

# Morgan Stanley

## **Market Risk Capital Disclosures Report**

**For the Quarterly Period Ended June 30, 2014**

# Morgan Stanley

## MARKET RISK CAPITAL DISCLOSURES REPORT

*For the quarterly period ended June 30, 2014*

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**Part I—Overview**

**1 Morgan Stanley**

Morgan Stanley is a global financial services firm that, through its subsidiaries and affiliates, provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. The Company is a financial holding company regulated by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) under the Bank Holding Company Act of 1956, as amended. Unless the context otherwise requires, the terms “Morgan Stanley” or the “Company” mean Morgan Stanley (the “Parent”) together with its consolidated subsidiaries. The Federal Reserve establishes capital requirements for the Company, including well-capitalized standards, and evaluates the Company’s compliance with such capital requirements. The Office of the Comptroller of the Currency (“OCC”) establishes similar capital requirements and standards for Morgan Stanley Bank, N.A. and Morgan Stanley Private Bank, National Association (“U.S. Banks”).

**Part II—Market Risk Capital Disclosures**

**1 Risk-based Capital Guidelines: Market Risk**

The U.S. banking regulators have comprehensively revised their risk-based and leverage capital framework to implement many aspects of the Basel III capital standards established by the Basel Committee on Banking Supervision (“Basel Committee”). The U.S. banking regulators’ revised capital framework is referred to herein as “Basel III.” In July 2013, the U.S. banking regulators issued a final rule to implement many aspects of Basel III (“U.S. Basel III”). Although the Company and its U.S. Banks became subject to the U.S. Basel III beginning on January 1, 2014, certain aspects of the U.S. Basel III will be phased in over several years. Prior to January 1, 2014, the Company and its U.S. Banks calculated regulatory capital ratios using the U.S. banking regulators’ Basel I-based rules as supplemented by rules that implement the Basel Committee’s market risk capital framework amendment, commonly referred to as “Basel 2.5.” The Company became subject to Basel 2.5 on January 1, 2013, which increased the capital requirements for securitizations and correlation trading positions within the Company’s trading book, as well as incorporated add-ons for stressed Value-at-Risk (“VaR”) and incremental risk requirements (“Basel 2.5 market risk capital framework amendment”). On February 21, 2014, the Federal Reserve and the OCC approved the Company’s and its U.S. Banks’ completion of the parallel run process for an advanced internal ratings-based approach for calculating credit risk-weighted assets (“RWAs”) and advanced measurement approaches for calculating operational RWAs, as supplemented by advanced market RWAs calculated under Basel III (the “Advanced Approach”) framework. The U.S. Basel III, including the Advanced Approach, modified the Basel 2.5 market risk capital framework amendment in certain respects. For further discussion of the regulatory capital framework applicable to the Company and the Company’s U.S. Banks and the Company’s required capital, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Regulatory Requirements” in Part I, Item 2 of the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2014 (“Form 10-Q”).

The U.S. Basel III requires banking organizations to make qualitative and quantitative disclosures regarding their market risk capital on a quarterly basis (“Pillar 3 Disclosures for Market Risk”). This report contains the Company’s Pillar 3 Disclosures for Market Risk for the quarter ended June 30, 2014, in accordance with the U.S. Basel III, 12 C.F.R. § 217.212.

The Company’s Pillar 3 Disclosures for Market Risk are not required to be, and have not been, audited by the Company’s independent registered public accounting firm. The Company’s Pillar 3 Disclosures for Market Risk were based on the Company’s current understanding of the U.S. Basel III and other factors, which may be subject to change as the Company receives additional clarification and implementation guidance from regulators relating to the U.S. Basel III, and as the interpretation of the final rule evolves over time. Some measures of exposures contained in this report may not be consistent with accounting principles generally accepted in the United States of America (“U.S. GAAP”), and may not be comparable with measures reported in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013 (“Form 10-K”) and the Form 10-Q.

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**2 Market Risk**

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio. Generally, the Company incurs market risk as a result of trading, investing and client facilitation activities, principally within the Institutional Securities business segment where the substantial majority of the Company's market risk capital is required. In addition, the Company incurs trading-related market risk within the Wealth Management business segment. The Investment Management business segment incurs principally Non-trading market risk primarily from investments in real estate funds and investments in private equity vehicles.

**2.1 Market Risk Capital Charge and RWAs**

The following table presents the total market risk capital charge and RWAs in accordance with the Advanced Approach, categorized by component type.

<u>Components of Market Risk Capital Charge and RWAs</u>	<u>At June 30, 2014</u>	
	<u>Capital Charge</u>	<u>RWAs</u>
	(dollars in millions)	
Regulatory VaR(1).....	\$ 732	\$ 9,153
Regulatory Stressed VaR(2) .....	2,614	32,672
Incremental Risk Charge(2).....	1,286	16,081
Comprehensive Risk Measure(2).....	359	4,484
Total Model-based Charges .....	<u>\$ 4,991</u>	<u>\$ 62,390</u>
Securitization Charge.....	2,429	30,365
Correlation Surcharge .....	944	11,795
Other Standardized Charges(3).....	1,780	22,250
Total Standardized Charges .....	<u>\$ 5,153</u>	<u>\$ 64,410</u>
Total Market Risk .....	<u>\$ 10,144</u>	<u>\$ 126,800</u>

- (1) Per regulatory requirements, the daily average of the previous 60 business days from the period-end date is utilized in the capital equation.  
(2) Per regulatory requirements, the weekly average of the previous 12 weeks from the period-end date is utilized in the capital equation.  
(3) Other Standardized Charges include non-securitization specific risk charges calculated using regulatory-prescribed risk-weighting factors for certain debt and equity positions. The prescribed risk-weighting factors are generally based on, among other things, the Organization for Economic Cooperation and Development's country risk classifications for the relevant home country (in the case of public sector and depository institution debt positions), the remaining contractual maturity and internal assessments of creditworthiness.

**Market RWAs Rollforward**

The following table rolls forward the Company's market RWAs under the Basel 2.5 market risk capital framework amendment at March 31, 2014 to its market RWAs under the U.S. Basel III at June 30, 2014.

<u>Market RWAs Rollforward</u>	<u>Quarter Ended</u>
	<u>June 30, 2014</u>
	(dollars in millions)
Basel 2.5 market RWAs at March 31, 2014 .....	\$ 119,456
Portfolio movement(1).....	(5,311)
Change due to U.S. Basel III(2).....	12,655
Change in market RWAs .....	<u>7,344</u>
U.S. Basel III market RWAs at June 30, 2014 .....	<u>\$ 126,800</u>

- (1) Portfolio movement refers to changes in positions and market movements.  
(2) The publication of the U.S. Basel III resulted in certain impacts to the market RWAs, primarily the removal of credit valuation adjustment ("CVA") hedges as eligible trading positions due to the clarification in the definition of covered position.

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The Company's total market RWAs at June 30, 2014 were \$126,800 million compared to \$119,456 million at March 31, 2014. This increase was primarily driven by the exclusion of CVA hedges from the trading book population as a result of the U.S. Basel III definition of covered position. This was partially offset by a reduction in exposure to credit spread products.

**2.2 Model Methodology and Assumptions**

**Regulatory VaR**

The Company estimates VaR using a model based on volatility-adjusted historical simulation for general market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. The model constructs a distribution of hypothetical daily changes in the value of trading portfolios based on the following: historical observation of daily changes in key market indices or other market risk factors; and information on the sensitivity of the portfolio values to these market risk factor changes. The Company's VaR model uses four years of historical data with a volatility adjustment to reflect current market conditions.

The Company utilizes the same VaR model for both risk management purposes as well as regulatory capital calculations. The portfolio of positions used for the Company's VaR for risk management purposes ("Management VaR") differs from that used for regulatory capital requirements ("Regulatory VaR"), as it contains certain positions which are excluded from Regulatory VaR. Examples include loans that are fair valued and associated hedges, as well as counterparty credit valuation adjustments. Additionally, the Company's Management VaR excludes certain positions contained in its Regulatory VaR, such as hedges to counterparty exposures related to the Company's own credit spread.

For regulatory capital purposes, Regulatory VaR is computed at a 99% level of confidence over a 10-day time horizon. The Company's Management VaR is computed at a 95% level of confidence over a one-day time horizon, which is a useful indicator of possible trading losses resulting from adverse daily market moves. For more information about the Company's Management VaR model, related statistics and limit monitoring process, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Market Risk" in Part II, Item 7A of the Form 10-K and Part I, Item 3 of the Form 10-Q.

The following table presents the period-end, daily average, high and low Regulatory VaR by risk category for a 10-day holding period for the quarter ended June 30, 2014. Additionally, the daily average Regulatory VaR for a one-day holding period is shown for comparison. The metrics below are calculated over the calendar quarter and therefore may not coincide with the period applied in the capital calculations.

**Regulatory VaR Table**

	<b>99% Regulatory VaR</b>				
	<b>Quarter Ended June 30, 2014</b>				
	<b>One-Day Holding Period</b>	<b>10-Day Holding Period</b>			
	<b>Daily Average(1)</b>	<b>Period End</b>	<b>Daily Average(1)</b>	<b>High</b>	<b>Low</b>
	(dollars in millions)				
Interest rate .....	\$ 31	\$ 91	\$ 98	\$ 117	\$ 84
Credit spread.....	47	155	150	165	126
Equity price.....	26	94	81	98	68
Foreign exchange rate.....	16	49	50	83	35
Commodity price .....	30	84	94	111	81
Less: Diversification benefit(2)(3).....	(73)	(212)	(229)	N/A	N/A
<b>Total Regulatory VaR.....</b>	<b>\$ 77</b>	<b>\$ 261</b>	<b>\$ 244</b>	<b>\$ 275</b>	<b>\$ 212</b>

- (1) The daily average shown is calculated over the entire quarter. Per regulatory requirements, the daily average of the previous 60 business days from the period-end date is utilized in the capital calculation.
- (2) Diversification benefit equals the difference between the total Regulatory VaR and the sum of the component VaRs. This benefit arises because the simulated one-day losses for each of the components occur on different days; similar diversification benefits also are taken into account within each component.
- (3) N/A—Not Applicable. The high and low VaR values for the total Regulatory VaR and each of the component VaRs might have occurred on different days during the quarter, and therefore the diversification benefit is not an applicable measure.

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**Regulatory Stressed VaR**

Regulatory Stressed VaR is calculated using the same methodology and portfolio composition as Regulatory VaR. However, Regulatory Stressed VaR is based on a continuous one-year historical period of significant market stress, appropriate to the Company's portfolio. The Company's selection of the one year stressed window is evaluated on an ongoing basis.

The following table presents the period-end, weekly average, high and low Regulatory Stressed VaR for a 10-day holding period for the quarter ended June 30, 2014. Additionally, the average Regulatory Stressed VaR for a one-day holding period is shown for comparison. The metrics below are calculated over the calendar quarter and therefore may not coincide with the period applied in the capital calculations.

**Regulatory Stressed VaR Table**

	99% Regulatory Stressed VaR				
	Quarter Ended June 30, 2014				
	One-Day Holding Period	10-Day Holding Period			
	Weekly Average(1)	Period End	Weekly Average(1)	High	Low
(dollars in millions)					
Total Regulatory Stressed VaR.....	\$ 271	\$ 1,018	\$ 856	\$ 1,018	\$ 675

(1) The weekly average shown is calculated over the entire quarter. Per regulatory requirements, the weekly average of the previous 12 weeks from the period-end date is utilized in the capital calculation.

**Incremental Risk Charge**

The Incremental Risk Charge ("IRC") is an estimate of default and migration risk of unsecuritized credit products in the trading book. The IRC also captures recovery risk, and assumes that average recoveries are lower when default rates are higher. A Monte Carlo simulation-based model is used to calculate the IRC at a 99.9% level of confidence over a one-year time horizon. A constant level of risk assumption is imposed which ensures that all positions in the IRC portfolio are evaluated over the full one-year time horizon.

The IRC model differentiates the underlying traded instruments by liquidity horizons, with the minimum liquidity horizon set to 3 months. Lower rated issuers receive longer liquidity horizons of between 6 and 12 months. In addition to the ratings-based liquidity horizon, the Company also applies liquidity horizon penalties to positions that are deemed concentrated.

The following table presents the period-end, weekly average, high and low IRC for the quarter ended June 30, 2014. The metrics below are calculated over the calendar quarter and therefore may not coincide with the period applied in the capital calculations.

**Incremental Risk Charge Table**

	Quarter Ended June 30, 2014			
	Period End	Weekly Average(1)	High	Low
	(dollars in millions)			
	Total Incremental Risk Charge .....	\$ 1,108	\$ 1,278	\$ 1,424

(1) The weekly average shown is calculated over the entire quarter. Per regulatory requirements, the weekly average of the previous 12 weeks from the period-end date is utilized in the capital calculation.

**Comprehensive Risk Measure**

The Comprehensive Risk Measure ("CRM") is an estimate of risk in the correlation trading portfolio, taking into account credit spread, correlation, basis, recovery and default risks. A Monte Carlo simulation-based model is used to calculate the CRM at a 99.9% level of confidence over a one-year time horizon, applying the constant level of risk assumption.

All positions in the CRM portfolio are given a liquidity horizon of 6 months.

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Positions eligible for CRM are also subject to an 8% capital surcharge, which is referred to as the “Correlation Surcharge” in the Components of Market Risk Capital Charge and RWAs table in Part II, Section 2.1.

The following table presents the period-end, weekly average, high and low CRM for the quarter ended June 30, 2014. The metrics below are calculated over the calendar quarter and therefore may not coincide with the period applied in the capital calculations.

**Comprehensive Risk Measure Table**

	Quarter Ended June 30, 2014			
	Period End	Weekly Average(1)	High	Low
	(dollars in millions)			
Total Comprehensive Risk Measure .....	\$ 359	\$ 315	\$ 359	\$ 291

(1) The weekly average shown is calculated over the entire quarter. Per regulatory requirements, the weekly average of the previous 12 weeks from the period-end date is utilized in the capital calculation.

**2.3 Model Limitations**

The Company uses VaR and Stressed VaR as components in a range of risk management tools. Among their benefits, VaR models permit estimation of a portfolio’s aggregate market risk exposure, incorporating a range of varied market risks and portfolio assets. However, VaR has various limitations, which include, but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behavior or reflect the historical distribution of results beyond the 99% confidence interval; and reporting of losses over a defined time horizon, which does not reflect the risk of positions that cannot be liquidated or hedged over that defined horizon.

The Company also uses IRC and CRM models to measure default and migration risk of credit spread and correlation products in the trading book. Among their benefits, these models permit estimation of a portfolio’s aggregate exposure to default and migration risk, incorporating a range of market risk factors in a period of financial stress. However, the IRC and CRM models have various limitations, which include, but are not limited to: use of historical default rates, credit spread movements, correlation and recovery rates, which may not be accurate predictors of future credit environments, and may not fully incorporate the risk of extreme credit events that are outsized relative to observed historical behavior or reflect the historical distribution of results beyond the 99.9% confidence interval.

Regulatory VaR, Regulatory Stressed VaR, IRC and CRM numbers are not readily comparable across firms because of differences in the firms’ portfolios, modeling assumptions and methodologies. In IRC and CRM, those differences may be particularly pronounced because of the long risk horizon measured by those models as well as the difficulty in performing backtesting. These differences can result in materially different numbers across firms for similar portfolios. As a result, the model-based numbers tend to be more useful when interpreted as indicators of trends in a firm's risk profile rather than as an absolute measure of risk to be compared across firms.

**2.4 Model Validation**

The Company validates its Regulatory VaR model, Regulatory Stressed VaR model, IRC model and CRM model on an ongoing basis. The Company’s model validation process is independent of the internal models’ development, implementation and operation. The validation process includes, among other things, an evaluation of the conceptual soundness of the internal models.

The Company’s Regulatory VaR model, Regulatory Stressed VaR model, IRC model and CRM model have all been approved for use by the Company’s regulators.

**2.5 Regulatory VaR Backtesting**

One method of evaluating the reasonableness of the Company’s VaR model as a measure of the Company’s potential volatility of net revenue is to compare the VaR with the hypothetical buy-and-hold trading revenue. Assuming no intra-day

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trading, for a 99%/one-day VaR, the expected number of times that trading losses should exceed VaR during the year is two to three times, and, in general, if trading losses were to exceed VaR more than ten times in a year, the adequacy of the VaR model would be questioned. For days where losses exceed the VaR statistic, the Company examines the drivers of trading losses to evaluate the VaR model's accuracy relative to realized trading results.

The Company regularly conducts a comparison of its VaR-based estimates with buy-and-hold gains or losses experienced ("backtesting"). The buy-and-hold gains or loss is defined in the U.S. Basel III as profits or losses on covered positions, as defined in Part II, Section 2.6 below, excluding fees, commissions, reserves, net interest income and intraday trading. The buy-and-hold gains or losses utilized for Regulatory VaR backtesting differs from the daily net trading revenue as disclosed in "Quantitative and Qualitative Disclosures about Market Risk—Market Risk" in Part I, Item 3 of the Form 10-Q. The Company had no Regulatory VaR backtesting exceptions during the quarter ended June 30, 2014.

## **2.6 Covered Positions**

### **Composition of Trading Book**

During the quarter ended June 30, 2014, the Company had exposures to a wide range of interest rates, credit spread, equity prices, foreign exchange rates and commodity prices—and the associated implied volatilities and spreads—related to the global markets in which it conducts its trading activities. For more information about such exposures, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Market Risk—Sales and Trading and Related Activities" in Part II, Item 7A of the Form 10-K.

Under U.S. Basel III, covered positions include trading assets or liabilities held by the Company for the purpose of short-term resale or with the intent of benefiting from actual or expected price movements related to its market-making activities, as well as, foreign exchange and commodity exposure of certain banking book assets. CVA is not a covered position under U.S. Basel III and as a result, hedges to the non-covered CVA are themselves not eligible to be covered positions.

The Company manages its covered positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (*e.g.*, futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that is being hedged. The Company manages the market risk associated with its trading activities on a Company-wide basis, on a world-wide trading division level and on an individual product basis. The Company manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Company believes is well-diversified in the aggregate with respect to market risk factors and that reflects the Company's aggregate risk tolerance as established by the Company's senior management.

### **Valuation Policies, Procedures, and Methodologies for Covered Positions**

For more information on the Company's valuation policies, procedures, and methodologies for covered positions (trading assets and trading liabilities), see Note 2 (Significant Accounting Policies) and Note 4 (Fair Value Disclosures) to the consolidated financial statements in Part II, Item 8 of the Form 10-K and Note 4 (Fair Value Disclosures) to the condensed consolidated financial statements in Part I, Item 1 of the Form 10-Q.

## **2.7 Stress Testing of Covered Positions**

The Company stress tests the market risk of its covered positions at a frequency appropriate to each portfolio and in no case less frequently than quarterly. The stress tests take into account concentration risk, illiquidity under stressed market conditions and other risks arising from the Company's trading activities.

In addition, the Company utilizes a proprietary economic stress testing methodology that comprehensively measures the Company's market and credit risk. The methodology simulates many stress scenarios based on more than 25 years of historical data and attempts to capture the different liquidities of various types of general and specific risks. Event and default risks for relevant credit portfolios are also captured.

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Furthermore, as part of the Federal Reserve’s annual Comprehensive Capital Analysis and Review, commonly referred to as “CCAR,” the Company is required to perform annual capital stress testing under scenarios prescribed by the Federal Reserve. The stress testing results are submitted to the Federal Reserve and a summary of the results under the severely adverse economic is publicly disclosed. For more information on the Company’s stress testing, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Regulatory Requirements” in Part II, Item 7 of the Form 10-K and Part I, Item 2 of the Form 10-Q.

**3 Correlation Trading Positions and Securitization Exposures in the Trading Book**

A correlation trading position is a securitization position for which all or substantially all of the value of the underlying exposure is based on the credit quality of a single company for which a two-way market exists, or on commonly traded indices based on such exposures for which a two-way market exists on the indices. Hedges of correlation trading positions are also considered correlation trading positions. At June 30, 2014, the Company’s aggregate CRM eligible correlation trading positions had a Net Market Value<sup>1</sup> of \$4,534 million, which is comprised of net long market values of \$2,788 million and net short market values of \$1,746 million. The net long and net short market values are inclusive of netting permitted under U.S. Basel III.

The Company also engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, municipal bonds and other types of financial instruments. The following table presents the Net Market Value of the Company’s aggregate on-balance sheet and off-balance sheet securitization positions by exposure type, inclusive of hedges, in the trading book:

<u>Exposures</u>	<u>At June 30, 2014</u>
	<u>Net Market Value(1)</u>
	(dollars in millions)
Residential mortgages.....	\$ 3,174
Commercial mortgages.....	1,678
Corporate debt(2).....	2,490
Asset-backed securitizations and other.....	840
Total.....	\$ 8,182

- (1) Net Market Value represents the fair value for cash instruments and the replacement value for derivative instruments.  
(2) Amount includes correlation trading positions that are not CRM eligible.

**3.1 Securitization and Resecuritization Positions**

The Company closely monitors the price, basis and liquidity risk in the covered securitization and resecuritization positions that are held in the trading book. Each position falls into at least one or more trading limits that have been set to limit the aggregate, concentration and basis risk in the portfolio to acceptable levels. Holdings are monitored against these limits on a daily basis.

The inherent market risk of these positions are captured in various risk measurement models including Regulatory VaR, Regulatory Stress VaR and stress loss scenarios which are calculated and reviewed on a daily basis. Further, the Company regularly performs additional analysis to comprehend various risks in its securitization and resecuritization portfolio, and changes in these risks. Analysis is performed in accordance with U.S. Basel III to understand structural features of the portfolio and the performance of underlying collateral.

In addition, the Company uses a variety of hedging strategies to mitigate credit spread and default risk for the securitization and resecuritization positions. Hedging decisions are based on market conditions, and are evaluated within the Company’s risk governance structure.

For general information on the Company’s securitization activities, see “Securitization Activities” in Note 7 (Variable Interest Entities and Securitization Activities) to the consolidated financial statements in Part II, Item 8 of the Form 10-K.

<sup>1</sup> Net Market Value represents the fair value for cash instruments and the replacement value for derivative instruments.