

## **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. The Company provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

The Company’s results of operations for the 12 months ended November 30, 2003 (“fiscal 2003”), November 30, 2002 (“fiscal 2002”) and November 30, 2001 (“fiscal 2001”) are discussed below.

## Results of Operations.

### Executive Summary.

#### Financial Information.

	Fiscal Year(1)		
	2003	2002	2001
<b>Net revenues (dollars in millions):</b>			
Institutional Securities .....	\$11,211	\$ 9,111	\$11,280
Individual Investor Group .....	4,017	4,069	4,671
Investment Management .....	2,509	2,721	3,040
Credit Services .....	3,427	3,557	3,559
Intersegment Eliminations .....	(307)	(338)	(445)
Consolidated net revenues .....	<u>\$20,857</u>	<u>\$19,120</u>	<u>\$22,105</u>
<b>Net income (dollars in millions):</b>			
Institutional Securities .....	\$ 2,437	\$ 1,664	\$ 2,335
Individual Investor Group .....	265	59	23
Investment Management .....	326	418	425
Credit Services .....	688	760	689
Intersegment Eliminations .....	71	87	49
Consolidated net income .....	<u>\$ 3,787</u>	<u>\$ 2,988</u>	<u>\$ 3,521</u>
<b>Basic earnings per common share</b> .....	<u>\$ 3.52</u>	<u>\$ 2.76</u>	<u>\$ 3.21</u>
<b>Diluted earnings per common share</b> .....	<u>\$ 3.45</u>	<u>\$ 2.69</u>	<u>\$ 3.11</u>
<i>Statistical Data (Unaudited).</i>			
<b>Return on average common equity</b> .....	16.5%	14.1%	18.0%
<b>Effective income tax rate</b> .....	29.0%	34.4%	36.1%
<b>Worldwide employees</b> .....	51,196	55,726	61,319
<b>Institutional Securities:</b>			
Mergers and acquisitions announced transactions(2):			
Rank .....	2	3	2
Global equity and related issues(2):			
Rank .....	3	4	4
Global investment grade debt issues(2):			
Rank .....	4	4	4
<b>Individual Investor Group:</b>			
Global financial advisors .....	11,086	12,546	13,690
Total client assets (dollars in billions) .....	\$ 565	\$ 516	\$ 595
Fee-based assets as a percentage of total client assets .....	23%	21%	19%
<b>Investment Management:</b>			
Assets under management or supervision (dollars in billions)(3) .....	\$ 462	\$ 420	\$ 459
Percent of fund assets in top half of Lipper rankings(4) .....	57%	62%	61%
<b>Credit Services(5):</b>			
Period-end credit card loans—Owned (dollars in millions) .....	\$18,930	\$22,153	\$19,654
Period-end credit card loans—Managed (dollars in millions) .....	\$48,358	\$51,143	\$49,332
Average credit card loans—Owned (dollars in millions) .....	\$19,531	\$20,659	\$20,285
Average credit card loans—Managed (dollars in millions) .....	\$50,864	\$49,835	\$49,432
Net principal charge-off rate—Owned .....	6.05%	6.06%	4.86%
Net principal charge-off rate—Managed .....	6.60%	6.19%	5.36%
Transaction volume (dollars in billions) .....	\$ 97.9	\$ 97.3	\$ 93.3

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

(2) Source: Thomson Financial—January 1 to December 31, for each respective period.

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

(4) Source: Lipper. One-year performance as of November 30 for each respective period.

(5) Managed data include owned and securitized credit card loans. For an explanation of managed data and a reconciliation of credit card loan and asset quality data, see "Credit Services—Managed General Purpose Credit Card Loan Data" herein.

### ***Fiscal 2003 Performance.***

*Company Results.* The Company recorded net income of \$3,787 million in fiscal 2003, a 27% increase from the prior year, and diluted earnings per share of \$3.45, a 28% increase from the prior year. Net revenues (total revenues less interest expense and the provision for consumer loan losses) rose 9% to \$20.9 billion, and the return on average common equity was 16.5% as compared with 14.1% in the prior year.

Fiscal 2003's results included a benefit from changes implemented to the Company's equity-based compensation program. The net effect of these changes reduced compensation expense by \$262 million, increased net income by \$177 million, or \$0.16 per share, and increased return on average common equity by 0.8% (see "Equity-Based Compensation Program" herein). Fiscal 2003's results included a lower effective tax rate, primarily reflecting lower taxes attributable to non-U.S. earnings as well as an increase in the utilization of domestic tax credits related to the Company's investments in the production of synthetic fuel (see "Investments in Unconsolidated Investees" herein). The year's results also included approximately \$280 million in legal expenses related to various litigation costs and settlements, reflecting the continued legal and regulatory focus on the financial services industry.

At year-end, the Company had approximately 51,000 employees worldwide, a decrease of 8% from the prior year, reflecting the Company's continuing efforts to manage costs in light of the weakened global economy and reduced business activity that existed in the first half of the year.

Subsequent to year-end, the Company's Board of Directors declared a \$0.25 quarterly dividend per common share, a 9% increase from the \$0.23 per common share declared for the previous quarter.

Business activity increased in the second half of fiscal 2003 as compared with the first half of the fiscal year. The Company ended the year with increased market shares in many key areas of its business and believes that its focus on enhancing client relationships and managing expenses has positioned it well for any improvement in the business environment.

*Institutional Securities.* The Company's Institutional Securities business recorded net income of \$2,437 million, an increase of 46% from a year ago. Net revenues rose 23% to \$11.2 billion, driven by record results in fixed income and an improved environment in equity underwriting during the second half of the year. Total non-interest expenses increased 17% to \$7.6 billion, largely reflecting the increase in business activity. This year's expenses included \$323 million in aircraft impairment-related charges, while prior-year expenses included \$117 million in restructuring charges and \$74 million in aircraft impairment charges (see "Restructuring and Other Charges" herein and Note 18 to the consolidated financial statements).

In investment banking, total underwriting revenues rose 18% from last year to \$1.4 billion, benefiting from the Company's improved market share and increased industry-wide fixed income underwriting activity. Advisory revenues fell 31% to \$662 million, partially reflecting a decline in industry-wide completed merger and acquisition transaction volume. In the Company's fixed income sales and trading business, revenues increased by 65% from a year ago to \$5.4 billion. This increase was broad-based across the interest rate and currency products, credit products and commodities groups. All three product areas benefited from strong customer flows and high levels of market volatility. In equity sales and trading, revenues increased 2% to \$3.6 billion as the benefit of rising indices was partially offset by the negative impact of lower U.S. market volumes and a decline in market volatility during the second half of the year.

In recent years, Institutional Securities took steps to streamline its business and better manage costs in light of difficult market and economic conditions. Investment banking headcount was reduced, and the debt and equity capital market areas were combined to better serve clients and take advantage of synergies. Institutional Securities continued to emphasize client service, including solving complex client problems through an integrated approach, with the goal of building and maintaining long-lasting client relationships. Institutional

Securities also focused on improving market share. At calendar year-end, the Company ranked No. 2 with a market share of approximately 20% in announced global merger and acquisition transactions. In addition, the Company improved its market share and ranked No. 2 in U.S. investment grade debt underwriting and No. 3 in worldwide equity and equity-related underwritings. The Company believes that it also improved market share in secondary equity and debt trading, although market share data in these areas are less transparent. The Company believes that the improved performance of Institutional Securities in fiscal 2003 indicates that the foregoing actions have begun to yield results and that Institutional Securities is well-positioned for a business upturn.

*Individual Investor Group.* The Individual Investor Group recorded net income of \$265 million as compared with \$59 million in the prior year. Net revenues were essentially unchanged at \$4.0 billion, as retail participation in the equity markets increased over the second half of the year after declining in the first half. The second half upswing was consistent with a stronger economy and improving investor confidence. Total non-interest expense decreased 10% from the prior year, which included \$112 million in restructuring charges (see “Restructuring and Other Charges” herein). Total client assets of \$565 billion rose 9% from the end of the prior year. In addition, client assets in fee-based accounts increased 21% to \$130 billion and represented 23% of total client assets as compared with 21% a year ago. At year-end, the number of global financial advisors was 11,086, a decline over the past year of 1,460.

The Company believes it is near the end of a process to substantially reorganize and transform its Individual Investor Group business. During the process, the Company re-evaluated almost every aspect of the business, including the cost base, management structure, client approach, financial advisor training and hiring, and growth strategy. As part of the process, the Individual Investor Group significantly reduced non-compensation expenses, closed 76 branches domestically and decreased financial advisor headcount by 12%. In addition, financial advisor training was focused on financial planning, retention, productivity and services to the high net worth client segment. As a result of these changes in cost structure and financial advisor training, the Company believes that the Individual Investor Group is well-positioned to capitalize on any improvement in the equity markets.

*Investment Management.* Investment Management reported net income of \$326 million, 22% lower than \$418 million in the prior year. The decline was driven by an 8% decrease in net revenues, reflecting a decline in average assets under management and a less favorable average asset mix. Assets under management at year-end were \$462 billion, up \$42 billion, or 10%, from a year ago—primarily as a result of market appreciation. At year-end, the percent of the Company’s fund assets performing in the top half of the Lipper rankings for one year was 57% as compared with 62% a year ago.

Investment Management also reorganized its business over the past few years, combining four distinct asset management complexes and eliminating money management style redundancies. Investment Management will continue to focus on improving investment performance across all asset classes, improving mutual fund flows and consolidating assets with the best performing managers. Investment Management will also focus on the pension and separately managed account business by building more alternative investment products and multi-disciplinary accounts. One of Investment Management’s primary challenges is the potential impact that legal and regulatory developments will have on its business, although this potential impact cannot be fully predicted and quantified at this time.

*Credit Services.* Credit Services net income was \$688 million, down 9% from the prior year’s record earnings of \$760 million. The current year’s results included pre-tax severance and facilities closing charges of \$35 million. The decline in earnings was driven by lower non-interest revenues and net interest income, which more than offset lower marketing and business development costs. The managed credit card charge-off rate increased 41 basis points from a year ago to 6.60%. The managed over-30-day-delinquency rate increased one basis point to 5.97%, and the managed over-90-day-delinquency rate increased 16 basis points to 2.82%. Relatively high levels of unemployment and record levels of U.S. bankruptcy filings along with changes in the Company’s re-age policy—which tightened terms under which delinquent accounts are returned to a current status—negatively

affected charge-off and delinquency rates. Managed credit card loans were \$48.4 billion at year-end, 5% lower than a year ago. Total transaction volume rose to a record \$97.9 billion.

During fiscal 2003, Credit Services faced a difficult credit environment and intense competition. In response to these challenges, Credit Services continued to focus on the credit quality of its credit card portfolio, which contributed to a lower level of loan growth. As a result, the effect of rising losses was magnified by lower receivables and charge-offs as a percentage of the portfolio increased. Improving credit quality will continue to be a primary area of management focus. Credit Services expects to increase marketing activities in fiscal 2004 if the economy continues to improve. These marketing initiatives will focus on increasing cardmember usage by leveraging the Discover brand and the Cashback Bonus® and expanding its merchant base.

*Business Challenges.* The Company believes that investor trust and confidence remains critical to the success of the financial services industry and the Company's franchise. The Company is taking appropriate measures to ensure that serving the interests of its clients remains its top priority, including reviews of potential conflicts, business and disclosure practices and product suitability.

Global financial services firms such as the Company continue to experience increased competition from firms that have commercial banking capabilities (see "Certain Factors Affecting Results of Operations" herein). Corporate clients continue to request that the Company provide loans or lending commitments in connection with certain investment banking activities, and this activity will continue in the future. The Company has augmented its lending infrastructure and continues to lend on a select and limited basis in support of clients when appropriate. The Company strives to syndicate loans that it originates and uses derivatives to hedge a portion of its credit exposure (see "Liquidity and Capital Resources" herein). The Company continues to believe that its current business model will allow the Company to achieve its strategic goals and objectives.

### **Global Market and Economic Conditions in Fiscal 2003.**

Global market and economic conditions improved during the latter half of fiscal 2003 from the difficult conditions that existed during the first half of fiscal 2003 and in fiscal 2002. Fiscal 2003 began amid significant investor uncertainty due to concerns about weak global economic conditions and the impact of numerous corporate accounting and governance irregularities that emerged during fiscal 2002. In addition, geopolitical tensions escalated in early 2003 as military operations in Iraq seemed imminent. However, conditions improved steadily in fiscal 2003. The conclusion of major military operations in Iraq in the second quarter of fiscal 2003 eased geopolitical tensions that existed at the beginning of the year. In addition, during the latter half of fiscal 2003, most global financial markets rallied in response to positive economic developments, primarily in the U.S. As fiscal 2003 concluded, there were increased expectations that the long-awaited global economic recovery was beginning to materialize.

In the U.S., market and economic conditions improved significantly as the year progressed. During the first half of fiscal 2003, the rate of U.S. economic growth remained weak. Consumer and investor confidence were adversely affected by a relatively high unemployment rate and increased geopolitical concerns, including the mobilization of U.S. military forces in the Middle East, and heightened risk aversion that caused U.S. Treasury yields to fall significantly. However, accommodative fiscal and monetary policies contributed to improved economic performance in the latter half of fiscal 2003, including improved business investment and consumer spending, as well as robust growth in productivity. The rate of unemployment appeared to stabilize, while inflation remained low. As a result of these improved conditions, U.S. financial markets rallied during the latter half of fiscal 2003. During fiscal 2003, the Federal Reserve Board (the "Fed") lowered both the overnight lending rate and the discount rate by 0.25%.

In Europe, market and economic conditions were generally difficult during most of fiscal 2003. At the beginning of the year, geopolitical tensions and the anticipation of a military conflict with Iraq contributed to investor uncertainty and weak conditions in the financial markets. Consumer and business spending were generally weak, particularly in the first half of the fiscal year, although there were indications of improvement during the fourth quarter. During fiscal 2003, the euro appreciated relative to the U.S. dollar, raising concern about price competitiveness of euro exports. In addition, the pace and strength of Europe's economic recovery remained uncertain as certain countries experienced negative economic growth during the year, including Germany. During fiscal 2003, the European Central Bank (the "ECB") lowered the benchmark interest rate on three separate occasions by an aggregate of 1.25%. The Bank of England reduced its benchmark interest rate by an aggregate of 0.50% in two separate actions but then increased its benchmark interest rate by 0.25% toward the end of the fiscal year.

In Japan, economic conditions generally improved during fiscal 2003. Japan's economy gained momentum as a result of improved investment spending and corporate profitability, as well as increased export growth. During the year, economies throughout Asia were adversely impacted by the sudden outbreak of Severe Acute Respiratory Syndrome ("SARS"), which primarily occurred during the second quarter. Toward the end of fiscal 2003, economic conditions within Asia began to recover from the slowdown in tourism and consumer spending that was caused by SARS.

### **Business Segments.**

During fiscal 2003, the Company reviewed its segment allocation methodology (see Note 17 to the consolidated financial statements). This review resulted in the reallocation of certain revenues, expenses and assets during fiscal 2003 among the Company's business segments: Institutional Securities, Individual Investor Group, Investment Management and Credit Services. The Company believes that the results of these reallocations better reflect the economics of each business segment by representing transactions as if conducted between a segment and an external party. Prior periods have been restated to reflect these segment allocation changes. While the segment allocation changes had no effect on the Company's consolidated net income, they affected the net income of each segment.

As a result of treating these intersegment transactions as transactions with external parties, the Company has included an "Intersegment Eliminations" category to reconcile the segment results to the Company's consolidated results. The net income in Intersegment Eliminations represents, among other things, the effect of timing differences associated with the revenue and expense recognition of commissions paid by Investment Management to Individual Investor Group associated with sales of certain products and the related compensation costs paid to Individual Investor Group's financial advisors. Net income recorded in Intersegment Eliminations was \$71 million, \$87 million and \$49 million in fiscal 2003, fiscal 2002 and fiscal 2001, respectively.

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. Certain revenues and expenses have been allocated to each business segment, generally in proportion to their respective revenues or other relevant measures.

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

**INSTITUTIONAL SECURITIES**  
**STATEMENTS OF INCOME**  
(dollars in millions)

	<u>Fiscal 2003</u>	<u>Fiscal 2002</u>	<u>Fiscal 2001</u>
Revenues:			
Investment banking .....	\$ 2,097	\$ 2,179	\$ 3,061
Principal transactions:			
Trading .....	5,487	2,088	4,605
Investments .....	64	42	(216)
Commissions .....	1,748	2,033	1,729
Asset management, distribution and administration fees .....	91	91	67
Interest and dividends .....	13,381	13,056	20,827
Other .....	289	396	436
Total revenues .....	<u>23,157</u>	<u>19,885</u>	<u>30,509</u>
Interest expense .....	11,946	10,774	19,229
Net revenues .....	<u>11,211</u>	<u>9,111</u>	<u>11,280</u>
Non-interest expenses .....	<u>7,603</u>	<u>6,474</u>	<u>7,593</u>
Income before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change .....	3,608	2,637	3,687
Losses from unconsolidated investees .....	279	77	30
Provision for income taxes .....	738	809	1,226
Dividends on preferred securities subject to mandatory redemption .....	154	87	50
Income before cumulative effect of accounting change .....	2,437	1,664	2,381
Cumulative effect of accounting change .....	<u>—</u>	<u>—</u>	<u>(46)</u>
Net income .....	<u>\$ 2,437</u>	<u>\$ 1,664</u>	<u>\$ 2,335</u>

Institutional Securities achieved net revenues of \$11,211 million and net income of \$2,437 million in fiscal 2003, increases of 23% and 46%, respectively, from fiscal 2002. The increase in net revenues was primarily attributable to higher revenues from fixed income sales and trading activities, partially offset by lower investment banking revenues. The increase in net income primarily reflected higher net revenues, partially offset by higher non-interest expenses. Non-interest expenses in fiscal 2003 included charges of \$323 million (\$191 million after-tax) in connection with the Company's aircraft financing activities. Compensation and benefits expense included a \$220 million (\$151 million after-tax) net benefit, composed of a \$352 million (\$242 million after-tax) benefit related to changes in the terms of the Company's equity-based compensation program, partially offset by \$132 million (\$91 million after-tax) related to expensing stock options based on the fair value of stock options granted in fiscal 2003 (see "Equity-Based Compensation Program" herein). Excluding this net benefit, compensation costs increased due to a higher level of net revenues. Net income for fiscal 2003 also reflected a decrease in the effective income tax rate, primarily reflecting lower tax rates attributable to non-U.S. earnings, as well as an increase in the utilization of domestic tax credits, which primarily resulted from the Company's investments in the production of synthetic fuel (see "Investments in Unconsolidated Investees" herein).

In fiscal 2002, Institutional Securities net revenues and net income decreased 19% and 29%, respectively, from fiscal 2001. Institutional Securities net income for fiscal 2001 included a charge of \$46 million from 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. 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.

**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 2003	Fiscal 2002	Fiscal 2001
	(dollars in millions)		
Advisory fees from merger, acquisition and restructuring transactions . . . . .	\$ 662	\$ 961	\$1,418
Equity underwriting revenues . . . . .	640	526	764
Fixed income underwriting revenues . . . . .	795	692	879
<b>Total investment banking revenues . . . . .</b>	<b>\$2,097</b>	<b>\$2,179</b>	<b>\$3,061</b>

Investment banking revenues decreased 4% in fiscal 2003, reflecting lower revenues from merger, acquisition and restructuring activities, partially offset by higher revenues from fixed income and equity underwriting transactions. In fiscal 2002, investment banking revenues decreased 29%, reflecting lower revenues from merger, acquisition and restructuring activities and equity and fixed income underwriting transactions.

Conditions in the worldwide merger and acquisition markets were difficult throughout most of fiscal 2003, with the fourth quarter of fiscal 2003 being the exception. Such conditions included weak corporate earnings as companies began the year focusing on cost reduction instead of expansion. In addition, the depressed level of fiscal 2002 merger and acquisition announcements had a direct impact on completed volumes during fiscal 2003, resulting in reduced advisory revenues. These conditions improved during the fourth quarter of fiscal 2003, when the global economy demonstrated signs of recovery and the equity markets rallied. As a result, transaction volume increased in the fourth quarter of fiscal 2003. There was \$1.4 trillion of transaction activity announced during calendar year 2003 (according to Thomson Financial) as compared with \$1.2 trillion in calendar year 2002. During calendar year 2003, the Company's volume of announced merger and acquisition transactions was approximately \$241 billion as compared with approximately \$193 billion in the prior year. The 25% increase primarily resulted from an increase in average transaction size, although volumes were still well below those reported in 2001. In fiscal 2002, increased concerns over corporate accounting and governance issues and declining global equity prices had a negative impact on the volume of advisory transactions as both the number of transactions and the average transaction size declined from the prior-year period.

The worldwide market for equity underwriting transactions was mixed in fiscal 2003. During the first half of fiscal 2003, the uncertainty in the global financial markets continued to adversely affect overall transaction volume. However, market conditions improved during the latter half of the year. The volume of fixed income underwritings remained steady throughout much of fiscal 2003, primarily due to a relatively low interest rate environment.

Equity underwriting revenues increased 22% in fiscal 2003 and decreased 31% in fiscal 2002. In the first half of fiscal 2003, equity underwriting revenues increased from relatively depressed levels, primarily led by a high level of convertible offerings. Rising equity markets contributed to a more favorable equity underwriting environment in the second half of fiscal 2003, with a significant increase in global transaction activity, particularly in the technology, financial services and utility sectors. In fiscal 2002, equity underwriting revenues decreased, 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 reflected the difficult conditions that existed in the global equity markets, including the media and telecommunications sectors. The decrease in fiscal 2002 also was due to lower revenues from underwriting convertible securities.

Fixed income underwriting revenues increased 15% in fiscal 2003, primarily reflecting favorable conditions in the global fixed income markets throughout the year. Transaction activity remained steady throughout fiscal 2003 as issuers took advantage of the lowest interest rates in nearly 45 years and relatively tight credit spreads. These conditions contributed to higher revenue from global high-yield, investment grade and securitized fixed income transactions. Fixed income underwriting revenues decreased 21% 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.

At the end of fiscal 2003, the backlog of merger, acquisition and restructuring transactions and equity underwriting transactions was higher as compared with the end of the prior year, generally reflecting improved global market and economic conditions.

**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 sales and trading 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 financial instruments in which the Company acts as principal and gains and losses on the Company's 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 ("OTC") 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, and 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 2003	Fiscal 2002	Fiscal 2001
	(dollars in millions)		
Equities . . . . .	\$3,591	\$3,528	\$4,490
Fixed income(1) . . . . .	5,356	3,245	3,813

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

Sales and trading revenues increased 35% in fiscal 2003, primarily reflecting higher fixed income sales and trading revenues. Sales and trading revenues decreased 19% in fiscal 2002, reflecting lower equity and fixed income sales and trading revenues.

Equity sales and trading revenues increased 2% in fiscal 2003, reflecting higher revenues from derivative products, certain proprietary trading activities and prime brokerage services, offset by lower revenues from cash products. Toward the end of fiscal 2003, equity sales and trading revenues benefited from rising market indices, increased cash flows into equity mutual funds and higher equity new issue volume. However, for the full fiscal year, U.S. market volumes and market volatility were generally lower, and commission revenues were impacted by a shift toward electronic trading.

Equity sales and trading revenues decreased 21% 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 concerns regarding corporate bankruptcies and accounting irregularities contributed to difficult conditions in the equity markets, primarily in the U.S. and Europe.

Fixed income sales and trading revenues increased 65% to a record level in fiscal 2003, reflecting volatile markets, significant new issue activity and higher client transaction volumes. The increase was broad-based and included higher revenues from the Company's credit product, interest rate and currency product, and commodities groups. Credit product revenues increased 67%, reflecting strong capital markets activity and higher revenues from residential and commercial mortgage loan securitization activities, investment grade corporate and global high-yield fixed income securities. Interest rate and currency product revenues increased 39%, primarily reflecting a generally favorable trading environment, a sharp rise in interest rates in the third quarter of fiscal 2003, higher derivative volumes and increased interest rate volatility in both the U.S. and European markets. Higher revenues from currency products, primarily due to higher market volatility and a declining U.S. dollar, also contributed to the increase. Commodities revenues increased 168% to record levels. The increase was primarily associated with activities in the energy sector, reflecting higher levels of volatility in certain energy markets, higher customer flow activity and increased trading activity in support of client securitizations.

Fixed income sales and trading revenues decreased 15% in fiscal 2002. The decrease was due to lower revenues from the Company's interest rate and currency product, credit product and commodities groups, each of which had strong results in fiscal 2001. The decrease in interest rate and currency product revenues was primarily due to lower revenues from government fixed income securities, partially offset by higher revenues from currency products. The trading environment for government fixed income securities was difficult during fiscal 2002 due to lack of direction with respect to interest rates. The increase in trading revenues from currency products reflected higher market volatility as the U.S. dollar depreciated against the yen and the euro during much of fiscal 2002. The decrease in credit product revenues was primarily due to lower revenues from investment grade fixed income securities, partially offset by higher revenues from global high-yield fixed income products. 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 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 decrease in the commodity revenues 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.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net interest expense associated with the Company's aircraft financing activities, as well as losses associated with the Company's corporate lending activities. In fiscal 2003, sales and trading revenues associated with corporate lending activities increased by approximately \$170 million due to lower markdowns as compared with fiscal 2002, reflecting tighter credit spreads as conditions in the credit market improved. In addition, lower net interest expense associated with aircraft financing activities contributed to the increase. 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 net interest expense associated with the Company's aircraft financing activities.

**Principal Investments.** Principal transaction net investment revenue aggregating \$64 million was recognized in fiscal 2003 as compared with net revenue aggregating \$42 million in fiscal 2002. Both periods' results primarily included gains on the Company's real estate investments, partially offset by losses in other principal investments.

Financial instruments 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 significant sales restrictions. Moreover, estimates of the fair 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 fund investment activities.

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

Other revenues decreased 27% in fiscal 2003. The decrease was primarily attributable to lower revenues from the Company's aircraft financing business, reflecting a decline in lease rates. The decrease also reflects the inclusion of a gain in fiscal 2002 (of which \$53 million was allocated to the Institutional Securities segment) related to the Company's sale of an office tower.

Other revenues decreased 9% 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 as compared with the prior year. The decrease was partially offset by the inclusion of a gain of \$53 million in the first quarter of fiscal 2002 related to the Company's sale of an office tower.

Net revenues from the Company's aircraft financing business continued to be adversely affected by the slowdown in the commercial aircraft industry that began in 2001. In fiscal 2002 and fiscal 2003, declining aircraft passenger volume, overcapacity of aircraft and financial difficulties experienced by major airlines contributed significantly to a decline in lease rates for operating lessors, including the Company's aircraft financing business. These conditions improved somewhat toward the end of fiscal 2003. At fiscal year-end, the number of the Company's aircraft that were unleased or not committed to a lease transaction had decreased from the end of fiscal 2002. However, lease rates had generally declined during fiscal 2003.

**Non-Interest Expenses.** Fiscal 2003's total non-interest expenses increased 17%. Compensation and benefits expense increased 20%. Compensation and benefits expense included a \$220 million net benefit related to changes in the terms of the Company's equity-based compensation program and the expensing of stock options (see "Equity-Based Compensation Program" herein). Excluding this benefit, compensation and benefits expense increased 26%, primarily due to higher incentive-based compensation, reflecting higher net revenues. Excluding compensation and benefits expense, non-interest expenses increased 14% from fiscal 2002. Brokerage, clearing and exchange fees increased 13%, primarily reflecting higher global securities trading volumes. Other expenses increased 114%, primarily reflecting higher costs associated with the Company's aircraft financing business, including a higher asset impairment charge of \$287 million (as compared with \$74 million in fiscal 2002) and higher aircraft repossession costs, as well as a \$36 million charge to adjust the carrying value of previously

impaired aircraft to market value (see Note 18 to the consolidated financial statements). The increase in other expenses also reflected accruals of approximately \$180 million for loss contingencies related to *IPO Allocation Matters* and the *LVMH Litigation* (see “Legal Proceedings” in Part I, Item 3). The increase in non-interest expenses was partially offset by restructuring and other charges of \$117 million that were recorded in fiscal 2002 (see “Restructuring and Other Charges” herein).

Fiscal 2002’s total non-interest expenses decreased 15%. Compensation and benefits expense decreased 21%, 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 4%. Brokerage, clearing and exchange fees increased 8%, primarily reflecting increased global securities trading volume, particularly in Europe and the U.S. Marketing and business development expense decreased 6%, 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 24%, 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 18 to the consolidated financial statements). The decrease in Other expense also reflected a loss of \$50 million recorded in fiscal 2001 related to the early extinguishment of certain long-term borrowings (see “New Accounting Developments—Gains and Losses from Extinguishment of Debt” herein). Non-interest expenses also included restructuring and other charges of \$117 million (see “Restructuring and Other Charges” herein).

**INDIVIDUAL INVESTOR GROUP**  
**STATEMENTS OF INCOME**  
**(dollars in millions)**

	<b>Fiscal 2003</b>	<b>Fiscal 2002</b>	<b>Fiscal 2001</b>
Revenues:			
Investment banking .....	\$ 304	\$ 267	\$ 320
Principal transactions:			
Trading .....	651	642	904
Investments .....	—	(45)	(11)
Commissions .....	1,276	1,330	1,623
Asset management, distribution and administration fees .....	1,413	1,409	1,367
Interest and dividends .....	368	443	889
Other .....	155	218	63
Total revenues .....	4,167	4,264	5,155
Interest expense .....	150	195	484
Net revenues .....	4,017	4,069	4,671
Non-interest expenses .....	3,563	3,960	4,613
Income before income taxes .....	454	109	58
Provision for income taxes .....	189	50	35
Net income .....	<u><u>\$ 265</u></u>	<u><u>\$ 59</u></u>	<u><u>\$ 23</u></u>

Individual Investor Group net revenues were \$4,017 million in fiscal 2003, a decrease of 1% from fiscal 2002. Individual Investor Group net income was \$265 million in fiscal 2003 as compared with \$59 million in fiscal 2002. The decrease in net revenues was primarily attributable to lower commissions, net interest and other revenues, partially offset by the absence of principal investment losses and higher investment banking revenues. The increase in net income was primarily due to lower non-interest expenses, including lower compensation and benefits and other expenses. Compensation and benefits expense included a \$28 million (\$17 million after-tax) net benefit, composed of a \$55 million (\$32 million after-tax) benefit related to changes in the terms of the Company's equity-based compensation program, partially offset by \$27 million (\$15 million after-tax) related to expensing stock options based on the fair value of stock options granted in fiscal 2003 (see "Equity-Based Compensation Program" herein).

Individual Investor Group net revenues were \$4,069 million in fiscal 2002, a decrease of 13% from fiscal 2001. Individual Investor Group net income was \$59 million in fiscal 2002 as compared with \$23 million in fiscal 2001. The decrease in net revenues in fiscal 2002 was primarily attributable to lower net interest, principal trading and commission revenues. The increase in net income 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). 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 results for the Individual Investor Group improved in the second half of fiscal 2003 as compared with the first half, reflecting higher individual investor participation in the U.S. equity markets and positive inflows into equity mutual funds. Approximately 25% of the increase in client assets, which rose \$49 billion to \$565 billion at November 30, 2003, was due to net new customer inflows.

**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 increased 14% in fiscal 2003 and decreased 17% in fiscal 2002. The increase in fiscal 2003 was primarily due to higher revenues from equity underwriting transactions reflecting higher volumes and from underwriting Unit Investment Trust products. The decrease in fiscal 2002 was primarily due to a decrease in Unit Investment Trust sales volume.

**Principal Transactions.** Principal transactions include revenues from customers' purchases and sales of financial instruments in which the Company acts as principal and gains and losses on the Company's positions. The Company maintains certain positions primarily to facilitate customer transactions. Principal transaction trading revenues increased 1% in fiscal 2003, reflecting higher revenues from fixed income products, partially offset by lower revenues from equity products. The increase in fixed income products reflected higher revenues from investment grade corporate fixed income securities, as individual investor activity increased. The decrease in revenues from equity products reflected the difficult conditions that existed in the equity markets during the first half of fiscal 2003. In fiscal 2002, principal transaction trading revenues decreased 29%, reflecting lower equity and fixed income trading revenues. The decrease in equity revenues reflected the difficult conditions that existed in the equity markets during fiscal 2002. 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 both fiscal 2003 and fiscal 2002, equity revenues were negatively affected by the Company's new pricing structure for executing transactions on the NASDAQ (see "Commissions" herein).

The Company recorded no principal transaction net investment gains or losses in fiscal 2003. 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.

**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 4% in fiscal 2003 and 18% in fiscal 2002. The decrease in both periods was due to lower customer trading volumes as individual investor participation in the U.S. equity markets declined. In fiscal 2003, this decline was partially offset by higher customer trading volumes in the second half of the year, as individual investor participation in the U.S. equity markets increased. In both periods, the decrease was partially offset by the impact of a new commission-based pricing structure for executing transactions on the NASDAQ.

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, and 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.

The Company offers various account options for its individual clients. For clients who prefer fee-based pricing, the Company offers the Morgan Stanley Choice<sup>SM</sup> account, which charges a percentage of assets rather than a per-transaction fee. Clients can also choose to have a fee-based separately managed account. 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 12% in fiscal 2003 and 39% in fiscal 2002. The decrease in both periods was primarily due to lower net interest revenues from brokerage services provided to individual customers as a result of decreases in the level of 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 individual investors electing a fee-based pricing arrangement under Morgan Stanley Choice. Asset management, distribution and administration fees also include revenues from asset management services 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 fees for services it provides in 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 increased marginally in fiscal 2003 and increased 3% in fiscal 2002. The slight increase in fiscal 2003 was primarily attributable to higher fees from investors electing fee-based pricing arrangements, including separately managed and Morgan Stanley Choice accounts, reflecting an increase in client assets toward the end of fiscal 2003. This increase was offset by lower fees from promoting and distributing mutual funds, reflecting a decrease in individual investors' average mutual fund asset levels and a less favorable asset mix that generated lower fees. The increase in fiscal 2002 was primarily attributable to higher ICS fees, partially offset by lower fees from promoting and distributing mutual funds and lower client asset balances. In fiscal 2003, client asset balances increased to \$565 billion at November 30, 2003 from \$516 billion at November 30, 2002. At November 30, 2001, client asset balances were \$595 billion. The increase in client asset balances in fiscal 2003 was primarily due to market appreciation, reflecting improvement in the global financial markets during the latter half of fiscal 2003, as well as net new inflows of client assets. The decrease in client asset balances in fiscal 2002 was 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 decreased 29% in fiscal 2003. The decrease was primarily due to approximately \$100 million of proceeds received in connection with the sale of the Company's self-directed online brokerage accounts (see "Business Acquisitions and Asset Sales" herein) in fiscal 2002. The decrease was partially offset by higher revenues from other miscellaneous service and account fees. Other revenues were \$218 million in fiscal 2002 as compared with \$63 million in fiscal 2001. The increase primarily reflected approximately \$100 million of proceeds received in connection with the sale of the Company's self-directed online brokerage accounts. The increase also was due to higher revenues from customer account fees.

**Non-Interest Expenses.** Non-interest expenses decreased 10% in fiscal 2003. The decrease was attributable to lower compensation and benefits expense, which decreased 6%, principally reflecting lower employment levels, as well as a net benefit of \$28 million related to changes in the terms of the Company's equity-based compensation program and the expensing of stock options (see "Equity-Based Compensation Program" herein). Excluding compensation and benefits expense, non-interest expenses decreased 17%. Occupancy and equipment expense decreased 13%, reflecting the results of the Company's initiative to consolidate its branch locations. Information processing and communications expense decreased 8%, reflecting lower data processing and telecommunications expenses. Marketing and business development expense decreased 33% due to lower advertising costs. Other expenses were relatively unchanged. Litigation costs increased, reflecting higher costs in fiscal 2003 due to mutual fund regulatory settlements, coupled with a benefit in fiscal 2002 from the resolution of a mutual fund litigation matter. These increases were offset by costs recorded in fiscal 2002 associated with the sale of the Company's self-directed online brokerage accounts. The decrease in non-interest expenses was also due to restructuring and other charges of \$112 million in fiscal 2002 (see "Restructuring and Other Charges" herein).

Non-interest expenses decreased 14% in fiscal 2002. The majority of the decrease was attributable to lower compensation and benefits expense, which decreased 12%, 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 17%. Occupancy and equipment expense decreased 9%, 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 17% due to lower telecommunications, market data and outsourced data processing costs. Professional services expense decreased 41%, primarily reflecting lower consulting costs. Other expenses decreased 40% 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 and Asset Sales" herein). Fiscal 2002's non-interest expenses also included restructuring and other charges of \$112 million (see "Restructuring and Other Charges" herein).

**INVESTMENT MANAGEMENT**  
**STATEMENTS OF INCOME**  
**(dollars in millions)**

	<b>Fiscal 2003</b>	<b>Fiscal 2002</b>	<b>Fiscal 2001</b>
Revenues:			
Investment banking .....	\$ 39	\$ 32	\$ 54
Principal transactions:			
Investments .....	22	(28)	(89)
Commissions .....	56	52	52
Asset management, distribution and administration fees .....	2,361	2,598	2,922
Interest and dividends .....	2	17	54
Other .....	34	51	58
Total revenues .....	2,514	2,722	3,051
Interest expense .....	5	1	11
Net revenues .....	2,509	2,721	3,040
Non-interest expenses .....	2,018	2,054	2,308
Income before income taxes .....	491	667	732
Provision for income taxes .....	165	249	307
Net income .....	<u>\$ 326</u>	<u>\$ 418</u>	<u>\$ 425</u>

Investment Management net revenues for fiscal 2003 were \$2,509 million, a decrease of 8% from fiscal 2002. Investment Management net income for fiscal 2003 was \$326 million, a decrease of 22% from fiscal 2002. The decrease in net revenues primarily reflected lower fee-based revenues due to a decline in average assets under management or supervision and a less favorable average asset mix, partially offset by higher principal investment revenues. The decrease in average assets under management was primarily attributable to market depreciation, reflecting declines in the global financial markets during the first half of fiscal 2003. The decrease in net income in fiscal 2003 was primarily due to lower net revenues, partially offset by a decline in non-interest expenses, including lower compensation costs. Compensation and benefits expense included a \$12 million (\$8 million after-tax) net benefit, composed of a \$24 million (\$16 million after-tax) benefit related to changes in the terms of the Company's equity-based compensation program, partially offset by \$12 million (\$8 million after-tax) related to expensing stock options based on the fair value of stock options granted in fiscal 2003 (see "Equity-Based Compensation Program" herein).

Investment Management net revenues for fiscal 2002 were \$2,721 million, a decrease of 10% from fiscal 2001. Investment Management net income for fiscal 2002 was \$418 million, a decrease of 2% 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 decrease in net income in fiscal 2002 was primarily due to lower net revenues, partially offset by lower non-interest expenses, including lower incentive-based compensation and a lower effective income tax rate.

The Company enters fiscal 2004 with assets under management or supervision at November 30, 2003 higher than fiscal 2003's average asset level due to improved conditions in the global equity markets during the latter half of the year. In fiscal 2004, the Company will continue to focus on improving fund performance across all asset classes and increasing net inflows of customer assets.

**Investment Banking.** Investment Management primarily generates investment banking revenues from the underwriting of Unit Investment Trust products. Investment banking revenues increased 22% in fiscal 2003 and decreased 41% in fiscal 2002. The increase in fiscal 2003 reflected a higher volume of Unit Investment Trust sales. The decrease in fiscal 2002 was primarily related to a lower volume of Unit Investment Trust sales. Unit

Investment Trust sales volume increased 10% to \$4.3 billion in fiscal 2003 and declined 43% to \$3.9 billion in fiscal 2002.

**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 gains aggregating \$22 million were recognized in fiscal 2003 as compared with losses of \$28 million in fiscal 2002. Fiscal 2003's results were primarily related to realized gains in the Company's private equity portfolio and reflected improved market conditions from the difficult market conditions that existed in fiscal 2002. Fiscal 2002's results were primarily related to unrealized losses in the Company's private equity portfolio and reflected difficult market conditions in the technology and telecommunications sectors.

Financial instruments 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 significant sales restrictions. Moreover, estimates of the fair 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 8% in fiscal 2003 and were unchanged in fiscal 2002 from the prior year. In fiscal 2003, the increase was associated with a higher sales volume of insurance products.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees primarily include revenues from the management and supervision of assets, including fees for distributing certain open-ended mutual funds and 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,		
	2003	2002	2001
	(dollars in billions)		
Assets under management or supervision by distribution channel:			
Retail .....	\$277	\$256	\$285
Institutional .....	185	164	174
Total(1) .....	<u>\$462</u>	<u>\$420</u>	<u>\$459</u>
Assets under management or supervision by asset class:			
Equity .....	\$207	\$172	\$199
Fixed income .....	123	127	128
Money market .....	64	66	70
Other(2) .....	68	55	62
Total(1) .....	<u>\$462</u>	<u>\$420</u>	<u>\$459</u>

(1) Revenues and expenses associated with customer assets of \$37 billion, \$38 billion and \$46 billion for fiscal 2003, fiscal 2002 and fiscal 2001, respectively, are included in the Company's Individual Investor Group segment, and \$14 billion, \$3 billion and \$3 billion for fiscal 2003, fiscal 2002 and fiscal 2001, respectively, are included in the Company's Institutional Securities segment.

(2) Amounts include alternative investment vehicles.

Asset management, distribution and administration fees decreased 9% in fiscal 2003 and 11% in fiscal 2002. In fiscal 2003, the decrease primarily reflected lower distribution, fund management, and administration and redemption fees resulting from lower average assets under management or supervision, a less favorable average asset mix and lower redemptions of certain open-ended funds. In fiscal 2002, 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, 2003, customer assets under management or supervision increased \$42 billion from fiscal year-end 2002. As of November 30, 2002, customer assets under management or supervision decreased \$39 billion from fiscal year-end 2001. The increase in fiscal 2003 was primarily due to market appreciation, reflecting improvement in the global equity markets during the latter half of fiscal 2003, as well as the addition of approximately \$11 billion of assets under management resulting from the Company's acquisition of the U.S. real estate equity advisory business of Lend Lease Corporation; the revenues and expenses associated with this acquisition will be included within the Institutional Securities segment (see "Business Acquisitions and Asset Sales" herein). The decrease in fiscal 2002 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.

**Non-Interest Expenses.** Fiscal 2003's total non-interest expenses decreased 2%. Compensation and benefits expense decreased 5%, principally reflecting a decrease in employment levels, as well as a net benefit of \$12 million related to changes in the terms of the Company's equity-based compensation program and the expensing of stock options (see "Equity-Based Compensation Program" herein). Excluding compensation and benefits expense, non-interest expenses were relatively unchanged from fiscal 2002. Brokerage, clearing and exchange fees decreased 8%, reflecting lower amortization expense associated with certain open-ended funds. The decrease in amortization expense reflected a lower level of deferred costs in the current year due to a decrease in past sales. Other expenses increased 163%, primarily due to legal accruals associated with mutual fund regulatory settlements in fiscal 2003. In addition, fiscal 2002's other expenses included the net benefit from certain legal matters, including the resolution of a mutual fund litigation matter.

Fiscal 2002's total non-interest expenses decreased 11%. 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 9%. Occupancy and equipment expense decreased 11%, reflecting lower rental expense due to the utilization of alternate facilities after the loss of the World Trade Center complex. Marketing and business development expense decreased 11%, primarily driven by lower advertising, travel and entertainment, and fund organization costs. Other expense decreased 71%, 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).

**CREDIT SERVICES**  
**STATEMENTS OF INCOME**  
**(dollars in millions)**

	<b>Fiscal 2003</b>	<b>Fiscal 2002</b>	<b>Fiscal 2001</b>
Fees:			
Merchant and cardmember .....	\$1,379	\$1,420	\$1,349
Servicing .....	2,015	2,080	1,888
Other .....	15	30	17
Total non-interest revenues .....	<u>3,409</u>	<u>3,530</u>	<u>3,254</u>
Interest revenue .....	2,091	2,413	2,593
Interest expense .....	806	1,050	1,236
Net interest income .....	1,285	1,363	1,357
Provision for consumer loan losses .....	1,267	1,336	1,052
Net credit income .....	18	27	305
Net revenues .....	<u>3,427</u>	<u>3,557</u>	<u>3,559</u>
Non-interest expenses .....	2,334	2,379	2,432
Income before income taxes and cumulative effect of accounting change .....	1,093	1,178	1,127
Provision for income taxes .....	405	418	425
Income before cumulative effect of accounting change .....	688	760	702
Cumulative effect of accounting change .....	—	—	(13)
Net income .....	<u><u>\$ 688</u></u>	<u><u>\$ 760</u></u>	<u><u>\$ 689</u></u>

Credit Services net revenues were \$3,427 million in fiscal 2003, a decrease of 4% from fiscal 2002. Credit Services net income was \$688 million in fiscal 2003, a decrease of 9% from fiscal 2002. The decrease in net revenues in fiscal 2003 was primarily attributable to lower non-interest revenues and lower net interest income, partially offset by a lower provision for consumer loan losses. The decrease in net income reflected lower net revenues, partially offset by lower non-interest expenses. Non-interest expenses included a charge of \$35 million (pre-tax) associated with workforce reductions and facility consolidations that were conducted during the fourth quarter. The charge reflected several actions in response to slower industry growth and difficult consumer credit conditions, and consisted of severance-related costs of \$29 million and space-related and other costs of \$6 million. The majority of these costs will be paid by the end of the first quarter of fiscal 2004. The fiscal year's results were also adversely affected by record levels of personal bankruptcy filings and a relatively high unemployment rate, both of which peaked during the middle of fiscal 2003. In response to these conditions, during fiscal 2003 the Company reduced marketing expenses and intensified its focus on the credit quality of its credit card loan portfolio, which contributed to the lower level of loan growth.

In fiscal 2002, Credit Services net revenues were \$3,557 million, a marginal decline from fiscal 2001. Credit Services achieved record net income of \$760 million in fiscal 2002, an increase of 10% 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 a 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.

***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, balance transfer fees, credit protection fees and cash advance fees, net of cardmember rewards. Cardmember rewards

include various reward programs, including the Cashback Bonus award program, pursuant to which the Company pays certain cardmembers a percentage of their purchase amounts based upon a cardmember's level and type of purchases.

Merchant and cardmember fees decreased 3% in fiscal 2003 and increased 5% in fiscal 2002. The decrease in fiscal 2003 was due to a decline in late payment fees and higher cardmember rewards, partially offset by higher merchant discount revenue. The decline in late payment fees reflected fewer late fee occurrences and higher charge-offs of late payment fees. The increase in cardmember rewards reflected higher Cashback Bonus costs due to merchant partner programs and record sales volume. The increase in merchant discount revenue was due to record sales volume and an increase in the average merchant discount rate. The increase in merchant and cardmember fees in fiscal 2002 was due to higher merchant discount revenue associated with increased sales volume, 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 response to new regulatory guidance on the management of overlimit accounts, the Company will suppress the assessment of overlimit fees on accounts that meet specific criteria beginning in fiscal 2004. The suppression of overlimit fees will lower merchant and cardmember fee revenue in the future.

**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 \$5.7 billion in fiscal 2003 and \$3.6 billion in fiscal 2002 and mortgage loan securitizations of \$1.2 billion in fiscal 2003 and \$0.5 billion in fiscal 2002. The credit card asset securitization transactions completed in fiscal 2003 have expected maturities ranging from approximately two to seven years from the date of issuance. The mortgage loan securitization transactions completed in fiscal 2003 have expected maturities ranging from approximately eight to nine years from the date of issuance.

The table below presents the components of servicing fees:

	Fiscal 2003	Fiscal 2002	Fiscal 2001
(dollars in millions)			
Merchant and cardmember fees .....	\$ 727	\$ 690	\$ 651
Interest revenue .....	4,174	4,061	4,336
Other revenue .....	94	50	74
Interest expense .....	(802)	(887)	(1,511)
Provision for consumer loan losses .....	(2,178)	(1,834)	(1,662)
<b>Servicing fees .....</b>	<b>\$ 2,015</b>	<b>\$ 2,080</b>	<b>\$ 1,888</b>

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 decreased 3% in fiscal 2003 and increased 10% in fiscal 2002. The decrease in fiscal 2003 reflected higher credit losses associated with a higher level of average securitized general purpose credit card loans and a higher rate of charge-offs related to the securitized general purpose credit card loan portfolio. The decrease was partially offset by higher net interest cash flows and cardmember fees on securitized general purpose credit card loans associated with a higher level of average securitized general purpose credit card loans. The increase in servicing fees in fiscal 2002 was due to a higher level of net interest cash flows driven primarily by the lower interest rate environment. The increase was partially offset by higher credit losses resulting from a higher rate of charge-offs related to the securitized general purpose credit card loan portfolio.

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 net revenues from mortgage servicing rights on mortgage whole loan sales. Net gains of \$68 million, \$36 million and \$65 million were recorded in fiscal 2003, fiscal 2002 and fiscal 2001, respectively. The increase in Other revenue in fiscal 2003 was attributable to higher levels of general purpose credit card and mortgage loan securitization transactions, offset in part by higher gain amortization related to prior securitization transactions. The decrease in fiscal 2002 was attributable to lower levels of general purpose credit card securitization transactions and modifications to certain assumptions in the gain calculations made during fiscal 2001. 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. The decrease in fiscal 2002 was partially offset by an increase in net securitization gains on mortgage loans and gains on mortgage whole loan sales due 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 decreased 6% in fiscal 2003 from the prior-year period, as a decline in interest revenue was partially offset by lower interest expense. The decline in interest revenue was due to a lower yield on general purpose credit card loans and a decrease in average general purpose credit card 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 and a higher level of net interest charge-offs. The decrease in average general purpose credit card loans was primarily due to a higher level of securitized loans and higher payments by cardmembers, partially offset by record levels of sales volume. The decrease in interest expense was primarily due to a decrease in the Company's average cost of borrowings and a lower level of average interest bearing liabilities. The Company's average cost of borrowings was 4.33% for fiscal 2003 as compared with 5.29% for fiscal 2002. The decline in the average cost of borrowings reflected the Fed's aggressive easing of interest rates that began in fiscal 2001 and the favorable impact of replacing certain maturing fixed rate debt with lower cost financing, reflecting the lower interest rate environment.

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.

The following tables present analyses of Credit Services average balance sheets and interest rates in fiscal 2003, fiscal 2002 and fiscal 2001 and changes in net interest income during those fiscal years:

### Average Balance Sheet Analysis.

	Fiscal 2003			Fiscal 2002(3)			Fiscal 2001(3)		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest	Average Balance	Rate	Interest
(dollars in millions)									
<b>ASSETS</b>									
Interest earning assets:									
General purpose credit card loans . . .	\$19,531	10.02%	\$1,956	\$20,659	11.03%	\$2,279	\$20,285	11.73%	\$2,379
Other consumer loans . . . . .	1,530	5.45	83	1,229	5.99	73	808	7.83	63
Investment securities . . . . .	73	0.88	1	60	1.46	1	444	5.09	23
Other . . . . .	<u>2,668</u>	<u>1.90</u>	<u>51</u>	<u>2,451</u>	<u>2.45</u>	<u>60</u>	<u>2,389</u>	<u>5.37</u>	<u>128</u>
Total interest earning assets . . .	23,802	8.79	2,091	24,399	9.89	2,413	23,926	10.84	2,593
Allowance for loan losses . . . . .	(967)			(890)			(790)		
Non-interest earning assets . . . . .	<u>2,511</u>			<u>2,534</u>			<u>2,586</u>		
Total assets . . . . .	<u><u>\$25,346</u></u>			<u><u>\$26,043</u></u>			<u><u>\$25,722</u></u>		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>									
Interest bearing liabilities:									
Interest bearing deposits									
Savings . . . . .	\$ 810	1.01%	\$ 8	\$ 1,018	1.56%	\$ 16	\$ 1,516	4.29%	\$ 65
Brokered . . . . .	10,523	5.28	556	9,732	6.01	584	8,891	6.63	590
Other time . . . . .	<u>1,620</u>	<u>4.38</u>	<u>71</u>	<u>2,037</u>	<u>5.10</u>	<u>104</u>	<u>3,058</u>	<u>5.99</u>	<u>183</u>
Total interest bearing deposits . . . . .	12,953	4.90	635	12,787	5.51	704	13,465	6.22	838
Other borrowings . . . . .	<u>5,676</u>	<u>3.02</u>	<u>171</u>	<u>7,053</u>	<u>4.91</u>	<u>346</u>	<u>6,299</u>	<u>6.33</u>	<u>398</u>
Total interest bearing liabilities . . . . .	18,629	4.33	806	19,840	5.29	1,050	19,764	6.26	1,236
Shareholder's equity/other liabilities . . . . .	<u>6,717</u>			<u>6,203</u>			<u>5,958</u>		
Total liabilities and shareholder's equity . . . . .	<u><u>\$25,346</u></u>			<u><u>\$26,043</u></u>			<u><u>\$25,722</u></u>		
Net interest income . . . . .				<u><u>\$1,285</u></u>			<u><u>\$1,363</u></u>		<u><u>\$1,357</u></u>
Net interest margin(1) . . . . .				5.40%			5.59%		5.67%
Interest rate spread(2) . . . . .				4.46%			4.60%		4.58%

(1) Net interest margin represents net interest income as a percentage of total interest earning assets.

(2) Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

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

**Rate/Volume Analysis.**

<b>Increase/(Decrease) due to Changes in:</b>	<b>Fiscal 2003 vs. Fiscal 2002</b>			<b>Fiscal 2002 vs. Fiscal 2001(1)</b>		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
<b>Interest Revenue</b>						
General purpose credit card loans .....	\$(125)	\$(198)	\$(323)	\$ 44	\$(144)	\$(100)
Other consumer loans .....	17	(7)	10	33	(23)	10
Investment securities .....	—	—	—	(20)	(2)	(22)
Other .....	5	(14)	(9)	3	(71)	(68)
Total interest revenue .....	(59)	(263)	(322)	51	(231)	(180)
<b>Interest Expense</b>						
Interest bearing deposits:						
Savings .....	(3)	(5)	(8)	(21)	(28)	(49)
Brokered .....	48	(76)	(28)	55	(61)	(6)
Other time .....	(21)	(12)	(33)	(61)	(18)	(79)
Total interest bearing deposits .....	9	(78)	(69)	(42)	(92)	(134)
Other borrowings .....	(68)	(107)	(175)	48	(100)	(52)
Total interest expense .....	(64)	(180)	(244)	5	(191)	(186)
Net interest income .....	<u>\$ 5</u>	<u>\$ (83)</u>	<u>\$ (78)</u>	<u>\$ 46</u>	<u>\$ (40)</u>	<u>\$ 6</u>

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

In response to regulatory guidance issued in the beginning of fiscal 2003, the Company is reviewing the minimum payment requirements on its general purpose credit card loans. A change in the minimum payment requirements may impact future levels of general purpose credit card loans and related interest and fee revenues and charge-offs.

**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 \$1,267 million and \$1,336 million for fiscal 2003 and fiscal 2002, respectively. The Company's allowance for consumer loan losses was \$1,002 million at November 30, 2003 and \$928 million at November 30, 2002.

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 primarily 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 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 addition, the Company estimates the losses inherent in the consumer loan portfolio based on coverage of a rolling average of historical credit losses. 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 collection management, policy changes, 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 is affected by net principal charge-offs, delinquencies, bankruptcy filings and loan growth as well as changes in the amount of consumer loans estimated to be uncollectible. In fiscal 2003, the provision for consumer loan losses decreased 5%, primarily due to a lower level of average general purpose credit card loans. In fiscal 2002, the provision for consumer loan losses increased 27%, primarily due to higher net charge-off rates. In response to unfavorable trends in U.S. consumer bankruptcy filings and relatively high unemployment levels, the Company recorded a provision for consumer loan losses that exceeded the amount of net consumer loans charged off by approximately \$70 million in fiscal 2003 and approximately \$75 million in fiscal 2002.

*Delinquencies and Charge-offs.* 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, deceased cardmembers and fraudulent transactions, where loans are charged off earlier. Loan delinquencies and charge-offs are affected by changes in economic conditions, account collection management and policy changes and may vary throughout the year due to seasonal consumer spending and payment behaviors.

In the second quarter of fiscal 2003, the Company changed its policy related to deceased cardmember accounts to charge off 60 days after notification as compared with charging off 180 days past due. This change accelerated charge-offs beginning in the third quarter of fiscal 2003 and increased charge-offs in the second half of fiscal 2003.

The practice of re-aging an account also may affect general purpose credit card loan delinquencies and charge-offs. A re-age is intended to assist delinquent cardmembers who have experienced financial difficulties by returning the account to current status. An account is re-aged when the Company and the cardmember agree on a temporary repayment schedule, which may include short-term concessionary terms, and the cardmember has demonstrated a willingness and ability to repay. Cardmembers may also qualify for a workout re-age, which restructures the account to incorporate permanent concessionary terms, when either a longer term or permanent hardship exists.

During the second half of fiscal 2002 and the first half of fiscal 2003, the Company changed its re-age policy in response to industry-wide regulatory guidelines. This change, along with the ongoing economic challenges as evidenced by high levels of unemployment and U.S. bankruptcy filings, have resulted in a significant decrease in the number of cardmembers eligible for re-age versus comparable periods in fiscal 2002. During fiscal 2003, the Company's re-age volume decreased by approximately 40% from fiscal 2002. The reduction in re-age volume was a contributing factor to the higher delinquencies and charge-off levels experienced in fiscal 2003.

In fiscal 2003, net principal charge-off rates increased in the managed portfolio as compared with fiscal 2002, reflecting the impact of lower re-age volume and the change in the Company's deceased cardmember policy discussed above (see "Managed General Purpose Credit Card Loan Data" herein). In the U.S., high levels of unemployment, the seasoning of the Company's general purpose credit card loan portfolio, a high level of bankruptcy filings and policy changes contributed to the higher net principal charge-off rate in the managed portfolio during fiscal 2003. In addition, these conditions impacted the Company's delinquency rates in both the over 30- and over 90-day categories, which were higher in both the owned and managed portfolio at November 30, 2003 as compared with November 30, 2002. A lower level of general purpose credit card loan balances also negatively impacted delinquency and net principal charge-off rates.

In fiscal 2002, net principal 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 principal charge-off rates during fiscal 2002.

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.

**Non-Interest Expenses.** Fiscal 2003's total non-interest expenses decreased 2% from fiscal 2002. Compensation and benefits expense increased 6%, reflecting an increase in personnel costs, including salaries and benefits, as well as costs associated with the workforce reductions conducted during the fourth quarter. Excluding compensation and benefits expense, non-interest expenses decreased 6%. Marketing and business development expense decreased 11% due to lower direct mail costs. Other expenses decreased 11%, primarily reflecting a decrease in certain operating expenses, including lower costs associated with cardmember fraud and merchant bankruptcies.

Fiscal 2002's total non-interest expenses decreased 2%, 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 increases in salaries and benefits. Excluding compensation and benefits expense, non-interest expenses decreased 4%. Marketing and business development expense 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.

**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.

**Managed General Purpose Credit Card Loan Data.** The Company analyzes its financial performance on both a "managed" loan basis and as reported under U.S. Generally Accepted Accounting Principles ("U.S. GAAP") ("owned" loan basis). Managed loan data assume that the Company's securitized loan receivables have not been sold and present the results of the securitized loan receivables in the same manner as the Company's owned loans. The Company operates its Credit Services business and analyzes its financial performance on a managed basis. Accordingly, underwriting and servicing standards are comparable for both owned and securitized loans. The Company believes that managed loan information is useful to investors because it provides information regarding the quality of loan origination and credit performance of the entire managed portfolio and allows investors to understand the related credit risks inherent in owned loans and retained interests in securitizations. In addition, investors often request information on a managed basis, which provides a more meaningful comparison to industry competitors.

The following table provides a reconciliation of owned and managed average loan balances, interest yields and interest rate spreads for the periods indicated. Certain reclassifications have been made to prior-period amounts to conform to the current year's presentation:

**Reconciliation of General Purpose Credit Card Loan Data (dollars in millions)**

	Fiscal 2003			Fiscal 2002			Fiscal 2001		
	Average Balance	Interest Yield	Interest Rate Spread	Average Balance	Interest Yield	Interest Rate Spread	Average Balance	Interest Yield	Interest Rate Spread
<b>General Purpose Credit Card Loans:</b>									
Owned .....	\$19,531	10.02%	5.69%	\$20,659	11.03%	5.74%	\$20,285	11.73%	5.47%
Securitized .....	<u>31,333</u>	13.13%	10.64%	<u>29,176</u>	13.79%	10.78%	<u>29,147</u>	14.66%	9.54%
Managed .....	<u>\$50,864</u>	11.93%	8.77%	<u>\$49,835</u>	12.64%	8.71%	<u>\$49,432</u>	13.45%	7.88%

The following tables present a reconciliation of owned and managed general purpose credit card loans and delinquency and net charge-off rates:

**Reconciliation of General Purpose Credit Card Loan Asset Quality Data (dollars in millions)**

	Fiscal 2003			Fiscal 2002			Fiscal 2001		
	Delinquency Rates		Period End Loans	Delinquency Rates		Period End Loans	Delinquency Rates		Period End Loans
	Over 30 Days	Over 90 Days		Over 30 Days	Over 90 Days		Over 30 Days	Over 90 Days	
<b>General Purpose Credit Card Loans:</b>									
Owned .....	\$18,930	5.36%	2.53%	\$22,153	5.32%	2.41%	\$19,654	6.15%	2.73%
Securitized .....	<u>29,428</u>	6.36%	3.01%	<u>28,990</u>	6.45%	2.85%	<u>29,678</u>	7.32%	3.21%
Managed .....	<u>\$48,358</u>	5.97%	2.82%	<u>\$51,143</u>	5.96%	2.66%	<u>\$49,332</u>	6.85%	3.02%
							Fiscal 2003	Fiscal 2002	Fiscal 2001
<b>Net Principal Charge-offs</b>									
Owned .....							6.05%	6.06%	4.86%
Securitized .....							6.95%	6.29%	5.70%
Managed .....							6.60%	6.19%	5.36%
							Fiscal 2003	Fiscal 2002	Fiscal 2001
<b>Net Total Charge-offs (inclusive of interest and fees)</b>									
Owned .....							8.33%	7.97%	6.41%
Securitized .....							9.75%	8.51%	7.69%
Managed .....							9.20%	8.28%	7.16%

## **Equity-Based Compensation Program.**

Effective December 1, 2002, the Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123," using the prospective adoption method (see Note 2 to the consolidated financial statements). The Company now records compensation expense based upon the fair value of stock-based awards (both deferred stock and stock options). In prior years, the Company accounted for its stock-based awards under the intrinsic value approach in accordance with Accounting Principles Board ("APB") Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." Under the approach in APB 25 and the terms of the Company's plans in prior years, the Company recognized compensation expense for deferred stock awards in the year of grant; however, no compensation expense was generally recognized for stock option grants.

During the third quarter of fiscal 2003, the Company completed an extensive analysis of its stock-based compensation program and revised elements of its program to further encourage and incent long-term performance, enhance employee retention, and better align employee and shareholder interests. The revisions to fiscal 2003 awards included extending the time period over which vesting and non-compete provisions apply and raising the eligibility requirements to participate in such awards.

As a result of the revisions to its stock-based compensation program, the Company will recognize the fair value of stock-based awards granted in fiscal 2003 over service periods of three and four years, including the year of grant. Historically, the service period for stock-based awards was deemed to be the year of grant.

The effect of expensing stock-based awards over a longer period of service reduced compensation expense recorded for deferred stock awards by \$438 million in fiscal 2003. In addition, in connection with the adoption of SFAS No. 123, the Company recorded compensation expense of \$176 million based on the fair value of stock options granted in fiscal 2003. The net impact of these revisions reduced the Company's compensation and benefits expense by \$262 million in fiscal 2003 and increased net income by \$177 million (or \$0.16 per share) in fiscal 2003 as compared with fiscal 2002.

## **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 reflected several actions that were intended to resize and refocus certain business areas in order to address the difficult conditions in the global financial markets. Such conditions, including significantly lower levels of investment banking activity and decreased retail investor participation in the equity markets, had an adverse impact on the Company's results of operations, particularly in its Institutional Securities and Individual Investor Group businesses.

The fiscal 2002 charge 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 provided to the affected individuals.

At November 30, 2003, the remaining liability associated with these charges was approximately \$100 million, which was included in Other liabilities and accrued expenses in the Company's consolidated statement of financial condition. The majority of the decrease from the original liability of \$235 million was due to cash payments of severance-related costs made by the Company during fiscal 2003. The decline in the liability balance during fiscal 2003 also reflected net rental payments associated with the office locations referred to

above. In fiscal 2004, the liability is expected to decline by an additional \$50 million due to the continuing payment of net rentals on these locations. The liability will continue to be reduced through 2012 as these leases expire.

### **Investments in Unconsolidated Investees.**

The Company invests in unconsolidated investees that own synthetic fuel production plants. The Company accounts for these investments under the equity method of accounting. The Company's share of the operating losses generated by these investments is recorded within Losses from unconsolidated investees, and the tax credits and the tax benefits associated with these operating losses are recorded within the Company's Provision for income taxes. In fiscal 2003, fiscal 2002 and fiscal 2001, the Company recorded Losses from unconsolidated investees of \$279 million, \$77 million and \$30 million, respectively. These losses were more than offset by tax credits of \$308 million, \$109 million and \$48 million in fiscal 2003, fiscal 2002 and fiscal 2001, respectively, and tax benefits on the losses of \$112 million, \$31 million and \$12 million in fiscal 2003, fiscal 2002 and fiscal 2001, respectively.

### **Business Acquisitions and Asset Sales.**

On November 20, 2003, the Company acquired selected components of the U.S. real estate equity advisory businesses of Lend Lease Corporation, an Australia-based company. The financial statement impact related to this acquisition, which is included in the Company's Institutional Securities segment, was not significant.

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 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) 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.

### **Pension Plans.**

The Company made contributions of \$239 million and \$463 million to its defined benefit pension plans in fiscal 2003 and fiscal 2002, respectively. 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 8.5% to 7.5%) for fiscal 2003 (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 2003.

The Company determines the amount of its pension contributions by considering the interaction of several factors. Such factors include the range of potential contributions (i.e., the Employee Retirement Income Security Act of 1974 ("ERISA") minimum required contribution up to the maximum tax-deductible amount), the level of plan assets relative to plan liabilities, expected plan liquidity needs and expected future contribution requirements. The Company currently has no known or expected ERISA minimum funding obligations for any of its pension plans.

In accordance with U.S. GAAP, the Company recognizes pension expense before the payment of benefits to retirees occurs. As a result, the recording of pension expense involves estimates and assumptions that must be made, including the discount rate and the expected long-term rate of return on plan assets.

The assumed discount rate, which reflects the rates at which pension benefits could be effectively settled, is used in the measurement of the projected and accumulated benefit obligations and in the calculation of service cost and interest cost. The assumed discount rate should reflect the rates of return on available high-quality fixed-income investments that reflect the timing and amount of expected benefit payments. For its U.S. pension plans, which comprised approximately 95% of the total assets of the Company's pension plans at November 30, 2003, the Company estimates its discount rate based on the Moody's Aa long-term rate bond yield (both absolute levels and year-to-year changes).

The Company uses the expected long-term rate of return on plan assets to compute the expected return on assets. For its U.S. pension plans, the Company estimates the expected long-term return by utilizing a portfolio return calculator model (the "Portfolio Model") that produces the expected return for a portfolio. Return assumptions are forward-looking gross returns that are not developed solely by an examination of historical returns. The Portfolio Model begins with the current U.S. Treasury yield curve, recognizing that expected returns on bonds are heavily influenced by the current level of yields. Corporate bond spreads and equity risk premiums, based on current market conditions, are then added to develop the return expectations for each asset class. Expenses that are expected to be paid from the investment return are reflected in the Portfolio Model as a percentage of plan assets. This includes investment and transaction fees that typically are paid from plan assets, added to the cost basis or subtracted from sale proceeds, as well as administrative expenses paid from the pension plan.

The Company's expected long-term rate of return on assets for its U.S. pension plans for fiscal 2003 was based on the following expected asset allocation:

	Target Investment Mix	Expected Annual Return
Domestic Equity:		
Large Capitalization .....	30.00%	8.5%
Small Capitalization .....	15.00%	9.0%
International Equity:		
Emerging Markets .....	1.25%	9.2%
Global Equity .....	20.00%	9.0%
Fixed Income:		
Aggregate .....	32.50%	5.2%
High Yield .....	1.25%	7.8%

For its U.S. pension plans, expected returns are computed using a market-related value of assets. For the market-related value of assets, a smoothed actuarial value of assets is used, equal to a moving average of market values in which investment income is recognized over a five-year period. Investment income equal to the expected return on the prior year's market-related value of plan assets is recognized immediately. Any difference between the actual investment income (on a market-value basis) and the expected return is recognized over a five-year period in accordance with SFAS No. 87, "Employers' Accounting for Pensions." In addition, the market-related value of assets must be no greater than 120% and no less than 80% of the market value of assets.

The Company amortizes (as a component of pension expense) unrecognized net gains and losses over the average future service (generally 11 to 13 years) of active participants to the extent that the gain/loss exceeds 10% of the greater of the projected benefit obligation or the market-related value of plan assets. The loss amortization component of fiscal 2003 pension expense was approximately \$23 million, and future amortization is not expected to have a material impact on the Company's pension expense.

## Critical Accounting Policies.

The consolidated financial statements are prepared in accordance with U.S. GAAP, 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 \$201 billion at November 30, 2003 and \$173 billion at November 30, 2002 and financial instruments sold, not yet purchased of \$111 billion at November 30, 2003 and \$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 liquidation 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 traded 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 techniques involve some 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 using 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, 2003, 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 \$9.9 billion and \$0.1 billion, respectively. 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 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 \$3 billion and \$3 billion, respectively, at November 30, 2003 and \$2 billion and \$2 billion, respectively, at November 30, 2002. OTC derivatives include 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 \$42 billion and \$33 billion, respectively, at November 30, 2003 and \$34 billion and \$27 billion, respectively, at November 30, 2002, were derived using pricing models.

The fair value of OTC derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. 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 observable 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 complexity of the modeling assumptions and 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, the Controllers Department 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 values 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 reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. 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 is used to determine fair value, recently executed comparable transactions are considered for purposes of validating assumptions underlying the model. 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 support 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 is then used to evaluate 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 primarily 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 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 addition, the Company estimates the losses inherent in the consumer loan portfolio based on coverage of a rolling average of historical credit losses. 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 collection management, policy changes, 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. Depreciation is calculated on a straight-line basis over the estimated useful life of the aircraft asset, which is generally 25 years from the date of manufacture. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which the Company adopted on December 1, 2002, 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. 144, 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, the Company will recognize an impairment charge equal to the excess of the carrying value over the fair value of the aircraft. 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 18 to the consolidated financial statements).

## **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 potentially could increase costs, thereby affecting 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.

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 the Company cannot control or predict 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, 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 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 the Company's reputation, investment objectives, quality of investment professionals, 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.

The Company strives to increase market share in all of its businesses and evaluates the competitive position of its businesses by, among other things, monitoring various market share data. For example, in the Institutional Securities investment banking business, the Company monitors its market share in key areas such as announced and completed worldwide mergers and acquisitions, worldwide equity underwritings and worldwide investment grade debt underwritings. In the Institutional Securities sales and trading business, the Company monitors its market share via independent client surveys as well as its market share of global exchange and non-exchange volumes. In the Individual Investor Group business, the Company monitors its market share of client assets and the number of financial advisors. In the Investment Management business, the Company monitors its market share of assets under management or supervision and mutual fund flows among mutual fund managers. It also monitors the relative performance of its funds as determined by organizations such as Morningstar and Lipper. In the Credit Services business, the Company monitors its ranking in the number of merchant and cash access locations, the level of general purpose credit card loan balances outstanding, transaction volume and the credit quality of its loan portfolio.

Besides competition from firms traditionally engaged in the financial services business, competition exists 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 has continued 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 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.

## Liquidity and Capital Resources.

The Company's senior management establishes the overall liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Company's asset and liability position. These committees, along with the Company's Treasury Department and other control groups, also assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its consolidated balance sheet, liquidity and capital structure, thereby helping to ensure that its business activities are integrated with the Company's liquidity and capital policies. For a description of the Company's other principal risks and how they are monitored and managed, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A.

### The Balance Sheet.

The Company's total assets increased to \$602.8 billion at November 30, 2003 from \$529.5 billion at November 30, 2002. The increase was primarily attributable to increases in financial instruments owned, largely driven by corporate and other debt inventories and increases in the value of derivatives. Growth in equity financing activities, including securities borrowed and receivables from customers, also contributed to the increase. A substantial portion of the Company's total assets consists of highly liquid marketable securities and short-term receivables arising principally from its Institutional Securities sales and trading activities. 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 reverse repurchase 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,	
	2003	2002
	(dollars in millions, except ratio and per share data)	
Total assets .....	\$602,843	\$529,499
Less:		
Lesser of securities purchased under agreements to resell or securities sold under agreements to repurchase .....	(78,205)	(76,910)
Assets recorded under certain provisions of SFAS No. 140 and Financial Accounting Standards Board ("FASB") Interpretation No. 46 ("FIN 46") .....	(35,217)	(19,224)
Lesser of securities borrowed or securities loaned .....	(64,375)	(43,229)
Segregated customer cash and securities balances .....	(20,705)	(30,217)
Goodwill .....	(1,514)	(1,449)
Adjusted assets .....	<u><u>\$402,827</u></u>	<u><u>\$358,470</u></u>
Shareholders' equity .....	<u><u>\$ 24,867</u></u>	<u><u>\$ 21,885</u></u>
Preferred securities subject to mandatory redemption .....	<u><u>2,810</u></u>	<u><u>1,210</u></u>
Subtotal .....	<u><u>27,677</u></u>	<u><u>23,095</u></u>
Less: Goodwill .....	<u><u>(1,514)</u></u>	<u><u>(1,449)</u></u>
Tangible shareholders' equity .....	<u><u>\$ 26,163</u></u>	<u><u>\$ 21,646</u></u>
Leverage ratio(1) .....	<u><u>23.0x</u></u>	<u><u>24.5x</u></u>
Adjusted leverage ratio(2) .....	<u><u>15.4x</u></u>	<u><u>16.6x</u></u>
Book value per share(3) .....	<u><u>\$ 22.93</u></u>	<u><u>\$ 20.24</u></u>

- (1) Leverage ratio equals total assets divided by tangible shareholders' equity.  
 (2) Adjusted leverage ratio equals adjusted assets divided by tangible shareholders' equity.  
 (3) Book value per share equals shareholders' equity divided by common shares outstanding of 1,085 million at November 30, 2003 and 1,081 million at November 30, 2002.

**Equity Capital Management 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 and provides some protection from the economic risks 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 equity 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 equity 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. At November 30, 2003, the Company's equity capital (which includes shareholders' equity and preferred securities subject to mandatory redemption) was \$27.7 billion, an increase of \$4.6 billion from November 30, 2002.

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, 2004 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. In December 2003, the Board of Directors increased the quarterly dividend per common share by 9% to \$0.25.

**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. Given the highly liquid nature of the Company's balance sheet, day-to-day funding requirements are largely fulfilled through the use of collateralized financing. In order to meet target liquidity requirements and withstand an unforeseen contraction in credit availability, the Company has designed a liquidity management framework. This framework is intended to ensure that the Company maintains sufficient liquidity to continue to fund its ongoing business and to meet all of its financial obligations maturing within a one-year period without issuing any new unsecured debt.

Liquidity Management Framework:	Designed to:
Cash Capital Policy	Ensure that the Company can fund its balance sheet while repaying its financial obligations maturing within one year without issuing new unsecured debt. The Company attempts to achieve this by maintaining sufficient Cash Capital (long-term debt and equity capital) to finance illiquid assets and the portion of its securities inventory that is not expected to be financed on a secured basis in a credit-stressed environment.
Liquidity Reserve	Maintain, at all times, a liquidity reserve in the form of immediately available cash and cash equivalents to cover volatility in day-to-day funding needs. The reserve is periodically assessed and determined based on funding volatility and liquidity targets and averaged approximately \$20 billion during fiscal 2003.
Contingency Planning	Maintain the Company's Contingency Funding Plan to ascertain 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's Contingency Funding Plan sets forth the process and the internal and external communication flows necessary to ensure effective management of the contingency event.

The Company also 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. In addition, the Company attempts to maintain cash and unhypothesized marketable securities equal to at least 110% of its outstanding short-term unsecured borrowings. The Company also maintains committed credit facilities (described below) to support its ongoing borrowing programs.

The level of the Company's borrowings is continually adjusted to maintain the target cash liquidity reserve after meeting the Company's daily funding requirements. The Company's funding requirements will vary based on changes in the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

### **Funding Management Policies.**

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; promissory notes; 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, issue short-term institutional certificates of deposits and issue 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 not financed by secured funding sources 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. 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 Company issues long-term debt in excess of the amount necessary to meet the needs of its securities inventory and less liquid assets as determined by its Cash Capital Policy. In addition to these needs, long-term debt funding is employed to enhance the Company's liquidity position by reducing reliance on short-term credit sensitive instruments (e.g., commercial paper and other unsecured short-term borrowings). 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.

During fiscal 2003, the Company's long-term financing strategy was driven, in part, by its continued focus on improved balance sheet strength (evaluated through enhanced capital and liquidity positions), a significant factor in the maintenance of strong credit ratings. As a result, for fiscal 2003, approximately \$20 billion of unsecured

debt was issued (excluding certain equity and credit-linked products not considered to be a component of the Company's cash capital) with over 70% of these transactions having a maturity of five years or longer. Financing transactions were structured to ensure staggered maturities, thereby mitigating refinancing risk, while a diversified investor base was targeted through sales to domestic as well as international institutional and retail clients. Unsecured debt issuance activity resulted in a net increase in the long-term debt component of the cash capital portfolio of approximately \$12 billion and a corresponding \$15 billion reduction in the level of short-term commercial paper outstanding at fiscal year-end.

The Company's total capital base primarily consists of equity capital combined with long-term borrowings (debt obligations scheduled to mature in more than 12 months) and preferred securities subject to mandatory redemption. At November 30, 2003, total capital was \$83 billion, an increase of \$17 billion from November 30, 2002.

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, which consists of two separate tranches: a U.S. dollar tranche with the Company as borrower and a Japanese yen tranche with Morgan Stanley Japan Limited ("MSJL") as borrower and the Company as guarantor. Under this combined facility (the "MS-MSJL Facility"), the banks are committed to provide up to \$5.5 billion under the U.S. dollar tranche and 70 billion Japanese yen under the Japanese yen tranche. At November 30, 2003, the Company had a \$10.6 billion surplus shareholders' equity as compared with the MS-MSJL 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 \$1.8 billion. At November 30, 2003, MS&Co. had a \$2.5 billion surplus consolidated stockholder's equity and a \$1.6 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 \$1.5 billion, available in six major currencies. At November 30, 2003, MSIL had a \$1.2 billion surplus Shareholder's Equity and a \$1.9 billion surplus Financial Resources, each as defined in the MSIL Facility and as compared with the MSIL Facility's covenant requirements.

The Company anticipates that it may utilize the MS-MSJL Facility, the MS&Co. Facility or the MSIL 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, 2003, no borrowings were outstanding under any of the Credit Facilities.

The Company and its subsidiaries also maintain a series of committed bilateral credit facilities to support general liquidity needs. These facilities are expected to be drawn from time to time to cover short-term funding needs.

The committed credit facilities demonstrate the diversity of lenders to the Company covering geographic regions including North America, Europe and Asia Pacific.

### **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 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 OTC derivative transactions, including credit derivatives and interest rate swaps.

In connection with certain OTC 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, 2003, 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 \$945 million.

As of January 31, 2004, the Company's credit ratings were as follows:

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

### **Fiscal 2003 Activity.**

During the 12 months ended November 30, 2003, the Company issued senior notes aggregating \$22.0 billion, including non-U.S. dollar currency notes aggregating \$6.9 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, 2003, the aggregate outstanding principal amount of the Company's Senior Indebtedness (as defined in the Company's public debt shelf registration statements) was approximately \$94.9 billion (including Senior Indebtedness consisting of guaranteed obligations of the indebtedness of subsidiaries). Subsequent to fiscal year-end and through January 31, 2004, the Company's long-term borrowings (net of repayments) increased by approximately \$8.4 billion.

During fiscal 2003, the Company purchased approximately \$350 million of its common stock through open market purchases at an average cost of \$39.12.

During fiscal 2003, Morgan Stanley Capital Trust III, a consolidated Delaware statutory trust (the "Capital Trust III"), all of the common securities of which are owned by the Company, issued \$880 million of 6.25% Capital Securities (the "Capital Securities III") that are guaranteed by the Company. The Capital Trust III issued the Capital Securities III and invested the proceeds in 6.25% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due March 1, 2033.

During fiscal 2003, Morgan Stanley Capital Trust IV, a consolidated Delaware statutory trust (the “Capital Trust IV”), all of the common securities of which are owned by the Company, issued \$620 million of 6.25% Capital Securities (the “Capital Securities IV”) that are guaranteed by the Company. The Capital Trust IV issued the Capital Securities IV and invested the proceeds in 6.25% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due April 1, 2033.

During fiscal 2003, Morgan Stanley Capital Trust V, a consolidated Delaware statutory trust (the “Capital Trust V”), all of the common securities of which are owned by the Company, issued \$500 million of 5.75% Capital Securities (the “Capital Securities V”) that are guaranteed by the Company. The Capital Trust V issued the Capital Securities V and invested the proceeds in 5.75% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due July 15, 2033.

During fiscal 2003, the Company redeemed all \$400 million of its 7.10% Junior Subordinated Deferrable Interest Debentures held by MSDW Capital Trust I. The Company also simultaneously redeemed all of the outstanding 7.10% Capital Securities of MSDW Capital Trust I at a redemption price of \$25 per share.

#### **Off-Balance Sheet Arrangements.**

The Company enters into various arrangements with unconsolidated entities, including variable interest entities, primarily in connection with its Institutional Securities and Credit Services businesses.

***Institutional Securities Activities.*** The Company utilizes special purpose entities (“SPEs”) primarily in connection with securitization activities. The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations, municipal bonds, and other types of financial assets. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the consolidated statements of income. Retained interests in securitized financial assets associated with the Company’s Institutional Securities business were approximately \$2.4 billion at November 30, 2003, the majority of which were related to U.S. agency collateralized mortgage obligation, commercial mortgage loan and residential mortgage loan securitization transactions. For further information about the Company’s Institutional Securities securitization activities, see Notes 2 and 4 to the consolidated financial statements. In addition, see Note 19 to the consolidated financial statements for information about variable interest entities, the Company’s arrangements with these entities and its adoption of FIN 46.

The Company has entered into liquidity facilities with SPEs and other counterparties whereby the Company is required to make certain payments if losses or defaults occur. The Company often may have recourse to the underlying assets held by the SPEs in the event payments are required under such liquidity facilities (see Note 20 to the consolidated financial statements).

***Credit Services Activities.*** 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. GAAP (see Notes 2 and 5 to the consolidated financial statements). In connection with its credit card securitization program, the Company transfers credit card receivables, on a revolving basis, to the trusts, which issue asset-backed securities that are registered with the Securities and Exchange Commission (the “SEC”), are used to support the issuance of publicly listed notes or are 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 trusts' 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 trusts 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 trusts 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.

A group of banks are committed to provide up to \$1.3 billion under a credit facility that supports the short-term extendible asset-backed certificate program issued by the Discover Card Master Trust I.

#### **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 and operating leases as of November 30, 2003 are summarized below:

	Payments due in:				
	Fiscal 2004	Fiscal 2005-2006	Fiscal 2007-2008	Thereafter	Total
	(dollars in millions)				
Long-term borrowings(1) .....	\$10,574	\$21,802	\$ 9,636	\$23,588	\$65,600
Operating leases(2) .....	490	926	684	2,502	4,602
Total .....	<u>\$11,064</u>	<u>\$22,728</u>	<u>\$10,320</u>	<u>\$26,090</u>	<u>\$70,202</u>

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

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

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, 2003 are summarized below by period of expiration. 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 2004	Fiscal 2005-2006	Fiscal 2007-2008	Thereafter	Total
	(dollars in millions)				
Letters of credit(1)(2) .....	\$ 7,703	\$ —	\$ —	\$ —	\$ 7,703
Private equity and other principal investments(1)(3) .....	242	112	8	105	467
Investment grade lending commitments(1)(4)(6) .....	8,161	2,229	3,729	125	14,244
Non-investment grade lending commitments(1)(4)(6) .....	317	462	432	658	1,869
Commitments for secured lending transactions(1)(5) .....	<u>6,465</u>	<u>3,175</u>	<u>—</u>	<u>185</u>	<u>9,825</u>
Total .....	<u>\$22,888</u>	<u>\$5,978</u>	<u>\$4,169</u>	<u>\$1,073</u>	<u>\$34,108</u>

(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 of approximately \$263 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, 2003, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$45 billion and \$30 billion, respectively.

#### **Less Liquid Assets.**

At November 30, 2003, certain assets of the Company, such as real property, equipment and leasehold improvements of \$2.4 billion, aircraft assets of \$4.4 billion and goodwill of \$1.5 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, 2003, 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 \$850 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 can 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, 2003 and

November 30, 2002, the Company had high-yield instruments owned with a market value of approximately \$3.7 billion and \$2.6 billion, respectively, and had high-yield instruments sold, not yet purchased with a market value of \$0.8 billion and \$0.7 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, 2003 and November 30, 2002, the aggregate value of investment grade loans and positions was \$1.0 billion and \$1.3 billion, respectively, and the aggregate value of non-investment grade loans and positions was \$0.7 billion and \$1.2 billion, respectively. At November 30, 2003 and November 30, 2002, the aggregate value of loans and positions and lending commitments (see the table on page 65) outstanding was \$17.8 billion and \$17.6 billion, respectively. In connection with these business activities (including the loans and positions and the lending commitments), the Company had hedges with a notional amount of \$5.5 billion at November 30, 2003 and \$4.4 billion at November 30, 2002. At January 31, 2004, the aggregate value of investment grade loans and positions was \$2.3 billion and the aggregate value of non-investment grade loans and positions was \$1.4 billion. At January 31, 2004, the aggregate value of investment grade lending commitments was \$16.0 billion and the aggregate value of non-investment grade lending commitments was \$4.9 billion. Requests to provide loans or lending commitments in connection with investment banking activities will continue in the future.

**New Office Facility.** In fiscal 2002, the Company purchased an office facility in Westchester County, New York and incurred costs of approximately \$55 million, including the purchase price. During fiscal 2003, the Company incurred additional costs of approximately \$120 million. The Company expects to incur additional project costs of approximately \$135 million in fiscal 2004. The Company intends to complete the project and occupy the building in fiscal 2004.

#### **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 New York Stock Exchange 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 (the "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, 2003, 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 required holding higher regulatory capital beginning December 31, 2002. The Company's FDIC-insured financial institutions have maintained capital ratios in excess of the regulatory minimums since 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.

### **New Accounting Developments.**

**Variable Interest Entities.** In January 2003, the FASB issued FIN 46, which 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 ("VIE") are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. Under FIN 46, 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 (see Note 19 to the 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 engages in these transactions principally 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 U.S. GAAP. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), which includes the credit card asset securitization master trusts (see Note 5 to the consolidated financial statements), the Company does not consolidate the entity.

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. In October 2003, the FASB deferred the effective date of FIN 46 for arrangements with VIEs existing prior to February 1, 2003 to fiscal periods ending after December 15, 2003. In December 2003, the FASB issued a revision of FIN 46 ("FIN 46R") to address certain technical corrections and implementation issues that have arisen. The Company anticipates adopting FIN 46R as of February 29, 2004 for VIEs in which it holds a variable interest that it had acquired before February 1, 2003 in addition to those VIEs for which the Company has previously applied FIN 46. The Company will apply FIN 46R for all variable interests obtained after February 29, 2004. For these variable interests, the Company will

consolidate those VIEs (including financial asset-backed securitization, credit-linked note, structured note, municipal bond trust, equity-linked note and exchangeable trust entities) in which the Company is the primary beneficiary. This accounting change is not expected to have a material effect on the Company's consolidated results of operations or consolidated financial position. In limited instances, the Company may deconsolidate VIEs for which it is not the primary beneficiary as a result of the adoption of FIN 46R. This is further discussed in Note 12 to the consolidated financial statements with respect to the statutory trusts associated with the issuance of preferred securities subject to mandatory redemption.

**Gains and Losses from Extinguishment of Debt.** 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 APB Opinion No. 30 for classification as an extraordinary item. As a result, the Company has reclassified an extraordinary loss from the early extinguishment of certain long-term borrowings of \$30 million, net of income taxes, previously reported in the third quarter of fiscal 2001 to income from operations. The pre-tax loss (\$50 million) was recorded in Other expenses, and the related tax benefit (\$20 million) was recorded in Provision for income taxes.

**Pensions and Other Postretirement Benefits.** In December 2003, the FASB made certain revisions to SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits." The revised statement requires additional disclosures about employers' pension and other postretirement plans while also retaining the disclosures originally required by SFAS No. 132. The new required disclosures include information describing the types of plan assets, investment strategy, measurement dates, plan obligations and cash flows. In addition, the revised statement requires certain disclosures during interim periods. The revised statement is generally effective for fiscal years ending after December 15, 2003. However, the Company has included the disclosures required by the revised statement in Note 15 to the consolidated financial statements.

**Derivative Financial Instruments.** During the fourth quarter of fiscal 2002, the Company adopted the provisions of Emerging Issues Task Force ("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." Under the provisions of EITF Issue No. 02-3, in the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, profit recognition at the inception of an OTC derivative financial instrument is not permitted.

**Stock-Based Compensation.** Effective December 1, 2002, the Company adopted SFAS No. 123, as amended by SFAS No. 148, using the prospective adoption method. The Company now records compensation expense based upon the fair value of stock-based awards (both deferred stock and stock options). In prior years, the Company accounted for its stock-based awards under the intrinsic value approach in accordance with APB 25 (see "Equity-Based Compensation Program" herein and Notes 2 and 14 to the consolidated financial statements).