

Morgan Stanley

Regulatory Capital Disclosures Report

For the Quarterly Period Ended September 30, 2013

Morgan Stanley

REGULATORY CAPITAL DISCLOSURES REPORT

For the quarterly period ended September 30, 2013

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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.

Part II—Market Risk Capital Disclosures

1 Risk-based Capital Guidelines: Market Risk

On January 1, 2013, the U.S. banking regulators’ final rules to implement the Basel Committee on Banking Supervision’s market risk capital framework amendment, commonly referred to as “Basel 2.5,” became effective, 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”).

The Company’s market risk capital disclosures contained in this report are required by Section 12 of *Risk-based Capital Guidelines: Market Risk*, published in the Federal Register (Vol. 77, No. 169) on August 30, 2012. The Company’s market risk disclosures required by the U.S. Securities and Exchange Commission (the “SEC”) in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 (the “Form 10-K”) and the Company’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 (the “Form 10-Q”) can be found at http://www.morganstanley.com/about/ir/sec_filings.html.

Measures of exposures and other metrics disclosed in the Company’s Regulatory Capital Disclosures Reports conform to the definitions set out in the Basel 2.5 market risk capital framework amendment. Some measures of exposures 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 Form 10-K or the Form 10-Q. The Company’s Regulatory Capital Disclosures Reports are not required to be, and have not been, audited by the Company’s independent registered public accounting firm.

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 generated. 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 capital investments in real estate funds and investments in private equity vehicles.

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2.1 Market Risk Capital Charge and RWAs

The following table presents the total market risk capital charge and risk-weighted assets (“RWAs”) under the Basel 2.5 market risk capital framework amendment categorized by component type.

<u>Components of Market Risk Capital Charge and RWAs</u>	At September 30, 2013	
	Capital Charge	RWAs
	(dollars in millions)	
Regulatory VaR(1).....	\$ 804	\$ 10,055
Regulatory Stressed VaR(2)	2,628	32,844
Incremental Risk Charge(2).....	1,250	15,621
Comprehensive Risk Measure(2).....	319	3,991
Total Model-based Charges	\$ 5,001	\$ 62,511
Securitization Charge.....	2,778	34,733
Correlation Surcharge	969	12,115
Other Standardized Charges	2,102	26,270
Total Standardized Charges	\$ 5,849	\$ 73,118
Total Market Risk	\$ 10,850	\$ 135,629

(1) Per regulatory requirements, the average of the previous 60 business days from the period end date is utilized in the capital equation.

(2) Per regulatory requirements, the average of the previous 12 weeks from the period end date is utilized in the capital equation.

The Company’s Total Market Risk RWAs at September 30, 2013 were \$135,629 million compared to \$142,966 million at June 30, 2013. This decrease was primarily driven by reduced risk in credit spread products and a reduction in the Company’s correlation portfolio.

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, average, high and low Regulatory VaR by risk category for a 10-day holding period for the quarter ended September 30, 2013. Additionally, the 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.

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Regulatory VaR

99% Regulatory VaR

Quarter Ended September 30, 2013

	One-Day Holding Period		10-Day Holding Period		
	Average(1)	Period End	Average(1)	High	Low
	(dollars in millions)				
Interest rate	\$ 41	\$ 104	\$ 129	\$ 191	\$ 88
Credit spread	56	160	177	227	138
Equity price	25	96	80	204	67
Foreign exchange rate	22	75	69	87	54
Commodity price	36	135	115	151	90
Less: Diversification benefit(2)(3)	(93)	(291)	(294)	N/A	N/A
Total Regulatory VaR	\$ 87	\$ 279	\$ 276	\$ 377	\$ 225

- (1) The averages shown are calculated over the entire quarter. Per regulatory requirements, the 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.

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, average, high and low Regulatory Stressed VaR for a 10-day holding period for the quarter ended September 30, 2013. 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

99% Regulatory Stressed VaR

Quarter Ended September 30, 2013

	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	\$ 282	\$ 991	\$ 893	\$ 1,095	\$ 682

- (1) The weekly average shown is calculated over the entire quarter. Per regulatory requirements, the 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 model also captures recovery risk, and assumes that average recoveries are lower when default rates are higher. The IRC is calculated at a 99.9% level of confidence over a one-year time horizon. A constant level of risk assumption is imposed and 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.

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The following table presents the period end, average, high and low IRC for the quarter ended September 30, 2013. 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

	Quarter Ended September 30, 2013			
	Period End	Weekly Average(1)	High	Low
	(dollars in millions)			
Total Incremental Risk Charge	\$ 795	\$ 1,262	\$ 1,524	\$ 795

(1) The weekly average shown is calculated over the entire quarter. Per regulatory requirements, the 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. The CRM is calculated to 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.

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, average, high and low CRM for the quarter ended September 30, 2013. 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

	Quarter Ended September 30, 2013			
	Period End	Weekly Average(1)	High	Low
	(dollars in millions)			
Total Comprehensive Risk Measure	\$ 313	\$ 324	\$ 382	\$ 253

(1) The weekly average is calculated over the entire quarter. Per regulatory requirements, the 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.

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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 Regulatory Approval of the Company's 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 Validation

The Company validates its VaR model on an ongoing basis. 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 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 could 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 Basel 2.5 market risk capital framework amendment 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 backtesting differs from the daily net trading revenue as disclosed in the Form 10-Q. The Company had no backtesting exceptions during the quarter ended September 30, 2013.

2.6 Covered Positions

Composition of Trading Book

During the quarter ended September 30, 2013, 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.

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. In addition to positions deemed a trading asset or liability, the foreign exchange and commodity exposure of certain banking book assets are also considered covered positions under the Federal Reserve's Basel 2.5 market risk capital framework amendment.

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 worldwide 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.

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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 Notes 2 (Significant Accounting Policies) and 4 (Fair Value Disclosures) to the consolidated financial statements in the Form 10-K and Note 4 (Fair Value Disclosures) to the condensed consolidated financial statements in 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.

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 September 30, 2013, the Company's aggregate CRM eligible correlation trading positions had a Net Market Value¹ of \$2,370 million, which is comprised of net long market values of \$1,220 million and net short market values of \$1,150 million. The net long and net short market values are inclusive of netting permitted under the Basel 2.5 market risk capital framework amendment.

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 September 30, 2013</u> <u>Net Market Value(1)</u> (dollars in millions)
Residential mortgages.....	\$ 3,511
Commercial mortgages.....	2,026
Corporate debt(2).....	608
Asset-backed securitizations and other.....	1,284
Total.....	\$ 7,429

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

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 the Form 10-K.

¹ Net Market Value represents the fair value for cash instruments and the replacement value for derivative instruments.

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Part III—Other Regulatory Capital Disclosures

1 Capital Structure

The Company calculates its capital ratios and RWAs in accordance with the capital adequacy standards for financial holding companies adopted by the Federal Reserve. These standards are based upon a framework described in the “International Convergence of Capital Measurement and Capital Standards,” July 1988, as amended, also referred to as Basel I. The Company’s risk-based capital and RWAs contained in this report for the quarter ended September 30, 2013 reflect the Basel 2.5 market risk capital framework amendment.

The following table reconciles the Company’s total shareholders’ equity to Tier 1 common capital, Tier 1 capital, Tier 2 capital and Total allowable capital as defined by the current regulations issued by the Federal Reserve and presents the Company’s consolidated capital ratios at September 30, 2013.

	<u>At</u> <u>September 30, 2013</u> (dollars in millions)
Allowable capital	
Common shareholders’ equity	\$ 62,758
Less: Goodwill	(6,591)
Less: Non-servicing intangible assets	(3,507)
Less: Net deferred tax assets	(3,592)
After-tax debt valuation adjustment	1,034
Other deductions	(1,406)
Tier 1 common capital	\$ 48,696
Qualifying preferred stock	2,370
Qualifying restricted core capital elements	7,837
Tier 1 capital	\$ 58,903
Qualifying subordinated debt and restricted core capital elements	3,722
Other qualifying amounts	289
Other deductions	(859)
Tier 2 capital	\$ 3,152
Total allowable capital	\$ 62,055
Risk-weighted assets	
Market risk	\$ 135,629
Credit risk	250,035
Total	\$ 385,664
Capital ratios	
Total capital ratio	16.1%
Tier 1 common capital ratio	12.6%
Tier 1 capital ratio	15.3%
Tier 1 leverage ratio	7.3%

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The following table presents the changes in Tier 1 common capital, Tier 1 capital and Tier 2 capital calculated under Basel I, inclusive of the Basel 2.5 market risk capital framework amendment, for the quarter ended September 30, 2013.

	<u>Quarter Ended</u> <u>September 30, 2013</u> (dollars in millions)
Tier 1 common capital	
Balance at June 30, 2013	\$ 47,603
Additional paid-in capital	302
Net income applicable to Morgan Stanley	906
Dividends	(124)
Change in accumulated other comprehensive loss	155
Net issuance of treasury stock	(154)
Net increase in common shareholders' equity	\$ 1,085
Change in goodwill	9
Change in non-servicing intangible assets	87
Change in net deferred tax assets	(46)
Change in after-tax debt valuation adjustment	121
Change in other deductions	(163)
Balance at September 30, 2013	<u>\$ 48,696</u>
Tier 1 capital	
Balance at June 30, 2013	\$ 56,780
Net increase in Tier 1 common capital	1,093
Change in qualifying preferred stock	862
Change in qualifying restricted core capital elements	168
Balance at September 30, 2013	<u>\$ 58,903</u>
Tier 2 capital	
Balance at June 30, 2013	\$ 3,207
Change in qualifying subordinated debt and restricted core capital elements	(8)
Change in other qualifying amounts	54
Change in other deductions	(101)
Balance at September 30, 2013	<u>\$ 3,152</u>
Total allowable capital at September 30, 2013	<u><u>\$ 62,055</u></u>

For further information about the Company's regulatory capital requirements, see "Liquidity and Capital Resources—Regulatory Requirements—Capital" in Part I, Item 2 of the Form 10-Q.

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2 Index of Risk and Capital Disclosures

The Company's market risk capital disclosures contained in this report are required by Section 12 of *Risk-based Capital Guidelines: Market Risk*, published in the Federal Register (Vol. 77, No. 169) on August 30, 2012. The Company's market risk disclosures required by the SEC in the Form 10-K and the Form 10-Q can be found at http://www.morganstanley.com/about/ir/sec_filings.html.

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The following table presents an index of the Company's risk and capital disclosures in the 2012 Annual Report on Form 10-K, the Form 10-Q and Regulatory Capital Disclosures Report for the quarterly period ended September 30, 2013.

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