

employment. The complaint sought compensatory and punitive damages. The EEOC also alleges that Morgan Stanley retaliated against Schieffelin. Also on September 10, 2001, Schieffelin filed a motion to intervene in the EEOC action, along with an individual complaint alleging that she had been discriminated and retaliated against and seeking similar damages. On October 15, 2001, the court granted Schieffelin's motion to intervene. On September 5, 2002, the court permitted the EEOC to amend its complaint to expand the class to include all IED female exempt non-officers eligible to be promoted to vice president, including associates and professionals. On December 2, 2002, the court denied without prejudice Morgan Stanley's motion for partial summary judgment.

X. Other. In addition to the matters described above, in the normal course of business, Morgan Stanley has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with its activities as a global diversified financial services institution, certain of which legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. Morgan Stanley is also involved, from time to time, in investigations and proceedings by governmental and self-regulatory agencies, certain of which may result in adverse judgments, fines or penalties. The number of these investigations and proceedings has increased in recent years with regard to many firms, including Morgan Stanley. This increase has been exacerbated by the general decline of securities prices that began in 2000 and continued through the end of fiscal 2002. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or otherwise in financial distress.

In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, Morgan Stanley cannot predict with certainty the eventual loss or range of loss related to such matters. Morgan Stanley is contesting liability and/or the amount of damages in each pending matter and believes, based on current knowledge and after consultation with counsel, that the outcome of each matter will not have a material adverse effect on the consolidated financial condition of Morgan Stanley, although the outcome could be material to Morgan Stanley's operating results for a particular future period, depending on, among other things, the level of Morgan Stanley's income for such period.

Item 4. Submission of Matters to a Vote of Security Holders. None.

Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters. Morgan Stanley's common stock trades on the NYSE and The Pacific Exchange. Morgan Stanley had approximately 141,000 holders of record at November 29, 2002; however, Morgan Stanley believes the number of beneficial owners of common stock exceeds this number.

Set forth below, for each of the last eight fiscal quarters, is the low and high sales prices per share of Morgan Stanley's common stock as reported by Bloomberg Financial Markets and the amount of any cash dividends declared per share of Morgan Stanley's common stock.

	<u>Low Sale Price</u>	<u>High Sale Price</u>	<u>Dividends</u>
Fiscal 2002:			
Fourth Quarter	\$28.80	\$46.83	\$0.23
Third Quarter	\$33.50	\$46.50	\$0.23
Second Quarter	\$43.92	\$58.27	\$0.23
First Quarter	\$45.90	\$60.02	\$0.23
Fiscal 2001:			
Fourth Quarter	\$35.75	\$59.60	\$0.23
Third Quarter	\$50.10	\$66.40	\$0.23
Second Quarter	\$44.10	\$75.23	\$0.23
First Quarter	\$61.63	\$90.49	\$0.23

Item 6. Selected Financial Data.

MORGAN STANLEY
SELECTED FINANCIAL DATA
(dollars in millions, except share and per share data)

	Fiscal Year(1)				
	2002	2001	2000	1999	1998
Income Statement Data:					
Revenues:					
Investment banking	\$ 2,527	\$ 3,425	\$ 5,008	\$ 4,523	\$ 3,339
Principal transactions:					
Trading	2,685	5,491	7,361	5,796	3,159
Investments	(35)	(316)	193	725	89
Commissions	3,280	3,162	3,647	2,774	2,208
Fees:					
Asset management, distribution and administration	3,945	4,216	4,405	3,462	3,111
Merchant and cardmember	1,420	1,349	1,256	1,030	1,244
Servicing	2,091	1,904	1,489	1,232	936
Interest and dividends	15,866	24,127	21,234	14,880	16,385
Other	636	516	513	250	268
Total revenues	<u>32,415</u>	<u>43,874</u>	<u>45,106</u>	<u>34,672</u>	<u>30,739</u>
Interest expense	11,970	20,729	18,148	12,487	13,443
Provision for consumer loan losses	1,336	1,052	810	526	1,174
Net revenues	<u>19,109</u>	<u>22,093</u>	<u>26,148</u>	<u>21,659</u>	<u>16,122</u>
Non-interest expenses:					
Compensation and benefits	7,933	9,372	10,896	8,361	6,609
Other	6,221	6,987	6,733	5,542	4,793
Restructuring and other charges	235	—	—	—	—
Total non-interest expenses	<u>14,389</u>	<u>16,359</u>	<u>17,629</u>	<u>13,903</u>	<u>11,402</u>
Gain on sale of businesses	—	—	35	—	685
Income before income taxes, dividends on preferred securities subject to mandatory redemption, extraordinary item and cumulative effect of accounting change	4,720	5,734	8,554	7,756	5,405
Provision for income taxes	1,645	2,074	3,070	2,937	1,992
Dividends on preferred securities subject to mandatory redemption	87	50	28	28	20
Income before extraordinary item and cumulative effect of accounting change	2,988	3,610	5,456	4,791	3,393
Extraordinary item	—	(30)	—	—	—
Cumulative effect of accounting change	—	(59)	—	—	(117)
Net income	<u>\$ 2,988</u>	<u>\$ 3,521</u>	<u>\$ 5,456</u>	<u>\$ 4,791</u>	<u>\$ 3,276</u>
Earnings applicable to common shares(2)	<u>\$ 2,988</u>	<u>\$ 3,489</u>	<u>\$ 5,420</u>	<u>\$ 4,747</u>	<u>\$ 3,221</u>
Per Share Data:					
Earnings per common share:					
Basic before extraordinary item and cumulative effect of accounting change	\$ 2.76	\$ 3.29	\$ 4.95	\$ 4.33	\$ 2.90
Extraordinary item	—	(0.03)	—	—	—
Cumulative effect of accounting change	—	(0.05)	—	—	(0.10)
Basic	<u>\$ 2.76</u>	<u>\$ 3.21</u>	<u>\$ 4.95</u>	<u>\$ 4.33</u>	<u>\$ 2.80</u>
Diluted before extraordinary item and cumulative effect of accounting change	\$ 2.69	\$ 3.19	\$ 4.73	\$ 4.10	\$ 2.76
Extraordinary item	—	(0.03)	—	—	—
Cumulative effect of accounting change	—	(0.05)	—	—	(0.09)
Diluted	<u>\$ 2.69</u>	<u>\$ 3.11</u>	<u>\$ 4.73</u>	<u>\$ 4.10</u>	<u>\$ 2.67</u>

	Fiscal Year(1)				
	2002	2001	2000	1999	1998
Book value per common share	\$ 20.24	\$ 18.64	\$ 16.91	\$ 14.85	\$ 11.94
Dividends per common share	\$ 0.92	\$ 0.92	\$ 0.80	\$ 0.48	\$ 0.40
Balance Sheet and Other Operating Data:					
Total assets	\$529,499	\$482,628	\$421,279	\$366,967	\$317,590
Consumer loans, net	23,404	20,108	21,743	20,963	16,412
Total capital(3)	65,936	61,633	49,637	39,699	37,922
Long-term borrowings(3) ..	44,051	40,917	30,366	22,685	23,803
Shareholders' equity	21,885	20,716	19,271	17,014	14,119
Return on average common shareholders' equity	14.1%	18.5%	30.9%	32.6%	24.5%
Average common and equivalent shares(2)	1,083,270,783	1,086,121,508	1,095,858,438	1,096,789,720	1,151,645,450

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

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

(3) These amounts exclude the current portion of long-term borrowings and include Capital Units and Preferred Securities Subject to Mandatory Redemption.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Introduction.

Morgan Stanley (the "Company") is a global financial services firm that maintains leading market positions in each of its business segments—Institutional Securities, Individual Investor Group, Investment Management and Credit Services. The Company's Institutional Securities business includes securities underwriting and distribution; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; sales, trading, financing and market-making activities in equity securities and related products and fixed income securities and related products, including foreign exchange and commodities; principal investing and aircraft financing activities. The Company's Individual Investor Group business provides comprehensive financial planning and investment advisory services designed to accommodate individual investment goals and risk profiles. The Company's Investment Management business provides global asset management products and services for individual and institutional investors through three principal distribution channels: a proprietary channel consisting of the Company's financial advisors and investment representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; and the Company's institutional channel. The Company's private equity activities also are included within the Investment Management business segment. The Company's Credit Services business offers Discover®-branded cards and other consumer finance products and services and includes the operation of Discover Business Services, a network of merchant and cash access locations primarily in the U.S.

In June 2002, the Company changed its name from "Morgan Stanley Dean Witter & Co." to "Morgan Stanley."

The Company's results of operations for the 12 months ended November 30, 2002 ("fiscal 2002"), November 30, 2001 ("fiscal 2001") and November 30, 2000 ("fiscal 2000") are discussed below.

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 political, economic and market conditions; the availability and cost of capital; the level and volatility of equity prices, commodity prices and interest rates; currency values and other market indices; technological changes and events; the availability and cost of credit; inflation; and investor sentiment and confidence in the financial markets. In addition, there has been a heightened level of legislative, legal and regulatory developments related to the financial services industry that may affect future results of operations. Such factors also may have an impact on the Company's ability to achieve its strategic objectives on a global basis, including (without limitation) increased market share in all of its businesses, growth in assets under management and expansion of its Credit Services business.

The Company's Institutional Securities business, particularly its involvement in primary and secondary markets for all types of financial products, including derivatives, is subject to substantial positive and negative fluctuations due to a variety of factors that cannot be predicted with great certainty, including variations in the fair value of securities and other financial products and the volatility and liquidity of global trading markets. Fluctuations also occur due to the level of global market activity, which, among other things, affects the size,

* 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.

number, and timing of investment banking client assignments and transactions and the realization of returns from the Company's principal investments. Such factors also affect the level of individual investor participation in the financial markets, which impacts the results of the Individual Investor Group. The level of global market activity also could impact the flow of investment capital into or from assets under management and supervision and the way in which such capital is allocated among money market, equity, fixed income or other investment alternatives, which could cause fluctuations to occur in the Company's Investment Management business. In the Company's Credit Services business, changes in economic variables, such as the number and size of personal bankruptcy filings, the rate of unemployment, and the level of consumer confidence and consumer debt, may substantially affect consumer loan levels and credit quality, which, in turn, could impact the results of Credit Services.

The Company's results of operations also may be materially affected by competitive factors. Included among the principal competitive factors affecting the Institutional Securities and Individual Investor Group businesses are the Company's reputation, the quality of its professionals and other personnel, its products, services and advice, capital commitments, relative pricing and innovation. Competition in the Company's Investment Management business is affected by a number of factors, including investment objectives; relative performance of investment products; advertising and sales promotion efforts; fee levels, distribution channels, and types and quality of services offered. In the Credit Services business, competition centers on merchant acceptance of credit cards, account acquisition and customer utilization of credit cards, all of which are impacted by the types of fees, interest rates and other features offered.

Besides competition from firms traditionally engaged in the financial services business, competition has continued to increase from other sources, such as commercial banks, insurance companies, sponsors of mutual funds and other companies offering financial services in the U.S., globally and through the Internet. The financial services industry has experienced consolidation and convergence, as financial institutions involved in a broad range of financial services industries have merged. Such convergence may continue and could result in the Company's competitors gaining greater capital and other resources, such as a broader range of products and services and geographic diversity. In addition, the Company has experienced competition for qualified employees. The Company's ability to sustain or improve its competitive position will substantially depend on its ability to continue to attract and retain qualified employees while managing compensation costs.

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 to mitigate the potential effects of market downturns by strengthening its competitive position in the global financial services industry through diversification of its revenue sources, enhancement of its global franchise, and management of costs and its capital structure. The Company's overall financial results will continue to be affected by its ability and success in addressing client goals; maintaining high levels of profitable business activities; emphasizing fee-based products that are designed to generate a continuing stream of revenues; evaluating credit product pricing; managing risks, costs and its capital position; and maintaining its strong reputation and franchise. 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 2002.

The difficult global market and economic conditions that existed during fiscal 2001 deteriorated further throughout fiscal 2002. Although fiscal 2002 began amid increased expectations of improved economic performance, the anticipated recovery never materialized, and global economic growth remained sluggish. In addition, weak corporate earnings and the emergence of numerous corporate accounting and governance irregularities undermined investor confidence, and the majority of global equity markets experienced sharp declines during fiscal 2002. Uncertainty surrounding lingering terrorist threats and increased geopolitical

tensions also contributed to investors becoming increasingly risk-averse. It currently is uncertain when these market and economic conditions will improve.

These conditions adversely affected the Company's fiscal 2002 results of operations, as the revenues of the Company's Institutional Securities, Individual Investor Group and Investment Management business segments declined from the levels achieved in fiscal 2001. The Company's Institutional Securities business recorded lower revenues from its investment banking and sales and trading activities in fiscal 2002 as compared with fiscal 2001. The Company's Individual Investor Group business continued to be adversely affected by low levels of retail investor participation in the equity markets, while the decline in revenues in the Company's Investment Management business reflected a decrease in customer assets under management or supervision and a shift toward investment allocations perceived to contain lower risk.

In the U.S., market and economic conditions remained difficult during fiscal 2002. Despite generally resilient consumer spending, economic growth continued to be sluggish. The unemployment rate remained at a relatively high level, and investors continued to be concerned with weak corporate earnings and increased uncertainty about the strength and pace of the global economic recovery. In addition, investor confidence weakened due to increased concerns regarding the quality of corporate financial reporting and accounting practices, corporate governance, unethical or illegal corporate practices and several significant corporate bankruptcies. These developments, coupled with increased geopolitical unrest, created difficult conditions in U.S. financial markets. U.S. equity markets declined for the third consecutive year, the first time that has occurred since the 1940s. In response to these conditions, during fiscal 2002 the Federal Reserve Board (the "Fed") eased interest rates in order to stimulate economic activity. In two separate actions, the Fed lowered both the overnight lending rate and the discount rate by an aggregate of 0.75%. The Securities and Exchange Commission (the "SEC") also responded by, among other things, requiring chief executive officers and chief financial officers of companies with large market capitalization to certify the accuracy of certain prior financial reports and other SEC filings. In addition, the Sarbanes-Oxley Act of 2002 was enacted, which includes broad legislation affecting public companies with provisions covering corporate governance and management, new disclosure requirements, oversight of the accounting profession and auditor independence.

Economic and market conditions also were difficult in Europe during fiscal 2002. Economic growth was generally sluggish, reflecting weak industrial production and the impact of difficult conditions existing in the global economy. In Germany, the region's largest economy, growth was adversely impacted by a relatively high unemployment rate and weak industrial production and job creation. As a result, the majority of equity market indices within the region declined during fiscal 2002. During the year, the European Central Bank ("ECB") left the benchmark interest rate within the region unchanged. Subsequent to fiscal year-end, in December 2002, the ECB lowered the benchmark interest rate within the European Union by 0.5%. In the U.K., inflation and unemployment were generally stable, and consumer spending was relatively strong. However, equity prices in the U.K. declined during fiscal 2002. The Bank of England left the benchmark interest rate unchanged during the year.

Economies in the Far East, which are heavily dependent on export levels, also were adversely impacted by the sluggish performance of the U.S. economy during fiscal 2002. In Japan, although the level of economic activity improved, economic growth was subdued, and the prospects for continued recovery still were uncertain in light of the difficult conditions existing throughout the global economy. In addition, lingering concerns over the banking sector, including the level of non-performing bank loans, and deflationary pressures negatively impacted the nation's economy. Consumer spending remained weak, reflecting a relatively high unemployment rate and low consumer confidence. As a result, Japanese equity markets declined during fiscal 2002. Certain nations elsewhere in the Far East experienced an improvement in the level of exports and manufacturing output. However, their prospects for continued recovery will be largely dependent on developments elsewhere in the world, particularly in the U.S.

The decline in the worldwide market for mergers and acquisitions that began in mid-2000 continued during fiscal 2002. The number of transactions and the average transaction size fell significantly during fiscal 2002 as compared with fiscal 2001. However, transaction activity continued to be diverse in terms of regional and

industry breadth, reflecting the continuing need for consolidation and globalization in a variety of industries, including consumer products, health-care, financial services and general-industrial business sectors. The market for merger and acquisition transactions was adversely affected by weakened investor confidence in light of several significant corporate accounting irregularities and bankruptcies, weak corporate earnings and declines in the global equity markets. In addition, many companies continued to respond to the difficult market and economic conditions by focusing on cost reduction instead of expansion.

The worldwide market for equity underwriting transactions was adversely affected by the uncertainty in the global financial markets, which contributed to a significant decline in transaction volume as compared with the prior year. Between mid-August 2002 and the second week of October 2002, there were no initial public offerings ("IPOs") in the U.S. equity markets, the first time this has occurred since 1975 (according to Thomson Financial). The market for fixed income underwritings also was more difficult in fiscal 2002 as compared with fiscal 2001, primarily due to lower transaction volumes resulting from an overall market slowdown coupled with increased competitive pressures.

U.S. consumer demand and spending continued its resiliency throughout much of fiscal 2002, stimulated by historically low interest rates that lowered borrowing costs and increased mortgage refinancings. However, due to reduced personal wealth, relatively high unemployment, declining equity prices, and general economic and geopolitical concerns, consumer demand and spending moderated as fiscal 2002 concluded. In addition, there was a continued rise in personal bankruptcy filings during fiscal 2002.

Fiscal 2002 and Fiscal 2001 Results of the Company.

The Company recorded net income of \$2,988 million in fiscal 2002, a 15% decrease from fiscal 2001. In fiscal 2001, the Company's net income was \$3,521 million, a decrease of 35% from fiscal 2000. Fiscal 2001's net income included an extraordinary loss of \$30 million associated with the early extinguishment of certain long-term borrowings and a charge of \$59 million for the cumulative effect of an accounting change associated with the Company's adoption, on December 1, 2000, of Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. Excluding the extraordinary item and the cumulative effect of the accounting change, the Company's net income for fiscal 2002 was 17% below the comparable period of fiscal 2001. Excluding the extraordinary item and the cumulative effect of the accounting change, the Company's net income for fiscal 2001 was 34% below the comparable period of fiscal 2000.

The Company's effective income tax rate was 34.9%, 36.2% and 35.9% in fiscal 2002, fiscal 2001 and fiscal 2000, respectively. The decrease in the effective tax rate in fiscal 2002 primarily reflected lower tax rates attributable to non-U.S. earnings. The effective tax rate in fiscal 2001 was relatively unchanged from the prior year.

Basic earnings per common share decreased 14% to \$2.76 in fiscal 2002 and decreased 35% to \$3.21 in fiscal 2001. Excluding the extraordinary loss and the impact of the cumulative effect of an accounting change noted above, fiscal 2001's basic earnings per common share were \$3.29. Diluted earnings per common share decreased 14% to \$2.69 in fiscal 2002 and decreased 34% to \$3.11 in fiscal 2001. Excluding the extraordinary loss and the impact of the cumulative effect of an accounting change, fiscal 2001's diluted earnings per common share were \$3.19.

The Company's return on average common shareholders' equity (excluding the extraordinary loss and the cumulative effect of the accounting change for fiscal 2001) was 14%, 19% and 31% in fiscal 2002, fiscal 2001 and fiscal 2000, respectively.

In light of the declines in the global financial markets over the past few years, the Company contributed approximately \$450 million to its defined benefit pension plans during fiscal 2002. These contributions were

funded with cash from operations and were recorded as a component of prepaid pension benefit cost in the Company's consolidated statements of financial condition. In addition, the Company, in consultation with its independent actuaries, lowered its expected long-term rate of return on plan assets (from 9.0% to 8.5%) for fiscal 2002 (see Note 15 to the consolidated financial statements). The impact of this change was not material to the Company's consolidated results of operations in fiscal 2002. The impact of the Company's cash contributions in fiscal 2002, coupled with a lower expected long-term rate of return on plan assets for fiscal 2003 (7.5%), is not expected to have a material impact on the Company's consolidated results of operations in fiscal 2003.

At November 30, 2002, the Company had approximately 56,000 employees worldwide, a decrease of 9% from November 30, 2001. The reduction in staffing levels reflected the Company's continued efforts to manage costs in light of the weakened global economy and reduced business activity. During the fourth quarter of fiscal 2002, the Company had workforce reductions of approximately 2,200 employees (see "Restructuring and Other Charges" herein).

Restructuring and Other Charges.

In the fourth quarter of fiscal 2002, the Company recognized restructuring and other charges of \$235 million (pre-tax). The charge reflects several actions that were intended to resize and refocus certain business areas in order to address the difficult conditions currently existing in the global financial markets. Such conditions, including significantly lower levels of investment banking activity and decreased retail investor participation in the equity markets, have had an adverse impact on the Company's results of operations, particularly in its Institutional Securities and Individual Investor Group businesses.

This charge, which is recorded as Restructuring and other charges on the Company's consolidated statements of income, consisted of space-related costs of \$162 million and severance-related costs of \$73 million. The space-related costs were attributable to the closure or subletting of excess office space, primarily in the U.S. and the U.K., as well as the Company's decision to consolidate its Individual Investor Group branch locations. The majority of the space-related costs consisted of rental charges and the write-off of furniture, fixtures and other fixed assets at the affected office locations. The severance-related costs were attributable to workforce reductions. The Company reduced the number of its employees by approximately 2,200 during the fourth quarter of fiscal 2002, primarily in the Institutional Securities and Individual Investor Group businesses. The majority of the severance-related costs consisted of severance payments and outplacement costs provided to the affected individuals. The restructuring and other charges were included in the Institutional Securities (\$117 million), Individual Investor Group (\$112 million) and Investment Management (\$6 million) business segments.

The Company expects that these actions will yield pre-tax savings of approximately \$245 million in fiscal 2003. Approximately \$195 million of these expected savings relate to reduced employee-related costs, which will be recognized within Compensation and benefits expenses in the Company's consolidated statements of income. The remainder of the expected savings for fiscal 2003 relate to lower facilities costs, which will be recognized within Occupancy and equipment expenses. Subsequent to fiscal 2003, the Company will continue to recognize lower occupancy and equipment expenses as a result of its decision to reduce its office space. However, the changes in these and other operating expenses from period to period have been, and will continue to be, affected by the Company's management of its costs in light of the overall level of business activity and other business initiatives.

The majority of the workforce reductions were completed during the fourth quarter of fiscal 2002. The consolidation of branch locations and other space-related actions are expected to be substantially completed by the second quarter of fiscal 2003. The Company expects that the remaining space-related payments and severance-related payments will be funded by cash from operations.

Recent Developments.

On December 19, 2002, the Company (and other financial services firms) reached an agreement in principle with the SEC, the New York State Attorney General's Office, the New York Stock Exchange, Inc. ("NYSE"), the National Association of Securities Dealers, Inc. and the North American Securities Administrators Association

(on behalf of state securities regulators) to resolve their investigations relating to alleged research analyst conflicts of interest. The agreement resolved the investigations as to the Company and the other firms but not as to individuals within the firms. Pursuant to the agreement in principle, the Company, without admitting or denying the allegations, agreed (i) to pay \$50 million in retrospective relief and (ii) to adopt internal structural and operational practices that will further enhance the steps it already has taken to help ensure research analyst integrity and promote investor confidence. In addition, the Company agreed to provide independent third-party research to clients and to pay \$75 million over five years to fund such research. The costs of the agreement in principle have been provided for in the Company's consolidated financial statements.

Business Acquisitions, Business Disposition and Asset Dispositions.

In fiscal 2002, the Company sold its self-directed online brokerage accounts to Bank of Montreal's *Harrisdirect*. The transaction closed during the third quarter of fiscal 2002. The Company recorded gross proceeds of approximately \$100 million (included within Other revenues) and related costs of approximately \$50 million (included within Non-interest expenses) in the Individual Investor Group business segment.

In fiscal 2002, the Company recorded a pre-tax gain of \$73 million related to the sale of a 1 million square-foot office tower in New York City that had been under construction since 1999. The pre-tax gain is included within the Institutional Securities (\$53 million), Individual Investor Group (\$7 million) and Investment Management (\$13 million) business segments. The allocation was based upon occupancy levels originally planned for the building.

In fiscal 2001, the Company acquired Quilter Holdings Limited ("Quilter"), a U.K.-based private client investment management business providing segregated account management and advisory services to individuals, pension funds and trusts. The Company's fiscal 2001 results include the operations of Quilter since March 13, 2001, the date of acquisition.

In fiscal 2000, the Company acquired Ansett Worldwide Aviation Services ("Ansett Worldwide"), one of the world's leading aircraft leasing groups, leasing new and used commercial jet aircraft to airlines around the world. The Company's fiscal 2000 results include the operations of Ansett Worldwide since April 27, 2000, the date of acquisition.

In the fourth quarter of fiscal 1998, the Company sold its Global Custody business to The Chase Manhattan Corporation ("Chase"). At that time, the Company recorded a pre-tax gain of \$323 million from the sale. Such gain included estimates for certain payments and purchase price adjustments which, under certain circumstances pursuant to the sales agreement, were payable by the Company to Chase. As a result of the resolution of these payments and purchase price adjustments, the Company recorded an additional pre-tax gain of \$35 million related to the sale of its Global Custody business in fiscal 2000.

Business Segments.

The remainder of Results of Operations is presented on a business segment basis. Substantially all of the operating revenues and operating expenses of the Company can be directly attributed to its business segments: Institutional Securities, Individual Investor Group, Investment Management and Credit Services. Certain revenues and expenses have been allocated to each business segment, generally in proportion to their respective revenues or other relevant measures.

Previously, the results of the Company's institutional and individual securities activities were aggregated into one reporting segment. In addition, the Investment Management business segment includes the Company's private equity activities. Prior to fiscal 2002, private equity activities were included within the Company's Institutional Securities business segment. The segment data for all periods presented have been restated to reflect these changes.

Allocation decisions in global financial services businesses are by their nature complex and subjective and involve a high degree of judgment. Management currently is evaluating the segment allocation methodology, and the effect of any changes may be material to a particular segment. Therefore, business segment results in the future may reflect reallocations of revenues and expenses that result from such changes. Reallocations of revenues or expenses among segments will have no effect on the Company's overall results of operations.

A substantial portion of the Company's compensation expense represents performance-based bonuses, which are determined at the end of the Company's fiscal year. The segment allocation of these bonuses reflects, among other factors, the overall performance of the Company as well as the performance of individual business units. The timing and magnitude of changes in the Company's bonus accruals can have a significant effect on segment operating results in a given period.

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

Critical Accounting Policies.

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions (see Note 1 to the consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements), the following may involve a higher degree of judgment and complexity.

Fair Value. Financial instruments owned of \$173 billion and financial instruments sold, not yet purchased of \$86 billion at November 30, 2002, which include cash and derivative products, are recorded at fair value in the consolidated statements of financial condition, and gains and losses are reflected in principal trading revenues in the consolidated statements of income. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or distressed sale.

The price transparency of the particular product will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly or not quoted will generally have reduced to no price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced for periods of time during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market-makers willing to purchase and sell a product provides a source of transparency for products that otherwise are not actively quoted or during periods of market dislocation.

A substantial percentage of the fair value of the Company's financial instruments owned and financial instruments sold, not yet purchased, is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing parameters in a product (or a related product) may be used to derive a price without requiring significant judgment. In certain markets, observable market prices or market parameters are not available for all products, and fair value is determined using techniques appropriate for each particular product. These analyses may involve a degree of judgment.

The Company's cash products include securities issued by the U.S. government and its agencies and instrumentalities, other sovereign debt obligations, corporate and other debt securities, corporate equity securities, exchange traded funds and physical commodities. The fair value of these products is based principally on observable market prices or is derived from observable market parameters. These products generally do not entail a significant degree of judgment in determining fair value. Examples of products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or

pricing parameters include securities issued by the U.S. government and its agencies and instrumentalities, exchange traded corporate equity securities, most municipal debt securities, most corporate debt securities, most high-yield debt securities, physical commodities, certain traded loan products and most mortgage-backed securities.

By contrast, some cash products exhibit little or no price transparency, and the determination of the fair value requires more judgment. Examples of cash products with little or no price transparency include certain high-yield debt, certain collateralized mortgage obligations, certain traded loan products, distressed debt securities (i.e., securities of issuers encountering financial difficulties, including bankruptcy or insolvency) and equity securities that are not publicly traded. Generally, the fair value of these types of cash products is determined using one of several valuation techniques appropriate for the product, which can include cash flow analysis, revenue or net income analysis, default recovery analysis (i.e., analysis of the likelihood of default and the potential for recovery) and other analyses applied consistently. At November 30, 2002, the fair value of cash products with little or no price transparency recorded in financial instruments owned and financial instruments sold, not yet purchased was \$7.6 billion and \$0.5 billion, respectively.

The Company's derivative products include listed and over-the-counter ("OTC") derivatives. Listed derivatives have valuation attributes similar to the cash products valued using observable market prices or market parameters described above. Fair values for listed derivatives recorded as financial instruments owned and financial instruments sold, not yet purchased amounted to \$2 billion and \$2 billion, respectively, at November 30, 2002. OTC derivatives included a wide variety of instruments, such as interest rate swap and option contracts, foreign currency option contracts, credit and equity swap and option contracts, and commodity swap and option contracts. Fair values for OTC derivative products recorded as financial instruments owned and financial instruments sold, not yet purchased, which amounted to \$34 billion and \$27 billion, respectively, at November 30, 2002, were derived from pricing models.

The fair value of OTC derivative contracts is derived from pricing models, which may require multiple market input parameters. This technique is deemed more reliable than subjective adjustment to prices obtained for similar instruments. The Company relies on pricing models as a valuation methodology to determine fair value for OTC derivative products because market convention is to quote input parameters to models rather than prices, not because of a lack of an active trading market. The term "model" typically refers to a mathematical calculation methodology based on accepted financial theories. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as quoted market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swap and option contracts. A substantial majority of OTC derivative products valued by the Company using pricing models falls into this category. Other derivative products, typically the newest and most complex products, will require more judgment in the implementation of the modeling technique applied due to the reduced price transparency surrounding the model's market parameters. The Company manages its market exposure for OTC derivative products primarily by entering into offsetting derivative contracts or related financial instruments. The Company's trading divisions and the Market Risk Department continuously monitor the price changes of the OTC derivatives in relation to the hedges. For a further discussion of the price transparency of the Company's OTC derivative products, see "Quantitative and Qualitative Disclosures about Market Risk — Risk Management — Credit Risk" in Part II, Item 7A.

The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the prices used for financial

reporting are based on observable market prices or market-based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and the assumptions are reasonable. These control processes include periodic review of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading divisions. Additionally, groups independent from the trading divisions within the Controllers and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model utilizes historical and statistical analysis to determine fair value, recently executed comparable transactions are considered for purposes of validating assumptions underlying the model. Where the fair value of the transaction deviates significantly from the fair value derived from the model, the transaction fair value will be used to further refine the model's input or statistical techniques in determining fair value in future periods. Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral ("margining") based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional validation of the Company's recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This information further validates the fair value of these OTC derivative products. For more information regarding the Company's risk management practices, see "Quantitative and Qualitative Disclosures about Market Risk — Risk Management" in Part II, Item 7A.

Transfers of Financial Assets. The Company engages in securitization activities in connection with certain of its businesses. Gains and losses from securitizations are recognized in the consolidated statements of income when the Company relinquishes control of the transferred financial assets in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a replacement of FASB Statement No. 125" and other related pronouncements. The gain or loss on the sale of financial assets depends in part on the previous carrying amount of the assets involved in the transfer, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale.

In connection with its Institutional Securities business, the Company engages in securitization transactions to facilitate client needs and as a means of selling financial assets. The Company recognizes any interests in the transferred assets and any liabilities incurred in securitization transactions in its consolidated statements of financial condition at fair value. Subsequently, changes in the fair value of such interests are recognized in the consolidated statements of income. The use of different pricing models or assumptions could produce different financial results.

In connection with its Credit Services business, the Company periodically sells consumer loans through asset securitizations and continues to service these loans. The present value of the future net servicing revenues that the Company estimates 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. The securitization gain or loss involves the Company's best estimates of key assumptions, including forecasted credit losses, payment rates, forward yield curves and appropriate discount rates. The use of different estimates or assumptions could produce different financial results.

Allowance for Consumer Loan Losses. The allowance for consumer loan losses in the Company's Credit Services business is established through a charge to the provision for consumer loan losses. Provisions are made to reserve for estimated losses in outstanding loan balances. The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is an allowance applicable to the owned homogeneous consumer credit card loan portfolio that is evaluated quarterly for adequacy.

In calculating the allowance for consumer loan losses, the Company uses a systematic and consistently applied approach. The amount of the allowance is established through a process that begins with estimates of the losses inherent in the consumer loan portfolio based on coverage of a rolling average of historical credit losses. In addition, the Company regularly performs a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge-off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact future credit loss experience, including current economic conditions, recent trends in delinquencies and bankruptcy filings, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level. The use of different estimates or assumptions could produce different provisions for consumer loan losses (see “Credit Services—Provision for Consumer Loan Losses” herein).

Aircraft under Operating Leases. Aircraft under operating leases are stated at cost less accumulated depreciation. In accordance with SFAS No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,” the Company’s aircraft are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of the aircraft may not be recoverable. Under SFAS No. 121, the carrying value of an aircraft may not be recoverable if its projected undiscounted cash flows are less than its carrying value. If an aircraft’s projected undiscounted cash flows are less than its carrying value, an impairment charge based on the excess of the carrying value over the fair value of the aircraft is recognized. The fair value of the Company’s impaired aircraft is based upon valuation information obtained from independent appraisal companies. Estimates of future cash flows associated with the aircraft assets as well as the appraisals of fair value are critical to the determination of whether an impairment exists and the amount of the impairment charge, if any (see Note 19 to the consolidated financial statements). On December 1, 2002, the Company adopted SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets” (see “New Accounting Pronouncements” herein).

INSTITUTIONAL SECURITIES
STATEMENTS OF INCOME
(dollars in millions)

	Fiscal 2002	Fiscal 2001	Fiscal 2000
Revenues:			
Investment banking	\$ 2,240	\$ 3,091	\$ 4,492
Principal transactions:			
Trading	2,114	4,719	6,591
Investments	41	(216)	100
Commissions	2,073	1,816	1,577
Asset management, distribution and administration fees	106	96	101
Interest and dividends	13,069	20,727	17,150
Other	414	438	385
Total revenues	<u>20,057</u>	<u>30,671</u>	<u>30,396</u>
Interest expense	<u>10,789</u>	<u>19,117</u>	<u>16,304</u>
Net revenues	<u>9,268</u>	<u>11,554</u>	<u>14,092</u>
Non-interest expenses	<u>6,564</u>	<u>7,715</u>	<u>8,685</u>
Income before income taxes, dividends on preferred securities subject to mandatory redemption, extraordinary item and cumulative effect of accounting change	2,704	3,839	5,407
Provision for income taxes	914	1,317	1,815
Dividends on preferred securities subject to mandatory redemption	87	50	28
Income before extraordinary item and cumulative effect of accounting change ...	1,703	2,472	3,564
Extraordinary item	—	(30)	—
Cumulative effect of accounting change	—	(46)	—
Net income	<u>\$ 1,703</u>	<u>\$ 2,396</u>	<u>\$ 3,564</u>

Institutional Securities provides a wide range of financial products, services and investment advice to institutional investors. Institutional Securities business activities are conducted in the U.S. and throughout the world and include investment banking, sales and trading, financing, market-making activities, full-service brokerage services, principal investing activities, aircraft financing activities and research.

Institutional Securities achieved net revenues of \$9,268 million and net income of \$1,703 million in fiscal 2002, decreases of 20% and 29%, respectively, from fiscal 2001. Institutional Securities net income for fiscal 2001 included an extraordinary loss of \$30 million associated with the early extinguishment of certain long-term borrowings and a charge of \$46 million from the cumulative effect of an accounting change associated with the Company's adoption of SFAS No. 133 on December 1, 2000. The decreases in net revenues and net income in fiscal 2002 were primarily attributable to lower revenues from the Company's sales and trading and investment banking activities, partially offset by lower non-interest expenses. In fiscal 2001, Institutional Securities net revenues and net income decreased 18% and 33%, respectively, from fiscal 2000. The decreases in net revenues and net income in fiscal 2001 were primarily attributable to lower revenues from the Company's investment banking and sales and trading activities, partially offset by lower levels of incentive-based compensation expense. The decrease in net revenues and net income also reflected principal investment losses in fiscal 2001 as compared with principal investment gains in fiscal 2000, as well as a higher level of expenses associated with the Company's aircraft financing business.

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

	Fiscal 2002	Fiscal 2001	Fiscal 2000
	(dollars in millions)		
Advisory fees from merger, acquisition and restructuring transactions	\$ 962	\$1,420	\$2,144
Equity underwriting revenues	534	775	1,537
Fixed income underwriting revenues	744	896	811
Total investment banking revenues	\$2,240	\$3,091	\$4,492

Investment banking revenues decreased 28% in fiscal 2002, reflecting lower revenues from merger, acquisition and restructuring activities and equity and fixed income underwriting transactions. In fiscal 2001, the 31% decrease in investment banking revenues reflected lower revenues from equity underwriting transactions and merger, acquisition and restructuring activities, partially offset by higher fixed income underwriting revenues.

Conditions in the worldwide merger and acquisition markets were extremely difficult in fiscal 2002. There was \$1.2 trillion of transaction activity announced during calendar year 2002 (according to Thomson Financial), a decrease of 29% from calendar year 2001. During calendar year 2002, the Company's volume of announced merger and acquisition transactions was approximately \$210 billion as compared with approximately \$460 billion in the prior year, a decrease of 54%. The number of transactions and the average transaction size fell significantly during fiscal 2002 as compared with fiscal 2001, primarily reflecting the difficult global market and economic conditions that existed during the period. Increased concerns over corporate accounting and governance issues and declining global equity prices also had a negative impact on the volume of advisory transactions, which contributed to a 32% decrease in revenues in fiscal 2002. In fiscal 2001, sharp declines in the volume of merger and acquisition transaction activity were experienced across many industries and geographic locations and had a negative impact on advisory fees, which decreased 34%. The declines in the global equity markets during fiscal 2001 negatively affected transaction activity by reducing the purchasing power of potential acquirers.

Equity underwriting revenues decreased 31% in fiscal 2002 and 50% in fiscal 2001, reflecting significantly lower volumes of equity offerings in the global equity markets, principally in the U.S. and Europe. The decline in new issue volume in both periods reflected the difficult conditions that existed in the global equity markets, including the technology, media and telecommunications sectors. The decrease in fiscal 2002 also was due to lower revenues from underwriting convertible securities. The decrease in fiscal 2001 was partially offset by a record level of revenues from underwriting convertible securities.

Fixed income underwriting revenues decreased 17% in fiscal 2002, primarily reflecting less favorable market conditions, including volatile credit spreads due to an increase in credit risks associated with certain issuers. These conditions contributed to a lower level of investment grade and structured credit underwriting transactions. This decrease was partially offset by higher revenues from underwriting municipal fixed income securities. Fixed income underwriting revenues increased 10% in fiscal 2001. The volume of fixed income underwriting transactions in fiscal 2001 reflected a lower interest rate environment in both the U.S. and Europe, resulting in issuers taking advantage of historically low yields rendered by the Fed's and the ECB's interest rate actions. The volume of fixed income underwriting transactions was generally strong throughout fiscal 2001, particularly in investment grade products and structured credit transactions.

Given current market and economic conditions, it is uncertain at what pace investment banking transactions will occur in future periods.

Sales and Trading Revenues. Sales and trading revenues are composed of principal transaction trading revenues, commissions and net interest revenues. In assessing the profitability of its business activities, the Company views principal trading, commissions and net interest revenues in the aggregate. In addition, 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, including any associated commissions, and the interest income or expense associated with financing or hedging the Company's positions.

The components of the Company's sales and trading revenues are described below:

Principal Transactions. Principal transaction trading revenues include revenues from customers' purchases and sales of securities in which the Company acts as principal and gains and losses on the Company's securities positions. The Company also engages in proprietary trading activities for its own account.

Commissions. Commission revenues primarily arise from agency transactions in listed and over-the-counter equity securities and options. In January 2002, the Company began implementing a commission-based pricing structure for executing transactions on the NASDAQ. Prior to January 2002, the Company operated its NASDAQ equity business through market-making activities, which were primarily based on earning a spread between the bid and ask prices. In prior periods, the results of such market-making activities were reported in principal transaction trading revenues. As a result of the new pricing structure, revenues earned from NASDAQ equity trading activities now are included in commission revenues.

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 and financial instruments sold, not yet purchased, reverse repurchase and repurchase agreements, trading strategies, customer activity in the Company's prime brokerage business, and the prevailing level, term structure and volatility of interest rates. Reverse repurchase and repurchase agreements and securities borrowed and securities loaned transactions may be entered into with different customers using the same underlying securities, thereby generating a spread between the interest revenue on the reverse repurchase agreements or securities borrowed transactions and the interest expense on the repurchase agreements or securities loaned transactions.

Sales and trading revenues include the following:

	Fiscal 2002	Fiscal 2001	Fiscal 2000
	(dollars in millions)		
Equities	\$3,584	\$4,615	\$5,975
Fixed income(1)	3,265	3,909	2,876

(1) Amounts include interest rate products, foreign exchange, credit products and commodities.

Sales and trading revenues decreased 21% in fiscal 2002, reflecting lower equity and fixed income trading revenues. Sales and trading revenues decreased 10% in fiscal 2001, as lower equity trading revenues were partially offset by higher fixed income trading revenues.

Equity sales and trading revenues decreased 22% in fiscal 2002, reflecting lower revenues from cash and derivative equity products due to lower levels of market volatility and lower trading opportunities related to new issue volume, decreased levels of inflows into equity mutual funds and lower revenues from certain proprietary trading activities. In fiscal 2002, the sluggish global economy and increased concerns regarding corporate bankruptcies and accounting irregularities contributed to difficult conditions in the equity markets, primarily in the U.S. and Europe.

Equity sales and trading revenues decreased 23% in fiscal 2001, primarily reflecting lower revenues from trading cash and derivative equity products. Despite higher customer trading volumes in both listed and OTC securities,

conditions in the equity markets were generally less favorable in comparison with fiscal 2000, primarily in the U.S. and Europe. In particular, the level of market volatility was significantly lower in fiscal 2001 as compared with fiscal 2000, especially in the technology sector. The decline in equity revenues also reflected lower new issue volume, lower levels of cash flows into equity mutual funds, increased margin pressure resulting from the decimalization of the quoted price of certain U.S. equity securities and lower revenues from certain proprietary trading activities.

Fixed income sales and trading revenues decreased 16% in fiscal 2002. The decrease primarily reflected lower revenues from government and investment grade fixed income securities and commodities, each of which had notably strong results in fiscal 2001, partially offset by higher revenues from global high-yield fixed income products and foreign exchange. The trading environment for government fixed income securities was difficult during fiscal 2002, due to lack of direction with respect to interest rates. The decrease in revenues from investment grade fixed income securities reflected a less favorable environment due to an increase in credit risks associated with certain issuers as corporate credit spreads widened due to concerns over corporate bankruptcies, corporate reporting and accounting issues, and credit downgrades. The decrease in commodity revenues from the record revenues achieved in fiscal 2001 was primarily attributable to difficult conditions in the energy markets, particularly in the electricity and natural gas sectors. Lower levels of market liquidity and volatility existed during much of fiscal 2002, resulting in fewer trading opportunities. These conditions reflected increased energy regulation and a decline in the number of active market participants. The increase in revenues from global high-yield fixed income products was primarily driven by distressed debt and emerging markets activities, as well as a lower level of markdowns as compared with the prior year. The increase in foreign exchange trading revenues reflected higher market volatility as the U.S. dollar depreciated against the yen and the euro during much of fiscal 2002. U.S. dollar-denominated assets were relatively less attractive in fiscal 2002, reflecting concerns over the U.S. economy and difficult conditions in U.S. financial markets.

In fiscal 2001, fixed income sales and trading revenues increased 36%, primarily reflecting higher revenues from trading government and investment grade fixed income products and foreign exchange and commodities, partially offset by lower revenues from trading global high-yield fixed income products, including emerging markets and distressed debt instruments. Revenues from trading government and investment grade securities benefited from strong trading volumes and market liquidity, partially reflecting the aggressive easing of interest rates by the Fed and the ECB during the year. The increase in foreign exchange revenues reflected higher levels of customer trading volumes and volatility in the foreign exchange markets in both the U.S. and Europe. The higher level of volatility in the foreign exchange markets primarily reflected the Fed's interest rate actions during fiscal 2001 and the euro's rally relative to the U.S. dollar during the first half of fiscal 2001. Commodity revenues increased to a record level in fiscal 2001, primarily driven by higher revenues from electricity and natural gas trading, which benefited from periods of heightened price volatility. The volatility in electricity and natural gas prices primarily resulted from periodic regional energy shortages, as well as fluctuations in demand due to changing weather conditions. Higher revenues from metals trading also contributed to the increase in fiscal 2001, as these markets rallied after September 11, 2001. The decline in revenues from global high-yield securities reflected the adverse impact of the difficult market and economic conditions that existed during fiscal 2001 on certain high-yield issuers, which resulted in markdowns of certain positions.

In addition, sales and trading revenues include the net interest expense associated with the Company's aircraft financing activities (see "Other" herein), as well as losses associated with the Company's corporate lending activities. In fiscal 2002, sales and trading revenues associated with these activities decreased and continued to reflect losses in the Company's corporate lending activities due to the difficult market conditions that existed during fiscal 2002, including the continued deterioration in the credit markets. These decreases were slightly offset by lower interest costs associated with the Company's aircraft financing activities. The decline in these sales and trading revenues in fiscal 2001 as compared with fiscal 2000 also was attributable to losses associated with the Company's corporate lending activities coupled with higher interest costs related to the Company's aircraft financing activities.

Principal Investments. Principal transaction net investment revenue aggregating \$41 million was recognized in fiscal 2002 as compared with losses of \$216 million in fiscal 2001. Fiscal 2002's results included gains on the Company's real estate investments, partially offset by losses in other principal investments. Fiscal 2001's results included losses in the Company's principal investments, primarily reflecting difficult market conditions in the technology and telecommunications sectors.

Securities purchased in principal investment transactions generally are held for appreciation and are not readily marketable. It is not possible to determine when the Company will realize the value of such investments since, among other factors, such investments generally are subject to sales restrictions. Moreover, estimates of the eventual realizable value of the investments involve significant judgment and may fluctuate significantly over time in light of business, market, economic and financial conditions generally or in relation to specific transactions.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees include revenues from asset management services, primarily fees associated with the Company's real estate investment activities.

Asset management, distribution and administration fees increased 10% in fiscal 2002, primarily due to higher management fees from the Company's real estate investment activities. Asset management, distribution and administration fees decreased 5% in fiscal 2001, primarily due to lower management fees from the Company's real estate investment activities.

Other. Other revenues consist primarily of net rental and other revenues associated with the Company's aircraft financing business.

Other revenues decreased 5% in fiscal 2002. The decrease was primarily attributable to lower revenues from the Company's aircraft financing business, reflecting lower lease rates and a higher number of unleased aircraft. The decrease was partially offset by the inclusion of a gain (of which \$53 million was allocated to the Institutional Securities segment) related to the Company's sale of an office tower in the first quarter of fiscal 2002.

Net revenues from the Company's aircraft financing business declined in fiscal 2002 as compared with the prior year, reflecting the slowdown in the commercial aircraft industry that began in early 2001 and was exacerbated by the events of September 11, 2001. During fiscal 2002, the continuing reduction in aircraft passenger volume and the bankruptcy of several major airlines resulted in the grounding of a significant number of aircraft. Such conditions have contributed significantly to a decline in lease rates for operating lessors, including the Company's aircraft financing business. The Company currently expects these conditions to continue or deteriorate further in the foreseeable future.

Other revenues increased 14% in fiscal 2001. The increase primarily related to higher revenues from the Company's aircraft financing business, as fiscal 2001 included a full year of revenues related to Ansett Worldwide, which was acquired in fiscal 2000. The terrorist attacks of September 11, 2001 had an adverse impact on the global aviation industry. As a result, the Company's aircraft financing business experienced a decline in revenues and an increase in non-interest expenses in the fourth quarter of fiscal 2001.

Non-Interest Expenses. Fiscal 2002's total non-interest expenses decreased 15%. Compensation and benefits expense decreased 22%, principally reflecting lower incentive-based compensation due to lower revenues and earnings and reduced employment levels attributable to the Company's focus on managing costs. Excluding compensation and benefits expense, non-interest expenses decreased 3%. Brokerage, clearing and exchange fees increased 8%, primarily reflecting higher brokerage and clearing costs due to increased global securities trading volume, particularly in Europe and the U.S. Marketing and business development expense decreased 7%, primarily reflecting a lower level of travel and entertainment costs, which reflected the overall decline in business activity in the global financial markets. Professional services expense decreased 22%, primarily

reflecting lower consulting costs, as well as lower temporary service costs and lower recruiting fees. Other expense decreased 16%, primarily reflecting lower costs associated with the Company's aircraft financing business, including a lower impairment charge of \$74 million (as compared with \$87 million in fiscal 2001) and lower maintenance and other aircraft-related costs in fiscal 2002 (see Note 19 to the consolidated financial statements). Non-interest expenses also included restructuring and other charges of \$117 million (see "Restructuring and Other Charges" herein).

Fiscal 2001's total non-interest expenses decreased 11%. Compensation and benefits expense decreased 19%, principally reflecting lower incentive-based compensation due to lower revenues and earnings. Fiscal 2001's compensation and benefits expense included severance and other related costs associated with reduced employment levels attributable to the Company's focus on managing costs. Excluding compensation and benefits expense, non-interest expenses increased 8%. Occupancy and equipment expense increased 22%, primarily due to increased office space and rental costs in New York City and London. Brokerage, clearing and exchange fees increased 22%, primarily reflecting higher brokerage and clearing costs due to increased global securities trading volume, particularly in Europe and the U.S. Information processing and communications expense increased 19%, primarily due to increased costs associated with the Company's information technology infrastructure, including data processing and market data services. Marketing and business development expense decreased 20%, primarily due to a lower level of travel and entertainment costs, which reflected the overall decline in business activity in the global financial markets. Other expense increased 23%, primarily reflecting significantly higher costs associated with the Company's aircraft financing business. Such costs include a charge of \$87 million for the impairment of certain aircraft assets, as well as higher repossession, maintenance and other aircraft-related costs (see Note 19 to the consolidated financial statements).

INDIVIDUAL INVESTOR GROUP
STATEMENTS OF INCOME
(dollars in millions)

	Fiscal 2002	Fiscal 2001	Fiscal 2000
Revenues:			
Investment banking	\$ 255	\$ 280	\$ 387
Principal transactions:			
Trading	567	772	770
Investments	(45)	(11)	34
Commissions	1,157	1,300	2,029
Asset management, distribution and administration fees	1,640	1,700	1,777
Interest and dividends	359	735	1,091
Other	178	45	72
Total revenues	<u>4,111</u>	<u>4,821</u>	<u>6,160</u>
Interest expense	131	366	454
Net revenues	<u>3,980</u>	<u>4,455</u>	<u>5,706</u>
Non-interest expenses	<u>3,995</u>	<u>4,516</u>	<u>4,813</u>
(Loss) income before income taxes	(15)	(61)	893
Income tax (benefit) provision	(8)	(17)	387
Net (loss) income	<u><u>\$ (7)</u></u>	<u><u>\$ (44)</u></u>	<u><u>\$ 506</u></u>

Individual Investor Group provides its clients with financial planning and investment advisory services through a flexible platform designed to accommodate individual investment goals and risk profiles. Individual Investor Group offers securities and investment products supported by the Company's investment banking, research, investment management, execution and operational resources. The Company's Private Wealth Management group provides financial solutions and management services to high net worth individuals and families. At November 30, 2002, the Company had client assets of \$517 billion and the second largest financial advisor sales organization in the U.S. On a global basis, the Company had approximately 12,500 professional financial advisors at November 30, 2002.

Individual Investor Group net revenues were \$3,980 million in fiscal 2002, a decrease of 11% from fiscal 2001. Individual Investor Group net loss was \$7 million in fiscal 2002 as compared with a net loss of \$44 million in fiscal 2001. The decrease in net revenues was primarily attributable to lower net interest, principal trading and commission revenues, and lower asset management, distribution and administration fees. The decline in the net loss was due to lower non-interest expenses, including lower compensation and benefits costs and a net gain of approximately \$50 million from the sale of the Company's self-directed online brokerage accounts, partially offset by restructuring and other charges of \$112 million (see "Restructuring and Other Charges" herein).

Individual Investor Group net revenues were \$4,455 million in fiscal 2001, a decrease of 22% from fiscal 2000. Individual Investor Group had a net loss of \$44 million in fiscal 2001 as compared with net income of \$506 million in fiscal 2000. The decrease in net revenues and the net loss were primarily attributable to lower commission, net interest and investment banking revenues, and lower asset management, distribution and administration fees, partially offset by a decrease in non-interest expenses, including lower compensation costs and lower marketing and business development costs.

In fiscal 2002, the Company sold its self-directed online brokerage accounts to Bank of Montreal's *Harrisdirect*. The transaction closed during the third quarter of fiscal 2002. The Company recorded gross proceeds of approximately \$100 million (included within Other revenues) and related costs of approximately \$50 million (included within Non-interest expenses).

The Company believes that the difficult economic and market conditions that currently exist, including weakened investor confidence and increased risk aversion among individual investors, are likely to continue to have an adverse impact on the results of its Individual Investor Group business.

Investment Banking. Investment banking revenues are derived from the Individual Investor Group's distribution of equity and fixed income securities underwritten by the Institutional Securities business, as well as underwritings of Unit Investment Trust products. Investment banking revenues decreased 9% in fiscal 2002 and 28% in fiscal 2001. The decrease in both periods was primarily due to a decrease in Unit Investment Trust sales volume.

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 the Company's securities positions. The Company maintains certain security positions primarily to facilitate Individual Investor Group customer transactions. Principal transaction trading revenues decreased 27% in fiscal 2002, reflecting lower equity and fixed income trading revenues. In fiscal 2001, principal transaction trading revenues remained stable versus fiscal 2000, as an increase in fixed income trading revenues was offset by a decline in equity trading revenues.

Equity trading revenues decreased during both fiscal 2002 and fiscal 2001, primarily due to difficult conditions in the equity markets. Fiscal 2002's equity trading revenues also were negatively affected by the Company's new pricing structure for executing transactions on the NASDAQ (see "Commissions" herein).

Fixed income trading revenues decreased during fiscal 2002 as compared with relatively high levels in fiscal 2001, reflecting less favorable market conditions in government and corporate fixed income securities. In fiscal 2001, weakness in the equity markets resulted in an increased demand for various fixed income products, which had a favorable impact on fixed income trading revenues.

Principal transaction net investment losses aggregating \$45 million were recorded in fiscal 2002 as compared with net losses of \$11 million in fiscal 2001. Fiscal 2002's results primarily reflected the write-down of an equity investment related to the Company's European individual securities business. Fiscal 2001's results primarily reflected unrealized losses in certain of the Company's principal investments.

Commissions. Commission revenues primarily arise from agency transactions in listed and OTC equity securities and sales of mutual funds, futures, insurance products and options. Commission revenues decreased 11% in fiscal 2002 and 36% in fiscal 2001. The decrease in fiscal 2002 was due to lower customer trading volumes as individual investor participation in the U.S. equity markets continued to decline. In fiscal 2002, the decrease was partially offset by the impact of a new commission-based pricing structure for executing transactions on the NASDAQ. In fiscal 2001, commission revenues declined as a result of lower transaction volume due to the economic downturn in the U.S. and the terrorist attacks on September 11, 2001.

In January 2002, the Company began implementing a commission-based pricing structure for executing transactions on the NASDAQ. Prior to January 2002, the Company operated its NASDAQ equity business through market-making activities, which were primarily based on earning a spread between the bid and ask prices. In prior periods, the results of such market-making activities were reported in principal transaction trading revenues. As a result of the new pricing structure, revenues earned from NASDAQ equity trading activities now are included in commission revenues.

Through Morgan Stanley ChoiceSM, a service and technology platform available to individual investors, the Company provides its individual investor clients with the choice of self-directed investing online; a traditional full-service brokerage relationship through a financial advisor; or some combination of both. Morgan Stanley Choice provides a range of pricing options, including fee-based pricing. As a result, revenues recorded within the Commissions and Asset management, distribution and administration fees income statement categories are affected by the number of the Company's clients electing a fee-based pricing arrangement.

Net Interest. Interest and dividend revenues and interest expense are a function of the level and mix of total assets and liabilities, including customer margin loans and securities borrowed and securities loaned transactions. Net interest revenues decreased 38% in fiscal 2002 and 42% in fiscal 2001, primarily due to lower interest revenues from a decrease in customer margin loans, partially offset by a decline in interest expense due to a decrease in the Company's average cost of borrowings.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees include revenues from asset management services, including fees for promoting and distributing mutual funds ("12b-1 fees") and fees for investment management services provided to segregated customer accounts pursuant to various contractual arrangements in connection with the Company's Investment Consulting Services ("ICS") business. The Company receives 12b-1 fees for services it provides in promoting and distributing certain open-ended mutual 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 or supervision. Asset management, distribution and administration fees also include revenues from individual investors electing a fee-based pricing arrangement under the Morgan Stanley Choice service and technology platform.

Asset management, distribution and administration fees decreased 4% in both fiscal 2002 and fiscal 2001. The decrease in both periods was primarily attributable to lower 12b-1 fees from distributing mutual funds to individual investors. The decreases in both periods also reflected lower client asset balances. In fiscal 2002, the decrease was partially offset by higher ICS fees. In fiscal 2002, client asset balances declined to \$517 billion at November 30, 2002 from \$595 billion at November 30, 2001. At November 30, 2000, client asset balances were \$662 billion. The decreases in client asset balances in both fiscal 2002 and fiscal 2001 were primarily due to market depreciation, reflecting declines in the global financial markets.

Other. Other revenues primarily include account fees and other miscellaneous service fees. Other revenues were \$178 million in fiscal 2002 as compared with \$45 million in fiscal 2001. The increase primarily reflected approximately \$100 million of revenue received in connection with the sale of the Company's self-directed online brokerage accounts (see "Business Acquisitions, Business Disposition and Asset Dispositions" herein). The increase also was due to higher customer account fees and the inclusion of a gain (of which \$7 million was allocated to the Individual Investor Group segment) related to the Company's sale of an office tower in the first quarter of fiscal 2002. Other revenues were \$45 million in fiscal 2001 as compared with \$72 million in fiscal 2000. The decrease was primarily attributable to lower miscellaneous account charges due to lower transaction volumes.

Non-Interest Expenses. Non-interest expenses decreased 12% in fiscal 2002. The majority of the decrease was attributable to lower compensation and benefits expense, which decreased 9%, principally reflecting lower incentive-based compensation due to lower levels of revenues and earnings as well as lower employment levels. Excluding compensation and benefits expense, non-interest expenses decreased 15%. Occupancy and equipment expense decreased 8%, reflecting lower maintenance and repair costs, as well as lower rent expense resulting from the utilization of alternate facilities after the loss of the World Trade Center complex. Information processing and communications expenses decreased 15% due to lower telecommunications, market data and outsourced data processing costs. Professional services expense decreased 40%, primarily reflecting lower consulting costs. Other expenses decreased 41% due to the benefit from the resolution of a mutual fund litigation matter, offset in part by increased exposure to other litigation matters. The decrease also reflected the elimination

of goodwill amortization due to the Company's adoption of SFAS No. 142, "Goodwill and Other Intangible Assets." These decreases were partially offset by costs associated with the Company's sale of its self-directed online brokerage accounts (see "Business Acquisitions, Business Disposition and Asset Dispositions" herein). Fiscal 2002's non-interest expenses also included restructuring and other charges of \$112 million (see "Restructuring and Other Charges" herein).

Non-interest expenses decreased 6% in fiscal 2001. The majority of the decrease was attributable to lower compensation and benefits expense, which decreased 11% in fiscal 2001, principally reflecting lower incentive-based compensation due to lower levels of revenues and earnings. Fiscal 2001's compensation and benefits expense included severance and other related costs associated with reduced employment levels attributable to the Company's focus on managing costs. Excluding compensation and benefits expense, non-interest expenses increased 4%. Occupancy and equipment expense increased 17%, reflecting increased rental and exit costs associated with the closing of several facilities, partially offset by lower rent expense as a result of the loss of the World Trade Center complex on September 11, 2001. Marketing and business development expense decreased 31%, primarily reflecting lower advertising costs. Professional services expense increased 39%, primarily due to higher consulting costs. Other expenses increased 14%, primarily due to a higher level of allocated expenses.

INVESTMENT MANAGEMENT
STATEMENTS OF INCOME
(dollars in millions)

	Fiscal 2002	Fiscal 2001	Fiscal 2000
Revenues:			
Investment banking	\$ 32	\$ 54	\$ 129
Principal transactions:			
Trading	4	—	—
Investments	(31)	(89)	59
Commissions	50	46	41
Asset management, distribution and administration fees	2,199	2,420	2,527
Interest and dividends	25	72	98
Other	25	32	28
Total revenues	2,304	2,535	2,882
Interest expense	—	10	12
Net revenues	2,304	2,525	2,870
Non-interest expenses	1,462	1,696	1,795
Gain on sale of business	—	—	35
Income before income taxes	842	829	1,110
Provision for income taxes	317	349	449
Net income	<u>\$ 525</u>	<u>\$ 480</u>	<u>\$ 661</u>

Investment Management provides a wide range of investment advisory products to individual, institutional and intermediary clients through numerous distribution channels. The investment products range from money market funds to equity, taxable and tax-exempt fixed income funds and alternative investments in developed and emerging markets. Through various service companies, distribution subsidiaries and investment advisors, the Company offers clients several investment styles, such as value, growth, core, fixed income and asset allocation, domestic and international investments; active and passive management; and diversified and concentrated portfolios. Investment Management also includes the Company's private equity activities in which the Company generally acts as general partner of the private equity funds through which it conducts certain of its principal investing activities and typically commits to invest a minority of the capital of such funds. In fiscal 2002, the Company's customer assets under management or supervision decreased \$39 billion to \$420 billion at November 30, 2002, principally reflecting market depreciation.

Investment Management net revenues for fiscal 2002 were \$2,304 million, a decrease of 9% from fiscal 2001. Investment Management net income for fiscal 2002 was \$525 million, an increase of 9% from fiscal 2001. The decrease in net revenues in fiscal 2002 primarily reflected lower fee-based revenues due to a decline in average assets under management and a less favorable asset mix. The decrease in the level of average assets under management was primarily attributable to market depreciation, reflecting declines in the global financial markets. The increase in net income in fiscal 2002 was primarily due to lower non-interest expenses, including lower incentive-based compensation and a lower effective income tax rate, partially offset by lower net revenues. Investment Management net revenues for fiscal 2001 were \$2,525 million, a decrease of 12% from fiscal 2000. Investment Management net income for fiscal 2001 was \$480 million, a decrease of 27% from fiscal 2000. Net income for fiscal 2000 included a \$21 million net gain on the sale of the Company's Global Custody business (see "Business Acquisitions, Business Disposition and Asset Dispositions" herein). Excluding the net gain on the sale of business, net income decreased 25% in fiscal 2001. The decrease in net revenues and net income in fiscal

2001 primarily reflected lower fee-based revenues due to a less favorable asset mix and lower average assets under management or supervision. Investment banking revenues also decreased, resulting from lower Unit Investment Trust sales. These revenue declines were partially offset by the favorable impact of expense management initiatives, including lower incentive-based compensation expense.

Investment Banking. Investment Management primarily generates investment banking revenues from the underwriting of Unit Investment Trust products. In fiscal 2002, investment banking revenues decreased 41%. In fiscal 2001, investment banking revenues decreased 58%. The decrease in both periods was primarily related to a lower volume of Unit Investment Trust sales. Unit Investment Trust sales volume declined 43% to \$3.9 billion in fiscal 2002 and 58% to \$6.9 billion in fiscal 2001. Due to the emergence of alternate investment products, the Company does not expect Unit Investment Trust sales volumes and associated investment banking revenues to return to the levels achieved in prior years.

Principal Transactions. Investment Management principal transaction revenues consist primarily of gains and losses on investments associated with the Company's private equity activities and net gains and losses on capital investments in certain of the Company's investment funds.

Principal transaction investment losses aggregating \$31 million were recognized in fiscal 2002 as compared with losses of \$89 million in fiscal 2001. Fiscal 2002's results primarily related to unrealized losses in the Company's private equity portfolio. Fiscal 2001's results included unrealized losses in the Company's private equity portfolio and certain other principal investments. Both periods' results reflected difficult market conditions in the technology and telecommunications sectors.

Securities purchased in principal investment transactions generally are held for appreciation and are not readily marketable. It is not possible to determine when the Company will realize the value of such investments since, among other factors, such investments generally are subject to sales restrictions. Moreover, estimates of the eventual realizable value of the investments involve significant judgment and may fluctuate significantly over time in light of business, market, economic and financial conditions generally or in relation to specific transactions.

Commissions. Investment Management primarily generates commission revenues from dealer and distribution concessions on sales of certain funds as well as certain allocated commission revenues. Commission revenues increased 9% in fiscal 2002 and 12% in fiscal 2001. In fiscal 2002, the increase was associated with commission revenues generated from the sale of insurance products and a higher level of allocated commission revenues. In fiscal 2001, the increase was associated with a higher level of allocated commission revenues, partially offset by decreases in the level of sales volume of certain Van Kampen products.

Net Interest. Investment Management generates net interest revenues from certain investment positions and from allocated interest revenues and expenses. Net interest revenue decreased 60% in fiscal 2002 and 28% in fiscal 2001. The decreases in both periods reflected lower interest revenue associated with a lower interest rate environment and a lower level of allocated net interest revenues.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees primarily include revenues from the management and administration of assets, including management fees associated with the Company's private equity activities. These fees arise from investment management services the Company provides to investment vehicles pursuant to various contractual arrangements. The Company receives fees primarily based upon mutual fund daily average net assets or quarterly assets for other vehicles.

The Company's customer assets under management or supervision at fiscal year-end were as follows:

	At November 30,		
	2002	2001	2000
	(dollars in billions)		
Assets under management or supervision by distribution channel:			
Retail	\$247	\$280	\$315
Institutional	173	179	185
Total(2)	<u>\$420</u>	<u>\$459</u>	<u>\$500</u>
Assets under management or supervision by asset class:			
Equity	\$172	\$199	\$236
Fixed income	127	128	134
Money market	66	70	61
Other(1)	55	62	69
Total(2)	<u>\$420</u>	<u>\$459</u>	<u>\$500</u>

(1) Amounts include alternative investment vehicles.

(2) Revenues and expenses associated with certain assets are included in the Company's Individual Investor Group and Institutional Securities segments.

Asset management, distribution and administration fees decreased 9% in fiscal 2002 and 4% in fiscal 2001. In both fiscal 2002 and 2001, the decrease in revenues primarily reflected lower management fees and other revenues resulting from a decline in the level of average assets under management or supervision and a less favorable asset mix, primarily due to a shift from equity products to fixed income and money market products.

As of November 30, 2002, customer assets under management or supervision decreased \$39 billion from fiscal year-end 2001. As of November 30, 2001, customer assets under management or supervision decreased \$41 billion from fiscal year-end 2000. The decrease in both periods was primarily attributable to market depreciation, reflecting declines in the global financial markets. The decline also was attributable to lower net flows of customer assets, as redemptions were marginally higher than new sales in both periods. The decrease in fiscal 2001 also reflected the sale of \$6 billion of assets.

Non-Interest Expenses. Fiscal 2002's total non-interest expenses decreased 14%, primarily reflecting a decline in goodwill amortization and a net benefit from the resolution of a mutual fund litigation matter. Compensation and benefits expense decreased 15%, principally reflecting lower incentive-based compensation, lower benefits expense and lower employment levels. Excluding compensation and benefits expense, non-interest expenses decreased 13%. Occupancy and equipment expense decreased 12%, reflecting lower rental expense due to the utilization of alternate facilities after the loss of the World Trade Center complex. Brokerage, clearing and exchange fees increased 18%, primarily reflecting a higher level of deferred commission amortization associated with net customer flows in certain funds. Marketing and business development expense decreased 17%, primarily driven by lower advertising, travel and entertainment, and fund organization costs. Other expense decreased 88%, primarily reflecting a decline in goodwill amortization as a result of the Company's adoption of SFAS No. 142, as well as the net benefit from certain legal matters, including the resolution of a mutual fund litigation matter. Non-interest expenses also included restructuring and other charges of \$6 million (see "Restructuring and Other Charges" herein).

Fiscal 2001's total non-interest expenses decreased 6%, partially reflecting the favorable impact of synergies resulting from integration initiatives within Investment Management's operating platforms. Compensation and benefits expense decreased 9%, reflecting lower incentive-based compensation costs due to Investment Management's lower level of revenues and earnings. Fiscal 2001's compensation and benefits expense included severance and other related costs associated with reduced employment levels attributable to the Company's focus on managing costs. Excluding compensation and benefits expense, non-interest expenses decreased 2%. Brokerage, clearing and exchange fees increased 19%, primarily due to a higher level of deferred commission amortization associated with net customer flows in certain funds, partially offset by lower commission expense due to lower sales of closed-end funds through the non-proprietary distribution channel. Marketing and business development expense decreased 23%, primarily driven by lower advertising and promotional costs.

CREDIT SERVICES
STATEMENTS OF INCOME
(dollars in millions)

	Fiscal 2002	Fiscal 2001	Fiscal 2000
Fees:			
Merchant and cardmember	\$1,420	\$1,349	\$1,256
Servicing	2,091	1,904	1,489
Other	19	1	28
Total non-interest revenues	<u>3,530</u>	<u>3,254</u>	<u>2,773</u>
Interest revenue	2,413	2,593	2,895
Interest expense	1,050	1,236	1,378
Net interest income	1,363	1,357	1,517
Provision for consumer loan losses	1,336	1,052	810
Net credit income	27	305	707
Net revenues	3,557	3,559	3,480
Non-interest expenses	2,368	2,432	2,336
Income before income taxes and cumulative effect of accounting change	1,189	1,127	1,144
Provision for income taxes	422	425	419
Income before cumulative effect of accounting change	767	702	725
Cumulative effect of accounting change	—	(13)	—
Net income	<u>\$ 767</u>	<u>\$ 689</u>	<u>\$ 725</u>

The Company's Credit Services business issues quality consumer credit products and operates Discover Business Services, a network of merchant and cash access locations primarily in the U.S. The credit cards issued by the Company include the Discover Classic Card, the Discover Platinum Card, the Discover Gold Card, the Discover Titanium Card and the Morgan Stanley CardSM.

In fiscal 2002, Credit Services net revenues were \$3,557 million, a marginal decline from fiscal 2001. Credit Services achieved record net income of \$767 million in fiscal 2002, an increase of 11% from fiscal 2001. Net income for fiscal 2001 included a charge of \$13 million from the cumulative effect of an accounting change associated with the Company's adoption of SFAS No. 133 on December 1, 2000. In fiscal 2002, an increase in non-interest revenues was offset by a higher provision for consumer loan losses. The increase in the provision for consumer loan losses reflected the impact of the continued difficult economic environment on the Company's credit card portfolio, including an adverse trend in bankruptcy filings. Lower non-interest expenses and a lower effective income tax rate contributed to the increase in net income in fiscal 2002.

In fiscal 2001, Credit Services net revenues were \$3,559 million, an increase of 2% from fiscal 2000. Credit Services net income was \$689 million in fiscal 2001, a decrease of 5% from fiscal 2000. The increase in net revenues was primarily attributable to increased servicing fees, partially offset by lower net credit income due to a higher provision for consumer loan losses and lower net interest income. In fiscal 2001, the increase also was attributable to higher merchant and cardmember fees, which reflected modest managed general purpose credit card loan growth from then record sales and transaction volumes. The higher provision for consumer loan losses reflected the impact of the slowdown in the U.S. economy on the Company's credit card portfolio and a related rise in personal bankruptcy filings. The decrease in net income was due to higher non-interest expenses, partially offset by higher net revenues.

Credit Services statistical data were as follows:

	Fiscal 2002	Fiscal 2001	Fiscal 2000
(dollars in billions)			
General purpose credit card loans at fiscal year-end:			
Owned	\$22.5	\$20.1	\$21.9
Managed	\$51.1	\$49.3	\$47.1
General purpose credit card transaction volume	\$97.3	\$93.3	\$90.1

The higher level of managed general purpose credit card loans at both November 30, 2002 and November 30, 2001 was primarily attributable to growth in the Company's Discover Platinum Card.

Merchant and Cardmember Fees. Merchant and cardmember fees include revenues from fees charged to merchants on credit card sales, as well as charges to cardmembers for late payment fees, overlimit fees, insurance fees and cash advance fees, net of cardmember rewards. Cardmember rewards include the Cashback Bonus® award program, pursuant to which the Company pays Discover Classic Card, Discover Platinum Card and Morgan Stanley Platinum Card cardmembers a percentage of their purchase amounts ranging up to 1% based upon a cardmember's level and type of purchases.

Merchant and cardmember fees increased 5% in fiscal 2002 and 7% in fiscal 2001. The increases in both years were due to higher merchant discount revenue associated with record sales volumes, coupled with a slight increase in the average merchant discount rate. In fiscal 2002, the increase in merchant and cardmember fees also was due to higher late payment fees and lower cardmember rewards incentives, partially offset by lower overlimit and cash advance fees. Late payment fees increased due to the implementation of a tiered fee and the elimination of certain payment features that previously mitigated late charges. Cardmember rewards incentives were lower due to modifications in the Cashback Bonus program and higher estimated future forfeitures of such rewards, partially offset by higher sales volume. Overlimit fees decreased due to fewer occurrences. Cash advance fees decreased due to lower cash advance transaction volume. In fiscal 2001, the increase in merchant and cardmember fees was partially offset by higher cardmember rewards incentives and lower net overlimit fees. Higher cardmember rewards incentives were due to then record levels of sales volume. The decline in overlimit fees reflected a higher level of charge-offs of such fees.

Servicing Fees. Servicing fees are revenues derived from consumer loans that have been sold to investors through asset securitizations and mortgage whole loan sales. Cash flows from the interest yield and cardmember fees generated by securitized general purpose credit card loans and the interest yield generated by securitized mortgage loans are used to pay investors in these loans a predetermined fixed or floating rate of return on their investment, to reimburse 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 general purpose credit card and mortgage loans through asset securitizations, therefore, has the effect of converting portions of net credit income and fee income to servicing fees. The Company completed credit card asset securitizations of \$3.6 billion in fiscal 2002 and \$7.3 billion in fiscal 2001 and mortgage loan securitizations of \$0.5 billion in fiscal 2002 and \$0.3 billion in fiscal 2001. The credit card asset securitization transactions completed in fiscal 2002 have expected maturities ranging from approximately three to five years from the date of issuance. The mortgage loan securitization transaction completed in fiscal 2002 has an expected maturity of 11 years from the date of issuance.

The table below presents the components of servicing fees:

	Fiscal 2002	Fiscal 2001	Fiscal 2000
(dollars in millions)			
Merchant and cardmember fees	\$ 690	\$ 651	\$ 565
Interest revenue	4,061	4,336	3,396
Other revenue	61	90	106
Interest expense	(887)	(1,511)	(1,456)
Provision for consumer loan losses	(1,834)	(1,662)	(1,122)
Servicing fees	\$ 2,091	\$ 1,904	\$ 1,489

Servicing fees are affected by the level of securitized loans and mortgage whole loan sales, 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 general purpose credit card loans. Servicing fees increased 10% in fiscal 2002 and 28% in fiscal 2001. The increases in both years were due to a higher level of net interest cash flows driven primarily by the lower interest rate environment. In both years, these increases were partially offset by higher credit losses resulting from a higher rate of charge-offs related to the securitized portfolio. The increase in servicing fees in fiscal 2001 was impacted by an increase in cardmember fee revenue associated with higher levels of average securitized general purpose credit card loans. In fiscal 2001, higher credit losses were impacted by a higher level of average securitized general purpose credit card loans.

The other revenue component of servicing fees is primarily composed of net securitization gains and losses on general purpose credit card loans and mortgage loans as well as gains and losses on mortgage whole loan sales and related mortgage loan servicing fees. Net securitization gains on general purpose credit card loans of \$20 million and \$70 million were recorded in fiscal 2002 and fiscal 2001, respectively. Approximately \$28 million of the decrease was attributable to lower levels of general purpose credit card securitization transactions in fiscal 2002. The decrease in net securitization gains also reflected modifications to certain assumptions in the gain calculations made during fiscal 2001, which increased the gain on general purpose credit card loans in fiscal 2001 by approximately \$24 million. The assumptions modified by the Company in fiscal 2001 were the net interest rate spread and the net charge-off rate. The assumed net interest rate spread increased, reflecting the projection of a lower interest rate environment and the resulting lower interest expense (i.e., cost of funding) on variable rate securitizations, partially offset by an estimated lower yield on credit card receivables attributable to estimated lower interest rates and higher charge-offs of interest. The assumed net charge-off rate increased, reflecting an increase in the projected charge-off rate attributable to weakening economic conditions and its impact on the Company's credit card portfolio. Net securitization gains on mortgage loans and gains on mortgage whole loan sales of \$28 million and \$10 million were recorded in fiscal 2002 and fiscal 2001, respectively. The \$18 million increase was attributable to higher levels of mortgage whole loan sales driven by a higher level of mortgage loan originations.

Net Interest Income. Net interest income represents the difference between interest revenue derived from consumer loans and short-term investment assets and interest expense incurred to finance those loans and assets. Assets, consisting primarily of consumer loans, currently earn interest revenue at both fixed rates and market-indexed variable rates. The Company incurs interest expense at fixed and floating rates. Interest expense also includes the effects of any 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 by having a financing portfolio that reflects the existing repricing schedules of consumer loans as well as the Company's right, with notice to cardmembers, to reprice certain fixed rate consumer loans to a new interest rate in the future.

Net interest income in fiscal 2002 increased slightly from the prior-year period. In fiscal 2002, a decline in interest expense and an increase in general purpose credit card loans were offset by a lower yield on these loans. The lower yield on general purpose credit card loans was primarily due to lower interest rates offered to new

cardmembers and certain existing cardmembers, as well as higher charge-offs of interest. The decrease in interest expense was primarily due to a decrease in the Company's average cost of borrowings. The Fed's aggressive interest rate easing that began in fiscal 2001 continued to benefit the Company's average cost of borrowings in fiscal 2002. The Company's average cost of borrowings was 5.29% for fiscal 2002 as compared with 6.26% for fiscal 2001.

Net interest income decreased 11% in fiscal 2001. The decrease was primarily due to lower interest revenue attributable to lower levels of average general purpose credit card loans and a lower yield on these loans, partially offset by a decline in interest expense. The decrease in the level of average general purpose credit card loans was due to a higher level of securitized credit card loans, partially offset by a higher level of sales volume. The lower yield on general purpose credit card loans was primarily due to lower interest rates offered to new cardmembers and certain existing cardmembers, as well as higher charge-offs of interest. The decrease in the yield was partially offset by the Company's repricing of certain credit card receivables. The decrease in interest expense was primarily due to a lower level of interest bearing liabilities, coupled with a decrease in the Company's average cost of borrowings, which reflected the Fed's aggressive interest rate easing during fiscal 2001. The Company's average cost of borrowings was 6.26% for fiscal 2001 as compared with 6.50% for fiscal 2000.

The following tables present analyses of Credit Services average balance sheets and interest rates in fiscal 2002, fiscal 2001 and fiscal 2000 and changes in net interest income during those fiscal years:

Average Balance Sheet Analysis.

	Fiscal 2002			Fiscal 2001			Fiscal 2000(3)		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest	Average Balance	Rate	Interest
(dollars in millions)									
ASSETS									
Interest earning assets:									
General purpose credit card loans .	\$21,054	10.82%	\$2,279	\$20,701	11.49%	\$2,379	\$21,906	12.15%	\$2,662
Other consumer loans	1,229	5.99	73	808	7.83	63	702	8.82	62
Investment securities	60	1.46	1	444	5.09	23	594	6.37	38
Other	2,451	2.45	60	2,389	5.36	128	1,813	7.34	133
Total interest earning assets .	24,794	9.73	2,413	24,342	10.65	2,593	25,015	11.57	2,895
Allowance for loan losses	(890)			(789)			(779)		
Non-interest earning assets	2,139			2,169			1,813		
Total assets	<u>\$26,043</u>			<u>\$25,722</u>			<u>\$26,049</u>		
LIABILITIES AND SHAREHOLDER'S EQUITY									
Interest bearing liabilities:									
Interest bearing deposits									
Savings	\$ 1,018	1.56%	\$ 16	\$ 1,516	4.29%	\$ 65	\$ 1,513	5.62%	\$ 85
Brokered	9,732	6.01	584	8,891	6.63	590	7,732	6.62	512
Other time	2,037	5.10	104	3,058	5.99	183	3,032	6.19	188
Total interest bearing deposits .	12,787	5.51	704	13,465	6.22	838	12,277	6.39	785
Other borrowings	7,053	4.91	346	6,299	6.33	398	8,925	6.65	593
Total interest bearing liabilities	19,840	5.29	1,050	19,764	6.26	1,236	21,202	6.50	1,378
Shareholder's equity/other liabilities	<u>6,203</u>			<u>5,958</u>			<u>4,847</u>		
Total liabilities and shareholder's equity	<u>\$26,043</u>			<u>\$25,722</u>			<u>\$26,049</u>		
Net interest income				<u>\$1,363</u>			<u>\$1,357</u>		<u>\$1,517</u>
Net interest margin(1)				5.50%			5.57%		6.06%
Interest rate spread(2)		4.44%			4.39%			5.07%	

(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:	Fiscal 2002 vs. Fiscal 2001			Fiscal 2001 vs. Fiscal 2000(1)		
	Volume	Rate	Total	Volume	Rate	Total
Interest Revenue						
General purpose credit card loans	\$ 41	\$(141)	\$(100)	\$(146)	\$(137)	\$(283)
Other consumer loans	33	(23)	10	9	(8)	1
Investment securities	(20)	(2)	(22)	(9)	(6)	(15)
Other	3	(71)	(68)	42	(47)	(5)
Total interest revenue	48	(228)	(180)	(78)	(224)	(302)
Interest Expense						
Interest bearing deposits:						
Savings	(21)	(28)	(49)	—	(20)	(20)
Brokered	55	(61)	(6)	77	1	78
Other time	(61)	(18)	(79)	1	(6)	(5)
Total interest bearing deposits	(42)	(92)	(134)	76	(23)	53
Other borrowings	48	(100)	(52)	(175)	(20)	(195)
Total interest expense	5	(191)	(186)	(94)	(48)	(142)
Net interest income	\$ 43	\$ (37)	\$ 6	\$ 16	\$ (176)	\$ (160)

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

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

Supplemental Average Managed Loan Information.

	Fiscal 2002		Fiscal 2001		Fiscal 2000(1)	
	Average Balance	Rate	Average Balance	Rate	Average Balance	Rate
General purpose credit card loans	\$49,835	12.64%	\$49,432	13.45%	\$43,536	13.82%
Total interest earning assets	54,243	11.94	53,881	12.86	47,061	13.37
Total interest bearing liabilities	49,290	3.93	49,303	5.57	43,248	6.49
General purpose credit card loan interest rate spread ..	8.71		7.88		7.33	
Interest rate spread	8.01		7.29		6.88	
Net interest margin	8.36		7.76		7.40	

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

Provision for Consumer Loan Losses. The provision for consumer loan losses is the amount necessary to establish the allowance for consumer 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 provision for consumer loan losses was \$1,336 million and \$1,052 million for fiscal 2002 and fiscal 2001, respectively. The Company's allowance for consumer loan losses was \$928 million at November 30, 2002 and \$847 million at November 30, 2001.

The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is an allowance

applicable to the owned homogeneous consumer credit card loan portfolio that is evaluated quarterly for adequacy and is established through a charge to the provision for consumer loan losses.

In calculating the allowance for consumer loan losses, the Company uses a systematic and consistently applied approach. The amount of the allowance is established through a process that begins with estimates of the losses inherent in the consumer loan portfolio based on coverage of a rolling average of historical credit losses. In addition, the Company regularly performs a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge-off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact future credit loss experience, including current economic conditions, recent trends in delinquencies and bankruptcy filings, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level.

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 uncollectible, increased 27% and 30% in fiscal 2002 and fiscal 2001, respectively. The increases in both periods were due to higher net charge-off rates. In fiscal 2001, the increase was partially offset by lower levels of average general purpose credit card loans. In addition, to reflect the impact of the continued difficult economic environment on its credit card portfolio and an adverse trend in bankruptcy filings, the Company recorded a provision for consumer loan loss expense that exceeded the amount of net consumer loans charged off by approximately \$75 million in fiscal 2002 and approximately \$65 million in fiscal 2001.

General purpose credit card loans are considered delinquent when interest or principal payments become 30 days past due. General purpose credit card loans are charged off at the end of the month during which an account becomes 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.

In both fiscal 2002 and fiscal 2001, net charge-offs increased in both the owned and managed portfolios as compared with the prior-year periods. Despite the increase in net charge-off rates, the Company's delinquency rates in both the over 30- and over 90-day categories were lower at November 30, 2002 as compared with November 30, 2001, reflecting the Company's increased focus on collections in the earlier stages of delinquency. Weak economic conditions and a higher level of bankruptcy filings in the U.S., coupled with the seasoning of the Company's general purpose credit card loan portfolio, contributed to the higher net charge-off rates during fiscal 2002. If weak economic conditions and a higher level of bankruptcy filings continue to persist, the rate of net charge-offs may be higher in future periods.

The Company's 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 general purpose credit card loan delinquencies and charge-offs, changes in consumer spending and payment behaviors, bankruptcy trends, the seasoning of the Company's general purpose credit card loan portfolio, interest rate movements and their impact on consumer behavior, and

the rate and magnitude of changes in the Company's general purpose credit card loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio.

Asset Quality.

The following table presents owned and managed general purpose credit card loans and delinquency and net charge-off rates:

	Fiscal 2002		Fiscal 2001		Fiscal 2000	
	Owned	Managed	Owned	Managed	Owned	Managed
General purpose credit card loans at fiscal year-end	\$22,543	\$51,143	\$20,085	\$49,332	\$21,866	\$47,123
General purpose credit card loans contractually past due as a percentage of fiscal year-end general purpose credit card loans:						
30 to 89 days	2.93%	3.30%	3.43%	3.83%	3.01%	3.50%
90 to 179 days	2.41%	2.66%	2.74%	3.02%	2.04%	2.42%
Net charge-offs as a percentage of average general purpose credit card loans	5.95%	6.19%	4.76%	5.36%	3.63%	4.40%

Non-Interest Expenses. Fiscal 2002's total non-interest expenses decreased 3%, primarily due to lower marketing and business development expense, partially offset by increases in professional services and compensation and benefits expense. Compensation and benefits expense increased 3% in fiscal 2002, principally reflecting an increase in salaries and benefits. Excluding compensation and benefits expense, non-interest expenses decreased 5%. Marketing and business development expenses decreased 13% in fiscal 2002 due to lower marketing and advertising expense as the Company shifted its focus from account growth to credit quality. Professional services expense increased 12%, attributable to higher consulting expenses and increased costs associated with enhanced credit and collection strategies.

Fiscal 2001's total non-interest expenses increased 4%, primarily due to higher compensation and benefits and information processing and communications expenses, partially offset by lower marketing and business development expenses. Increased business activity related to the Discover Platinum Card also contributed to the increase in non-interest expenses in fiscal 2001. Compensation and benefits expense increased 12% in fiscal 2001, primarily due to higher costs associated with increased employment levels resulting from higher transaction volume and collection activities. Excluding compensation and benefits expense, non-interest expenses increased 1%. Information processing and communications expense increased 16% due to higher volume-related external data processing costs as well as higher depreciation costs associated with equipment at transaction processing facilities. Marketing and business development expenses decreased 13% in fiscal 2001 due to lower marketing and advertising expense, including domestic and international direct mailing costs. Other expenses increased 11%, primarily reflecting increases in certain operating expenses due to higher levels of transaction volume, business activity and a higher level of allocated costs, partially offset by a decline in inquiry fees resulting from fewer new account applications.

Seasonal Factors. The credit card lending activities of Credit Services are affected by seasonal patterns of retail purchasing. Historically, a substantial percentage of general purpose credit card loan growth occurs in the fourth calendar quarter, followed by a flattening or decline of these loans in the following calendar quarter. Merchant fees, therefore, historically have tended to increase in the first fiscal quarter, reflecting higher sales activity in the month of December. Additionally, higher cardmember rewards incentives historically have been accrued for as a reduction of merchant and cardmember fee revenues in the first fiscal quarter, reflecting seasonal growth in retail sales volume.

Liquidity and Capital Resources.

Liquidity and Capital Policies.

The Company's senior management establishes the overall liquidity and capital policies of the Company, reviews the Company's performance relative to these policies, monitors the availability of sources of financing, and oversees the liquidity and interest rate sensitivity of the Company's asset and liability position.

Liquidity Management Policies. 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. The following liquidity framework is designed to ensure that the Company maintains sufficient liquidity to meet all of its obligations for a one-year period without issuing any new unsecured debt:

Liquidity Framework:	Designed to:
Cash Capital Policy	Ensure that the Company can fund its balance sheet while repaying its debt obligations maturing within one year without issuing new unsecured debt. The Company attempts to achieve this by maintaining sufficient long-term debt and equity capital to finance its securities inventory and all illiquid assets.
Liquidity Reserve	Cover volatility in funding needs, which may not be covered in the short term by cash capital (long-term debt and equity capital). The reserve is periodically assessed and determined based on funding volatility and capacity. Excess cash liquidity averaged approximately \$19 billion during fiscal 2002 in the form of immediately available cash and cash equivalents.
Contingency Planning	Establish and maintain a Contingency Funding Plan to stress test the Company's ability to manage a prolonged liquidity contraction and provide a course of action over a one-year time period to ensure orderly functioning of the Company's businesses.

The Company pursues a strategy of diversification of funding sources (by products and markets) and attempts to ensure that the tenor of the Company's liabilities equals or exceeds the expected holding period of the assets being financed. Maturities of financings are designed to manage exposure to refinancing risk in any one period. The Company maintains a surplus of unused short-term funding sources at all times to withstand any unforeseen contraction in credit capacity. The Company emphasizes the use of collateralized financing to limit reliance on credit sensitive unsecured borrowings. In addition, the Company attempts to maintain cash and unhypothecated marketable securities equal to at least 110% of its outstanding short-term unsecured borrowings. The Company also maintains committed credit facilities to support its ongoing borrowing programs.

Capital Policies. The Company's senior management views equity capital as an important source of financial strength and, therefore, pursues a strategy of ensuring that the Company's equity base adequately reflects the economic risk inherent in its businesses. Capital is required for, among other things, the Company's securities inventories, underwritings, principal investments, private equity activities, consumer loans, bridge loans and other financings, and investments in fixed assets, including aircraft assets. The Company also considers return on common 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 attempts to maintain total equity, on a consolidated basis, at least equal to the sum of its operating subsidiaries' equity. Currently, the Company believes it has sufficient capital to meet its needs.

The Company returns internally generated equity capital that is in excess of the needs of its businesses to its shareholders through common stock repurchases and dividends. The Board of Directors has authorized the

Company to purchase, subject to market conditions and certain other factors, shares of common stock for capital management purposes. The unused portion of this authorization at January 31, 2003 was approximately \$600 million. The Company also has an ongoing repurchase authorization in connection with awards granted under its equity-based compensation plans. The Board of Directors determines the declaration and payment of dividends on a quarterly basis.

The Balance Sheet.

The Company's total assets increased to \$529.5 billion at November 30, 2002 from \$482.6 billion at November 30, 2001, primarily attributable to increases in financial instruments owned, including corporate and other debt, U.S. government and agency securities and other sovereign government obligations, securities purchased under agreements to resell 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.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company's overall liquidity and capital policies. The Company views the adjusted leverage ratio as a more relevant measure of financial risk when comparing financial services firms and evaluating leverage trends. This ratio is adjusted to reflect the low-risk nature of assets attributable to matched resale agreements, certain securities borrowed transactions and segregated customer cash balances. In addition, the adjusted leverage ratio reflects the deduction from shareholders' equity of the amount of equity used to support goodwill, as the Company does not view this amount of equity as available to support its risk capital needs.

The following table sets forth the Company's total assets, adjusted assets, leverage ratios and book value per share:

	At November 30,	
	2002	2001
(dollars in millions, except ratio and per share data)		
Total assets	\$529,499	\$482,628
Adjusted assets(1)	<u><u>\$358,470</u></u>	<u><u>\$338,157</u></u>
Leverage ratio(2)	<u><u>24.5x</u></u>	<u><u>23.6x</u></u>
Adjusted leverage ratio(3)	<u><u>16.6x</u></u>	<u><u>16.5x</u></u>
Book value per share(4)	<u><u>\$ 20.24</u></u>	<u><u>\$ 18.64</u></u>

(1) Adjusted assets represent total assets less the sum of (i) assets that were recorded under certain provisions of SFAS No. 140, (ii) the lesser of securities purchased under agreements to resell or securities sold under agreements to repurchase, (iii) the lesser of securities borrowed or securities loaned, (iv) segregated customer cash balances and (v) goodwill.

(2) Leverage ratio equals total assets divided by tangible shareholders' equity (\$21,646 million at November 30, 2002 and \$20,488 million at November 30, 2001). For purposes of this calculation, tangible shareholders' equity includes preferred and common equity and Preferred Securities Subject to Mandatory Redemption, less goodwill.

(3) Adjusted leverage ratio equals adjusted assets divided by tangible shareholders' equity.

(4) Book value per share equals common shareholders' equity divided by common shares outstanding of 1,081 million at November 30, 2002 and 1,093 million at November 30, 2001.

Principal Sources of Funding.

The Company funds its balance sheet on a global basis through diverse sources. These sources include the Company's equity capital; long-term debt; repurchase agreements; U.S., Canadian, Euro, Japanese and Australian commercial paper; asset-backed securitizations; letters of credit; unsecured bond borrowings; 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 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 deposit accounts sold nationally and savings deposits from individual securities clients. Brokered deposits consist primarily of certificates of deposits issued by the Company's bank subsidiaries. Other time deposits include individual and institutional certificates of deposits.

Unsecured Debt and Borrowings. The Company views long-term debt as a stable source of funding for core inventories, consumer loans and illiquid assets. In general, securities inventories and the majority of 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 rate, and fixed assets are financed with fixed rate long-term debt. Both fixed rate and floating rate long-term debt (in addition to sources of funds accessed directly by the Company's Credit 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 8 to the consolidated financial statements).

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 loan receivables, and overall market conditions. Availability and cost of financing to the Company can vary depending on market conditions, the volume of certain trading and lending activities, the Company's credit ratings and the overall availability of credit.

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 values committed credit as a significant component of its liquidity policy.

Committed Credit Facilities. 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 "MS Facility"). Under the terms of the MS Facility, the banks are committed to provide up to \$5.5 billion. At November 30, 2002, the Company maintained an \$8.4 billion surplus shareholders' equity as compared with the MS Facility's covenant requirement.

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. At November 30, 2002, MS&Co. maintained a \$2.5 billion surplus consolidated stockholder's equity and a \$3.2 billion surplus Net Capital, each as defined in the MS&Co. Facility and as compared with the MS&Co. Facility's covenant requirements.

The Company also maintains a revolving credit facility that enables Morgan Stanley & Co. International Limited ("MSIL"), the Company's London-based broker-dealer subsidiary, to obtain committed funding from a syndicate of banks (the "MSIL Facility") by providing a broad range of collateral under repurchase agreements for a secured repo facility and a Company guarantee for an unsecured facility. The syndicate of banks is committed to provide up to an aggregate of \$1.95 billion, available in six major currencies. At November 30, 2002, MSIL maintained a \$1.5 billion surplus Shareholder's Equity and a \$1.8 billion surplus Financial Resources, each as defined in the MSIL Facility and as compared with the MSIL Facility's covenant requirements.

Morgan Stanley Japan Limited ("MSJL"), the Company's Tokyo-based broker-dealer subsidiary, maintains a committed revolving credit facility, guaranteed by the Company, that provides funding to support general liquidity needs, including support of MSJL's unsecured borrowings (the "MSJL Facility"). The MS Facility's covenant requirements described above apply to the Company as guarantor. Under the terms of the MSJL Facility, a syndicate of banks is committed to provide up to 70 billion Japanese yen.

The Company anticipates that it may utilize the MS Facility, the MS&Co. Facility, the MSIL Facility or the MSJL Facility (the “Credit Facilities”) for short-term funding from time to time (see Note 7 to the consolidated financial statements). The Company does not believe that any of the covenant requirements in any of its Credit Facilities will impair its ability to obtain funding under the Credit Facilities, to pay its current level of dividends, or to secure loan arrangements, letters of credit or other financial accommodations. At November 30, 2002, no borrowings were outstanding under any of the Credit Facilities.

The Company and its subsidiaries also maintain a series of committed credit facilities to support general liquidity needs. The facilities are expected to be drawn from time to time to cover short-term funding needs. Additionally, through one of its subsidiaries, the Company maintains a series of committed credit facilities to support the collateralized commercial mortgage whole loan business. The banks are committed to provide up to an aggregate of \$1.0 billion.

Off-Balance Sheet Funding. The asset securitization market is a significant source of funding for the Company’s Credit Services business. By utilizing this market, the Company further diversifies its funding sources, realizes cost-effective funding and reduces reliance on the Company’s other funding sources, including unsecured debt. The securitization transaction structures utilized for the Credit Services business are accounted for as sales i.e., off-balance sheet transactions in accordance with U.S. generally accepted accounting principles (see Notes 2 and 5 to the consolidated financial statements). In connection with its Discover Card securitization program, the Company transfers credit card receivables, on a revolving basis, to the Discover Card Master Trust I (the “Trust”), which issues asset-backed securities that are registered with the SEC or privately placed. This structure includes certain features designed to protect the investors that could result in earlier-than-expected amortization of the transactions, potentially resulting in the need for the Company to obtain alternative funding arrangements. The primary feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements (“economic early amortization”).

Economic early amortization risk reflects the possibility of negative net securitization cash flows (which would occur if the coupon, contractual servicing fee and net charge-offs exceeded the collections of finance charges and cardmember fees on securitized credit card receivables) and is driven primarily by the Trust’s credit card receivables performance (in particular, receivables yield, cardmember fees and credit losses incurred) as well as the contractual rate of return of the asset-backed securities. In the event of an economic early amortization, receivables that otherwise would have been subsequently purchased by the Trust from the Company would instead continue to be recognized on the Company’s consolidated statements of financial condition since the cash flows generated in the Trust would instead be used to repay investors in the asset-backed securities. These recognized receivables would require the Company to obtain alternative funding. Although the Company believes that the combination of factors that would result in an economic early amortization event is remote, the Company also believes its access to alternative funding sources would mitigate this potential liquidity risk.

The Company maintains a committed credit facility with a group of banks to support the short-term extendible asset-backed certificate program issued by the Trust (the “Newcastle Facility”). Under the terms of the Newcastle Facility, the banks are committed to provide up to \$1.1 billion.

Credit Ratings.

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 credit ratings. Factors that are significant to the determination of the Company’s credit ratings or otherwise affect the ability of the Company to raise short-term and long-term financing include its: level and volatility of earnings, relative positions in the markets in which it operates, global and product diversification, risk management policies, cash liquidity and capital structure. In addition, the agencies that rate the Company’s debt have focused on certain recent changes in the market that may require financial services firms to assume more credit risk in connection with their corporate lending activities and recent legal and regulatory developments. A deterioration in any of the previously mentioned

factors or combination of these factors may lead rating agencies to downgrade the credit ratings of the Company, thereby increasing the cost to the Company in obtaining unsecured financings. 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, including credit derivatives and interest rate swaps.

In connection with certain over-the-counter trading agreements associated with the Institutional Securities business, the Company would be required to provide additional collateral to certain counterparties in the event of a downgrade by either Standard & Poor's or Moody's Investors Service. At November 30, 2002, the amount of additional collateral that would be required in the event of a one notch downgrade of the Company's senior debt credit rating was approximately \$475 million.

As of January 31, 2003, the Company's credit ratings were as follows:

	<u>Commercial Paper</u>	<u>Senior Debt</u>
Dominion Bond Rating Service Limited	R-1 (middle)	AA (low)
Fitch Ratings(1)	F1+	AA-
Moody's Investors Service	P-1	Aa3
Rating and Investment Information, Inc.	a-1+	AA
Standard & Poor's(2)	A-1	A+

(1) In May 2002, Fitch Ratings lowered the Company's senior debt credit rating from "AA" to "AA-."

(2) In October 2002, Standard & Poor's lowered the Company's commercial paper credit rating from "A-1+" to "A-1" and its senior debt credit rating from "AA-" to "A+."

Fiscal 2002 Activity.

During the 12 months ended November 30, 2002, the Company issued senior notes aggregating \$11.3 billion, including non-U.S. dollar currency notes aggregating \$2.3 billion. The Company has entered into certain transactions to obtain floating interest rates based primarily on short-term London Interbank Offered Rates ("LIBOR") trading levels. At November 30, 2002, the aggregate outstanding principal amount of the Company's Senior Indebtedness (as defined in the Company's public debt shelf registration statements) was approximately \$98.6 billion (including Senior Indebtedness consisting of guaranteed obligations of the indebtedness of subsidiaries).

During fiscal 2002, the Company purchased \$990 million of its common stock through a combination of open market purchases and the settlement of put options.

In fiscal 2002, the Company redeemed all 1,725,000 outstanding shares of its Series A Fixed/Adjustable Rate 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 \$50 per Depositary Share. Each Depositary Share represented 1/4 of a share of the Company's Series A Fixed/Adjustable Rate Cumulative Preferred Stock.

The Company has Capital Units outstanding that were issued by the Company and Morgan Stanley Finance plc ("MSF"), a U.K. subsidiary. A Capital Unit consists of (a) a Subordinated Debenture of MSF guaranteed by the Company and maturing in 2017 and (b) a related Purchase Contract issued by the Company, which may be accelerated by the Company, 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 \$66 million at November 30, 2002 and November 30, 2001, respectively.

Contractual Obligations and Contingent Liabilities and Commitments.

In connection with its operating activities, the Company enters into certain contractual obligations, as well as commitments to fund certain fixed assets and other less liquid investments.

The Company's future cash payments associated with its contractual obligations pursuant to its long-term debt, operating leases and aircraft purchase obligations as of November 30, 2002 are summarized below:

	Payments due in:				
	Fiscal 2003	Fiscal 2004-2005	Fiscal 2006-2007	Thereafter	Total
	(dollars in millions)				
Long-term debt(1)	\$12,386	\$18,175	\$12,153	\$12,447	\$55,161
Operating leases(2)	488	905	758	2,571	4,722
Aircraft purchase obligations(2)(3)	116	—	—	—	116
Total	\$12,990	\$19,080	\$12,911	\$15,018	\$59,999

(1) See Note 8 to the consolidated financial statements.

(2) See Note 9 to the consolidated financial statements.

(3) All of the aircraft and equipment to be acquired under these purchase obligations are subject to contractual lease arrangements.

The Company's commitments associated with outstanding letters of credit, private equity and other principal investment activities, and lending and financing commitments as of November 30, 2002 are summarized below. Since commitments associated with letters of credit and lending and financing arrangements may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Fiscal 2003	Fiscal 2004-2005	Fiscal 2006-2007	Thereafter	Total
	(dollars in millions)				
Letters of credit(1)(2)	\$ 3,589	\$ —	\$ —	\$ —	\$ 3,589
Private equity and other principal investments(1)(3)	105	213	80	177	575
Investment grade lending commitments(1)(4)(6)	8,679	824	2,381	1,902	13,786
Non-investment grade lending commitments(1)(4)(6)	202	360	199	557	1,318
Commitments for secured lending transactions(1)(5)	3,493	1,562	—	—	5,055
Total	\$16,068	\$2,959	\$2,660	\$2,636	\$24,323

(1) See Note 9 to the consolidated financial statements.

(2) This amount represents the Company's outstanding letters of credit, which are primarily used to satisfy various collateral requirements.

(3) This amount represents the Company's commitments in connection with its private equity and other principal investment activities.

(4) The Company's investment grade and non-investment grade lending commitments are made in connection with its corporate lending activities. See "Less Liquid Assets—Lending Activities" herein.

(5) This amount represents lending commitments extended by the Company to companies that are secured by assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide for over-collateralization based upon the creditworthiness of the borrower.

(6) Credit ratings are determined by the Company's Credit Department, using methodologies generally consistent with those employed by external rating agencies. Credit ratings of BB+ or lower are considered non-investment grade.

The table above does not include commitments to extend credit for consumer loans in the amount of approximately \$260 billion. Such commitments arise primarily from agreements with customers for 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 (see Note 5 to the consolidated financial statements). In addition, in the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company's consolidated financial statements.

At November 30, 2002, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$37 billion and \$34 billion, respectively.

Less Liquid Assets.

At November 30, 2002, certain assets of the Company, such as real property, equipment and leasehold improvements of \$2.3 billion, aircraft assets of \$4.8 billion and goodwill of \$1.4 billion, were illiquid. Certain equity investments made in connection with the Company's private equity and other principal investment activities, certain high-yield debt securities, certain collateralized mortgage obligations and mortgage-related loan products, bridge financings, and certain senior secured loans and positions also are not highly liquid.

At November 30, 2002, the Company had aggregate principal investments associated with its private equity and other principal investment activities (including direct investments and partnership interests) with a carrying value of approximately \$800 million, of which approximately \$300 million represented the Company's investments in its real estate funds.

High-Yield Instruments. In connection with the Company's fixed income securities activities, the Company underwrites, trades, invests and makes markets in non-investment grade instruments ("high-yield instruments"). For purposes of this discussion, high-yield instruments are defined as fixed income, emerging market, preferred equity securities and distressed debt rated BB+ or lower (or equivalent ratings by recognized credit rating agencies) as well as non-rated securities which, in the opinion of the Company, contain credit risks associated with non-investment grade instruments. For purposes of this discussion, positions associated with the Company's credit derivatives business are not included because reporting gross market value exposures would not accurately reflect the risks associated with these positions due to the manner in which they are risk-managed. High-yield instruments 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 high-yield instruments is, and may continue to be, characterized by periods of volatility and illiquidity. The Company monitors total inventory positions and risk concentrations for high-yield instruments in a manner consistent with the Company's market risk management policies and control structure. The Company manages its aggregate and single-issuer net exposure through the use of derivatives and other financial instruments. The Company records high-yield instruments at fair value. Unrealized gains and losses are recognized currently in the Company's consolidated statements of income. At November 30, 2002 and November 30, 2001, the Company had high-yield instruments owned with a market value of approximately \$2.6 billion and \$1.3 billion, respectively, and had high-yield instruments sold, not yet purchased with a market value of \$0.7 billion and \$0.5 billion, respectively.

Lending Activities. In connection with certain of its business activities, the Company provides to corporate clients, on a selective basis, through subsidiaries (including Morgan Stanley Bank), loans or lending commitments, including bridge financing. The borrowers may be rated investment grade or non-investment grade. These loans and commitments have varying terms, may be senior or subordinated, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated or traded by the Company. At November 30, 2002 and November 30, 2001, the aggregate value of investment grade loans and positions was \$1.3 billion and \$1.5 billion, respectively, and the aggregate value of non-investment grade loans and positions was \$1.2 billion and \$1.4 billion, respectively. In connection with these business activities (which include the loans and positions discussed above and the lending commitments included in the table on page 55), the Company had hedges with a notional amount of \$4.4 billion at November 30, 2002 and \$1.4 billion at November 30, 2001. Requests to provide loans or lending commitments in connection with investment banking activities will continue and may grow in the future.

New Office Facility. In fiscal 2002, the Company purchased an office facility in Westchester County, New York. During fiscal 2002, the Company incurred costs of approximately \$55 million, including the purchase price. The Company expects to incur additional project costs of approximately \$265 million. The Company intends to occupy the building upon project completion, which currently is anticipated in the fourth quarter of fiscal 2003.

Regulatory Capital Requirements.

MS&Co. and Morgan Stanley DW Inc. (“MSDWI”) are registered broker-dealers and registered futures commission merchants and, accordingly, are subject to the minimum net capital requirements of the SEC, the NYSE and the Commodity Futures Trading Commission. MSIL, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJL, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MS&Co., MSDWI, MSIL and MSJL have consistently operated in excess of their respective regulatory capital requirements (see Note 13 to the consolidated financial statements).

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation (“FDIC”) and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1 capital, as defined, to average assets (“leverage ratio”), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets (“Tier 1 risk-weighted capital ratio”) and (c) 8% of total capital, as defined, to risk-weighted assets (“total risk-weighted capital ratio”). At November 30, 2002, the leverage ratio, Tier 1 risk-weighted capital ratio and total risk-weighted capital ratio of each of the Company’s FDIC-insured financial institutions exceeded these regulatory minimums.

In fiscal 2002, the FDIC, in conjunction with other bank regulatory agencies, issued guidance requiring FDIC-insured financial institutions to treat accrued interest receivable related to credit card securitizations as a subordinated retained interest, which will require holding higher regulatory capital beginning December 31, 2002. The Company’s FDIC-insured financial institutions will maintain capital ratios in excess of the regulatory minimums after implementing this revised guidance.

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, maintains certain operating restrictions that 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, upon 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 significant portion of the Company’s business is conducted in currencies other than the U.S. dollar, and changes in foreign exchange rates relative to the U.S. dollar can therefore affect the value of non-U.S. dollar net assets, revenues and expenses. Potential exposures as a result of these fluctuations in currencies are closely monitored and, where cost-justified, strategies are adopted that are designed to reduce the impact of these fluctuations on the Company’s financial performance. These strategies may include the financing of non-U.S. dollar assets with direct or swap-based borrowings in the same currency and the use of currency forward contracts or the spot market in various hedging transactions related to net assets, revenues, expenses or cash flows.

Derivative Financial Instruments.

The Company actively offers to counterparties 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 (including credit default swaps), caps, collars, floors, swap options and similar instruments that derive their value from underlying interest rates, foreign exchange rates, commodities, equity instruments, equity indices, reference credits or other assets. The Company’s trading 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 11 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 counterparties. 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 control structure (see “Quantitative and Qualitative Disclosures about Market Risk — Risk Management” in Part II, Item 7A). 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.

With respect to its derivatives positions (including both listed and OTC), 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, 2002 was \$35.6 billion. Approximately \$28.4 billion of that credit risk exposure was with counterparties rated single-A or better.

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 11 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 counterparties with innovative financial products. The Company established Morgan Stanley Derivative Products Inc. to offer derivative products to counterparties that 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, 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 counterparties in meeting their overall financial needs.

New Accounting Pronouncements.

In August 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 144. For long-lived assets to be held and used, SFAS No. 144 retains the requirements of SFAS No. 121 to recognize an impairment loss if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and to measure an impairment loss as the difference between the carrying amount and the fair value of the asset. In addition, SFAS No. 144 retains the accounting model of SFAS No. 121 to measure long-lived assets to be disposed of by sale at the lower of the carrying amount or fair value less cost to sell and to cease depreciation. Further, it establishes additional criteria to determine when a long-lived asset is held for sale. The Company adopted SFAS No. 144 on December 1, 2002. The Company believes that the adoption of SFAS No. 144 will not have a material effect on the Company’s consolidated financial statements.

In April 2002, the FASB issued SFAS No. 145, “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.” Under SFAS No. 145, gains and losses from extinguishment of debt are to be presented as part of an entity’s recurring operations unless they meet the specific

criteria of Accounting Principles Board (“APB”) Opinion No. 30 for classification as an extraordinary item. The Company adopted SFAS No. 145 on December 1, 2002. As a result of the adoption of SFAS No. 145, the Company will reclassify an extraordinary loss of \$30 million, net of income taxes, previously reported in the third quarter of fiscal 2001 from the early extinguishment of certain long-term borrowings to income from operations when presenting prior periods beginning with its fiscal 2003 consolidated financial statements.

In August 2002, the Company announced that beginning in fiscal 2003 it will expense employee stock options in accordance with SFAS No. 123, “Accounting for Stock-Based Compensation.” Under the fair value-based method of SFAS No. 123, compensation expense is recognized based on the fair value of stock options on the date of grant. In December 2002, the FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of FASB Statement No. 123.” SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value-based method of accounting for stock-based compensation. In addition, SFAS No. 148 requires, on an annual basis, disclosures about the method of accounting for stock-based compensation and tabular information about the effect of the method of accounting for stock-based compensation on net income and earnings per share, including pro forma amounts, in the “Summary of Significant Accounting Policies.” On a quarterly basis, SFAS No. 148 requires prominent disclosure in tabular form of the effect of the method of stock-based compensation on net income and earnings per share for all periods presented if awards of stock-based compensation were outstanding and accounted for under APB Opinion No. 25. Pursuant to its announcement to begin expensing stock options in fiscal 2003, the Company adopted SFAS No. 148 on December 1, 2002 and has elected the prospective method of transition to the fair value-based method of accounting for stock-based compensation. The Company is in the process of evaluating the impact of adopting the fair value-based method of accounting and the recognition provisions of the prospective method of transition for stock-based employee compensation plans.

In November 2002, the Emerging Issues Task Force (“EITF”) finalized the various consensuses reached in EITF Issue No. 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.” EITF Issue No. 02-3 requires that all new energy and energy-related contracts entered into subsequent to October 25, 2002 that do not qualify as derivatives under SFAS No. 133 be accounted for using the accrual method of accounting, rather than fair value accounting as was previously required under EITF Issue No. 98-10, “Accounting for Contracts Involved in Energy Trading and Risk Management Activities.” Energy and energy-related contracts that meet the definition of a derivative under SFAS No. 133 will continue to be accounted for at fair value. Energy and energy-related contracts existing prior to October 25, 2002 that do not qualify as derivatives under SFAS No. 133 are to be accounted for using the accrual method of accounting with the effect reported as a cumulative effect of a change in accounting principle upon adoption of EITF Issue No. 02-3. Generally, the Company’s energy and energy-related contracts qualify as derivatives under SFAS No. 133 and, therefore, continue to be accounted for at fair value. In addition, EITF Issue No. 02-3 requires that changes in fair value of energy and energy-related trading contracts be presented net in the consolidated statements of operations, which is consistent with the Company’s current and past practice of recording principal transaction trading revenues. Accordingly, this presentation requirement had no impact on the Company’s consolidated statements of income. In addition, the FASB staff believes that, in the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of the arrangement for all derivatives. With respect to these criteria, the Company does not have any material unrealized gains and losses and believes that the application of EITF Issue No. 02-3 will not have a material impact on its consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45 (“FIN 45”), “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” FIN 45 identifies characteristics of certain guarantee contracts and requires that a liability be recognized at fair value at the inception of such guarantees for the obligations undertaken by the guarantor. Additional disclosures also are prescribed for certain guarantee contracts. The initial recognition and initial measurement provisions of FIN 45 are effective for these guarantees issued or modified after December 31, 2002. The disclosure requirements of

FIN 45 are effective for the Company for its quarter ending February 28, 2003. The Company currently is evaluating the impact of FIN 45 on its consolidated financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities". FIN 46 clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements", to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties ("variable interest entities"). Variable interest entities ("VIEs") are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests. FIN 46 also requires new disclosures about VIEs.

On February 1, 2003, the Company adopted FIN 46 for VIEs created after January 31, 2003 and for VIEs in which the Company obtains an interest after January 31, 2003. The Company will adopt FIN 46 on September 1, 2003 for VIEs in which it holds a variable interest that it acquired before February 1, 2003. The Company is currently evaluating the impact of the provisions of FIN 46 on its consolidated financial statements. The Company is involved with various entities in the normal course of business that may be deemed to be VIEs and may hold interests therein, including interest-only strip investments and derivative instruments, that may be considered variable interests. Transactions associated with these entities include asset- and mortgage-backed securitizations and structured financings (including collateralized debt, bond or loan obligations and credit-linked notes). The Company principally engages in these transactions to facilitate client needs and as a means of selling financial assets. The Company currently consolidates entities in which it has a controlling financial interest in accordance with accounting principles generally accepted in the U.S. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), which includes the credit card asset securitization master trust (see Note 5 to the consolidated financial statements), the Company does not consolidate the entity.

The Company believes that it is reasonably possible that it will either disclose information in its Form 10-K for fiscal 2003 about certain VIEs created before February 1, 2003 for which it holds a significant variable interest or it will be the primary beneficiary of the entity and thus be required to consolidate the VIE on September 1, 2003. At November 30, 2002, in connection with its institutional securities business, the aggregate size of the entities for which the Company's interest is either significant or for which the Company could be deemed to be the primary beneficiary of the entity was approximately \$8.5 billion. The Company's variable interests associated with these entities, primarily financial asset-backed securitization and collateralized debt and bond obligation entities, was approximately \$120 million, which represents the Company's maximum exposure to loss at November 30, 2002. In connection with its investment management business, where the Company is the asset manager for collateralized bond and loan obligation entities, the aggregate size of potential VIEs at November 30, 2002 was approximately \$2.5 billion. The Company's variable interests associated with its investment management activities was approximately \$1 million, which represents the Company's maximum exposure to loss at November 30, 2002.

The Company purchases and sells interests in entities that may be deemed to be VIEs in its market-making capacity in the ordinary course of its institutional securities business. As a result of these activities, it is reasonably possible that such entities may be consolidated and deconsolidated at various points in time. Therefore, the Company's variable interests included above may not be held by the Company at its fiscal 2003 year-end.

On January 8, 2003, the Federal Financial Institutions Examination Council ("FFIEC") issued guidance on "Account Management and Loss Allowance Practices" for credit card lending. The guidance addresses credit line management, overlimit practices, workout and forbearance practices and income recognition and loss allowance practices. The FFIEC expects banking organizations to implement the changes needed to comply with this guidance as promptly as possible. The Company is in the process of reviewing and assessing the impact of this guidance to ensure it is properly integrated into its existing policies, practices and systems and that it is in compliance with the guidance. The Company does not believe, at this time, that the guidance will have a material adverse affect on its consolidated financial statements.