risk as a result of making markets in equity securities and equity derivatives and maintaining proprietary positions. The Company is exposed to foreign exchange rate risk in connection with making markets in foreign currencies, foreign currency options and maintaining foreign exchange positions. The Company's currency trading covers many foreign currencies including the yen, deutsche mark, pound sterling and French franc. The Company is exposed to commodity price risk as a result of trading in commodity-related derivatives and physical commodities.

The Company manages its trading positions by employing a variety of hedging strategies, which include diversification of risk exposures and the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., swaps, options, futures and forwards). The Company manages the market risk associated with its trading activities Company-wide, on a trading division level worldwide and on an individual product basis. The Company manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Company believes is well-diversified with respect to market risk factors. Market risk guidelines and limits have been approved for the Company and each trading division of the Company worldwide (equity, fixed income, foreign exchange and commodities). Discrete market risk limits are assigned to trading divisions and trading desks within trading areas which are compatible with the trading division limits. Trading division risk managers, desk risk managers and the Market Risk Department all monitor market risk measures against limits and report major market and position events to senior management.

The Market Risk Department independently reviews the Company's trading portfolios on a regular basis from a market risk perspective utilizing Value-at-Risk and other quantitative and qualitative risk measurements and analyses. The Company may use measures, such as rate sensitivity, convexity, volatility and time decay measurements, to estimate market risk and to assess the sensitivity of positions to changes in market conditions. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors, for certain products is performed periodically and reviewed by trading division risk managers, desk risk managers and the Market Risk Department.

Value-at-Risk

The Company uses a statistical technique known as Value-at-Risk ("VaR") to assist management in measuring its exposure to market risk related to its trading positions. The VaR model is one of the tools used by senior management to monitor and review the market risk exposure of the Company's trading portfolios.

VaR Methodology, Assumptions and Limitations. VaR incorporates numerous variables that could impact the fair value of the Company's trading portfolio, including equity and commodity prices, interest rates, foreign exchange rates and associated volatilities, as well as correlation that exists among these variables. The VaR model generally takes into account linear and non-linear exposures to price and interest rate risk and linear exposure to implied volatility risks. The Company estimates VaR using a model based on historical simulation with a confidence level of 99%. Historical simulation involves constructing a distribution of hypothetical daily changes in trading portfolio value. The hypothetical changes in portfolio value are based on daily observed percentage changes in key market indices or other market factors ("market risk factors") to which the portfolio is sensitive. In the case of the Company's VaR, the historical observation period is approximately four years. The Company's one-day 99% VaR corresponds to the negative change in portfolio value that, based on observed market risk factor moves, would have been exceeded with a frequency of 1%, or once in 100 trading days.

VaR models such as the Company's are continually evolving as trading portfolios become more diverse and modeling techniques and systems capabilities improve. During fiscal 1997, the position and risk coverage of the Company's VaR model were broadened and risk measurement methodologies were refined. Among the most significant enhancements were the incorporation of name-specific risk in global equities and in U.S. corporate and high-yield bonds. As of November 30, 1997, a total of approximately 420 market risk factor benchmark data series were incorporated in the Company's VaR model covering interest rates, equity prices, foreign exchange rates, commodity prices and associated volatilities. In addition, the model includes market risk factors for approximately 7,500 equity names and 60 classes of corporate and high-yield bonds.

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks; reflect risk reduction due to portfolio diversification; and are comprehensive yet relatively easy to interpret. However, VaR risk measures should be interpreted in light of the methodology's limitations, which include that past changes in market risk factors will not always accurately predict future changes in a portfolio's value; it is not possible to perfectly model all of a trading portfolio's market risk factors; published VaR results reflect past trading positions while future risk depends on future positions; and VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day. The Company is aware of these and other limitations and therefore uses VaR as only one component in its risk management review process. This process also incorporates stress testing and extensive risk monitoring and control at the trading desk, division and Company levels.

VaR for Fiscal 1997. The table below presents the results of the Company's VaR for each of the Company's primary market risk exposures and on an aggregate basis at November 30, 1997 incorporating substantially all financial instruments generating market risk (including funding liabilities related to trading positions and certain merchant banking positions). A small proportion of trading positions however, were not covered, and the modeling of the risk characteristics of some positions involved approximations which could be significant under certain circumstances. Market risks that the Company has found particularly difficult to incorporate in its VaR model include certain risks associated with mortgage-backed securities and certain commodity price risks (such as electricity price risk).

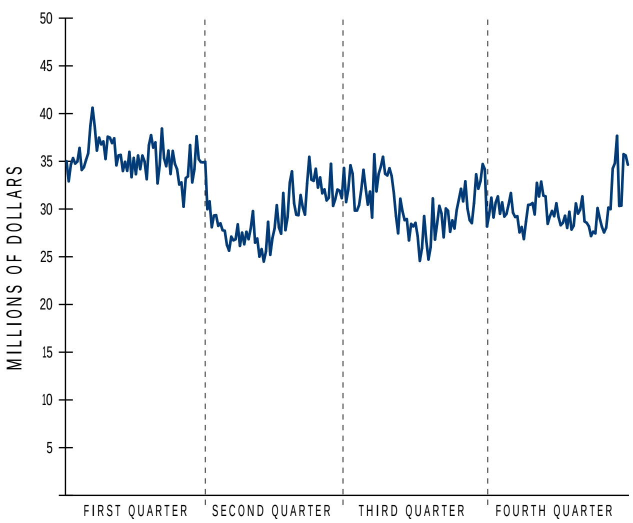
Since VaR is based on historical data and changes in market risk factor returns, VaR should not be viewed as predictive of the Company's future financial performance or its ability to manage and monitor risk and there can be no assurance that the Company's actual losses on a particular day will not exceed the VaR amounts indicated below or that such losses will not occur more than once in 100 trading days.

PRIMARY MARKET RISK CATEGORY (DOLLARS IN MILLIONS, PRE-TAX)	99%/ONE-DAY VaR AT NOVEMBER 30, 1997
Interest rate	$28
Equity price	17
Foreign exchange rate	7
Commodity price	6
Subtotal	58
Less diversification benefit[1]	19
Aggregate Value-at-Risk	$39

[1] Equals the difference between aggregate VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated 99%/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 such category.

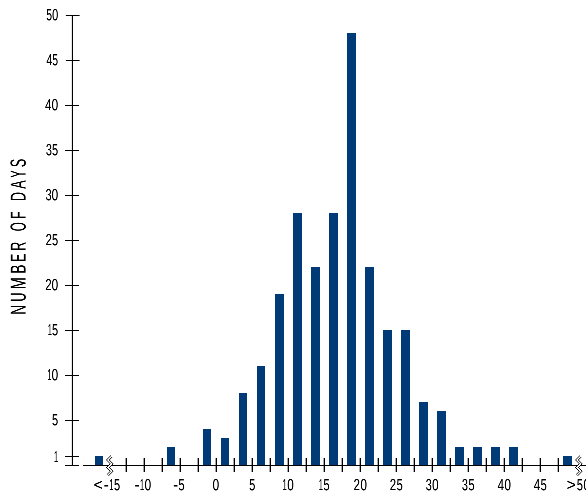
In order to facilitate comparison with other global financial services firms, the Company notes that its aggregate year-end VaR for other confidence levels and time horizons was as follows: $21 million for 95%/one-day VaR and $98 million for 99%/two-week VaR.

The chart below presents supplemental information regarding 99%/one-day VaR over the course of fiscal 1997 for substantially all of the Company's institutional trading activities. These activities include most of the Company's trading-related market risk, but exclude certain market risks incorporated in the Company's November 30, 1997 VaR calculation discussed above such as market risks related to the Company's retail trading activities, equity price risk in certain merchant banking positions and funding liabilities related to trading positions.



99%/ONE-DAY VALUE AT RISK

The Company evaluates the reasonableness of its VaR model by comparing the potential declines in portfolio values generated by the model with actual trading results. The histogram below shows daily trading revenue net of interest expense for fiscal 1997 for substantially all of the Company's institutional trading activities. In fiscal 1997, the Company did not incur any daily trading losses in its institutional trading business in excess of the corresponding daily 99%/one-day VaR.



DAILY TRADING REVENUE IN MILLIONS OF DOLLARS

CONSUMER LENDING AND RELATED ACTIVITIES

Interest Rate Risk and Management

In its consumer lending activities, the Company is exposed to market risk primarily from changes in interest rates. Such changes in interest rates impact interest earning assets, principally credit card and other consumer loans and net servicing fees received in connection with consumer loans sold through asset securitizations, as well as the interest sensitive liabilities which finance these assets, including asset securitizations, commercial paper, medium-term notes, long-term borrowings, deposits, asset-backed commercial paper, Fed Funds and short-term bank notes.

The Company's interest rate risk management policies are designed to reduce the potential volatility of earnings which may arise from changes in interest rates. This is accomplished primarily by matching the repricing of credit card and consumer loans, and the related financing. To the extent that asset and related financing repricing characteristics of a particular portfolio are not matched effectively, the Company utilizes interest rate derivative contracts, such as swap, cap and cost of funds agreements, to achieve its matched financing objectives. Interest rate swap agreements effectively convert the underlying asset or financing from fixed to variable repricing, variable to fixed repricing, or in more limited circumstances from variable to variable repricing. Interest rate cap agreements effectively establish a maximum interest rate on certain variable rate financings. Cost of funds agreements, entered into in connection with certain private label credit card merchant agreements, effectively establish a fixed rate of financing for the related private label credit card portfolio.

Sensitivity Analysis Methodology, Assumptions and Limitations
For its consumer lending activities, the Company uses a variety of techniques to assess its interest rate risk exposure, one of which is interest rate sensitivity simulation. For purposes of presenting the possible earnings effect of a hypothetical, adverse change in interest rates over the 12-month period from November 30, 1997, the Company assumed that all interest rate sensitive assets and liabilities will be impacted by a hypothetical, immediate 100 basis point increase in interest rates as of the beginning of the period.

Interest rate sensitive assets are assumed to be those for which the stated interest rate is not contractually fixed for the next 12-month period. Thus, assets which have a market-based index, such as the prime rate, which will reset before the end of the 12-month period, or assets whose rates are fixed at November 30, 1997, but which will mature, or otherwise contractually reset to a market-based indexed rate prior to the end of the 12-month period, are rate-sensitive. The latter category includes certain credit card loans which may be offered at below-market rates for an introductory period, such as for balance transfers and special promotional programs, after which the loans will contractually reprice in accordance with the Company's normal market-based pricing structure. For purposes of measuring rate-sensitivity for such loans, only the effect of the hypothetical 100 basis point change in the underlying market-based index, such as the prime rate, has been considered rather than the full change in the rate to which the loan would contractually reprice. For assets which have a fixed rate at November 30, 1997 but which contractually will, or are assumed to, reset to a market-based index during the next 12 months, earnings sensitivity is measured from the expected repricing date. In addition, for all interest rate sensitive assets, earnings sensitivity is calculated net of expected loan losses.

Interest rate sensitive liabilities are assumed to be those for which the stated interest rate is not contractually fixed for the next 12-month period. Thus, liabilities which have a market-based index, such as the prime, commercial paper, or LIBOR rates, which will reset before the end of the 12-month period, or liabilities whose rates are fixed at November 30, 1997, but which will mature and be replaced with a market-based indexed rate prior to the end of the 12-month period, are rate-sensitive. For liabilities which have a fixed rate at November 30, 1997, but which are assumed to reset to a market-based index during the next 12 months, earnings sensitivity is measured from the expected repricing date.

Assuming a hypothetical, immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities as of November 30, 1997, pretax income of consumer lending activities (Credit and Transaction Services) over the next 12-month period would be reduced by approximately $66 million.

The hypothetical model assumes that the balances of interest rate sensitive assets and liabilities at November 30, 1997 will remain constant over the next 12-month period. It does not assume any growth, strategic change in business focus, change in asset pricing philosophy, or change in asset/liability funding mix. Thus, this model represents a static analysis which cannot adequately portray how the Company would respond to significant changes in market conditions. Furthermore, the analysis does not necessarily reflect the Company's expectations regarding the movement of interest rates in the near term, including the likelihood of an immediate 100 basis point change in market interest rates nor necessarily the actual effect on earnings if such rate changes were to occur.

CREDIT RISK

The Company's exposure to credit risk arises from the possibility that a customer or counterparty to a transaction might fail to perform under its contractual commitment, resulting in the Company incurring losses. With respect to its trading activities, the Company has credit guidelines which limit the Company's credit exposure to any one counterparty. Specific credit risk limits based on the credit guidelines are also in place for each type of counterparty (by rating category) as well as for secondary positions in high-yield and emerging market debt. In addition to monitoring credit limits, the Company manages the credit exposure relating to the Company's trading activities by reviewing counterparty financial soundness periodically, by entering into master netting agreements and collateral arrangements with counterparties in appropriate circumstances and by limiting the duration of exposure. With respect to its consumer lending activities, potential credit card holders undergo credit reviews by the Credit Department to establish that they meet standards of ability and willingness to pay. Credit card applications are evaluated using credit scoring systems (statistical evaluation models that assign point values to information contained in applications). The Company's credit scoring systems are customized using the Company's criteria and historical data. Each cardmember's credit line is reviewed at least annually, and actions resulting from such review may include lowering a cardmember's credit line or closing the account. In addition, the Company reviews the creditworthiness of prospective Novus Network merchants and conducts annual reviews of merchants, with greatest scrutiny given to merchants with substantial sales volume.

OPERATIONAL RISK

Operational risk refers to the risk of loss resulting from improper processing of transactions or deficiencies in the Company's operating systems or control processes. With respect to its trading activities, the Company has developed and continues to enhance specific policies and procedures that are designed to provide, among other things, that all transactions are accurately recorded and properly reflected in the Company's books and records and confirmed on a timely basis; position valuations are subject to periodic independent review procedures; and collateral and adequate documentation (e.g., master agreements) are obtained from counterparties in appropriate circumstances. With respect to its consumer lending activities, operating systems are designed to provide for the efficient servicing of consumer loan accounts. The Company manages operational risk through its system of internal controls which provides checks and balances to ensure that transactions and other account-related activity (e.g., new account solicitation, transaction authorization and processing, billing and collection of delinquent accounts) are properly approved, processed, recorded and reconciled. Disaster recovery plans are in place on a Company-wide basis for critical systems, and redundancies are built into the systems as deemed appropriate.

LEGAL RISK

Legal risk includes the risk of non-compliance with applicable legal and regulatory requirements and the risk that a counterparty's performance obligations will be unenforceable. The Company is generally subject to extensive regulation in the different jurisdictions in which it conducts its business. The Company has established procedures based on legal and regulatory requirements on a worldwide basis that are designed to ensure compliance with all applicable statutory and regulatory requirements. The Company, principally through the Law, Compliance and Governmental Affairs Department, also has established procedures that are designed to ensure that senior management's policies relating to conduct, ethics and business practices are followed globally. In connection with its business, the Company has various procedures addressing issues, such as regulatory capital requirements, sales and trading practices, new products, use and safekeeping of customer funds and securities, credit granting, collection activities, money-laundering and recordkeeping. The Company also has established procedures to mitigate the risk that a counterparty's performance obligations will be unenforceable, including consideration of counterparty legal authority and capacity, adequacy of legal documentation, the permissibility of a transaction under applicable law and whether applicable bankruptcy or insolvency laws limit or alter contractual remedies.

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders of Morgan Stanley, Dean Witter, Discover & Co.

To the Board of Directors and Shareholders of Morgan Stanley, Dean Witter, Discover & Co.We have audited the accompanying consolidated statements of financial condition of Morgan Stanley , Dean Witter , Discover & Co. and subsidiaries at fiscal years ended November 30, 1997 and 1996, and the related consolidated statements of income, cash flows and changes in shareholders' equity for each of the three fiscal years in the period ended November 30, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. The consolidated financial statements give retroactive effect to the merger of Morgan Stanley Group Inc. and Dean Witter, Discover & Co., which has been accounted for as a pooling of interests as described in Note 1 to the consolidated financial statements. We did not audit the consolidated statement of financial condition of Morgan Stanley Group Inc. and subsidiaries as of November 30, 1996, or the related statements of income, cash flows and changes in shareholders' equity for the fiscal years ended November 30, 1996 and 1995, which statements reflect total assets of $196,446 million as of November 30, 1996 and total revenues of $13,144 million and $10,797 million for the fiscal years ended November 30, 1996 and 1995, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Morgan Stanley Group Inc. and subsidiaries for such periods, is based solely on the report of such other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and per for m the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of Morgan Stanley , Dean Witter , Discover & Co. and subsidiaries at fiscal years ended November 30, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three fiscal years in the period ended November 30, 1997, in conformity with generally accepted accounting principles.

FPO

New York, New York
January 23, 1998

(DOLLARS IN MILLIONS, EXCEPT SHARE DATA)	NOVEMBER 30, 1997	AT FISCAL YEAR-END 1996
ASSETS		
Cash and cash equivalents	$ 8,255	$ 6,544
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (including securities at fair value of $4,655 at November 30, 1997 and $3,759 at fiscal year-end 1996)	6,890	5,209
Financial instruments owned:		
U.S. government and agency securities	12,901	12,032
Other sovereign government obligations	22,900	19,473
Corporate and other debt	24,499	16,899
Corporate equities	10,329	12,662
Derivative contracts	17,146	11,220
Physical commodities	242	375
Securities purchased under agreements to resell	84,516	64,021
Securities borrowed	55,266	43,546
Receivables:		
Consumer loans (net of allowances of $884 at November 30, 1997 and $802 at fiscal year-end 1996)	20,033	21,262
Customers, net	12,259	8,600
Brokers, dealers and clearing organizations	13,263	5,421
Fees, interest and other	4,705	3,981
Office facilities, at cost (less accumulated depreciation and amortization of $1,279 at November 30, 1997 and $1,060 at fiscal year-end 1996)	1,705	1,681
Other assets	7,378	5,934
Total assets	$302,287	$238,860

(DOLLARS IN MILLIONS, EXCEPT SHARE DATA)	NOVEMBER 30, 1997	AT FISCAL YEAR-END 1996
LIABILITIES AND SHAREHOLDERS' EQUITY		
Commercial paper and other short-term borrowings	$ 22,614	$ 26,326
Deposits	8,993	7,213
Financial instruments sold, not yet purchased:		
U.S. government and agency securities	11,563	11,395
Other sovereign government obligations	12,095	6,513
Corporate and other debt	1,699	1,176
Corporate equities	13,305	8,900
Derivative contracts	15,599	9,982
Physical commodities	68	476
Securities sold under agreements to repurchase	111,680	86,863
Securities loaned	14,141	12,907
Payables:		
Customers	25,086	22,062
Brokers, dealers and clearing organizations	16,097	1,820
Interest and dividends	970	1,678
Other liabilities and accrued expenses	8,630	6,340
Long-term borrowings	24,792	22,642
	287,332	226,293
Capital Units	999	865
Commitments and contingencies		
Shareholders' equity:		
Preferred stock	876	1,223
Common stock[1] ($0.01 par value, 1,750,000,000 shares authorized, 602,829,994 and 611,314,509 shares issued, 594,708,971 and 572,682,876 shares outstanding at November 30, 1997 and fiscal year-end 1996)	6	6
Paid-in capital[1]	3,952	4,007
Retained earnings	9,330	7,477
Cumulative translation adjustments	(9)	(11)
Subtotal	14,155	12,702
Note receivable related to sale of preferred stock to ESOP	(68)	(78)
Common stock held in treasury, at cost[1] ($0.01 par value, 8,121,023 and 38,631,633 shares at November 30, 1997 and fiscal year-end 1996)	(250)	(1,005)
Stock compensation related adjustments	119	83
Total shareholders' equity	13,956	11,702
Total liabilities and shareholders' equity	$302,287	$238,860

[1] Amounts have been restated to reflect the Company's two-for-one stock split.
See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

FISCAL YEAR (DOLLARS IN MILLIONS, EXCEPT SHARE AND PER SHARE DATA)	1997	1996	1995
Revenues:			
Investment banking	$ 2,694	$ 2,190	$ 1,556
Principal transactions:			
Trading	3,191	2,659	1,685
Investments	463	86	121
Commissions	2,086	1,776	1,533
Fees:			
Asset management, distribution and administration	2,505	1,732	1,377
Merchant and cardmember	1,704	1,505	1,135
Servicing	762	809	680
Interest and dividends	13,583	11,288	10,530
Other	144	126	115
Total revenues	27,132	22,171	18,732
Interest expense	10,806	8,934	8,190
Provision for consumer loan losses	1,493	1,214	722
Net revenues	14,833	12,023	9,820
Non-interest expenses:			
Compensation and benefits	6,019	5,071	4,005
Occupancy and equipment	526	493	454
Brokerage, clearing and exchange fees	460	317	289
Information processing and communications	1,080	996	889
Marketing and business development	1,179	1,027	874
Professional services	451	334	252
Other	770	668	706
Relocation charge	–	–	59
Merger-related expenses	74	–	–
Total non-interest expenses	10,559	8,906	7,528
Income before income taxes	4,274	3,117	2,292
Provision for income taxes	1,688	1,137	827
Net income	$ 2,586	$ 1,980	$ 1,465
Preferred stock dividend requirements	$ 66	$ 66	$ 65
Earnings applicable to common shares(1)	$ 2,520	$ 1,914	$ 1,400
Earnings per common share(2)			
Primary	$ 4.25	$ 3.22	$ 2.30
Fully diluted	$ 4.15	$ 3.14	$ 2.25
Average common shares outstanding(2)			
Primary	594,182,885	594,478,535	608,246,433
Fully diluted	609,043,924	611,012,101	622,098,868

(1) Amounts shown are used to calculate primary earnings per common share.
(2) Per share and share data have been restated to reflect the Company's two-for-one stock split.
See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 2,586	$ 1,980	$ 1,465
Adjustments to reconcile net income to net cash used for operating activities:			
Non-cash charges included in net income:			
Defer red income taxes	(77)	(426)	(212)
Compensation payable in common or preferred stock	374	513	353
Depreciation and amortization	338	251	201
Relocation charge	Ð	Ð	59
Provision for losses on credit receivables	1,493	1,214	722
Changes in assets and liabilities:			
Cash and securities deposited with clearing organizations or segregated under federal and other regulations	(1,691)	(1,943)	519
Financial instruments owned, net of financial instruments sold, not yet purchased	1,730	(2,536)	(9,846)
Securities borrowed, net of securities loaned2,	(10,561)	(13,087)	489
Receivables and other assets	(13,808)	(8,227)	390
Payables and other liabilities	19,028	6,910	2,484
Net cash used for operating activities	(588)	(15,351)	(1,376)
CASH FLOWS FROM INVESTING ACTIVITIES			
Net (payments for) proceeds from:			
Of fice facilities	(301)	(152)	(403)
Purchase of Miller Anderson & Sherrerd, LLP , net of cash acquired	Ð	(200)	Ð
Purchase of Van Kampen American Capital, Inc., net of cash acquired	Ð	(986)	Ð
Net principal disbursed on consumer loans	(4,994)	(7,532)	(7,429)
Purchases of consumer loans	(11)	(51)	(307)
Sales of consumer loans	2,783	4,824	1,827
Other investing activities	(5)	(40)	(116)
Net cash used for investing activities	(2,528)	(4,137)	(6,428)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (payments for) proceeds from short-term borrowings	(1,336)	8,106	5,833
Securities sold under agreements to repurchase, net of securities purchased under agreements to resell	3,080	7,748	(1,384)
Proceeds from:			
Deposits	2,113	1,022	982
Issuance of cumulative prefer red stock	Ð	540	Ð
Issuance of common stock	224	156	122
Issuance of long-term borrowings	6,619	8,745	4,311
Issuance of Capital Units	134	Ð	513
Payments for:			
Repayments of long-term borrowings	(3,964)	(2,637)	(1,604)
Redemption of cumulative prefer red stock	(345)	(138)	Ð
Repurchases of common stock	(124)	(1,133)	(267)
Cash dividends	(416)	(313)	(235)
Net cash provided by financing activities	5,985	22,096	8,271
Dean Witter , Discover & Co' s net cash activity for the month of December 1996	(1,158)	Ð	Ð
Net increase in cash and cash equivalents	1,711	2,608	467
Cash and cash equivalents, at beginning of period	6,544	3,936	3,469
Cash and cash equivalents, at end of period	$ 8,255	$ 6,544	$ 3,936

See Notes to Consolidated Financial Statements.

(DOLLARS IN MILLIONS)	PREFERRED STOCK	COMMON STOCK[1]	PAID-IN CAPITAL[1]	RETAINED EARNINGS	CUMULATIVE TRANSLATION ADJUSTMENTS	NOTE RECEIVABLE RELATED TO SALE OF PREFERRED STOCK TO ESOP	COMMON STOCK HELD IN TREASURY, AT COST[1]	OTHER	TOTAL
BALANCE AT FISCAL YEAR-END 1994	$ 819	$6	$3,384	$4,758	$ (3)	$(109)	$ (310)	$ 36	$ 8,581
Net income	–	–	–	1,465	–	–	–	–	1,465
Dividends	–	–	–	(242)	–	–	–	–	(242)
Conversion of ESOP Preferred Stock	(1)	–	1	–	–	–	–	–	–
Issuance of common stock	–	–	73	–	–	–	90	–	163
Repurchases of common stock	–	–	–	–	–	–	(267)	–	(267)
Compensation payable in common stock	–	–	149	–	–	–	126	19	294
ESOP shares allocated, at cost	–	–	–	–	–	20	–	–	20
Translation adjustments	–	–	–	–	(6)	–	–	–	(6)
BALANCE AT FISCAL YEAR-END 1995	818	6	3,607	5,981	(9)	(89)	(361)	55	10,008
Net income	–	–	–	1,980	–	–	–	–	1,980
Dividends	–	–	–	(323)	–	–	–	–	(323)
Issuance of common stock in connection with MAS acquisition	–	–	9	–	–	–	74	–	83
Redemption of 9.36% Cumulative Preferred Stock	(138)	–	–	–	–	–	–	–	(138)
Issuance of 7-¾% Cumulative Preferred Stock	200	–	(3)	–	–	–	–	–	197
Issuance of Series A Fixed/Adjustable Rate Cumulative Preferred Stock	345	–	(2)	–	–	–	–	–	343
Conversion of ESOP Preferred Stock	(2)	–	2	–	–	–	–	–	–
Issuance of common stock	–	–	97	–	–	–	133	–	230
Repurchases of common stock	–	–	–	–	–	–	(1,133)	–	(1,133)
Retirement of treasury stock	–	–	(4)	(161)	–	–	165	–	–
Compensation payable in common stock	–	–	301	–	–	–	117	28	446
ESOP shares allocated, at cost	–	–	–	–	–	11	–	–	11
Translation adjustments	–	–	–	–	(2)	–	–	–	(2)

(DOLLARS IN MILLIONS)	PREFERRED STOCK	COMMON STOCK(1)	PAID-IN CAPITAL(1)	RETAINED EARNINGS	CUMULATIVE TRANSLATION ADJUSTMENTS	NOTE RECEIVABLE RELATED TO SALE OF PREFERRED STOCK TO ESOP	COMMON STOCK HELD IN TREASURY, AT COST(1)	OTHER	TOTAL
BALANCE AT FISCAL YEAR-END 1996	$1,223	$6	$4,007	$7,477	$(11)	$(78)	$(1,005)	$ 83	$11,702
Net income	–	–	–	2,586	–	–	–	–	2,586
Dividends	–	–	–	(387)	–	–	–	–	(387)
Redemption of 8.88% Cumulative Preferred Stock	(195)	–	–	–	–	–	–	–	(195)
Redemption of 8-¾% Cumulative Preferred Stock	(150)	–	–	–	–	–	–	–	(150)
Conversion of ESOP Preferred Stock	(2)	–	(1)	–	–	–	3	–	–
Issuance of common stock	–	–	(22)	–	–	–	246	–	224
Repurchases of common stock	–	–	–	–	–	–	(124)	–	(124)
Compensation payable in common stock	–	–	(38)	–	–	–	278	124	364
ESOP shares allocated, at cost	–	–	–	–	–	10	–	–	10
Retirement of treasury stock	–	–	(6)	(265)	–	–	271	–	–
Translation adjustments	–	–	–	–	2	–	–	–	2
Issuance of common stock in connection with Lombard acquisition	–	–	14	–	–	–	49	–	63
Adjustment for change in Dean Witter Discover's year-end	–	–	(2)	(81)	–	–	32	(88)	(139)
BALANCE AT NOVEMBER 30, 1997	$ 876	$6	$3,952	$9,330	$ (9)	$(68)	$ (250)	$119	$13,956

(1) Amounts have been restated to reflect the Company's two-for-one stock split.
See Notes to Consolidated Financial Statements.

1. INTRODUCTION AND BASIS OF PRESENTATION

THE MERGER

On May 31, 1997, Morgan Stanley Group Inc. ("Morgan Stanley") was merged with and into Dean Witter, Discover & Co. ("Dean Witter Discover") (the "Merger"). At that time, Dean Witter Discover changed its corporate name to Morgan Stanley, Dean Witter, Discover & Co. (the "Company"). In conjunction with the Merger, the Company issued 260,861,078 shares of its common stock, as each share of Morgan Stanley common stock then outstanding was converted into 1.65 shares of the Company's common stock (the "Exchange Ratio"). In addition, each share of Morgan Stanley preferred stock was converted into one share of a corresponding series of preferred stock of the Company. The Merger was treated as a tax-free exchange.

THE COMPANY

The Company's consolidated financial statements include the accounts of Morgan Stanley, Dean Witter, Discover & Co. and its U.S. and international subsidiaries, including Morgan Stanley & Co. Incorporated ("MS&Co."), Morgan Stanley & Co. International Limited ("MSIL"), Morgan Stanley Japan Limited ("MSJL"), Dean Witter Reynolds Inc. ("DWR"), Dean Witter InterCapital Inc. ("ICAP"), and NOVUS Credit Services Inc.

The Company, through its subsidiaries, provides a wide range of financial and securities services on a global basis and provides credit and transaction services nationally. Its securities and asset management businesses include securities underwriting, distribution and trading; merger, acquisition, restructuring, real estate, project finance and other corporate finance advisory activities; asset management; merchant banking and other principal investment activities; brokerage and research services; the trading of foreign exchange and commodities as well as derivatives on a broad range of asset categories, rates and indices; and global custody, securities clearance services and securities lending. The Company's credit and transaction services businesses include the operation of the NOVUS Network, a proprietary network of merchant and cash access locations, and the issuance of the Discover® Card and other proprietary general purpose credit cards.

The Company's services are provided to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

BASIS OF FINANCIAL INFORMATION

The consolidated financial statements give retroactive effect to the Merger, which was accounted for as a pooling of interests. The pooling of interests method of accounting requires the restatement of all periods presented as if Dean Witter Discover and Morgan Stanley had always been combined. The fiscal year end 1996, 1995 and 1994 shareholders' equity data reflects the accounts of the Company as if the preferred and additional common stock had been issued during all of the periods presented.

Prior to the consummation of the Merger, Dean Witter Discover's year ended on December 31 and Morgan Stanley's fiscal year ended on November 30. Subsequent to the Merger, the Company adopted a fiscal year end of November 30. In recording the pooling of interests combination, Dean Witter Discover's financial statements for the years ended December 31, 1996 and 1995 were combined with Morgan Stanley's financial statements for the fiscal years ended November 30, 1996 and 1995 (on a combined basis, "fiscal 1996" and "fiscal 1995," respectively). The Company's results for the 12 months ended November 30, 1997 ("fiscal 1997") include the results of Dean Witter Discover that were restated to conform with the new fiscal year-end date. The Company's results of operations for fiscal 1997 and fiscal 1996 include the month of December 1996 for Dean Witter Discover.

The separate results of operations for Dean Witter Discover and Morgan Stanley during the periods preceding the Merger that are included in the Company's Consolidated Statements of Income were as follows:

(DOLLARS IN MILLIONS)	SIX MONTHS ENDED MAY 31, 1997	FISCAL 1996	FISCAL 1995
Net Revenues:			
Dean Witter Discover	$3,318	$ 6,247	$5,698
Morgan Stanley	3,676	5,776	4,122
Combined	$6,994	$12,023	$9,820
Net Income:			
Dean Witter Discover	$ 472	$ 951	$ 856
Morgan Stanley	626	1,029	609
Combined	$1,098	$ 1,980	$1,465

In connection with the Merger, the Company incurred pre-tax expenses of $74 million ($63 million after tax) in the second fiscal quarter of 1997. These expenses consisted primarily of proxy solicitation costs, severance costs, financial advisory and accounting fees, legal costs and regulatory filing fees.

The consolidated financial statements are prepared in accordance with generally accepted accounting principles, which require management to make estimates and assumptions regarding certain trading inventory valuations, consumer loan loss levels, the potential outcome of litigation and other matters that affect the financial statements and related disclosures. Management believes that the estimates utilized in the preparation of the consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

Certain reclassifications have been made to prior year amounts to conform to the current presentation. All material intercompany balances and transactions have been eliminated.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less.

In connection with the fiscal 1997 purchase of Lombard Brokerage, Inc. ("Lombard"), the Company issued 1.9 million shares of common stock having a fair value on the date of acquisition of approximately $63 million. In connection with the purchase of Miller Anderson & Sherrerd, LLP ("MAS") in fiscal 1996, the Company issued approximately $66 million of notes payable, as well as 3.3 million shares of common stock having a fair value on the date of acquisition of approximately $83 million. In addition, in connection with the purchase in fiscal 1996 of VK/AC Holding, Inc., the parent of Van Kampen American Capital, Inc. ("VKAC"), the Company assumed approximately $162 million of long-term debt (see Note 16).

CONSUMER LOANS

Consumer loans, which consist primarily of credit card and other consumer installment loans, are reported at their principal amounts outstanding, less applicable allowances. Interest on consumer loans is credited to income as earned.

Interest is accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account becomes 180 days past due, except in the case of bankruptcies and fraudulent transactions, which are charged off earlier. The interest portion of charged off credit card loans is written off against interest revenue. Origination costs related to the issuance of credit cards are charged to earnings over periods not exceeding 12 months.

ALLOWANCE FOR CONSUMER LOAN LOSSES

The allowance for consumer loan losses is a significant estimate that is regularly evaluated by management for adequacy on a portfolio-by-portfolio basis and is established through a charge to the provision for loan losses. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to pay.

The Company uses the results of these evaluations to provide an allowance for loan losses. The exposure for credit losses for owned loans is influenced by the performance of the portfolio and other factors discussed above, with the Company absorbing all related losses. The exposure for credit losses for securitized loans is represented by the Company retaining a contingent risk based on the amount of credit enhancement provided.

In fiscal 1996, the Company revised its estimate of the allowance for losses for loans intended to be securitized. This revision was based on the Company's experience with credit losses related to securitized loans in a mature asset securitization market and the issuance of Statement of Financial Accounting Standards ("SFAS") No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," by the Financial Accounting Standards Board ("FASB"), which eliminated the uncertainty surrounding the appropriate accounting treatment for asset securitization transactions.

SECURITIZATION OF CONSUMER LOANS

The Company periodically sells consumer loans through asset securitizations and continues to service these loans. The revenues derived from servicing these loans are recorded in the consolidated statements of income as servicing fees over the term of the securitized loans rather than at the time the loans are sold. The effects of recording these revenues over the term of the securitized loans rather than at the time the loans were sold are not material.

FINANCIAL INSTRUMENTS USED FOR TRADING AND INVESTMENT

Financial instruments, including derivatives, used in the Company's trading activities are recorded at fair value, and unrealized gains and losses are reflected in trading revenues. Interest revenue and expense arising from financial instruments used in trading activities are reflected in the consolidated statements of income as interest revenue or expense. The fair values of the trading positions generally are based on listed market prices. If listed market prices are not available or if liquidating the Company's positions would reasonably be expected to impact market prices, fair value is determined based on other relevant factors, including dealer price quotations and price quotations for similar instruments traded in different markets, including markets located in different geographic areas. Fair values for certain derivative contracts are derived from pricing models which consider current market and contractual prices for the underlying financial instruments or commodities, as well as time value and yield curve or volatility factors underlying the positions. Purchases and sales of financial instruments are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company's dealings in over-the-counter ("OTC") financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

Equity securities purchased in connection with merchant banking and other principal investment activities are initially carried in the consolidated financial statements at their original costs. The carrying value of such equity securities is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by listed market prices or transactions which directly affect the value of such equity securities. Downward adjustments relating to such equity securities are made in the event that the Company determines that the eventual realizable value is less than the carrying value. The carrying value of investments made in connection with principal real estate activities which do not involve equity securities are adjusted periodically based on independent appraisals, estimates prepared by the Company of discounted future cash flows of the underlying real estate assets or other indicators of fair value.

Loans made in connection with merchant banking and investment banking activities are carried at cost plus accrued interest less reserves, if deemed necessary, for estimated losses.

FINANCIAL INSTRUMENTS USED FOR ASSET AND LIABILITY MANAGEMENT

The Company has entered into various contracts as hedges against specific assets, liabilities or anticipated transactions. These contracts include interest rate swaps, foreign exchange forwards, foreign currency swaps and cost of funds agreements. The Company uses interest rate and currency swaps to manage the interest rate and currency exposure arising from certain borrowings and to match the repricing characteristics of consumer loans with those of the borrowings that fund these loans. For contracts that are designated as hedges of the Company's assets and liabilities, gains and losses are deferred and recognized as adjustments to interest revenue or expense over the remaining life of the underlying assets or liabilities. For contracts that are hedges of asset securitizations, gains and losses are recognized as adjustments to servicing fees. Gains and losses resulting from the termination of hedge contracts prior to their stated maturity are recognized ratably over the remaining life of the instrument being hedged. The Company also uses foreign exchange forward contracts to manage the currency exposure relating to its net monetary investment in non-U.S. dollar functional currency operations. The gain or loss from revaluing these contracts is deferred and reported within cumulative translation adjustments in shareholders' equity, net of tax effects, with the related unrealized amounts due from or to counterparties included in receivables from or payables to brokers, dealers and clearing organizations.

SECURITIES TRANSACTIONS

Clients' securities transactions are recorded on a settlement date basis with related commission revenues and expenses recorded on trade date. Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements), principally government and agency securities, are treated as financing transactions and are carried at the amounts at which the securities will subsequently be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. It is the Company's policy to take possession of securities purchased under agreements to resell. The Company monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral.

Securities borrowed and securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions. The Company measures the fair value of the securities borrowed and loaned against the collateral on a daily basis. Additional collateral is obtained as necessary to ensure such transactions are adequately collateralized.

INVESTMENT BANKING

Underwriting revenues and fees for mergers and acquisitions and advisory assignments are recorded when services for the transaction are substantially completed. Transaction-related expenses are deferred and later expensed to match revenue recognition.

OFFICE FACILITIES

Office facilities are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of buildings and improvements are provided principally by the straight-line method, while depreciation and amortization of furniture, fixtures and equipment are provided by both straight-line and accelerated methods. Property and equipment are depreciated over the estimated useful lives of the related assets, while leasehold improvements are amortized over the lesser of the economic useful life of the asset or, where applicable, the remaining term of the lease.

INCOME TAXES

Income tax expense is provided for using the asset and liability method, under which deferred tax assets and liabilities are determined based upon the temporary differences between the financial statement and income tax bases of assets and liabilities, using currently enacted tax rates.

EARNINGS PER SHARE

The calculations of earnings per common share are based on the weighted average number of common shares and share equivalents outstanding and give effect to preferred stock dividend requirements. All per share and share amounts reflect stock splits effected by Dean Witter Discover and Morgan Stanley prior to the Merger, as well as the additional shares issued to Morgan Stanley shareholders pursuant to the Exchange Ratio.

CARDMEMBER REWARDS

Cardmember rewards, primarily the Cashback Bonus award, pursuant to which the Company annually pays Discover cardmembers and Private Issue cardmembers a percentage of their purchase amounts ranging up to one percent (up to two percent for the Private Issue Card), are based upon a cardmember's level of annual purchases. The liability for cardmember rewards expense, included in other liabilities and accrued expenses, is accrued at the time that qualified cardmember transactions occur and is calculated on an individual cardmember basis.

STOCK-BASED COMPENSATION

SFAS No. 123, "Accounting for Stock-Based Compensation" encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has elected to continue to account for its stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). Under the provisions of APB No. 25, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's common stock at the date of grant over the amount an employee must pay to acquire the stock.

TRANSLATION OF FOREIGN CURRENCIES

Assets and liabilities of operations having non-U.S. dollar functional currencies are translated at year-end rates of exchange, and the income statements are translated at weighted average rates of exchange for the year. In accordance with SFAS No. 52, "Foreign Currency Translation," gains or losses resulting from translating foreign currency financial statements, net of hedge gains or losses and related tax effects, are reflected in cumulative translation adjustments, a separate component of shareholders' equity. Gains or losses resulting from foreign currency transactions are included in net income.

GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets are amortized on a straight-line basis over periods from five to 40 years, generally not exceeding 25 years, and are periodically evaluated for impairment. At November 30, 1997, goodwill of approximately $1.4 billion was included in the Company's consolidated statements of financial condition as a component of Other Assets (see Note 16).

NEW ACCOUNTING PRONOUNCEMENTS

As of January 1, 1997, the Company adopted SFAS No. 125, which was effective for transfers of financial assets made after December 31, 1996, except for transfers of certain financial assets for which the effective date has been delayed for one year. SFAS No. 125 provides financial reporting standards for the derecognition and recognition of financial assets, including the distinction between transfers of financial assets which should be recorded as sales and those which should be recorded as secured borrowings. The adoption of the enacted provisions of SFAS No. 125 had no material effect on the Company's financial condition or results of operations. With respect to the provisions of SFAS No. 125 which became effective in 1998, the Company does not expect the impact of the adoption of the deferred provisions to be material to the Company's financial condition or results of operations.

In February 1997, the FASB issued SFAS No. 128, "Earnings per Share" ("EPS"), effective for periods ending after December 15, 1997, with restatement required for all prior periods. SFAS No. 128 replaces the current EPS categories of primary and fully diluted with "basic EPS," which reflects no dilution from common stock equivalents, and "diluted EPS," which reflects dilution from common stock equivalents and other dilutive securities based on the average price per share of the Company's common stock during the period. The adoption of SFAS No. 128 would not have had, and is not expected to have, a material effect on the Company's EPS calculations.

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income" and SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." These statements, which are effective for fiscal years beginning after December 15, 1997, establish standards for the reporting and display of comprehensive income and the disclosure requirements related to segments.

3. CONSUMER LOANS

Consumer loans were as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Credit card	$20,914	$22,062
Other consumer installment	3	2
	20,917	22,064
Less		
Allowance for loan losses	884	802
Consumer loans, net	$20,033	$21,262

Activity in the allowance for consumer loan losses was as follows:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Balance beginning of period	$ 781[2]	$ 709	$ 556
Additions			
Provision for loan losses	1,493	1,214	722
Purchase of loan portfolios	–	4	31
Total additions	1,493	1,218	753
Deductions			
Charge-offs	1,639	1,182	711
Recoveries	(196)	(155)	(120)
Net charge-offs	1,443	1,027	591
Other[1]	53	(98)	(9)
Balance end of period	$ 884	$ 802	$ 709

(1) Primarily reflects net transfers related to asset securitizations.
(2) Beginning balance differs from the fiscal 1996 end of period balance due to the Company's change in fiscal year-end.

Interest accrued on loans subsequently charged off, recorded as a reduction of interest revenue, was $301 million, $181 million and $115 million in fiscal 1997, 1996 and 1995.

At fiscal year-end 1997 and 1996, $5,385 million and $5,695 million of the Company's consumer loans had minimum contractual maturities of less than one year. Because of the uncertainty regarding consumer loan repayment patterns, which historically have been higher than contractually required minimum payments, this amount may not necessarily be indicative of the Company's actual consumer loan repayments.

At fiscal year-end 1997, the Company had commitments to extend credit in the amount of $178.5 billion. Commitments to extend credit arise from agreements to extend to customers unused lines of credit on certain credit cards provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness.

The Company received proceeds from asset securitizations of $2,783 million, $4,528 million, and $1,827 million in fiscal 1997, 1996 and 1995. The uncollected balances of consumer loans sold through asset securitizations were $15,033 million and $13,197 million at fiscal year-end 1997 and 1996.

The Company uses interest rate exchange agreements to hedge the risk from changes in interest rates on servicing fee revenues (which are derived from loans sold through asset securitizations). Gains and losses from these agreements are recognized as adjustments to servicing fees. Under these interest rate exchange agreements the Company primarily pays floating rates and receives fixed rates.

In connection with certain asset securitizations, the Company has written interest rate cap agreements with notional amounts of $303 million and strike rates of 11%. Any settlement payments made under these agreements will generally be passed back to the Company through an adjustment of servicing fees, although this is subject to the risk of counterparty nonperformance. At fiscal year end 1997 and 1996, the fair values of these agreements were not material. No payments have been made by the Company under these agreements, which expire through 2000.

The estimated fair value of the Company's consumer loans approximated carrying value at fiscal year end 1997 and 1996. The Company's consumer loan portfolio, including securitized loans, is geographically diverse, with a distribution approximating that of the population of the United States.

4. DEPOSITS

Deposits were as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Demand, passbook and money market accounts	$1,210	$1,716
Consumer certificate accounts	1,498	1,354
$100,000 minimum certificate accounts	6,285	4,143
Total	$8,993	$7,213

The weighted average interest rates of interest-bearing deposits outstanding during fiscal 1997 and 1996 were 6.2% and 6.3%.

At fiscal year-end 1997 and 1996, the notional amounts of interest rate exchange agreements that hedged deposits outstanding were $535 million and $495 million and had fair values of $7 million and $5 million. Under these interest rate exchange agreements the Company primarily pays floating rates and receives fixed rates. At November 30, 1997, the weighted average interest rate of the Company's deposits including the effect of interest rate exchange agreements was 6.16%.

At November 30, 1997, certificate accounts maturing over the next five years were as follows:

(DOLLARS IN MILLIONS)

1998	$3,810
1999	1,579
2000	963
2001	819
2002	312

The estimated fair value of the Company's deposits, using current rates for deposits with similar maturities, approximated carrying value at fiscal year-end 1997 and 1996.

5. SHORT-TERM BORROWINGS

At fiscal year-end 1997 and 1996, commercial paper in the amount of $15,447 million and $18,890 million, with weighted average interest rates of 5.5% and 5.4%, was outstanding.

At fiscal year-end 1997 and 1996, the notional amounts of interest rate contracts that hedged commercial paper outstanding were $732 million and $808 million and had fair values of $(5) million and $(7) million. These interest rate contracts converted the commercial paper to fixed rates. These contracts had no material effect on the weighted average interest rates of commercial paper.

At fiscal year-end 1997 and 1996, other short-term borrowings of $7,167 million and $7,436 million were outstanding. These borrowings included bank loans, federal funds and bank notes.

In November 1997, the Company replaced the predecessor Dean Witter Discover and Morgan Stanley holding company senior revolving credit agreements with a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the "MSDWD Facility"). Under the terms of the MSDWD Facility, the banks are committed to provide up to $6.0 billion. The MSDWD Facility contains restrictive covenants which require, among other things, that the Company maintain shareholders' equity of at least $8.3 billion at all times. The Company believes that the covenant restrictions will not impair the Company's ability to pay its current level of dividends. At November 30, 1997, no borrowings were outstanding under the MSDWD Facility.

Riverwoods Funding Corporation ("RFC"), an entity included in the consolidated financial statements of the Company, maintains a senior bank credit facility to support the issuance of asset-backed commercial paper. In fiscal 1997, RFC renewed this facility and increased its amount to $2.55 billion from $2.1 billion. Under the terms of the asset-backed commercial paper program, certain assets of RFC were subject to a lien in the amount of $2.6 billion at November 30, 1997. RFC has never borrowed from its senior bank credit facility.

The Company maintains a master collateral facility that enables MS&Co. to pledge certain collateral to secure loan arrangements, letters of credit and other financial accommodations (the "MS&Co. Facility"). As part of the MS&Co. Facility, MS&Co. also maintains a secured committed credit agreement with a group of banks that are parties to the master collateral facility under which such banks are committed to provide up to $1.5 billion. The credit agreement contains restrictive covenants which require, among other things, that MS&Co. maintain specified levels of consolidated shareholders' equity and Net Capital, as defined. In January 1998, the MS&Co. Facility was renewed and the amount of the commitment of the credit agreement was increased to $1.875 billion. At November 30, 1997, no borrowings were outstanding under the MS&Co. Facility.

The Company also maintains a revolving committed financing facility that enables MSIL to secure committed funding from a syndicate of banks by providing a broad range of collateral under repurchase agreements (the "MSIL Facility"). Such banks are committed to provide up to an aggregate of $1.85 billion available in 12 major currencies. The facility agreements contain restrictive covenants which require, among other things, that MSIL maintain specified levels of Shareholders' Equity and Financial Resources, each as defined. At November 30, 1997, no borrowings were outstanding under the MSIL Facility.

The Company anticipates that it will utilize the MSDWD Facility, the MS&Co. Facility or the MSIL Facility for short-term funding from time to time.

6. LONG-TERM BORROWINGS

MATURITIES AND TERMS

Long-term borrowings at fiscal year-end consist of the following:

	U.S. DOLLAR			NON-U.S. DOLLAR[1]		AT FISCAL YEAR-END	
(DOLLARS IN MILLIONS)	FIXED RATE	FLOATING RATE	INDEX/ EQUITY LINKED	FIXED RATE	FLOATING RATE	1997 TOTAL	1996 TOTAL
Due in fiscal 1997	$ –	$ –	$ –	$ –	$ –	$ –	$ 4,057
Due in fiscal 1998	1,190	3,488	747	468	277	6,170	5,616
Due in fiscal 1999	774	2,474	488	200	757	4,693	3,218
Due in fiscal 2000	774	1,501	22	48	73	2,418	1,686
Due in fiscal 2001	1,335	719	68	52	108	2,282	2,226
Due in fiscal 2002	1,077	1,097	91	17	341	2,623	1,299
Thereafter	5,460	140	194	774	38	6,606	4,540
Total	$10,610	$9,419	$1,610	$1,559	$1,594	$24,792	$22,642
Weighted average coupon at fiscal year-end	7.1%	5.9%	n/a	5.3%	5.0%	6.1%	6.2%

[1] Weighted average coupon was calculated utilizing non-U.S. dollar interest rates.

MEDIUM-TERM NOTES

Included in the table above are medium-term notes of $14,049 million and $13,272 million at fiscal year-end 1997 and 1996. The effective weighted average interest rate on all medium-term notes was 5.9% in fiscal 1997 and 5.8% in fiscal 1996. Maturities of these notes range from fiscal 1998 through fiscal 2023.

STRUCTURED BORROWINGS

U.S. dollar index/equity linked borrowings include various structured instruments whose payments and redemption values are linked to the performance of a specific index (i.e., Standard & Poor's 500), a basket of stocks or a specific equity security. To minimize the exposure resulting from movements in the underlying equity position or index, the Company has entered into various equity swap contracts and purchased options which effectively convert the borrowing costs into floating rates based upon London Interbank Offered Rates ("LIBOR"). These instruments are included in the preceding table at their redemption values based on the performance of the underlying indices, baskets of stocks, or specific equity securities at fiscal year-end 1997 and 1996.

OTHER BORROWINGS

U.S. dollar contractual floating rate borrowings bear interest based on a variety of money market indices, including LIBOR and Federal Funds rates. Non-U.S. dollar contractual floating rate borrowings bear interest based on Euro floating rates.

Included in the Company's long-term borrowings are subordinated notes of $1,302 million and $1,325 million at fiscal year-end 1997 and 1996 respectively. The effective weighted average interest rate on these subordinated notes was 7.2% in fiscal 1997 and 7.0% in fiscal 1996. Maturities of the subordinated notes range from fiscal 1999 to fiscal 2016.

Certain of the Company's long-term borrowings are redeemable prior to maturity at the option of the holder. These notes contain certain provisions which effectively enable noteholders to put the notes back to the Company and therefore are scheduled in the foregoing table to mature in fiscal 1998 through fiscal 1999. The stated maturities of these notes, which aggregate $1,495 million, are from fiscal 1998 to fiscal 2004.

MS&Co., a registered U.S. broker-dealer subsidiary of the Company, has outstanding approximately $313 million of 6.81% fixed rate subordinated Series C notes,

$96 million of 7.03% fixed rate subordinated Series D notes, $82 million of 7.28% fixed rate subordinated Series E notes and $25 million of 7.82% fixed rate subordinated Series F notes. These notes have maturities from 2001 to 2016. The terms of such notes contain restrictive covenants which require, among other things, that MS&Co. maintain specified levels of Consolidated Tangible Net Worth and Net Capital, each as defined.

ASSET AND LIABILITY MANAGEMENT

A portion of the Company's fixed rate long-term borrowings is used to fund highly liquid marketable securities, short-term receivables arising from securities transactions and consumer loans. The Company uses interest rate swaps to more closely match the duration of these borrowings to the duration of the assets being funded and to minimize interest rate risk. These swaps effectively convert certain of the Company's fixed rate borrowings into floating rate obligations. In addition, for non-U.S. dollar currency borrowings that are not used to fund assets in the same currency, the Company has entered into currency swaps which effectively convert the borrowings into U.S. dollar obligations. The Company's use of swaps for asset and liability management reduced its interest expense and effective average borrowing rate as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996	1995
Net reduction in interest expense from swaps for the fiscal year	$21	$29	$20
Weighted average coupon of long-term borrowings at fiscal year-end[1]	6.1%	6.2%	6.6%
Effective average borrowing rate for long-term borrowings after swaps at fiscal year-end[1]	6.0%	6.1%	6.4%

[1] Included in the weighted average and effective average calculations are non-U.S. dollar interest rates.

The effective weighted average interest rate on the Company's index/equity linked notes, which is not included in the table above, was 5.7% and 5.6% in fiscal 1997 and fiscal 1996, respectively, after giving effect to the related hedges.

The table below summarizes the notional or contract amounts of these swaps by maturity and weighted average interest rates to be received and paid at fiscal year end 1997. Swaps utilized to hedge the Company's structured borrowings are presented at their redemption values:

	U.S. DOLLAR			NON-U.S. DOLLAR[1]			
(DOLLARS IN MILLIONS)	RECEIVE FIXED PAY FLOATING	RECEIVE FLOATING PAY FLOATING	INDEX/ EQUITY LINKED	RECEIVE FIXED PAY FLOATING	RECEIVE FLOATING PAY FLOATING[2]	NOV. 30, 1997 TOTAL	AT FISCAL YEAR-END 1996 TOTAL
Maturing in fiscal 1997	$ –	$ –	$ –	$ –	$ –	$ –	$ 1,878
Maturing in fiscal 1998	974	320	747	468	235	2,744	2,411
Maturing in fiscal 1999	542	375	488	187	380	1,972	1,668
Maturing in fiscal 2000	375	120	22	48	73	638	379
Maturing in fiscal 2001	924	5	68	52	33	1,082	1,093
Maturing in fiscal 2002	720	–	91	17	3	831	533
Thereafter	3,434	–	194	774	38	4,440	2,227
Total	$6,969	$820	$1,610	$1,546	$762	$11,707	$10,189
Weighted average at fiscal year-end[3]							
Receive rate	6.72%	6.17%	n/a	5.06%	3.67%		
Pay rate	5.83%	5.96%	n/a	5.87%	6.75%		

(1) The differences between the receive rate and the pay rate may reflect differences in the rate of interest associated with the underlying currency.
(2) These amounts include currency swaps used to effectively convert borrowings denominated in one currency into obligations denominated in another currency.
(3) The table was prepared under the assumption that interest rates remain constant at year-end levels. The variable interest rates to be received or paid will change to the extent that rates fluctuate. Such changes may be substantial. Variable rates presented generally are based on LIBOR or Treasury bill rates.

As noted above, the Company uses interest rate and currency swaps to modify the terms of its existing borrowings. Activity during the periods in the notional value of the swap contracts used by the Company for asset and liability management (and the unrecognized gain at period end) is summarized in the table below:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996
Notional value at beginning of period	$10,189	$ 7,355
Additions	3,567	4,137
Matured	(1,657)	(1,068)
Terminated	(216)	(157)
Effect of foreign currency translation on non-U.S. dollar notional values and changes in redemption values on structured borrowings	(176)	(78)
Notional value at fiscal year-end	$11,707	$10,189
Unrecognized gain at fiscal year-end	$ 104	$ 139

The Company also uses interest rate swaps to modify certain of its repurchase financing agreements. The Company had interest rate swaps with notional values of approximately $1.8 billion and $1.1 billion at fiscal year end 1997 and 1996, and unrecognized gains of approximately $13 million and $14 million as of fiscal year end 1997 and 1996, for such purpose. The unrecognized gains on these swaps were offset by unrecognized losses on certain of the Company's repurchase financing agreements.

The estimated fair value of the Company's long-term borrowings approximated carrying value based on rates available to the Company at year-end for borrowings with similar terms and maturities.

Cash paid for interest for the Company's borrowings and deposits approximated interest expense in fiscal 1997, 1996 and 1995.

7. COMMITMENTS AND CONTINGENCIES

The Company has non-cancelable operating leases covering office space and equipment. At fiscal year-end 1997, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

(DOLLARS IN MILLIONS)	
1998	$309
1999	268
2000	240
2001	210
2002	183
Thereafter	701

Occupancy lease agreements, in addition to base rentals, generally provide for rent and operating expense escalations resulting from increased assessments for real estate taxes and other charges. Total rent expense, net of sublease rental income, was $262 million, $264 million and $271 million in fiscal 1997, 1996 and 1995, respectively.

The Company has an agreement with IBM, under which the Company receives information processing, data networking and related services. Under the terms of the agreement, the Company has an aggregate minimum annual commitment of $166 million subject to annual cost of living adjustments.

During fiscal 1995, the Company recognized a pre-tax charge of $59 million ($39 million after tax, which reduced primary and fully diluted earnings per share by $0.06). The charge was in connection with the relocation of the majority of Morgan Stanley's New York City employees from leased space at 1221 and 1251 Avenue of the Americas to space in the Company's buildings at 1585 Broadway and 750 Seventh Avenue that were purchased in fiscal 1993 and fiscal 1994, respectively, as well as a move to new leased office space in Tokyo. The charge specifically covered the Company's termination of certain leased office space and the write-off of remaining leasehold improvements in both cities.

In the normal course of business, the Company has been named as a defendant in various lawsuits and has been involved in certain investigations and proceedings. Some of these matters involve claims for substantial amounts. Although the ultimate outcome of these matters cannot be ascertained at this time, it is the opinion of management, after consultation with outside counsel, that the resolution of such matters will not have a material adverse effect on the consolidated financial condition of the Company, but may be material to the Company's operating results for any particular period, depending upon the level of the Company's income for such period.

The Company had approximately $5.5 billion of letters of credit outstanding at November 30, 1997 to satisfy various collateral requirements.

Financial instruments sold, not yet purchased represent obligations of the Company to deliver specified financial instruments at contracted prices, thereby creating commitments to purchase the financial instruments in the market at prevailing prices. Consequently, the Company's ultimate obligation to satisfy the sale of financial instruments sold, not yet purchased may exceed the amounts recognized in the consolidated statements of financial condition.

The Company also has commitments to fund certain fixed assets and other less liquid investments, including at November 30, 1997, approximately $150 million in connection with its merchant banking and other principal investment activities. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit to clients (including subordinated loans on an interim basis to leveraged companies associated with its investment banking and its merchant banking and other principal investment activities), that may subject the Company to increased credit and liquidity risks.

8. TRADING ACTIVITIES

TRADING REVENUES

The Company's trading activities include providing securities brokerage, derivatives dealing, and underwriting services to clients. While trading activities are generated by client order flow, the Company also takes proprietary positions based on expectations of future market movements and conditions. The Company's trading strategies rely on the integrated management of its client-driven and proprietary transactions, along with the hedging and financing of these positions.

The Company manages its trading businesses by product groupings and therefore has established distinct, worldwide trading divisions having responsibility for equity, fixed income, foreign exchange and commodities products. Because of the integrated nature of the markets for such products, each product area trades cash instruments as well as related derivative products (i.e., options, swaps, futures, forwards and other contracts with respect to such underlying instruments or commodities). Revenues related to principal trading are summarized below by trading division:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Equities	$1,310	$1,181	$ 728
Fixed Income	1,187	1,172	710
Foreign Exchange	500	169	177
Commodities	194	137	70
Total principal trading revenues	$3,191	$2,659	$1,685

Interest revenue and expense are integral components of trading activities. In assessing the profitability of trading activities, the Company views net interest and principal trading revenues in the aggregate.

The Company's trading portfolios are managed with a view toward the risk and profitability of the portfolios to the Company. The nature of the equities, fixed income, foreign exchange and commodities activities conducted by the Company, including the use of derivative products in these businesses, and the market, credit and concentration risk management policies and procedures covering these activities are discussed below.

EQUITIES

The Company makes markets and trades in the global secondary markets for equities and convertible debt and is a dealer in equity warrants, exchange traded and OTC equity options, index futures, equity swaps and other sophisticated equity derivatives. The Company's activities as a dealer primarily are client-driven, with the objective of meeting clients' needs while earning a spread between the premiums paid or received on its contracts with clients and the cost of hedging such transactions in the cash or forward market or with other derivative transactions. The Company limits its market risk related to these contracts, which stems primarily from underlying equity/index price and volatility movements, by employing a variety of hedging strategies, such as delta hedging (delta is a measure of a derivative contract's price movement based on the movement of the price of the security or index underlying the contract). The Company also takes proprietary positions in the global equity markets by using derivatives, most commonly futures and options, in addition to cash positions, intending to profit from market price and volatility movements in the underlying equities or indices positioned.

Equity option contracts give the purchaser of the contract the right to buy (call) or sell (put) the equity security or index underlying the contract at an agreed-upon price (strike price) during or at the conclusion of a specified period of time. The seller (writer) of the contract is subject to market risk, and the purchaser is subject to market risk (to the extent of the premium paid) and credit risk. Equity swap contracts are contractual agreements whereby one counterparty receives the appreciation (or pays the depreciation) on an equity investment in return for paying another rate, often based upon equity index movements or interest rates. The counterparties to the Company's equity transactions include commercial banks, investment banks, broker-dealers, investment funds and industrial companies.

FIXED INCOME

The Company is a market-maker for U.S. and non-U.S. government securities, corporate bonds, money market instruments, medium-term notes and Eurobonds, high-yield securities, emerging market securities, mortgage- and other asset-backed securities, preferred stock and tax-exempt securities. In addition, the Company is a dealer in interest rate and currency swaps and other related derivative products, OTC options on U.S. and foreign government bonds and mortgage-backed forward agreements ("TBA"), options and swaps. In this capacity, the Company facilitates asset and liability management for its customers in interest rate and currency swaps and related products and OTC government bond options.

Swaps used in fixed income trading are, for the most part, contractual agreements to exchange interest payment streams (i.e., an interest rate swap may involve exchanging fixed for floating interest payments) or currencies (i.e., a currency swap may involve exchanging yen for U.S. dollars in one year at an agreed-upon exchange rate). The Company profits by earning a spread between the premium paid or received for these contracts and the cost of hedging such contracts. The Company seeks to manage the market risk of its swap portfolio, which stems from interest rate and currency movements and volatility, by using modeling that quantifies the sensitivity of its portfolio to movements in interest rates and currencies and by adding positions to or selling positions from its portfolio as needed to minimize such sensitivity. Typically, the Company adjusts its positions by entering into additional swaps or interest rate and foreign currency futures, foreign currency forwards and by purchasing or selling additional underlying government bonds. The Company manages the risk related to its option portfolio by using a variety of hedging strategies such as delta hedging, which includes the use of futures and forward contracts to hedge market risk. The Company also is involved in using debt securities to structure products with multiple risk/return factors designed to suit investor objectives.

The Company is an underwriter of and a market-maker in mortgage-backed securities and collateralized mortgage obligations ("CMO") as well as commercial, residential and real estate loan products. The Company also structures mortgage-backed swaps for its clients, enabling them to derive the cash flows from an underlying mortgage-backed security without purchasing the cash position. The Company earns the spread between the premium inherent in the swap and the cost of hedging the swap contract through the use of cash positions or TBA contracts. The Company also uses TBAs in its role as a dealer in mortgage-backed securities and facilitates customer trades by taking positions in the TBA market. Typically, these positions are hedged by offsetting TBA contracts or underlying cash positions. The Company profits by earning the bid-offer spread on such transactions. Further, the Company uses TBAs to ensure delivery of underlying mortgage-backed securities in its CMO issuance business. As is the case with all mortgage-backed products, market risk associated with these instruments results from interest rate fluctuations and changes in mortgage prepayment speeds. The counterparties to the Company's fixed income transactions include investment advisors, commercial banks, insurance companies, investment funds and industrial companies.

FOREIGN EXCHANGE

The Company is a market-maker in a number of foreign currencies. In this business, it actively trades currencies in the spot and forward markets earning a dealer spread. The Company seeks to manage its market risk by entering into offsetting positions. The Company conducts an arbitrage business in which it seeks to profit from inefficiencies between the futures, spot and forward markets. The Company also makes a market in foreign currency options. This business largely is client-driven and involves the purchasing and writing of European and American style options and certain sophisticated products to meet specific client needs. The Company profits in this business by earning spreads between the options' premiums and the cost of the hedging of such positions. The Company limits its market risk by using a variety of hedging strategies, including the buying and selling of the currencies underlying the options based upon the options' delta equivalent. Foreign exchange option contracts give the purchaser of the contract the right to buy (call) or sell (put) the currency underlying the contract at an agreed-upon strike price at or over a specified period of time. Forward contracts and futures represent commitments to purchase or sell the underlying currencies at a specified future date at a specified price. The Company also takes proprietary positions in currencies to profit from market price and volatility movements in the currencies positioned.

The majority of the Company's foreign exchange business relates to major foreign currencies such as deutsche marks, yen, pound sterling, French francs, Swiss francs, Italian lire and Canadian dollars. The balance of the business covers a broad range of other currencies. The counterparties to the Company's foreign exchange transactions include commercial banks, investment banks, broker-dealers, investment funds and industrial companies.

COMMODITIES

The Company, as a major participant in the world commodities markets, trades in physical precious, base and platinum group metals, electricity, energy products (principally oil, refined oil products and natural gas) as well as a variety of derivatives related to these commodities such as futures, forwards and exchange traded and OTC options and swaps. Through these activities, the Company provides clients with a ready market to satisfy end users' current raw material needs and facilitates their ability to hedge price fluctuations related to future inventory needs. The former activity at times requires the positioning of physical commodities. Derivatives on those commodities, such as futures, forwards and options, often are used to hedge price movements in the underlying physical inventory. The Company profits as a market-maker in physical commodities by capturing the bid-offer spread inherent in the physical markets.

To facilitate hedging for its clients, the Company often is required to take positions in the commodity markets in the form of forward, option and swap contracts involving oil, natural gas, precious and base metals, and electricity. The Company generally hedges these positions by using a variety of hedging techniques such as delta hedging, whereby the Company takes positions in the physical markets and/or positions in other commodity derivatives such as futures and forwards to offset the market risk in the underlying derivative. The Company profits from this business by earning a spread between the premiums paid or received for these derivatives and the cost of hedging such derivatives.

The Company also maintains proprietary trading positions in commodity derivatives, including futures, forwards and options in addition to physical commodities, to profit from price and volatility movements in the underlying commodities markets.

Forward, option and swap contracts on commodities are structured similarly to like-kind derivative contracts for cash financial instruments. The counterparties to OTC commodity contracts include precious metals producers, refiners and consumers as well as shippers, central banks, and oil, gas and electricity producers.

The following discussions of risk management, market risk, credit risk, concentration risk and customer activities relate to the Company's trading activities.

RISK MANAGEMENT

Risk management at the Company is a multi-faceted process with independent oversight which requires constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administrative and business functions to assist in the identification, assessment and control of various risks. In recognition of the increasingly varied and complex nature of the financial services business, the Company's risk management policies and procedures are evolutionary in nature and are subject to ongoing review and modification. Many of the Company's risk management and control practices are subject to periodic review by the Company's internal auditors as well as to interactions with various regulatory authorities.

The Management Committee, composed of the Company's most senior officers, establishes the overall risk management policies for the Company and reviews the Company's performance relative to these policies. The Management Committee has created several Risk Committees to assist it in monitoring and reviewing the Company's risk management practices. These Risk Committees, among other things, review the general framework, levels and monitoring procedures relating to the Company's market and credit risk profile, general sales practice policies, legal enforceability and operational and systems risks. The Controllers, Treasury, Law, Compliance and Governmental Affairs and Market Risk Departments, which are all independent of the Company's business units, assist senior management and the Risk Committees in monitoring and controlling the Company's risk profile. In addition, the Internal Audit Department, which also reports to senior management, evaluates the Company's operations and control environment through periodic examinations of business operational areas. The Company continues to be committed to employing qualified personnel with appropriate expertise in each of its various administrative and business areas to implement effectively the Company's risk management and monitoring systems and processes.

MARKET RISK

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

The Company manages the market risk associated with its trading activities Company-wide, on a trading division level worldwide and on an individual product basis. Market risk guidelines and limits have been approved for the Company and each trading division of the Company worldwide. Discrete market risk limits are assigned to trading divisions and trading desks within trading areas which are compatible with the trading division limits. Trading division risk managers, desk risk managers and the Market Risk Department all monitor market risk measures against limits and report major market and position events to senior management.

The Market Risk Department independently reviews the Company's trading portfolios on a regular basis from a market risk perspective utilizing Value-at-Risk and other quantitative and qualitative risk measurements and analyses. The Company may use measures, such as rate sensitivity, convexity, volatility and time decay measurements, to estimate market risk and to assess the sensitivity of positions to changes in market conditions. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors, for certain products is performed periodically and is reviewed by trading division risk managers, desk risk managers and the Market Risk Department.

CREDIT RISK

The Company's exposure to credit risk arises from the possibility that a counterparty to a transaction might fail to perform under its contractual commitment, resulting in the Company incurring losses. The Company has credit guidelines which limit the Company's credit exposure to any one counterparty. Specific credit risk limits based on the credit guidelines are also in place for each type of counterparty (by rating category) as well as for secondary positions of high-yield and emerging market debt.

The Credit Department administers and monitors the credit limits among trading divisions on a worldwide basis. In addition to monitoring credit limits, the Company manages the credit exposure relating to the Company's trading activities by reviewing counterparty financial soundness periodically, by entering into master netting agreements and collateral arrangements with counterparties in appropriate circumstances and by limiting the duration of exposure. In certain cases, the Company also may close out transactions or assign them to other counterparties to mitigate credit risk.

CONCENTRATION RISK

The Company is subject to concentration risk by holding large positions in certain types of securities or commitments to purchase securities of a single issuer, including sovereign governments and other entities, issuers located in a particular country or geographic area, public and private issuers involving developing countries or issuers engaged in a particular industry. Financial instruments owned by the Company include U.S. government and agency securities and securities issued by other sovereign governments (principally Japan and Italy), which, in the aggregate, represented approximately 12% of the Company's total assets at fiscal year end 1997. In addition, substantially all of the collateral held by the Company for resale agreements or bonds borrowed, which together represented approximately 34% of the Company's total assets at fiscal year end 1997, consists of securities issued by the U.S. government, federal agencies or other sovereign government obligations. Positions taken and commitments made by the Company, including positions taken and underwriting and financing commitments made in connection with its merchant banking and principal investment activities, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment grade issuers. The Company seeks to limit concentration risk through the use of the systems and procedures described in the preceding discussions of market and credit risk.

CUSTOMER ACTIVITIES

The Company's customer activities involve the execution, settlement, custody and financing of various securities and commodities transactions on behalf of customers. Customer securities activities are transacted on either a cash or margin basis. Customer commodities activities, which include the execution of customer transactions in commodity futures transactions (including options on futures), are transacted on a margin basis.

The Company's customer activities may expose it to off-balance sheet credit risk. The Company may have to purchase or sell financial instruments at prevailing market prices in the event of the failure of a customer to settle a trade on its original terms or in the event cash and securities in customer margin accounts are not sufficient to fully cover customer losses. The Company seeks to control the risks associated with customer activities by requiring customers to maintain margin collateral in compliance with various regulations and Company policies.

NOTIONAL/CONTRACT AMOUNTS AND FAIR VALUES OF DERIVATIVES

The gross notional or contract amounts of derivative instruments and fair value (carrying amount) of the related assets and liabilities at fiscal year-end 1997 and 1996, as well as the average fair value of those assets and liabilities for fiscal year 1997 and 1996, are presented in the table which follows. Fair value represents the cost of replacing these instruments and is further described in Note 2. Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts may ultimately result in cash settlements exceeding fair value amounts recognized in the consolidated statements of financial condition. Assets represent unrealized gains on purchased exchange traded and OTC options and other contracts (including interest rate, foreign exchange and other forward contracts and swaps) net of any unrealized losses owed to these counterparties on offsetting positions in situations where netting is appropriate. Similarly, liabilities represent net amounts owed to counterparties. These amounts will vary based on changes in the fair values of underlying financial instruments and/or the volatility of such underlying instruments:

FISCAL YEAR-END GROSS NOTIONAL/CONTRACT AMOUNT(1)(2)			FISCAL YEAR-END FAIR VALUES(3)				AVERAGE FAIR VALUES(3)(4)			
(DOLLARS IN BILLIONS, AT FISCAL YEAR-END)			ASSETS		LIABILITIES		ASSETS		LIABILITIES	
1997	1996		1997	1996	1997	1996	1997	1996	1997	1996
$1,042	$ 622	Interest rate and currency swaps and options (including caps, floors and swap options)	$ 7.1	$ 4.9	$ 6.3	$ 5.0	$ 4.8	$4.2	$ 5.9	$3.8
1,035	362	Foreign exchange forward and futures contracts and options	4.6	2.2	4.2	2.0	3.4	1.6	3.2	1.6
42	31	Mortgage-backed securities forward contracts, swaps and options	.3	.2	–	.1	.3	.2	–	.1
220	178	Other fixed income securities contracts (including futures contracts and options)	–	.2	.1	.2	–	.2	–	.4
112	61	Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	3.8	2.3	3.8	1.5	2.6	1.6	2.6	1.1
78	63	Commodity forwards, futures, options and swaps	1.3	1.4	1.2	1.2	1.1	1.3	.9	.7
$2,529	$1,317	Total	$17.1	$11.2	$15.6	$10.0	$12.2	$9.1	$12.6	$7.7

(1) The notional amounts of derivatives have been adjusted to reflect the effects of leverage, where applicable.
(2) Notional amounts include purchased and written options of $572 billion and $549 billion, respectively, at fiscal year-end 1997, and $247 billion and $193 billion, respectively, at fiscal year-end 1996.
(3) These amounts represent carrying value (exclusive of collateral) at fiscal year-end 1997 and 1996, respectively, and do not include receivables or payables related to exchange traded futures contracts.
(4) Amounts are calculated using a monthly average.

The gross notional or contract amounts of these instruments are indicative of the Company's degree of use of derivatives for trading purposes but do not represent the Company's exposure to market or credit risk. Credit risk arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. These amounts are presented on a net-by-counterparty basis when appropriate, but are not reported net of collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary. The Company believes that the ultimate settlement of the transactions outstanding at fiscal year-end 1997 will not have a material effect on the Company's financial condition.

The remaining maturities of the Company's swaps and other derivative products at fiscal year-end 1997 and 1996 are summarized in the following table, showing notional values by year of expected maturity:

(DOLLARS IN BILLIONS)	LESS THAN 1 YEAR	1 TO 3 YEARS	3 TO 5 YEARS	MORE THAN 5 YEARS	TOTAL
AT FISCAL YEAR-END 1997					
Interest rate and currency swaps and options (including caps, floors and swap options)	$ 210	$318	$209	$305	$1,042
Foreign exchange forward and futures contracts and options	1,026	7	2	–	1,035
Mortgage-backed securities forward contracts, swaps and options	20	1	4	17	42
Other fixed income securities contracts (including futures contracts and options)	109	80	26	5	220
Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	87	17	7	1	112
Commodity forwards, futures options and swaps	58	14	4	2	78
Total	$1,510	$437	$252	$330	$2,529
Percent of total	60%	17%	10%	13%	100%
AT FISCAL YEAR-END 1996					
Interest rate and currency swaps and options (including caps, floors and swap options)	$ 132	$191	$119	$180	$ 622
Foreign exchange forward and futures contracts and options	338	20	4	–	362
Mortgage-backed securities forward contracts, swaps and options	20	1	2	8	31
Other fixed income securities contracts (including futures contracts and options)	132	39	6	1	178
Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	50	9	2	–	61
Commodity forwards, futures options and swaps	50	10	2	1	63
Total	$ 722	$270	$135	$190	$1,317
Percent of total	55%	21%	10%	14%	100%

The credit quality of the Company's trading-related derivatives at fiscal year-end 1997 and 1996 is summarized in the table below, showing the fair value of the related assets by counterparty credit rating. The actual credit ratings are determined by external rating agencies or by equivalent ratings used by the Company's Credit Department:

(DOLLARS IN MILLIONS)	AAA	AA	A	BBB	COLLATERALIZED NON-INVESTMENT GRADE	OTHER NON-INVESTMENT GRADE	TOTAL
AT FISCAL YEAR-END 1997							
Interest rate and currency swaps and options (including caps, floors and swap options)	$ 740	$2,757	$2,534	$ 434	$ 26	$ 560	$ 7,051
Foreign exchange forward contracts and options	788	2,504	1,068	72	–	176	4,608
Mortgage-backed securities forward contracts, swaps and options	156	90	50	2	–	10	308
Other fixed income securities contracts (including options)	14	4	10	2	7	8	45
Equity securities contracts (including equity swaps, warrants and options)	1,141	917	567	233	780	152	3,790
Commodity forwards, options and swaps	70	425	380	312	12	145	1,344
Total	$2,909	$6,697	$4,609	$1,055	$825	$1,051	$17,146
Percent of total	17%	39%	27%	6%	5%	6%	100%
AT FISCAL YEAR-END 1996							
Interest rate and currency swaps and options (including caps, floors and swap options)	$ 739	$1,393	$1,977	$ 674	$ 25	$ 152	$ 4,960
Foreign exchange forward contracts and options	727	824	539	28	–	50	2,168
Mortgage-backed securities forward contracts, swaps and options	66	65	64	19	–	5	219
Other fixed income securities contracts (including options)	53	52	41	22	6	31	205
Equity securities contracts (including equity swaps, warrants and options)	1,074	274	408	60	426	43	2,285
Commodity forwards, options and swaps	95	318	318	280	72	300	1,383
Total	$2,754	$2,926	$3,347	$1,083	$529	$ 581	$11,220
Percent of total	24%	26%	30%	10%	5%	5%	100%

The Company has also obtained assets posted as collateral by investment grade counterparties amounting to $1,219 million and $948 million at fiscal year-end 1997 and fiscal year-end 1996, respectively.

9. PREFERRED STOCK AND CAPITAL UNITS

Preferred stock is composed of the following issues:

	SHARES OUTSTANDING AT FISCAL YEAR-END		BALANCE AT FISCAL YEAR-END	
(DOLLARS IN MILLIONS)	1997	1996	1997	1996
ESOP Convertible Preferred Stock, liquidation preference $35.88	3,646,664	3,699,302	$131	$ 133
Series A Fixed/Adjustable Rate Cumulative Preferred Stock, stated value $200	1,725,000	1,725,000	345	345
7-¾% Cumulative Preferred Stock, stated value $200	1,000,000	1,000,000	200	200
7-⅜% Cumulative Preferred Stock, stated value $200	1,000,000	1,000,000	200	200
8.88% Cumulative Preferred Stock, stated value $200	–	975,000	–	195
8-¾% Cumulative Preferred Stock, stated value $200	–	750,000	–	150
Total			$876	$1,223

Each issue of outstanding preferred stock ranks in parity with all other outstanding preferred stock of the Company.

During fiscal 1997, the Company redeemed all 975,000 shares of its 8.88% Cumulative Preferred Stock at a redemption price of $201.632 per share, which reflects the stated value of $200 per share together with an amount equal to all dividends accrued and unpaid to, but excluding, the redemption date. During fiscal 1997, the Company also redeemed all 750,000 shares of its 8-¾% Cumulative Preferred Stock at a redemption price of $200 per share, which was equal to the stated value of $200 per share.

The Company has Capital Units outstanding which were issued by the Company and Morgan Stanley Finance plc ("MS plc"), a U.K. subsidiary. A Capital Unit consists of (a) a Subordinated Debenture of MS plc guaranteed by the Company and having maturities from 2013 to 2017 and (b) a related Purchase Contract issued by the Company, which may be accelerated by the Company beginning approximately one year after the issuance of each Capital Unit, requiring the holder to purchase one Depositary Share representing shares (or fractional shares) of the Company's Cumulative Preferred Stock. The aggregate amount of Capital Units outstanding was $999 million at fiscal year end 1997 and $865 million at fiscal year end 1996.

During fiscal 1997, the Company and MS plc issued 8.03% Capital Units in the aggregate amount of $134 million which mature in 2017.

The estimated fair value of the Capital Units approximated carrying value at fiscal year-end 1997 and fiscal year-end 1996.

10. COMMON STOCK AND SHAREHOLDERS' EQUITY

In conjunction with the Merger, the Company increased the number of authorized common shares to 1,750 million and changed the number of authorized preferred shares to 30 million.

Prior to the consummation of the Merger, both Morgan Stanley and Dean Witter Discover rescinded their respective outstanding share repurchase authorizations. At the time of the Merger, 5,902,751 shares of Morgan Stanley common stock which had been held in treasury were retired.

MS&Co. and DWR are registered broker-dealers and registered futures commission merchants and, accordingly, subject to the minimum net capital requirements of the Securities Exchange Commission, the New York Stock Exchange and the Commodity Futures Trading Commission. MS&Co. and DWR have consistently operated in excess of these requirements. MS&Co.'s net capital totaled $2,186 million at November 30, 1997 which exceeded the amount required by $1,753 million. DWR's net capital totaled $764 million at November 30, 1997 which exceeded the amount required by $643 million. MSIL, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Securities and Futures Authority, and MSJL, a Tokyo-based broker-dealer, is subject to the capital requirements of the Japanese Ministry of Finance. MSIL and MSJL have consistently operated in excess of their respective regulatory capital requirements.

Under regulatory net capital requirements adopted by the Federal Deposit Insurance Corporation ("FDIC") and other regulatory capital guidelines, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1 capital, as defined, to total assets ("leverage ratio") and (b) 8% combined Tier 1 and Tier 2 capital, as defined, to risk weighted assets ("risk-weighted capital ratio"). At November 30, 1997, the leverage ratio and risk-weighted capital ratio of each of the Company's FDIC-insured financial institutions exceeded these and all other regulatory minimums.

Certain other U.S. and non-U.S. subsidiaries are subject to various securities, commodities and banking regulations, and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. These subsidiaries have consistently operated in excess of their local capital adequacy requirements. Morgan Stanley Derivative Products

Inc., the Company's triple-A rated derivative products subsidiary, also has established certain operating restrictions which have been reviewed by various rating agencies.

The regulatory capital requirements referred to above, and certain covenants contained in various agreements governing indebtedness of the Company, may restrict the Company's ability to withdraw capital from its subsidiaries. At November 30, 1997, approximately $4,303 million of net assets of consolidated subsidiaries may be restricted as to the payment of cash dividends and advances to the Company.

Cumulative translation adjustments include gains or losses resulting from translating foreign currency financial statements from their respective functional currencies to U.S. dollars, net of hedge gains or losses and related tax effects. The Company uses foreign currency contracts and designates certain non-U.S. dollar currency debt as hedges to manage the currency exposure relating to its net monetary investments in non-U.S. dollar functional currency subsidiaries. Increases or decreases in the value of the Company's net foreign investments generally are tax-deferred for U.S. purposes, but the related hedge gains and losses are taxable currently. Therefore, the gross notional amounts of the contracts and debt designated as hedges exceed the Company's net foreign investments to result in effective hedging on an after-tax basis. The Company attempts to protect its net book value from the effects of fluctuations in currency exchange rates on its net monetary investments in non-U.S. dollar subsidiaries by selling the appropriate non-U.S. dollar currency in the forward market. However, under some circumstances, the Company may elect not to hedge its net monetary investments in certain foreign operations due to market conditions, including the availability of various currency contracts at acceptable costs. Information relating to the hedging of the Company's net monetary investments in non-U.S. dollar functional currency subsidiaries and their effects on cumulative translation adjustments is summarized below:

	AT FISCAL YEAR-END	
(DOLLARS IN MILLIONS)	1997	1996
Net investments in non-U.S. dollar functional currency subsidiaries	$1,128	$1,279
Gross notional amounts of foreign exchange contracts and non-U.S. dollar debt designated as hedges[1]	$1,881	$2,247
Cumulative translation adjustments resulting from net investments in subsidiaries with a non-U.S. dollar functional currency	$ 6	$ 100
Cumulative translation adjustments resulting from realized or unrealized gains or losses on hedges, net of tax	$ (15)	$ (111)
Total cumulative translation adjustments	$ (9)	$ (11)

[1] Notional amounts represent the contractual currency amount translated at respective fiscal year-end spot rates.

11. EMPLOYEE COMPENSATION PLANS

The Company has adopted a variety of compensation plans for certain of its employees as well as the Company's non-employee directors. These plans are designed to facilitate a pay-for-performance policy, provide compensation commensurate with other leading financial services companies and provide for internal ownership in order to align the interests of employees with the long-term interests of the Company's shareholders. These plans are summarized below.

EQUITY-BASED COMPENSATION PLANS

The Company is authorized to issue up to approximately 260 million shares of its common stock in connection with awards under its equity-based compensation plans. At November 30, 1997, approximately 164 million shares were available for future grant under these plans.

Stock Option Awards

Stock option awards have been granted pursuant to several equity-based compensation plans. Each plan provides for the granting of stock options having an exercise price not less than the fair value of the Company's common stock (as defined in the plan) on the date of grant. Such options generally become exercisable over a one to five year period and expire seven to 10 years from the date of grant.

The following table sets forth activity relating to the Company's stock option awards (share data in millions):

	FISCAL 1997		FISCAL 1996		FISCAL 1995	
	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Options outstanding at beginning of period	60.3	$17.04	63.1	$14.46	39.0	$10.60
Granted	20.2	48.16	7.5	30.15	32.0	17.89
Exercised	(14.9)	11.68	(9.0)	9.45	(7.3)	8.60
Forfeited	(1.5)	26.66	(1.3)	21.14	(.6)	17.17
Options outstanding at end of period	64.1	$27.85	60.3	$17.04	63.1	$14.46
Options exercisable at end of period	44.3	$26.67	36.4	$13.82	36.0	$12.38

The following table presents information relating to the Company's stock options outstanding at November 30, 1997 (share data in millions):

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE	AVERAGE REMAINING LIFE (YEARS)	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
$ 6.00 - $12.99	4.0	$ 8.51	1.9	4.0	$ 8.51
$13.00 - $19.99	31.8	17.24	6.9	26.0	17.07
$20.00 - $26.99	2.0	23.02	4.2	.7	23.62
$27.00 - $33.99	5.9	30.02	5.1	—	33.13
$34.00 - $40.99	3.5	35.55	8.9	.1	36.19
$41.00 - $47.99	4.9	43.33	6.2	3.7	43.23
$48.00 - $54.99	11.9	53.75	10.0	9.7	53.73
$55.00 - $61.99	.1	57.35	5.2	.1	57.35
Total	64.1		7.0	44.3	

Deferred Compensation Awards

The Company has made deferred compensation awards under a number of equity-based compensation plans. These plans provide for the deferral of a portion of certain key employees' compensation with payments made in the form of the Company's common stock or in the right to receive unrestricted shares (collectively, "Restricted Stock"). Compensation expense for all such awards (including those subject to forfeiture) amounted to $347 million, $534 million and $235 million in fiscal 1997, fiscal 1996 and fiscal 1995. Compensation expense for Restricted Stock awards was determined based on the fair value of the Company's common stock (as defined in the plans). The number of Restricted Stock shares outstanding were 62 million at fiscal year-end 1997, 65 million at fiscal year-end 1996, and 56 million at fiscal year-end 1995.

Restricted Stock awarded under these plans are subject to restrictions on sale, transfer or assignment until the end of a specified restriction period, generally 5 to 10 years from the date of grant. Holders of Restricted Stock generally may forfeit ownership of a portion of their award if employment is terminated before the end of the relevant restriction period. Holders of vested Restricted Stock generally will forfeit ownership only in certain limited situations, including termination for cause during the restriction period.

Employees Equity Accumulation Plan

Shareholders approved the Employees' Equity Accumulation Plan on May 28, 1997. This plan is intended to align key employees' interest with shareholders' through equity-based compensation and to permit the granting of awards that will constitute performance-based compensation for certain executive officers. Under this plan, the Company will issue an aggregate of not more than 30 million shares of common stock, as calculated in accordance with the plan.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan, employees may purchase shares of the Company's common stock at not less than 85% of the fair value on the date of purchase. Employees of the Company purchased 0.5 million shares of common stock in fiscal 1997, 0.7 million shares in fiscal 1996 and 0.8 million shares in fiscal 1995.

The discount to fair value was $2 million for both fiscal 1997 and fiscal 1996 and $1 million in fiscal 1995. The plan is "non-compensatory" under APB No. 25, and, accordingly, no charge to earnings has been recorded for the amount of the discount to fair value.

Non-Employee Director Awards
The Company sponsors a stock plan for non-employee directors under which shares of the Company's common stock have been authorized for issuance in the form of option grants, stock awards or deferred compensation. The effect of these grants on results of operations was not material.

OTHER COMPENSATION PLANS

Capital Accumulation Plan
Under the Capital Accumulation Plan ("CAP"), vested units consisting of unsecured rights to receive payments based on notional interests in existing and future risk-capital investments made directly or indirectly by the Company ("CAP Units") are granted to key employees. The value of the CAP Units awarded for services rendered in fiscal 1997, 1996 and 1995 was approximately $14 million, $7 million and $12 million, respectively, all of which relate to vested units.

Carried Interest Plans
Under various Carried Interest Plans, certain key employees effectively participate in a portion of the Company's realized gains from certain of its equity investments in merchant banking transactions. Compensation expense for fiscal 1997, 1996 and 1995 related to these plans aggregated $38 million, $0.2 million and $14 million, respectively.

Real Estate Fund Plans
Under the Real Estate Compensation Plan and the Real Estate Profits Participation Plan, select employees and consultants may participate in certain gains realized by the Company's real estate funds. Compensation expense relating to these plans aggregated $8 million, $13 million and $9 million for fiscal 1997, fiscal 1996 and fiscal 1995, respectively.

Profit Sharing Plans
The Company sponsors qualified profit sharing plans covering substantially all U.S. employees and also provides cash payment of profit sharing to employees of its international subsidiaries. Contributions are made to eligible employees at the discretion of management based upon the financial performance of the Company. Total profit sharing expense for fiscal 1997, fiscal 1996 and fiscal 1995 (excluding Company contributions to the Employee Stock Ownership Plan, which increased in fiscal 1995) was $113 million, $72 million and $51 million, respectively.

Employee Stock Ownership Plan
The Company has a $140 million leveraged employee stock ownership plan, funded through an independently managed trust. The Employee Stock Ownership Plan ("ESOP") was established to broaden internal ownership of the Company and to provide benefits to its employees in a cost-effective manner. Each of the 3,646,664 preferred shares outstanding at fiscal year end 1997 is held by the ESOP trust, is convertible into 3.3 shares of the Company's common stock and is entitled to annual dividends of $2.78 per preferred share. The ESOP trust funded its stock purchase through a loan of $140 million from the Company. The ESOP trust note, due September 19, 2010 (extendable at the option of the ESOP trust to September 19, 2015), bears a 10-⅜% interest rate per annum with principal payable without penalty on or before the due date. The ESOP trust expects to make principal and interest payments on the note from funds provided by dividends on the shares of convertible preferred stock and contributions from the Company. The note receivable from the ESOP trust is reflected as a reduction in the Company's shareholders' equity. Shares allocated to employees generally may not be withdrawn until the employee's death, disability, retirement or termination. Upon withdrawal, each share of ESOP preferred stock generally will be converted into 3.3 shares of the Company's common stock. If the fair value of such 3.3 common shares at conversion is less than the $35.88 liquidation value of an ESOP preferred share, the Company will pay the withdrawing employee the difference in additional common shares or cash.

Contributions to the ESOP by the Company and allocation of ESOP shares to employees are made annually at the discretion of the Board of Directors. The cost of shares allocated to participants' accounts amounted to $8 million in fiscal 1997, $9 million in fiscal 1996 and $13 million in fiscal 1995. The ESOP debt service costs for fiscal 1997, fiscal 1996 and fiscal 1995 were paid from dividends received on preferred stock held by the plan and from Company contributions.

PRO FORMA EFFECT OF SFAS NO. 123

Had the Company elected to recognize compensation cost pursuant to SFAS No. 123 for its stock option plans and the Employee Stock Purchase Plan, net income would have been reduced by $196 million, $41 million and $147 million for fiscal 1997, 1996 and 1995. Primary and fully diluted earnings per common share would have been reduced by $0.36, $0.08 and $0.25 for fiscal 1997, 1996 and 1995.

The weighted average fair value at date of grant for stock options granted during fiscal 1997, 1996 and 1995 was $16.76, $9.08 and $7.27 per option, respectively. The fair value of stock options at date of grant was estimated using the Black-Scholes option pricing model utilizing the following weighted average assumptions:

FISCAL YEAR	1997	1996	1995
Risk-free interest rate	6.0%	5.5%	7.4%
Expected option life in years	6.0	5.3	8.1
Expected stock price volatility	28.0%	27.5%	29.7%
Expected dividend yield	1.3%	1.6%	1.9%

12. EMPLOYEE BENEFIT PLANS

The Company sponsors various pension plans for the majority of its worldwide employees. The Company provides certain other postretirement benefits, primarily health care and life insurance, to eligible employees. The Company also provides certain benefits to former or inactive employees prior to retirement. The following summarizes these plans:

Pension Plans

Substantially all of the U.S. employees of the Company and its U.S. affiliates are covered by non-contributory pension plans that are qualified under Section 401(a) of the Internal Revenue Code (the "Qualified Plans"). Unfunded supplementary plans (the "Supplemental Plans") cover certain executives. In addition to the Qualified Plans and the Supplemental Plans (collectively, the "U.S. Plans"), ten of the Company's international subsidiaries also have pension plans covering substantially all of their employees. These pension plans generally provide pension benefits that are based on each employee's years of credited service and on compensation levels specified in the plans. For the Qualified Plans and the other international plans, the Company's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations. Liabilities for benefits payable under the Supplemental Plans are accrued by the Company and are funded when paid to the beneficiaries.

The Company also maintains a separate pension plan which covers substantially all employees of the Company's U.K. subsidiaries (the "U.K. Plan"). During fiscal 1996, the benefit structure of the U.K. Plan was changed from a defined benefit plan to a defined contribution plan. Under the defined contribution plan, benefits are determined by the purchasing power of the accumulated value of contributions paid. Under the defined benefit plan, benefits were expressed as a proportion of earnings at or near retirement based on years of service. In fiscal 1997 and 1996, the Company's expense related to the defined contribution U.K. Plan was $15 million and $3 million, respectively.

The following tables present information for the Dean Witter Discover predecessor pension plans and Morgan Stanley predecessor pension plans on an aggregate basis.

Pension expense includes the following components:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
U.S. Plans			
Service cost, benefits earned during the period	$ 54	$ 48	$ 35
Interest cost on projected benefit obligation	67	58	50
Return on plan assets	(170)	(111)	(103)
Difference between actual and expected return on assets	104	53	51
Net amortization	1	2	(1)
Total U.S. Plans	56	50	32
International plans	9	12	13
Total pension expense	$ 65	$ 62	$ 45

The following table provides the assumptions used in determining the projected benefit obligation for the U.S. Plans:

FISCAL YEAR	1997	1996
Weighted average discount rate	7.25%	7.50-7.75%
Rate of increase in future compensation levels	5.00%	5.00%
Expected long-term rate of return on plan assets	9.00%	9.00%

The following table sets forth the funded status of the U.S. Plans:

	1997		1996	
AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	QUALIFIED	SUPPLEMENTAL	QUALIFIED	SUPPLEMENTAL
Actuarial present value of vested benefit obligation	$ (735)	$ (34)	$(592)	$(38)
Accumulated benefit obligation	$ (807)	$ (71)	$(636)	$(59)
Effect of future salary increases	(181)	(30)	(140)	(19)
Projected benefit obligation	(988)	(101)	(776)	(78)
Plan assets at fair market value (primarily listed stocks and bonds)	1,006	–	785	–
Projected benefit obligation less than or (in excess of) plan assets	18	(101)	9	(78)
Unrecognized net (gain) or loss	(4)	27	(15)	13
Unrecognized prior service cost	31	(4)	5	(4)
Unrecognized net transition obligation	3	5	–	5
Prepaid (accrued) pension cost at fiscal year-end	$ 48	$ (73)	$ (1)	$(64)

POSTRETIREMENT BENEFITS

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees, employees and dependents. At fiscal year end 1997 and 1996, the Company's accrued postretirement benefit costs were $91 million and $85 million.

POSTEMPLOYMENT BENEFITS

Postemployment benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits, and continuation of health care and life insurance coverage provided to former or inactive employees after employment but before retirement. These benefits were not material to the consolidated financial statements in fiscal 1997, 1996 and 1995.

13. INCOME TAXES

The provision for income taxes consists of:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Current			
U.S. federal	$1,079	$1,096	$ 730
U.S. state and local	348	290	205
Non-U.S.	338	177	104
	1,765	1,563	1,039
Deferred			
U.S. federal	(45)	(326)	(120)
U.S. state and local	(17)	(74)	(54)
Non-U.S.	(15)	(26)	(38)
	(77)	(426)	(212)
Provision for income taxes	$1,688	$1,137	$ 827

The following table reconciles the provision to the U.S. federal statutory income tax rate:

FISCAL YEAR	1997	1996	1995
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
U.S. state and local income taxes, net of U.S. federal income tax benefits	5.1	4.6	4.2
Lower tax rates applicable to non-U.S. earnings	(1.1)	(1.7)	(2.9)
Reduced tax rate applied to dividends	(.1)	(.1)	(.2)
Other	.6	(1.3)	–
Effective income tax rate	39.5%	36.5%	36.1%

As of November 30, 1997 the Company had approximately $2.2 billion of earnings attributable to foreign subsidiaries for which no tax provisions have been recorded for income tax that could occur upon repatriation. Except to the extent such earnings can be repatriated tax efficiently, they are permanently invested abroad. It is not practicable to determine the amount of income taxes payable in the event all such foreign earnings are repatriated. Deferred income taxes reflect the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. Significant components of the Company's deferred tax assets and liabilities at fiscal year-end 1997 and 1996 are as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Deferred tax assets		
Employee compensation and benefit plans	$1,168	$1,061
Loan loss allowance	459	437
Other valuation and liability allowances	545	448
Other	180	100
Total deferred tax assets	2,352	2,046
Deferred tax liabilities		
Prepaid commissions	233	200
Valuation of inventory, investments and receivables	298	225
Other	265	169
Total deferred tax liabilities	796	594
Net deferred tax assets	$1,556	$1,452

Cash paid for income taxes were $1,251 million, $1,190 million and $887 million in fiscal 1997, 1996 and 1995.

14. GEOGRAPHIC AREA DATA

Total revenues, net revenues, income before taxes and identifiable assets of the Company's operations by geographic area are as follows:

	TOTAL REVENUES			NET REVENUES		
(DOLLARS IN MILLIONS)	FISCAL 1997	FISCAL 1996	FISCAL 1995	FISCAL 1997	FISCAL 1996	FISCAL 1995
International						
Europe	$ 6,468	$ 5,616	$ 4,551	$ 1,757	$ 1,429	$ 1,079
Asia	952	768	748	866	700	626
Total	7,420	6,384	5,299	2,623	2,129	1,705
North America	28,711	24,235	18,110	12,519	10,193	8,374
Eliminations	(8,999)	(8,448)	(4,677)	(309)	(299)	(259)
Total	$27,132	$22,171	$18,732	$ 14,833	$ 12,023	$ 9,820

	INCOME BEFORE TAXES			IDENTIFIABLE ASSETS		
(DOLLARS IN MILLIONS)	FISCAL 1997	FISCAL 1996	FISCAL 1995	FISCAL 1997	FISCAL 1996	FISCAL 1995
International						
Europe	$ 399	$ 328	$ 237	$ 126,138	$ 113,734	$ 85,393
Asia	240	161	158	30,656	21,561	17,363
Total	639	489	395	156,794	135,295	102,756
North America	3,635	2,628	1,897	307,728	242,510	178,009
Eliminations	–	–	–	(162,235)	(138,945)	(98,804)
Total	$ 4,274	$ 3,117	$ 2,292	$ 302,287	$ 238,860	$181,961

Because of the international nature of the financial markets and the resulting geographic integration of the Company's business, the Company manages its business with a view to the profitability of the enterprise as a whole, and, as such, profitability by geographic area is not necessarily meaningful.

15. SEGMENT INFORMATION

The Company is in the business of providing financial services, and operates in two business segments — Securities and Asset Management and Credit and Transaction Services. Securities and Asset Management engages in delivering a broad range of financial products and services, including asset management, to individual and institutional investors. Credit and Transaction Services is engaged in the issuance and servicing of general purpose credit cards, consumer lending and electronic transaction processing services.

The following table presents certain information regarding these business segments:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Total revenues			
Securities & Asset Management	$ 21,499	$ 17,136	$ 14,523
Credit & Transaction Services	5,633	5,035	4,209
Income before income taxes[1]			
Securities & Asset Management	3,597	2,426	1,591
Credit & Transaction Services	751	691	701
Identifiable assets at end of period[2]			
Securities & Asset Management	277,878	213,967	159,318
Credit & Transaction Services	24,409	24,893	22,643

[1] Excludes merger-related expenses of $74 million.
[2] Corporate assets have been fully allocated to the Company's business segments.

16. ACQUISITIONS AND DISPOSITION

In January 1997, the Company acquired Lombard, a company which provides discount trading services, principally to individual investors, through its Internet site, an automated telephone system, and a core group of registered representatives. Subsequent to the date of acquisition, Lombard's corporate name was changed to Discover Brokerage Direct, Inc.

In April 1997, the Company acquired the institutional global custody business of Barclays PLC ("Barclays"). The amount of consideration for this business is to be fixed over a period of time based on account retention. Barclays has agreed to provide global subcustodial services to the Company for a period of time after completion of the acquisition.

In July 1997, the Company sold the DWR institutional futures business to Carr Futures, Inc., a subsidiary of Credit Agricole Indosuez. This sale did not have a material effect on the Company's results of operations or financial position.

In fiscal 1996, the Company completed its purchase of MAS, an institutional investment manager, for $350 million, payable in a combination of cash, notes and common stock of the Company. The Company's fiscal 1996 results include the results of MAS since January 3, 1996, the date of acquisition.

In fiscal 1996, the Company completed its purchase of VKAC for $1.175 billion. The consideration for the purchase of the equity of VKAC consisted of cash and approximately $26 million of preferred securities issued by one of the Company's subsidiaries and exchangeable into common stock of the Company. The Company's fiscal 1996 results include the results of VKAC since October 31, 1996, the date of acquisition.

17. QUARTERLY RESULTS (UNAUDITED)

(DOLLARS IN MILLIONS, EXCEPT SHARE AND PER SHARE DATA)	1997 FISCAL QUARTER FIRST	SECOND	THIRD	FOURTH	1996 FISCAL QUARTER FIRST	SECOND	THIRD	FOURTH
Revenues								
Investment banking	$ 522	$ 581	$ 818	$ 773	$ 464	$ 599	$ 477	$ 650
Principal transactions:								
Trading	869	722	778	822	823	679	534	623
Investments	56	136	206	65	(7)	38	29	26
Commissions	490	484	559	553	455	463	412	446
Fees:								
Asset management, distribution and administration	587	610	656	652	397	429	427	479
Merchant and cardmember	436	424	433	411	319	346	379	461
Servicing	202	184	196	180	198	189	220	202
Interest and dividends	3,369	3,197	3,570	3,447	2,794	2,809	3,038	2,647
Other	29	38	41	36	30	37	23	36
Total revenues	6,560	6,376	7,257	6,939	5,473	5,589	5,539	5,570
Interest expense	2,709	2,478	2,765	2,854	2,250	2,245	2,419	2,020
Provision for consumer loan losses	379	376	385	353	224	270	302	418
Net revenues	3,472	3,522	4,107	3,732	2,999	3,074	2,818	3,132
Non-interest expenses								
Compensation and benefits	1,490	1,505	1,849	1,175	1,275	1,303	1,171	1,322
Occupancy and equipment	128	127	134	137	119	120	122	132
Brokerage, clearing and exchange fees	95	113	130	122	77	79	76	85
Information processing and communications	270	267	249	294	232	239	249	276
Marketing and business development	288	274	293	324	229	243	247	308
Professional services	93	99	127	132	60	80	85	109
Other	180	180	219	191	167	166	160	175
Merger-related expenses	–	74	–	–	–	–	–	–
Total non-interest expenses	2,544	2,639	3,001	2,375	2,159	2,230	2,110	2,407
Income before income taxes	928	883	1,106	1,357	840	844	708	725
Provision for income taxes	357	356	428	547	322	304	250	261
Net income	$ 571	$ 527	$ 678	$ 810	$ 518	$ 540	$ 458	$ 464
Earnings applicable to common shares(1)	$ 552	$ 509	$ 663	$ 796	$ 502	$ 523	$ 443	$ 446
Per common share(2)								
Primary earnings(3)	$ .93	$ .85	$ 1.11	$ 1.33	$ .83	$ .87	$ .75	$ .76
Fully diluted earnings(3)	$ .91	$ .83	$ 1.09	$ 1.30	$ .81	$ .86	$ .73	$ .74
Dividends to common shareholders	$ .14	$ .14	$ .14	$ .14	$ .11	$ .11	$ .11	$ .11
Book value	$18.70	$19.37	$20.25	$22.11	$15.86	$16.42	$16.93	$18.43
Average common and equivalent shares(2)								
Primary	593,495,440	598,282,535	597,921,853	600,038,489	606,585,943	600,219,450	591,882,036	587,117,776
Fully diluted	606,621,425	611,724,590	610,187,894	612,255,249	620,807,404	612,616,954	604,879,722	601,438,805
Stock price range(4)	$32.19-43.75	$34.50-41.50	$41.00-53.88	$47.31-58.75	$22.50-29.00	$25.56-31.06	$24.13-28.88	$27.56-34.38

(1) Amounts shown are used to calculate primary earnings per share.
(2) Per share and share data have been restated to reflect the Company's two-for-one stock split.
(3) Summation of the quarters' earnings per common share may not equal the annual amounts due to the averaging effect of the number of shares and share equivalents throughout the year.
(4) Prices represent the range of sales per share on the New York Stock Exchange for the periods indicated. The number of stockholders of record at November 30, 1997 approximated 192,440. The number of beneficial owners of common stock is believed to exceed this number.

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COMMON STOCK
Ticker Symbol: MWD

The common stock of Morgan Stanley, Dean Witter, Discover & Co. is listed on the New York Stock Exchange and on the Pacific Stock Exchange.

DIVIDENDS
Effective January 1998, Morgan Stanley, Dean Witter, Discover & Co.'s Board of Directors increased the quarterly cash dividend to $0.20 per share of common stock.

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Dean Witter Trust FSB is the Record Keeper for the Share Purchase and Dividend Reinvestment Plan and the Transfer Agent for the Company's common stock. For more information about the plan or assistance with address changes, lost stock certificates, and share ownership, contact:

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Design: Inc Design, New York City Printed on recycled paper