

MORGAN STANLEY  
Form 10-Q  
April 06, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

**x    QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

For the quarterly period ended February 28, 2007

OR

**..    TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-11758

**Morgan Stanley**

(Exact Name of Registrant as Specified in its Charter)

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**Delaware**  
(State of Incorporation)

**36-3145972**  
(I.R.S. Employer Identification No.)

**1585 Broadway**

**New York, NY**  
(Address of Principal  
Executive Offices)

**10036**  
(Zip Code)

**Registrant's telephone number, including area code: (212) 761-4000**

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☒

Accelerated Filer ☐

Non-Accelerated Filer ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of March 31, 2007, there were 1,053,930,564 shares of the Registrant's Common Stock, par value \$.01 per share, outstanding.

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**AVAILABLE INFORMATION**

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Morgan Stanley) file electronically with the SEC. Morgan Stanley's electronic SEC filings are available to the public at the SEC's internet site, [www.sec.gov](http://www.sec.gov).

Morgan Stanley's internet site is [www.morganstanley.com](http://www.morganstanley.com). You can access Morgan Stanley's Investor Relations webpage at [www.morganstanley.com/about/ir](http://www.morganstanley.com/about/ir). Morgan Stanley makes available free of charge, on or through our Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through its Investor Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of Morgan Stanley's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

Morgan Stanley has a Corporate Governance webpage. You can access information about Morgan Stanley's corporate governance at [www.morganstanley.com/about/company/governance](http://www.morganstanley.com/about/company/governance). Morgan Stanley posts the following on its Corporate Governance webpage:

Composite Certificate of Incorporation;

Bylaws;

Charters for our Audit Committee, Compensation, Management Development and Succession Committee and Nominating and Governance Committee;

Corporate Governance Policies;

Policy Regarding Communication with the Board of Directors;

Policy Regarding Director Candidates Recommended by Shareholders;

Policy Regarding Corporate Political Contributions;

Policy Regarding Shareholder Rights Plan;

Code of Ethics and Business Conduct; and

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Integrity Hotline.

Morgan Stanley's Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, its Chief Financial Officer and its Controller and Principal Accounting Officer. Morgan Stanley will post any amendments to the Code of Ethics and Business Conduct and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, Inc. ( NYSE ) on its internet site. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley's internet site is not incorporated by reference into this report.

**Table of Contents****Item 1.****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(dollars in millions, except share data)**

	February 28, 2007	November 30, 2006 (unaudited)
<b>Assets</b>		
Cash and cash equivalents	\$ 16,636	\$ 20,606
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$10,189 at February 28, 2007 and \$8,648 at November 30, 2006)	35,739	29,565
Financial instruments owned (approximately \$136 billion and \$125 billion were pledged to various parties at February 28, 2007 and November 30, 2006, respectively):		
U.S. government and agency securities	42,569	39,352
Other sovereign government obligations	32,349	27,305
Corporate and other debt	181,963	169,664
Corporate equities	97,082	86,058
Derivative contracts	50,952	55,443
Physical commodities	2,839	3,031
Total financial instruments owned	407,754	380,853
Securities received as collateral	82,684	64,588
Collateralized agreements:		
Securities purchased under agreements to resell	192,038	174,866
Securities borrowed	277,093	299,631
Receivables:		
Consumer loans (net of allowances of \$790 at February 28, 2007 and \$831 at November 30, 2006)	22,429	24,173
Customers	90,320	82,931
Brokers, dealers and clearing organizations	14,426	7,633
Fees, interest and other	11,087	9,700
Office facilities and other equipment, at cost (net of accumulated depreciation of \$3,790 at February 28, 2007 and \$3,645 at November 30, 2006)	4,313	4,086
Goodwill	3,131	2,792
Intangible assets (net of accumulated amortization of \$137 million at February 28, 2007 and \$109 million at November 30, 2006)	1,131	651
Other assets	23,280	19,117
Total assets	\$ 1,182,061	\$ 1,121,192

**Table of Contents****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (Continued)**

(dollars in millions, except share data)

	February 28, 2007	November 30, 2006
	(unaudited)	
<b>Liabilities and Shareholders' Equity</b>		
Commercial paper and other short-term borrowings	\$ 33,829	\$ 29,092
Deposits	37,313	28,343
Financial instruments sold, not yet purchased:		
U.S. government and agency securities	18,062	26,168
Other sovereign government obligations	26,192	28,961
Corporate and other debt	8,436	10,336
Corporate equities	52,086	59,399
Derivative contracts	51,574	57,491
Physical commodities	1,457	764
Total financial instruments sold, not yet purchased	157,807	183,119
Obligation to return securities received as collateral	82,684	64,588
Collateralized financings:		
Securities sold under agreements to repurchase	288,672	267,566
Securities loaned	161,839	150,257
Other secured financings	51,594	45,556
Payables:		
Customers	132,980	134,907
Brokers, dealers and clearing organizations	8,806	7,635
Interest and dividends	4,687	4,746
Other liabilities and accrued expenses	24,063	24,975
Long-term borrowings	159,833	144,978
	1,144,107	1,085,762
Capital Units		66
Commitments and contingencies		
Shareholders' equity:		
Preferred stock	1,100	1,100
Common stock, \$0.01 par value;		
Shares authorized: 3,500,000,000 at February 28, 2007 and November 30, 2006;		
Shares issued: 1,211,701,552 at February 28, 2007 and November 30, 2006;		
Shares outstanding: 1,061,644,077 at February 28, 2007 and 1,048,877,006 at November 30, 2006	12	12
Paid-in capital	2,084	2,213
Retained earnings	43,975	41,422
Employee stock trust	5,773	4,315
Accumulated other comprehensive loss	(127)	(35)
Common stock held in treasury, at cost, \$0.01 par value;		
150,057,475 shares at February 28, 2007 and 162,824,546 shares at November 30, 2006	(9,090)	(9,348)
Common stock issued to employee trust	(5,773)	(4,315)

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Total shareholders' equity	37,954	35,364
Total liabilities and shareholders' equity	\$ 1,182,061	\$ 1,121,192

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(dollars in millions, except share and per share data)

	<b>Three Months Ended February 28,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(unaudited)</b>	
Revenues:		
Investment banking	\$ 1,227	\$ 982
Principal transactions:		
Trading	4,158	3,086
Investments	920	349
Commissions	1,005	920
Fees:		
Asset management, distribution and administration	1,479	1,268
Merchant, cardmember and other fees, net	297	289
Servicing and securitization income	556	596
Interest and dividends	14,814	10,544
Other	222	134
Total revenues	24,678	18,168
Interest expense	13,485	9,461
Provision for consumer loan losses	195	155
Net revenues	10,998	8,552
Non-interest expenses:		
Compensation and benefits	4,992	4,242
Occupancy and equipment	280	230
Brokerage, clearing and exchange fees	361	292
Information processing and communications	369	346
Marketing and business development	294	238
Professional services	499	433
Other	339	311
Total non-interest expenses	7,134	6,092
Income from continuing operations before losses from unconsolidated investees and income taxes	3,864	2,460
Losses from unconsolidated investees	44	69
Provision for income taxes	1,261	789
Income from continuing operations	2,559	1,602
Discontinued operations:		
Gain/(loss) from discontinued operations	174	(48)
Income tax (provision)/benefit	(61)	20
Gain/(loss) on discontinued operations	113	(28)
Net income	\$ 2,672	\$ 1,574
Preferred stock dividend requirements	\$ 17	\$
Earnings applicable to common shareholders	\$ 2,655	\$ 1,574

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Earnings per basic common share:			
Income from continuing operations	\$	2.52	\$ 1.57
Gain/(loss) on discontinued operations		0.11	(0.03)
Earnings per basic common share	\$	2.63	\$ 1.54
Earnings per diluted common share:			
Income from continuing operations	\$	2.40	\$ 1.51
Gain/(loss) on discontinued operations		0.11	(0.03)
Earnings per diluted common share	\$	2.51	\$ 1.48
Average common shares outstanding:			
Basic		1,009,186,993	1,020,041,181
Diluted		1,057,912,545	1,061,764,798

See Notes to Condensed Consolidated Financial Statements.

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**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in millions)

	<b>Three Months Ended February 28, 2007      2006 (unaudited)</b>	
Net income	\$ 2,672	\$ 1,574
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments	(102)	33
Net change in cash flow hedges	8	27
Minimum pension liability adjustment	2	
Comprehensive income	\$ 2,580	\$ 1,634

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in millions)

	Three Months Ended February 28, 20072006 (unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,672	\$ 1,574
Adjustments to reconcile net income to net cash used for operating activities:		
Compensation payable in common stock and options	607	763
Depreciation and amortization	204	179
Provision for consumer loan losses	195	155
Gain on sale of Quilter	(168)	
Aircraft-related charges		125
Changes in assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	(6,171)	1,830
Financial instruments owned, net of financial instruments sold, not yet purchased	(44,068)	(20,398)
Securities borrowed	22,538	(8,655)
Securities loaned	11,582	20,567
Receivables and other assets	(19,048)	(26,298)
Payables and other liabilities	(1,807)	2,648
Securities purchased under agreements to resell	(17,172)	(1,930)
Securities sold under agreements to repurchase	20,471	8,450
Net cash used for operating activities	(30,165)	(20,990)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Office facilities and aircraft under operating leases	(295)	(129)
Business acquisitions, net of cash acquired	(1,167)	(1,676)
Net principal disbursed on consumer loans	(623)	(2,857)
Sales of consumer loans	1,578	6,613
Net cash (used for) provided by investing activities	(507)	1,951
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from (payments for):		
Short-term borrowings	4,523	(1,711)
Derivatives financing activities	(578)	(168)
Other secured financings	(409)	3,501
Deposits	8,950	4,668
Tax benefits associated with stock-based awards	110	14
Net proceeds from:		
Issuance of common stock	332	99
Issuance of long-term borrowings	21,839	12,093
Payments for:		
Repayments of long-term borrowings	(6,484)	(1,973)
Redemption of Capital Units	(66)	
Repurchases of common stock	(1,210)	(1,199)
Cash dividends	(305)	(290)

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Net cash provided by financing activities	26,702	15,034
Net decrease in cash and cash equivalents	(3,970)	(4,005)
Cash and cash equivalents, at beginning of period	20,606	29,414
Cash and cash equivalents, at end of period	\$ 16,636	\$ 25,409

See Notes to Condensed Consolidated Financial Statements.

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**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. Introduction and Basis of Presentation.**

**The Company.** Morgan Stanley (the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group, Asset Management and Discover.

A summary of the activities of each of the Company's business segments is as follows:

*Institutional Securities* includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; 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; benchmark indices and risk management analytics; research; and investment activities.

*Global Wealth Management Group* provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; banking and cash management services; retirement services; and trust and fiduciary services.

*Asset Management* provides global asset management products and services in equity, fixed income, alternative investments and private equity to institutional and retail clients through proprietary and third party retail distribution channels, intermediaries and the Company's institutional distribution channel. Asset Management also engages in investment activities.

*Discover* offers Discover®-branded credit cards and related consumer products and services and operates the Discover Network, a merchant and cash access network for Discover Network-branded cards, and PULSE® EFT Association LP (PULSE), an automated teller machine/debit and electronic funds transfer network. Discover also offers consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard and Visa networks.

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (the Discover Spin-off). The Discover Spin-off, which is subject to regulatory approval and other customary conditions, is expected to occur in the third quarter of fiscal 2007.

**Basis of Financial Information.** The condensed 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 regarding the valuations of certain financial instruments, consumer loan loss levels, the outcome of litigation and tax matters, incentive-based compensation accruals and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

In connection with the Company's application of Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* in fiscal 2006, the Company has adjusted its opening retained earnings for fiscal 2006 and its financial results for the first two quarters of fiscal 2006. See Note 24 to the consolidated financial statements for the fiscal year ended November 30, 2006, included in the Form 10-K.

The Company maintains various deferred compensation plans for the benefit of certain employees. Beginning in the quarter ended February 28, 2007, increases or decreases in assets or earnings associated with such plans are reflected in net revenues, and increases or decreases in liabilities associated with such plans are reflected in compensation expense. Previously, the increases or decreases in assets and liabilities associated with these plans were both recorded in net revenues. Prior periods have been reclassified to conform to the current presentation.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

The amount of the reclassification that was recorded in the three months ended February 28, 2007 and February 28, 2006 was \$245 million and \$94 million, respectively.

All material intercompany balances and transactions have been eliminated.

**Consolidation.** The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and other entities in which the Company has a controlling financial interest.

For entities where (1) the total equity investment at risk is sufficient to enable the entity to finance its activities independently, and (2) the equity holders bear the economic residual risks of the entity and have the right to make decisions about the entity's activities, the Company consolidates those entities it controls through a majority voting interest or otherwise. For entities that do not meet these criteria, commonly known as variable interest entities ( VIE ), the Company consolidates those entities where the Company absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of such entity.

Notwithstanding the above, certain securitization vehicles, commonly known as qualifying special purpose entities, are not consolidated by the Company if they meet certain criteria regarding the types of assets and derivatives they may hold, the types of sales they may engage in, and the range of discretion they may exercise in connection with the assets they hold.

For investments in entities in which the Company does not have a controlling financial interest, but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting. As discussed in Note 18, the Company has elected to fair value certain investments that had previously been accounted for under the equity method.

Equity and partnership interests held by entities qualifying for accounting purposes as investment companies are carried at fair value.

The Company's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated ( MS&Co. ), Morgan Stanley & Co. International Limited ( MSIL ), Morgan Stanley Japan Securities Co., Ltd. ( MSJS ), Morgan Stanley Investment Advisors Inc. and Discover Financial Services (formerly NOVUS Credit Services Inc.). On April 1, 2007, the Company merged Morgan Stanley DW Inc. ( MSDWI ) into MS&Co. Upon completion of the merger, the surviving entity, MS&Co., became the Company's principal U.S. broker-dealer.

**Income Statement Presentation.** The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. In connection with the delivery of the various products and services to clients, the Company manages its revenues and related expenses in the aggregate. As such, when assessing the performance of its businesses, the Company considers its principal trading, investment banking, commissions and interest and dividend income, along with the associated interest expense and provision for loan losses, as one integrated activity for each of the Company's separate businesses.

The Company's cost infrastructure supporting its businesses varies by activity. In some cases, these costs are directly attributable to one line of business, and, in other cases, such costs relate to multiple businesses. As such, when assessing the performance of its businesses, the Company does not consider these costs separately, but rather assesses performance in the aggregate along with the related revenues.

Therefore, the Company's pricing structure considers various items, including the level of expenses incurred directly and indirectly to support the cost infrastructure, the risk it incurs in connection with a transaction, the overall client relationship and the availability in the market for the particular product and/or service. Accordingly, the Company does not manage or capture the costs associated with the products or services sold or its general and administrative costs by revenue line, in total or by product.





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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

***Discontinued Operations.***

*Quilter Holdings Ltd.* The results of Quilter Holdings Ltd. ( Quilter ) are reported as discontinued operations for all periods presented through its sale on February 28, 2007. The results of Quilter were formerly included in the Global Wealth Management Group business segment.

*Aircraft Leasing.* The Company's aircraft leasing business was classified as held for sale prior to its sale on March 24, 2006, and associated revenues and expenses through the date of sale have been reported as discontinued operations for the quarter ended February 28, 2006. The results of the Company's aircraft leasing business were formerly included in the Institutional Securities business segment.

See Note 15 for additional information on discontinued operations.

***Revenue Recognition.***

*Investment Banking.* Underwriting revenues and fees for mergers, acquisitions and advisory assignments are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

*Commissions.* The Company generates commissions from executing and clearing customer transactions on stock, options and futures markets. Commission revenues are recorded in the accounts on trade date.

*Asset Management, Distribution and Administration Fees.* Asset management, distribution and administration fees are recognized over the relevant contract period, generally quarterly or annually. In certain management fee arrangements, the Company is entitled to receive performance fees when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement.

*Merchant, Cardmember and Other Fees, Net.* Merchant, cardmember and other fees include revenues from fees charged to merchants on credit card sales (net of interchange fees paid to banks that issue cards on the Company's merchant and cash access network), transaction processing fees on debit card transactions as well as charges to cardmembers for late payment fees, overlimit fees, balance transfer fees, credit protection fees and cash advance fees, net of cardmember rewards. Merchant, cardmember and other fees are recognized as earned. Cardmember rewards include various reward programs, including the Cashback Bonus® reward program, pursuant to which the Company pays certain cardmembers a percentage of their purchase amounts based upon a cardmember's level and type of purchases. The liability for cardmember rewards, included in Other liabilities and accrued expenses, is computed on an individual cardmember basis and is accumulated as qualified cardmembers make progress toward earning a reward through their ongoing purchase activity. In determining the liability for cardmember rewards, the Company considers estimated forfeitures based on historical account closure, charge-off and transaction activity. The Company records the cost of its cardmember reward programs as a reduction of Merchant, cardmember and other fees.

*Consumer Loans.* Consumer loans, which consist primarily of general purpose credit card, mortgage and consumer installment loans, are generally reported at their principal amounts outstanding less applicable allowances. Interest on consumer loans is recorded to income as earned. Interest is generally accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

becomes 180 contractually days past due, except in the case of cardmember bankruptcies, probate accounts, and fraudulent transactions. Cardmember bankruptcies and probate accounts are charged off at the end of the month 60 days following the receipt of notification of the bankruptcy or death but not later than the 180-day contractual time frame. Fraudulent transactions are reported in consumer loans at their net realizable value upon receipt of notification of the fraud through a charge to operating expenses and are subsequently written off at the end of the month 90 days following notification but not later than the contractual 180-day time frame. The interest portion of charged-off credit card loans is written off against interest revenue. Origination costs related to the issuance of credit cards are charged to earnings over periods not exceeding 12 months.

The Company classifies a portion of its consumer loans as held for sale. Loans held for sale include the lesser of loans eligible for securitization or sale, or loans that management intends to securitize within three months, net of amortizing securitizations. These loans are carried at the lower of aggregate cost or fair value.

As discussed in Note 18, the Company has elected to account for certain mortgage lending products at fair value.

*Financial Instruments.* The Company's financial assets and financial liabilities are primarily recorded at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

As a result of the Company's adoption of Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159), on December 1, 2006, the Company elected the fair value option for certain instruments. Such instruments included loans and other financial instruments held by subsidiaries that are not registered broker-dealers as defined in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, or that are held by investment companies as defined in the AICPA Audit and Accounting Guide, *Investment Companies*. A substantial portion of these positions, as well as the financial instruments included within Other secured financings, had been accounted for by the Company at fair value prior to the adoption of SFAS No. 159. Changes in the fair value of these positions are included within Principal transactions trading revenues in the Company's condensed consolidated statements of income.

Financial Instruments Used for Trading and Investment. Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected net in Principal transactions trading revenues in the condensed consolidated statements of income.

The fair value of the Company's financial instruments are generally based on or derived from bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased.

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

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Also as a result of the adoption of SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ), on December 1, 2006, the Company no longer utilizes block discounts in cases where it has large holdings of unrestricted financial instruments with quoted prices that are readily and regularly available in an active market.

In the case of over-the-counter ( OTC ) derivative contracts, fair value is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed-form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty. As a result of the Company's adoption of SFAS No. 157, the impact of the Company's own credit spreads are also considered when measuring the fair value of liabilities, including certain OTC derivative contracts.

Prior to the adoption of SFAS No. 157, the Company followed the provisions of Emerging Issues Task Force ( EITF ) Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities ( EITF Issue No. 02-3 ). See also Note 18. Under EITF Issue No. 02-3, in the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, revenue recognition at the inception of an OTC derivative financial instrument was not permitted. Such revenue was recognized in income at the earlier of when there was market value observability or at the end of the contract period. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value was based on the transaction price. With the adoption of SFAS No. 157, the Company is no longer applying the revenue recognition criteria of EITF Issue No. 02-3.

Substantially all equity and debt investments purchased in connection with private equity and other investment activities are valued at fair value and are included within Other assets in the condensed consolidated statements of financial condition, and gains and losses are reflected in Principal transactions' investment revenues. The carrying value of such investments reflects expected exit values based upon appropriate valuation techniques applied on a consistent basis. Such techniques employ various market, income and cost approaches to determine fair value at the measurement date. The Company's partnership interests, including general partnership and limited partnership interests in real estate funds, are included within Other assets in the condensed consolidated statements of financial condition and are recorded at fair value based upon changes in the fair value of the underlying partnership's net assets.

Purchases and sales of financial instruments and related expenses are recorded on trade date. The fair value of OTC financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

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The Company nets cash collateral paid or received against its derivatives inventory under credit support annexes, which the Company views as conditional contracts, pursuant to legally enforceable master netting agreements.

Financial Instruments Used for Asset and Liability Management. The Company applies hedge accounting to various derivative financial instruments used to hedge interest rate, foreign exchange and credit risk arising from assets, liabilities and forecasted transactions. These instruments are included within Financial instruments owned derivative contracts or Financial instruments sold, not yet purchased derivative contracts within the condensed consolidated statements of financial condition.

These hedges are designated and qualify for accounting purposes as one of the following types of hedges: hedges of changes in fair value of assets and liabilities due to the risk being hedged (fair value hedges), hedges of the variability of future cash flows from forecasted transactions and floating rate assets and liabilities due to the risk being hedged (cash flow hedges) and hedges of net investments in foreign operations whose functional currency is different from the reporting currency of the parent company (net investment hedges).

For all hedges where hedge accounting is being applied, effectiveness testing and other procedures to ensure the ongoing validity of the hedges are performed at least monthly. The impact of hedge ineffectiveness and amounts excluded from the assessment of hedge effectiveness on the condensed consolidated statements of income was not material for all periods presented. If a derivative is de-designated as a hedge, it is thereafter accounted for as a financial instrument used for trading.

**Fair Value Hedges Interest Rate Risk.**

In the first quarter of fiscal 2007, the Company's designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of senior long-term fixed rate borrowings. In the first quarter of fiscal 2007, the Company began using regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (i.e., the Company applied the long-haul method of hedge accounting). A hedging relationship is deemed to be effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%.

Previously, the Company's designated fair value hedges consisted primarily of interest rate swaps, including swaps with embedded options that mirrored features contained in the hedged items, designated as fair value hedges of changes in the benchmark interest rate of fixed rate borrowings, including both certificates of deposit and senior long-term borrowings. For these hedges, the Company ensured that the terms of the hedging instruments and hedged items matched and other accounting criteria were met so that the hedges were assumed to have no ineffectiveness (i.e., the Company applied the shortcut method of hedge accounting). The Company also used interest rate swaps as fair value hedges of the benchmark interest rate risk of host contracts of equity-linked notes that contained embedded derivatives. For these hedging relationships, regression analysis was used for the prospective and retrospective assessments of hedge effectiveness.

For qualifying fair value hedges of benchmark interest rates, the changes in the fair value of the derivative and the changes in the fair value of the hedged liability provide offset of one another and, together with any resulting ineffectiveness, are recorded in Interest expense. When a derivative is de-designated as a hedge, any basis adjustment remaining on the hedged liability is amortized to Interest expense over the life of the liability using the effective interest method.

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**Fair Value Hedges Credit Risk.**

The Company has designated a portion of the credit derivative embedded in a non-recourse structured note liability as a fair value hedge of the credit risk arising from a loan receivable to which the structured note liability is specifically linked. Regression analysis is used to perform prospective and retrospective assessments of hedge effectiveness for this hedge relationship. The changes in the fair value of the derivative and the changes in the fair value of the hedged item provide offset of one another and, together with any resulting ineffectiveness, are recorded in Principal transactions trading revenues.

**Cash Flow Hedges.**

Before the sale of the aircraft leasing business (see Note 15), the Company applied hedge accounting to interest rate swaps used to hedge variable rate long-term borrowings associated with this business. Changes in the fair value of the swaps were recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and then reclassified to Interest expense as interest on the hedged borrowings was recognized.

In connection with the sale of the aircraft leasing business, the Company de-designated the interest rate swaps associated with this business effective August 31, 2005 and no longer accounts for them as cash flow hedges. Amounts in Accumulated other comprehensive income (loss) related to those interest rate swaps continue to be reclassified to Interest expense since the related borrowings remain outstanding.

*Net Investment Hedges.* The Company utilizes forward foreign exchange contracts and non-U.S. dollar-denominated debt to manage the currency exposure relating to its net investments in non-U.S. dollar functional currency operations. No hedge ineffectiveness is recognized in earnings since the notional amounts of the hedging instruments equal the portion of the investments being hedged, and, where forward contracts are used, the currencies being exchanged are the functional currencies of the parent and investee; where debt instruments are used as hedges, they are denominated in the functional currency of the investee. The gain or loss from revaluing hedges of net investments in foreign operations at the spot rate is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects. The forward points on the hedging instruments are recorded in Interest and dividend revenues.

*Securitization Activities.* The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations, credit card loans and other types of financial assets (see Notes 3 and 4). The Company may retain interests in the securitized financial assets as one or more tranches of the securitization, undivided seller's interests, accrued interest receivable subordinate to investors' interests (see Note 4), cash collateral accounts, rights to any excess cash flows remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses, and other retained interests. The exposure to credit losses from securitized loans is limited to the Company's retained contingent risk, which represents the Company's retained interest in securitized loans, including any credit enhancement provided. 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, and each subsequent transfer in revolving structures, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. To determine fair values, observable market prices are used if available. However, observable market prices are generally not available for retained interests so the Company estimates fair value based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, payment rates, forward yield curves and discount rates commensurate with the risks involved. The present value of future net excess cash flows that the Company estimates it will receive over the term of the securitized loans is recognized in income as the loans are securitized. An asset also is recorded and charged to income over the term of the securitized loans, with actual net excess cash flows continuing to be recognized in income as they are earned.

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In connection with the adoption of SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140 ( *SFAS No. 156* ) on December 1, 2006, the Company has elected to fair value mortgage servicing rights (see Note 3).

**Stock-Based Compensation.** The Company early adopted SFAS No. 123R, *Share-Based Payment*, using the modified prospective approach as of December 1, 2004. SFAS No. 123R revised the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to service periods.

For stock-based awards issued prior to the adoption of SFAS No. 123R, the Company's accounting policy for awards granted to retirement-eligible employees was to recognize compensation cost over the service period specified in the award terms. The Company accelerates any unrecognized compensation cost for such awards if and when a retirement-eligible employee leaves the Company.

For fiscal 2005 year-end stock-based compensation awards that were granted to retirement-eligible employees in December 2005, the Company recognized the compensation cost for such awards at the date of grant instead of over the service period specified in the award terms. As a result, the Company recorded non-cash incremental compensation expenses of approximately \$395 million in the first quarter of fiscal 2006 for stock-based awards granted to retirement-eligible employees as part of the fiscal 2005 year-end award process and for awards granted to retirement-eligible employees, including new hires, in the first quarter of fiscal 2006. These incremental expenses were included within Compensation and benefits expense and reduced income before taxes within the Institutional Securities (\$270 million), Global Wealth Management Group (\$80 million), Asset Management (\$28 million) and Discover (\$17 million) business segments.

**Consolidated Statements of Cash Flows.** For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less. In connection with business acquisitions, the Company assumed liabilities of \$7,679 million and \$30 million in the first quarter of fiscal 2007 and fiscal 2006, respectively.

## **2. Goodwill and Net Intangible Assets.**

During the first quarter of fiscal 2007, the Company completed the annual goodwill impairment test (as of December 1 in each fiscal year). The Company's testing did not indicate any goodwill impairment.

Changes in the carrying amount of the Company's goodwill and intangible assets for the three month period ended February 28, 2007 were as follows:

	Institutional Securities	Global Wealth Management Group	Asset Management	Discover	Total
	(dollars in millions)				
<b>Goodwill:</b>					
<b>Balance as of November 30, 2006</b>	\$ 701	\$ 589	\$ 968	\$ 534	\$ 2,792
Goodwill acquired during the period(1)	503		91		594
Goodwill disposed during the period(2)		(255)			(255)
<b>Balance as of February 28, 2007</b>	\$ 1,204	\$ 334	\$ 1,059	\$ 534	\$ 3,131





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	Institutional Securities	Global Wealth Management Group	Asset Management (dollars in millions)	Discover	Total
<b>Intangible assets(3):</b>					
<b>Balance as of November 30, 2006</b>	\$ 447	\$	\$ 3	\$ 201	\$ 651
Intangible assets acquired during the period(1)	284		224		508
Amortization expense	(19)		(5)	(4)	(28)
<b>Balance as of February 28, 2007</b>	\$ 712	\$	\$ 222	\$ 197	\$ 1,131

(1) Institutional Securities activity primarily represents goodwill and intangible assets acquired in connection with the Company's acquisitions of Saxon Capital, Inc. and CityMortgage Bank. Asset Management activity represents goodwill and intangible assets acquired in connection with the Company's acquisitions of FrontPoint Partners and Brookville Capital Management (see Note 16).

(2) Activity represents goodwill disposed in connection with the Company's sale of Quilter (see Note 15).

(3) Effective December 1, 2006, mortgage servicing rights have been included in net intangible assets. Amounts as of November 30, 2006 have been reclassified to conform with the current presentation.

**3. Collateralized and Securitization Transactions.**

Securities purchased under agreements to resell (reverse repurchase agreements) and Securities sold under agreements to repurchase (repurchase agreements), principally government and agency securities, are carried at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase agreements and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. The Company's policy is to take possession of securities purchased under agreements to resell. Securities borrowed and Securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions. Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales, consolidated variable interest entities where the Company is deemed to be the primary beneficiary and certain equity-referenced securities and loans where in all instances these liabilities are payable solely from the cash flows of the related assets accounted for as Financial instruments owned.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged securities that can be sold or repledged by the secured party are identified as Financial instruments owned (pledged to various parties) in the condensed consolidated statements of financial condition. The carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	At February 28, 2007 (dollars in millions)	At November 30, 2006
Financial instruments owned:		
U.S. government and agency securities	\$ 13,837	\$ 12,111
Other sovereign government obligations	866	893
Corporate and other debt	51,609	44,237
Corporate equities	6,845	6,662
Total	\$ 73,157	\$ 63,903

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The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Company's inventory positions. The

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Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. At February 28, 2007 and November 30, 2006, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$960 billion and \$942 billion, respectively, and the fair value of the portion that has been sold or repledged was \$762 billion and \$780 billion, respectively.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statement of financial condition. At February 28, 2007 and November 30, 2006, \$82,684 million and \$64,588 million, respectively, were reported as Securities received as collateral and an Obligation to return securities received as collateral in the condensed consolidated statements of financial condition.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company's collateral policies significantly limits the Company's credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold, but not delivered from customers.

In connection with its Institutional Securities business, the Company engages in securitization activities related to residential and commercial mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, and other types of financial assets. These assets are carried at fair value, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income. Retained interests in securitized financial assets associated with the Institutional Securities business were approximately \$4.6 billion at February 28, 2007, the majority of which were related to residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan securitization transactions. Net gains at the time of securitization were not material in the three month period ended February 28, 2007. The assumptions that the Company used to determine the fair value of its retained interests at the time of securitization related to those transactions that occurred during the quarter were not materially different from the assumptions included in the table below. Additionally, as indicated in the table below, the Company's exposure to credit losses related to these retained interests was not material to the Company's results of operations.

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The following table presents information on the Company's residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions at February 28, 2007 were as follows (dollars in millions):

	<b>Residential</b>		
	<b>Mortgage</b>	<b>U.S. Agency</b>	<b>Commercial</b>
	<b>Loans</b>	<b>Collateralized</b>	<b>Mortgage</b>
		<b>Mortgage</b>	<b>Loans</b>
		<b>Obligations</b>	
Retained interests (carrying amount/fair value)	\$ 2,654	\$ 831	\$ 712
Weighted average life (in months)	40	57	98
Credit losses (rate per annum)	0.00 - 5.00%		0.00 - 11.35%
Impact on fair value of 10% adverse change	\$ (156)	\$	\$ (7)
Impact on fair value of 20% adverse change	\$ (298)	\$	\$ (13)
Weighted average discount rate (rate per annum)	11.01%	5.62%	6.76%
Impact on fair value of 10% adverse change	\$ (53)	\$ (17)	\$ (27)
Impact on fair value of 20% adverse change	\$ (105)	\$ (33)	\$ (54)
Prepayment speed assumption(1)(2)	194-2833	PSA 163-580	PSA
Impact on fair value of 10% adverse change	\$ (122)	\$ (3)	\$
Impact on fair value of 20% adverse change	\$ (167)	\$ (7)	\$

(1) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.

(2) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

The table above does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge risks inherent in its retained interests. In addition, the sensitivity analysis is hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the retained interests is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that the Company may take to mitigate the impact of any adverse changes in the key assumptions.

In connection with its Institutional Securities business, during the quarters ended February 28, 2007 and 2006, the Company received proceeds from new securitization transactions of \$14.5 billion and \$12.9 billion, respectively, and cash flows from retained interests in securitization transactions of \$1.7 billion and \$1.2 billion, respectively.

**Mortgage Servicing Rights.** In connection with its Institutional Securities business, the Company may retain servicing rights to certain mortgage loans that are sold through its securitization activities. These transactions create an asset referred to as mortgage servicing rights (MSRs), which are included within Intangible assets on the condensed consolidated statements of financial condition.

In March 2006, the Financial Accounting Standards Board (the FASB) issued SFAS No. 156, which requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The standard permits an entity to subsequently measure each class of servicing assets or servicing



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liabilities at fair value and report changes in fair value in the statement of income in the period in which the changes occur. The Company adopted SFAS No. 156 on December 1, 2006 and has elected to fair value MSR's held as of the date of adoption. This election did not have a material impact on the Company's opening balance of Retained earnings as of December 1, 2006. The Company also elected to fair value MSR's acquired after December 1, 2006.

The following table presents information about the Company's MSR's, which relate to its mortgage loan business activities (dollars in millions):

Fair value as of the beginning of the period	\$ 93
Additions:	
Purchases of servicing assets (1)	187
Servicing assets that result from transfers of financial assets	50
Total Additions	237
Subtractions:	
Sales/Disposals	(18)
Changes in fair value (2):	
Due to change in valuation inputs or assumptions used in the valuation model	
Other changes in fair value	(25)
Fair value as of the end of the period	\$ 287
Amount of contractually specified (2):	
Servicing fees	\$ 38
Late fees	6
Ancillary fees	1
	\$ 45

(1) Includes MSR's obtained in connection with the Company's acquisition of Saxon Capital, Inc. (see Note 16).

(2) These amounts are recorded within Servicing and securitization income in the Company's condensed consolidated statements of income.

**Assumptions Used in Measuring Fair Value:**

Weighted average discount rate	17.87%
Weighted average prepayment speed assumption	977 PSA

The Company generally utilizes information provided by third parties in order to determine the fair value of its MSR's. The valuation of MSR's consist of projecting servicing cash flows and discounting such cash flows using an appropriate risk-adjusted discount rate. These valuations require estimation of various assumptions, including future servicing fees, credit losses and other related costs, discount rates and mortgage prepayment speeds. The Company also compares the estimated fair values of the MSR's from the valuations with observable trades of similar instruments or portfolios. Due to subsequent changes in economic and market conditions, the actual rates of prepayments, credit losses and the value of collateral may differ significantly from the Company's original estimates. Such differences could be material. If actual prepayment rates and credit losses were higher than those assumed, the value of the Company's MSR's could be adversely affected. The Company may hedge a portion of its MSR's through the use of financial instruments, including certain derivative contracts.



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Consumer loans were as follows:

	At February 28, 2007	At November 30, 2006
	(dollars in millions)	
General purpose credit card, mortgage and consumer installment	\$ 23,219	\$ 25,004
Less:		
Allowance for consumer loan losses	790	831
Consumer loans, net	\$ 22,429	\$ 24,173

Activity in the allowance for consumer loan losses was as follows:

	Three Months Ended	
	February 28, 2007	February 28, 2006(1)
	(dollars in millions)	
Balance at beginning of period	\$ 831	\$ 838
Additions:		
Provision for consumer loan losses	195	155
Purchase of loans(2)		44
Deductions:		
Charge-offs	281	300
Recoveries	(45)	(47)
Net charge-offs	236	253
Translation adjustments and other		1
Balance at end of period	\$ 790	\$ 785

(1) Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.

(2) Amount relates to the Company's acquisition of Goldfish and other acquisitions.

Information on net charge-offs of interest and cardmember fees was as follows:

Three Months  
Ended  
February 28,



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	2007 (dollars in millions)	2006
Interest accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction of Interest revenue)	\$ 53	\$ 38
Cardmember fees accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction to Merchant, cardmember and other fee revenue)	\$ 23	\$ 22

At February 28, 2007, the Company had commitments to extend credit for consumer loans of approximately \$273 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. These

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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.

At February 28, 2007 and November 30, 2006, \$1.0 billion and \$2.3 billion, respectively, of the Company's consumer loans were classified as held for sale.

The Company received net proceeds from consumer loan sales of \$1,578 million and \$6,613 million in the quarters ended February 28, 2007 and 2006, respectively.

**Credit Card Securitization Activities.** The Company's retained interests in credit card asset securitizations include undivided seller's interests, accrued interest receivable on securitized credit card receivables, cash collateral accounts, rights to any excess cash flows (Residual Interests) remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses, and other retained interests. The undivided seller's interests less an applicable allowance for loan losses is recorded in Consumer loans. The Company's undivided seller's interests rank *pari passu* with investors' interests in the securitization trusts, and the remaining retained interests are subordinate to investors' interests. Accrued interest receivable and certain other subordinated retained interests are recorded in Other assets at amounts that approximate fair value. The Company receives annual servicing fees based on a percentage of the investor principal balance outstanding. The Company does not recognize servicing assets or servicing liabilities for servicing rights as the servicing contracts provide just adequate compensation, as defined in SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 140), to the Company for performing the servicing. Residual Interests and cash collateral accounts are recorded in Other assets and reflected at fair value with changes in fair value recorded currently in earnings. At February 28, 2007, the Company had \$13,274 million of retained interests, including \$9,805 million of undivided seller's interests, in credit card asset securitizations. The retained interests are subject to credit, payment and interest rate risks on the transferred credit card assets. The investors and the securitization trusts have no recourse to the Company's other assets for failure of cardmembers to pay when due.

During the quarters ended February 28, 2007 and 2006, the Company completed credit card asset securitizations of \$1.6 billion and \$6.6 billion, respectively, and recognized net securitization losses of \$4 million and net securitization gains of \$139 million, respectively, as servicing and securitization income in the condensed consolidated statements of income. The amount for the quarter ended February 28, 2006 includes an increase in the fair value of the Company's retained interests in securitized receivables primarily resulting from a favorable impact on charge-offs following the enactment of federal bankruptcy legislation that became effective in October 2005. Securitized general purpose credit card loans were \$28.3 billion and \$26.7 billion at February 28, 2007 and November 30, 2006, respectively.

Key economic assumptions used in measuring the Residual Interests at the date of securitization resulting from credit card asset securitizations completed during the quarters ended February 28, 2007 and 2006 were as follows:

	<b>Three Months Ended</b>	
	<b>February 28,</b>	
	<b>2007</b>	<b>2006</b>
Weighted average life (in months)	4.8	3.7 - 4.7
Payment rate (rate per month)	20.92%	19.69% - 21.34%
Credit losses (rate per annum)	4.36%	4.72% - 5.23%
Discount rate (rate per annum)	11.00%	11.00%

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Key economic assumptions and the sensitivity of the current fair value of the Residual Interests to immediate 10% and 20% adverse changes in those assumptions were as follows (dollars in millions):

	<b>At February 28, 2007</b>
Residual Interests (carrying amount/fair value)	\$ 332
Weighted average life (in months)	4.2
Weighted average payment rate (rate per month)	20.93%
Impact on fair value of 10% adverse change	\$ (25)
Impact on fair value of 20% adverse change	\$ (47)
Weighted average credit losses (rate per annum)	4.37%
Impact on fair value of 10% adverse change	\$ (38)
Impact on fair value of 20% adverse change	\$ (75)
Weighted average discount rate (rate per annum)	11.00%
Impact on fair value of 10% adverse change	\$ (1)
Impact on fair value of 20% adverse change	\$ (3)

The sensitivity analysis in the table above is hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the Residual Interests is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower payments and increased credit losses), which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that the Company may take to mitigate the impact of any adverse changes in the key assumptions.

The table below summarizes certain cash flows received from the securitization master trusts (dollars in billions):

	<b>Three Months Ended February 28, 2007</b>	<b>2006</b>
Proceeds from new credit card asset securitizations	\$ 1.6	\$ 6.6
Proceeds from collections reinvested in previous credit card asset securitizations	\$ 16.7	\$ 13.9
Contractual servicing fees received	\$ 0.1	\$ 0.1
Cash flows received from retained interests	\$ 0.4	\$ 0.4

The table below presents quantitative information about delinquencies, net principal credit losses and components of managed general purpose credit card loans, including securitized loans (dollars in millions):

**Three Months Ended  
February 28, 2007**

**At February 28, 2007**

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	Loans Outstanding	Loans Delinquent	Average Loans	Net Principal
				Credit Losses
Managed general purpose credit card loans	\$ 50,730	\$ 1,749	\$ 51,390	\$ 521
Less: Securitized general purpose credit card loans	28,320			
Owned general purpose credit card loans	\$ 22,410			

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**5. Long-Term Borrowings and Capital Units.**

**Long-term Borrowings.** Long-term borrowings at February 28, 2007 scheduled to mature within one year aggregated \$20,515 million.

During the quarter ended February 28, 2007, the Company issued senior notes with a carrying value at quarter-end aggregating \$22,235 million, including non-U.S. dollar currency notes aggregating \$10,299 million. Maturities in the aggregate of these notes by fiscal year are as follows: 2007, \$141 million; 2008, \$1,985 million; 2009, \$698 million; 2010, \$3,455 million; 2011, \$975 million; and thereafter, \$14,981 million. In the quarter ended February 28, 2007, \$6,484 million of senior notes were repaid.

The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 5.5 years at February 28, 2007.

**Capital Units.** The Company redeemed all \$66 million of the outstanding Capital Units on February 28, 2007.

**6. Shareholders' Equity.**

**Regulatory Requirements.** MS&Co. is and, until it merged into MS&Co. on April 1, 2007, MSDWI was a registered broker-dealer and registered futures commission merchant and, accordingly, subject to the minimum net capital requirements of the Securities and Exchange Commission (the "SEC"), the New York Stock Exchange, Inc. and the Commodity Futures Trading Commission. MS&Co. and MSDWI have consistently operated in excess of these requirements. MS&Co.'s net capital totaled \$4,385 million at February 28, 2007, which exceeded the amount required by \$2,898 million. MSDWI's net capital totaled \$1,314 million at February 28, 2007, which exceeded the amount required by \$1,246 million. MSIL, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJS, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIL and MSJS have consistently operated in excess of their respective regulatory capital requirements.

On April 1, 2007, the Company merged MSDWI into MS&Co. Upon completion of the merger, the surviving entity, MS&Co., became the Company's principal U.S. broker-dealer.

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation (the "FDIC") and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1 capital, as defined, to average assets ("leverage ratio"), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets ("Tier 1 risk-weighted capital ratio") and (c) 8% of total capital, as defined, to risk-weighted assets ("total risk-weighted capital ratio"). At February 28, 2007, 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.

Effective December 1, 2005, the Company became a consolidated supervised entity ("CSE") as defined by the SEC. As such, the Company is subject to group-wide supervision and examination by the SEC and to minimum capital requirements on a consolidated basis. As of February 28, 2007, the Company was in compliance with the CSE capital requirements.



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MS&Co. is required to hold tentative net capital in excess of \$1 billion and net capital in excess of \$500 million in accordance with the market and credit risk standards of Appendix E of Rule 15c3-1. MS&Co. is also required to notify the SEC in the event that its tentative net capital is less than \$5 billion. As of February 28, 2007, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

**Treasury Shares.** During the quarter ended February 28, 2007, the Company purchased approximately \$1.2 billion of its common stock through open market purchases at an average cost of \$82.02 per share. During the quarter ended February 28, 2006, the Company purchased approximately \$1.2 billion of its common stock through open market purchases at an average cost of \$59.08 per share.

**7. Earnings per Common Share.**

Basic earnings per share ( EPS ) is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the assumed conversion of all dilutive securities. The following table presents the calculation of basic and diluted EPS (in millions, except for per share data):

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	<b>February 28,</b>
	<b>2007</b>	<b>2006</b>
<b>Basic EPS:</b>		
Income from continuing operations	\$ 2,559	\$ 1,602
Gain/(loss) on discontinued operations, net	113	(28)
Preferred stock dividend requirements	(17)	
Net income applicable to common shareholders	\$ 2,655	\$ 1,574
Weighted average common shares outstanding	1,009	1,020
Earnings per basic common share:		
Income from continuing operations	\$ 2.52	\$ 1.57
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per basic common share	\$ 2.63	\$ 1.54
<b>Diluted EPS:</b>		
Net income applicable to common shareholders	\$ 2,655	\$ 1,574
Weighted average common shares outstanding	1,009	1,020
Effect of dilutive securities:		
Stock options and restricted stock units	49	42
Weighted average common shares outstanding and common stock equivalents	1,058	1,062
Earnings per diluted common share:		

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Income from continuing operations	\$ 2.40	\$ 1.51
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per diluted common share	\$ 2.51	\$ 1.48



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The following securities were considered antidilutive and therefore were excluded from the computation of diluted EPS:

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	<b>February 28,</b>
	<b>2007</b>	<b>2006</b>
	<b>(shares in millions)</b>	
Number of antidilutive securities (including stock options and restricted stock units) outstanding at end of period	16	33
Cash dividends declared per common share were \$0.27 for the quarters ended February 28, 2007 and 2006.		

**8. Commitments and Contingencies.**

**Letters of Credit and Other Financial Guarantees.** At February 28, 2007 and November 30, 2006, the Company had approximately \$7.2 billion and \$5.8 billion, respectively, of letters of credit and other financial guarantees outstanding to satisfy various collateral requirements.

**Securities Activities.** In connection with certain of its Institutional Securities business activities, the Company provides loans or lending commitments (including bridge financing) to selected clients. The borrowers may be rated investment grade or non-investment grade. These loans and commitments have varying terms, may be senior or subordinated and/or secured or non-secured, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated, hedged or traded by the Company.

The aggregate value of the investment grade and non-investment grade primary and secondary lending commitments are shown below:

	<b>At</b>	<b>At</b>
	<b>February 28,</b>	<b>November 30,</b>
	<b>2007</b>	<b>2006</b>
	<b>(dollars in millions)</b>	
Investment grade corporate lending commitments	\$ 34,725	\$ 34,306
Non-investment grade corporate lending commitments	24,341	17,809
<b>Total</b>	<b>\$ 59,066</b>	<b>\$ 52,115</b>

Financial instruments sold, not yet purchased include obligations of the Company to deliver specified financial instruments at contracted prices, thereby creating commitments to purchase the financial instruments in the market at prevailing prices. Consequently, the Company's ultimate obligation to satisfy the sale of financial instruments sold, not yet purchased may exceed the amounts recognized in the condensed consolidated statements of financial condition.

The Company has commitments to fund other less liquid investments, including at February 28, 2007, \$900 million in connection with investment activities, \$1,889 million related to forward purchase contracts involving mortgage loans, \$901 million related to mortgage loan

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originations and \$584 million related to commercial loan commitments to small businesses and commitments related to securities-based lending activities. As of February 28, 2007, the Company also had commitments of \$21,191 million related to secured lending transactions. Such commitments to subprime lenders were \$5.2 billion, of which \$2.3 billion was funded and fully collateralized. As of March 31, 2007, the amount that was funded and fully collateralized to subprime lenders was \$2.5 billion, and the amount of the unfunded commitments was \$1.1 billion. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit, to clients that may subject the Company to increased credit and liquidity risks.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

At February 28, 2007, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$129 billion and \$101 billion, respectively.

**Legal.** In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company's business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. The number of reviews, investigations and proceedings has increased in recent years with regards to many firms in the financial services industry, including the Company.

The Company contests liability and/or the amount of damages as appropriate in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how or if such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, and except for the pending matters described in the paragraphs below, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of the pending matters will not have a material adverse effect on the condensed consolidated financial condition of the Company, although the outcome of such matters could be material to the Company's operating results and cash flows for a particular future period, depending on, among other things, the level of the Company's revenues or income for such period. Legal reserves have been established in accordance with SFAS No. 5, Accounting for Contingencies (SFAS No. 5). Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

**Coleman Litigation.** On May 8, 2003, Coleman (Parent) Holdings Inc. (CPH) filed a complaint against the Company in the Circuit Court of the Fifteenth Judicial Circuit for Palm Beach County, Florida. The complaint relates to the 1998 merger between The Coleman Company, Inc. (Coleman) and Sunbeam, Inc. (Sunbeam). The complaint, as amended, alleges that CPH was induced to agree to the transaction with Sunbeam based on certain financial misrepresentations, and it asserts claims against the Company for aiding and abetting fraud, conspiracy and punitive damages. Shortly before trial, which commenced in April 2005, the trial court granted, in part, a motion for entry of a default judgment against the Company and ordered that portions of CPH's complaint, including those setting forth CPH's primary allegations against the Company, be read to the jury and deemed established for all purposes in the action. In May 2005, the jury returned a verdict in favor of CPH and awarded CPH \$604 million in compensatory damages and \$850 million in punitive damages. On June 23, 2005, the trial court issued a final judgment in favor of CPH in the amount of \$1,578 million, which includes prejudgment interest and excludes certain payments received by CPH in settlement of related claims against others.

On June 27, 2005, the Company filed a notice of appeal with the District Court of Appeal for the Fourth District of Florida (the Court of Appeal) and posted a supersedeas bond, which automatically stayed execution of the

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

judgment pending appeal. Included in cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements in the condensed consolidated statement of financial condition is \$1,840 million of money market deposits that have been pledged to obtain the supersedeas bond. The Company filed its initial brief in support of its appeal on December 7, 2005, and, on June 28, 2006, the Court of Appeal heard oral argument. The Company's appeal sought to reverse the judgment of the trial court on several grounds and asked that the case be remanded for entry of a judgment in favor of the Company or, in the alternative, for a new trial. On March 21, 2007, the Court of Appeal issued an opinion reversing the trial court's award for compensatory and punitive damages and remanding the case to the trial court for entry of a judgment for the Company. The opinion will become final upon disposition of any timely filed motions for rehearing.

Until the March 21, 2007 opinion becomes final, the Company is maintaining a reserve for the Coleman litigation. The reserve is presently \$360 million, which the Company believes to be a reasonable estimate, under SFAS No. 5, of the low end of the range of its probable exposure in the event the Court of Appeal's March 21, 2007 opinion is reversed or modified as a result of further appellate proceedings and the case remanded for a new trial. If the trial court's compensatory and/or punitive awards are ultimately upheld on appeal, in whole or in part, the Company may incur an additional expense equal to the difference between the amount affirmed on appeal (and post-judgment interest thereon) and the amount of the reserve. While the Company cannot predict with certainty the amount of such additional expense, such additional expense could have a material adverse effect on the condensed consolidated financial condition of the Company and/or the Company's or Institutional Securities operating results and cash flows for a particular future period, and the upper end of the range could exceed \$1.4 billion.

**Income Taxes.** For information on contingencies associated with income tax examinations, see Note 17.

**9. Derivative Contracts.**

In the normal course of business, the Company enters into a variety of derivative contracts related to financial instruments and commodities. The Company uses these instruments for trading and investment purposes, as well as for asset and liability management. These instruments generally represent future commitments to swap interest payment streams, exchange currencies, or purchase or sell commodities and other financial instruments on specific terms at specified future dates. Many of these products have maturities that do not extend beyond one year, although swaps, options and equity warrants typically have longer maturities. For further discussion of these matters, refer to Note 11 to the consolidated financial statements for the fiscal year ended November 30, 2006, included in the Form 10-K.

Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts ultimately may result in cash settlements exceeding fair value amounts recognized in the condensed consolidated statements of financial condition. The amounts in the following table represent the fair value of exchange traded and OTC options and other contracts (including interest rate, foreign exchange, and other forward contracts and swaps) for derivatives for trading and investment and for asset and liability management, net of offsetting positions in situations where netting is appropriate. The asset amounts are not reported net of non-cash collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses.

Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary.

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#### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (UNAUDITED)

The Company's derivatives (both listed and OTC) at February 28, 2007 and November 30, 2006 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

Product Type	At February 28, 2007		At November 30, 2006	
	Assets	Liabilities	Assets	Liabilities
(dollars in millions)				
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	\$ 19,300	\$ 13,284	\$ 19,444	\$ 15,688
Foreign exchange forward contracts and options	4,354	4,610	7,325	7,725
Equity securities contracts (including equity swaps, warrants and options)	16,409	23,421	16,705	23,155
Commodity forwards, options and swaps	10,889	10,259	11,969	10,923
Total	\$ 50,952	\$ 51,574	\$ 55,443	\$ 57,491

#### 10. Segment Information.

The Company structures its segments primarily based upon the nature of the financial products and services provided to customers and the Company's management organization. The Company provides a wide range of financial products and services to its customers in each of its business segments: Institutional Securities, Global Wealth Management Group, Asset Management and Discover. For further discussion of the Company's business segments, see Note 1. Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.

Revenues and expenses directly associated with each respective segment are included in determining their operating results. Other revenues and expenses that are not directly attributable to a particular segment are allocated based upon the Company's allocation methodologies, generally based on each segment's respective net revenues, non-interest expenses or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group's global representatives.

Selected financial information for the Company's segments is presented below:

	Global Wealth				Intersegment	Total
	Institutional	Management	Asset	Discover		
Three Months Ended February 28, 2007	Securities	Group	Management	Discover	Eliminations	
(dollars in millions)						
Net revenues excluding net interest	\$ 6,838	\$ 1,354	\$ 907	\$ 632	\$ (62)	\$ 9,669
Net interest	793	136	(2)	393	9	1,329

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Net revenues	\$ 7,631	\$ 1,490	\$ 905	\$ 1,025	\$ (53)	\$ 10,998
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 3,031	\$ 220	\$ 236	\$ 372	\$ 5	\$ 3,864
Losses from unconsolidated investees	43			1		44
Provision for income taxes	942	83	96	138	2	1,261
Income from continuing operations(1)	\$ 2,046	\$ 137	\$ 140	\$ 233	\$ 3	\$ 2,559

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	<b>Global Wealth</b>					
	<b>Institutional</b>	<b>Management</b>	<b>Asset</b>		<b>Intersegment</b>	
<b>Three Months Ended February 28, 2006(2)</b>	<b>Securities</b>	<b>Group</b>	<b>Management</b>	<b>Discover</b>	<b>Eliminations</b>	<b>Total</b>
	<b>(dollars in millions)</b>					
Net revenues excluding net interest	\$ 4,927	\$ 1,178	\$ 702	\$ 734	\$ (72)	\$ 7,469
Net interest	624	88	3	355	13	1,083
<b>Net revenues</b>	<b>\$ 5,551</b>	<b>\$ 1,266</b>	<b>\$ 705</b>	<b>\$ 1,089</b>	<b>\$ (59)</b>	<b>\$ 8,552</b>
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 1,775	\$ 15	\$ 172	\$ 479	\$ 19	\$ 2,460
Losses from unconsolidated investees	68			1		69
Provision for income taxes	531	6	67	178	7	789
<b>Income from continuing operations(1)</b>	<b>\$ 1,176</b>	<b>\$ 9</b>	<b>\$ 105</b>	<b>\$ 300</b>	<b>\$ 12</b>	<b>\$ 1,602</b>

	<b>Global Wealth</b>					
	<b>Institutional</b>	<b>Management</b>	<b>Asset</b>		<b>Intersegment</b>	
<b>Net Interest</b>	<b>Securities</b>	<b>Group</b>	<b>Management</b>	<b>Discover</b>	<b>Eliminations</b>	<b>Total</b>
	<b>(dollars in millions)</b>					
<b>Three Months Ended February 28, 2007</b>						
Interest and dividends	\$ 13,961	\$ 274	\$ 13	\$ 680	\$ (114)	\$ 14,814
Interest expense	13,168	138	15	287	(123)	13,485
<b>Net interest</b>	<b>\$ 793</b>	<b>\$ 136</b>	<b>\$ (2)</b>	<b>\$ 393</b>	<b>\$ 9</b>	<b>\$ 1,329</b>
<b>Three Months Ended February 28, 2006(2)</b>						
Interest and dividends	\$ 9,789	\$ 203	\$ 5	\$ 586	\$ (39)	\$ 10,544
Interest expense	9,165	115	2	231	(52)	9,461
<b>Net interest</b>	<b>\$ 624</b>	<b>\$ 88</b>	<b>\$ 3</b>	<b>\$ 355</b>	<b>\$ 13</b>	<b>\$ 1,083</b>

	<b>Global Wealth</b>					
	<b>Institutional</b>	<b>Management</b>	<b>Asset</b>		<b>Intersegment</b>	
<b>Total Assets(2)(3)</b>	<b>Securities</b>	<b>Group</b>	<b>Management</b>	<b>Discover</b>	<b>Eliminations</b>	<b>Total</b>
	<b>(dollars in millions)</b>					
At February 28, 2007	\$ 1,126,190	\$ 20,661	\$ 5,674	\$ 29,583	\$ (47)	\$ 1,182,061
At November 30, 2006	\$ 1,066,238	\$ 21,166	\$ 4,947	\$ 28,897	\$ (56)	\$ 1,121,192

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- (1) See Note 15 for a discussion of discontinued operations.
  - (2) Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.
  - (3) Corporate assets have been fully allocated to the Company's business segments.

**11. Variable Interest Entities.**

FASB Interpretation No. 46, as revised (FIN 46R), Consolidation of Variable Interest Entities, applies to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties (variable interest entities). Variable interest entities are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests. The Company is involved with various entities in the normal course of business that may be deemed to be VIEs and may hold interests therein, including debt securities, interest-only strip investments and derivative instruments that may be considered variable interests. Transactions associated with these entities include asset- and mortgage-backed securitizations and



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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structured financings (including collateralized debt, bond or loan obligations and credit-linked notes). The Company engages in these transactions principally to facilitate client needs and as a means of selling financial assets. The Company consolidates entities in which it is deemed to be the primary beneficiary. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), which includes the credit card asset securitization master trusts (see Note 4), the Company does not consolidate the entity.

The Company purchases and sells interests in entities that may be deemed to be VIEs in the ordinary course of its business. As a result of these activities, it is possible that such entities may be consolidated and deconsolidated at various points in time. Therefore, the Company's variable interests described below may not be held by the Company at the end of future quarterly reporting periods.

At February 28, 2007, in connection with its Institutional Securities business, the aggregate size of VIEs, including financial asset-backed securitization, mortgage-backed securitization, collateralized debt obligation, credit-linked note, structured note, municipal bond trust, loan issuing, commodities monetization, equity-linked note, equity fund and exchangeable trust entities, for which the Company was the primary beneficiary of the entities was approximately \$33.5 billion, which is the carrying amount of the consolidated assets recorded as Financial instruments owned that are collateral for the entities' obligations. The nature and purpose of these entities that the Company consolidated were to issue a series of notes to investors that provides the investors a return based on the holdings of the entities. These transactions were executed to facilitate client investment objectives. The structured note, equity-linked note, equity fund, certain credit-linked note, certain collateralized debt obligation, certain mortgage-backed securitization, certain financial asset-backed securitization and municipal bond transactions also were executed as a means of selling financial assets. The Company consolidates those entities where it holds either the entire class or a majority of the class of subordinated notes or entered into a derivative instrument with the VIE, which bears the majority of the expected losses or receives a majority of the expected residual returns of the entities. The Company accounts for the assets held by the entities as Financial instruments owned and the liabilities of the entities as Other secured financings.

At February 28, 2007, also in connection with its Institutional Securities business, the aggregate size of the entities for which the Company holds significant variable interests, which consist of subordinated and other classes of beneficial interests, derivative instruments, limited partnership investments and secondary guarantees, was approximately \$40.7 billion. The Company's variable interests associated with these entities, primarily credit-linked note, structured note, loan and bond issuing, collateralized debt, loan and bond obligation, financial asset-backed securitization, mortgage-backed securitization and tax credit limited liability entities, including investments in affordable housing tax credit funds and underlying synthetic fuel production plants, were approximately \$21.0 billion consisting primarily of senior beneficial interests, which represent the Company's maximum exposure to loss at February 28, 2007. The Company may hedge the risks inherent in its variable interest holdings, thereby reducing its exposure to loss. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company utilizes to hedge these risks.

**12. Guarantees.**

The Company has certain obligations under certain guarantee arrangements, including contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying measure (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or non-occurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. Also included as guarantees are contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement, as well as indirect guarantees of the indebtedness of others. The Company's use of guarantees is disclosed below by type of guarantee:

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**Derivative Contracts.** Certain derivative contracts meet the accounting definition of a guarantee, including certain written options, contingent forward contracts and credit default swaps. Although the Company's derivative arrangements do not specifically identify whether the derivative counterparty retains the underlying asset, liability or equity security, the Company has disclosed information regarding all derivative contracts that could meet the accounting definition of a guarantee. The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated, as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. For this reason, the Company does not monitor its risk exposure to such derivative contracts based on derivative notional amounts; rather, the Company manages its risk exposure on a fair value basis. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

**Financial Guarantees to Third Parties.** In connection with its corporate lending business and other corporate activities, the Company provides standby letters of credit and other financial guarantees to counterparties. Such arrangements represent obligations to make payments to third parties if the counterparty fails to fulfill its obligation under a borrowing arrangement or other contractual obligation.

**Market Value Guarantees.** Market value guarantees are issued to guarantee return of principal invested to fund investors associated with certain European equity funds and to guarantee timely payment of a specified return to investors in certain affordable housing tax credit funds. The guarantees associated with certain European equity funds are designed to provide for any shortfall between the market value of the underlying fund assets and invested principal and a stipulated return amount. The guarantees provided to investors in certain affordable housing tax credit funds are designed to return an investor's contribution to a fund and the investor's share of tax losses and tax credits expected to be generated by a fund.

**Liquidity Guarantees.** The Company has entered into liquidity facilities with special purpose entities and other counterparties, whereby the Company is required to make certain payments if losses or defaults occur. The Company often may have recourse to the underlying assets held by the special purpose entities in the event payments are required under such liquidity facilities.

The table below summarizes certain information regarding these guarantees at February 28, 2007:

Type of Guarantee	Maximum Potential Payout/Notional Years to Maturity				Total	Carrying Amount	Collateral/ Recourse
	Less than 1	1-3	3-5	Over 5 (dollars in millions)			
Notional amount of derivative contracts	\$ 742,335	\$ 638,755	\$ 1,246,855	\$ 1,100,519	\$ 3,728,464	\$ 36,163	\$ 119
Standby letters of credit and other financial guarantees	3,869	548	654	3,912	8,983	206	1,764
Market value guarantees	17	150		605	772	46	128
Liquidity facilities	1,598			110	1,708		

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**Indemnities.** In the normal course of its business, the Company provides standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products and other financial arrangements. These indemnity payments could be required based on a change in the tax laws or change in interpretation of applicable tax rulings or a change in factual circumstances. Certain contracts contain provisions that enable the Company to terminate the agreement upon the occurrence of such events. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these indemnifications and believes that the occurrence of any events that would trigger payments under these contracts is remote.

**Exchange/Clearinghouse Member Guarantees.** The Company is a member of various U.S. and non-U.S. exchanges and clearinghouses that trade and clear securities and/or futures contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange or clearinghouse. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

**General Partner Guarantees.** As a general partner in certain private equity and real estate partnerships, the Company receives distributions from the partnerships according to the provisions of the partnership agreements. The Company may, from time to time, be required to return all or a portion of such distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in various partnership agreements, subject to certain limitations. The maximum potential amount of future payments that the Company could be required to make under these provisions at February 28, 2007 and November 30, 2006 was \$348 million and \$320 million, respectively. As of February 28, 2007 and November 30, 2006, the Company's accrued liability for distributions that the Company has determined is probable it will be required to refund based on the applicable refund criteria specified in the various partnership agreements was \$26 million and \$25 million, respectively.

**Securitized Asset Guarantees.** As part of the Company's Institutional Securities and Discover securitization activities, the Company provides representations and warranties that certain securitized assets conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met, and, to the extent the Company has acquired such assets to be securitized from other parties, the Company seeks to obtain its own representations and warranties regarding the assets. The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. Also, in connection with originations of residential mortgage loans under the Company's FlexSource® program, the Company may permit borrowers to pledge marketable securities as collateral instead of requiring cash down payments for the purchase of the underlying residential property. Upon sale of the residential mortgage loans, the Company may provide a surety bond that reimburses the purchasers for shortfalls in the borrowers' securities accounts up to certain limits if the collateral maintained in the securities accounts (along with the associated real estate collateral) is insufficient to cover losses that purchasers experience as a result of defaults by borrowers on the

underlying residential mortgage loans. The Company requires the borrowers to meet daily collateral calls to

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ensure the marketable securities pledged in lieu of a cash down payment are sufficient. At February 28, 2007 and November 30, 2006, the maximum potential amount of future payments the Company may be required to make under its surety bond was \$116 million and \$121 million, respectively. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these representations and warranties and reimbursement agreements and believes that the probability of any payments under these arrangements is remote.

**Merchant Chargeback Guarantees.** In connection with its Discover business segment, the Company issues credit cards in the U.S. and U.K. and owns and operates the Discover Network in the U.S. The Company is contingently liable for certain transactions processed on the Discover Network in the event of a dispute between the cardmember and a merchant. The contingent liability arises if the disputed transaction involves a merchant or merchant acquirer with whom the Discover Network has a direct relationship. If a dispute is resolved in the cardmember's favor, the Discover Network will credit or refund the disputed amount to the Discover Network card issuer, who in turn credits its cardmember's account. Discover Network will then charge back the transaction to the merchant or merchant acquirer. If the Discover Network is unable to collect the amount from the merchant or merchant acquirer, it will bear the loss for the amount credited or refunded to the cardmember. In most instances, a payment requirement by the Discover Network is unlikely to arise because most products or services are delivered when purchased, and credits are issued by the merchant acquirer or merchant on returned items in a timely fashion. However, where the product or service is not provided until some later date following the purchase, the likelihood of payment by the Discover Network increases. Similarly, the Company is also contingently liable for the resolution of cardmember disputes associated with its general purpose credit cards issued by its U.K. chartered bank on the MasterCard and Visa networks. The maximum potential amount of future payments related to these contingent liabilities is estimated to be the portion of the total Discover Network sales transaction volume processed to date as well as the total U.K. cardmember sales transaction volume billed to date for which timely and valid disputes may be raised under applicable law, and relevant issuer and cardmember agreements. The Company believes, however, that this amount is not representative of the Company's actual potential loss exposure based on the Company's historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees during the quarters ended February 28, 2007 and 2006:

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	<b>February 28,</b>
	<b>2007</b>	<b>2006</b>
Losses related to merchant chargebacks (dollars in millions)	\$ 2.0	\$ 0.5
Aggregate credit card sales volume (dollars in billions)	26.4	23.2

The amount of the liability related to the Company's credit cardmember merchant guarantee was not material at February 28, 2007. The Company mitigates this risk by withholding settlement from merchants or obtaining escrow deposits from certain merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services. The table below provides information regarding the settlement withholdings and escrow deposits:

<b>At</b>	<b>At</b>
<b>February 28,</b>	<b>November 30,</b>
<b>2007</b>	<b>2006</b>
<b>(dollars in millions)</b>	

Settlement withholdings and escrow deposits	\$ 61.2	\$ 54.7
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**Other.** The Company may, from time to time, in its role as investment banking advisor be required to provide guarantees in connection with certain European merger and acquisition transactions. If required by the regulating authorities, the Company provides a guarantee that the acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer's funds are insufficient at the completion date of the transaction. These arrangements generally cover the time frame from the transaction offer date to its closing date and therefore are generally short term in nature. The maximum potential amount of future payments that the Company could be required to make cannot be estimated. The Company believes the likelihood of any payment by the Company under these arrangements is remote given the level of the Company's due diligence associated with its role as investment banking advisor.

**13. Investments in Unconsolidated Investees.**

The Company invests in unconsolidated investees that own synthetic fuel production plants. The Company accounts for these investments under the equity method of accounting. The Company's share of the operating losses generated by these investments is recorded within Losses from unconsolidated investees, and the tax credits and the tax benefits associated with these operating losses are recorded within the Provision for income taxes.

In the quarters ended February 28, 2007 and 2006, the losses from unconsolidated investees were more than offset by the respective tax credits and tax benefits on the losses. The table below provides information regarding the losses from unconsolidated investees, tax credits and tax benefits on the losses:

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	<b>February 28,</b>
	<b>2007</b>	<b>2006</b>
	<b>(dollars in millions)</b>	
Losses from unconsolidated investees	\$ 44	\$ 69
Tax credits	57	74
Tax benefits on losses	17	27

Under the current tax law, synthetic fuels tax credits are granted under Section 45K of the Internal Revenue Code. Synthetic fuels tax credits are available in full only when the price of oil is less than a base price specified by the tax code, as adjusted for inflation ( Base Price ). The Base Price for each calendar year is determined by the Secretary of the Treasury by April 1 of the following year. If the annual average price of a barrel of oil in 2007 or future years exceeds the applicable Base Price, the synthetic fuels tax credits generated by the Company's synthetic fuel facilities will be phased out, on a ratable basis, over the phase-out range. Based on fiscal year to date and futures prices at February 28, 2007, the Company estimates that there will be a partial phase-out of tax credits earned in fiscal 2007. The impact of this partial phase-out is included within Losses from unconsolidated investees and the Provision for income taxes for the quarter ended February 28, 2007.

The Company has entered into derivative contracts designed to reduce its exposure to rising oil prices and the potential phase-out of the synthetic fuels tax credits. Changes in fair value relative to these derivative contracts are included within Principal transactions' trading revenues.

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The Company maintains various pension and benefit plans for eligible employees.

The components of the Company's net periodic benefit expense for its pension and postretirement plans were as follows:

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(dollars in millions)</b>	
Service cost, benefits earned during the period	\$ 34	\$ 35
Interest cost on projected benefit obligation	38	37
Expected return on plan assets	(35)	(34)
Net amortization transition obligation/prior service cost	(4)	(4)
Net amortization actuarial loss	12	16
Net periodic benefit expense	\$ 45	\$ 50

**15. Discontinued Operations.**

**Quilter.** On February 28, 2007, the Company sold Quilter, its standalone U.K. mass affluent business that was formerly included within the Global Wealth Management Group business segment. The results of Quilter are included within discontinued operations for all periods presented. The results for discontinued operations in the quarter ended February 28, 2007 also included a pre-tax gain of \$168 million (\$109 million after-tax) on disposition.

**Aircraft Leasing.** On March 24, 2006, the Company sold its aircraft leasing business to Terra Firma, a European private equity group. The results for discontinued operations in the quarter ended February 28, 2006 included a loss of \$125 million (\$75 million after-tax) related to the impact of the finalization of the sales proceeds and balance sheet adjustments related to the closing (see Financial Statements and Supplementary Data Note 18 in Part II, Item 8 of the Form 10-K for further information).

***Summarized financial information for the Company's discontinued operations:***

The table below provides information regarding amounts included within discontinued operations (dollars in millions):

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>February 28,</b>	
	<b>2007</b>	<b>2006</b>
Pre-tax gain/(loss) on discontinued operations		
Quilter	\$ 174	\$ 7

Aircraft leasing

(55)

\$ 174      \$ (48)



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**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**16. Business and Other Acquisitions.**

**JM Financial.** On February 22, 2007, the Company announced that it would dissolve its India joint venture with JM Financial. The Company has reached an agreement in principle to purchase the joint venture's institutional equities sales, trading and research platform by acquiring JM Financial's 49% interest and to sell the Company's 49% interest in the joint venture's investment banking, fixed income and retail operation to JM Financial.

**CityMortgage Bank.** On December 21, 2006, the Company acquired CityMortgage Bank (CityMortgage), a Moscow-based mortgage bank that specializes in originating, servicing and securitizing residential mortgage loans in the Russian Federation. Since the acquisition date, the results of CityMortgage have been included within the Institutional Securities business segment.

**Olco Petroleum Group Inc.** On December 15, 2006, the Company acquired a 60% equity stake in Olco Petroleum Group Inc. (Olco), a petroleum products marketer and distributor based in eastern Canada. Since the acquisition date, the results of Olco have been included within the Institutional Securities business segment.

**Saxon Capital, Inc.** On December 4, 2006, the Company acquired Saxon Capital, Inc. (Saxon), a servicer and originator of residential mortgages. Since the acquisition date, the results of Saxon have been included within the Institutional Securities business segment.

**FrontPoint Partners.** On December 4, 2006, the Company acquired FrontPoint Partners (FrontPoint), a provider of absolute return investment strategies. Since the acquisition date, the results of FrontPoint have been included within the Asset Management business segment.

The proforma impact of each of the above business acquisitions individually and in the aggregate was not material to the condensed consolidated financial statements. In addition, the allocations of the purchase prices are preliminary and subject to further adjustment as the valuations of certain intangible assets are still in process.

**17. Income Tax Examinations.**

The Company is under continuous examination by the Internal Revenue Service (the IRS) and other tax authorities in certain countries, such as Japan and the U.K., and states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999-2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations. The Company has established tax reserves that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts tax reserves only when more information is available or when an event occurs necessitating a change to the reserves. The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statement of income for a particular future period and on the Company's effective income tax rate for any period in which such resolution occurs.

**18. Fair Value Disclosures.**

Effective December 1, 2006 the Company early adopted SFAS No. 157 and SFAS No. 159, which require disclosures about the Company's assets and liabilities that are measured at fair value. Further information about such assets and liabilities is presented below.

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**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

***Fair Value Measurements.*** In September 2006, the FASB issued SFAS No. 157, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. In addition, SFAS No. 157 disallows the use of block discounts for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available in an active market, and nullifies select guidance provided by EITF Issue No. 02-3, which prohibited the recognition of trading gains or losses at the inception of a derivative contract, unless the fair value of such derivative is obtained from a quoted market price, or other valuation technique that incorporates observable market data. SFAS No. 157 also requires the Company to consider its own credit spreads when measuring the fair value of liabilities, including derivatives. Effective December 1, 2006, the Company elected early adoption of SFAS No. 157. In accordance with the provisions of SFAS No. 157 related to block discounts and EITF Issue No. 02-3, the Company recorded a cumulative effect adjustment of approximately \$80 million after-tax as an increase to the opening balance of Retained Earnings as of December 1, 2006, which was primarily associated with EITF Issue No. 02-3. The impact of considering the Company's own credit spreads when measuring the fair value of liabilities, including derivatives, did not have a material impact on fair value measurements at the date of adoption.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis as of February 28, 2007, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, and includes situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Assets and Liabilities Measured at Fair Value on a Recurring Basis as of February 28, 2007**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance as of February 28, 2007
<b>Assets</b>					
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 10,189	\$	\$	\$	\$ 10,189
Financial instruments owned:					
U.S. government and agency securities	23,119	19,302	148		42,569
Other sovereign government obligations	24,869	6,569	911		32,349
Corporate and other debt(1)	560	131,755	36,351		168,666
Corporate equities	95,321	522	1,239		97,082
Derivative contracts	7,799	346,471	12,209	(315,527)	50,952
Physical commodities		2,839			2,839
Total financial instruments owned	151,668	507,458	50,858	(315,527)	394,457
Consumer loans		718			718
Net intangible assets(2)		287			287
Other assets	869	597	8,994		10,460
<b>Liabilities</b>					
Commercial paper and other short-term borrowings	\$	\$ 1,590	\$	\$	\$ 1,590
Deposits		5,304			5,304
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	17,830	232			18,062
Other sovereign government obligations	24,752	1,440			26,192
Corporate and other debt	64	8,304	68		8,436
Corporate equities	52,060	11	15		52,086
Derivative contracts	10,574	340,343	11,933	(311,276)	51,574
Physical commodities		1,457			1,457
Total financial instruments sold, not yet purchased	105,280	351,787	12,016	(311,276)	157,807
Other secured financings		45,506	6,088		51,594
Long-term borrowings		15,076	544		15,620

(1) At February 28, 2007, there were approximately \$13 billion of certain structured loan products included within Financial instruments owned corporate and other debt that were accounted for on an accrual basis.

(2) Amount represents MSRs accounted for at fair value (see Note 3).



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The following table presents additional information about assets and liabilities measured at fair value on a recurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

**Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis**

	Total Realized and Unrealized Gains or (Losses) included in Income				Total Realized and Unrealized Gains or Losses	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or Out of Level 3	Ending Balance
	Beginning Balance	Principal Transactions: Trading	Principal Transactions: Investments	Other Revenues	(dollars in millions)			
<b>Assets</b>								
Financial instruments owned:								
U.S. government and agency securities	\$ 2	\$ (6)	\$	\$	\$ (6)	\$ 152	\$	\$ 148
Other sovereign government obligations	162	35			35	682	32	911
Corporate and other debt	33,941	(5)			(5)	2,458	(43)	36,351
Corporate equities	1,040	37			37	170	(8)	1,239
Net derivative contracts (1)(2)	30	547			547	(335)	34	276
Other assets (3)	6,583	2	569	5	576	1,848	(13)	8,994
<b>Liabilities</b>								
Financial instruments sold, not yet purchased:								
Corporate and other debt	185	(8)			(8)	(167)	42	68
Corporate equities	9					1	5	15
Other secured financings	4,724					1,364		6,088
Long-term borrowings	464	(53)			(53)	27		544

(1) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.

(2) The gains and losses associated with Net derivative contracts were primarily driven by credit products as a result of market movements.

(3) The gains and losses associated with Other assets were primarily related to investments in the Company's real estate funds.

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The following table presents the amounts of unrealized gains or (losses) for the three months ended February 28, 2007 relating to those assets and liabilities for which the Company utilized significant Level 3 inputs to determine fair value and that were still held by the Company at February 28, 2007:

	Principal Transactions: Trading	Principal Transactions: Investments (dollars in millions)	Other Revenues
<b>Assets</b>			
Financial instruments owned:			
U.S. government and agency securities	\$ (6)	\$	\$
Other sovereign government obligations	33		
Corporate and other debt	(6)		
Corporate equities	90		
Net derivative contracts(1)	741		
Other assets(1)		553	5
<b>Liabilities</b>			
Financial instruments sold, not yet purchased:			
Corporate and other debt	\$ 2	\$	\$
Long-term borrowings	(53)		

(1) The amount associated with Net derivative contracts was primarily driven by credit products as a result of market movements. The amounts associated with Other assets were primarily driven by investments in the Company's real estate funds.

Both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains and losses for assets and liabilities within the Level 3 category presented in the table above may include changes in fair value that were attributable to both observable (e.g., changes in market interest rates) and unobservable (e.g., changes in unobservable long-dated volatilities) inputs.

The Company also employs various hedging techniques in order to manage risks associated with certain positions, including those that have been classified within the Level 3 category. Such techniques may include the purchase or sale of financial instruments that are classified within the Level 1 and/or Level 2 categories. As a result, the realized and unrealized gains and losses for assets and liabilities within the Level 3 category presented in the tables above do not reflect the related realized or unrealized gains and losses on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories.

At February 28, 2007, the Company also had assets and liabilities measured at fair value on a non-recurring basis. During the quarter ended February 28, 2007, the only fair value measurements for assets and liabilities measured at fair value on a non-recurring basis were associated with certain assets and liabilities of acquired businesses, including goodwill and intangible assets. Such measurements were determined utilizing Level 3 inputs. See Notes 2 and 16 for further information.

**Fair Value Option.** In February 2007, the FASB issued SFAS No. 159, which provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. Effective



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

December 1, 2006, the Company elected early adoption of SFAS No. 159. As a result of the adoption of SFAS No. 159, the Company recorded a cumulative effect adjustment of approximately \$166 million (\$102 million after-tax) as an increase to the opening balance of Retained earnings as of December 1, 2006.

The following table presents information about the eligible instruments for which the Company elected the fair value option and for which a transition adjustment was recorded as of December 1, 2006:

	Carrying Value of Instrument at December 1, 2006	Transition Adjustment to Retained Earnings Gain/(Loss) (dollars in millions)	Carrying Value of Instrument at December 1, 2006 (After Adoption of SFAS No. 159)
Financial instruments owned(1)	\$ 8,587	\$ 16	\$ 8,603
Consumer loans(2)	1,258	7	1,265
Other assets(3)	1,305	13	1,318
Commercial paper and other short-term borrowings(4)	946	(1)	947
Deposits(5)	3,143	1	3,142
Long-term borrowings(4)	14,354	130	14,224
Pretax cumulative effect of adoption of the fair value option		166	
Deferred taxes		64	
Cumulative effect of adoption of the fair value option		\$ 102	

The transition adjustments were primarily related to the following:

(1) Loans and loan commitments made in connection with the Company's corporate lending activities. The fair value option was elected for these positions as they are risk-managed on a fair value basis.

(2) Certain mortgage lending products which are risk-managed by the Institutional Securities business segment on a fair value basis. The Company did not elect the fair value option for other eligible instruments within Consumer loans that are managed by the Discover business segment.

(3) Certain investments that had been previously accounted for under the equity method, as well as certain interests in clearinghouses. The fair value option was elected only for positions that are risk-managed on a fair value basis.

(4) Structured notes and other hybrid long-term debt instruments. The fair value option was elected for these positions as they are risk-managed on a fair value basis. The fair value option was elected for all such instruments issued after December 1, 2006, and a portion of the portfolio of instruments outstanding as of December 1, 2006. The fair value option was not elected for the remaining portion of the portfolio that existed as of December 1, 2006 due to cost-benefit considerations, including the operational effort involved.

(5) Brokered and callable certificates of deposit issued by certain of the Company's bank subsidiaries. The fair value option was elected for these positions as they are risk-managed on a fair value basis. The Company did not elect the fair value option for other eligible instruments within Deposits that are managed by the Discover business segment.





**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following table presents gains and (losses) due to changes in fair value for items measured at fair value pursuant to election of the fair value option for the three months ended February 28, 2007:

	Principal Transactions: Trading	Principal Transactions: Investments	Net Interest Revenue (dollars in millions)	Gains/(Losses) Included in the Three Months Ended February 28, 2007(1)
Consumer loans	\$ 15	\$	\$ 16	\$ 31
Other assets		128	3	131
Commercial paper and other short-term borrowings	(5)			(5)
Deposits	4			4
Long-term borrowings	136		(49)	87

(1) In addition to these amounts, as discussed in Note 2, the majority of the instruments within Financial instruments owned and Financial instruments sold, not yet purchased, are measured at fair value, either through the election of SFAS No. 159 or as required by other accounting pronouncements. Changes in the fair value of these instruments are recorded in Principal transactions trading revenues.

Interest income and expense and dividend income are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest and dividends are included as a component of the change in the instruments fair value, interest and dividends are included within Principal transactions trading revenues. Otherwise, they are included within Interest and dividend income or Interest expense.

As of February 28, 2007, the aggregate contractual principal amount of loans and long-term receivables for which the fair value option was elected exceeded the fair value of such loans and long-term receivables by approximately \$22,626 million. The aggregate fair value of loans that were 90 or more days past due as of February 28, 2007 was \$2,174 million. The aggregate contractual principal amount of such loans exceeded their fair value by approximately \$22,230 million.

For the quarter ended February 28, 2007, the estimated changes in the fair value of liabilities for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material. As of February 28, 2007, the aggregate contractual principal amount of long-term debt instruments for which the fair value option was elected exceeded the fair value of such instruments by approximately \$577 million.

For the quarter ended February 28, 2007, changes in the fair value of loans and other receivables for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were estimated to be an immaterial unrealized loss.

**Hybrid Financial Instruments.** In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155), which amends SFAS No. 133 and SFAS No. 140. SFAS No. 155 permits hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation to irrevocably be accounted for at fair value, with changes in fair value recognized in the statement of income. The fair value election may be applied on an instrument-by-instrument basis. SFAS No. 155 also eliminates a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. The Company adopted SFAS No. 155 on December 1, 2006. Since SFAS No. 159 incorporates accounting and disclosure requirements that are similar to SFAS No. 155, the Company decided to apply SFAS No. 159, rather than SFAS No. 155, to its fair value elections for hybrid financial instruments.



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**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**19. Other Accounting Developments.**

In June 2005, the FASB ratified the consensus reached in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* ( EITF Issue No. 04-5 ). Under the provisions of EITF Issue No. 04-5, a general partner in a limited partnership is presumed to control that limited partnership and, therefore, should include the limited partnership in its consolidated financial statements, regardless of the amount or extent of the general partner's interest unless a majority of the limited partners can vote to dissolve or liquidate the partnership or otherwise remove the general partner without having to show cause or the limited partners have substantive participating rights that can overcome the presumption of control by the general partner. EITF Issue No. 04-5 was effective immediately for all newly formed limited partnerships and existing limited partnerships for which the partnership agreements have been modified. For all other existing limited partnerships for which the partnership agreements have not been modified, the Company adopted EITF Issue No. 04-5 on December 1, 2006. The adoption of EITF Issue No. 04-5 on December 1, 2006 did not have a material impact on the Company's condensed consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for the Company as of December 1, 2007. The Company is currently evaluating the potential impact of adopting FIN 48.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R) ( SFAS No. 158 ). Among other items, SFAS No. 158 requires recognition of the overfunded or underfunded status of an entity's defined benefit and postretirement plans as an asset or liability in the financial statements and requires the measurement of defined benefit and postretirement plan assets and obligations as of the end of the employer's fiscal year. SFAS No. 158's requirement to recognize the funded status in the financial statements is effective for fiscal years ending after December 15, 2006, and its requirement to use the fiscal year-end date as the measurement date is effective for fiscal years ending after December 15, 2008. The Company is currently assessing the impact that SFAS No. 158 will have on its condensed consolidated financial statements.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of

Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the Company ) as of February 28, 2007, and the related condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended February 28, 2007 and 2006. These interim financial statements are the responsibility of the management of Morgan Stanley.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of Morgan Stanley and subsidiaries as of November 30, 2006, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for the fiscal year then ended (not presented herein) included in Morgan Stanley's Annual Report on Form 10-K for the fiscal year ended November 30, 2006; and in our report dated February 12, 2007, which report contains an explanatory paragraph relating to the adoption, in fiscal 2005, of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment and effective December 1, 2005, the change in accounting policy for recognition of equity awards granted to retirement-eligible employees and an explanatory paragraph relating to, in fiscal 2006, the application of Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statement , we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2006 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

As discussed in Note 18 to the condensed consolidated interim financial statements, effective December 1, 2006, the Company adopted SFAS No. 157, Fair Value Measurement and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.

/s/ Deloitte & Touche LLP

New York, New York

April 5, 2007

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Introduction.**

Morgan Stanley (the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group, Asset Management and Discover. The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. A summary of the activities of each of the segments follows:

*Institutional Securities* includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; 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; benchmark indices and risk management analytics; research; and investment activities.

*Global Wealth Management Group* provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; banking and cash management services; retirement services; and trust and fiduciary services.

*Asset Management* provides global asset management products and services in equity, fixed income, alternative investments and private equity to institutional and retail clients through proprietary and third party retail distribution channels, intermediaries and the Company's institutional distribution channel. Asset Management also engages in investment activities.

*Discover* offers Discover®-branded credit cards and related consumer products and services and operates the Discover Network, a merchant and cash access network for Discover Network-branded cards, and PULSE® EFT Association LP (PULSE), an automated teller machine/debit and electronic funds transfer network. Discover also offers consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard and Visa networks.

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (the Discover Spin-off) (see Discover Spin-off herein).

The discussion of the Company's results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company's future results, please see Forward-Looking Statements immediately preceding Part I, Item 1, Competition and Regulation in Part I, Item 1, Risk Factors in Part I, Item 1A, Certain Factors Affecting Results of Operations in Part II, Item 7 and other items throughout the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2006 (the Form 10-K) and the Company's 2007 Current Reports on Form 8-K.

The Company's results of operations for the quarters ended February 28, 2007 and 2006 are discussed below. The results of Quilter Holdings Ltd. (Quilter), Global Wealth Management Group's mass affluent business in the U.K., are reported as discontinued operations for all periods presented through its sale on February 28, 2007. The results of the aircraft leasing business, which was sold on March 24, 2006, are also reported as discontinued operations for the three months ended February 28, 2006 (see Discontinued Operations herein).

**Table of Contents****Results of Operations.****Executive Summary.****Financial Information.**

	<b>Three Months Ended February 28,</b>	
	<b>2007</b>	<b>2006(1)</b>
<b>Net revenues (dollars in millions):</b>		
Institutional Securities	\$ 7,631	\$ 5,551
Global Wealth Management Group	1,490	1,266
Asset Management	905	705
Discover	1,025	1,089
Intersegment Eliminations	(53)	(59)
Consolidated net revenues	\$ 10,998	\$ 8,552
<b>Income before taxes (dollars in millions)(2):</b>		
Institutional Securities	\$ 3,031	\$ 1,775
Global Wealth Management Group	220	15
Asset Management	236	172
Discover	372	479
Intersegment Eliminations	5	19
Consolidated income before taxes	\$ 3,864	\$ 2,460
<b>Consolidated net income (dollars in millions)</b>	<b>\$ 2,672</b>	<b>\$ 1,574</b>
<b>Earnings applicable to common shareholders (dollars in millions)(3)</b>	<b>\$ 2,655</b>	<b>\$ 1,574</b>
<b>Earnings per basic common share:</b>		
Income from continuing operations	\$ 2.52	\$ 1.57
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per basic common share	\$ 2.63	\$ 1.54
<b>Earnings per diluted common share:</b>		
Income from continuing operations	\$ 2.40	\$ 1.51
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per diluted common share	\$ 2.51	\$ 1.48
<b>Statistical Data.</b>		
<b>Book value per common share(4)</b>	<b>\$ 34.71</b>	<b>\$ 28.12</b>
<b>Average common equity (dollars in billions)(5)(6):</b>		
Institutional Securities	\$ 20.3	\$ 16.2
Global Wealth Management Group	1.7	3.3
Asset Management	2.7	2.0
Total from securities businesses	24.7	21.5
Discover	5.5	4.6

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Total from operating segments	30.2	26.1
Discontinued operations	0.2	0.2
Unallocated capital	5.1	3.2
Consolidated	\$ 35.5	\$ 29.5



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### Statistical Data (Continued).

	Three Months	
	Ended February 28,	
	2007	2006(1)
<b>Return on average common equity(5)(6):</b>		
Consolidated	30%	21%
Institutional Securities	40%	29%
Global Wealth Management Group	32%	1%
Asset Management	20%	21%
Discover	17%	26%
<b>Effective income tax rate</b>	33.1%	32.8%
<b>Worldwide employees</b>	57,845	53,870
<b>Consolidated assets under management or supervision by asset class (dollars in billions):</b>		
Equity	\$ 317	\$ 288
Fixed income	111	105
Money market	90	82
Alternative investments	29	18
Real estate	76	45
Subtotal	623	538
Unit trusts	15	12
Other(7)	59	52
Total assets under management or supervision(8)	697	602
Share of minority interest assets(9)	5	
Total	\$ 702	\$ 602
<b>Institutional Securities:</b>		
Mergers and acquisitions completed transactions (dollars in billions)(10):		
Global market volume	\$ 141.5	\$ 107.8
Market share	33.7%	26.1%
Rank	2	3
Mergers and acquisitions announced transactions (dollars in billions)(10):		
Global market volume	\$ 147.0	\$ 139.2
Market share	25.9%	29.4%
Rank	6	9
Global equity and equity-related issues (dollars in billions)(10):		
Global market volume	\$ 6.0	\$ 4.8
Market share	6.0%	6.0%
Rank	8	5
Global debt issues (dollars in billions)(10):		
Global market volume	\$ 66.4	\$ 76.1
Market share	5.6%	6.7%
Rank	6	3
Global initial public offerings (dollars in billions)(10):		
Global market volume	\$ 1.7	\$ 1.5
Market share	7.2%	6.5%
Rank	5	4
Pre-tax profit margin(11)	40%	32%



**Table of Contents***Statistical Data (Continued).*

	Three Months	
	Ended February 28,	
	2007	2006(1)
<b>Global Wealth Management Group:</b>		
Global representatives	7,993	8,913
Annualized net revenue per global representative (dollars in thousands)(12)	\$ 748	\$ 552
Client assets by segment (dollars in billions)(12):		
\$10 million or more	\$ 210	\$ 166
\$1 million \$10 million	248	220
Subtotal \$1 million or more	458	386
\$100,000 \$1 million	174	177
Less than \$100,000	26	32
Client assets excluding corporate and other accounts	658	595
Corporate and other accounts	32	29
Total client assets	\$ 690	\$ 624
Fee-based assets as a percentage of total client assets	29%	28%
Client assets per global representative (dollars in millions)(13)	\$ 86	\$ 70
Bank deposit program (dollars in millions)(14)	\$ 16,364	\$ 7,319
Pre-tax profit margin(11)	15%	1%
<b>Asset Management:</b>		
Assets under management or supervision (dollars in billions)(15)	\$ 500	\$ 442
Percent of fund assets in top half of Lipper rankings(16)	48%	60%
Pre-tax profit margin(11)	26%	24%
<b>Discover (dollars in millions, unless otherwise noted)(17):</b>		
Period-end credit card loans Owned	\$ 22,410	\$ 19,924
Period-end credit card loans Managed	\$ 50,730	\$ 47,825
Average credit card loans Owned	\$ 24,672	\$ 21,976
Average credit card loans Managed	\$ 51,390	\$ 47,575
Net principal charge-off rate Owned	3.78%	4.54%
Net principal charge-off rate Managed	4.05%	5.06%
Return on average receivables Owned	3.84%	5.54%
Return on average receivables Managed	1.84%	2.56%
Transaction volume (dollars in billions):		
Net sales	\$ 25.1	\$ 22.5
Other transaction volume	5.2	4.3
Total	\$ 30.3	\$ 26.8
Payment services transaction volume (millions of transactions):		
Discover network	361	339
PULSE network	521	425
Total network transaction volume	882	764
Pre-tax profit margin(11)	36%	44%

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- (1) Certain prior-period information has been reclassified to conform to the current period's presentation.
- (2) Amounts represent income from continuing operations before losses from unconsolidated investees, income taxes and gain (loss) from discontinued operations.
- (3) Earnings applicable to common shareholders are used to calculate earnings per share information.
- (4) Book value per common share equals common shareholders' equity of \$36,854 million at February 28, 2007 and \$30,103 million at February 28, 2006, divided by common shares outstanding of 1,062 million at February 28, 2007 and 1,070 million at February 28, 2006.
- (5) The computation of average common equity for each business segment is based upon an economic capital model that the Company uses to determine the amount of equity capital needed to support the risk of its business activities and to ensure that the Company remains adequately capitalized. Economic capital is defined as the amount of capital needed to run the business through the business cycle and

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satisfy the requirements of regulators, rating agencies and the market. The Company's methodology is based on an approach that assigns economic capital to each segment based on regulatory capital usage plus additional capital for stress losses, goodwill and intangible assets, and principal investment risk. The economic capital model and allocation methodology may be enhanced over time in response to changes in the business and regulatory environment. The effective tax rates used in the computation of segment return on average common equity were determined on a separate entity basis.

- (6) For the quarter ended February 28, 2007, the Company reassessed the amount of capital required to support the market risks and credit risks in its Global Wealth Management Group business segment.
- (7) Amounts include assets under management or supervision associated with the Global Wealth Management Group business segment.
- (8) Revenues and expenses associated with these assets are included in the Company's Asset Management, Global Wealth Management Group and Institutional Securities business segments.
- (9) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (10) Source: Thomson Financial, data as of March 7, 2007. The data for the three months ended February 28, 2007 and 2006 are for the periods from January 1 to February 28, 2007 and January 1 to February 28, 2006, respectively, as Thomson Financial presents these data on a calendar-year basis.
- (11) Percentages represent income from continuing operations before losses from unconsolidated investees and income taxes as a percentage of net revenues.
- (12) Annualized net revenue per global representative amounts equal Global Wealth Management Group's net revenues divided by the quarterly average global representative headcount for the periods presented.
- (13) Client assets per global representative equal total period-end client assets divided by period-end global representative headcount.
- (14) Bank deposits are held at certain of the Company's Federal Deposit Insurance Corporation insured depository institutions for the benefit of retail clients through their brokerage accounts.
- (15) Amount includes Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (16) Source: Lipper, one-year performance excluding money market funds as of February 28, 2007 and 2006, respectively.
- (17) The Company analyzes its financial performance on both a managed loan basis and as reported under U.S. Generally Accepted Accounting Principles. Managed data include owned and securitized credit card loans. For an explanation of managed data and a reconciliation of credit card loan and asset quality data, see "Discover Managed General Purpose Credit Card Loan Data" herein.

### **First Quarter 2007 Performance.**

**Company Results.** The Company achieved record net income of \$2,672 million and record quarterly diluted earnings per share of \$2.51 for the quarter ended February 28, 2007, both increases of 70% from the comparable fiscal 2006 period. Net revenues (total revenues less interest expense and the provision for loan losses) increased 29% to a record \$10,998 million and the annualized return on average common equity was 29.9% compared with 21.3% in the first quarter of last year. Income from continuing operations was \$2,559 million, an increase of 60% from a year ago. Diluted earnings per share from continuing operations were a record \$2.40 compared with \$1.51 in last year's first quarter. The annualized return on average common equity from continuing operations was 28.8% compared with 21.9% in the first quarter of last year.

Non-interest expenses of \$7,134 million increased 17% from the prior year period, primarily due to higher compensation costs resulting from higher net revenues, partially offset by the incremental compensation expense (\$395 million) related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see "Other Items Stock-Based Compensation" herein).

The Company's effective income tax rate was 33.1% for the first quarter of fiscal 2007 and 32.8% for the first quarter of fiscal 2006.

The current quarter's results included a gain of \$168 million (\$109 million after-tax) in discontinued operations related to the sale of Quilter on February 28, 2007. Discontinued operations in the first quarter of fiscal 2006 included a loss of \$125 million (\$75 million after-tax) related to the sale of the Company's aircraft leasing business (see "Other Items Discontinued Operations" herein).

**Institutional Securities.** Institutional Securities achieved record income from continuing operations before losses from unconsolidated investees and income taxes of \$3,031 million, a 71% increase from last year's first quarter. Net revenues rose 37% to a record \$7,631 million driven by record fixed income and equity sales and trading revenues, along with higher investment banking revenues. Non-interest expenses increased 22% to \$4,600 million, reflecting higher compensation accruals resulting from higher net revenues, as well as higher compensation costs associated with certain employee deferred compensation plans (see "Other Items Deferred Compensation Plans" herein), partially offset by Institutional Securities' share (\$270 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Non-compensation expenses increased as a result of higher levels of business activity.

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Investment banking revenues increased 16% from last year's first quarter to \$1,049 million. Underwriting revenues rose 20% from last year's first quarter to \$659 million. Advisory fees from merger, acquisition and restructuring transactions were \$390 million, an increase of 10% from last year's first quarter.

Fixed income sales and trading revenues were a record \$3,566 million, up 31% from the previous record in the first quarter of fiscal 2006. The increase was driven by strong performances in credit products and interest rate and currency products. Credit products had record revenues, primarily due to favorable positioning in the residential mortgage markets, improved corporate credit trading and strong customer flows. Interest rate and currency product revenues benefited from improved interest rate trading and emerging market revenues. Commodities revenues decreased from last year's record first quarter, reflecting lower trading results in electricity, natural gas products and oil liquids. Equity sales and trading revenues increased 36% to a record \$2,243 million. The increase was broad based and included higher revenues from derivatives products, prime brokerage, financing products, principal trading strategies and equity cash products.

Principal transaction net investment revenues were \$801 million in the quarter compared with \$312 million a year ago. The increase was primarily related to net gains associated with certain of the Company's investments, including both realized and unrealized gains from investments in the Company's real estate funds. The current quarter also included higher revenues related to certain employee deferred compensation plans (see "Other Items - Deferred Compensation Plans" herein).

**Global Wealth Management Group.** The Global Wealth Management Group recorded income from continuing operations before income taxes of \$220 million compared with \$15 million in the first quarter of fiscal 2006. Net revenues increased 18% from last year's first quarter to \$1,490 million reflecting higher transactional revenues due to increased underwriting activity, higher asset management revenues reflecting growth in fee-based products and higher net interest revenue from the bank deposit sweep program. Total non-interest expenses increased 2% from a year ago to \$1,270 million. Compensation and benefits expense increased, primarily reflecting higher incentive-based compensation accruals related to higher net revenues, partially offset by Global Wealth Management Group's share (\$80 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Non-compensation costs decreased, primarily due to lower costs associated with legal and regulatory matters. Total client assets increased to \$690 billion, up 11% from last year's first quarter. In addition, client assets in fee-based accounts rose 17% to a record \$202 billion at February 28, 2007 and increased to 29% as a percentage of total client assets from 28% a year ago. At quarter-end, the number of global representatives was 7,993, a decline of 920 from a year ago, resulting largely from planned sales force reductions completed in the second quarter of fiscal 2006 and attrition.

**Asset Management.** Asset Management recorded income before income taxes of \$236 million, a 37% increase from last year's first quarter. Net revenues increased 28% from last year's first quarter to \$905 million driven by higher investment revenues, primarily in the private equity business, and higher asset management, distribution and administration fees, primarily due to an increase in assets under management and higher performance fees from the alternatives business. Non-interest expenses increased 26% to \$669 million, largely due to higher incentive-based compensation accruals associated with increased revenues and business investment, partially offset by Asset Management's share (\$28 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Assets under management or supervision within Asset Management of \$500 billion were up \$58 billion, or 13%, from the first quarter of last year, primarily due to market appreciation, acquisitions and investments in minority stakes. In fiscal 2007, the Company expects that Asset Management's profit margins will be affected by its continued investments in its core business, alternative products and private equity.

**Discover.** Discover recorded income before losses from unconsolidated investees and income taxes of \$372 million, a decrease of 22% from the first quarter of fiscal 2006. The first quarter of fiscal 2006 benefited from the effect of a sharp decline in consumer bankruptcy receipts following the October 2005 enactment of new U.S. bankruptcy legislation, resulting in an increase in the value of the Company's residual interests in securitization transactions and a decrease in the allowance for consumer loan losses. Net revenues of \$1,025 million were

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6% lower than a year ago, primarily due to lower Servicing and securitization income and a higher Provision for consumer loan losses, partially offset by higher net interest revenues. Non-interest expenses of \$653 million increased 7% from a year ago, primarily due to higher marketing and business development expenses, higher professional services expenses and incremental costs as a result of the acquisition of Goldfish in February 2006. The managed credit card net principal charge-off rate decreased 101 basis points to 4.05% from the same period a year ago. The managed over-30-day delinquency rate was unchanged at 3.45% from a year ago, and the managed over-90-day delinquency rate was 8 basis points higher than a year ago at 1.69%. Managed credit card loans were \$50,730 million at quarter-end, a 6% increase from a year ago.

### **Global Market and Economic Conditions in the Quarter Ended February 28, 2007.**

In the U.S., the moderate pace of economic growth that occurred during the second half of fiscal 2006 continued during the first quarter of fiscal 2007, reflecting, among other things, generally lower energy prices, although the slowdown in the residential real estate market persisted. The U.S. unemployment rate increased slightly to 4.6% at the end of the quarter from 4.5% at the end of fiscal 2006. Conditions in the U.S. equity markets were generally favorable, and major equity market indices rose during most of the quarter and were supported by strong corporate earnings. Equity markets declined sharply at quarter-end, however, due to concerns about the residential real estate market and conditions in China's equity markets. The Federal Reserve Board (the "Fed") left interest rates unchanged during the quarter and has not raised interest rates since June 2006. Inflationary pressures appeared to be contained, although it continued to be a primary concern of the Fed.

In Europe, economic growth during the first quarter of fiscal 2007 continued to be strong. Major equity market indices in Europe increased during much of the quarter, reflecting strong corporate earnings as well as merger and acquisition activity and generally favorable economic conditions. The European Central Bank (the "ECB") raised the benchmark interest rate by 0.25% during the quarter. In March 2007, the ECB raised the benchmark interest rate by an additional 0.25%. The Bank of England raised the benchmark interest rate by 0.25% during the quarter.

In Japan, moderate economic growth continued to be driven by exports and domestic demand. The level of unemployment also remained relatively low, and Japanese equity market indices increased during the quarter. The Bank of Japan raised the benchmark interest rate from 0.25% to 0.50% during the quarter. Economies elsewhere in Asia also expanded, particularly in China, which benefited from strength in exports, domestic demand and continued globalization. Although equity market indices in China rose sharply during much of the quarter, they declined at quarter-end. In March 2007, the People's Bank of China raised the benchmark interest rate by 0.27%.

### **Business Segments.**

The remainder of "Results of Operations" is presented on a business segment basis before discontinued operations. Substantially all of the operating revenues and operating expenses of the Company can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective revenues or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group's global representatives. Income before taxes recorded in Intersegment Eliminations was \$5 million in the quarter ended February 28, 2007 and \$19 million in the quarter ended February 28, 2006.

Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation, including the reporting of Quilter within discontinued operations for all periods presented.

**Table of Contents****INSTITUTIONAL SECURITIES****INCOME STATEMENT INFORMATION**

	<b>Three Months Ended February 28, 2007      2006 (dollars in millions)</b>	
Revenues:		
Investment banking	\$ 1,049	\$ 903
Principal transactions:		
Trading	4,029	2,963
Investments	801	312
Commissions	691	610
Asset management, distribution and administration fees	88	43
Servicing and securitization income	35	
Interest and dividends	13,961	9,789
Other	145	96
Total revenues	20,799	14,716
Interest expense	13,168	9,165
Net revenues	7,631	5,551
Total non-interest expenses	4,600	3,776
Income from continuing operations before losses from unconsolidated investees and income taxes	3,031	1,775
Losses from unconsolidated investees	43	68
Provision for income taxes	942	531
Income from continuing operations	\$ 2,046	\$ 1,176

**Investment Banking.** Investment banking revenues for the quarter ended February 28, 2007 increased 16% from the comparable period of fiscal 2006. The increase was primarily due to higher revenues from equity underwriting transactions and merger, acquisition and restructuring activities. Advisory fees from merger, acquisition and restructuring transactions were \$390 million, an increase of 10% from the comparable period of fiscal 2006. Underwriting revenues were \$659 million, an increase of 20% from the comparable period of fiscal 2006. Equity underwriting revenues increased 52% to \$300 million, reflecting an increase in industry-wide transaction activity. Fixed income underwriting revenues increased 2% to \$359 million.

At February 28, 2007, the backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions was higher as compared with the first quarter of fiscal 2006. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval or a decision on the part of the parties involved not to pursue a transaction.

**Sales and Trading.** Sales and trading revenues are composed of principal transaction trading revenues, commissions and net interest revenues (expenses). In assessing the profitability of its sales and trading activities, the Company views principal trading, commissions and net interest revenues in the aggregate. In addition, decisions relating to principal transactions are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes, among other things, an assessment of the potential gain or loss associated with a transaction, including any associated commissions, dividends, the interest income or expense associated with financing or hedging the Company's positions and other related expenses.





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Total sales and trading revenues increased 31% from the comparable period of fiscal 2006, reflecting record fixed income and equity sales and trading revenues.

Sales and trading revenues include the following:

	<b>Three Months Ended February 28, 2007(1) 2006(1) (dollars in millions)</b>	
Equity	\$ 2,243	\$ 1,654
Fixed income(2)	3,566	2,724

(1) Amounts exclude sales and trading revenues of \$(296) million and \$(181) million for the three months ended February 28, 2007 and 2006, respectively, which relate to unallocated net revenues, net revenues associated with corporate lending activities and certain other adjustments.

(2) Amounts include interest rate and currency products, credit products and commodities. Amounts exclude corporate lending activities.

Equity sales and trading revenues increased 36% to a record \$2,243 million in the first quarter of fiscal 2007. The increase was broad based and included higher revenues from derivatives products, prime brokerage, financing products, principal trading strategies and equity cash products. Derivative revenues increased due to strong customer flows, new transaction activity and principal risk taking. Revenues from financing and equity cash products also benefited from increased client activity. Prime brokerage generated record revenues reflecting continued growth in global client asset balances. Global equity markets trended higher during much of the quarter and created favorable opportunities for principal trading strategies. Although commission revenues increased, revenues continued to be affected by intense competition, particularly in the U.S., and a continued shift toward electronic trading.

Fixed income sales and trading revenues increased 31% to a record \$3,566 million driven by strong performances in credit products and interest rate and currency products. Credit product revenues increased 94%, primarily due to higher revenues from securitized products. Trading revenues benefited from favorable positioning in the residential mortgage markets, improved corporate credit trading and strong customer flows. Interest rate and currency product revenues increased 17% benefiting from improved interest rate trading and emerging market revenues. Commodities decreased 26% from last year's record first quarter, reflecting lower trading results in electricity, natural gas products and oil liquids.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net revenues from the Company's corporate lending activities. In the quarter ended February 28, 2007, revenues from corporate lending activities decreased by approximately \$10 million from the first quarter of fiscal 2006, reflecting the impact of mark-to-market valuations on a higher level of new loans made in the quarter, partially offset by higher revenues from principal trading strategies.

**Principal Transactions-Investments.** Principal transaction net investment revenues aggregating \$801 million were recognized in the quarter ended February 28, 2007 as compared with \$312 million in the quarter ended February 28, 2006. The increase was primarily related to net gains associated with certain of the Company's investments, including both realized and unrealized gains from investments in the Company's real estate funds, Grifols S.A. and IntercontinentalExchange. The current quarter also included revenues of \$237 million related to certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein). Principal transaction net investment revenues for the first quarter of fiscal 2006 included \$130 million from the Company's investment in IntercontinentalExchange.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased \$45 million from the comparable period of fiscal 2006, reflecting higher fees associated with certain real estate fund investments.

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***Servicing and Securitization Income.*** Servicing and securitization income of \$35 million recognized in the first quarter of fiscal 2007 was primarily attributable to Saxon Capital, Inc. ( Saxon ), which the Company acquired on December 4, 2006.

***Other.*** Other revenues increased 51%. The increase was primarily attributable to revenues related to the operation of pipelines, terminals and barges and the distribution of refined petroleum products associated with TransMontaigne Inc. ( TransMontaigne ), which the Company acquired on September 1, 2006, and higher sales of benchmark indices and risk management analytic products.

***Non-Interest Expenses.*** Non-interest expenses increased 22%. Compensation and benefits expense increased 21% primarily reflecting higher incentive-based compensation costs resulting from higher net revenues as well as higher compensation costs associated with certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein). The increase was partially offset by Institutional Securities share (\$270 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses increased 25%. Occupancy and equipment expense increased 35%, primarily due to higher rent and occupancy costs, including additional costs associated with TransMontaigne, the Heidmar Group of companies ( Heidmar ), and a new office building in New York City. The Company acquired TransMontaigne and Heidmar in September 2006 and the office building in June 2006. Brokerage, clearing and exchange fees increased 29%, primarily reflecting increased equity and fixed income trading activity. Marketing and business development expense increased 32%, primarily due to a higher level of business activity. Professional services expense increased 20%, primarily due to higher consulting and legal costs. Other expenses increased 34%, reflecting costs associated with TransMontaigne and Heidmar.

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## GLOBAL WEALTH MANAGEMENT GROUP

## INCOME STATEMENT INFORMATION

	Three Months	
	Ended February 28, 2007	2006
	(dollars in millions)	
Revenues:		
Investment banking	\$ 166	\$ 67
Principal transactions:		
Trading	129	125
Investments	(2)	1
Commissions	315	310
Asset management, distribution and administration fees	702	638
Interest and dividends	274	203
Other	44	37
Total revenues	1,628	1,381
Interest expense	138	115
Net revenues	1,490	1,266
Total non-interest expenses	1,270	1,251
Income from continuing operations before income taxes	220	15
Provision for income taxes	83	6
Income from continuing operations	\$ 137	\$ 9

**Investment Banking.** Investment banking revenues increased 148%, driven by robust equity underwriting results primarily related to a closed end fund offering in the quarter. The increase also reflected strong results from fixed income underwriting and unit trusts.

**Principal Transactions Trading.** Principal transaction trading revenues increased 3%, as higher revenues from corporate fixed income securities, foreign exchange products and equity linked notes were partially offset by lower revenues from government and municipal fixed income securities.

**Principal Transactions Investments.** Principal transaction net investment losses aggregating \$2 million were recognized in the quarter ended February 28, 2007 as compared with net gains aggregating \$1 million in the comparable period. The results in both periods were primarily related to investments in exchanges.

**Commissions.** Commission revenues increased 2% as compared with the prior-year period reflecting improved market conditions. Commission revenues were limited by growth in other product areas, such as underwritten products, which are included within investment banking revenues.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased 10%, primarily reflecting higher client assets in fee-based accounts.

Client assets in fee-based accounts rose 17% to \$202 billion at February 28, 2007 and increased as a percentage of total client assets to 29% of total client assets from 28% in the prior-year period. Client asset balances increased to \$690 billion at February 28, 2007 from \$624 billion at February 28, 2006, primarily due to market appreciation. Client asset balances in accounts greater than \$1 million increased to \$458 billion at February 28, 2007 from \$386 billion at February 28, 2006.



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**Net Interest.** Net interest revenues increased 55%, primarily related to increased account balances in the bank deposit program. Balances in the bank deposit program rose to \$16,364 million at February 28, 2007 as compared with \$7,319 million at February 28, 2006.

**Non-Interest Expenses.** Non-interest expenses increased 2%. Compensation and benefits expense increased 7%, primarily reflecting higher incentive-based compensation accruals related to higher net revenues, partially offset by Global Wealth Management Group's share (\$80 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see "Other Items - Stock-Based Compensation" herein). Excluding compensation and benefits expense, non-interest expenses decreased 9%. Occupancy and equipment expense increased 9%, primarily due to higher rental charges. Professional services expense decreased 6%, largely due to lower costs for outside legal counsel and consulting fees, partially offset by higher sub-advisory fees associated with growth in fee-based assets. Marketing and business development expense increased 27%, primarily due to higher costs associated with a new advertising campaign that was launched in the first quarter of fiscal 2007. Other expenses decreased 37%, primarily resulting from lower costs associated with legal and regulatory matters, which declined by approximately \$40 million.

**Table of Contents****ASSET MANAGEMENT****INCOME STATEMENT INFORMATION**

	<b>Three Months Ended February 28, 2007      2006 (dollars in millions)</b>	
Revenues:		
Investment banking	\$ 14	\$ 12
Principal transactions:		
Investments	121	36
Commissions	6	7
Asset management, distribution and administration fees	732	640
Interest and dividends	13	5
Other	34	7
Total revenues	920	707
Interest expense	15	2
Net revenues	905	705
Total non-interest expenses	669	533
Income before income taxes	236	172
Provision for income taxes	96	67
Net income	\$ 140	\$ 105

**Investment Banking.** Investment banking revenues increased 17%, primarily reflecting a higher volume of equity unit trust sales.

**Principal Transactions-Investments.** Principal transaction net investment gains aggregating \$121 million were recognized in the first quarter of fiscal 2007 as compared with \$36 million in the prior-year period. The increase was primarily related to higher net gains on certain investments in the Company's private equity portfolio and investments in the Company's alternatives products.

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**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased 14%, primarily due to higher fund management and administration fees associated with a 12% increase in average assets under management and higher performance fees from the alternatives business, including those associated with the acquisition of FrontPoint Partners ( FrontPoint ) (see Other Items Business and Other Acquisitions herein).

Asset Management's period-end and average customer assets under management or supervision were as follows:

	At February 28,		Average for the Three Months Ended February 28,	
	2007	2006(1)	2007	2006(1)
	(dollars in billions)			
Assets under management or supervision by distribution channel:				
Americas Retail Morgan Stanley brand	\$ 61	\$ 64	\$ 61	\$ 66
Americas Retail Van Kampen brand	96	90	96	90
Americas Intermediary(2)	61	47	60	46
U.S. Institutional	95	88	94	88
Non-U.S.	97	75	92	71
Total long-term assets under management or supervision	410	364	403	361
Institutional money markets/liquidity	52	37	51	35
Retail money markets	33	41	34	43
Total money markets	85	78	85	78
Total assets under management or supervision	495	442	488	439
Share of minority interest assets(3)	5		5	
Total	\$ 500	\$ 442	\$ 493	\$ 439

	At February 28,		Average for the Three Months Ended	
	2007	2006(1)	February 28,	February 28,
	(dollars in billions)			
Assets under management or supervision by asset class:				
Equity	\$ 245	\$ 230	\$ 244	\$ 226
Fixed income	94	90	93	91
Money market	85	78	85	78
Alternative investments	29	18	27	19
Real estate	27	14	25	13
Subtotal	480	430	474	427
Unit trusts	15	12	14	12
Total assets under management or supervision	495	442	488	439
Share of minority interest assets(3)	5		5	
Total	\$ 500	\$ 442	\$ 493	\$ 439



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- (1) Certain prior-period information has been reclassified to conform to the current period's presentation.
- (2) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.
- (3) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.

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Activity in Asset Management's customer assets under management or supervision were as follows:

	<b>Three Months Ended February 28, 2007                      2006 (dollars in billions)</b>	
<b>Balance at beginning of period</b>	<b>\$ 478</b>	<b>\$ 431</b>
Net flows by distribution channel:		
Americas Retail Morgan Stanley brand	(2)	(3)
Americas Retail Van Kampen brand		(1)
Americas Intermediary(1)	1	2
U.S. Institutional		(4)
Non-U.S.	5	1
Net inflows/(outflows) excluding money markets	4	(5)
Money market net flows:		
Institutional	3	4
Retail	(2)	(6)
Total money market net flows	1	(2)
Net market appreciation	10	18
Total net increase	15	11
Acquisitions	6	
Net increase in share of minority interest assets(2)	1	
<b>Balance at end of period</b>	<b>\$ 500</b>	<b>\$ 442</b>

(1) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.

(2) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.

Net inflows (excluding money markets) in the quarter ended February 28, 2007 were primarily associated with positive flows into Non-U.S. products, partially offset by outflows in Americas Retail Morgan Stanley branded products. For the quarter ended February 28, 2007, positive flows into institutional liquidity assets were partially offset by outflows from certain money market funds that were impacted by the growth of Global Wealth Management Group's bank deposit program.

**Other.** Other revenues were \$34 million for the fiscal quarter ended February 28, 2007 as compared with \$7 million in the prior-year period. The increase was primarily due to revenue recognized from the Company's minority stakes in Avenue Capital Group and Lansdowne Partners, which were acquired in the fourth quarter of fiscal 2006.

**Non-Interest Expenses.** Non-interest expenses increased 26%. Compensation and benefits expense increased 45%, primarily reflecting higher incentive-based compensation accruals due to higher net revenues and investments in the business, particularly in alternatives. The increase was partially offset by Asset Management's share (\$28 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses increased 9%. Brokerage, clearing and exchange fees decreased 12%, primarily reflecting lower amortization expense associated with certain open-ended funds. The decrease in amortization expense reflected a lower level of deferred costs in recent periods due to a decrease in sales of certain open-ended funds. Professional services expense increased 15%, primarily due to higher sub-advisory, consulting and legal fees. Other expenses increased 113%, primarily due to the amortization of intangible assets associated with the acquisition of FrontPoint.



**Table of Contents****DISCOVER****INCOME STATEMENT INFORMATION**

	<b>Three Months</b>	
	<b>Ended February 28, 2007</b>	<b>2006</b>
	<b>(dollars in millions)</b>	
Merchant, cardmember and other fees, net	\$ 297	\$ 289
Servicing and securitization income	521	596
Other revenue	9	4
 Total non-interest revenues	 827	 889
 Interest revenue	 680	 586
Interest expense	287	231
 Net interest income	 393	 355
Provision for consumer loan losses	195	155
 Net credit income	 198	 200
 Net revenues	 1,025	 1,089
 Total non-interest expenses	 653	 610
 Income before losses from unconsolidated investees and income taxes	 372	 479
Losses from unconsolidated investees	1	1
Provision for income taxes	138	178
 Net income	 \$ 233	 \$ 300

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (see Other Items Discover Spin-off herein).

**Merchant, Cardmember and Other Fees, Net.** Merchant, cardmember and other fees, net, increased 3%, primarily due to higher cardmember and other fees and higher merchant discount revenues, partially offset by higher cardmember rewards. The increase in cardmember and other fees was primarily related to higher balance transfer fees and higher credit protection revenues. The increase in merchant discount revenue was due to higher sales volume, partially offset by higher allocations of interchange revenue to securitization transactions. The allocation of interchange revenue has the effect of decreasing Merchant, cardmember and other fees, net, and increasing Servicing and securitization income. During the quarter ended February 28, 2007, the Company had a higher level of outstanding securitization transactions receiving interchange allocations than in the comparable prior-year period. The increase in sales volume reflected the acquisition of Goldfish in February 2006 and increased cardmember usage in the U.S. The increase in cardmember rewards reflected higher sales volume and the impact of promotional programs.

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**Servicing and Securitization Income.** The table below presents the components of servicing and securitization income:

	Three Months	
	Ended February 28, 2007	2006
	(dollars in millions)	
Merchant, cardmember and other fees, net	\$ 255	\$ 230
Other revenue	(4)	139
Total non-interest revenues	251	369
Interest revenue	919	889
Interest expense	362	310
Net interest income	557	579
Provision for consumer loan losses	287	352
Net credit income	270	227
Servicing and securitization income	\$ 521	\$ 596

Servicing and securitization income decreased 13%, primarily due to a decrease in Other revenue and lower net interest income, partially offset by a lower provision for consumer loan losses and higher Merchant, cardmember and other fees, net. Other revenue for the quarter ended February 28, 2006 benefited from an increase in the fair value of the Company's retained interests in securitized receivables resulting from lower projected charge-offs following the enactment of new bankruptcy legislation in October 2005. The decrease in Other revenues also reflected a lower level of new general purpose credit card securitization transactions in the quarter ended February 28, 2007. The decrease in net interest income was attributable to a lower net interest spread rate, partially offset by a higher level of average securitized general purpose credit card loans. The lower provision for consumer loan losses was primarily attributable to a lower rate of net principal charge-offs on the securitized general purpose credit card portfolio. The increase in Merchant, cardmember and other fees, net primarily reflected a higher level of outstanding securitization transactions that received interchange allocations.

The net proceeds received from general purpose credit card asset securitizations were \$1,578 million in the quarter ended February 28, 2007 and \$6,613 million in the quarter ended February 28, 2006. The credit card asset securitization completed in the quarter ended February 28, 2007 has an expected maturity of approximately three years from the date of issuance.

**Net Interest Income.** Net interest income increased 11% due to an increase in interest revenue, partially offset by an increase in interest expense. The increase in interest revenue was due to a higher yield and an increase in average owned general purpose credit card loans. The increase in average owned general purpose credit card loans was due to the acquisition of Goldfish and higher sales volume, partially offset by a higher level of average securitized general purpose credit card loans. The increase in interest expense was primarily due to an increase in the Company's average cost of borrowings and a higher level of average interest bearing liabilities, primarily to support the increase in average owned general purpose credit card loans.

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The following tables present analyses of Discover's average balance sheets and interest rates for the quarters ended February 28, 2007 and 2006 and changes in net interest income during those periods:

### Average Balance Sheet Analysis.

	Three Months Ended February 28,					
	2007			2006		
	Average			Average		
	Balance	Rate	Interest	Balance	Rate	Interest
	(dollars in millions)					
ASSETS						
Interest earning assets:						
General purpose credit card loans	\$ 24,672	10.44%	\$ 635	\$ 21,976	9.87%	\$ 535
Other consumer loans	96	6.56	2	306	7.52	6
Investment securities	80	5.14	1	39	3.70	
Other	2,983	5.76	42	4,033	4.65	45
Total interest earning assets	27,831	9.91	680	26,354	9.02	586
Allowance for loan losses	(832)			(838)		
Non-interest earning assets	3,110			2,157		
Total assets	\$ 30,109			\$ 27,673		
LIABILITIES AND SHAREHOLDER S EQUITY						
Interest bearing liabilities:						
Interest bearing deposits						
Savings	\$ 3,453	5.27%	\$ 45	\$ 820	3.86%	\$ 8
Brokered	9,920	5.05	123	12,394	4.46	136
Other time	1,570	4.87	19	1,783	4.40	19
Total interest bearing deposits	14,943	5.08	187	14,997	4.42	163
Other borrowings	7,243	5.57	100	6,001	4.55	68
Total interest bearing liabilities	22,186	5.24	287	20,998	4.46	231
Shareholder s equity/other liabilities	7,923			6,675		
Total liabilities and shareholder s equity	\$ 30,109			\$ 27,673		
Net interest income			\$ 393			\$ 355
Net interest margin(1)			5.73%			5.47%
Interest rate spread(2)		4.67%			4.56%	

(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.

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**Rate/Volume Analysis.**

Increase/(Decrease) due to Changes in:	Three Months Ended February 28, 2007 vs. 2006		
	Volume	Rate	Total
	(dollars in millions)		
<b>Interest Revenue</b>			
General purpose credit card loans	\$ 65	\$ 35	\$ 100
Other consumer loans	(4)		(4)
Investment securities	1		1
Other	(12)	9	(3)
Total interest revenue	33	61	94
<b>Interest Expense</b>			
Interest bearing deposits:			
Savings	25	12	37
Brokered			