

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

### **Introduction.**

Morgan Stanley Dean Witter & Co. (the "Company") is a global financial services firm that maintains leading market positions in each of its three business segments—Securities, Investment Management and Credit Services. The Company's Securities business includes securities underwriting and distribution; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; full-service brokerage services; 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, including private equity activities; and aircraft financing activities. The Company's Investment Management business provides global asset management products and services for individual and institutional investors through three principal distribution channels: 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 Credit Services business includes the issuance of the Discover® Classic Card, the Discover Gold Card, the Discover Platinum Card, the Morgan Stanley Card<sup>SM</sup> and other proprietary general purpose credit cards; and the operation of Discover Business Services, a proprietary network of merchant and cash access locations in the U.S.

The Company's results of operations for the 12 months ended November 30, 2001 ("fiscal 2001"), November 30, 2000 ("fiscal 2000") and November 30, 1999 ("fiscal 1999") are discussed below.

### **Results of Operations.**

#### **Certain Factors Affecting Results of Operations.**

The Company's results of operations may be materially affected by market fluctuations and by economic factors. In addition, results of operations in the past have been, and in the future may continue to be, materially affected by many factors of a global nature, including 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 (such as the use of the Internet to conduct electronic commerce and the use of electronic communications trading networks); the availability and cost of credit; inflation; investor sentiment; and legislative, legal and regulatory developments (see also "Terrorist Attacks" herein). Such factors also may have an impact on the Company's ability to achieve its strategic objectives on a global basis, including (without limitation) increased market share in its securities activities, growth in assets under management and the expansion of its Credit Services business.

The Company's Securities business, particularly its involvement in primary and secondary markets for all types of financial products, including derivatives, is subject to substantial positive and negative fluctuations due to a variety of factors that cannot be predicted with great certainty, including variations in the fair value of securities and other financial products and the volatility and liquidity of global trading markets. Fluctuations also occur due to the level of global market activity, which, among other things, affects the size, number and timing of investment banking client assignments and transactions and the realization of returns from the Company's private equity and other principal investments. 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 Securities business are the quality of its professionals and other personnel, its products and services, relative pricing and innovation. Competition in the Company's Investment Management business is affected by a number of factors, including investment objectives and performance; advertising and sales promotion efforts; and the level of fees, distribution channels, and types and quality of services offered. In the Credit Services business, competition centers on merchant acceptance of credit cards, credit cardmember acquisition and customer utilization of credit cards, all of which are impacted by the types of fees, interest rates and other features offered.

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

As a result of the above economic and competitive factors, net income and revenues in any particular period may not be representative of full-year results and may vary significantly from year to year and from quarter to quarter. The Company intends to manage its business for the long term and to mitigate the potential effects of market downturns by strengthening its competitive position in the global financial services industry through diversification of its revenue sources, enhancement of its global franchise and management of costs. The Company's overall financial results will continue to be affected by its ability and success in maintaining high levels of profitable business activities, emphasizing fee-based products that are designed to generate a continuing stream of revenues, evaluating credit product pricing, and managing risks and costs. In addition, the complementary trends in the financial services industry of consolidation and globalization present, among other things, technological, risk management and other infrastructure challenges that will require effective resource allocation in order for the Company to remain competitive.

#### **Global Market and Economic Conditions in Fiscal 2001.**

Global market and economic conditions during fiscal 2001 were significantly less favorable compared with those experienced during the prior fiscal year. The level of global economic activity declined throughout fiscal 2001, as the world's major economies, including the U.S., Japan and the European region, all experienced difficulties. These conditions contributed to sharp declines in the global equity markets, as well as lower levels of investment banking activity and retail investor participation in the financial markets. Such conditions were exacerbated by the terrorist attacks on the U.S. that occurred on September 11, 2001 (see "Terrorist Attacks" herein). It currently is not clear when these market and economic conditions will improve.

These conditions adversely affected the Company's fiscal 2001 results of operations, as the net income of each of its three business segments (Securities, Investment Management and Credit Services) declined from the record levels achieved in fiscal 2000. The Company's Securities business recorded lower revenues from its investment banking, institutional sales and trading, and individual securities activities in fiscal 2001 as compared with fiscal 2000. The decline in revenues in the Company's Investment Management business reflected a decrease in customer assets under management or supervision, while the Company's Credit Services business recorded lower net credit income due to higher charge-offs (see "Business Segments" herein).

In the U.S., market and economic conditions were difficult during fiscal 2001. Although the level of consumer spending remained steady for most of fiscal 2001, the rate of U.S. economic growth declined significantly, primarily reflecting lower levels of corporate investment and production. The reduced economic activity, coupled with lower corporate earnings and uncertainty about future business prospects, led to higher levels of unemployment and decreased consumer confidence. These conditions, as well as the reduction in the level of overall global economic activity, contributed to the declines experienced by U.S. equity markets. The terrorist attacks of September 11, 2001 placed additional pressure on the U.S. economy and financial markets in the fourth quarter of fiscal 2001 (see “Terrorist Attacks” herein). In response to these conditions, during fiscal 2001 the Federal Reserve Board (the “Fed”) aggressively eased interest rates in order to stimulate economic activity and to avoid a recession. In 10 separate actions, the Fed lowered both the overnight lending rate and the discount rate by an aggregate of 4.5%. Subsequent to fiscal year-end, in December 2001 the Fed lowered both the overnight lending rate and the discount rate by an additional 0.25%.

Economic and market conditions also were difficult in Europe during fiscal 2001. The European region experienced lower levels of employment and industrial production, which was partially attributable to the slowdown in U.S. economic growth and the weakened global economy. As a result, the majority of equity market indices within the region declined during fiscal 2001. In response to these conditions, as well as increased indications of slowing economic growth within the European Union, particularly in Germany, the European Central Bank (the “ECB”) lowered the benchmark interest rate within the European Union by an aggregate of 1.5% in four separate actions during fiscal 2001. The U.K. also was adversely affected by the difficult conditions in the global economy during fiscal 2001, which contributed to the decline in the nation’s equity markets. Indications of weakened domestic demand, business activity and investment growth prompted the Bank of England to lower the benchmark interest rate by an aggregate of 2.0% in seven separate actions during fiscal 2001.

Economic and market conditions also were weak in the Far East during fiscal 2001. In Japan, financial markets continued to be adversely impacted by the worsening condition of the nation’s economy. Throughout the year, the deceleration of global economic growth negatively impacted the level of Japan’s exports, industrial production, corporate earnings and investment. In addition, consumer spending was sluggish, reflecting an increased unemployment rate and a decline in consumer confidence. In an effort to mitigate these conditions, the Bank of Japan lowered the official discount rate by an aggregate of 0.4% in three separate actions during fiscal 2001. Conditions elsewhere in the Far East also were difficult during fiscal 2001, as the region’s export and production levels continued to be adversely impacted by the difficult conditions in Japan and by the overall global economic slowdown.

The decline in the worldwide market for mergers and acquisitions that began in mid-2000 steepened considerably during fiscal 2001, as economic growth slowed in both the U.S. and Europe and the level of corporate earnings declined. Activity continued to be diverse in terms of regional and industry breadth, reflecting the continuing need for consolidation and globalization in a variety of industries, including the financial services, the natural resources and the technology, media and telecommunications sectors. However, the number of transactions and the average transaction size fell significantly during fiscal 2001 as compared with fiscal 2000, as many companies responded to the difficult market and economic conditions by changing their focus from expansion to cost reduction.

The worldwide market for equity underwriting transactions was adversely affected by the significant uncertainty in the global financial markets, which contributed to a significant decline in transaction volume as compared with the prior year. In contrast, the market for fixed income underwritings was generally strong during fiscal 2001. The higher transaction volume primarily was attributable to the favorable global interest rate environment, as the major central banks reduced interest rates throughout fiscal 2001. As a result, many issuers took advantage of lower borrowing costs.

U.S. consumer demand and spending were resilient for much of fiscal 2001. However, toward the end of the year consumer confidence declined following the reduction in personal wealth, rising unemployment and general economic concerns. Consumer confidence was further weakened following the terrorist attacks of September 11, 2001 (see “Terrorist Attacks” herein), which significantly depressed consumer spending in the fourth quarter of fiscal 2001. There also was a rise in personal bankruptcy filings during fiscal 2001.

#### **Fiscal 2001 and Fiscal 2000 Results of the Company.**

The Company recorded net income of \$3,521 million in fiscal 2001, a 35% decrease from fiscal 2000. In fiscal 2000, the Company’s net income was \$5,456 million, an increase of 14% from fiscal 1999. Fiscal 2001’s net income included an extraordinary loss of \$30 million associated with the early extinguishment of certain long-term borrowings. Fiscal 2001’s net income also included a charge of \$59 million for the cumulative effect of an accounting change associated with the Company’s adoption, on December 1, 2000, of Statement of Financial Accounting Standards (“SFAS”) No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended. Excluding the extraordinary item and the cumulative effect of the accounting change, the Company’s net income for fiscal 2001 was \$3,610 million, a decrease of 34% from fiscal 2000.

The Company’s income tax rate was 36.5%, 36% and 38% in fiscal 2001, fiscal 2000 and fiscal 1999, respectively. The tax rate in fiscal 2001 was relatively unchanged from the prior year. The decrease in fiscal 2000 primarily reflected reduced U.S. state and local taxes.

Basic earnings per common share decreased 35% to \$3.21 in fiscal 2001 and increased 14% to \$4.95 in fiscal 2000. Excluding the extraordinary loss and the impact of the cumulative effect of an accounting change noted above, fiscal 2001’s basic earnings per common share were \$3.29. Diluted earnings per common share decreased 34% to \$3.11 in fiscal 2001 and increased 15% to \$4.73 in fiscal 2000. Excluding the extraordinary loss and the impact of the cumulative effect of an accounting change, fiscal 2001’s diluted earnings per common share were \$3.19.

The Company’s return on average common shareholders’ equity (excluding the extraordinary loss and the cumulative effect of the accounting change for fiscal 2001) was 19%, 31% and 33% in fiscal 2001, fiscal 2000 and fiscal 1999, respectively.

At November 30, 2001, the Company had approximately 61,000 employees worldwide, a decrease of 2% from November 30, 2000. The reduction in staffing levels reflected the Company’s efforts to manage costs in light of the weakened global economy and reduced business activity.

#### **Business Acquisitions and Disposition.**

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

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

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

payments and purchase price adjustments during fiscal 2000, the Company recorded an additional pre-tax gain of \$35 million related to the sale of its Global Custody business.

In fiscal 1999, the Company acquired Morgan Stanley, S.V., S.A. (formerly AB Asesores), the largest independent financial services firm in Spain. The Company's fiscal 1999 results include the operations of Morgan Stanley, S.V., S.A. since March 25, 1999, the date of acquisition.

### **Terrorist Attacks.**

On September 11, 2001, the U.S. experienced terrorist attacks targeted against New York City and Washington, D.C. The attacks in New York resulted in the destruction of the World Trade Center complex, where approximately 3,700 of the Company's employees were located, and the temporary closing of the debt and equity financial markets in the U.S. Through the implementation of its business recovery plans, the Company relocated its displaced employees to other facilities.

The terrorist attacks had an immediate adverse impact on global economies, financial markets and certain industries, including the global aviation industry. These conditions had an adverse impact on the Company's results of operations in the fourth quarter of fiscal 2001, including an asset impairment charge and higher expenses associated with its aircraft financing activities. In addition to the immediate impact, there is much uncertainty regarding the potential long-term impact of these attacks. In the future, fears of global recession, war and additional acts of terrorism in the aftermath of the September 11, 2001 attacks may continue to impact global economies and financial markets.

During the fourth quarter of fiscal 2001, the Company recorded costs related to the terrorist attacks, which were offset by an expected insurance recovery. These costs and the related expected insurance recovery pertain to write-offs of leasehold improvements and destroyed technology and telecommunications equipment in the World Trade Center complex, employee relocation and certain employee-related expenditures, and other business recovery costs.

### **Business Segments.**

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

The accompanying Credit Services business segment information includes the operating results of Morgan Stanley Dean Witter Credit Corporation ("MSDWCC"), the Company's provider of mortgage and other consumer lending services. Prior to fiscal 2001, the Company included MSDWCC's results within its Securities business segment. In addition, the operating results of the Investment Management business segment includes certain revenues and expenses associated with the Company's Investment Consulting Services ("ICS") business. Prior to fiscal 2001, such revenues and expenses were included within the Company's Securities business segment. The segment data for all periods presented have been restated to reflect these changes. Certain reclassifications have been made to prior-period amounts to conform to the current year's presentation.

### **Critical Accounting Policies.**

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

**Fair Value.** Financial instruments, including derivatives, used in the Company's trading activities are recorded at fair value, and unrealized gains and losses are reflected in principal trading revenues. Fair values are based on listed market prices, where possible. If listed market prices are not available or if the liquidation of the Company's positions would reasonably be expected to impact market prices, fair value is determined based on other relevant factors, including dealer price quotations and price quotations for similar instruments traded in different markets, including markets located in different geographic areas. Fair values for certain derivative contracts are derived from pricing models that consider current market and contractual prices for the underlying financial instruments or commodities, as well as time value and yield curve or volatility factors underlying the positions.

Pricing models and their underlying assumptions impact the amount and timing of unrealized gains and losses recognized, and the use of different pricing models or assumptions could produce different financial results. Changes in the fixed income, equity, foreign exchange and commodity markets will impact the Company's estimates of fair value in the future, potentially affecting principal trading revenues. To the extent financial contracts have extended maturity dates, the Company's estimates of fair value may involve greater subjectivity due to the lack of transparent market data available upon which to base modeling assumptions. The illiquid nature of certain securities or debt instruments (such as certain high-yield debt securities, certain collateralized mortgage obligations and mortgage-related loan products, bridge financings, and certain senior secured loans and positions) also requires a high degree of judgment in determining fair value due to the lack of listed market prices and the potential impact of the liquidation of the Company's position on market prices, among other factors.

**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 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 on 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 and is regularly evaluated by the Company for adequacy by taking into consideration factors such as changes in the nature and volume of the loan portfolio; trends in actual and forecasted portfolio credit quality, including delinquency, charge-off and bankruptcy rates; and current economic conditions that may affect a borrower's ability to pay. The use of different estimates or assumptions could produce different provisions for consumer loan losses.

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

	Fiscal 2001	Fiscal 2000	Fiscal 1999
Revenues:			
Investment banking .....	\$ 3,362	\$ 4,881	\$ 4,430
Principal transactions:			
Trading .....	5,501	7,361	5,796
Investments .....	(311)	133	712
Commissions .....	3,116	3,605	2,751
Asset management, distribution and administration fees .....	1,830	1,898	1,302
Interest and dividends .....	21,464	18,256	12,506
Other .....	483	457	221
Total revenues .....	35,445	36,591	27,718
Interest expense .....	<u>19,531</u>	<u>16,784</u>	<u>11,590</u>
Net revenues .....	<u>15,914</u>	<u>19,807</u>	<u>16,128</u>
Non-interest expenses:			
Compensation and benefits .....	7,927	9,464	7,153
Occupancy and equipment .....	716	609	483
Brokerage, clearing and exchange fees .....	496	425	378
Information processing and communications .....	1,026	958	731
Marketing and business development .....	507	678	488
Professional services .....	837	815	583
Other .....	775	611	488
Total non-interest expenses .....	12,284	13,560	10,304
Income before income taxes, extraordinary item and cumulative effect of accounting change .....	3,630	6,247	5,824
Provision for income taxes .....	<u>1,267</u>	<u>2,193</u>	<u>2,167</u>
Income before extraordinary item and cumulative effect of accounting change .....	2,363	4,054	3,657
Extraordinary item .....	(30)	—	—
Cumulative effect of accounting change .....	(46)	—	—
Net income .....	<u>\$ 2,287</u>	<u>\$ 4,054</u>	<u>\$ 3,657</u>

Securities provides a wide range of financial products, services and investment advice to individual and institutional investors. Securities business activities are conducted in the U.S. and throughout the world and include investment banking, institutional sales and trading, full-service brokerage services, private equity and other principal investing activities, and aircraft financing activities. At November 30, 2001, the Company's financial advisors provided securities and investment services to approximately 5.6 million client accounts in the U.S. and had client assets of \$595 billion. The Company had the second largest financial advisor sales organization in the U.S. On a global basis, the Company had 13,690 professional financial advisors at November 30, 2001.

Securities achieved net revenues of \$15,914 million and net income of \$2,287 million in fiscal 2001, decreases of 20% and 44%, respectively, from fiscal 2000. Securities net income for fiscal 2001 included an extraordinary loss of \$30 million associated with the early extinguishment of certain long-term borrowings. Securities net income for fiscal 2001 also included a charge of \$46 million from the cumulative effect of an accounting change associated with the Company's adoption of SFAS No. 133 on December 1, 2000. Excluding the extraordinary

loss and the cumulative effect of the accounting change, Securities net income for fiscal 2001 was \$2,363 million, a decrease of 42% from fiscal 2000. The decreases in net revenues and net income in fiscal 2001 were primarily attributable to lower revenues from the Company's investment banking, institutional sales and trading, and individual securities activities, partially offset by lower levels of incentive-based compensation expense. The decrease in net revenues and net income also reflected principal investment losses in fiscal 2001 as compared with principal investment gains in fiscal 2000, as well as a higher level of expenses associated with the Company's aircraft financing business. In fiscal 2000, Securities had record net revenues and net income, which increased 23% and 11%, respectively, from fiscal 1999. In fiscal 2000, the levels of net revenues and net income in the Company's Securities business reflected a strong global market for mergers and acquisitions and securities underwritings, higher principal trading and commission revenues, higher customer trading volume, and an increased level of client accounts and asset balances. Fiscal 2000's results reflected increased costs for incentive-based compensation, as well as increased non-compensation expenses associated with a higher level of global business activities and employees. Fiscal 2000's results also were negatively affected by more difficult economic and market conditions during the latter half of the year, which reduced the volume of merger and acquisition and underwriting transactions and contributed to a more difficult trading environment. In fiscal 2000, declines in certain equity markets also resulted in unrealized losses in the Company's private equity business.

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

	Fiscal 2001	Fiscal 2000	Fiscal 1999
	(dollars in millions)		
Advisory fees from merger, acquisition and restructuring transactions .....	\$1,420	\$2,141	\$1,895
Equity underwriting revenues .....	847	1,739	1,267
Fixed income underwriting revenues .....	1,095	1,001	1,268
<b>Total investment banking revenues .....</b>	<b>\$3,362</b>	<b>\$4,881</b>	<b>\$4,430</b>

Investment banking revenues decreased 31% in fiscal 2001 from the record level attained in fiscal 2000. Revenues in fiscal 2001 reflected lower revenues from equity underwriting transactions and merger, acquisition and restructuring activities, partially offset by higher fixed income underwriting revenues. In fiscal 2000, the 10% increase in investment banking revenues reflected higher advisory fees from merger, acquisition and restructuring transactions and increased revenues from underwriting equity securities, partially offset by lower revenues from underwriting fixed income securities.

Conditions in the worldwide merger and acquisition markets were generally unfavorable in fiscal 2001. There was \$1.7 trillion of transaction activity announced during calendar year 2001 (according to Thomson Financial), a decrease of 51% from calendar year 2000's record volume. During calendar year 2001, the Company's volume of announced merger and acquisition transactions was approximately \$461 billion, as compared with approximately \$1,100 billion in the prior year. The decline primarily reflected the difficult global market and economic conditions that existed during fiscal 2001. In addition, the declines in the global equity markets reduced the purchasing power of potential acquirers. Sharp declines in the volume of merger and acquisition transaction activity were experienced across many industries and geographic locations and had a negative impact on advisory fees, which decreased 34% in fiscal 2001. Given current market and economic conditions, it is uncertain at what pace merger, acquisition and restructuring transactions will occur in future periods. The 13% increase in advisory fees in fiscal 2000 reflected high transaction volumes resulting from the strong global market for merger, acquisition and restructuring activities primarily in the technology, media and telecommunications sectors.

Equity underwriting revenues decreased 51% in fiscal 2001, primarily reflecting a significantly lower volume of equity offerings in the global equity markets, principally in the U.S. and Europe. The decline in new issue volume in fiscal 2001 primarily reflected the difficult conditions in the global equity markets, particularly in the

technology, media and telecommunications sectors. The decrease was partially offset by a record level of revenues from underwriting convertible securities. However, given current economic and market conditions, it is uncertain at what pace equity underwriting transactions will occur in future periods. Equity underwriting revenues increased 37% in fiscal 2000, reflecting the Company's strong global market share. In fiscal 2000, equity underwriting revenues also benefited from a high volume of equity issuances, particularly in the technology, telecommunications and energy sectors. However, new issue volume declined toward the end of fiscal 2000 due to difficult conditions in the global financial markets, including reduced investor confidence.

Fixed income underwriting revenues increased 9% in fiscal 2001. The volume of fixed income underwriting transactions reflected a lower interest rate environment in both the U.S. and Europe, resulting in issuers taking advantage of historically low yields rendered by the Fed's and the ECB's interest rate actions. The volume of fixed income underwriting transactions was generally strong throughout fiscal 2001, particularly in investment grade products and structured credit transactions. Revenues from fixed income underwriting decreased 21% in fiscal 2000, as the volume of fixed income underwriting transactions was adversely affected by a higher interest rate environment in both the U.S. and Europe, resulting in higher borrowing costs. In fiscal 2000, revenues from underwriting global high-yield fixed income securities declined significantly, reflecting difficult conditions in this market sector. In addition, investor demand for these securities declined due to heightened concerns over credit quality. Revenues from underwriting derivative fixed income products also declined. These decreases were partially offset by higher revenues from securitized debt issuances, resulting from an increased volume of asset-backed transactions.

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

Principal transaction trading revenues were as follows:

	Fiscal 2001	Fiscal 2000	Fiscal 1999
	(dollars in millions)		
Equities .....	\$3,110	\$4,705	\$3,065
Fixed income .....	1,319	1,728	1,903
Foreign exchange .....	373	349	397
Commodities .....	699	579	431
Total principal transaction trading revenues .....	<u>\$5,501</u>	<u>\$7,361</u>	<u>\$5,796</u>

Principal transaction trading revenues decreased 25% in fiscal 2001, primarily reflecting lower equity and fixed income trading revenues, partially offset by higher commodity and foreign exchange trading revenues. Principal transaction trading revenues increased 27% in fiscal 2000, primarily reflecting higher equity and commodity trading revenues, partially offset by a decline in fixed income and foreign exchange trading revenues.

Equity trading revenues decreased 34% in fiscal 2001, primarily reflecting lower revenues from trading cash and derivative equity products. Despite higher customer trading volumes in both listed and over-the-counter securities, conditions in the equity markets were generally less favorable in comparison with fiscal 2000, primarily in the U.S. and Europe. In particular, the level of market volatility was significantly lower in fiscal 2001 as compared with fiscal 2000, especially in the technology sector. The decline in equity trading revenues also reflected lower new issue volume, lower levels of cash flows into equity mutual funds, increased margin pressure resulting from the decimalization of the quoted price of certain U.S. equity securities and lower

revenues from certain proprietary trading activities. In fiscal 2000, equity trading revenues increased 54% to a record level, reflecting higher revenues from both cash and derivative equity products. Higher revenues from trading in equity cash products were primarily driven by significantly increased levels of customer trading volumes and volatility in both over-the-counter and listed securities, particularly in the U.S. and Europe. Revenues from equity derivative products benefited from these conditions as well. Higher revenues from certain proprietary trading activities also contributed significantly to the increase in equity trading revenues.

Fixed income trading revenues decreased 24% in fiscal 2001. The decrease primarily reflected lower revenues from trading global high-yield fixed income products, including both debt and loan instruments. The difficult market and economic conditions that existed during fiscal 2001 adversely affected certain high-yield issuers, which resulted in markdowns of certain positions. Lower revenues from swaps trading also contributed to the decrease. These declines were partially offset by higher revenues from trading investment grade and structured fixed income products. In fiscal 2000, fixed income trading revenues decreased 9%, primarily reflecting lower revenues from global high-yield and investment grade fixed income securities. Trading revenues from global high-yield fixed income securities decreased significantly due to lighter trading activity and decreased market liquidity, which resulted in markdowns of certain high-yield positions. During fiscal 2000, several high-yield issuers experienced financial difficulties, triggering an increased number of credit downgrades and defaults, particularly in the telecommunications sector. Revenues from investment grade fixed income securities also declined, reflecting more difficult market conditions, which resulted in reduced liquidity and widening credit spreads. These decreases were partially offset by higher revenues from trading derivative and government agency products.

Foreign exchange revenues increased 7% in fiscal 2001, reflecting higher levels of customer trading volumes and volatility in the foreign exchange markets in both the U.S. and Europe. The higher level of volatility in the foreign exchange markets primarily reflected the Fed's interest rate actions during fiscal 2001 and the euro's rally relative to the U.S. dollar during the first half of fiscal 2001. In fiscal 2000, foreign exchange revenues decreased 12%, reflecting lower levels of trading volumes and volatility in the global foreign exchange markets. Trading volumes were negatively affected by the exit of certain hedge funds from the foreign exchange market and by reduced liquidity in the Japanese yen and euro markets.

Commodity trading revenues increased 21% to a record level in fiscal 2001. The increase was primarily driven by higher revenues from electricity and natural gas trading, which benefited from periods of heightened price volatility. The volatility in electricity and natural gas prices primarily resulted from periodic regional energy shortages, as well as fluctuations in the level of demand due to changing weather conditions. Higher revenues from metals trading also contributed to the increase, as these markets rallied after September 11, 2001. Commodity trading revenues rose 34% in fiscal 2000, primarily driven by higher revenues from certain energy-related products, including electricity, natural gas and crude oil. Trading revenues from energy-related products benefited from periods of rising prices and increased volatility across the entire energy sector. Such conditions were primarily attributable to low inventory levels, strong demand and concerns regarding the adequacy of production levels.

Principal transaction investment losses aggregating \$311 million were recognized in fiscal 2001 as compared with gains of \$133 million in fiscal 2000. Fiscal 2001's results included unrealized losses in the Company's private equity portfolio and certain other principal investments, primarily reflecting difficult market conditions in the technology and telecommunications sectors. Fiscal 2000's revenues included realized gains from certain of the Company's private equity investments, including Commerce One, Inc. and Equant N.V., as well as gains from the Company's other principal investment activities. These gains were partially offset by unrealized losses in the private equity business, reflecting difficult market conditions in the technology, telecommunications and Internet sectors in the latter half of the fiscal year.

Securities purchased in principal investment transactions generally are held for appreciation and are not readily marketable. It is not possible to determine when the Company will realize the value of such investments since,

among other factors, such investments are generally subject to sales restrictions. Moreover, estimates of the eventual realizable value of the investments involve significant judgment and may fluctuate significantly over time in light of business, market, economic and financial conditions generally or in relation to specific transactions.

**Commissions.** Commission revenues primarily arise from agency transactions in listed and over-the-counter equity securities and sales of mutual funds, futures, insurance products and options. Commission revenues decreased 14% in fiscal 2001, primarily due to lower commission revenues in the U.S., reflecting a significant decline in the level of retail investor participation in the equity markets as compared with the prior year. Lower institutional commissions from markets in Japan and elsewhere in the Far East also contributed to the decrease. The decline in fiscal 2001 was partially offset by higher institutional commissions from European markets, benefiting from higher trading volumes, and higher revenues associated with exchange traded funds. Commission revenues increased 31% in fiscal 2000, primarily reflecting higher revenues from equity cash products from markets in Europe, the U.S. and the Far East. Revenues from European markets benefited from a significant increase in market volumes, particularly in the technology and telecommunications sectors. In the U.S., trading volumes on the New York Stock Exchange and the NASDAQ increased to record levels. Commission revenues from markets in Japan and elsewhere in the Far East increased as improved economic prospects within the region during the first half of fiscal 2000 increased investor interest and led to higher transaction volumes. In fiscal 2000, commission revenues also benefited from higher sales of mutual funds and growth in the number of the Company's financial advisors.

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

**Net Interest.** Interest and dividend revenues and interest expense are a function of the level and mix of total assets and liabilities, including financial instruments owned, reverse repurchase and repurchase agreements, trading strategies associated with the Company's institutional securities business, customer margin loans and the prevailing level, term structure and volatility of interest rates. Interest and dividend revenues and interest expense are integral components of trading activities. In assessing the profitability of trading activities, the Company views net interest, commissions and principal trading 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. 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. Net interest revenues increased 31% in fiscal 2001 and 61% in fiscal 2000, primarily reflecting the level and mix of interest earning assets and interest bearing liabilities (including liabilities associated with the Company's aircraft financing activities) during the respective periods as well as certain trading strategies utilized in the Company's institutional securities business. The increase in fiscal 2001 was primarily due to certain trading strategies utilized in the Company's institutional securities business, including higher net interest revenues from the Company's repurchase financing activities, which reflected a favorable interest rate environment. Higher average inventory balances of U.S. government and agency securities also contributed to the increase in net interest revenues. The increase was partially offset by a decrease in net interest revenues from brokerage services provided to both institutional and individual customers, including a decrease in the level of customer margin loans. In fiscal 2000, higher net interest revenues from brokerage services provided to institutional and individual customers, including an increase in the level of customer margin loans, had a positive impact on net interest revenues.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees include revenues from asset management services, including fees for promoting and distributing mutual funds (“12b-1 fees”) and fees for investment management services provided to segregated customer accounts pursuant to various contractual arrangements in connection with the Company’s ICS business. The Company receives 12b-1 fees for services it provides in promoting and distributing certain open-ended mutual funds. These fees are based on either the average daily fund net asset balances or average daily aggregate net fund sales and are affected by changes in the overall level and mix of assets under management or supervision. Asset management, distribution and administration fees also include revenues from individual investors electing a fee-based pricing arrangement under the Morgan Stanley Choice service and technology platform.

Asset management, distribution and administration fees decreased 4% in fiscal 2001 and increased 46% in fiscal 2000. In fiscal 2001, the decrease was primarily attributable to lower 12b-1 fees from promoting and distributing mutual funds to individual investors and lower fee revenue from Morgan Stanley Choice accounts. Both decreases reflected lower levels of assets under management and lower client balances subject to Morgan Stanley Choice fees. In fiscal 2001, client asset balances declined to \$595 billion at November 30, 2001 from \$662 billion at November 30, 2000. The increase in asset management, distribution and administration fees in fiscal 2000 was primarily attributable to higher 12b-1 fees from promoting and distributing mutual funds to individual investors through the Company’s financial advisors. In fiscal 2000, higher revenues from investment management services associated with the ICS business and higher client asset balances, which rose to \$662 billion at November 30, 2000 from \$595 billion at November 30, 1999, also contributed to the increase.

**Other.** Other revenues primarily consist of net rental and other revenues associated with the Company’s aircraft financing business, as well as account fees and other miscellaneous service fees associated with the Company’s individual securities activities.

Other revenues increased 6% in fiscal 2001. The increase was primarily attributable to higher revenues from the Company’s aircraft financing business, as fiscal 2001 included a full year of revenues related to Ansett Worldwide, which was acquired in fiscal 2000. The increase was partially offset by lower miscellaneous fee revenues in the individual securities business. Other revenues increased 107% in fiscal 2000. The increase primarily related to higher net rental and other revenues associated with Ansett Worldwide, which the Company acquired in April 2000.

The terrorist attacks of September 11, 2001 had an adverse impact on the global aviation industry. As a result, the Company’s aircraft financing business experienced a decline in revenues and an increase in non-interest expenses in the fourth quarter of fiscal 2001. While there is much uncertainty regarding the potential long-term impact of the terrorist attacks, the Company currently believes that the conditions caused by the attacks could continue to have an adverse impact on the results of its aircraft financing business (see “Terrorist Attacks” and “Non-Interest Expenses” herein).

**Non-Interest Expenses.** Fiscal 2001’s total non-interest expenses decreased 9% to \$12,284 million. Compensation and benefits expense decreased 16%, principally reflecting lower incentive-based compensation due to lower levels of revenues and earnings. Fiscal 2001’s compensation and benefits expense included severance and other related costs associated with reduced employment levels attributable to the Company’s focus on managing costs. Excluding compensation and benefits expense, non-interest expenses increased 6% to \$4,357 million. Occupancy and equipment expense increased 18%, primarily due to increased office space and rental costs in New York City and London, partially offset by lower rent expense as a result of the loss of the World Trade Center complex on September 11, 2001 (see “Terrorist Attacks” herein). Brokerage, clearing and exchange fees increased 17%, primarily reflecting higher brokerage and clearing costs due to increased institutional global securities trading volume, particularly in Europe and the U.S. Information processing and communications expense increased 7%, primarily due to increased costs associated with the Company’s information technology infrastructure, including data processing and market data services. Marketing and business development expense decreased 25%, primarily reflecting lower advertising expenses in both the institutional and individual securities businesses. A lower level of travel and entertainment costs, which reflected the overall decline in business

activity in the global financial markets, also contributed to the decrease. Professional services expense increased 3%, as higher consulting costs in the individual securities business were partially offset by a decrease in consulting costs in the institutional securities business. Other expense increased 27%, primarily reflecting significantly higher costs associated with the Company's aircraft financing business. Such costs include a charge of \$87 million for the impairment of certain aircraft assets, as well as higher repossession, maintenance and other aircraft-related costs. Many of these increased costs were associated with the difficult conditions existing in the aviation industry in the aftermath of the terrorist attacks on September 11, 2001 (see "Terrorist Attacks" herein). The amortization of goodwill associated with the Company's acquisition of Quilter and costs associated with the closure of certain branch locations, including those associated with the Japanese retail business, also contributed to the increase. These increases were partially offset by lower costs for certain consumption taxes.

Fiscal 2000's total non-interest expenses increased 32% to \$13,560 million. Compensation and benefits expense increased 32%, reflecting increased incentive compensation based on record fiscal 2000 revenues and earnings, incremental costs related to the Company's focus on increasing the number of its financial advisors and increased competitive pressures in certain institutional businesses. Excluding compensation and benefits expense, non-interest expenses increased 30% to \$4,096 million. Occupancy and equipment expense increased 26%, primarily due to additional rent associated with new U.S. branch locations and increased office space in New York City and certain other locations. Brokerage, clearing and exchange fees increased 12%, primarily due to higher brokerage costs related to increased global trading volume, particularly in the U.S. and Europe. Brokerage costs associated with the business activities of Morgan Stanley, S.V., S.A., which was acquired by the Company in March 1999, also contributed to the increase. Information processing and communications expense increased 31%, primarily due to increased costs associated with the Company's information technology infrastructure, including data processing, market data services and telecommunications costs for network equipment associated with increased business activity and higher employment levels. These increases were partially offset by the exclusion of certain Year 2000 costs from fiscal 2000's results. Marketing and business development expense increased 39%, primarily due to increased travel and entertainment costs associated with a high level of business activity in the global financial markets, new advertising campaigns and additional promotional expenses in the individual securities business. Professional services expense increased 40%, primarily reflecting higher consulting costs associated with certain strategic initiatives, including e-commerce. The increase also reflected higher costs for employment fees and temporary staffing due to increased global business activity. Other expense increased 25%, reflecting a higher level of business activity on various operating expenses. Higher costs associated with the Company's aircraft financing business (including Ansett Worldwide, which the Company acquired in April 2000) and amortization of goodwill associated with the Company's acquisition of Morgan Stanley, S.V., S.A. also contributed to the increase.

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

	<b>Fiscal 2001</b>	<b>Fiscal 2000</b>	<b>Fiscal 1999</b>
<b>Revenues:</b>			
Investment banking .....	\$ 53	\$ 127	\$ 93
Principal transactions:			
Investments .....	(5)	60	13
Commissions .....	37	40	23
Asset management, distribution and administration fees .....	2,248	2,388	2,075
Interest and dividends .....	70	83	65
Other .....	32	28	23
Total revenues .....	2,435	2,726	2,292
Interest expense .....	12	14	10
Net revenues .....	<u>2,423</u>	<u>2,712</u>	<u>2,282</u>
<b>Non-interest expenses:</b>			
Compensation and benefits .....	743	814	694
Occupancy and equipment .....	103	97	102
Brokerage, clearing and exchange fees .....	168	161	160
Information processing and communications .....	106	90	101
Marketing and business development .....	138	178	141
Professional services .....	112	113	143
Other .....	126	159	157
Total non-interest expenses .....	1,496	1,612	1,498
Gain on sale of business .....	—	35	—
Income before income taxes .....	927	1,135	784
Provision for income taxes .....	382	458	326
Net income .....	<u>\$ 545</u>	<u>\$ 677</u>	<u>\$ 458</u>

Investment Management ranks among the top global active asset managers and provides a wide range of investment advisory products through numerous distribution channels. The Company offers a wide variety of investment products to individual, institutional and intermediary clients. The investment products range from money market funds to equity, taxable and tax-exempt fixed income funds and alternative investments in developed and emerging markets. Through various service companies, distribution subsidiaries and investment advisors, the Company offers clients various investment styles, including value, growth and blended; active and passive management; and diversified and concentrated portfolios. In fiscal 2001, Investment Management's assets under management or supervision decreased \$41 billion to \$459 billion at November 30, 2001, reflecting market value declines, the sale of \$6 billion in customer assets and lower Unit Investment Trust sales.

Investment Management's net revenues for fiscal 2001 were \$2,423 million, a decrease of 11% from fiscal 2000. Investment Management's net income for fiscal 2001 was \$545 million, a decrease of 19% from fiscal 2000. Net income for fiscal 2000 included a net gain of \$21 million from the sale of the Company's Global Custody business (see "Business Acquisitions and Disposition" herein). Excluding fiscal 2000's net gain on the sale of business, net income decreased 17% in fiscal 2001. The decrease in net revenues and net income in fiscal 2001 primarily reflected lower fee-based revenues due to a less favorable asset mix and lower average assets under management or supervision. Investment banking revenues also decreased, resulting from lower Unit Investment Trust sales. These revenue declines were partially offset by the favorable impact of expense management

initiatives, including lower incentive-based compensation expense. In fiscal 2000, Investment Management achieved record net revenues of \$2,712 million, an increase of 19% from fiscal 1999. Investment Management's net income for fiscal 2000 was a record \$677 million, an increase of 48% from fiscal 1999. Net income for fiscal 2000 included the \$21 million net gain on the sale of business noted above. Excluding the net gain on the sale of business, net income increased 43% from fiscal 1999. The increase in net income in fiscal 2000 primarily reflected higher asset management, distribution and administration fees resulting from the accumulation and management of customer assets and a more favorable asset mix, partially offset by higher incentive-based compensation expense.

**Investment Banking.** Investment Management primarily generates investment banking revenues from the underwriting of Unit Investment Trust products. In fiscal 2001, investment banking revenues decreased 58% to \$53 million. The decrease primarily relates to a lower volume of Unit Investment Trust sales. Unit Investment Trust sales volume declined 58% to \$6.9 billion in fiscal 2001. In fiscal 2000, investment banking revenues increased 37% to \$127 million, primarily associated with higher levels of Unit Investment Trust sales volumes, which rose 35% to a record \$16.6 billion. The increase was driven by demand for Internet and telecommunications investment trusts. The Company does not expect Unit Investment Trust sales volumes and associated investment banking revenues to return to the levels achieved in fiscal 2000 and fiscal 1999.

**Principal Transactions.** Investment Management's principal transaction revenues are primarily generated from net gains and losses on capital investments in certain of the Company's funds and other investments.

Principal transaction investment losses aggregating \$5 million were recognized in fiscal 2001 as compared with revenues aggregating \$60 million in fiscal 2000. The decline in revenues reflected the difficult market conditions that existed during fiscal 2001. In addition, during fiscal 2001 the Company had a lower level of capital investments in certain of its funds as compared with the prior year.

**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 of \$37 million decreased 8% in fiscal 2001 and increased 74% to \$40 million in fiscal 2000. In both periods, the fluctuations were associated with changes in the level of sales volume of certain Van Kampen products and allocated commission revenues.

**Net Interest.** Investment Management generates net interest revenues from certain investment positions and from allocated interest revenues and expenses.

Net interest revenue decreased 16% to \$58 million in fiscal 2001, primarily due to a lower level of allocated net interest revenues. In fiscal 2000, net interest revenue increased 25% to \$69 million, reflecting higher net revenues from certain investment positions, as well as higher allocated net interest revenues.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees primarily include revenues from the management and administration of assets. These fees arise from investment management services the Company provides to investment vehicles pursuant to various contractual arrangements. Generally, the Company receives fees primarily based upon mutual fund 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:

	Fiscal 2001	Fiscal 2000	Fiscal 1999
(dollars in billions)			
Products offered primarily to individuals:			
Mutual funds:			
Equity .....	\$ 83	\$103	\$ 94
Fixed income .....	36	46	53
Money markets .....	66	57	47
Total mutual funds .....	<u>185</u>	<u>206</u>	<u>194</u>
ICS assets .....	30	31	23
Separate accounts, unit trust and other arrangements .....	65	78	68
Total individual .....	<u>280</u>	<u>315</u>	<u>285</u>
Products offered primarily to institutional clients:			
Mutual funds .....	38	35	33
Separate accounts, pooled vehicle and other arrangements .....	141	150	152
Total institutional .....	<u>179</u>	<u>185</u>	<u>185</u>
Total assets under management or supervision(1) .....	<u><u>\$459</u></u>	<u><u>\$500</u></u>	<u><u>\$470</u></u>

(1) Revenues and expenses associated with certain assets are included in the Company's Securities segment.

Asset management, distribution and administration fees decreased 6% in fiscal 2001 and increased 15% in fiscal 2000. In fiscal 2001, the decrease primarily reflected a less favorable asset mix, primarily due to a shift from equity products to money market products, which typically generate lower management fees. The decrease also reflected a lower level of customer assets under management or supervision as compared with fiscal 2000. In fiscal 2000, the increase in revenues primarily reflected higher levels of management fees as well as other revenues resulting from a higher level of assets under management or supervision. The increase in fiscal 2000 also reflected a more favorable asset mix, primarily due to a shift in asset mix to a greater percentage of equity products, which typically generate higher management fees.

As of November 30, 2001, customer assets under management or supervision decreased \$41 billion from fiscal year-end 2000. The decrease largely reflected a decline in the market value of equity assets, as well as the sale of \$6 billion of assets. The decline also was attributable to lower net flows of customer assets, as redemptions were marginally higher than new sales in fiscal 2001. As of November 30, 2000, assets under management or supervision increased \$30 billion from fiscal year-end 1999. In fiscal 2000, virtually all of the increase in assets under management or supervision was attributable to net inflows of customer assets. The increases in assets under management or supervision due to market appreciation in the first three quarters of fiscal 2000 were offset by market depreciation during the fourth quarter of fiscal 2000. This market depreciation reflected the declines in many global financial markets that occurred during that period.

**Non-Interest Expenses.** Fiscal 2001's total non-interest expenses decreased 7% to \$1,496 million, partially reflecting the favorable impact of synergies resulting from integration initiatives within Investment Management's operating platforms. Compensation and benefits expense decreased 9%, reflecting lower incentive-based compensation costs due to Investment Management's lower level of revenues and earnings. Fiscal 2001's compensation and benefits expense included severance and other related costs associated with reduced employment levels attributable to the Company's focus on managing costs. Excluding compensation and benefits expense, non-interest expenses decreased 6% to \$753 million. Occupancy and equipment expense increased 6%, primarily due to an increase in space and rental costs. Brokerage, clearing and exchange fees increased 4%, primarily due to a higher level of deferred commission amortization associated with the sale of

certain funds, partially offset by lower commission expense due to lower sales of closed-end funds through the non-proprietary distribution channel. Information processing and communications expense increased 18%, primarily due to increased data processing costs and the write-off of certain capitalized software. Marketing and business development expense decreased 22%, primarily driven by lower advertising costs. Professional services expense decreased 1%, primarily reflecting lower consulting costs. Other expense decreased 21%, primarily due to a reduction in various operating expenses in an effort to reduce discretionary spending, as well as a lower level of allocated expenses.

Fiscal 2000's total non-interest expenses increased 8% to \$1,612 million. Compensation and benefits expense increased 17%, reflecting higher incentive-based compensation costs due to Investment Management's higher level of revenues and earnings. Excluding compensation and benefits expense, non-interest expenses decreased 1% to \$798 million. Occupancy and equipment expense decreased 5%, primarily due to lower depreciation expense on certain data processing equipment. These decreases were partially offset by higher occupancy costs at certain office locations. Brokerage, clearing and exchange fees increased 1%, primarily due to a higher level of deferred commission amortization, offset by lower sales of closed-end funds through the non-proprietary distribution channel. Information processing and communications expense decreased 11%, primarily due to lower costs incurred in fiscal 2000 related to outside data processing and computer software costs. Marketing and business development expense increased 26%, primarily due to higher promotional and distribution costs for certain mutual funds. Professional services expense decreased 21%, reflecting higher consulting costs in fiscal 1999 related to the Company's preparation for the Year 2000, partially offset by higher consulting costs in fiscal 2000 for various e-commerce initiatives. Other expense increased 1%, primarily due to new and increased business activity.

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

	<b>Fiscal 2001</b>	<b>Fiscal 2000</b>	<b>Fiscal 1999</b>
Fees:			
Merchant and cardmember .....	\$1,345	\$1,323	\$1,074
Servicing .....	1,904	1,450	1,194
Other .....	5	—	—
Total non-interest revenues .....	3,254	2,773	2,268
Interest revenue .....	2,593	2,895	2,309
Interest expense .....	1,236	1,378	915
Net interest income .....	1,357	1,517	1,394
Provision for consumer loan losses .....	1,052	810	526
Net credit income .....	305	707	868
Net revenues .....	3,559	3,480	3,136
Non-interest expenses:			
Compensation and benefits .....	727	658	551
Occupancy and equipment .....	76	66	58
Information processing and communications .....	490	438	418
Marketing and business development .....	613	704	592
Professional services .....	199	182	187
Other .....	327	288	210
Total non-interest expenses .....	2,432	2,336	2,016
Income before income taxes and cumulative effect of accounting change .....	1,127	1,144	1,120
Provision for income taxes .....	425	419	444
Income before cumulative effect of accounting change .....	702	725	676
Cumulative effect of accounting change .....	(13)	—	—
Net income .....	<u>\$ 689</u>	<u>\$ 725</u>	<u>\$ 676</u>

The Company's Credit Services business is operated by Discover Financial Services, a business unit which issues quality consumer credit products and operates Discover Business Services, a proprietary network of merchant and cash access locations in the U.S. The credit cards issued by the Company include the Discover Classic Card, the Discover Gold Card, the Discover Platinum Card, the Morgan Stanley Card and other proprietary general purpose credit cards. Credit Services financial data reflect the Company's fiscal 2001 adoption of Emerging Issues Task Force ("EITF") Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future." Prior to the adoption of EITF Issue No. 00-22, the Company recorded its Cashback Bonus® award program as a marketing and business development expense. In accordance with EITF Issue No. 00-22, such incentives are to be considered a reduction in revenues and are recorded in merchant and cardmember fees. Credit Services data for all periods presented have been restated to reflect this change.

In fiscal 2001, Credit Services net revenues were \$3,559 million, an increase of 2% from fiscal 2000. Credit Services net income was \$689 million, a decrease of 5% from fiscal 2000. 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. Excluding the cumulative effect of the accounting change for fiscal 2001, net income decreased 3%. The increase in net revenues was primarily attributable to increased

servicing fees, partially offset by lower net credit income due to a higher provision for consumer loan losses and lower net interest income. The increase also was attributable to higher merchant fees, which reflected modest managed general purpose credit card loan growth from record sales and transaction volumes. The higher provision for consumer loan losses reflected the slowdown in the U.S. economy and a rise in personal bankruptcy filings. The decrease in net income was due to higher non-interest expenses, partially offset by higher net revenues.

In fiscal 2000, Credit Services achieved record net income of \$725 million, an increase of 7% from fiscal 1999. The increase reflected higher merchant and cardmember fees, servicing fees and net interest income, reflecting overall growth of the business, including higher levels of transaction volume and average managed general purpose credit card loans. The increase in net income was partially offset by a higher provision for consumer loan losses and higher non-interest expenses.

Credit Services statistical data were as follows:

	Fiscal 2001	Fiscal 2000	Fiscal 1999
	(dollars in billions)		
General purpose credit card loans at fiscal year-end:			
Owned .....	\$20.1	\$21.9	\$21.0
Managed .....	\$49.3	\$47.1	\$38.0
General purpose credit card transaction volume .....	\$93.3	\$90.1	\$70.6

The higher level of managed general purpose credit card loans at November 30, 2001 and November 30, 2000 was primarily attributable to growth in the Company's Discover Platinum Card.

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

Merchant and cardmember fees increased 2% to \$1,345 million during fiscal 2001 and 23% to \$1,323 million during fiscal 2000. The increase in fiscal 2001 was due to higher merchant discount revenue associated with record levels of sales and transaction volumes, coupled with an increase in the average merchant discount rate, partially offset by higher cardmember rewards incentives and lower net overlimit fees. Higher cardmember rewards incentives were due to record levels of sales volume. The decline in overlimit fees reflected a higher level of charge-offs of such fees. In fiscal 2000, the increase in merchant and cardmember fees was primarily due to higher merchant discount revenue and late payment fees, partially offset by higher cardmember rewards incentives. The increase in merchant discount revenues and cardmember rewards incentives was primarily due to a higher level of sales volume. The increase in merchant discount revenues also reflected an increase in the average merchant discount rate. The increase in late payment fees in fiscal 2000 was primarily due to a fee increase introduced during April 1999, coupled with an increase in the number of late fee occurrences, reflecting higher levels of transaction volume and general purpose credit card loans subject to such fees.

***Servicing Fees.*** Servicing fees are revenues derived from consumer loans that have been sold to investors through asset securitizations. Cash flows from the interest yield and cardmember fees generated by securitized loans are used to pay investors in these loans a predetermined fixed or floating rate of return on their investment, to reimburse investors for losses of principal resulting from charged-off loans and to pay the Company a fee for servicing the loans. Any excess cash flows remaining are paid to the Company. The servicing fees and excess net

cash flows paid to the Company are reported as servicing fees in the consolidated statements of income. The sale of consumer loans through asset securitizations, therefore, has the effect of converting portions of net credit income and fee income to servicing fees. The Company completed credit card asset securitizations of \$7.3 billion in fiscal 2001 and \$9.8 billion in fiscal 2000. The credit card asset securitization transactions completed in fiscal 2001 have expected maturities ranging from approximately three to seven years from the date of issuance.

The table below presents the components of servicing fees:

	Fiscal 2001	Fiscal 2000	Fiscal 1999
	(dollars in millions)		
Merchant and cardmember fees .....	\$ 741	\$ 627	\$ 552
Interest revenue .....	4,336	3,432	2,694
Interest expense .....	(1,511)	(1,462)	(996)
Provision for consumer loan losses .....	(1,662)	(1,147)	(1,056)
<b>Servicing fees .....</b>	<b>\$ 1,904</b>	<b>\$ 1,450</b>	<b>\$ 1,194</b>

Servicing fees are affected by the level of securitized loans, the spread between the interest yield on the securitized loans and the yield paid to the investors, the rate of credit losses on securitized loans and the level of cardmember fees earned from securitized loans. Servicing fees increased 31% in fiscal 2001 and 21% in fiscal 2000. The increases in both fiscal 2001 and fiscal 2000 were due to a higher level of net interest cash flows and increased cardmember fee revenue, primarily due to a higher level of average securitized general purpose credit card loans. In both periods, these increases were partially offset by higher credit losses. In fiscal 2001, the increase in credit losses was primarily due to a higher level of average securitized general purpose credit card loans, coupled with a higher rate of charge-offs related to the securitized portfolio. In fiscal 2000, the increase in credit losses was primarily due to a higher level of average securitized general purpose credit card loans, partially offset by a lower rate of charge-offs related to the securitized portfolio. Net securitization gains on general purpose credit card loans, included in servicing fees, were \$70 million in fiscal 2001 and \$80 million in fiscal 2000. The decrease primarily reflected a lower level of asset securitization transactions in fiscal 2001 as compared with fiscal 2000, partially offset by modifications to certain assumptions in the gain calculations.

**Net Interest Income.** Net interest income represents the difference between interest revenue derived from Credit Services consumer loans and short-term investment assets and interest expense incurred to finance those loans and assets. Credit Services 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 11% in fiscal 2001 and increased 9% in fiscal 2000. The decrease in fiscal 2001 was primarily due to lower interest revenue attributable to lower levels of average general purpose credit card loans and a lower yield on these loans, partially offset by a decline in interest expense. The decrease in the level of average general purpose credit card loans was due to a higher level of securitized credit card loans, partially offset by a higher level of sales volume. The lower yield on general purpose credit card loans was primarily due to lower interest rates offered to new cardmembers and certain existing cardmembers, as well as higher charge-offs. The decrease in the yield was partially offset by the Company's repricing of certain credit card receivables. The decrease in interest expense was primarily due to a lower level of interest bearing liabilities, coupled with a decrease in the Company's average cost of borrowings, which reflected the Fed's aggressive interest rate easing

campaign during fiscal 2001. The Company's average cost of borrowings was 6.26% for fiscal 2001 as compared with 6.50% for fiscal 2000. The increase in net interest income in fiscal 2000 was primarily due to higher average levels of general purpose credit card loans, partially offset by a lower yield on these loans and increased financing costs incurred by the Company. The increase in average general purpose credit card loans was due to higher levels of sales and balance transfer volume and promotional programs. The lower yield was primarily due to lower interest rates offered to new cardmembers and certain existing cardmembers, partially offset by the Company's repricing of certain credit card receivables. The lower yield also reflected an increase in general purpose credit card loans from balance transfers and from promotional purchases, which generally are offered at lower interest rates for an introductory period. The increase in interest expense in fiscal 2000 was due to a higher level of interest bearing liabilities, coupled with an increase in the Company's average cost of borrowings, reflecting interest rate increases made by the Fed in fiscal 1999 and the first half of fiscal 2000. The Company's average cost of borrowings was 6.50% for fiscal 2000 as compared with 5.82% for fiscal 1999.

The following tables present analyses of Credit Services average balance sheets and interest rates in fiscal 2001, fiscal 2000 and fiscal 1999 and changes in net interest income during those fiscal years:

#### Average Balance Sheet Analysis.

	Fiscal 2001			Fiscal 2000(3)			Fiscal 1999(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 ..	\$20,701	11.49%	\$2,379	\$21,906	12.15%	\$2,662	\$16,173	13.10%	\$2,118
Other consumer loans .....	808	7.83	63	663	9.41	62	811	9.27	75
Investment securities .....	444	5.09	23	594	6.37	38	672	5.16	35
Other .....	2,389	5.36	128	1,813	7.34	133	1,426	5.68	81
Total interest earning assets ..	24,342	10.65	2,593	24,976	11.59	2,895	19,082	12.10	2,309
Allowance for loan losses .....	(789)			(779)			(780)		
Non-interest earning assets .....	2,169			1,852			1,744		
Total assets .....	<u>\$25,722</u>			<u>\$26,049</u>			<u>\$20,046</u>		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>									
Interest bearing liabilities:									
Interest bearing deposits									
Savings .....	\$ 1,516	4.29%	\$ 65	\$ 1,513	5.62%	\$ 85	\$ 1,492	4.51%	\$ 67
Brokered .....	8,891	6.63	590	7,732	6.62	512	5,609	6.37	357
Other time .....	3,058	5.99	183	3,032	6.19	188	1,927	5.61	108
Total interest bearing deposits	13,465	6.22	838	12,277	6.39	785	9,028	5.90	532
Other borrowings .....	6,299	6.33	398	8,925	6.65	593	6,686	5.72	383
Total interest bearing liabilities ..	19,764	6.26	1,236	21,202	6.50	1,378	15,714	5.82	915
Shareholder's equity/other liabilities	5,958			4,847			4,332		
Total liabilities and shareholder's equity .....	<u>\$25,722</u>			<u>\$26,049</u>			<u>\$20,046</u>		
Net interest income .....				<u>\$1,357</u>			<u>\$1,517</u>		<u>\$1,394</u>
Net interest margin(1) .....				5.57%			6.07%		7.31%
Interest rate spread(2) .....		4.39%			5.09%			6.28%	

(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 2001 vs. Fiscal 2000</b>			<b>Fiscal 2000 vs. Fiscal 1999</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
(dollars in millions)						
<b>Interest Revenue</b>						
General purpose credit card loans .....	\$(146)	\$(137)	\$(283)	\$752	\$(208)	\$544
Other consumer loans .....	14	(13)	1	(14)	1	(13)
Investment securities .....	(9)	(6)	(15)	(4)	7	3
Other .....	42	(47)	(5)	22	30	52
Total interest revenue .....	(73)	(229)	(302)	713	(127)	586
<b>Interest Expense</b>						
Interest bearing deposits:						
Savings .....	—	(20)	(20)	1	17	18
Brokered .....	77	1	78	136	19	155
Other time .....	1	(6)	(5)	62	18	80
Total interest bearing deposits .....	76	(23)	53	192	61	253
Other borrowings .....	(175)	(20)	(195)	127	83	210
Total interest expense .....	(93)	(49)	(142)	319	144	463
Net interest income .....	<u>\$ 20</u>	<u>\$(180)</u>	<u>\$(160)</u>	<u>\$394</u>	<u>\$(271)</u>	<u>\$123</u>

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

**Supplemental Average Managed Loan Information.**

	<b>Fiscal 2001</b>		<b>Fiscal 2000(1)</b>		<b>Fiscal 1999(1)</b>	
	<b>Average Balance</b>	<b>Rate</b>	<b>Average Balance</b>	<b>Rate</b>	<b>Average Balance</b>	<b>Rate</b>
(dollars in millions)						
General purpose credit card loans .....	\$49,432	13.45%	\$43,536	13.82%	\$33,530	14.23%
Total interest earning assets .....	53,881	12.86	46,606	13.41	36,439	13.61
Total interest bearing liabilities .....	49,303	5.57	42,832	6.56	33,071	5.73
General purpose credit card loan interest rate spread ..		7.88		7.26		8.50
Interest rate spread .....		7.29		6.85		7.88
Net interest margin .....		7.76		7.39		8.41

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

**Provision for Consumer Loan Losses.** The provision for consumer loan losses is the amount necessary to establish the allowance for loan losses at a level that the Company believes is adequate to absorb estimated losses in its consumer loan portfolio at the balance sheet date. The Company's allowance for loan losses is regularly evaluated by management for adequacy and was \$847 million at November 30, 2001 and \$783 million at November 30, 2000.

The provision for consumer loan losses, which is affected by net charge-offs, loan volume and changes in the amount of consumer loans estimated to be uncollectable, increased 30% and 54% in fiscal 2001 and fiscal 2000, respectively. The increase in fiscal 2001 was due to higher net charge-off rates, partially offset by lower levels of average general purpose credit card loans. In addition, in fiscal 2001 the Company increased the allowance for loan losses in excess of the charge-off rate to reflect the impact of the difficult economic environment on the Company's credit card portfolio. The increase in fiscal 2000 was primarily due to higher levels of average general purpose credit card loans, partially offset by a lower net charge-off rate.

General purpose credit card loans are considered delinquent when interest or principal payments become 30 days past due. General purpose credit card loans are charged off at the end of the month during which an account becomes 180 days past due, except in the case of bankruptcies and fraudulent transactions, where loans are charged off earlier. Loan delinquencies and charge-offs are primarily affected by changes in economic conditions and may vary throughout the year due to seasonal consumer spending and payment behaviors.

During fiscal 2001, net charge-offs in both the owned and managed portfolios increased as compared with fiscal 2000. In the U.S., the increase in unemployment, reduced overtime and the rising debt service burden on borrowers, coupled with the seasoning of the Company's general purpose credit card loan portfolio and a high level of national bankruptcy filings, contributed to the higher net charge-off rate. In addition, the Company's delinquency rates in both the greater than 30-day and 90-day categories increased in fiscal 2001 from fiscal 2000. If these conditions continue to persist, the rate of net charge-offs may be higher in future periods.

The Company's future charge-off rates and credit quality are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that influence the provision for consumer loan losses include the level and direction of general purpose credit card loan delinquencies and charge-offs, changes in consumer spending and payment behaviors, bankruptcy trends, the seasoning of the Company's general purpose credit card loan portfolio, interest rate movements and their impact on consumer behavior, and the rate and magnitude of changes in the Company's general purpose credit card loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio.

The following table presents delinquency and net charge-off rates with supplemental managed general purpose credit card loan information:

#### **Asset Quality.**

	Fiscal 2001		Fiscal 2000		Fiscal 1999	
	Owned	Managed	Owned	Managed	Owned	Managed
	(dollars in millions)					
General purpose credit card loans at fiscal year-end .....	\$20,085	\$49,332	\$21,866	\$47,123	\$20,994	\$37,971
General purpose credit card loans contractually past due as a percentage of fiscal year-end general purpose credit card loans:						
30 to 89 days .....	3.43%	3.83%	3.01%	3.50%	3.35%	3.79%
90 to 179 days .....	2.74%	3.02%	2.04%	2.42%	2.20%	2.53%
Net charge-offs as a percentage of average general purpose credit card loans .....	4.76%	5.36%	3.63%	4.40%	4.79%	5.42%

**Non-Interest Expenses.** Total non-interest expenses increased 4% to \$2,432 million in fiscal 2001 and increased 16% to \$2,336 million in fiscal 2000. Increased business activity related to the Discover Platinum Card contributed to the increase in non-interest expenses in both fiscal 2001 and fiscal 2000.

Employee compensation and benefits expense increased 10% in fiscal 2001 and 19% in fiscal 2000. The increase in fiscal 2001 was primarily due to higher costs associated with increased employment levels resulting from higher transaction volume and collection activities. The increase in fiscal 2000 was due to higher domestic and international compensation costs, reflecting increased employment levels associated with higher levels of business activity and transaction volume.

Occupancy and equipment expense increased 15% in fiscal 2001 and 14% in fiscal 2000. The increases in both fiscal 2001 and fiscal 2000 were due primarily to higher occupancy costs associated with increased office space, including new transaction processing centers.

Information processing and communications expense increased 12% in fiscal 2001 and 5% in fiscal 2000. The increase in fiscal 2001 was due to higher volume-related external data processing costs as well as higher depreciation expense associated with equipment at transaction processing facilities. The increase in fiscal 2000 was primarily due to an increase in volume-related external data processing costs associated with the Morgan Stanley Card in the U.K., partially offset by the termination of an external transaction processing contract in fiscal 1999.

Marketing and business development expense decreased 13% in fiscal 2001 and increased 19% in fiscal 2000. Marketing and business development expense decreased in fiscal 2001 due to lower marketing and advertising expense, including domestic and international direct mailing costs. The increase in fiscal 2000 was primarily due to increased advertising and direct mailing costs associated with both domestic and international operations.

Professional services expense increased 9% in fiscal 2001 and decreased 3% in fiscal 2000. The increase in fiscal 2001 was primarily due to increased costs associated with enhanced credit and collection strategies, as well as higher consulting costs. The decrease in fiscal 2000 reflected the exclusion of Year 2000 consulting costs from fiscal 2000's results.

Other expense increased 14% in fiscal 2001 and 37% in fiscal 2000. In fiscal 2001, the increase primarily reflected increases in certain operating expenses due to higher levels of transaction volume, business activity and a higher level of allocated costs, partially offset by a decline in inquiry fees resulting from fewer new account applications. In fiscal 2000, the increase was primarily due to increases in certain domestic and international operating expenses due to higher levels of transaction volume and business activity.

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

## **Liquidity and Capital Resources.**

### **The Balance Sheet.**

The Company's total assets increased to \$482.6 billion at November 30, 2001 from \$421.3 billion at November 30, 2000, primarily attributable to increases in cash and cash equivalents, financial instruments owned and securities borrowed. Securities provided as collateral also increased, primarily due to the adoption of SFAS No. 140, which required the Company to recognize securities received as collateral (as opposed to cash received as collateral) in certain securities lending transactions in the consolidated statements of financial condition at November 30, 2001. A substantial portion of the Company's total assets consists of highly liquid marketable securities and short-term receivables arising principally from securities transactions. The highly liquid nature of these assets provides the Company with flexibility in financing and managing its business.

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

	At November 30,	
	2001	2000
	(dollars in millions, except per share data)	
Total assets .....	\$482,628	\$421,279
Adjusted assets(1) .....	<u>\$414,847</u>	<u>\$370,287</u>
Leverage ratio(2) .....	22.0x	21.4x
Adjusted leverage ratio(3) .....	<u>18.9x</u>	<u>18.8x</u>
Book value per share(4) .....	<u><u>\$ 18.64</u></u>	<u><u>\$ 16.91</u></u>

- (1) Adjusted assets represent total assets less the sum of (i) assets that were recorded under certain provisions of SFAS No. 140 in fiscal 2001 and (ii) the lesser of securities purchased under agreements to resell or securities sold under agreements to repurchase.
- (2) Leverage ratio equals total assets divided by shareholders' equity (\$21,926 million at November 30, 2001 and \$19,671 million at November 30, 2000). For purposes of this calculation, shareholders' equity includes preferred and common equity and Preferred Securities Issued by Subsidiaries.
- (3) Adjusted leverage ratio equals adjusted assets divided by shareholders' equity.
- (4) Book value per share equals common shareholders' equity divided by common shares outstanding of 1,093 million at November 30, 2001 and 1,107 million at November 30, 2000.

### **Funding and Capital Policies.**

The Company's senior management establishes the overall funding and capital policies of the Company, reviews the Company's performance relative to these policies, monitors the availability of sources of financing, reviews the foreign exchange risk of the Company, and oversees the liquidity and interest rate sensitivity of the Company's asset and liability position. The primary goal of the Company's funding and liquidity activities is to ensure adequate financing over a wide range of potential credit ratings and market environments.

Many of the Company's businesses are capital-intensive. Capital is required to finance, among other things, the Company's securities inventories, underwritings, principal investments, private equity activities, consumer loans, bridge loans and other financings, and investments in fixed assets, including aircraft assets. As a policy, the Company attempts to maintain sufficient capital and funding sources in order to have the capacity to finance itself on a fully collateralized basis at all times, including periods of financial stress. Currently, the Company believes it has sufficient capital to meet its needs. In addition, the Company attempts to maintain total equity, on a consolidated basis, at least equal to the sum of all of its subsidiaries' equity. Subsidiary equity capital requirements are determined by regulatory requirements (if applicable), asset mix, leverage considerations and earnings volatility.

The Company views return on equity to be an important measure of its performance, in the context of both the particular business environment in which the Company is operating and its peer group's results. In this regard, the Company actively manages its consolidated capital position based upon, among other things, business opportunities, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses. The Company 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 Company's liquidity policies emphasize diversification of funding sources. The Company also follows a funding strategy that is designed to ensure that the tenor of the Company's liabilities equals or exceeds the expected holding period of the assets being financed. Short-term funding generally is obtained at rates related to

U.S., Euro or Asian money market rates for the currency borrowed. Repurchase transactions are effected at negotiated rates. Other borrowing costs are negotiated depending upon prevailing market conditions (see Notes 6 and 7 to the consolidated financial statements). Maturities of both short-term and long-term financings are designed to minimize exposure to refinancing risk in any one period.

The volume of the Company's borrowings generally fluctuates in response to changes in the amount of repurchase transactions outstanding, the level of the Company's securities inventories and consumer loan receivables, and overall market conditions. Availability and cost of financing to the Company can vary depending upon market conditions, the volume of certain trading activities, the Company's credit ratings and the overall availability of credit. The Company, therefore, maintains a surplus of unused short-term funding sources at all times to withstand any unforeseen contraction in credit capacity. In addition, the Company attempts to maintain cash and unhypothesized marketable securities equal to at least 110% of its outstanding short-term unsecured borrowings. The Company has in place a contingency funding strategy, which provides a comprehensive one-year action plan in the event of a severe funding disruption. These policies and strategies are designed to ensure that the Company maintains sufficient liquidity to meet all of its obligations for a one-year period without issuing any new unsecured debt.

The Company views long-term debt as a stable source of funding for core inventories, consumer loans and illiquid assets and, therefore, maintains a long-term debt-to-capitalization ratio at a level appropriate for the current composition of its balance sheet. In general, fixed assets are financed with fixed rate long-term debt, and securities inventories and 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 basis. 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 7 to the consolidated financial statements).

The Company's reliance on external sources to finance a significant portion of its day-to-day operations makes access to global sources of financing important. The cost and availability of unsecured financing generally are dependent on the Company's short-term and long-term credit ratings. Factors that are significant to the determination of the Company's credit ratings or otherwise affect the ability of the Company to raise short-term and long-term financing include its: level and volatility of earnings, relative positions in the markets in which it operates, global and product diversification, risk management policies, cash liquidity and capital structure. In addition, the agencies that rate the Company's debt have focused on certain recent changes in the market that may require financial services firms to assume more credit risk in connection with their corporate lending activities. A deterioration in any of the previously mentioned factors or combination of these factors may lead rating agencies to downgrade the credit ratings of the Company, thereby increasing the cost to the Company in obtaining unsecured financings. In addition, the Company's debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as over-the-counter derivative transactions, including credit derivatives and interest rate swaps.

As of January 31, 2002, the Company's credit ratings were as follows:

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

(1) In October 2001, Fitch placed the Company's senior debt credit ratings on negative outlook.

(2) In July 2001, Standard & Poor's placed the Company's senior debt credit ratings on negative outlook.

As the Company continues to expand globally and derives revenues increasingly in various currencies, foreign currency management is a key element of the Company's financial policies. The Company benefits from operating in several different currencies because weakness in any particular currency often is offset by strength in another currency. The Company closely monitors its exposure to fluctuations in currencies and, where cost-justified, adopts strategies to reduce the impact of these fluctuations on the Company's financial performance. These strategies include engaging in various hedging activities to manage income and cash flows denominated in foreign currencies and using foreign currency borrowings, when appropriate, to finance investments outside the U.S.

### **Principal Sources of Funding.**

The Company funds its balance sheet on a global basis. The Company raises funding for its Securities and Investment Management businesses through diverse sources. These sources include the Company's capital, including equity and long-term debt; repurchase agreements; U.S., Canadian, Euro, Japanese and Australian commercial paper; letters of credit; unsecured bond borrowings; securities lending; buy/sell agreements; municipal reinvestments; master notes; and committed and uncommitted lines of credit. Repurchase agreement transactions, securities lending and a portion of the Company's bank borrowings are made on a collateralized basis and, therefore, provide a more stable source of funding than short-term unsecured borrowings.

The funding sources utilized for the Company's Credit Services business include the Company's capital, including equity and long-term debt; asset-backed securitizations; deposits; Federal Funds; and short-term bank notes. The Company sells consumer loans through asset securitizations using several transaction structures, including an extendible asset-backed certificate program.

The asset securitization market is a significant source of funding for the Company's Credit Services business. By utilizing this market, the Company further diversifies its funding sources, realizes cost-effective funding and reduces reliance on the Company's other funding sources, including unsecured debt. The securitization transaction structures utilized for the Credit Services business are accounted for as sales, i.e., off-balance sheet transactions in accordance with U.S. generally accepted accounting principles (see Note 4 to the consolidated financial statements). In connection with its Discover Card securitization program, the Company transfers credit card receivables, on a revolving basis, to the Discover Card Master Trust I (the "Trust"), which issues asset-backed securities registered with the Securities and Exchange Commission. 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 such 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 and is driven primarily by the Trust's credit card receivables performance (in particular, receivables yield, cardmember fees and credit losses incurred) as well as the contractual rate of return of the asset-backed securities. In the event of an economic early amortization, receivables that would otherwise have been subsequently purchased by the Trust from the Company would instead continue to be recognized on the Company's consolidated statements of financial condition since the cash flows generated in the Trust would instead be used to repay investors in the asset-backed securities. These recognized receivables would require the Company to obtain alternative funding. Although the Company believes that the combination of factors that would result in an economic early amortization event is remote, the Company also believes its access to alternative funding sources would mitigate this potential liquidity risk.

The Company's bank subsidiaries solicit deposits from consumers, purchase Federal Funds and issue short-term bank notes. Interest bearing deposits are classified by type as savings, brokered and other time deposits. Savings deposits consist primarily of money market deposit accounts sold directly to cardmembers 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.

The Company maintains borrowing relationships with a broad range of banks, financial institutions, counterparties and others from which it draws funds in a variety of currencies.

The Company maintains a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the “MSDW Facility”). Under the terms of the MSDW Facility, the banks are committed to provide up to \$5.5 billion. The MSDW Facility contains restrictive covenants which require, among other things, that the Company maintain specified levels of shareholders’ equity. At November 30, 2001, the Company maintained an \$8.2 billion surplus shareholders’ equity as compared with the MSDW Facility’s restrictive covenant requirement. The Company believes that the covenant restrictions will not impair its ability to obtain funding under the MSDW Facility nor impair its ability to pay its current level of dividends. At November 30, 2001, no borrowings were outstanding under the MSDW Facility.

The Company maintains a master collateral facility that enables Morgan Stanley & Co. Incorporated (“MS&Co.”), one of the Company’s U.S. broker-dealer subsidiaries, to pledge certain collateral to secure loan arrangements, letters of credit and other financial accommodations (the “MS&Co. Facility”). As part of the MS&Co. Facility, MS&Co. also maintains a secured committed credit agreement with a group of banks that are parties to the master collateral facility under which such banks are committed to provide up to \$1.875 billion. The credit agreement contains restrictive covenants which require, among other things, that MS&Co. maintain specified levels of consolidated stockholder’s equity and Net Capital, each as defined in the MS&Co. Facility. At November 30, 2001, MS&Co. maintained a \$2.3 billion surplus consolidated stockholder’s equity and a \$3.0 billion surplus Net Capital. The Company believes that the restrictive covenants will not impair its ability to secure loan arrangements, letters of credit and other financial accommodations under the MS&Co. Facility. At November 30, 2001, no borrowings were outstanding under the MS&Co. Facility.

The Company also maintains a revolving credit facility that enables Morgan Stanley & Co. International Limited (“MSIL”), the Company’s London-based broker-dealer subsidiary, to obtain committed funding from a syndicate of banks (the “MSIL Facility”) by providing a broad range of collateral under repurchase agreements for a secured repo facility and a Company guarantee for an unsecured facility. The syndicate of banks is committed to provide up to an aggregate of \$1.95 billion, available in six major currencies. The facility agreement contains restrictive covenants which require, among other things, that MSIL maintain specified levels of Shareholder’s Equity and Financial Resources, each as defined in the MSIL Facility. At November 30, 2001, MSIL maintained a \$1.4 billion surplus Shareholder’s Equity and a \$1.0 billion surplus Financial Resources. The MSDW Facility’s restrictive covenants described above apply to the Company as guarantor. The Company believes that the restrictive covenants will not impair its ability to obtain funding under the MSIL Facility. At November 30, 2001, no borrowings were outstanding under the MSIL Facility.

Morgan Stanley Japan Limited (“MSJL”), the Company’s Tokyo-based broker-dealer subsidiary, maintains a committed revolving credit facility, guaranteed by the Company, that provides funding to support general liquidity needs, including support of MSJL’s unsecured borrowings (the “MSJL Facility”). The MSDW Facility’s restrictive covenants described above apply to the Company as guarantor. Under the terms of the MSJL Facility, a syndicate of banks is committed to provide up to 70 billion Japanese yen. The Company believes that the restrictive covenants will not impair its ability to obtain funding under the MSJL Facility. At November 30, 2001, no borrowings were outstanding under the MSJL Facility.

The Company anticipates that it will utilize the MSDW Facility, the MS&Co. Facility, the MSIL Facility or the MSJL Facility for short-term funding from time to time (see Note 6 to the consolidated financial statements).

#### **Fiscal 2001 and Subsequent Activity.**

During the 12 months ended November 30, 2001, the Company issued senior notes aggregating \$18,101 million, including non-U.S. dollar currency notes aggregating \$5,995 million. These notes have maturities from 2002 to 2031 and had a weighted average coupon interest rate of 4.8% at November 30, 2001. 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, 2001, the aggregate outstanding principal amount of the

Company's Senior Indebtedness (as defined in the Company's public debt shelf registration statements) was approximately \$80.3 billion (including Senior Indebtedness consisting of guaranteed obligations of the indebtedness of subsidiaries). Between November 30, 2001 and January 31, 2002, the Company's long-term borrowings, net of repayments and repurchases, decreased by approximately \$1.7 billion.

The Board of Directors has authorized the Company to purchase, subject to market conditions and certain other factors, shares of its common stock for capital management purposes. The Company also has an ongoing repurchase authorization in connection with awards granted under its equity-based compensation plans. During fiscal 2001, the Company purchased \$1,583 million of its common stock. Subsequent to November 30, 2001 and through January 31, 2002, the Company purchased an additional \$133 million of its common stock; the unused portion of the capital management common stock repurchase authorization at January 31, 2002 was approximately \$700 million.

In fiscal 2001, the Company redeemed all 1,000,000 outstanding shares of its 7-3/4% Cumulative Preferred Stock at a redemption price of \$200 per share. The Company also simultaneously redeemed all corresponding Depositary Shares at a redemption price of \$50 per Depositary Share. Each Depositary Share represented 1/4 of a share of the Company's 7-3/4% Cumulative Preferred Stock.

Subsequent to fiscal 2001, the Company redeemed all 1,725,000 outstanding shares of its Series A Fixed/Adjustable Rate Cumulative Preferred Stock at a redemption price of \$200 per share. The Company also simultaneously redeemed all corresponding Depositary Shares at a redemption price of \$50 per Depositary Share. Each Depositary Share represented 1/4 of a share of the Company's Series A Fixed/Adjustable Rate Cumulative Preferred Stock.

The Company has Capital Units outstanding that were issued by the Company and Morgan Stanley Finance plc ("MSF"), a U.K. subsidiary. A Capital Unit consists of (a) a Subordinated Debenture of MSF guaranteed by the Company and maturing in 2017 and (b) a related Purchase Contract issued by the Company, which may be accelerated by the Company, requiring the holder to purchase one Depositary Share representing shares (or fractional shares) of the Company's Cumulative Preferred Stock. The aggregate amount of Capital Units outstanding was \$66 million and \$70 million at November 30, 2001 and November 30, 2000, respectively.

In fiscal 2001, Morgan Stanley Capital Trust II, a consolidated Delaware statutory business trust (the "Capital Trust II"), all of the common securities of which are owned by the Company, issued \$810 million of 7-1/4% Capital Securities (the "Capital Securities II") that are guaranteed by the Company. The Capital Trust II issued the Capital Securities II and invested the proceeds in 7-1/4% Junior Subordinated Deferrable Interest Debentures issued by the Company, which are due July 31, 2031.

#### **Contractual Obligations, Commitments and Less Liquid Assets.**

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

The Company's future cash payments associated with its contractual obligations pursuant to its long-term debt, operating leases and aircraft purchase obligations as of November 30, 2001 are summarized below:

	Payments due in:				
	Fiscal 2002	Fiscal 2003-2004	Fiscal 2005-2006	Thereafter	Total
(dollars in millions)					
Long-term debt(1) . . . . .	\$10,027	\$17,842	\$12,744	\$ 9,055	\$49,668
Operating leases(2) . . . . .	457	740	647	2,594	4,438
Aircraft purchase obligations(2)(3) . . . . .	447	117	—	—	564
<b>Total</b> . . . . .	<b>\$10,931</b>	<b>\$18,699</b>	<b>\$13,391</b>	<b>\$11,649</b>	<b>\$54,670</b>

(1) See Note 7 to the consolidated financial statements.

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

(3) Approximately 80% of the aircraft to be acquired under these purchase obligations are subject to contractual lease arrangements.

The Company's commitments associated with outstanding letters of credit, private equity and other principal investment activities, and financing commitments as of November 30, 2001 are summarized below. Since commitments associated with letters of credit and financing arrangements may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Fiscal 2002	Fiscal 2003-2004	Fiscal 2005-2006	Thereafter	Total
(dollars in millions)					
Letters of credit(1) .....	\$4,520	\$ —	\$ —	\$ —	\$ 4,520
Private equity and other principal investments(1) .....	18	60	47	675	800
Financing commitments to investment grade counterparties(1) .....	3,190	2,727	315	62	6,294
Financing commitments to non-investment grade counterparties(1) .....	230	69	344	185	828
<b>Total</b> .....	<b>\$7,958</b>	<b>\$2,856</b>	<b>\$706</b>	<b>\$922</b>	<b>\$12,442</b>

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

The table above does not include commitments to extend credit for consumer loans in the amount of \$304 billion. Such commitments arise 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 4 to the consolidated financial statements). In addition, in the ordinary course of business, the Company guarantees the unsecured 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 unsecured debt or trading obligations) are included in the Company's consolidated financial statements.

At November 30, 2001, certain assets of the Company, such as real property, equipment and leasehold improvements of \$2.6 billion, aircraft assets of \$4.8 billion and goodwill of \$1.4 billion, were illiquid. Certain equity investments made in connection with the Company's private equity and other principal investment activities, certain high-yield debt securities, certain collateralized mortgage obligations and mortgage-related loan products, bridge financings, and certain senior secured loans and positions also are not highly liquid. At November 30, 2001, the Company had aggregate principal investments associated with its private equity and other principal investment activities (including direct investments and partnership interests) with a carrying value of approximately \$800 million, of which approximately \$300 million represented the Company's investments in its real estate funds.

In connection with the Company's fixed income securities activities, the Company underwrites, trades, invests and makes markets in non-investment grade instruments ("high-yield instruments"). For purposes of this discussion, high-yield instruments are defined as fixed income, emerging market, preferred equity securities and distressed debt rated BB+ or lower (or equivalent ratings by recognized credit rating agencies) as well as non-rated securities which, in the opinion of the Company, contain credit risks associated with non-investment grade instruments. For purposes of this discussion, positions associated with the Company's credit derivatives business are not included because reporting gross market value exposures would not accurately reflect the risks associated with these positions due to the manner in which they are risk-managed. High-yield instruments generally involve greater risk than investment grade securities due to the lower credit ratings of the issuers, which typically have relatively high levels of indebtedness and, therefore, are more sensitive to adverse economic conditions. In addition, the market for high-yield instruments is, and may continue to be, characterized by periods of volatility and illiquidity. The Company has credit and other risk policies and procedures to monitor total inventory

positions and risk concentrations for high-yield instruments that are administered in a manner consistent with the Company's overall risk management policies and control structure. 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, 2001 and November 30, 2000, the Company had high-yield instruments owned with a market value of approximately \$1.3 billion and \$2.2 billion, respectively, and had high-yield instruments sold, not yet purchased with a market value of \$0.5 billion and \$0.5 billion, respectively.

In connection with certain of its business activities, the Company provides, on a selective basis, through certain of its subsidiaries (including Morgan Stanley Bank) financing or financing commitments to companies in the form of senior and subordinated debt, including bridge financing. The borrowers may be rated investment grade or non-investment grade. These loans and funding commitments typically are secured against the borrower's assets (in the case of senior loans), have varying maturity dates, and are generally contingent upon certain representations, warranties and contractual conditions applicable to the borrower. As part of these activities, the Company may syndicate and trade certain of these loans. At November 30, 2001 and November 30, 2000, the aggregate value of investment grade loans and positions was \$1.5 billion and \$2.1 billion, respectively, and the aggregate value of non-investment grade loans and positions was \$1.4 billion and \$2.2 billion, respectively. The aggregate value and volume of financing activity decreased in fiscal 2001, primarily due to difficult global market and economic conditions. The Company expects that requests to provide financing or financing commitments in connection with certain investment banking activities will continue and may grow in the future.

In fiscal 2001, the Company sold a 1 million-square-foot office tower in New York City that has been under construction since 1999. Under the terms of the sale agreement, the Company is obligated to complete the construction of the building, which is expected to occur in mid-2002.

#### **Regulatory Capital Requirements.**

MS&Co. and Morgan Stanley DW Inc. (formerly Dean Witter Reynolds Inc.) ("MSDWI") are registered broker-dealers and registered futures commission merchants and, accordingly, are subject to the minimum net capital requirements of the Securities and Exchange Commission, the New York Stock Exchange and the Commodity Futures Trading Commission. 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 12 to the consolidated financial statements).

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation ("FDIC") and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1 capital, as defined, to average assets ("leverage ratio"), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets ("Tier 1 risk-weighted capital ratio") and (c) 8% of total capital, as defined, to risk-weighted assets ("total risk-weighted capital ratio"). At November 30, 2001, 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.

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 portion of the Company's business is conducted in currencies other than the U.S. dollar. Non-U.S. dollar assets typically are financed by direct borrowing or swap-based funding in the same currency. Changes in foreign exchange rates affect non-U.S. dollar revenues as well as non-U.S. dollar expenses. Those foreign exchange exposures that arise and are not hedged by an offsetting foreign currency exposure are actively managed by the Company to minimize risk of loss due to currency fluctuations.

### **Derivative Financial Instruments.**

The Company actively offers to counterparties and trades for its own account a variety of financial instruments described as "derivative products" or "derivatives." These products generally take the form of futures, forwards, options, swaps (including credit default swaps), caps, collars, floors, swap options and similar instruments that derive their value from underlying interest rates, foreign exchange rates, commodities, equity instruments, equity indices, reference credits or other assets. All of the Company's trading-related divisions use derivative products as an integral part of their respective trading strategies, and such products are used extensively to manage the market exposure that results from a variety of proprietary trading activities (see Note 10 to the consolidated financial statements). In addition, as a dealer in certain derivative products, most notably interest rate and currency swaps, the Company enters into derivative contracts to meet a variety of risk management and other financial needs of its counterparties. Given the highly integrated nature of derivative products and related cash instruments in the determination of overall trading division profitability and the context in which the Company manages its trading areas, it is not meaningful to allocate trading revenues between the derivative and underlying cash instrument components. Moreover, the risks associated with the Company's derivative activities, including market and credit risks, are managed on an integrated basis with associated cash instruments in a manner consistent with the Company's overall risk management policies and control structure (see "Risk Management" following "Management's Discussion and Analysis of Financial Condition and Results of Operations"). It should be noted that while particular risks may be associated with the use of derivatives, in many cases derivatives serve to reduce, rather than increase, the Company's exposure to market, credit and other risks.

With respect to its derivatives positions, the Company's exposure to market risk relates to changes in interest rates, foreign currency exchange rates, or the fair value of the underlying financial instruments or commodities. The Company's exposure to credit risk at any point in time is represented by the fair value of such contracts reported as assets. Such total fair value outstanding as of November 30, 2001 was \$32.1 billion. Approximately \$25.7 billion of that credit risk exposure was with counterparties rated single-A or better (see Note 10 to the consolidated financial statements).

The Company also uses derivative products (primarily interest rate, currency and equity swaps) to assist in asset and liability management, reduce borrowing costs and hedge interest rate risk (see Note 7 to the consolidated financial statements).

The Company believes that derivatives are valuable tools that can provide cost-effective solutions to complex financial problems and remains committed to providing its counterparties with innovative financial products. The Company established Morgan Stanley Derivative Products Inc. to offer derivative products to counterparties that will enter into derivative transactions only with triple-A rated counterparties. In addition, the Company, through its continuing involvement with regulatory, self-regulatory and industry activities, provides leadership in the development of policies and practices in order to maintain confidence in the markets for derivative products, which is critical to the Company's ability to assist counterparties in meeting their overall financial needs.