

Dear Shareholders,

1998 was a turbulent year in the world's financial markets, but Morgan Stanley Dean Witter performed exceptionally well. We were there for our clients, and our shareholders were rewarded with strong financial results:

- * *Morgan Stanley Dean Witter earned a record \$3.3 billion in 1998, an increase of \$690 million, or 27 percent over 1997. Diluted earnings per share were \$5.33 — up 28 percent from \$4.16 in 1997.*
- * *Return on equity was 24.5 percent, which compares favorably with our goal of an average of 18 percent to 20 percent over the course of the business cycle.*
- * *In January 1999, our Board of Directors increased the quarterly cash dividend per common share by 20 percent to \$0.24.*

1998 was a year in which we set ourselves apart from our competitors. Many firms in our industry suffered large trading losses, announced layoffs and began to scale back on their global commitments. Our disciplined approach to trading and risk management kept us on an even keel; we continued to expand the number of financial advisors serving individual investors; and we achieved record results in our individual securities, individual asset management and credit services businesses. We *increased* our commitment to global markets with a 20 percent staff increase in Europe and 10 percent in Asia.

There are countless examples of how we have served our clients and customers during difficult times this past year. Perhaps the most dramatic example was our role as lead-manager in raising \$4.4 billion in the first step of DuPont's spin-off of Conoco, which was the largest U.S. initial public offering in history. The timing of the deal was particularly significant since it was launched in late September when market turmoil had virtually frozen the new issues business. We believe it is an example of our firm's leadership and our ability to execute superbly in even the most difficult market conditions.

A deal such as Conoco brings together the skills and talent of literally thousands of Morgan Stanley Dean Witter professionals. We believe our firm's combined origi-

THE WISDOM OF OUR LONG-TERM STRATEGY IS INCREASINGLY APPARENT



PHILIP J. PURCELL
Chairman & Chief Executive Officer

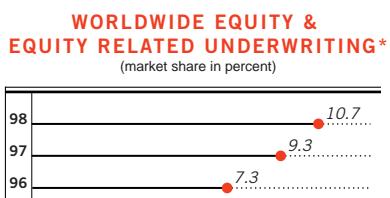
JOHN J. MACK
President & Chief Operating Officer

nation and distribution strengths — forged in our merger two years ago — are particularly noteworthy. Conoco was not only the largest U.S. IPO in history, it also provided an extraordinary opportunity for individual investors. Through their Morgan Stanley Dean Witter financial advisors, our clients purchased an unprecedented 20 million shares, or \$460 million, in more than 40,000 client accounts.

In last year's Annual Report, we said we had put the merger behind us. That is true. But it also is true that the success of the merger continues to have enormous benefits, as evidenced by market share gains in our securities business. This past year, we solidified our leadership position in global equity underwriting — since the merger, our market share has increased from 7.3 percent to 10.7 percent. We were No.1 in IPOs for U.S. issuers in 1998. In underwriting asset-backed securities, our ranking has improved from No. 8 to No.1 since the merger. In our individual securities business, market share measured by both financial advisors and branch revenues has also increased. As a result of a 10 percent annual growth rate in financial advisors since the merger, we now rank as the second largest securities sales organization in the U.S.

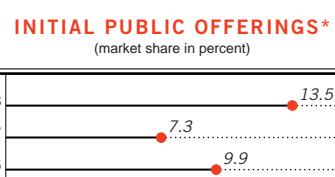
Our two other major businesses — asset management and credit services — also performed well. Despite the fear and uncertainty in many markets during much of the year, we had a net inflow of more than \$24 billion in investor funds in our individual and institutional asset management businesses. Two of our newest funds — Competitive Edge and Senior Income Trust — together attracted more than \$4 billion in 1998. Our credit services business had a record year as we refocused on our highly successful Discover® Card brand. By year-end, we had begun several new initiatives, including the launch of the new Discover Platinum Card, which we believe will be a major source of future growth. In addition, our international expansion plans now are well underway, and we plan to launch a card outside of North America in 1999.

figure 1



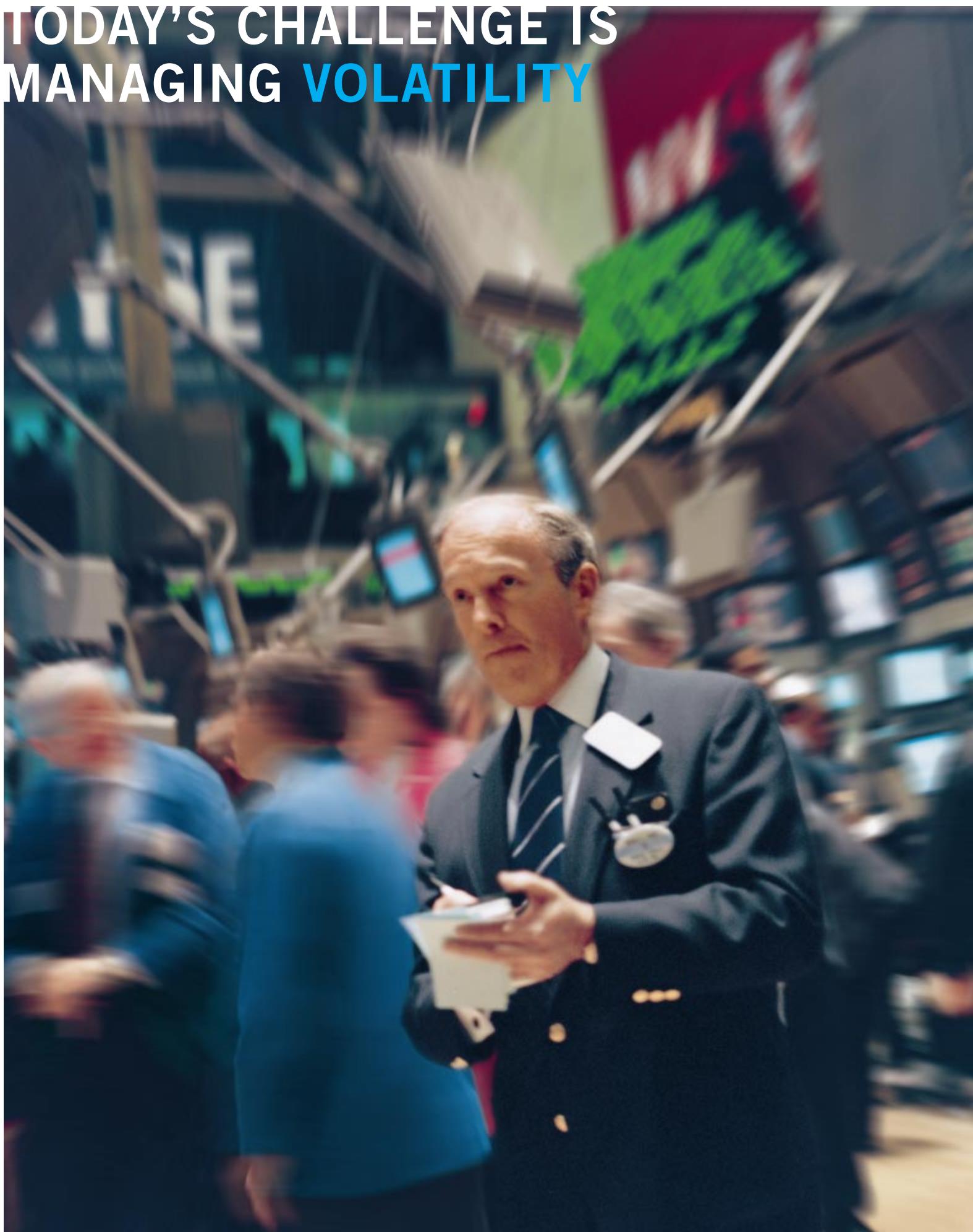
* Securities Data Company

figure 2



* Securities Data Company

TODAY'S CHALLENGE IS
MANAGING VOLATILITY



We clearly had an excellent year in 1998, but we are not going to pretend that it was easy. Like many in our industry, our firm was severely tested, and we are proud to look back and say that we passed the test. But what of the future? It is clear that certain long-term trends in the financial services marketplace, very evident this past year, will continue to create challenges and opportunities. These trends are increasing volatility, globalization, complexity and consolidation. Our strategy has been built to take full advantage of these forces of change. And we believe our performance this past year demonstrates the success of our strategy.

OUR DIVERSE REVENUE STREAMS AND EFFECTIVE RISK MANAGEMENT PROVIDE STABILITY

If there is one word to characterize financial markets in 1998, it is volatility. The Dow swung from a high of 9,340 in July to 7,539 in August and back to a near record by year-end. The Russian bond default in August contributed to a flight to quality, unprecedented bond spreads and several weeks of paralysis in fixed income markets. Continuing instability in Asia caused capital flight and currency fluctuations that led to a virtual standstill in capital market activity.

Our own stock price was not immune from the wild swings in financial markets: \$96 $\frac{1}{2}$ in July, down to \$38 $\frac{1}{2}$ in October only to rebound by year-end. When you look at our steady revenue streams, it is difficult to understand this volatility. But it is symptomatic of the view that all financial services firms are equally impacted by volatile markets. The question is: How do you counter this perception? We believe there are two ways: diversity of revenues and effective risk management.

We have diversified revenue streams from three major businesses — securities, asset management and credit services. This diversity was important in the difficult third quarter when record earnings in credit services helped us to report stronger earnings than all of our major competitors. Asset management also tends to produce steady revenue streams. We offer a wide range of asset management products and

figure 3

FINANCIAL ADVISORS

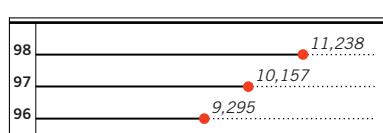


figure 4

TOTAL ASSETS UNDER MANAGEMENT

(in billions of U.S. dollars)



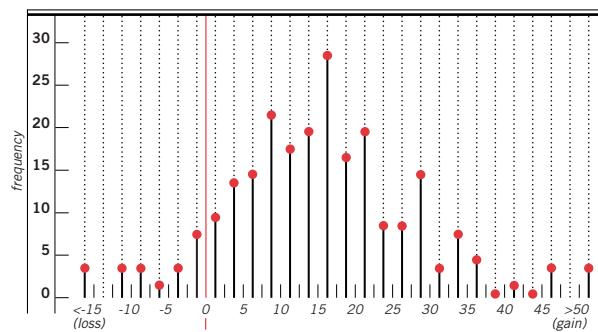
services, including 45 mutual funds ranked 4- or 5-Star by Morningstar. This past year, we brought our diverse asset management activities under a single organizational roof to create an even stronger presence in the marketplace.

There also is great diversity in our securities business. In individual securities, we achieved stable growth in client assets despite volatile markets largely because our 11,238 financial advisors provided a steady influence and kept clients focused on long-term objectives. In institutional equities, foreign exchange and commodities, we had strong revenues in part because we do not take major proprietary market positions, but focus on assisting customers with a wide array of products, hedging solutions and transaction execution.

Our record earnings were a tribute to our strong culture of managing risk. Like most firms, we review market risk exposure in our institutional securities business using both quantitative and qualitative approaches. But we believe our success in managing risk comes down to the experience and discipline of our people.

OUR COMMITMENT TO GLOBAL MARKETS IS UNDIMINISHED The events of 1998 forced people to rethink the concept of globalization. The information technology that makes it possible for capital to flow freely and for investors to seek the best returns, regardless of national borders, also makes it possible for capital to exit a country just as readily. This is what happened in Asia, and, with the links between economies worldwide, it created uncertainty in other parts of the world. The operative word became “contagion,” and suddenly talk turned from the benefits of globalization to fears of worldwide recession.

figure 5

HISTOGRAM OF DAILY INSTITUTIONAL TRADING REVENUE
(in millions of U.S. dollars)



**GLOBALIZATION CREATES
OPPORTUNITIES AND RISKS**

CLIENTS MUST DEAL WITH INCREASED COMPLEXITY



In the midst of these uncertainties, Morgan Stanley Dean Witter remained focused, and both our customers and shareholders have benefited. We were able to structure large financings for oil ventures in Mexico and Venezuela and an innovative high-yield financing for the Republic of Argentina during a period when the markets were not receptive to emerging market securities. We continued to expand our activities in Europe, providing financing for a high-growth telecommunications company in the Netherlands, entering and achieving substantial share in the Italian lira markets, and even leading the first asset-backed offering for a group of British pubs. Our company ranked No.1 in M&A in Europe for the fourth straight year, acting as advisor on groundbreaking mergers such as British Petroleum-Amoco and Deutsche Bank-Bankers Trust. At year-end, the influential European publication, *International Financing Review*, named us Bank of the Year, Bond House of the Year and Equity House of the Year. It was the first time ever that one firm has won these three top awards in a single year.

There is no better example of our global commitment than our 1998 performance in Asia. Despite the continuing turmoil, we expanded our presence in equity markets throughout the region, attaining market leadership on both the Tokyo and Hong Kong Stock Exchanges. We grew our equity business in Australia and Taiwan, provided advisory services in restructuring two national banks in Korea and coordinated the \$1.1 billion secondary offering of Bangkok Bank — the largest ever equity offering by a Thai company. Despite Japan's continuing economic troubles, we significantly expanded our investment banking and brokerage businesses as Japan embarks on a comprehensive reform of its financial markets.

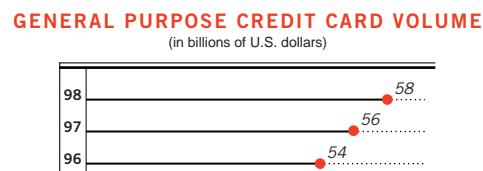
WE SUPPORT OUR CLIENTS WITH INNOVATIVE SOLUTIONS The increased complexity of today's financial marketplace reflects the forces of globalization, which have made the world a smaller place but also have created wider opportunities. Investors can

figure 6



* Securities Data Company

figure 7



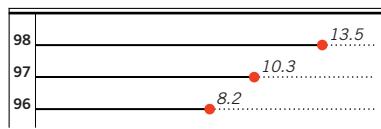
seek higher returns across national borders and diverse products, while issuers have a much greater variety of financing sources. The great proliferation of products and financial strategies has added a further layer of complexity. A third element of complexity in financial services is the challenge posed by technology, which has greatly accelerated the speed of transactions and created a much wider bandwidth in the flow of information.

Since the world is unlikely to become a simpler place in the foreseeable future, we believe the best response to ever-increasing complexity is continuous, relentless innovation. For our firm, innovation and the application of new technology to financial challenges have been hallmarks of our success. Whether in mergers and acquisitions, the use of derivatives to hedge risk, new high-yield or asset-backed securities, or making research and securities available to individual investors on the Internet, we will continue to use the flexibility and intellectual capital of our people to serve customers and create opportunities. Examples of continuing innovation this past year include our underwritings for Amazon.com in the first-ever high yield financing for an Internet retailer, the expansion of online services for our 2 million individual investor clients and the successful launch of Discover Card's high-speed transaction report system for its merchant network.

PRODUCT RANGE AND SCOPE OF DISTRIBUTION ARE PRIZED ATTRIBUTES Last year we noted that in bringing together Morgan Stanley and Dean Witter in mid-1997, we had anticipated a trend. Our merger was the first of the blockbuster combinations in financial services. The wave of consolidation has continued. In 1998, M&A activity in financial services reached \$700 billion compared with \$117 billion two years ago. We believe that consolidation in our industry will continue, driven by customer needs. Customers now want advice, products and liquidity across all geographic markets, and they are turning to the global firms that can meet their needs.

figure 8

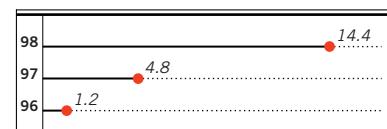
**U.S. HIGH-YIELD
DEBT OFFERINGS***
(market share in percent)



* Securities Data Company

figure 9

**U.S. PUBLIC RETAIL
PREFERRED STOCK OFFERINGS***
(market share in percent)



* Securities Data Company

MORGAN STANLEY
DEAN WITTER
INVESTMENT CENTER

MARKET FORCES ARE
DRIVING CONSOLIDATION



**IN UNCERTAIN TIMES, CLIENTS LOOK
FOR FINANCIAL STRENGTH**

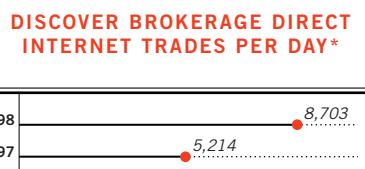
Few firms can match Morgan Stanley Dean Witter in range of products and scale of distribution. In fact, this was the reason for our merger. By bringing top-ranked research and underwritten products to retail clients, we achieved significant gains in our individual client business. By the same token, investment banking has gained market share because of the distribution power of our 11,238 financial advisors.

The newest and most rapidly growing distribution channel is the Internet. Our firm has positioned itself on the Internet through Discover Brokerage Direct, our online provider of financial services to individuals. In 1998, Discover Brokerage Direct expanded its product line to include proprietary equity research, 24-hour trading of U.S. government securities and a mutual funds marketplace. We also have introduced several Internet initiatives for Discover Card customers, including online payment capabilities and Discover ShopCenter,SM a new Internet shopping link. In 1999, we will focus on the growing number of consumers interested in using the Internet to purchase a variety of products and services.

The next frontier is the global distribution of securities and asset management products to individuals, particularly to capitalize on the huge pool of savings in Japan and the trend toward privatization of pension funds in Europe. There is no firm yet with a global retail capability, but we believe that firms that have the most extensive products and distribution today will have the advantage in developing such a capability tomorrow. In late 1998, we founded a new business unit to pursue global opportunities in retail securities and asset management, and we expect significant strides in 1999.

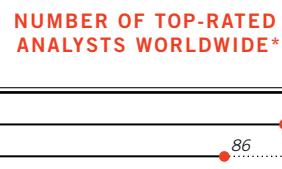
FEW FIRMS CAN MATCH OUR STAYING POWER We believe that Morgan Stanley Dean Witter clearly has demonstrated its ability to adapt, prosper and grow in a rapidly changing and often turbulent marketplace. We believe the diversity of our revenue

figure 10



*Average for last month of fiscal year

figure 11



*Institutional Investor 1998 Ranked Analysts

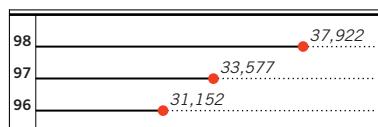
streams and our ability to manage risk make us less subject to market volatility. Our global commitment and expertise position us to take full advantage of the continuing trend of globalization. Our capacity for innovation enables us to serve our clients in an increasingly complex financial marketplace. And as the consolidation of the financial services industry continues, we believe we have the range of products and broad distribution channels that will enable us to continue to gain market share.

These capabilities and strategies are the source of considerable financial strength. Underlying them is a capital base that is one of the largest in our industry. At fiscal year-end, our shareholders' equity stood at \$14.1 billion, significantly higher than any of our U.S. securities industry competitors. Our total capital (including long-term debt) was \$38 billion. The diversity and growth potential of our revenue stream mean we should continue to generate substantial capital internally. This was particularly evident in 1998 as we were able to repurchase approximately \$3 billion of our stock. Because we have three profitable businesses (securities, asset management and credit services), a broad institutional and individual customer base, a global presence and a strong stream of continuing revenues, we believe our earnings will be less subject to volatility than many of our competitors.

In November, Moody's upgraded our credit rating to Aa3, which brought independent confirmation of our financial strength and the continued success of our strategy. We believe the timing of this affirmation was particularly significant. It came when many of our competitors had suffered setbacks in the difficult environment and had their ratings downgraded or placed on negative credit watch. In its analysis of our upgrade, Moody's echoed most of the same themes that we have emphasized in this letter: namely, that our performance, capabilities and strategy have set us apart from most of our competitors.

figure 12

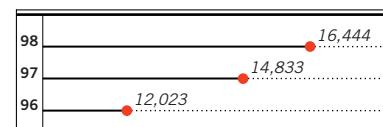
TOTAL CAPITAL*
(in millions of U.S. dollars)



*Excludes the current portion of long-term debt
and includes Capital Units and Preferred Securities
Issued by Subsidiaries.

figure 13

NET REVENUES
(in millions of U.S. dollars)



1998 was a great year for Morgan Stanley Dean Witter. But it was by no means an easy year. So we would like to thank each of our 45,000 employees for their strong spirit and hard work, in often tough circumstances, on behalf of our clients, our shareholders and our firm. We are pleased that our employees own approximately 25 percent of the stock in our company, which helps ensure that their interests are closely aligned with our shareholders.

In April, Richard B. Fisher and Thomas C. Schneider, who played key roles in the merger and helped create our new company, will be leaving our Board of Directors. As Chairman of Morgan Stanley, Dick led the company's successful global expansion. Tom was Chief Financial Officer of Dean Witter Discover and had a central part in taking the company public in 1993. They have served our company exceptionally well and will continue to play active roles. We are pleased that Charles F. Knight, the Chairman and CEO of Emerson Electric Co., has joined our Board of Directors. The company will benefit from his counsel and experience.

At the time of the merger, we said our goal was to be the world's preeminent financial services company. Since then, we have had two straight years of record earnings and strong business growth in varying market conditions, and the goal we set for ourselves two years ago now is well within our reach. Some enormous opportunities, as well as challenges, lie just ahead. We also know there will be surprises. But we believe our firm is well-prepared for whatever lies in store and we are excited about the future. We want to thank our fellow shareholders for your support. We will continue to do everything we can to reward your commitment.



PHILIP J. PURCELL
Chairman & Chief Executive Officer



JOHN J. MACK
President & Chief Operating Officer

February 5, 1999



SECURITIES

MSDW serves three principal constituencies: institutional investors, individual investors, and investment banking clients including corporations, governments and other entities around the globe. The firm provides investment banking advice on complex financial transactions like mergers and acquisitions, financial restructurings and privatizations, and is a major underwriter of stocks and bonds. Its sales and trading services cover virtually every type of financial instrument traded in the world today, including stocks, bonds, derivatives, foreign exchange and commodities. Backed by more than 11,000 financial advisors in its individual securities operation, the group handles \$438 billion in individual client assets.

- * *The firm maintained a top three ranking in global M&A transactions, worldwide equity and equity-related issues, high-yield debt and U.S. investment grade debt. It ranked first in the underwriting of U.S. equity and equity-related issues.*
- * *The equity research group was ranked #1 (by weighted formula) and had the greatest number of first-team positions in the 1998 Institutional Investor All-America Poll.*
- * *The firm gained 455,000 new individual accounts — which brought the total number of accounts to 3.9 million.*

ASSET MANAGEMENT

MSDW's asset management group offers a wide range of products and services. They include a large family of domestic and international bond, equity and multi-asset class funds for individual and institutional investors; and private partnerships that invest in private equity, venture capital and real estate opportunities.

- * *MSDW managed \$376 billion for institutional and individual investors at fiscal year-end 1998 to rank #2 among U.S. full-service securities firms.*
- * *Van Kampen Funds have won the DALBAR Quality Tested Seal of Approval for the last nine years for superior service.*
- * *There are 138 MSDW Funds and portfolios with more than \$121 billion in assets and more than 3 million investors.*

CREDIT AND TRANSACTION SERVICES

The Discover Card was started in 1985 and was marketed as the first value card — with no annual fee and a Cashback Bonus® Award. The credit services business has \$32.5 billion in receivables and is accepted at more than 3 million merchant locations across the United States. Discover Brokerage Direct, the firm's Internet brokerage service, continues to expand as the demand for Internet trading continues to grow briskly.

- * *The Discover/NOVUS® Network enrolled nearly 400,000 merchant locations during 1998.*
- * *General purpose credit card transaction volume continued to grow, reaching \$58 billion in 1998.*
- * *Discover Brokerage Direct continued to expand the range of services it offers to its growing client list, including online equity research and 24-hour trading in U.S. government securities.*

MORGAN STANLEY DEAN WITTER AT-A-GLANCE



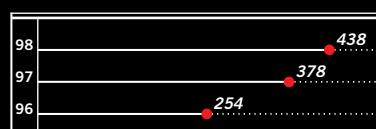
INCOME AFTER TAXES
(in millions of U.S. dollars)



INVESTMENT BANKING REVENUES
(in millions of U.S. dollars)



INDIVIDUAL CLIENT ASSETS
(in billions of U.S. dollars)



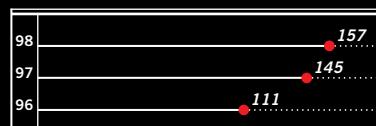
INCOME AFTER TAXES
(in millions of U.S. dollars)



RETAIL ASSETS UNDER MANAGEMENT
(in millions of U.S. dollars)



**INSTITUTIONAL ASSETS
UNDER MANAGEMENT**
(in millions of U.S. dollars)



INCOME AFTER TAXES
(in millions of U.S. dollars)



MANAGED CONSUMER LOANS
(in billions of U.S. dollars)



**GENERAL PURPOSE
CREDIT CARD ACCOUNTS**
(in millions)



SELECTED FINANCIAL DATA

fiscal year ⁽¹⁾ (dollars in millions, except share data)	1998	1997	1996	1995	1994
INCOME STATEMENT DATA:					
Revenues:					
Investment banking	\$ 3,340	\$ 2,694	\$ 2,190	\$ 1,556	\$ 1,102
Principal transactions:					
Trading	3,291	3,191	2,659	1,685	1,614
Investments	89	463	86	121	154
Commissions	2,353	2,086	1,776	1,533	1,323
Fees:					
Asset management, distribution and administration	2,849	2,505	1,732	1,377	1,317
Merchant and cardmember	1,647	1,704	1,505	1,135	940
Servicing	928	762	809	680	565
Interest and dividends	16,436	13,583	11,288	10,530	8,715
Other	198	144	126	115	127
Total revenues	31,131	27,132	22,171	18,732	15,857
Interest expense	13,514	10,806	8,934	8,190	6,697
Provision for consumer loan losses	1,173	1,493	1,214	722	530
Net revenues	16,444	14,833	12,023	9,820	8,630
Non-interest expenses:					
Compensation and benefits	6,636	6,019	5,071	4,005	3,535
Other	5,108	4,466	3,835	3,464	3,133
Merger-related expenses	—	74	—	—	—
Relocation charge	—	—	—	59	—
Total non-interest expenses	11,744	10,559	8,906	7,528	6,668
Gain on sale of businesses	685	—	—	—	—
Income before income taxes and cumulative effect of accounting change	5,385	4,274	3,117	2,292	1,962
Provision for income taxes	1,992	1,688	1,137	827	705
Income before cumulative effect of accounting change	3,393	2,586	1,980	1,465	1,257
Cumulative effect of accounting change	(117)	—	—	—	—
Net income	\$ 3,276	\$ 2,586	\$ 1,980	\$ 1,465	\$ 1,257
Earnings applicable to common shares ⁽²⁾	\$ 3,221	\$ 2,520	\$ 1,914	\$ 1,400	\$ 1,192
PER SHARE DATA:					
Earnings per common share ⁽³⁾ :					
Basic before cumulative effect of accounting change	\$ 5.80	\$ 4.38	\$ 3.34	\$ 2.37	\$ 2.01
Cumulative effect of accounting change	(0.20)	—	—	—	—
Basic	5.60	4.38	3.34	2.37	2.01
Diluted before cumulative effect of accounting change	5.52	4.16	3.16	2.26	1.93
Cumulative effect of accounting change	(0.19)	—	—	—	—
Diluted	5.33	4.16	3.16	2.26	1.93
Book value per common share	23.88	22.11	18.43	15.63	13.38
Dividends per common share	0.80	0.56	0.44	0.32	0.25
BALANCE SHEET AND OTHER OPERATING DATA:					
Total assets	\$ 317,590	\$ 302,287	\$ 238,860	\$ 181,961	\$ 159,477
Consumer loans, net	15,209	20,033	21,262	19,733	14,731
Total capital ⁽⁴⁾	37,922	33,577	31,152	24,644	20,933
Long-term borrowings ⁽⁴⁾	23,803	19,621	19,450	14,636	12,352
Shareholders' equity	14,119	13,956	11,702	10,008	8,581
Return on average common shareholders' equity	24.5%	22.0%	20.0%	16.4%	15.8%
Average common and equivalent shares ⁽²⁾⁽³⁾	575,822,725	574,818,233	573,356,930	590,144,217	594,212,948

(1) Fiscal 1994 through fiscal 1996 represents the combination of Morgan Stanley Group Inc.'s financial statements for the fiscal years ended November 30 with Dean Witter, Discover & Co.'s financial statements for the years ended December 31.

(2) Amounts shown are used to calculate basic earnings per common share.

(3) Earnings per share data for fiscal 1994 through fiscal 1997 have been restated to reflect the Company's adoption of SFAS No. 128.

(4) These amounts exclude the current portion of long-term borrowings and include Capital Units and Preferred Securities Issued by Subsidiaries.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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. ("MSDWD"). In conjunction with the Merger, each share of Morgan Stanley common stock then outstanding was converted into 1.65 shares of MSDWD'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 MSDWD. The Merger was treated as a tax-free exchange.

On March 24, 1998, MSDWD changed its corporate name to Morgan Stanley Dean Witter & Co. (the "Company").

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 global strengths in investment banking (including underwriting public offerings of securities 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 AND CHANGE IN FISCAL YEAR-END

The Company's 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 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 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

year ended December 31, 1996 were combined with Morgan Stanley's financial statements for the fiscal year ended November 30, 1996 (on a combined basis, "fiscal 1996"). The Company's results for the 12 months ended November 30, 1998 ("fiscal 1998") and November 30, 1997 ("fiscal 1997") reflect the change in fiscal year-end. Fiscal 1997 includes 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 inter-company 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 equity prices and interest rates; currency values and other market indices; technological changes and events (such as the increased use of the Internet and the Year 2000 issue); 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 on a global basis, including (without limitation) continued increased market share in its securities activities, growth in assets under management and the expansion of its Discover Card brand.

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

*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.

products and the volatility and liquidity of global 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 the realization of returns from the Company's private equity investments).

In the Company's Credit and Transaction Services business, changes in economic variables may substantially affect consumer loan levels and credit quality. Such variables include the number and size of personal bankruptcy filings, the rate of unemployment and the level of consumer debt as a percentage of income.

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 and asset management business, there has been increased competition from other sources, such as commercial banks, insurance companies, mutual fund groups, online service providers 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 historically been dominated by investment banks and retail securities firms has increased and may continue to increase in the near future. In addition, recent and continuing global convergence and consolidation in the financial services industry will lead to increased competition from larger diversified financial services organizations.

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 offering credit cards with competitive and appealing features such as no annual fees, low introductory inter-

est 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.

GLOBAL MARKET AND ECONOMIC CONDITIONS IN FISCAL 1998

Conditions in the global financial markets were extremely turbulent during fiscal 1998. While the favorable market and economic conditions which characterized fiscal 1997 continued through much of the first and second quarters of fiscal 1998, periods of extreme volatility in the latter half of the year created difficult conditions in many global financial markets. Nevertheless, the Company's Securities and Asset Management business generated record levels of net income and net revenues and ended the fiscal year with record levels of financial advisors, customer accounts and assets, and assets under management and administration. The Company's Credit and Transaction Services business also achieved record operating results in fiscal 1998, reflecting an improvement in the credit quality of customer receivables.

In the U.S., market conditions continued to benefit from the overall strength of the domestic economy. Throughout fis-

cal 1998, the U.S. economy was characterized by moderate levels of growth, a stable level of inflation, low unemployment, and high levels of consumer confidence and spending. However, U.S. financial markets also experienced periods of volatility. In the first half of the year, investors were concerned with the potential impact of the ongoing economic downturn in the Far East and with domestic wage inflation. Later in the year, U.S. markets were adversely affected by investor reaction to the severe economic turmoil in the Far East, Russia and other emerging market nations. Investor preferences shifted toward less-risky investments, resulting in unprecedented widening of credit spreads, reduced liquidity in the marketplace and dramatic declines in U.S. Treasury yields. In addition, equity prices declined significantly as a result of these developments. During the fourth quarter, these conditions prompted the Federal Reserve Board to lower the overnight lending rate by 0.25% on three separate occasions in an effort to increase liquidity, to minimize the risk of recession in the U.S. due to the weaknesses in foreign economies and to avert a continued global economic slowdown. The actions of the Federal Reserve Board, coupled with the continued resilience of the U.S. economy, contributed to improved conditions in the financial markets in late 1998, and both equity and bond prices rebounded.

Conditions in European financial markets were generally favorable in fiscal 1998. Many European stock exchanges reached record levels during the year as the result of strong corporate earnings, merger and consolidation activity, and stable economic conditions in the first half of fiscal 1998. European financial markets also benefited from positive investor sentiment relating to the European Economic and Monetary Union ("EMU"). EMU commenced on January 1, 1999 when the European Central Bank assumed control of monetary policy for the 11 European Union countries participating in the EMU. Those national currencies of the participating countries have become fixed denominations of the euro and ultimately will cease to exist as separate currencies and will be replaced by the euro. European markets also experienced periods of extreme volatility during the year, particularly during the third quarter as investors reacted to the severe economic and financial difficulties which developed in Russia. The Russian economy was adversely affected by the difficult conditions in the Far East,

declining oil prices and an unstable political infrastructure. The Russian government's decision to reschedule its domestic debt obligations and some of its external Soviet debt obligations and to devalue the ruble severely reduced investor confidence and resulted in significant levels of volatility in Russian and other financial markets. Toward the end of fiscal 1998, conditions in Europe recovered due to, among other things, lower interest rates and increased stability in the global financial markets.

Market conditions in the Far East continued to be sluggish due to the ongoing financial and economic difficulties that have existed in that region since the latter half of fiscal 1997. The Japanese economy continued to be adversely affected by shrinking consumer demand, declining corporate profits, deflation and rising unemployment. These conditions contributed to the resignation of Japan's Prime Minister during the year, as well as the announcement of more aggressive fiscal, monetary and financial sector policies designed to improve the nation's rate of economic growth. However, due to the weakness of the Japanese banking system and the difficult economic conditions existing throughout the Far East, many investors were concerned that the length of time necessary for economic recovery would be longer than expected. Financial markets elsewhere in the Far East also were weak during fiscal 1998. The poor economic performance of Japan, outbreaks of political and social unrest, and crises in other emerging markets adversely affected the financial markets of many nations within the region.

The worldwide market for mergers and acquisitions continued to be robust during fiscal 1998, contributing to record levels of revenues by the Company's investment banking business. The merger and acquisition market reflected ongoing consolidation and globalization across many industry sectors, as well as an increased level of deregulation and privatization. As a result, fiscal 1998 included some of the largest merger and acquisition transactions ever completed. The markets for the underwriting of securities were positively impacted by the generally favorable market and economic conditions which existed during the first half of fiscal 1998. Activity in the primary markets virtually came to a standstill in the latter part of the third quarter and the beginning of the fourth quarter. However, toward the end of fiscal 1998, activity in the primary markets, par-

ticularly for fixed income securities, began to strengthen as conditions in the global financial markets stabilized.

In fiscal 1998, U.S. consumer demand and retail sales continued to increase at a moderate pace, despite an earlier consensus that a slowdown may have been imminent. The favorable interest rate environment that existed in the U.S. during fiscal 1998 enabled consumers to manage finances advantageously while still allowing for steady growth in consumer credit. During fiscal 1998, loan losses and personal bankruptcies appeared to level off from the record growth of industry-wide loan losses set in 1997. The Company continued to invest in the growth of its credit card business through the expansion of its Discover/NOVUS® Network and by increasing its marketing and solicitation activities with respect to the Discover Card brand.

FISCAL 1998 AND 1997 RESULTS FOR THE COMPANY

The Company achieved net income of \$3,276 million in fiscal 1998, a 27% increase from fiscal 1997. Fiscal 1998's net income included a net gain of \$345 million from the sale of the Company's Global Custody business, its interest in the operations of SPS Transaction Services, Inc. ("SPS"), and certain BRAVO® Card receivables ("BRAVO") (see "Results of Operations — Business Dispositions" herein). Fiscal 1998 net income also included a charge of \$117 million resulting from the cumulative effect of an accounting change. This charge represents the effect of an accounting change adopted in the fourth quarter (effective December 1, 1997) with respect to the accounting for offering costs paid by investment advisors of closed-end mutual funds, where such costs are not specifically reimbursed through separate advisory contracts (see Note 2 to the consolidated financial statements).

Excluding the net gain from the sale of the businesses noted above and the charge resulting from the cumulative effect of an accounting change, fiscal 1998 income was \$3,048 million, an increase of 18% from fiscal 1997. In fiscal 1997, net income was \$2,586 million, an increase of 31% from fiscal 1996. Basic earnings per common share increased 28% to \$5.60 in fiscal 1998 and 31% to \$4.38 in fiscal 1997. Excluding the net gain from the sale of the businesses noted above and the impact of the cumulative effect

of an accounting change, basic earnings per common share was \$5.20 in fiscal 1998, an increase of 19% from fiscal 1997. Diluted earnings per common share increased 28% to \$5.33 in fiscal 1998 and 32% to \$4.16 in fiscal 1997. Excluding the net gain from the sale of the businesses noted above and the impact of the cumulative effect of an accounting change, diluted earnings per common share was \$4.95 in fiscal 1998, an increase of 19% from fiscal 1997. The Company's return on average shareholders' equity was 25%, 22% and 20% in fiscal 1998, fiscal 1997 and fiscal 1996, respectively. Excluding the net gain from the sale of the businesses noted above and the impact of the cumulative effect of an accounting change, fiscal 1998's return on average shareholders' equity was 23%.

BUSINESS DISPOSITIONS

In fiscal 1998, the Company entered into several transactions reflecting its strategic decision to focus on growing its core Securities and Asset Management and Credit and Transaction Services businesses.

In the fourth quarter of fiscal 1998, the Company completed the sale of its Global Custody business. The Company also sold its interest in the operations of SPS, a 73%-owned, publicly held subsidiary of the Company. In addition, the Company sold certain credit card receivables relating to its discontinued BRAVO Card. The Company's aggregate net pre-tax gain resulting from these transactions was \$685 million.

In addition, during fiscal 1998 the Company sold its Prime Option™ MasterCard® portfolio ("Prime Option"), a business it had operated with NationsBank of Delaware, N.A., and its Correspondent Clearing business. The gains resulting from the sale of these businesses were not material to the Company's results of operations or financial condition.

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. This discussion excludes the cumulative effect of the accounting change in references to fiscal 1998 net

income. Certain reclassifications have been made to prior-period amounts to conform to the current year's presentation.

**SECURITIES AND ASSET MANAGEMENT
STATEMENTS OF INCOME**

<i>(dollars in millions)</i>	FISCAL 1998	<i>fiscal 1997</i>	<i>fiscal 1996</i>
Revenues:			
Investment banking	\$ 3,340	\$ 2,694	\$ 2,190
Principal transactions:			
Trading	3,291	3,191	2,659
Investments	89	463	86
Commissions	2,317	2,059	1,776
Asset management, distribution and administration fees	2,848	2,505	1,732
Interest and dividends	13,696	10,455	8,571
Other	182	132	122
Total revenues	25,763	21,499	17,136
Interest expense	12,519	9,633	7,902
Net revenues	13,244	11,866	9,234
Compensation and benefits	6,071	5,475	4,585
Occupancy and equipment	510	462	432
Brokerage, clearing and exchange fees	538	448	317
Information processing and communications	666	602	514
Marketing and business development	487	393	296
Professional services	579	378	282
Other	529	511	382
Total non-interest expenses	9,380	8,269	6,808
Gain on sale of businesses	323	—	—
Income before income taxes and cumulative effect of accounting change	4,187	3,597	2,426
Provision for income taxes	1,482	1,416	880
Income before cumulative effect of accounting change	2,705	2,181	1,546
Cumulative effect of accounting change	(117)	—	—
Net income	\$ 2,588	\$ 2,181	\$ 1,546

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, and investment and asset management products and services for institutional and individual clients. At November 30, 1998, the Company's financial advisors provided investment services to more than 3.9 million client accounts with assets of \$438 billion. The Company had the second largest financial advisor sales organization in the U.S. with 11,238 professional financial advisors and 438 branches at November 30, 1998. With several brands, including those associated with Morgan Stanley Dean Witter Advisors (formerly known as Dean Witter InterCapital), Van Kampen Investments ("VK"), Morgan Stanley Dean Witter Investment Management and Miller Anderson & Sherrerd, 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 \$376 billion at November 30, 1998.

Securities and Asset Management achieved record net revenues and income of \$13,244 million and \$2,705 million in fiscal 1998, increases of 12% and 24%, respectively, from fiscal 1997. Fiscal 1998's net income includes a net gain of \$182 million resulting from the sale of the Company's Global Custody business. Excluding the net gain from the sale of this business, income increased 16% to \$2,523 million. Fiscal 1998's net income also reflects a decline in the effective income tax rate, primarily resulting from lower tax rates applicable to non-U.S. earnings. In fiscal 1997, Securities and Asset Management net revenues and net income increased 29% and 41%, respectively, from fiscal 1996. The Company's fiscal 1998 and 1997 levels of net revenues and net income in its Securities and Asset Management business reflected a strong global market for mergers and acquisitions, higher principal trading and commission revenues primarily driven by generally favorable economic conditions, increased customer trading volume, and the positive accumulation and management of client assets. In fiscal 1998, record levels of net revenues were partially offset by losses from an institutional leveraged emerging markets debt portfolio that occurred during the third quarter. The results of both years were partially offset 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 operating results of both years were favorably impacted by 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:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Advisory fees from merger, acquisition and restructuring transactions	\$1,322	\$ 920	\$ 848
Equity underwriting revenues	815	888	722
Fixed income underwriting revenues	1,203	886	620
Total investment banking revenues	\$3,340	\$2,694	\$2,190

Investment banking revenues increased 24% and attained record levels in fiscal 1998, surpassing the Company's previous record in fiscal 1997. Revenues in fiscal 1998 benefited from increased advisory fees from merger, acquisition and restructuring transactions, as well as increased revenues from underwriting fixed income securities. Fiscal 1997's revenues reflect higher advisory fees from merger, acquisition and restructuring transactions, as well as increased revenues from underwriting both equity and fixed income securities.

The worldwide merger and acquisition markets remained robust for the fourth consecutive year with more than \$2.5 trillion of transactions (per Securities Data Company) announced during calendar year 1998, including record volume in the U.S. During calendar year 1998, the Company's dollar volume of announced merger and acquisition transactions increased by more than 80% over the comparable period of 1997. The high level of transaction activity reflected the continuing trend of consolidation and globalization across many industry sectors, as companies attempted to expand into new markets and businesses through strategic combinations. 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 44% in fiscal 1998. Advisory fees from real estate transactions also were higher as com-

pared with the prior year, driven by strong levels of market consolidation activities in the U.S. and by recovering real estate markets in Europe. The 8% increase in advisory fees in fiscal 1997 was primarily due to high transaction volumes resulting from the strong global market for merger, acquisition and restructuring activities, as well as increased revenues from real estate advisory transactions.

Equity underwriting revenues decreased 8% in fiscal 1998 although continuing to reflect a high volume of equity offerings and the Company's strong market share. During the first half of fiscal 1998, the primary market for equity issuances benefited from a high volume of cash inflows into equity mutual funds, as well as from a generally favorable economic environment. Equity underwriting revenues were adversely affected by the reduced activity in the primary market in the second half of the fiscal year due to the significant uncertainty and volatility in global financial markets. 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. In fiscal 1997, the primary market for equity issuances also benefited from a high volume of cash inflows into equity mutual funds and from a favorable economic environment.

Revenues from fixed income underwriting increased 36% in fiscal 1998, primarily driven by higher revenues from issuances of global high-yield and investment grade fixed income securities. The primary market for these securities benefited from relatively low nominal interest rates which existed throughout the year and attracted many issuers to the market, as well as from periods of strong investor demand. During the latter part of fiscal 1998, the primary market was less active as increased volatility in global financial markets caused an unprecedented widening of credit spreads and a shift of investor preferences toward financial instruments with higher credit ratings. Revenues from fixed income 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. Fiscal 1997's fixed income underwriting 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.

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 transaction trading revenues were as follows:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Equities	\$2,056	\$1,310	\$1,181
Fixed income	455	1,187	1,172
Foreign exchange	587	500	169
Commodities	193	194	137
Total principal transaction trading revenues	\$3,291	\$3,191	\$2,659

Principal transaction trading revenues increased 3% in fiscal 1998, primarily due to higher equities and foreign exchange trading revenues, partially offset by a decline in fixed income trading revenues. In fiscal 1997, principal trading revenues increased 20%, primarily reflecting higher equities and foreign exchange trading revenues.

Equity trading revenues increased 57% to a record level in fiscal 1998, primarily reflecting higher revenues from equity cash and derivative products. The increase in revenues from equity cash products was primarily attributable to higher trading volumes in European markets, which benefited from the Company's increased sales and research coverage of the region that began in mid-1997. European equity trading revenues also benefited from generally favorable market conditions and positive investor sentiment regarding EMU. Revenues from trading equity derivative products also increased, primarily due to increased transaction volume and the high levels of market volatility that existed throughout the year, particularly in technology-related issues. Equity trading revenues increased 11% 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.

Fixed income trading revenues decreased 62% in fiscal 1998, reflecting significantly lower revenues from investment grade, high-yield and securitized fixed income securities. Revenues from investment grade fixed income securities were adversely affected by the severe economic and financial turmoil in the Far East, Russia and emerging markets that occurred during the year. These difficult conditions caused investor preferences to shift toward higher quality financial instruments, principally to U.S. treasury securities. This negatively affected the trading of credit-sensitive fixed income securities by widening credit spreads, reducing market liquidity and de-coupling the historical price relationships between credit-sensitive securities and government securities. Revenues from high-yield fixed income securities also were impacted by the turbulent conditions in the global financial markets due to investors' concerns about the impact of a prolonged economic downturn on high-yield issuers. Revenues from securitized fixed income securities also declined, as the relatively low interest rate environment in the U.S. increased prepayment concerns and resulted in increased spreads. 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.

Revenues from foreign exchange trading increased 17% to record levels in fiscal 1998. The increase was primarily attributable to high levels of customer trading volume and volatility in the foreign exchange markets. During fiscal 1998, the U.S. dollar fluctuated against major currencies due to concerns about the U.S. economy's exposure to the financial crises in the Far East and emerging markets, as well as from the Federal Reserve Board's decision to lower the overnight lending rate on three occasions during the fourth

quarter. Certain European currencies also experienced periods of volatility, resulting from expectations of interest rate fluctuations in anticipation of EMU and the collapse of the Russian ruble. Difficult political and economic conditions in certain Asian nations, coupled with the continued recession in Japan, also contributed to periods of high volatility in the currency markets. Foreign exchange trading revenues increased 196% in fiscal 1997, primarily resulting from the Company's increased client market share and from high levels of volatility in the foreign exchange markets. During fiscal 1997, 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 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.

Commodities trading revenues were comparable to prior-year levels, as higher revenues from crude oil, refined energy products and electricity were partially offset by lower revenues from natural gas trading. Revenues from trading crude oil and refined energy products were impacted by energy prices that fell during much of fiscal 1998. Diminished demand for these products, partially due to the ongoing economic crisis in the Far East, coupled with high inventory levels, contributed to the decline in prices. Electricity trading revenues benefited from higher electricity prices, primarily during the summer months when the demand for electric power increased. The Company's continued presence in the electricity market and the ongoing deregulation of the industry also had a favorable impact on electricity trading revenues. Revenues from natural gas trading decreased as unseasonably warm weather in certain regions of the U.S. during the winter months reduced the demand for home heating oil, leading to a decline in prices. 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 1998 and fiscal 1997, commodities trading revenues benefited from the expansion of the cus-

tomer base for commodity-related products, including derivatives, and the use of such products for risk management purposes.

Principal transaction investment revenues aggregating \$89 million were recognized in fiscal 1998 as compared with \$463 million in fiscal 1997. Fiscal 1998 revenues reflected the second highest level of revenues from the Company's private equity business, which primarily resulted from gains on certain positions that were sold during the year and increases in the carrying value of certain of the Company's private equity investments. Such increases included gains from the initial public offering of Equant and gains from the sale of positions in Fort James Corporation and Jefferson Smurfit Corporation. These gains were substantially offset by losses from an institutional leveraged emerging markets debt portfolio that occurred during the third quarter. Fiscal 1997 revenues primarily reflect increases in the carrying value of certain of the Company's private equity investments, including an increase related to the Company's holdings of Fort James Corporation, 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 fiscal 1997's revenues.

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 13% in fiscal 1998, reflecting higher revenues from equity cash products, primarily from markets in the U.S. and Europe, as well as higher revenues from derivative products. Revenues from U.S. markets benefited from high levels of market volatility, which contributed to increased customer trading volumes. Revenues from European markets also benefited from strong customer trading volumes, which were positively impacted by the generally favorable performances of certain European equity markets and from the Company's increased sales and research activities in the region. Commissions on derivative products increased as the high levels of market volatility contributed to increased customer hedging activities and trading volumes. Higher commissions from the sale of mutual funds and the Company's addition of more than 1,000 financial advisors during fiscal 1998 also contributed to the increase. 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 expe-

rienced 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.

Net Interest

Interest and dividend revenues and interest expense are a function of the level and mix of total assets and liabilities, including financial instruments owned, reverse repurchase and repurchase agreements, trading strategies associated with the Company's institutional securities activities, customer margin loans and the prevailing level, term structure and volatility of interest rates. Interest and dividend revenues and interest 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 43% in fiscal 1998, primarily attributable to higher levels of revenues from net interest earning assets, including financial instruments owned and customer margin receivable balances. Higher levels of securities lending transactions also had a positive impact on net interest revenues. Net interest revenues increased 23% in fiscal 1997, reflecting higher levels of trading activities and retail customer financing activity, including margin interest. In fiscal 1997, net interest revenues also 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:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Asset management, distribution and administration fees	\$2,848	\$2,505	\$1,732

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

(dollars in billions)	FISCAL 1998	fiscal 1997	fiscal 1996
Customer assets under management or supervision (at fiscal year-end)	\$376	\$338	\$278

In fiscal 1998, asset management, distribution and administration fees increased 14%, reflecting the Company's continuing strategic emphasis on the asset management business. The increase in revenues primarily reflects higher fund management and 12b-1 fees as well as other revenues resulting from a higher level of assets under management or supervision, including revenues from developed country global equity and fixed income products. Such increases were partially offset by the impact of market depreciation in certain of the Company's products resulting from the downturn in certain global financial markets which occurred during the latter half of the year. Fiscal 1998's revenues also were negatively impacted by the Company's sale of its Correspondent Clearing and Global Custody businesses which occurred during fiscal 1998. In fiscal 1997, asset management, distribution and administration fees increased 45%. This increase reflects revenues from VK, which was acquired by the Company on October 31, 1996. Fiscal 1997 revenues also 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.

As of November 30, 1998, assets under management or supervision increased \$38 billion from fiscal year-end 1997. The increase in assets under management or supervision in both fiscal 1998 and fiscal 1997 reflected continued inflows of customer assets as well as appreciation in the value of customer portfolios. In both fiscal 1998 and 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.

Non-Interest Expenses

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Compensation and benefits	\$6,071	\$5,475	\$4,585
Occupancy and equipment	510	462	432
Brokerage, clearing and exchange fees	538	448	317
Information processing and communications	666	602	514
Marketing and business development	487	393	296
Professional services	579	378	282
Other	529	511	382
Total non-interest expenses	\$9,380	\$8,269	\$6,808

Fiscal 1998's total non-interest expenses increased 13% to \$9,380 million. Within the non-interest expense category, employee compensation and benefits expense increased 11%, reflecting increased levels of incentive compensation based on record fiscal 1998 revenues and earnings, as well as an increase in the number of employees. Excluding compensation and benefits expense, non-interest expenses increased \$515 million. Occupancy and equipment expense increased 10%, principally reflecting additional office space and higher occupancy costs in New York and Hong Kong, as well as incremental rent attributable to the opening of 27 securities branch locations. Brokerage, clearing and exchange fees increased 20%, primarily reflecting increased expenses related to higher levels of trading volume in the global securities markets. Commissions paid in

connection with the Company's launch of The Van Kampen Senior Income Trust mutual fund also contributed to the increase. Information processing and communications costs increased 11% due to higher data services and communications costs related to an increased number of employees and continued enhancements and maintenance associated with the Company's information technology infrastructure. Marketing and business development expense increased 24%, reflecting higher travel and entertainment costs relating to increased levels of business activity associated with active financial markets. Higher advertising and promotional costs also contributed to the increase. Professional services expense increased 53%, primarily reflecting higher consulting costs as a result of certain information technology initiatives, including the Company's preparations for EMU and Year 2000 (see also "Year 2000 and EMU" herein). Higher levels of temporary staff and employment fees due to the increased level of overall business activity also contributed to the increase. Other expenses increased 4%, which reflects the impact of a higher level of business activity on various operating expenses.

Fiscal 1997's total non-interest expenses increased 21% to \$8,269 million. Within the non-interest expense category, employee compensation and benefits expense increased 19%, reflecting increased levels of incentive compensation based on then-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 VK and the global institutional custody business of Barclays. Occupancy and equipment expense increased 7%, principally reflecting the occupancy costs of VK and increased office space in London and Hong Kong. Brokerage, clearing and exchange fees increased 41%, primarily reflecting the acquisitions of VK 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 VK and continued enhancements to the Company's information technology infrastructure. Marketing and business development expense 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 VK's retail mutual funds also contributed to the increase. Professional services expense increased 34%, reflecting higher consulting costs as a result of information technology ini-

tiatives and the increased level of overall business activity. Other expenses increased 34%, which includes goodwill amortization of \$43 million associated with the acquisitions of VK and Barclays, as well as the impact of a higher level of business activity on various operating expenses.

**CREDIT AND TRANSACTION SERVICES
STATEMENTS OF INCOME**

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Fees:			
Merchant and cardmember	\$1,647	\$1,704	\$1,505
Servicing	928	762	809
Commissions	36	27	—
Asset management, distribution and administration fees	1	—	—
Other	16	12	4
Total non-interest revenues	2,628	2,505	2,318
Interest revenue	2,740	3,128	2,717
Interest expense	995	1,173	1,032
Net interest income	1,745	1,955	1,685
Provision for consumer loan losses			
Net credit income	572	462	471
Net revenues	3,200	2,967	2,789
Compensation and benefits	565	544	486
Occupancy and equipment	73	64	61
Brokerage, clearing and exchange fees	14	12	—
Information processing and communications	474	478	482
Marketing and business development	924	786	731
Professional services	98	73	52
Other	216	259	286
Total non-interest expenses	2,364	2,216	2,098
Gain on sale of businesses	362	—	—
Income before income taxes	1,198	751	691
Provision for income taxes	510	283	257
Net income	\$ 688	\$ 468	\$ 434

CREDIT AND TRANSACTION SERVICES

In fiscal 1998, Credit and Transaction Services net income increased 47% to \$688 million, including a net after-tax gain of \$163 million related to the sale of the Company's interest in the operations of SPS and certain BRAVO receivables. Excluding this gain, net income increased 12%. The increase in net income in fiscal 1998

was primarily attributable to the gain on the above-mentioned sales and a lower provision for loan losses primarily resulting from the sale of Prime Option and the operations of SPS. This increase was partially offset by increases in marketing and business development expense and incremental taxes associated with the sale of the operations of SPS. In fiscal 1997, 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.

The sale of Prime Option, the operations of SPS and certain BRAVO receivables reflect the Company's strategic decision to focus on the growth of its existing Discover Card brand and Discover/NOVUS Network. Reflecting this renewed focus, the Company introduced the Discover® Platinum Card in December 1998 and plans to launch the Discover Card in a major foreign market during fiscal 1999.

As a result of enhancements made to certain of the Company's operating systems in the fourth quarter of fiscal 1997, the Company began recording charged-off cardmember fees and interest revenue directly against the income statement line items to which they were originally recorded. Prior to the enhancements, charged-off cardmember fees and interest revenue both were recorded as a reduction of interest revenue. While this change had no impact on net revenues, the Company believes the revised presentation better reflects the manner in which charge-offs affect the Credit and Transaction Services statements of income. However, since prior periods have not been restated to reflect this change, the comparability of merchant and cardmember fees and interest revenue between fiscal 1998 and fiscal 1997 has been affected. Accordingly, the following sections also will discuss the changes in these income statement categories excluding the impact of this reclassification.

Credit and Transaction Services statistical data were as follows:

(dollars in billions)	FISCAL 1998	fiscal 1997	fiscal 1996
Consumer loans at fiscal year-end:			
Owned	\$16.0	\$20.9	\$22.1
Managed	\$32.5	\$36.0	\$35.3
General Purpose Credit Card transaction volume	\$58.0	\$55.8	\$53.6

The lower level of consumer loans at November 30, 1998 reflects the Company's sale of Prime Option, the operations of SPS and certain BRAVO receivables during fiscal 1998.

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, and fees for the administration of credit card programs and transaction processing services.

Merchant and cardmember fees decreased 3% in fiscal 1998 and increased 13% in fiscal 1997. Excluding the effect of the reclassification of charged-off cardmember fees discussed above, merchant and cardmember fees would have increased 2% in fiscal 1998. This increase in fiscal 1998 was attributable to higher merchant discount revenue primarily associated with increased growth of general purpose credit card transaction volume related to the Discover Card offset by lower revenues due to the sale of the operations of SPS in October 1998. In addition, merchant and cardmember fees benefited from higher overlimit and late fees attributable to a fee increase introduced during fiscal 1998 and an increase in occurrences of delinquent and overlimit accounts. Partially offsetting these increases was a decrease in cash advance fees as a result of lower cash advance transaction volume primarily attributable to limits on cash advances imposed by the Company in an effort to improve credit quality. The increase in fiscal 1997 was due to an increase in merchant discount revenue associated with increased growth of general purpose credit card transaction volume and increased late payment fees and overlimit fees. The increase in overlimit fees was due to a higher incidence of overlimit occurrences. The increase in late payment fee revenues was due to an increase in the incidence of late payments and higher levels of delinquent accounts.

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 resulting from 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 Company completed asset securitizations of \$4.5 billion in fiscal 1998 and \$2.8 billion in fiscal 1997. The asset securitizations in fiscal 1998 and 1997 have expected maturities ranging from three to 10 years from the date of issuance.

The table below presents the components of servicing fees:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Merchant and cardmember fees	\$ 505	\$ 436	\$ 307
Interest revenue	2,598	2,116	2,025
Interest expense	(1,010)	(829)	(792)
Provision for consumer loan losses	(1,165)	(961)	(731)
Servicing fees	\$ 928	\$ 762	\$ 809

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 increased 22% in fiscal 1998 and decreased 6% in fiscal 1997. The increase in fiscal 1998 was due to higher levels of net interest cash flows and increased fee revenue, partially offset by increased credit losses from securitized consumer loans which were primarily a result of higher levels of average securitized loans. The decline in fiscal 1997 servicing fees was attributable to higher credit losses, partially offset by higher cardmember fees and net interest revenues.

Commission Revenues

Commission revenues arise from customer securities transactions associated with Discover Brokerage Direct, Inc. ("DBD"), the Company's provider of electronic brokerage services acquired in January 1997. Commission revenues increased 33% in fiscal 1998 resulting from an increase in the level of customer trading activity, partially offset by lower revenue per trade due to an increase in Internet trades as a percentage of total trades. In addition, fiscal 1998 contained a full year of commissions for DBD, while fiscal 1997 reflected only 10 months.

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 by DBD for promoting and distributing mutual funds.

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 inter-

est 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 1998, fiscal 1997 and fiscal 1996 and changes in net interest income during those fiscal years:

AVERAGE BALANCE SHEET ANALYSIS

(dollars in millions)	FISCAL 1998			FISCAL 1997 ⁽³⁾			FISCAL 1996 ⁽³⁾		
	AVERAGE BALANCE	RATE	INTEREST	Average Balance	Rate	Interest	Average Balance	Rate	Interest
ASSETS									
Interest earning assets:									
General purpose credit card loans	\$17,184	13.87%	\$2,383	\$19,512	14.03%	\$2,738	\$17,083	13.99%	\$2,391
Other consumer loans	1,374	16.70	229	1,773	15.73	279	1,766	14.25	252
Investment securities	496	6.25	31	176	5.45	10	234	5.38	13
Other	1,465	6.61	97	1,680	6.06	101	1,078	5.60	61
Total interest earning assets	20,519	13.35	2,740	23,141	13.52	3,128	20,161	13.47	2,717
Allowance for loan losses	(847)			(828)			(669)		
Non interest earning assets	1,517			1,529			1,334		
Total assets	\$21,189			\$23,842			\$20,826		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Interest bearing deposits									
Savings	\$ 1,073	4.79%	\$ 51	\$ 963	4.27%	\$ 41	\$ 1,021	4.58%	\$ 47
Brokered	5,656	6.62	375	4,589	6.66	306	3,418	6.93	237
Other time	2,189	6.16	135	2,212	6.12	135	1,921	6.05	116
Total interest bearing deposits	8,918	6.29	561	7,764	6.21	482	6,360	6.29	400
Other borrowings	7,162	6.06	434	11,371	6.07	691	10,307	6.11	632
Total interest bearing liabilities	16,080	6.19	995	19,135	6.13	1,173	16,667	6.18	1,032
Shareholders' equity/other liabilities	5,109			4,707			4,159		
Total liabilities and shareholders' equity	\$21,189			\$23,842			\$20,826		
Net interest income		\$1,745			\$1,955			\$1,685	
Net interest margin ⁽¹⁾		8.51%			8.45%			8.36%	
Interest rate spread ⁽²⁾		7.16%			7.39%			7.29%	

(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.

(3) Certain prior-year information has been reclassified to conform to the current year's presentation.

RATE/VOLUME ANALYSIS

INCREASE/(DECREASE) DUE TO CHANGES IN:
(dollars in millions)

	VOLUME	1998 vs. 1997			Volume	1997 vs. 1996		
		RATE	TOTAL	Rate		Total	Rate	Total
INTEREST REVENUE								
General purpose credit card loans	\$ (327)	\$(28)	\$(355)	\$339	\$ 8	\$347		
Other consumer loans	(63)	13	(50)	1	26	27		
Investment securities	17	4	21	(3)	—	(3)		
Other	(12)	8	(4)	33	7	40		
Total interest revenue	(353)	(35)	(388)	400	11	411		
INTEREST EXPENSE								
Interest bearing deposits:								
Savings	5	5	10	(3)	(3)	(6)		
Brokered	71	(2)	69	81	(12)	69		
Other time	(1)	1	—	18	1	19		
Total interest bearing deposits	72	7	79	88	(6)	82		
Other borrowings	(256)	(1)	(257)	64	(5)	59		
Total interest expense	(188)	10	(178)	151	(10)	141		
Net interest income	\$ (165)	\$(45)	\$ (210)	\$249	\$21	\$270		

Net interest income decreased 11% in fiscal 1998 and increased 16% in fiscal 1997. Excluding the effect of the reclassification of charged-off cardmember fees discussed previously, net interest income would have decreased 15% in fiscal 1998. The decrease in fiscal 1998 was due to lower average levels of owned consumer loans and a lower yield on general purpose credit card loans. The decrease in owned consumer loans was primarily due to an increase in securitized loans and the sale of the Prime Option and SPS portfolios. The lower yield on general purpose credit card loans in fiscal 1998 was due to a larger number of cardmembers taking advantage of promotional rates. 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. The Company believes that the effect of changes in market interest rates on net interest income was mitigated as a result of its liquidity and interest rate risk management policies. The increase in net interest income in fiscal 1997 was 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.

The Company anticipates the repricing of a substantial portion of its existing credit card receivables to a fixed interest rate during fiscal 1999. The Company does not believe this repricing will have a material impact on its interest rate sensitivity due to the Company's matched financing objectives.

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

(dollars in millions)	FISCAL 1998		FISCAL 1997		FISCAL 1996	
	AVERAGE BALANCE	RATE	Average Balance	Rate	Average Balance	Rate
Consumer loans	\$34,619	14.86%	\$34,619	14.83%	\$31,459	14.83%
General purpose credit card loans	32,684	14.72	32,176	14.72	29,021	14.81
Total interest earning assets	36,580	14.41	36,475	14.38	32,770	14.46
Total interest bearing liabilities	32,141	6.16	32,469	6.17	29,277	6.22
Consumer loan interest rate spread		8.70		8.66		8.61
Interest rate spread		8.25		8.21		8.24
Net interest margin		9.00		8.89		8.90

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 \$787 million at November 30, 1998 and \$884 million at November 30, 1997.

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, decreased 21% in fiscal 1998 and increased 23% in fiscal 1997. The decrease in fiscal 1998 was due to a decrease in net charge-offs resulting from lower average levels of owned consumer loans, primarily attributable to an increased level of securitized loans and reduced levels of charge-offs associated with the sale of Prime Option and SPS receivables, partially offset by a small increase in the net charge-off rate of the Discover Card portfolio. The provision for loan losses also was positively impacted by a decline in the loan loss allowance in connection with securitization transactions entered into prior to the third quarter of 1996. The Company expects this loan loss allowance will be fully amortized over fiscal 1999. In fiscal 1997, the increase in consumer loan losses 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. 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 provision for consumer loan losses include the level and direction of consumer loan delinquencies and charge-offs, 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. Delinquency rates decreased in fiscal 1998 as a reflection of the Company's increased focus on credit quality and account collections, as well as the sale of Prime Option, SPS and BRAVO.

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 as compared with November 30, 1996 was favorably impacted by a September 1997 skip-a-payment offer allowing certain cardmembers to skip their next monthly payment. The following table presents delinquency and net charge-off rates with supplemental managed loan information:

ASSET QUALITY

(dollars in millions)	FISCAL 1998		FISCAL 1997		FISCAL 1996	
	Owned	Managed	Owned	Managed	Owned	Managed
Consumer loans at period-end	\$15,996	\$32,502	\$20,917	\$35,950	\$20,085	\$33,316
Consumer loans contractually past due as a percentage of period-end consumer loans:						
30 to 89 days	3.54%	3.69%	3.96%	3.91%	4.45%	4.49%
90 to 179 days	2.67%	2.84%	3.11%	3.07%	2.78%	2.78%
Net charge-offs as a percentage of average consumer loans	6.75%	6.90%	6.78%	6.95%	5.29%	5.43%

Non-Interest Expenses

Total non-interest expenses increased 7% to \$2,364 million in fiscal 1998 and 6% to \$2,216 million in fiscal 1997.

Employee compensation and benefits expense increased 4% in fiscal 1998 and 12% in fiscal 1997. The increase in fiscal 1998 was due to an increased number of employees and higher executive compensation costs associated with Discover Card operations and DBD, offset by lower compensation costs associated with the sale of Prime Option and the operations of SPS. The increase in fiscal 1997 was due to an increased number of employees and employment costs associated with processing increased credit card transaction volume and servicing additional Discover/NOVUS Network merchants and active credit card accounts, including collection activities.

Occupancy and equipment expense increased 14% in fiscal 1998 and 5% in fiscal 1997. The increases in both years were due to higher rent and other occupancy costs at certain of the Company's facilities, including payment processing centers.

Brokerage, clearing and exchange fees increased 17% from fiscal 1997. The increase is attributable to higher levels of DBD customer trading volume, partially offset by lower costs per trade resulting from DBD's implementation of self-clearing operations in October 1998.

Information processing and communications expense decreased 1% in fiscal 1998 and 1997. In fiscal 1998, lower

transaction processing costs resulting from the sale of the operations of SPS were partially offset by higher external data processing costs related to the Year 2000 project and increased cardmember data analysis associated with credit risk management activity. In fiscal 1997, information processing and communications expense increased due to higher levels of transaction volume, additional Discover/NOVUS Network servicing costs and the development of the systems supporting the Company's multi-card strategy. In fiscal 1997, the 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 18% in fiscal 1998 and 8% in fiscal 1997. The increase in fiscal 1998 was attributed to higher advertising and promotional expenses associated with increased direct mail and other promotional activities related to the Discover Card, Private Issue® Card, partnership programs and DBD, as well as higher cardmember rewards expense. The Company increased marketing and promotional spending significantly in the third and fourth quarters of fiscal 1998 in an effort to renew and increase growth in the Discover Card brand. In the past several years, the Company focused its attention on improving and maintaining credit quality. In fiscal 1999, the Company expects to continue to invest in the growth of its credit card business, including the introduction of a Discover Platinum Card and the launch of the Discover Card into a major foreign market.

The increase in fiscal 1997 was primarily attributable to higher card-member rewards expense and marketing and promotional costs. Higher marketing and promotional costs were associated with the growth of new and existing credit card brands. 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 1% (up to 2% for the Private Issue Card) based upon a cardmember's level of annual purchases. Higher cardmember rewards expense in both years was associated with growth in credit card transaction volume and increased credit card-member qualification for higher award levels. Commencing March 1, 1998, the terms of the Private Issue Cashback Bonus program were amended by limiting the maximum annual bonus amount to \$500 and by increasing the amount of purchases required to receive this bonus amount. Cardmember rewards expense was not materially impacted by these changes.

Professional services expense increased 34% in fiscal 1998 and 40% in fiscal 1997. The increase in fiscal 1998 was due to services related to increased partnership program activity, higher expenditures for consumer credit counseling and collections services and consulting fees. The increase in fiscal 1997 was primarily due to higher expenditures for consumer credit counseling and collections services.

Other non-interest expenses decreased 17% in fiscal 1998 and 9% in fiscal 1997. Other expenses primarily include fraud losses, credit inquiry fees and other administrative costs. The decrease in both years was due to a continuing decline in the level of fraud losses. Fiscal 1998 also reflects a lower level of expenses resulting from the sale of Prime Option and the operations of SPS.

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 following 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 first fiscal quarter, reflecting seasonal growth in retail sales volume.

LIQUIDITY AND CAPITAL RESOURCES

The Balance Sheet

The Company's total assets increased to \$317.6 billion at November 30, 1998 from \$302.3 billion at November 30, 1997, primarily reflecting growth in cash and cash equivalents, cash and securities deposited with clearing organizations or segregated under federal and other regulations, and securities borrowed. 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, private equity 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 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, in the future, may expand or contract its capital base to address the changing needs of its businesses. The Company also has returned to shareholders 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 unencumbered 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 floating 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 and duration characteristics of the loans financed. The Company 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 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 unsecured 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, 1999, the Company's credit ratings were as follows:

	<i>Commercial Paper</i>	<i>Senior Debt</i>
Dominion Bond Rating Service	R-1	n/a
Duff & Phelps Credit Rating Co.	D-1+	AA
Fitch IBCA, Inc.	F1+	AA-
Japan Rating & Investment Information, Inc.	A-1+	AA-
Moody's Investors Service	P-1	Aa3
Standard & Poor's	A-1	A+
Thomson BankWatch, Inc.	TBW-1	AA

During fiscal 1998, Moody's Investors Service upgraded the Company's senior debt rating from A1 to Aa3. In January 1999, Duff & Phelps Credit Rating Co. upgraded the Company's senior debt rating from AA- to AA.

As the Company continues its global expansion and derives revenues increasingly 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 engag-

ing 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 Japanese commercial paper; letters of credit; unsecured bond borrows; 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, Federal 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 Federal 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 individual 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.

The Company maintains a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the "MSDW Facility"). Under the terms of the MSDW Facility, the banks are committed to provide up to \$6.0 billion. The MSDW Facility contains restrictive covenants which require, among other things, that the Company maintain shareholders' equity of at least \$9.1 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, 1998, no borrowings were outstanding under the MSDW 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 \$1.875 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 1999, the MS&Co. Facility was renewed. At November 30, 1998, 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"), the Company's London-based broker-dealer subsidiary, 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 and, effective January 1, 1999, the euro. 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, 1998, no borrowings were outstanding under the MSIL Facility.

RFC maintains a senior bank credit facility to support the issuance of asset-backed commercial paper in the amount of \$2.6 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, 1998. RFC has never borrowed from its senior bank credit facility.

The Company anticipates that it will utilize the MSDW 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 1998 and Subsequent Activity

During fiscal 1998, 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 \$4,345 million to \$37,922 million at November 30, 1998.

During fiscal 1998, the Company issued senior notes aggregating \$9,800 million, including non-U.S. dollar currency notes aggregating \$1,640 million, primarily pursuant to its public debt shelf registration statements. These notes have maturities from 1999 to 2028 and a weighted average coupon interest rate of 5.6% at November 30, 1998; the Company has entered into certain transactions to obtain floating interest rates based primarily on short-term LIBOR trading levels. At November 30, 1998, the aggregate outstanding principal amount of the Company's Senior Indebtedness (as defined in the Company's public debt shelf registration statements) was approximately \$45.3 billion. Between November 30, 1998 and January 31, 1999, the Company issued additional debt obligations aggregating approximately \$2,298 million. These notes have maturities from 2000 to 2013.

Effective January 1999, the Company's Board of Directors authorized the Company to purchase, subject to market conditions and certain other factors, up to \$1 billion of the Company's common stock. The Board of Directors also approved a separate ongoing repurchase authorization in connection with awards granted under the Company's equity-based compensation plans. During fiscal 1998, the Company purchased \$2,925 million of its common stock. Subsequent to November 30, 1998 and through January 31, 1999, the Company purchased an additional \$110 million of its common stock.

On March 5, 1998, MSDW Capital Trust I, a Delaware statutory business trust (the "Capital Trust"), all of the common securities of which are owned by the Company, issued \$400 million of 7.10% Capital Securities (the "Capital Securities") that are guaranteed by the Company. The Capital Trust issued the Capital

Securities and invested the proceeds in 7.10% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due February 28, 2038.

On March 12, 1998, the Company's shelf registration statement for an additional \$8 billion of debt securities, warrants, preferred stock or purchase contracts, or any combination thereof in the form of units, became effective.

On August 31, 1998, the Company redeemed all 1,000,000 outstanding shares of its 7-3/8% Cumulative Preferred Stock at a redemption price of \$200 per share. The Company also simultaneously redeemed all corresponding Depositary Shares at a redemption price of \$25 per Depositary Share. Each Depositary Share represented 1/8 of a share of the Company's 7-3/8% Cumulative Preferred Stock.

On January 28, 1999, the Company and Morgan Stanley Finance, plc, a U.K. subsidiary, called for redemption all of the outstanding 7.82% Capital Units and 7.80% Capital Units on February 28, 1999. The aggregate principal amount of the Capital Units to be redeemed is \$352 million.

At November 30, 1998, certain assets of the Company, such as real property, equipment and leasehold improvements of \$1.8 billion, and goodwill and other intangible assets of \$1.2 billion, were illiquid. In addition, certain equity investments made in connection with the Company's private equity 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 private equity 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, 1998, the aggregate carrying value of the Company's equity investments in privately held companies (including direct investments and partnership interests) was \$185 million, and its aggregate investment in publicly held companies was \$320 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, 1998 traded in markets that the Company believed were experiencing lower levels of liquidity than traditional mortgage-backed pass-through securities approximated \$1,369 million.

In addition, at November 30, 1998, the aggregate value of high-yield debt securities and emerging market loans and securitized instruments held in inventory was \$2,395 million (a substantial portion of which was subordinated debt). These securities, loans and instruments were not attributable to more than 6% to any one issuer, 22% to any one industry or 18% to any one geographic region. 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, therefore, are 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 that are administered 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").

The Company also has commitments to fund certain fixed assets and other less liquid investments, including at November 30, 1998 approximately \$181 million in connection with its private equity 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.

In November 1998, the Company announced that it had entered into an agreement that will result in the development of an office tower in New York City. Pursuant to this agreement, the Company has entered into a 99-year lease for the land at the proposed development site.

The Company may, from time to time, also provide financing or financing commitments to companies in connection with its investment banking and private equity 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. At November 30, 1998, the Company had two com-

mitments to provide an aggregate of \$82 million and had one loan in the amount of \$8 million outstanding in connection with its high-yield underwriting activities. Between November 30, 1998 and January 31, 1999, the Company's aggregate commitments increased to \$89 million and had two loans in the amount of \$112 million outstanding.

In September 1998, the Company made an investment of \$300 million in the Long-Term Capital Portfolio, L.P. ("LTCP"). The Company is a member of a consortium of 14 financial institutions participating in an equity recapitalization of LTCP. The objectives of this investment, the term of which is three years, are to continue active management of its positions and, over time, reduce excessive risk exposures and leverage, return capital to the participants and ultimately realize the potential value of the LTCP portfolio. At November 30, 1998, the carrying value of the Company's investment in LTCP approximated fair value.

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 generally are 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, 1998, the aggregate value of senior secured loans and positions held by the Company was \$1,259 million, and aggregate senior secured loan commitments were \$447 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 9, respectively, to the consolidated financial statements (see also "Derivative Financial Instruments" herein).

YEAR 2000 AND EMU

Year 2000 Readiness Disclosure

Many of the world's computer systems (including those in non-information technology equipment and systems) currently record years in a two-digit format. If not addressed, such computer systems may 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.

The Company has established a firm-wide initiative to address issues associated with the Year 2000. Each of the Company's business areas has taken responsibility for the identification and remediation of Year 2000 issues within its own areas of operations and for addressing all interdependencies. A corporate team of internal and external professionals supports the business teams by providing direction and company-wide coordination as needed. The Year 2000 and EMU (discussed below) projects have been designated as the highest priority activities of the Company's Information Technology Department. 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 its systems and programs to identify those that contain two-digit year codes and is in the process of upgrading its global infrastructure and corporate facilities to achieve Year 2000 compliance. In addition, the Company is actively working with its major external counterparties and suppliers to assess their compliance and remediation efforts and the Company's exposure to them.

In addressing the Year 2000 issue, the Company has identified the following phases. In the *Awareness phase*, the Company defined the Year 2000 issue and obtained executive level support and funding. In the *Inventory phase*, the Company collected a comprehensive list of items that may be affected by Year 2000 compliance issues. Such items include facilities and related non-information technology systems (embedded technology), computer systems, hardware, and services and products provided by third parties. In the *Assessment phase*, the Company evaluated the items identified in the *Inventory phase* to determine which will function properly with the change to the new century and ranked items which will need to be remediated based on their potential impact to the Company. The *Remediation phase* includes an analysis of the items that are affected by Year 2000, the identification of problem areas and the repair of non-compliant items. The *Testing phase* includes a thorough testing of all proposed repairs, including present and forward date testing which simulates dates in the Year 2000. The *Implementation phase* consists of placing all items that have been remediated and successfully tested into production. Finally, the *Integration and External Testing phase* includes exercising business-critical production systems in a future time environment and testing with external entities.

The Company has completed the Awareness, Inventory and Assessment phases. As of November 30, 1998, the Remediation, Testing and Implementation phases were substantially complete. Due to resource allocations between the Year 2000 and EMU projects, as well as late vendor delivery of third-party products, the Company expects that the remaining portions of the Remediation, Testing and Implementation phases of substantially all mission-critical systems will be complete by March 31, 1999 as compared with the original expected completion date of December 31, 1998. The Integration and External Testing phase commenced in the second quarter of 1998 and will continue through 1999. In addition, the major business relationships of the Company have been identified, and the most critical of them have been or are scheduled to be tested.

In addition, the Company is closely monitoring the Year 2000 compliance status of its most critical business relationships. The Company continues to survey and communicate with counterparties, intermediaries and vendors with whom it has important financial and operational relationships to determine the extent to which they are vulnerable to Year 2000 issues. As of November 30, 1998, the Company had not yet received sufficient information from all parties about their remediation plans to predict the outcomes of their efforts. In particular, in some international markets in which the Company conducts business, the level of awareness and remediation efforts relating to the Year 2000 issue is thought to be less advanced than in the United States.

During the third quarter of fiscal 1998, the Company participated in the Securities Industry Association's Beta test and a test sponsored by the Bank of England's Central Gilt's Office. These tests were run in "future time," using a portion of the Company's production system, and employed test scripts to check functionality. The Company has achieved successful results in each of the industry-wide tests in which it participated. The Company will continue to participate in industry-wide and vendor-specific tests throughout 1999.

There are many risks associated with the Year 2000 issue, including the possibility of a failure of the Company's computer and non-information technology systems. Such failures could have a material adverse effect on the Company and may cause systems malfunctions; incorrect or incomplete transaction processing resulting in failed trade settlements; the inability to reconcile accounting books and records; the inability to reconcile credit card transactions and

balances; the inability to reconcile trading positions and balances with counterparties; and inaccurate information to manage the Company's exposure to trading risks and disruptions of funding requirements. In addition, even if the Company successfully remediates its Year 2000 issues, it can be materially and adversely affected by failures of third parties to remediate their own Year 2000 issues. The Company recognizes the uncertainty of such external dependencies since it cannot directly control the remediation efforts of third parties. The failure of third parties with which the Company has financial or operational relationships, such as securities exchanges, clearing organizations, depositories, regulatory agencies, banks, clients, counterparties, vendors (including data center, data network and voice service providers) and utilities, to remediate their computer and non-information technology systems issues in a timely manner could result in a material financial risk to the Company.

If the above-mentioned risks are not remedied, the Company may experience business interruption or shutdown, financial loss, regulatory actions, damage to the Company's global franchise and legal liability.

The Company has business continuity plans in place for its critical business functions on a worldwide basis. The Company also has in place a contingency funding strategy (see "Liquidity and Capital Resources"). The Company has begun Year 2000 contingency planning. The Company is currently reviewing responses from its major external counterparties and suppliers with respect to Year 2000 preparation, assessing the results of various internal and external systems tests and analyzing possible Year 2000 scenarios to determine a range of likely outcomes. The Company intends to document and test Year 2000 specific contingency plans during fiscal 1999 as part of its Year 2000 mitigation efforts.

Based upon current information, the Company estimates that the total cost of implementing its Year 2000 initiative will be between \$200 million and \$225 million. The decrease in these estimates from amounts previously reported is associated with the Company's sale of its interest in the operations of SPS and with revised internal estimates. The Year 2000 costs include all activities undertaken on Year 2000 related matters across the Company, including, but not limited to, remediation, testing (internal and external), third-party review, risk mitigation and contingency planning. Through November 30, 1998, the Company expended approximately \$110 million on the Year 2000 project. The Company expects the major-

ity of the remaining costs to be directed primarily toward testing activities. These costs have been and will continue to be funded through operating cash flow and are expensed in the period in which they are incurred.

The Company's expectations about future costs, the timely completion and the potential risks of its Year 2000 modifications are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that could influence the amount of future costs and the effective timing of remediation efforts include the success of the Company in identifying computer programs and non-information technology systems that contain two-digit year codes; the nature and amount of programming and testing required to upgrade or replace each of the affected programs and systems; the nature and amount of testing, verification and reporting required by the Company's regulators around the world, including securities exchanges, central banks and various governmental regulatory bodies; the rate and magnitude of related labor and consulting costs; and the success of the Company's external counterparties and suppliers, as well as worldwide exchanges, clearing organizations and depositories, in addressing the Year 2000 issue.

EMU

EMU replaces the national currencies of 11 participating European Union countries with a single European currency — the euro. The euro was launched on January 1, 1999, when the European Central Bank assumed control of monetary policy for the participating nations. During the transition period until the national currencies are withdrawn from circulation (July 2002 at the latest), such currencies will continue to exist but only as fixed denominations of the euro. EMU will primarily impact the Company's Securities and Asset Management business.

The introduction of the euro presents major business opportunities for financial market participants such as the Company. The Company expects that the introduction of the euro will lead to greater cross-border price transparency and will have a significant impact on the markets in which the Company operates.

The Company prepared actively for the introduction of the euro and implemented significant modifications to its information technology systems and programs in order to prepare for transition to the euro. The Company engaged in extensive testing of the

systems and processes affected by EMU and also communicated extensively with its clients and counterparties regarding the implications of EMU. The Company considers that the initial redenomination exercise that took place between January 1 and January 3, 1999 was successful from the perspective of its internal systems and books and records. Despite certain initial issues with the settlement of euro payments, as of January 31, 1999 it appears that the changeover to the euro has been successful across Europe.

Based upon current information, the Company estimates that the costs associated with reviewing, amending and testing its information technology systems to prepare for EMU for fiscal 1998 and through the project's completion will be approximately \$76 million. Substantially all of such costs were incurred by the end of fiscal 1998. These costs have been and will continue to be funded through operating cash flow and are expensed in the period in which they are incurred.

REGULATORY CAPITAL REQUIREMENTS

Dean Witter Reynolds Inc. ("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 11 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 9 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, 1998 was \$2,860 billion (as compared with \$2,529 billion at November 30, 1997). 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, 1998 was \$21.4 billion. Approximately \$16.2 billion of that credit risk exposure was with counterparties rated single-A or better (see Note 9 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 Note 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 23.

Risk management at the Company is a multi-faceted process with independent oversight that 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, as well as other committees established to manage and monitor specific risks, review the risk monitoring and risk management policies and procedures relating to the Company's market

and credit risk profile, sales practices, pricing of consumer loans and reserve adequacy, legal enforceability and operational and systems risks. The Controllers, Treasury, Law, Compliance and Governmental Affairs and Firm Risk Management 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, periodically examines and evaluates the Company's operations and control environment. 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 predictions 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 11 to the consolidated financial statements.

TRADING AND RELATED ACTIVITIES

Primary Market Risk Exposures and Market Risk Management

During fiscal 1998, the Company had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commod-

ity 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, French franc and, on a going-forward basis, the euro. 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 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 on a Company-wide basis, 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 limits have been approved for the Company and each major trading division of the Company worldwide (equity, fixed income, foreign exchange and commodities). Discrete market risk limits are assigned to trading desks and, as appropriate, products and regions, that are compatible with the trading division limits. Trading division risk managers, desk risk managers and the Firm Risk Management Department all monitor market risk measures against limits and report major market and position events to senior management.

The Firm Risk Management 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 Firm Risk Management Department.

Value-at-Risk

The statistical technique known as Value-at-Risk ("VaR") is one of the tools used by management to measure, monitor and review the market risk exposures of the Company's trading portfolios. The Company's independent Firm Risk Management Department calculates and distributes daily VaR-based risk measures to various levels of management.

VaR Methodology, Assumptions and Limitations

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 movements, would have been exceeded with a frequency of 1%, or once in 100 trading days.

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. Market risks that are incorporated in the VaR model include equity and commodity prices, interest rates, foreign exchange rates and associated volatilities, as well as correlation that exists among these variables. As a supplement to the use of historical simulation for major market risk factors, the Company's VaR model uses Monte Carlo simulation to capture name-specific risk in global equities and in U.S. corporate and high-yield bonds. As of November 30, 1998, a total of approximately 500 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.

VaR models such as the Company's are continually evolving as the composition of trading portfolios change and as modeling techniques and systems capabilities improve. During fiscal 1998, as part of the Company's ongoing program of VaR model enhancement, position and risk coverage were broadened and risk measurement methodologies were refined. Included in such enhancements were improved capture of implied volatility risks in certain derivative products and interest rate related risks in mortgage-backed and emerging-market financial instruments, which had the primary effect of increasing the VaR for interest rate risk.

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 can cover a wide range of portfolio assets yet are relatively easy to interpret. However, VaR risk measures should be interpreted in light of the methodology's limitations, which include the following: past changes in market risk factors will not always yield accurate predictions of the distributions and correlations of future market movements; changes in portfolio value in response to market movements may differ from the responses implicit in a VaR model; published VaR results reflect past trading positions while future risk depends on future positions; 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; and the historical market risk factor data used for VaR estimation may provide only limited insight into losses that could be incurred under certain unusual market movements. 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 1998

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, 1998 and November 30, 1997, incor-

porating substantially all financial instruments generating market risk (including funding liabilities related to hedging trading positions, retail trading activities and certain private equity positions that are not reported separately because the aggregate impact on the Company's VaR was not material). However, a small proportion of trading positions generating market risk 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, some commodity price risks (such as electricity price risk) and liquidity risks in certain financial products.

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, 1998		99%/ONE-DAY VaR AT NOVEMBER 30, 1997 ⁽¹⁾
	High	Average	
Interest rate	\$36	\$42	
Equity price	17	17	
Foreign exchange rate	5	7	
Commodity price	6	6	
Subtotal	64	72	
Less diversification benefit⁽²⁾	26	26	
Aggregate Value-at-Risk	\$38	\$46	

(1) The Interest rate and Aggregate Value-at-Risk for fiscal 1997 have been restated to reflect the estimated impact of enhancements to the Company's VaR model made during fiscal 1998 described above.

(2) 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 also are taken into account within each such category.

The change in Aggregate Value-at-Risk from November 30, 1997 to November 30, 1998 primarily reflected a reduction in certain interest rate risk positions.

In order to facilitate comparison with other global financial services firms, the Company notes that its Aggregate VaR at November 30, 1998 for other confidence levels and time horizons

was as follows: \$26 million for 95%/one-day VaR and \$121 million for 99%/two-week VaR.

The table below presents the average, high and low 99%/one-day VaR over the course of fiscal 1998 for substantially all of the Company's institutional trading activities. This measure of VaR incorporates most of the Company's trading-related market risks. Certain market risks included in the year-end VaR discussed above are excluded from this measure (i.e., those associated with the Company's retail trading activities, equity price risk in certain private equity positions and funding liabilities related to hedging trading positions).

PRIMARY MARKET RISK CATEGORY (dollars in millions, pre-tax)	DAILY 99%/ONE-DAY VaR FOR FISCAL 1998		
	High	Low	Average
Interest rate	\$50	\$35	\$41
Equity price	19	12	15
Foreign exchange rate	10	3	5
Commodity price	8	5	6
Aggregate Value-at-Risk	\$50	\$35	\$43

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. Despite volatile market conditions during fiscal 1998, there were no days during which the Company incurred daily trading losses in its institutional trading business in excess of the 99%/one-day VaR which incorporates the enhancements to the Company's VaR model made during fiscal 1998.

The chart below presents the Company's daily 99%/one-day VaR for its institutional trading activities over the course of fiscal 1998:



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, Federal 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 and cap agreements, to achieve its matched financing objectives. Interest rate swap agreements effectively convert the underlying asset or financing from fixed to variable repricing, from 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.

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 its fiscal year-end, the Company assumes 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 with rates that are fixed at fiscal year-end, 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 fiscal year-end, 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 fiscal year-end, 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 fiscal year-end, 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, 1998, pre-tax income of consumer lending and related activities over the following 12-month period would be reduced by approximately \$65 million. The comparable reduction of pre-tax income for the 12-month period following November 30, 1997 was estimated to be approximately \$66 million.

The hypothetical model assumes that the balances of interest rate sensitive assets and liabilities at fiscal year-end 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.

The Company anticipates the repricing of a substantial portion of its existing credit card receivables to a fixed interest rate during fiscal 1999. The Company does not believe this repricing will have a material impact on its interest rate sensitivity due to the Company's matched financing objectives.

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, which could result 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 also are 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 scoring models (statistical evaluation models) based on information obtained from credit bureaus. The Company's credit scoring systems include both industry and customized models 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 Discover/NOVUS Network merchants and conducts annual reviews of merchants, with the 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 sys-

tems 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 adequate documentation (e.g., master agreements) is 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 & CO.**

We have audited the accompanying consolidated statements of financial condition of Morgan Stanley Dean Witter & Co. and subsidiaries as of fiscal years ended November 30, 1998 and 1997, 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, 1998. 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 statements of income, cash flows and changes in shareholders' equity of Morgan Stanley Group Inc. and subsidiaries for the fiscal year ended November 30, 1996, which statements reflect total revenues of \$13,144 million for the fiscal year then ended. 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 period, 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 perform 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 & Co. and subsidiaries at fiscal years ended November 30, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three fiscal years in the period ended November 30, 1998, in conformity with generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in fiscal 1998, Morgan Stanley Dean Witter & Co. changed its method of accounting for certain offering costs of closed-end funds.

Deloitte & Touche LLP

New York, New York

January 22, 1999

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(dollars in millions, except share data)

	NOVEMBER 30, 1998	NOVEMBER 30, 1997
ASSETS		
Cash and cash equivalents	\$ 16,878	\$ 8,255
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (including securities at fair value of \$7,518 at November 30, 1998 and \$4,655 at November 30, 1997)	10,531	6,890
Financial instruments owned:		
U.S. government and agency securities	12,350	12,901
Other sovereign government obligations	15,050	22,900
Corporate and other debt	22,388	24,499
Corporate equities	14,289	10,329
Derivative contracts	21,442	17,146
Physical commodities	416	242
Securities purchased under agreements to resell	79,570	84,516
Receivable for securities provided as collateral ⁽¹⁾	4,388	—
Securities borrowed	69,338	55,266
Receivables:		
Consumer loans (net of allowances of \$787 at November 30, 1998 and \$884 at November 30, 1997)	15,209	20,033
Customers, net	18,785	12,259
Brokers, dealers and clearing organizations	4,432	13,263
Fees, interest and other	3,359	4,705
Office facilities, at cost (less accumulated depreciation and amortization of \$1,837 at November 30, 1998 and \$1,279 at November 30, 1997)	1,834	1,705
Other assets	7,331	7,378
Total assets	\$ 317,590	\$ 302,287

(dollars in millions, except share data)

	NOVEMBER 30, 1998	NOVEMBER 30, 1997
LIABILITIES AND SHAREHOLDERS' EQUITY		
Commercial paper and other short-term borrowings	\$ 28,137	\$ 22,614
Deposits	8,197	8,993
Financial instruments sold, not yet purchased:		
U.S. government and agency securities	11,305	11,563
Other sovereign government obligations	13,899	12,095
Corporate and other debt	3,093	1,699
Corporate equities	11,501	13,305
Derivative contracts	21,198	15,599
Physical commodities	348	68
Securities sold under agreements to repurchase	92,327	111,680
Obligation to return securities received as collateral ⁽¹⁾	6,636	—
Securities loaned	23,152	14,141
Payables:		
Customers	40,606	25,086
Brokers, dealers and clearing organizations	5,244	16,097
Interest and dividends	371	970
Other liabilities and accrued expenses	8,623	8,630
Long-term borrowings	27,435	24,792
	302,072	287,332
Capital Units	999	999
Preferred Securities Issued by Subsidiaries	400	—
Commitments and contingencies		
Shareholders' equity:		
Preferred stock	674	876
Common stock (\$0.01 par value, 1,750,000,000 shares authorized, 605,842,952 and 602,829,994 shares issued, 565,670,808 and 594,708,971 shares outstanding at November 30, 1998 and November 30, 1997)	6	6
Paid-in capital	3,746	3,727
Retained earnings	12,080	9,330
Employee stock trust	1,913	1,681
Cumulative translation adjustments	(12)	(9)
Subtotal	18,407	15,611
Note receivable related to sale of preferred stock to ESOP	(60)	(68)
Common stock held in treasury, at cost (\$0.01 par value, 40,172,144 and 8,121,023 shares at November 30, 1998 and November 30, 1997)	(2,702)	(250)
Common stock issued to employee trust	(1,526)	(1,337)
Total shareholders' equity	14,119	13,956
Total liabilities and shareholders' equity	\$ 317,590	\$ 302,287

(1) These amounts relate to the Company's adoption of SFAS No. 127.
See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

fiscal year (dollars in millions, except share and per share data)	1998	1997	1996
Revenues:			
Investment banking	\$ 3,340	\$ 2,694	\$ 2,190
Principal transactions:			
Trading	3,291	3,191	2,659
Investments	89	463	86
Commissions	2,353	2,086	1,776
Fees:			
Asset management, distribution and administration	2,849	2,505	1,732
Merchant and cardmember	1,647	1,704	1,505
Servicing	928	762	809
Interest and dividends	16,436	13,583	11,288
Other	198	144	126
Total revenues	31,131	27,132	22,171
Interest expense	13,514	10,806	8,934
Provision for consumer loan losses	1,173	1,493	1,214
Net revenues	16,444	14,833	12,023
Non-interest expenses:			
Compensation and benefits	6,636	6,019	5,071
Occupancy and equipment	583	526	493
Brokerage, clearing and exchange fees	552	460	317
Information processing and communications	1,140	1,080	996
Marketing and business development	1,411	1,179	1,027
Professional services	677	451	334
Other	745	770	668
Merger-related expenses	—	74	—
Total non-interest expenses	11,744	10,559	8,906
Gain on sale of businesses	685	—	—
Income before income taxes and cumulative effect of accounting change	5,385	4,274	3,117
Provision for income taxes	1,992	1,688	1,137
Income before cumulative effect of accounting change	3,393	2,586	1,980
Cumulative effect of accounting change	(117)	—	—
Net income	\$ 3,276	\$ 2,586	\$ 1,980
Preferred stock dividend requirements	\$ 55	\$ 66	\$ 66
Earnings applicable to common shares ⁽¹⁾	\$ 3,221	\$ 2,520	\$ 1,914
Earnings per common share⁽²⁾:			
Basic before cumulative effect of accounting change	\$ 5.80	\$ 4.38	\$ 3.34
Cumulative effect of accounting change	\$ (0.20)	\$ —	\$ —
Basic	\$ 5.60	\$ 4.38	\$ 3.34
Diluted before cumulative effect of accounting change	\$ 5.52	\$ 4.16	\$ 3.16
Cumulative effect of accounting change	\$ (0.19)	\$ —	\$ —
Diluted	\$ 5.33	\$ 4.16	\$ 3.16
Average common shares outstanding⁽²⁾:			
Basic	575,822,725	574,818,233	573,356,930
Diluted	606,294,065	606,306,475	606,790,754

(1) Amounts shown are used to calculate basic earnings per common share.

(2) Per share and share data for fiscal 1997 and 1996 have been restated to reflect the Company's adoption of SFAS No. 128.

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

fiscal year (dollars in millions)	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 3,276	\$ 2,586	\$ 1,980
Adjustments to reconcile net income to net cash provided by (used for) operating activities:			
Non-cash charges included in net income:			
Cumulative effect of accounting change	117	—	—
Gain on sale of businesses	(685)	—	—
Deferred income taxes	(55)	(77)	(426)
Compensation payable in common or preferred stock	334	374	513
Depreciation and amortization	575	338	251
Provision for consumer loan losses	1,173	1,493	1,214
Changes in assets and liabilities:			
Cash and securities deposited with clearing organizations or segregated under federal and other regulations	(3,641)	(1,691)	(1,943)
Financial instruments owned, net of financial instruments sold, not yet purchased	11,127	1,730	(2,536)
Securities borrowed, net of securities loaned	(5,061)	(10,561)	(13,087)
Receivables and other assets	2,114	(13,808)	(8,227)
Payables and other liabilities	6,095	19,058	6,910
Net cash provided by (used for) operating activities	15,369	(558)	(15,351)
CASH FLOWS FROM INVESTING ACTIVITIES			
Net (payments for) proceeds from:			
Office facilities	(358)	(301)	(152)
Sale of businesses, net of disposal costs	1,399	—	—
Purchase of Miller Anderson & Sherrerd, LLP, net of cash acquired	—	—	(200)
Purchase of Van Kampen American Capital, Inc., net of cash acquired	—	—	(986)
Net principal disbursed on consumer loans	(2,314)	(4,994)	(7,532)
Purchases of consumer loans	—	(11)	(51)
Sales of consumer loans	4,466	2,783	4,824
Other investing activities	—	(5)	(40)
Net cash provided by (used for) investing activities	3,193	(2,528)	(4,137)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net proceeds from (payments for) short-term borrowings	5,620	(1,336)	8,106
Securities sold under agreements to repurchase, net of securities purchased under agreements to resell	(14,407)	3,080	7,748
Net proceeds from (payments for):			
Deposits	(796)	2,113	1,022
Issuance of cumulative preferred stock	—	—	540
Issuance of common stock	186	194	156
Issuance of long-term borrowings	9,771	6,619	8,745
Issuance of Preferred Securities Issued by Subsidiaries	400	—	—
Issuance of Capital Units	—	134	—
Payments for:			
Repayments of long-term borrowings	(7,069)	(3,964)	(2,637)
Redemption of cumulative preferred stock	(200)	(345)	(138)
Repurchases of common stock	(2,925)	(124)	(1,133)
Cash dividends	(519)	(416)	(313)
Net cash (used for) provided by financing activities	(9,939)	5,955	22,096
Dean Witter, Discover & Co.'s net cash activity for the month of December 1996	—	(1,158)	—
Net increase in cash and cash equivalents	8,623	1,711	2,608
Cash and cash equivalents, at beginning of period	8,255	6,544	3,936
Cash and cash equivalents, at end of period	\$ 16,878	\$ 8,255	\$ 6,544

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(dollars in millions)	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Cumulative Translation Adjustments	Note Receivable Related to Sale of Preferred Stock to ESOP	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Total
BALANCE AT FISCAL YEAR-END 1995										
Net income	\$ 818	\$ 6	\$ 3,456	\$ 5,981	\$ 1,050	\$ (9)	\$ (89)	\$ (361)	\$ (844)	\$ 10,008
Dividends	—	—	—	1,980	—	—	—	—	—	1,980
Issuance of common stock in connection with MAS acquisition	—	—	9	—	—	—	—	74	—	83
Redemption of 9.36% Cumulative Preferred Stock	(138)	—	—	—	—	—	—	—	—	(138)
Issuance of 7-3/4% 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	—	—	34	—	445	—	—	117	(150)	446
ESOP shares allocated, at cost	—	—	—	—	—	—	11	—	—	11
Translation adjustments	—	—	—	—	—	(2)	—	—	—	(2)
BALANCE AT FISCAL YEAR-END 1996										
Net income	\$ 1,223	\$ 6	\$ 3,589	\$ 7,477	\$ 1,495	\$ (11)	\$ (78)	\$ (1,005)	\$ (994)	\$ 11,702
Dividends	—	—	—	2,586	—	—	—	—	—	2,586
Redemption of 8.88% Cumulative Preferred Stock	(195)	—	—	—	—	—	—	—	—	(195)
Redemption of 8-3/4% 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	—	—	243	—	186	—	—	278	(343)	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	—	—	(90)	(81)	—	—	—	32	—	(139)

(dollars in millions)	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Cumulative Translation Adjustments	Note Receivable Related to Sale of Preferred Stock to ESOP	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Total
BALANCE AT NOVEMBER 30, 1997	\$ 876	\$ 6	\$ 3,727	\$ 9,330	\$ 1,681	\$ (9)	\$ (68)	\$ (250)	\$ (1,337)	\$ 13,956
Net income	—	—	—	3,276	—	—	—	—	—	3,276
Dividends	—	—	—	(526)	—	—	—	—	—	(526)
Redemption of 7-3/4%										
Cumulative Preferred Stock	(200)	—	—	—	—	—	—	—	—	(200)
Conversion of ESOP Preferred Stock	(2)	—	(12)	—	—	—	—	14	—	—
Issuance of common stock	—	—	(210)	—	—	—	—	417	—	207
Repurchases of common stock	—	—	—	—	—	—	—	(2,925)	—	(2,925)
Compensation payable in common stock	—	—	241	—	232	—	—	42	(189)	326
ESOP shares allocated, at cost	—	—	—	—	—	—	8	—	—	8
Translation adjustments	—	—	—	—	—	(3)	—	—	—	(3)
BALANCE AT NOVEMBER 30, 1998	\$ 674	\$ 6	\$ 3,746	\$ 12,080	\$ 1,913	\$ (12)	\$ (60)	\$ (2,702)	\$ (1,526)	\$ 14,119

See Notes to Consolidated Financial Statements.

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. ("MSDWD"). In conjunction with the Merger, MSDWD 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 MSDWD'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 MSDWD. The Merger was treated as a tax-free exchange.

On March 24, 1998, MSDWD changed its corporate name to Morgan Stanley Dean Witter & Co. (the "Company").

THE COMPANY

The consolidated financial statements include the accounts of the Company 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"), Morgan Stanley Dean Witter Advisors Inc. (formerly known as Dean Witter InterCapital Inc.) 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; private equity 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 securities lending. The Company's Credit and Transaction Services businesses include the issuance of the Discover® Card and other proprietary general purpose credit cards, the operation of the Discover/NOVUS® Network, a proprietary

network of merchant and cash access locations, and direct-marketed activities such as the online securities services offered by Discover Brokerage Direct, Inc. 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 consolidated statement of changes in shareholders' equity 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 year ended December 31, 1996 were combined with Morgan Stanley's financial statements for the fiscal year ended November 30, 1996 (on a combined basis, "fiscal 1996"). The Company's results for the 12 months ended November 30, 1998 ("fiscal 1998") and November 30, 1997 ("fiscal 1997") reflect the change in fiscal year-end. Fiscal 1997 includes 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 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 consolidated financial statements and related disclosures. Management believes that the estimates utilized in the preparation of the con-

solidated 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 inter-company 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 Discover Brokerage Direct, Inc. (formerly Lombard Brokerage, Inc.), 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., the Company assumed approximately \$162 million of long-term debt.

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 writ-

ten 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 factors such 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.

SECURITIZATION OF CONSUMER LOANS

The Company periodically sells consumer loans through asset securitizations and continues to service these loans. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS No. 125"), the present value of the future net servicing revenues which the Company estimates that it will receive over the term of the securitized loans is recognized in income as the loans are securitized. A corresponding asset also is recorded and then amortized as a charge to income over the term of the securitized loans, with actual net servicing revenues continuing to be recognized in income as they are earned. The impact of recognizing the present value of estimated future net servicing revenues as loans are securitized has not been material to the consolidated statements of income.

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 and dividend revenue and interest expense arising from financial instruments used in trading activities are reflected in the consolidated statements of income as interest and dividend revenue or interest 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 private equity and other principal investment activities initially are 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 private equity 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 and foreign currency swaps. 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 subsequently will 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 leasehold 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.

As of December 1, 1997, the Company adopted SFAS No. 128, "Earnings per Share" ("SFAS No. 128"). SFAS No. 128 replaces the previous earnings per share ("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 EPS amounts of prior periods have been restated in accordance with SFAS No. 128. The adoption of SFAS No. 128 has not had a material effect on the Company's EPS calculations.

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 1% (up to 2% 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, 1998, goodwill of approximately \$1.2 billion was included in the Company's consolidated statements of financial condition as a component of Other Assets.

ACCOUNTING CHANGE

In the fourth quarter of fiscal 1998, the Company adopted American Institute of Certified Public Accountants ("AICPA") Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities" ("SOP

98-5"), with respect to the accounting for offering costs paid by investment advisors of closed-end funds where such costs are not specifically reimbursed through separate advisory contracts. In accordance with SOP 98-5 and per an announcement by the Financial Accounting Standards Board ("FASB") staff in September 1998, such costs are to be considered start-up costs and expensed as incurred. Prior to the adoption of SOP 98-5, the Company deferred such costs and amortized them over the life of the fund. The Company recorded a charge to earnings for the cumulative effect of the accounting change as of December 1, 1997, of \$117 million, net of taxes of \$79 million. The first three quarters of fiscal 1998 have been retroactively restated to reflect this change (see Note 18). The effect of adopting these provisions on the Company's income before the cumulative effect of the accounting change for fiscal year 1998 was a decrease of \$24 million, net of taxes. The effect on diluted and basic earnings per share was \$0.04. The pro forma effect on net income for fiscal years 1997 and 1996 would not have been material.

NEW ACCOUNTING PRONOUNCEMENTS

As of January 1, 1998, the Company adopted SFAS No. 127, "Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125," which was effective for transfers and pledges of certain financial assets and collateral made after December 31, 1997. The adoption of SFAS No. 127 required the recognition of assets and liabilities on the Company's consolidated statement of financial condition related to certain securities provided and received as collateral. At November 30, 1998, the Company recorded an obligation to return securities received as collateral of \$6,636 million. The related collateral assets were recorded among various captions included in the Company's consolidated statement of financial condition. After giving effect to reclassifications, the net increase in total assets and total liabilities was \$2,089 million.

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 presentation of comprehensive income and the disclosure requirements related to segments.

In February 1998, the FASB issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," which revises and standardizes pension and other postretirement benefit plan disclosures that are to be included in the employers' financial statements. SFAS No. 132 does not change the measurement or recognition rules for pensions and other postretirement benefit plans and is effective for fiscal years beginning after December 15, 1997.

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The statement is effective for fiscal years beginning after June 15, 1999. The Company is in the process of evaluating the impact of adopting SFAS No. 133.

In July 1998, the Emerging Issues Task Force ("EITF") reached a consensus on EITF Issue 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested" ("EITF 97-14"). Under EITF 97-14, assets of the rabbi trust are to be consolidated with those of the employer, and the value of the employer's stock held in the rabbi trust should be classified in shareholders' equity and generally accounted for in a manner similar to treasury stock. The Company therefore has included its obligations under certain deferred compensation plans in employee stock trust. Shares that the Company has issued to the rabbi trusts are recorded in common stock issued to employee trust. Both employee stock trust and common stock issued to employee trust are components of shareholders' equity. The adoption of EITF 97-14 did not result in any change to the Company's consolidated statement of income, total assets, total liabilities or total shareholders' equity.

3 CONSUMER LOANS

Consumer loans were as follows:

(dollars in millions)	NOV. 30, 1998	NOV. 30, 1997
Credit card	\$15,993	\$20,914
Other consumer installment	3	3
	15,996	20,917
Less:		
Allowance for loan losses	787	884
Consumer loans, net	\$15,209	\$20,033

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

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Balance beginning of period	\$ 884	\$ 781 ⁽²⁾	\$ 709
Additions:			
Provision for loan losses	1,173	1,493	1,214
Purchase of loan portfolios	1	—	4
Total additions	1,174	1,493	1,218
Deductions:			
Charge-offs	1,423	1,639	1,182
Recoveries	(170)	(196)	(155)
Net charge-offs	1,253	1,443	1,027
Other ⁽¹⁾	(18)	53	(98)
Balance end of period	\$ 787	\$ 884	\$ 802

(1) These amounts primarily reflect net transfers related to asset securitizations and the sale of consumer loans associated with SPS, Prime Option and BRAVO (see Note 17).

(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 \$199 million, \$301 million and \$181 million in fiscal 1998, 1997 and 1996, respectively. The amounts charged off in fiscal 1998 include only interest, whereas amounts in fiscal 1997 and 1996 also include cardmember fees.

At November 30, 1998 and 1997, \$3,999 million and \$5,385 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 November 30, 1998, the Company had commitments to extend credit in the amount of \$170.5 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 \$4,466 million, \$2,783 million and \$4,528 million in fiscal 1998, 1997 and 1996, respectively. The uncollected balances of consumer loans sold through asset securitizations were \$16,506 million and \$15,033 million at November 30, 1998 and 1997.

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.

The estimated fair value of the Company's consumer loans approximated carrying value at November 30, 1998 and 1997. 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:

(dollars in millions)	NOV. 30, 1998	NOV. 30, 1997
Demand, passbook and money market accounts	\$1,355	\$1,210
Consumer certificate accounts	1,635	1,498
\$100,000 minimum certificate accounts	5,207	6,285
Total	\$8,197	\$8,993

The weighted average interest rates of interest bearing deposits outstanding during fiscal 1998 and 1997 were 6.2%.

At November 30, 1998 and 1997, the notional amounts of interest rate exchange agreements that hedged deposits outstanding were \$650 million and \$535 million and had fair values of \$15 million and \$7 million. Under these interest rate exchange agreements, the Company primarily pays floating rates and receives fixed rates. At November 30, 1998, the weighted average interest rate of the Company's deposits, including the effect of interest rate exchange agreements, was 6.1%.

At November 30, 1998, certificate accounts maturing over the next five years were as follows:

(dollars in millions)	
1999	\$2,448
2000	1,502
2001	1,261
2002	592
2003	620

The estimated fair value of the Company's deposits, using current rates for deposits with similar maturities, approximated carrying value at November 30, 1998 and 1997.

5 SHORT-TERM BORROWINGS

At November 30, 1998 and 1997, commercial paper in the amount of \$19,643 million and \$15,447 million, with weighted average interest rates of 5.3% and 5.5%, was outstanding.

At November 30, 1998 and 1997, the notional amounts of interest rate contracts that hedged commercial paper outstanding were \$208 million and \$732 million and had fair values of \$(6) million and \$(5) million. These interest rate contracts effectively converted the commercial paper to fixed rates. These contracts had no material effect on the weighted average interest rates of commercial paper.

At November 30, 1998 and 1997, other short-term borrowings of \$8,494 million and \$7,167 million were outstanding. These borrowings included bank loans, Federal Funds and bank notes.

The Company maintains a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the "MSDW Facility").

Under the terms of the MSDW Facility, the banks are committed to provide up to \$6.0 billion. The MSDW Facility contains restrictive covenants which require, among other things, that the Company maintain shareholders' equity of at least \$9.1 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, 1998, no borrowings were outstanding under the MSDW 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 the amount of \$2.6 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, 1998. 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 \$1.875 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 1999, the MS&Co. Facility was renewed. At November 30, 1998, 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 and, effective January 1, 1999, the euro. 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, 1998, no borrowings were outstanding under the MSIL Facility.

The Company anticipates that it will utilize the MSDW 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:

(dollars in millions)	U.S. DOLLAR			NON-U.S. DOLLAR ⁽¹⁾			AT NOVEMBER 30	
	Fixed Rate	Floating Rate ⁽²⁾	Index / Floating Linked	Fixed Rate	Floating Rate ⁽²⁾	1998 TOTAL	1997 Total	
Due in fiscal 1998	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 6,170	
Due in fiscal 1999	842	2,627	587	208	767	5,031	4,693	
Due in fiscal 2000	1,568	4,396	347	62	490	6,863	2,418	
Due in fiscal 2001	1,496	1,596	88	115	604	3,899	2,282	
Due in fiscal 2002	1,077	1,033	42	17	332	2,501	2,623	
Due in fiscal 2003	1,093	1,034	105	428	235	2,895	1,621	
Thereafter	4,460	899	217	642	28	6,246	4,985	
Total	\$10,536	\$11,585	\$1,386	\$1,472	\$2,456	\$27,435	\$24,792	
Weighted average coupon at fiscal year-end	7.4%	5.7%	n/a	5.4%	4.9%	6.1%		6.1%

(1) Weighted average coupon was calculated utilizing non-U.S. dollar interest rates.

(2) U.S. dollar contractual floating rate borrowings bear interest based on a variety of money market indices, including London Interbank Offered Rates ("LIBOR") and Federal Funds rates. Non-U.S. dollar contractual floating rate borrowings bear interest based on Euro floating rates.

MEDIUM-TERM NOTES

Included in the table above are medium-term notes of \$17,011 million and \$14,049 million at November 30, 1998 and 1997. The effective weighted average interest rate on all medium-term notes was 5.7% in fiscal 1998 and 5.9% in fiscal 1997. Maturities of these notes range from fiscal 1999 through fiscal 2028.

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 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 November 30, 1998 and 1997.

OTHER BORROWINGS

Included in the Company's long-term borrowings are subordinated notes of \$1,309 million and \$1,302 million at November 30, 1998 and 1997, respectively. The effective weighted average interest rate on these subordinated notes was 7.1% in fiscal 1998 and 7.2% in fiscal 1997. 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 1999 through fiscal 2001. The stated maturities of these notes, which aggregate \$1,933 million, are from fiscal 2000 to fiscal 2011.

MS&Co., a registered U.S. broker-dealer subsidiary of the Company, has outstanding \$357 million of 8.22% fixed rate subordinated Series A notes, \$243 million of 8.51% fixed rate subor-

dinated Series B notes, \$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:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Net reduction in interest expense from swaps for the fiscal year	\$48	\$21	\$29
Weighted average coupon of long-term borrowings at fiscal year-end ⁽¹⁾	6.1%	6.1%	6.2%
Effective average borrowing rate for long-term borrowings after swaps at fiscal year-end ⁽¹⁾	5.9%	6.0%	6.1%

(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 5.2% and 5.7% in fiscal 1998 and fiscal 1997, 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 1998. Swaps utilized to hedge the Company's structured borrowings are presented at their redemption values:

(dollars in millions)	U.S. DOLLAR				NON-U.S. DOLLAR ⁽¹⁾			NOV. 30, 1998 TOTAL	NOV. 30, 1997 TOTAL
	Receive Fixed Pay Floating	Receive Floating Pay Fixed	Receive Floating Pay Floating	Index/ Equity Linked	Receive Fixed Pay Floating	Receive Floating Pay Floating ⁽²⁾			
Maturing in fiscal 1998	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 2,744
Maturing in fiscal 1999	552	100	375	587	195	372	2,181	1,972	
Maturing in fiscal 2000	1,169	400	20	347	62	243	2,241	638	
Maturing in fiscal 2001	1,384	80	5	88	110	514	2,181	1,082	
Maturing in fiscal 2002	720	200	—	42	17	—	979	831	
Maturing in fiscal 2003	500	—	—	105	428	219	1,252	1,029	
Thereafter	3,020	400	—	217	620	10	4,267	3,411	
Total	\$7,345	\$1,180	\$400	\$1,386	\$1,432	\$1,358	\$13,101	\$11,707	
Weighted average at fiscal year-end⁽³⁾									
Receive rate	6.53%	5.25%	4.88%	n/a	5.24%	4.77%			
Pay rate	5.59%	6.22%	5.65%	n/a	4.94%	5.44%			

(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 fiscal year-end) is summarized in the table below:

(dollars in millions)	FISCAL 1998	fiscal 1997
Notional value at beginning of period	\$11,707	\$10,189
Additions	4,520	3,567
Matured	(2,305)	(1,657)
Terminated	(868)	(216)
Effect of foreign currency translation on non-U.S. dollar notional values and changes in redemption values on structured borrowings	47	(176)
Notional value at fiscal year-end	<b style="text-align: right;">\$13,101	<b style="text-align: right;">\$11,707
Unrecognized gain at fiscal year-end	<b style="text-align: right;">\$ 279	<b style="text-align: right;">\$ 104

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 \$1.3 billion and \$1.8 billion at November 30, 1998 and 1997, and unrecognized gains of approximately \$28 million and \$13 million at November 30, 1998 and 1997, 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 1998, 1997 and 1996.

7 COMMITMENTS AND CONTINGENCIES

The Company has non-cancelable operating leases covering office space and equipment. At November 30, 1998, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

<i>(dollars in millions)</i>	
1999	\$363
2000	324
2001	286
2002	238
2003	193
Thereafter	959

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 \$274 million, \$262 million and \$264 million in fiscal 1998, 1997 and 1996, 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.

In November 1998, the Company announced that it had entered into an agreement that will result in the development of an office tower in New York City. Pursuant to this agreement, the Company has entered into a 99-year lease for the land at the proposed development site.

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 \$5.7 billion of letters of credit outstanding at November 30, 1998 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, 1998 approximately \$181 million in connection with its private equity 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 private equity and other principal investment activities), that may subject the Company to increased credit and liquidity risks.

8 EARNINGS PER SHARE

Earnings per share was calculated as follows (in millions, except for per share data):

BASIC EPS:	FISCAL 1998	fiscal 1997	fiscal 1996
Income before cumulative effect of accounting change	\$3,393	\$2,586	\$1,980
Cumulative effect of accounting change	(117)	—	—
Preferred stock dividend requirements	(55)	(66)	(66)
Net income available to common shareholders	\$3,221	\$2,520	\$1,914
Weighted average common shares outstanding	576	575	573
Basic EPS before cumulative effect of accounting change	\$ 5.80	\$ 4.38	\$ 3.34
Cumulative effect of accounting change	\$ (0.20)	—	—
Basic EPS	\$ 5.60	\$ 4.38	\$ 3.34
DILUTED EPS:	FISCAL 1998	fiscal 1997	fiscal 1996
Income before cumulative effect of accounting change	\$3,393	\$2,586	\$1,980
Cumulative effect of accounting change	(117)	—	—
Preferred stock dividend requirements	(47)	(61)	(62)
Net income available to common shareholders	\$3,229	\$2,525	\$1,918
Weighted average common shares outstanding	576	575	573
Effect of dilutive securities:			
Stock options	18	19	21
ESOP convertible preferred stock	12	12	13
Weighted average common shares outstanding and common stock equivalents	606	606	607
Diluted EPS before cumulative effect of accounting change	\$ 5.52	\$ 4.16	\$ 3.16
Cumulative effect of accounting change	\$ (0.19)	—	—
Diluted EPS	\$ 5.33	\$ 4.16	\$ 3.16

9 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:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Equities	\$2,056	\$1,310	\$1,181
Fixed Income	455	1,187	1,172
Foreign Exchange	587	500	169
Commodities	193	194	137
Total principal trading revenues	\$3,291	\$3,191	\$2,659

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 secu-

rities, 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 non-U.S. 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 or 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, Canadian dollars and, effective January 1, 1999, the euro. 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 global 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 matters, review the general framework, levels and monitoring procedures relating to the Company's market and credit risk profile, sales practices, legal enforceability and operational

and systems risks. The Controllers, Treasury, Law, Compliance and Governmental Affairs and Firm Risk Management 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, periodically examines and evaluates the Company's operations and control environment. 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 on a Company-wide basis, on a trading division level worldwide and on an individual product basis. Market risk 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 and, as appropriate, products and regions, that are compatible with the trading division limits. Trading division risk managers, desk risk managers and the Firm Risk Management Department all monitor market risk measures against limits and report major market and position events to senior management.

The Firm Risk Management 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 Firm Risk Management 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, which could result 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 also are 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, Germany and Italy), which, in the aggregate, represented approximately 9% of the Company's total assets at November 30, 1998. In addition, substantially all of the collateral held by the Company for resale agreements or bonds borrowed, which together represented approximately 33% of the Company's total assets at November

30, 1998, 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 private equity 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 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 November 30, 1998 and 1997, as well as the average fair value of those assets and liabilities for fiscal 1998 and 1997, 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 the 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⁾ (dollars in billions at fiscal year-end)		FISCAL YEAR-END FAIR VALUES ⁽³⁾				AVERAGE FAIR VALUES ⁽³⁾⁽⁴⁾				
1998	1997	Assets		Liabilities		Assets		Liabilities		
		1998	1997	1998	1997	1998	1997	1998	1997	
\$1,719	\$1,262	Interest rate and currency swaps and options (including caps, floors and swap options) and other fixed income securities contracts	\$10.1	\$ 7.1	\$10.4	\$ 6.4	\$ 9.5	\$ 4.8	\$ 8.6	\$ 5.9
903	1,035	Foreign exchange forward and futures contracts and options	3.7	4.6	4.1	4.2	4.6	3.4	4.4	3.2
107	112	Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	5.2	3.8	4.8	3.8	4.8	2.6	4.6	2.6
91	78	Commodity forwards, futures, options and swaps	2.2	1.3	1.9	1.2	2.0	1.1	1.7	0.9
40	42	Mortgage-backed securities forward contracts, swaps and options	0.2	0.3	—	—	0.2	0.3	—	—
\$2,860	\$2,529	Total	\$21.4	\$17.1	\$21.2	\$15.6	\$21.1	\$12.2	\$19.3	\$12.6

(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 \$485 billion and \$442 billion, respectively, at November 30, 1998, and \$572 billion and \$549 billion, respectively, at November 30, 1997.

(3) These amounts represent carrying value (exclusive of collateral) at November 30, 1998 and 1997, 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 the ultimate settlement of the transactions outstanding at November 30, 1998 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 November 30, 1998 and 1997 are sum-

marized in the following table, showing notional values by year of expected maturity:

(dollars in billions)	<i>Less than 1 Year</i>	<i>1 to 3 Years</i>	<i>3 to 5 Years</i>	<i>More than 5 Years</i>	TOTAL
AT NOVEMBER 30, 1998					
Interest rate and currency swaps and options (including caps, floors and swap options)					
and other fixed income securities contracts	\$ 457	\$479	\$371	\$412	\$1,719
Foreign exchange forward and futures contracts and options	892	11	—	—	903
Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	82	17	7	1	107
Commodity forwards, futures, options and swaps	53	22	8	8	91
Mortgage-backed securities forward contracts, swaps and options	25	1	2	12	40
Total	\$1,509	\$530	\$388	\$433	\$2,860
Percent of total	53%	19%	13%	15%	100%
AT NOVEMBER 30, 1997					
Interest rate and currency swaps and options (including caps, floors and swap options)					
and other fixed income securities contracts	\$ 319	\$398	\$235	\$310	\$1,262
Foreign exchange forward and futures contracts and options	1,026	7	2	—	1,035
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
Mortgage-backed securities forward contracts, swaps and options	20	1	4	17	42
Total	\$1,510	\$437	\$252	\$330	\$2,529
Percent of total	60%	17%	10%	13%	100%

The credit quality of the Company's trading-related derivatives at November 30, 1998 and 1997 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 NOVEMBER 30, 1998							
Interest rate and currency swaps and options (including caps, floors and swap options) and other fixed income securities contracts							
\$ 894	\$ 3,727	\$ 3,694	\$ 1,181	\$ 98	\$ 510	\$ 10,104	
306	1,413	1,435	337	—	263	3,754	
Foreign exchange forward contracts and options							
Equity securities contracts (including equity swaps, warrants and options)	1,995	1,105	478	61	1,364	165	5,168
Commodity forwards, options and swaps	71	448	401	708	46	534	2,208
Mortgage-backed securities forward contracts, swaps and options	130	51	21	3	—	3	208
Total	\$3,396	\$6,744	\$6,029	\$2,290	\$1,508	\$1,475	\$21,442
Percent of total	16%	31%	28%	11%	7%	7%	100%
AT NOVEMBER 30, 1997							
Interest rate and currency swaps and options (including caps, floors and swap options) and other fixed income securities contracts							
\$ 754	\$ 2,761	\$ 2,544	\$ 436	\$ 33	\$ 568	\$ 7,096	
788	2,504	1,068	72	—	176	4,608	
Foreign exchange forward contracts and options							
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
Mortgage-backed securities forward contracts, swaps and options	156	90	50	2	—	10	308
Total	\$2,909	\$6,697	\$4,609	\$1,055	\$825	\$1,051	\$17,146
Percent of total	17%	39%	27%	6%	5%	6%	100%

The Company also has obtained assets posted as collateral by investment grade counterparties amounting to \$2.5 billion and \$1.2 billion at November 30, 1998 and November 30, 1997, respectively.

10 PREFERRED STOCK, CAPITAL UNITS AND PREFERRED SECURITIES ISSUED BY SUBSIDIARIES

Preferred stock of the Company is composed of the following issues:

(dollars in millions)	Shares Outstanding at November 30 1998	Shares Outstanding at November 30 1997	Balance at November 30 1998	Balance at November 30 1997
ESOP Convertible Preferred Stock, liquidation preference \$35.88	3,581,964	3,646,664	\$129	\$131
Series A Fixed/Adjustable Rate Cumulative Preferred Stock, stated value \$200	1,725,000	1,725,000	345	345
7-3/4% Cumulative Preferred Stock, stated value \$200	1,000,000	1,000,000	200	200
7-3/8% Cumulative Preferred Stock, stated value \$200	—	1,000,000	—	200
Total	—	1,000,000	\$674	\$876

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

During fiscal 1998, MSDW Capital Trust I, a Delaware statutory business trust (the "Capital Trust"), all of the common securities of which are owned by the Company, issued \$400 million of 7.10% Capital Securities (the "Capital Securities") that are guaranteed by the Company. The Capital Trust issued the Capital Securities and invested the proceeds in 7.10% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due February 28, 2038.

During fiscal 1998, the Company redeemed all 1,000,000 outstanding shares of its 7-3/8% Cumulative Preferred Stock at a redemption price of \$200 per share. The Company also simultaneously redeemed all corresponding Depositary Shares at a redemption price of \$25 per Depositary Share. Each Depositary Share represented 1/8 of a share of the Company's 7-3/8% Cumulative Preferred Stock.

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 November 30, 1998 and 1997.

In January 1999, the Company and MS plc called for redemption all of the outstanding 7.82% Capital Units and 7.80% Capital Units on February 28, 1999. The aggregate principal amount of the Capital Units to be redeemed is \$352 million.

The estimated fair value of the Capital Units approximated carrying value at November 30, 1998 and November 30, 1997.

11 SHAREHOLDERS' EQUITY

MS&Co. and DWR 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, 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 \$3,205 million at November 30, 1998, which exceeded the amount required by \$2,699 million. DWR's net capital totaled \$752 million at November 30, 1998, which exceeded the amount required by \$668 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, 1998, 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, 1998, approximately \$4.9 billion 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:

	<i>At November 30</i>	
	<i>1998</i>	<i>1997</i>
Net monetary investments in non-U.S. dollar functional currency subsidiaries	\$1,364	\$1,128
Gross notional amounts of foreign exchange contracts and non-U.S. dollar debt designated as hedges⁽¹⁾	\$2,239	\$1,881
Cumulative translation adjustments resulting from net investments in subsidiaries with a non-U.S. dollar functional currency	\$ 29	\$ 6
Cumulative translation adjustments resulting from realized or unrealized gains or losses on hedges, net of tax	\$ (41)	\$ (15)
Total cumulative translation adjustments	\$ (12)	\$ (9)

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

12 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 270 million shares of its common stock in connection with awards under its equity-

based compensation plans. At November 30, 1998, approximately 150 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. Historically, these plans have generally

provided 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 1998	FISCAL 1997	FISCAL 1996			
	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	64.1	\$27.85	60.3	\$17.04	63.1	\$14.46
Granted	15.6	68.77	20.2	48.16	7.5	30.15
Exercised	(15.3)	18.23	(14.9)	11.68	(9.0)	9.45
Forfeited	(1.1)	39.40	(1.5)	26.66	(1.3)	21.14
Options outstanding at end of period	63.3	\$40.08	64.1	\$27.85	60.3	\$17.04
Options exercisable at end of period	40.6	\$39.37	44.3	\$26.67	36.4	\$13.82

The following table presents information relating to the Company's stock options outstanding at November 30, 1998 (share data in millions):

Range of Exercise Prices	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE		
	Number Outstanding	Weighted Average Exercise Price	Average Remaining Life (Years)	Number Exercisable	Weighted Average Exercise Price	
\$ 8.00 – \$19.99	22.7	\$17.29	5.9	17.9	\$17.09	
\$20.00 – \$29.99	2.0	24.02	3.3	1.0	23.35	
\$30.00 – \$39.99	7.9	32.13	5.5	1.3	32.42	
\$40.00 – \$49.99	4.4	43.47	8.6	3.8	43.47	
\$50.00 – \$59.99	15.0	54.90	8.1	9.2	55.64	
\$60.00 – \$69.99	0.5	63.08	7.1	0.5	62.88	
\$70.00 – \$79.99	9.5	71.56	9.8	5.7	71.73	
\$80.00 – \$96.00	1.3	89.90	7.1	1.2	90.00	
Total	63.3		7.1	40.6		

Deferred Compensation Awards

The Company has made deferred compensation awards pursuant to several 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 \$415 million, \$347 million and \$534 million in fiscal 1998, fiscal 1997 and fiscal 1996, respectively. 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 59 million at fiscal year-end 1998, 62 million at fiscal year-end 1997, and 65 million at fiscal year-end 1996.

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.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan, eligible 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 0.6 million shares of common stock in fiscal 1998, 0.5 million shares in fiscal 1997 and 0.7 million shares in fiscal 1996.

The discount to fair value was \$6 million for fiscal 1998 and \$3 million for both fiscal 1997 and fiscal 1996. 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 an equity-based 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 1998, 1997 and 1996 was approximately \$15 million, \$14 million and \$7 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 private equity transactions. Compensation expense for fiscal 1998, 1997 and 1996 related to these plans aggregated \$33 million, \$38 million and \$0.2 million, respectively.

Real Estate Fund Plans

Under various plans, select employees and consultants to certain partnerships may participate in certain gains realized by the Company's real estate funds. Compensation expense relating to these plans aggregated \$3 million, \$8 million and \$13 million for fiscal 1998, fiscal 1997 and fiscal 1996, 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 1998, fiscal 1997 and fiscal 1996 was \$115 million, \$113 million and \$72 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 3,581,964 preferred shares outstanding at November 30, 1998 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, 2005 (extendible at the option of the ESOP trust to September 19, 2010), bears a 10-3/8% 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 both fiscal 1998 and fiscal 1997, and \$9 million in fiscal 1996. The ESOP debt service costs for fiscal 1998, fiscal 1997 and fiscal 1996 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 \$214 million, \$196 million and \$41 million for fiscal 1998, 1997 and 1996, respectively. Basic and diluted earnings per common share would have been reduced by \$0.38, \$0.34 and \$0.07 for fiscal 1998, 1997 and 1996, respectively.

The weighted average fair value at date of grant for stock options granted during fiscal 1998, 1997 and 1996 was \$22.37, \$16.76 and \$9.08 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 1998	<i>fiscal</i> 1997	<i>fiscal</i> 1996
Risk-free interest rate	4.9%	6.0%	5.5%
Expected option life in years	4.8	6.0	5.3
Expected stock price volatility	33.2%	28.0%	27.5%
Expected dividend yield	1.3%	1.3%	1.6%

13 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"), nine 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 following tables present information for the Company's pension plans on an aggregate basis.

Pension expense includes the following components:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
U.S. Plans:			
Service cost, benefits earned during the period	\$ 72	\$ 54	\$ 48
Interest cost on projected benefit obligation	78	67	58
Return on plan assets	(7)	(170)	(111)
Difference between actual and expected return on assets	(80)	104	53
Net amortization	1	1	2
Total U.S. plans	64	56	50
International plans	12	9	12
Total pension expense	\$ 76	\$ 65	\$ 62

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

	FISCAL 1998	fiscal 1997
Weighted average discount rate	6.75%	7.25%
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:

(dollars in millions)	NOVEMBER 30, 1998		NOVEMBER 30, 1997	
	ASSETS EXCEED ACCUMULATED BENEFITS	ACCUMULATED BENEFITS EXCEED ASSETS	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets
Actuarial present value of vested benefit obligation	\$(269)	\$(616)	\$ (735)	\$ (34)
Accumulated benefit obligation	\$(314)	\$(693)	\$ (807)	\$ (71)
Effect of future salary increases	(114)	(93)	(181)	(30)
Projected benefit obligation	(428)	(786)	(988)	(101)
Plan assets at fair value (primarily listed stocks and bonds)	384	597	1,006	—
Projected benefit obligation (in excess of) or less than plan assets	(44)	(189)	18	(101)
Unrecognized net loss or (gain)	53	83	(4)	27
Unrecognized prior service cost	1	28	31	(4)
Unrecognized net transition obligation	—	8	3	5
Prepaid (accrued) pension cost at fiscal year-end	\$ 10	\$ (70)	\$ 48	\$ (73)
Additional liability for unfunded accumulated benefit obligation	—	(30)	—	—
Pension asset (liability)	\$ 10	\$ (100)	\$ 48	\$ (73)

The Company also maintains a separate defined contribution pension plan which covers substantially all employees of the Company's U.K. subsidiaries (the "U.K. Plan"). Under the U.K. Plan, benefits are determined by the purchasing power of the accumulated value of contributions paid. In fiscal 1998 and 1997, the Company's expense related to the U.K. Plan was \$17 million and \$15 million, respectively.

POSTRETIREMENT BENEFITS

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees, employees and dependents. At November 30, 1998 and 1997, the Company's accrued postretirement benefit costs were \$95 million and \$91 million, respectively.

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 1998, 1997 and 1996.

14. INCOME TAXES

The provision for income taxes consists of:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Current			
U.S. federal	\$1,199	\$1,079	\$1,096
U.S. state and local	372	348	290
Non-U.S.	476	338	177
	2,047	1,765	1,563
Deferred			
U.S. federal	(26)	(45)	(326)
U.S. state and local	1	(17)	(74)
Non-U.S.	(30)	(15)	(26)
	(55)	(77)	(426)
Provision for income taxes	\$1,992	\$1,688	\$1,137

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

	FISCAL 1998	fiscal 1997	fiscal 1996
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	4.6	5.1	4.6
Lower tax rates applicable to non-U.S. earnings	(2.4)	(1.1)	(1.7)
Reduced tax rate applied to dividends	(0.1)	(0.1)	(0.1)
Other	(0.1)	0.6	(1.3)
Effective income tax rate	37.0%	39.5%	36.5%

As of November 30, 1998, the Company had approximately \$2.6 billion of earnings attributable to foreign subsidiaries for which no 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 November 30, 1998 and 1997 are as follows:

(dollars in millions)	NOV. 30, 1998	NOV. 30, 1997
Deferred tax assets		
Employee compensation and benefit plans	\$1,289	\$1,168
Loan loss allowance	371	459
Other valuation and liability allowances	604	545
Other	167	180
Total deferred tax assets	2,431	2,352
Deferred tax liabilities		
Prepaid commissions	239	233
Valuation of inventory, investments and receivables	127	298
Other	237	265
Total deferred tax liabilities	603	796
Net deferred tax assets	\$1,828	\$1,556

Cash paid for income taxes was \$1,591 million, \$1,251 million and \$1,190 million in fiscal 1998, 1997 and 1996, respectively.

15 GEOGRAPHIC AREA DATA

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

(dollars in millions)	TOTAL REVENUES			NET REVENUES		
	FISCAL 1998	fiscal 1997	fiscal 1996	FISCAL 1998	fiscal 1997	fiscal 1996
International:						
Europe	\$ 7,541	\$ 6,468	\$ 5,616	\$ 2,786	\$ 1,757	\$ 1,429
Asia	1,176	952	768	1,023	866	700
Total	8,717	7,420	6,384	3,809	2,623	2,129
North America	28,001	28,711	24,235	12,933	12,519	10,193
Eliminations	(5,587)	(8,999)	(8,448)	(298)	(309)	(299)
Total	\$31,131	\$27,132	\$22,171	\$ 16,444	\$ 14,833	\$ 12,023
 INCOME BEFORE TAXES						
(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996	FISCAL 1998	fiscal 1997	fiscal 1996
	FISCAL 1998	fiscal 1997	fiscal 1996	FISCAL 1998	fiscal 1997	fiscal 1996
International:						
Europe	\$ 1,088	\$ 399	\$ 328	\$ 139,923	\$ 126,138	\$ 113,734
Asia	287	240	161	25,712	30,656	21,561
Total	1,375	639	489	165,635	156,794	135,295
North America	4,010	3,635	2,628	337,588	307,728	242,510
Eliminations	—	—	—	(185,633)	(162,235)	(138,945)
Total	\$ 5,385	\$ 4,274	\$ 3,117	\$ 317,590	\$ 302,287	\$ 238,860

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.

16 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:

(dollars in millions)	FISCAL 1998	fiscal 1997	fiscal 1996
Total revenues:			
Securities and Asset Management	\$ 25,763	\$ 21,499	\$ 17,136
Credit and Transaction Services	5,368	5,633	5,035
Income before income taxes⁽¹⁾:			
Securities and Asset Management	4,187	3,597	2,426
Credit and Transaction Services	1,198	751	691
Identifiable assets at end of period⁽²⁾:			
Securities and Asset Management	297,054	277,878	213,967
Credit and Transaction Services	20,536	24,409	24,893

(1) Excludes merger-related expenses of \$74 million in fiscal 1997.

(2) Corporate assets have been fully allocated to the Company's business segments.

17 BUSINESS DISPOSITIONS

In fiscal 1998, the Company entered into several transactions reflecting its strategic decision to focus on growing its core Securities and Asset Management and Credit and Transaction Services businesses.

In the fourth quarter of fiscal 1998, the Company completed the sale of its Global Custody business. The Company also sold its interest in the operations of SPS Transaction Services, Inc., a 73%-owned, publicly held subsidiary of the Company. In addition, the Company sold certain credit card receivables relating to its discontinued BRAVO Card. The Company's aggregate net pre-tax gain resulting from these transactions was \$685 million.

In addition, during fiscal 1998 the Company sold its Prime OptionSM MasterCard[®] portfolio, a business it had operated with NationsBank of Delaware, N.A., and its Correspondent Clearing business. The gains resulting from the sale of these businesses were not material to the Company's results of operations or financial condition.

18 QUARTERLY RESULTS (UNAUDITED)

(dollars in millions, except share and per share data)	FIRST (RESTATED) ⁽¹⁾	1998 FISCAL QUARTER			1997 FISCAL QUARTER			
		SECOND (RESTATED) ⁽¹⁾	THIRD (RESTATED) ⁽¹⁾	FOURTH	First	Second	Third	Fourth
Revenues:								
Investment banking	\$ 800	\$ 988	\$ 819	\$ 733	\$ 522	\$ 581	\$ 818	\$ 773
Principal transactions:								
Trading	903	1,091	499	798	869	722	778	822
Investments	72	101	(174)	90	56	136	206	65
Commissions	547	611	608	587	490	484	559	553
Fees:								
Asset management, distribution and administration	676	741	718	714	587	610	656	652
Merchant and cardmember	428	404	438	377	436	424	433	411
Servicing	171	232	255	270	202	184	196	180
Interest and dividends	3,933	4,213	4,283	4,007	3,369	3,197	3,570	3,447
Other	55	47	52	44	29	38	41	36
Total revenues	7,585	8,428	7,498	7,620	6,560	6,376	7,257	6,939
Interest expense	3,145	3,554	3,377	3,438	2,709	2,478	2,765	2,854
Provision for consumer loan losses	405	275	280	213	379	376	385	353
Net revenues	4,035	4,599	3,841	3,969	3,472	3,522	4,107	3,732
Non-interest expenses:								
Compensation and benefits	1,788	2,017	1,609	1,222	1,490	1,505	1,849	1,175
Occupancy and equipment	140	143	148	152	128	127	134	137
Brokerage, clearing and exchange fees	121	135	160	136	95	113	130	122
Information processing and communications	267	275	291	307	270	267	249	294
Marketing and business development	294	286	354	477	288	274	293	324
Professional services	128	156	176	217	93	99	127	132
Other	165	190	193	197	180	180	219	191
Merger-related expenses						74		
Total non-interest expenses	2,903	3,202	2,931	2,708	2,544	2,639	3,001	2,375
Gain on sale of businesses				685				
Income before income taxes and cumulative effect of accounting change	1,132	1,397	910	1,946	928	883	1,106	1,357
Provision for income taxes	441	545	284	722	357	356	428	547
Income before cumulative effect of accounting change	691	852	626	1,224	571	527	678	810
Cumulative effect of accounting change	(117)	—	—	—	—	—	—	—
Net income	\$ 574	\$ 852	\$ 626	\$ 1,224	\$ 571	\$ 527	\$ 678	\$ 810
Earnings applicable to common shares ⁽²⁾	\$ 559	\$ 838	\$ 612	\$ 1,212	\$ 552	\$ 509	\$ 663	\$ 796
Basic earnings per share⁽³⁾:								
Income before cumulative effect of accounting change	\$ 1.15	\$ 1.44	\$ 1.07	\$ 2.16	\$ 0.96	\$ 0.88	\$ 1.15	\$ 1.37
Cumulative effect of accounting change	(0.20)	—	—	—	—	—	—	—
Net income	\$ 0.95	\$ 1.44	\$ 1.07	\$ 2.16	\$ 0.96	\$ 0.88	\$ 1.15	\$ 1.37
Diluted earnings per share⁽³⁾:								
Income before cumulative effect of accounting change	\$ 1.10	\$ 1.37	\$ 1.01	\$ 2.07	\$ 0.91	\$ 0.84	\$ 1.09	\$ 1.30
Cumulative effect of accounting change	(0.19)	—	—	—	—	—	—	—
Net income	\$ 0.91	\$ 1.37	\$ 1.01	\$ 2.07	\$ 0.91	\$ 0.84	\$ 1.09	\$ 1.30
Dividends to common shareholders	\$ 0.20	\$ 0.20	\$ 0.20	\$ 0.20	\$ 0.14	\$ 0.14	\$ 0.14	\$ 0.14
Book value	\$ 22.48	\$ 21.95	\$ 22.13	\$ 23.88	\$ 18.70	\$ 19.37	\$ 20.25	\$ 22.11
Average common and equivalent shares:								
Basic	586,751,340	581,326,618	573,170,507	560,108,890	573,410,658	577,985,371	578,082,806	580,985,871
Diluted	616,377,562	612,625,354	604,779,594	585,533,337	605,691,066	610,430,898	610,019,122	612,092,405
Stock price range ⁽⁴⁾	\$52.25-70.50	\$69.75-84.44	\$58.06-96.88	\$38.44-74.75	\$32.19-43.75	\$34.50-41.50	\$41.00-53.88	\$47.31-58.75

(1) The quarterly results for the first, second and third quarters of fiscal 1998 have been restated to reflect the effects of the accounting change adopted in the fourth quarter, effective December 1, 1997. As a result of this restatement, net income has been decreased by \$117 million, \$2 million and \$21 million for the first, second and third quarters of fiscal 1998, respectively. For further information regarding the change in accounting, see Note 2.

(2) Amounts shown are used to calculate basic earnings per share.

(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, 1998 approximated 186,000. The number of beneficial owners of common stock is believed to exceed this number.

OFFICERS AND DIRECTORS

BOARD OF DIRECTORS

PHILIP J. PURCELL
Chairman & Chief Executive Officer

JOHN J. MACK
President & Chief Operating Officer

RICHARD B. FISHER
Chairman of the Executive Committee

THOMAS C. SCHNEIDER
Executive Vice President
MSDW Direct Business Group

ROBERT P. BAUMAN
Non-Executive Chairman, BTR plc

EDWARD A. BRENNAN
Former Chairman & Chief Executive Officer
Sears, Roebuck and Co.

DIANA D. BROOKS
President & Chief Executive Officer
Sotheby's Holdings, Inc.

DANIEL B. BURKE
Former Chief Executive Officer, President &
Chief Operating Officer, Capital Cities/ABC, Inc.

C. ROBERT KIDDER
Chairman & Chief Executive Officer
Borden, Inc.

CHARLES F. KNIGHT
Chairman & Chief Executive Officer
Emerson Electric Co.

MILES L. MARSH
Chairman & Chief Executive Officer
Fort James Corporation

MICHAEL A. MILES
Special Limited Partner
Forstmann Little & Co.

ALLEN E. MURRAY
Former Chairman & Chief Executive Officer
Mobil Corporation

CLARENCE B. ROGERS, JR.
Chairman of the Board & Former Chief Executive Officer
Equifax Inc.

LAURA D'ANDREA TYSON
Dean, Walter A. Haas School of Business
University of California at Berkeley

OTHER OFFICERS

CHRISTINE A. EDWARDS
Chief Legal Officer & Secretary

JOHN H. SCHAEFER
Chief Strategic & Administrative Officer

ROBERT G. SCOTT
Chief Financial Officer

ALEXANDER C. FRANK
Treasurer

EILEEN K. MURRAY
Controller & Principal Accounting Officer

MANAGEMENT COMMITTEE

PHILIP J. PURCELL
Chairman & Chief Executive Officer

JOHN J. MACK
President & Chief Operating Officer

RICHARD M. DEMARTINI
International Private Client Group

KENNETH M. DEREGT
Institutional Fixed Income

CHRISTINE A. EDWARDS
Chief Legal Officer & Secretary

JAMES F. HIGGINS
Individual Securities

PETER F. KARCHES
Institutional Securities

MITCHELL M. MERIN
Asset Management

DAVID W. NELMS
Discover Financial Services

STEPHAN F. NEWHOUSE
Institutional Securities

VIKRAM S. PANDIT
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Investment Banking

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STOCKHOLDER INFORMATION

COMMON STOCK

Ticker Symbol: MWD

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

DIVIDENDS

Effective January 1999, Morgan Stanley Dean Witter & Co.'s Board of Directors increased the quarterly cash dividend to \$0.24 per share of common stock.

INDEPENDENT AUDITORS

Deloitte & Touche LLP
Two World Financial Center
New York, NY 10281
212-436-2000

SHARE PURCHASE AND DIVIDEND REINVESTMENT PLAN & STOCKHOLDER SERVICES

Morgan Stanley 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:

Morgan Stanley Dean Witter Trust FSB
Harborside Financial Center, Plaza Two
Jersey City, NJ 07311-3977
800-622-2393

ANNUAL REPORT ON FORM 10-K AND STOCKHOLDER INQUIRIES

General information about the Company and copies of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission can be obtained at:

Online:
[HTTP://WWW.MSDW.COM](http://WWW.MSDW.COM)

Stockholder Helpline:
800-733-2307

INVESTOR RELATIONS

Security analysts, portfolio managers and representatives of financial institutions seeking information about the Company are invited to contact:

Investor Relations:
212-762-8131