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MORGAN STANLEY & CO. INTERNATIONAL plc

Half-yearly financial report

30 June 2017

MORGAN STANLEY & CO. INTERNATIONAL plc

CONTENTS

	Page
Interim management report	3
Directors' responsibilities statement	17
Independent review report to Morgan Stanley & Co. International plc	18
Condensed consolidated income statement	19
Condensed consolidated statement of comprehensive income	20
Condensed consolidated statement of changes in equity	21
Condensed consolidated statement of financial position	22
Condensed consolidated statement of cash flows	23
Notes to the condensed consolidated financial statements	24

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

The Directors present their interim management report and the condensed consolidated financial statements (“Interim Financial Statements”) of Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary undertakings (together the “Group”), for the six months ended 30 June 2017. This interim management report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary undertakings when viewed as a whole.

The interim management report contains certain forward-looking statements. These statements are made by the Directors in good faith based on the information available at the time of their approval of this report and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information.

RESULTS AND DIVIDENDS

The Group made a profit after tax in the six months ended 30 June 2017 of \$695 million (30 June 2016: \$296 million).

On 31 May 2017, the Directors approved and paid a coupon payment on the Additional Tier 1 (“AT1”) capital instruments of \$118,625,000 (31 December 2016: \$157,625,000 of pre-tax coupon interest on the AT1 instrument was paid on 20 December 2016) out of reserves available for distribution at 31 December 2016. See note 10. No other dividends were proposed or paid during the six months ended 30 June 2017.

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions.

The Company operates branches in the Dubai International Financial Centre, the Netherlands, Poland, the Qatar Financial Centre, South Korea and Switzerland. On 1 February 2017, the Company transferred the assets and liabilities of the French branch to Morgan Stanley (France) S.A., a wholly owned subsidiary. On transfer, the branch was dissolved.

There have not been any changes in the Group’s principal activity during the period and no significant change in the Group’s principal activity is expected.

The Group’s ultimate parent undertaking and controlling entity is Morgan Stanley, which, together with the Group and Morgan Stanley’s other subsidiary undertakings, form the “Morgan Stanley Group”.

The Morgan Stanley Group is a global financial services firm that maintains significant market positions in each of its business segments: Institutional Securities, Wealth Management and Investment Management. The Morgan Stanley Group 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. As a key contributor to the execution of the Morgan Stanley Group’s Institutional Securities strategy in Europe, the Middle East and Africa (“EMEA”), the Group provides 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 and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

REGULATION

The Company is authorised by the Prudential Regulation Authority (“PRA”) and regulated by the PRA and the Financial Conduct Authority (“FCA”). In addition, the Company is a registered swap dealer and is regulated by the United States (“US”) Commodity Futures Trading Commission (“CFTC”).

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

BUSINESS REVIEW

Global markets and economic conditions

Growth in the global economy was robust in the first half of 2017, likely expanding close to 4% in both the first and second quarter. Strength was broad-based across both developed economies and emerging markets. Growth averaged close to 2% in the US and slightly higher in the Euro area. The United Kingdom (“UK”) was a laggard with growth averaging around 1%. In emerging markets, Chinese growth was more resilient than expected and the Brazilian and Russian economies experienced economic recoveries. In March, the US Federal Reserve increased interest rates for the third time in the current cycle and then followed with a fourth increase in June to 1.25%. Moreover, at its July meeting it announced that it expects to begin the process of balance sheet normalisation “relatively soon”. The Chinese authorities implemented policy measures to reduce capital outflows and financial sector risks. In terms of the political cycle, populist parties failed to make major breakthroughs in the Dutch and French Presidential elections. UK Prime Minister Theresa May triggered the Article 50 process for the UK to leave the European Union (“EU”) in March and her Conservative party lost its majority at the June election.

UK Referendum

On 23 June 2016, the UK electorate voted to leave the EU. On 29 March 2017, the UK formally invoked Article 50 of the Lisbon Treaty, which triggered a two-year period, subject to extension, during which the UK government is expected to negotiate its withdrawal agreement with the EU. It is difficult to predict the future of the UK’s relationship with the EU, which uncertainty may increase the volatility in the global financial markets in the short- and medium-term. Absent any extension, the UK is expected to leave the EU in early 2019. The terms and conditions of the anticipated withdrawal from the EU, and which of the several alternative models of relationship that the UK might ultimately negotiate with the EU, remain uncertain. However, the UK government has stated that the UK will leave the EU single market and will seek a phased period of implementation for the new relationship that may cover the legal and regulatory framework applicable to financial institutions with significant operations in Europe, such as Morgan Stanley. Potential effects of the UK exit from the EU and potential mitigation actions may vary considerably depending on the timing of withdrawal and the nature of any transition or successor arrangements. Any future limitations on providing financial services into the EU from our UK operations could require us to make potentially significant changes to our operations in the UK and Europe and our legal structure there, which could have an adverse effect on our business and financial results.

Overview of 2017 Financial Results

The condensed consolidated income statement for the six months ended 30 June 2017 is set out on page 19. The Group reported a profit after tax for the six months ended 30 June 2017 of \$695 million compared to a profit after tax of \$296 million for the six months ended 30 June 2016 as a result of increased revenues, partially offset by higher expenses.

The Group’s revenues are best reviewed across the aggregate of ‘Net gains on financial instruments classified as held for trading’, ‘Net losses on financial instruments designated at fair value through profit or loss’, ‘Net gain on available-for-sale financial assets’, ‘Interest income’, ‘Interest expense’ and ‘Other income’ (“aggregate revenues”). Aggregate revenues for the six months ended 30 June 2017 increased by 48% to \$3,219 million compared to \$2,180 million for the six months ended 30 June 2016.

The increase in aggregate revenues was primarily driven by increased revenues in the Institutional Equities division, the Fixed Income division and the Investment Banking division. In addition, revenues increased in the period as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing Policy, effective 1 January 2017. This change in transfer policy is consistent with evolving transfer pricing guidance under Organization for Economic Cooperation and Development (“OECD”)’s and evolving regulatory guidance. The transfer pricing method selected for implementation is one of the methods specified under the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This new policy is the subject of a multilateral Advanced Pricing Agreement that is currently under review by relevant tax authorities.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2017 Financial Results (continued)

The increase in Institutional Equities revenues was primarily driven by Cash Equities and Derivatives as a result of increased client activity during the period, with 2016 being lower due to challenging market conditions.

The increase in Fixed Income revenues was due to increased client activity and market volatility as markets rallied. The revenues for the six months ended 30 June 2016 were impacted by market uncertainty, including the slowdown in China's growth and the UK referendum.

The increase in Investment Banking revenues was due to increased advisory revenues, with 2016 revenues having been lower as a result of market uncertainty.

Other expenses increased from \$1,712 million for the six months ended 30 June 2016 to \$2,220 million for the six months ended 30 June 2017.

Staff related expenses increased by 17% from \$757 million for the six months ended 30 June 2016 to \$884 million for the six months ended 30 June 2017. The increase was primarily driven by higher discretionary compensation due to the higher revenues, partially offset by lower salary costs due to the weakening of the British Pound against the US dollar.

Non-staff related expenses increased by 40% from \$955 million for the six months ended 30 June 2016 to \$1,336 million for the six months ended 30 June 2017. The increase in non-staff related costs is principally as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing Policy, effective 1 January 2017.

Included in non-staff related expenses for the six months ended 30 June 2017 is an \$86 million provision related to a UK indirect tax (Value-added Tax "VAT") matter. Refer to note 8 for further details.

The Group's tax expense for the six months ended 30 June 2017 was \$304 million compared to \$172 million for the six months ended 30 June 2016. This represents an effective tax rate of 30.40% (30 June 2016: 36.75%) which is higher than the average standard rate of UK corporation tax (inclusive of the UK Banking surcharge) of 27.25% (30 June 2016: 28%). See note 3 for further details.

The condensed consolidated statement of financial position presented on page 22 reflects increases in the Group's total assets and total liabilities of \$15,950 million and \$15,296 million respectively, in each case representing increases of 4% as at 30 June 2017 when compared to 31 December 2016. The increase in total assets is driven by increases of \$10,245 million in trade receivables and \$7,050 million in 'financial assets classified as held for trading', partially offset by a decrease of \$7,710 in 'securities purchased under agreements to resell'. The increase in total liabilities is driven by increases in other payables of \$23,809 million, and an increase in 'financial liabilities designated at fair value' of \$17,387 million, which were partially offset by a decrease in 'financial liabilities classified as held for trading' of \$19,306 million.

The increase in trade receivables is driven by an increase in Prime Brokerage receivables and increases in cash collateral pledged as a result of changes in the underlying derivative exposures. The increase in financial assets held for trading is driven by an increase in corporate equities as a result of increased client demand and market movements, partially offset by a decrease in derivative assets driven by trades maturing and reduced client demand.

The increase in other liabilities is driven by an increase in the long-term intercompany funding due to increases in business activity. The increase in financial liabilities designated at fair value is due to an increase in client financing activity. The decrease in financial liabilities held for trading was driven by a decrease in derivative liabilities as a result of trades maturing and reduced client demand.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2017 Financial Results (continued)

The condensed consolidated statement of cash flows presented on page 23 shows a decrease in cash and cash equivalents of \$60 million during the six months ended 30 June 2017 (six months ended 30 June 2016: net increase of \$2,365 million). Net cash inflows from operating activities were \$1,108 million (30 June 2016: \$2,452 million). This has been partially offset by net cash outflows from financing activities due to the net repayment of the subordinated loans of \$906 million (30 June 2016: \$nil) and payment of the AT1 coupon of \$119 million (30 June 2016: \$nil million).

Key performance indicators

The Board of Directors monitors the results of the Group by reference to a range of performance and risk based metrics, including, but not limited to the following:

Profitability metrics

Return on ordinary shareholder's equity: The Group's return on ordinary shareholder's equity (profit/loss for the period attributable to the parent less dividends paid on AT1 instruments as a percentage of ordinary shareholder's equity at the beginning of the year (total equity less AT1 Instruments and Non-controlling Interest)) was 3.9% for the six months ended 30 June 2017 (six months ended 30 June 2016: 1.9%).

Return on assets: The Group's return on assets (profit/ loss for the period as a percentage of total assets at the beginning of the year) was 0.2% for the six months ended 30 June 2017 (six months ended 30 June 2016: 0.1%).

Balance sheet assets

Total assets: Total assets of the Group continue to be closely monitored. The Group's total assets, as disclosed on page 22, increased by 4% from \$423,346 million at 31 December 2016 to \$439,296 million at 30 June 2017.

Capital

The Group monitors its, and the Company's capital position against a range of key metrics including the following:

Tier 1 regulatory capital: The Company's Tier 1 capital as calculated in accordance with PRA rules which are based on the fourth EU Capital Requirements Directive ("CRD") and EU Capital Requirements Regulation ("CRR"), collectively known as "CRD IV", was \$15,282 million as at 30 June 2017 (31 December 2016: \$15,185 million) and its Tier 1 capital ratio was 11.2% as at 30 June 2017 (31 December 2016: 14.8%), which is in excess of the required minimum regulatory ratio. Tier 1 capital ratio is defined as Tier 1 capital divided by risk-weighted assets ("RWAs"). The decrease in Tier 1 capital ratio is mainly driven by an increase in RWAs, principally in market, credit and concentration risk RWAs.

Leverage ratio: CRD IV, as amended by the European Commission Delegated Act, introduced on 10 October 2014 a new requirement to calculate a leverage ratio, which compares Tier 1 capital to a measure of leverage exposure, which is defined as the sum of assets less Tier 1 capital deductions plus off-balance sheet exposures. Currently no regulatory minimum ratio has been set pending further European legislation, although public disclosure requirements were effective for reporting periods from 1 January 2015. As at 30 June 2017, the Company had a leverage ratio of 3.6% (31 December 2016: 4.0%), which is above the minimum regulatory ratio of 3% that is expected to apply in the future once new legislation is introduced.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT

Risk is an inherent part of the Group's business activity. The Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities, in accordance with defined policies and procedures. The Group has developed its own risk management policy framework, which leverages the risk management policies and procedures of the Morgan Stanley Group and the Morgan Stanley International Limited ("MSI") Group and which includes escalation to the Group's Board of Directors and to appropriate senior management personnel of the Group as well as oversight through the Group's Board of Directors and through a dedicated Risk Committee of non-executive Directors that reports to the Board of MSI, the Company's ultimate UK parent undertaking.

Note 13 to the condensed consolidated financial statements provides more detailed quantitative disclosures. Pages 6 to 28 of the strategic report and note 27 to the consolidated financial statements for the year ended 31 December 2016 provide more detailed qualitative disclosures on the Group's exposure to financial risks.

Set out below is an overview of the Group's policies for the management of financial risk and other significant business risks.

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

The Group manages the market risk associated with its trading activities at both a division and an individual product level, and includes consideration of market risk at the legal entity level.

The Group uses the statistical technique known as VaR as one of the tools used to measure, monitor and review the market risk exposures of its trading portfolios. The Market Risk Department calculates and distributes daily VaR-based risk measures to various levels of management. The following table shows the Group's VaR for primary risk categories and total Management VaR for the six month period ended 30 June 2017 and for the year ended 31 December 2016.

	95% / one-day VaR for the six months ended 30 June 2017		95% / one-day VaR for the year ended 31 December 2016	
	Period End \$millions	Average \$millions	Period End \$millions	Average \$millions
Primary Risk Categories	22	20	16	17
Credit Portfolio ⁽¹⁾	5	6	7	8
Less: Diversification benefit ⁽²⁾	(3)	(4)	(6)	(5)
Total Management VaR	24	22	17	20

(1) The Credit Portfolio VaR includes loans that are carried at fair value and associated hedges as well as counterparty credit valuation adjustments and related hedges.

(2) Diversification benefit equals the difference between total management VaR and the sum of the VaRs for the Primary Market Risk Categories and the Credit Portfolio. This benefit arises because the simulated one-day losses for each of the component categories occur on different days; similar diversification benefits are also taken into account within each category.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Market risk (continued)

The Group's average Management VaR for Primary Risk Categories for the six months ended 30 June 2017 was \$20 million compared to \$17 million for the year ended 31 December 2016. The increase in average Management VaR for Primary Market Risk Categories is spread across underlying risk factors, including interest rates, credit spreads, equity price and foreign exchange risk.

The Group's average Credit Portfolio VaR for the six months ended 30 June 2017 was \$6 million, compared to \$8 million for the year ended 31 December 2016. This reduction was mainly due to a decrease in credit risk exposure in high rated corporates.

The Group's average Total Management VaR for the six months ended 30 June 2017 was \$22 million, compared to \$20 million for the year ended 31 December 2016.

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Group. Credit risk includes country risk, which is further described below. The Group primarily incurs credit risk exposure to institutions and sophisticated investors through its Institutional Securities business segment.

Credit risk exposure is managed on a global basis and in consideration of each significant legal entity within the Morgan Stanley Group. The credit risk management policies and procedures establish the framework for identifying, measuring, monitoring and controlling credit risk whilst ensuring transparency of material credit risks, and compliance with established limits and escalating risk concentrations to appropriate senior management.

For further information on the Group's credit risk management framework, monitoring and control, credit evaluation and risk mitigation procedures, refer to pages 15 to 17 of the strategic report in the consolidated financial statements for the year ended 31 December 2016.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

The following table shows the Group's maximum exposure to credit risk and credit exposure for certain financial assets the Group believes are subject to credit risk and where the Group has entered into credit enhancements, including receiving cash and security as collateral and master netting agreements. The financial effect of the credit enhancements is also disclosed in the table. The net credit exposure represents the credit exposure remaining after the effect of the credit enhancements. Exposure to other Morgan Stanley Group undertakings is included in this table.

Exposure to credit risk by class

Class	30 June 2017			31 December 2016		
	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure ⁽²⁾ \$millions	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure ⁽²⁾ \$millions
Cash collateral on securities borrowed	21,947	(21,089)	858	19,601	(18,900)	701
Securities purchased under agreements to resell	69,736	(68,320)	1,416	77,446	(75,053)	2,393
Financial assets classified as held for trading:						
Derivatives	160,718	(152,636)	8,082	183,553	(175,809)	7,744
Financial assets designated at fair value through profit or loss	8,181	(7,834)	347	4,312	(3,697)	615
	<u>260,582</u>	<u>(249,879)</u>	<u>10,703</u>	<u>284,912</u>	<u>(273,459)</u>	<u>11,453</u>

(1) The carrying amount recognised in the condensed consolidated statement of financial position best represents the Group's maximum exposure to credit risk.

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$4,470 million (2016: \$3,696 million) to be offset in the event of default by certain Morgan Stanley counterparties.

Country risk exposure

Country risk is the risk that events in, or affecting, a foreign country might adversely affect the Group. "Foreign country" means any country other than the UK. Sovereign Risk, by contrast, is the risk that a government will be unwilling or unable to meet its debt obligations, or renege on the debt it guarantees. Sovereign risk is single-name risk for a sovereign government, its agencies and guaranteed entities. For further information on how the Group identifies, monitors and manages country risk exposure refer to page 19 of the strategic report of the consolidated financial statements for the year ended 31 December 2016.

The Group's sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures consist of exposures to primarily corporations and financial institutions. The table below shows the Group's five largest non-UK country net exposures. Exposure to other Morgan Stanley Group undertakings has been excluded from this table.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Country risk exposure (continued)

Five largest non-UK country risk net exposures as at 30 June 2017:

Country	Net Inventory ⁽¹⁾ \$millions	Net Counterparty Exposure ⁽²⁾ \$millions	Funded lending \$millions	Unfunded Commitments \$millions	Exposure Before Hedges \$millions	Hedges ⁽³⁾ \$millions	Net Exposure ⁽⁴⁾ \$millions
United States:							
Sovereigns	(646)	23	-	-	(623)	-	(623)
Non-sovereigns	2,226	1,547	20	16	3,809	(89)	3,720
Total United States	1,580	1,570	20	16	3,186	(89)	3,097
Belgium							
Sovereigns	1,132	-	-	-	1,132	-	1,132
Non-sovereigns	8	83	-	-	91	-	91
Total Belgium	1,140	83	-	-	1,223	-	1,223
Germany							
Sovereigns	623	745	-	-	1,368	(1,048)	320
Non-sovereigns	(110)	1,293	7	22	1,212	(458)	754
Total Germany	513	2,038	7	22	2,580	(1,506)	1,074
Japan							
Sovereigns	49	-	-	-	49	-	49
Non-sovereigns	109	852	-	-	961	(37)	924
Total Japan	158	852	-	-	1,010	(37)	973
Italy							
Sovereigns	64	(1)	-	-	63	48	111
Non-sovereigns	(35)	500	48	482	995	(240)	755
Total Italy	29	499	48	482	1,058	(192)	866

- (1) Net inventory represents exposure to both long and short single name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable). As a market maker, the Group transacts in these CDS positions to facilitate client trading.
- (2) Net counterparty exposure (i.e. repurchase transactions, securities lending and over-the-counter ("OTC") derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Amounts are based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) In addition, as at 30 June 2017, the Group had exposure to these countries for overnight deposits with banks of approximately \$1,085 million.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk

Liquidity and funding risk refers to the risk that the Group will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the Group's ability to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern.

For a further discussion on the Group's liquidity and funding risk refer to pages 21 to 24 of the strategic report in the consolidated financial statements for the year ended 31 December 2016.

Secured funding

The table below presents the Group's secured funding liabilities split between short-term secured funding (with a maturity of less than one year remaining from 30 June 2017 and 31 December 2016) and long-term secured funding (with a maturity of more than one year from 30 June 2017 and 31 December 2016) consisting of securities sold under agreements to repurchase and cash collateral on securities loaned.

For further information on how the Group's uses secured funding refer to page 24 of the strategic report in the consolidated financial statements for the year ended 31 December 2016.

	30 June 2017	31 December 2016
	\$millions	\$millions
<i>Short-term secured funding:</i>		
Cash collateral on securities loaned	23,237	21,119
Securities sold under agreements to repurchase	33,157	44,033
Total short-term secured funding	56,394	65,152
<i>Long-term secured funding:</i>		
Cash collateral on securities loaned	708	105
Securities sold under agreements to repurchase	6,245	4,383
Total long-term secured funding	6,953	4,488
Total secured funding	63,347	69,640

Credit ratings

The Company relies on external sources to finance a significant portion of its day-to-day operations. The cost and availability of financing generally are impacted by, among other variables, the Company's credit ratings. In addition, the Company's credit ratings can have an impact on certain trading revenues, particularly in those businesses where longer-term counterparty performance is a key consideration, such as OTC derivative transactions, including credit derivatives and interest rate swaps. Ratings agencies consider company-specific factors; other industry factors such as regulatory or legislative changes; the macroeconomic environment; and perceived levels of government support, among other things.

Some rating agencies have stated that they currently incorporate various degrees of credit rating uplift from non-governmental third party sources of potential support.

At 30 June 2017, the Company's senior unsecured ratings were as follows:

	Short- Term Debt	Long- Term Debt	Rating Outlook
Moody's Investors Service, Inc ("Moody's")	P-1	A1	Stable
Standard & Poor's Rating Service ("S&P")	A-1	A+	Stable

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Collateral impact of a downgrade

In connection with certain OTC trading agreements and certain other agreements where the Company is a liquidity provider to certain financing vehicles, the Company may be required to provide additional collateral or immediately settle any outstanding liability balances with certain counterparties or pledge additional collateral to certain exchanges and clearing organisations in the event of a future credit rating downgrade irrespective of whether the Company is in a net asset or net liability position.

The additional collateral or termination payments that may be called in the event of a future credit rating downgrade vary by contract and can be based on ratings by either or both of Moody's and S&P. As at 30 June 2017, based on the relevant contractual downgrade triggers, the future potential collateral amounts and termination payments that could be called or required by counterparties or exchanges and clearing organisations, in the event of one-notch or two-notch downgrade scenarios, from the lower of Moody's or S&P ratings, were \$211 million and an incremental \$267 million, respectively.

While certain aspects of a credit rating downgrade are quantifiable pursuant to contractual provisions, the impact it would have on the Company's business and results of operations in future periods is inherently uncertain and would depend on a number of interrelated factors, including, the magnitude of the downgrade, the rating relative to peers, the rating assigned by the relevant agency pre-downgrade, individual client behaviour and future mitigating actions which the Company might take. The liquidity impact of additional collateral requirements is included in the Group's Liquidity Stress Tests.

Operational risk

Operational risk refers to the risk of loss, or of damage to the Group's reputation, resulting from inadequate or failed processes, people and systems or from external events (e.g. fraud, theft, legal and compliance risks, cyber-attacks or damage to physical assets). Operational risk relates to the following risk event categories as defined by Basel Capital Standards: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; business disruption and system failure; damage to physical assets; and execution, delivery and process management. The Group may incur operational risk across the full scope of its business activities, including revenue-generating activities (e.g. sales and trading) and support and control groups (e.g., information technology and trade processing). Legal and compliance risk is discussed below under "Legal, regulatory and compliance risk".

For further information on the Group's operational risk, refer to the pages 25 to 27 of the strategic report in the consolidated financial statements for the year ended 31 December 2016.

Conduct risk

Conduct risk refers to the risk that the Group's actions or behaviours do not adequately consider the impact on its clients, expected market users or the markets. Conduct risk is managed within the framework set out by the MSI Group and is managed and owned across business and control functions through policies, processes and controls within a designed framework.

Legal, regulatory and compliance risk

Legal, regulatory and compliance risk includes the risk of legal or regulatory sanctions, material financial loss; including fines, penalties, judgements, damages and/ or settlements or loss to reputation which the Group may suffer as a result of a failure to comply with laws, regulations, rules, related self-regulatory organisation standards and codes of conduct applicable to our business activities. This risk also includes contractual and commercial risk, such as the risk that a counterparty's performance obligations will be unenforceable. It also includes compliance with Anti-Money Laundering and terrorist financing rules and regulations. The Group is generally subject to extensive regulation in the different jurisdictions in which it conducts its business.

For further information on the Group's legal, regulatory and compliance risk, refer to the page 27 of the strategic report in the consolidated financial statements for the year ended 31 December 2016.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT CAPITAL MANAGEMENT

The Group views capital as an important source of financial strength. It actively manages and monitors its capital in line with established policies and procedures and in compliance with local regulatory requirements.

The Group, in line with Morgan Stanley Group's capital management policies, manages its capital position based upon among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses. The appropriate level of capital is determined at a legal entity level to safeguard that entity's ability to continue as a going concern and ensure that it meets all regulatory capital requirements. The key components of the capital management framework used by the Group are set out in the Capital Management Policy and include a point in time capital assessment, forward looking capital projections and stress testing.

MSI and all of its subsidiary undertakings prepare an Internal Capital Adequacy Assessment Process ("ICAAP") document to meet obligations under CRD IV and the requirements of the PRA. The Group forms part of the MSI Group.

The ICAAP is one of the key tools used to inform the MSI Group's capital adequacy assessment, planning and management. The MSI Group ICAAP:

- Ensures that the risks to which the MSI Group is exposed are appropriately capitalised and risk managed, including those risks that are either not captured, or not fully captured under Pillar 1;
- Uses stress testing to size a capital buffer aimed at ensuring the MSI Group will continue to operate above regulatory requirements under a range of severe but plausible stress scenarios; and
- Assesses capital adequacy under normal and stressed operating environments over the three year capital planning horizon to ensure the MSI Group maintains a capital position in line with internal operating targets and above post stress minimums

The key elements of the ICAAP are embedded in the MSI Group's day-to-day management processes and decision making culture

The PRA reviews the ICAAP document through its Supervisory Review Process and issues an Individual Capital Guidance which sets the minimum level of regulatory capital for the MSI Group and the Company. In addition, the PRA sets a capital planning buffer which is available to support the MSI Group in a stressed market environment.

REGULATORY REQUIREMENTS

Regulatory capital

The Group continues to actively manage its capital and liquidity position to ensure that adequate resources are available to support its activities, to enable it to withstand market stresses, and to meet regulatory stress testing requirements proposed by its regulators globally.

The Company is regulated by the FCA and the PRA and as such is subject to minimum capital requirements. The Company's capital is monitored on an ongoing basis to ensure compliance with these requirements. At a minimum, the Company must ensure that Capital Resources described in accordance with CRR as Own Funds, are greater than the Capital Resource Requirement covering credit, market and operational risk.

The Company complied with all of its regulatory capital requirements during the period.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT REGULATORY REQUIREMENTS (CONTINUED)

Regulatory capital (continued)

Set out below are the details of the Company's Capital Resources, described in accordance with the CRR and in the tables below as Own Funds, as at 30 June 2017 and 31 December 2016:

	30 June 2017	31 December 2016
	\$millions	\$millions
Capital instruments and the related share premium accounts eligible as Common Equity Tier 1 capital ("CET 1")	11,978	11,978
Retained earnings	2,156	1,762
Other reserves	1,218	1,220
CET 1 capital before regulatory adjustments	15,352	14,960
Total regulatory adjustments to CET 1	(1,370)	(1,075)
CET1 capital	13,982	13,885
Additional Tier 1 capital	1,300	1,300
Tier 1 capital	15,282	15,185
Tier 2 capital instruments (long-term subordinated loans)	7,000	7,906
Own Funds	22,282	23,091

Movement in Own Funds of the Company was as follows:

	30 June 2017	31 December 2016
	\$millions	\$millions
Opening Own Funds	23,091	23,161
Change in Tier 1 capital:		
CET 1 capital before regulatory adjustments	392	(175)
Regulatory adjustments to CET 1	(295)	105
Change in Tier 2 capital (long-term subordinated loans) ⁽¹⁾	(906)	-
Closing Own Funds	22,282	23,091

(1) Refer to Note 6 for detail of the reduction in long-term subordinated loans.

Basel Liquidity Framework

The Basel Committee on Banking Supervision (the "Basel Committee") has developed two standards intended for use in liquidity risk supervision: the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR").

Liquidity Coverage Ratio: The LCR was developed to ensure that banking organisations have sufficient high quality liquid assets to cover net cash outflows arising from significant stress over 30 calendar days. The standard's objective is to promote the short-term resilience of the liquidity risk profile of banking organisations. The LCR was phased in from its effective date of 1 October 2015, with full compliance required by the beginning of 2018. The Company and MSI Group are compliant with the minimum required LCR based on current interpretations and continue to evaluate the impact on its liquidity and funding requirements.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT REGULATORY REQUIREMENTS (CONTINUED)

Basel Liquidity Framework (continued)

Net Stable Funding Ratio: The objective of the NSFR is to reduce funding risk over a one year horizon by requiring banking organisations to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress. In October 2014, the Basel Committee finalised revisions to the NSFR, which is expected to become effective on 1 January 2018. In November 2016, as part of the European Commission’s comprehensive regulatory reform package, the proposed NSFR rules are expected to be introduced in the EU in 2019 at the earliest, with Member States implementing the new rules in 2021 based on current estimates. The Company and MSI Group continue to evaluate the NSFR and its potential impact on the Company’s and MSI Group’s current liquidity and funding requirements.

Resolution and recovery planning

Both the Morgan Stanley Group and the MSI Group, prepare, on an annual basis, a recovery plan which identifies mitigation tools available to both groups in times of severe stress.

The Morgan Stanley Group has developed a resolution plan in accordance with the requirements of Section 165(d) of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations adopted by the Federal Reserve Board and the Federal Deposit Insurance Corporation. The resolution plan presents the Morgan Stanley Group’s strategy for resolution of the Morgan Stanley Group upon material financial distress or failure in a severely adverse macroeconomic environment. The Company is a Material Operating Entity of the Morgan Stanley Group and is within the scope of the single point of entry resolution strategy adopted by the Morgan Stanley Group.

The EU Bank Recovery and Resolution Directive (“BRRD”) has established a recovery and resolution framework for EU credit institutions and investment firms, including the Company. The Company produces information required by the UK Resolution Authority in the form of a resolution pack and ad hoc regulatory submissions, as necessary under BRRD and UK regulatory requirements.

European Financial Regulation Reform

In November 2016, the European Commission published a comprehensive regulatory reform package which aims to continue the reforms that the EU implemented in the wake of the financial crisis. The proposals seek to amend to the existing prudential regime implemented through the CRD and the CRR, with the amendments to those regulations known as CRD5 and CRR2, the BRRD and the Single Resolution Mechanism (“SRM”).

These proposals are now subject to further discussion and negotiation among European policy-makers and it is not possible to anticipate their final content. The proposals are expected to be introduced in the EU in 2019 at the earliest, with Member States implementing the new rules in 2020-21 based on current estimates.

In light of these potential developments as well as the impact of the UK’s decision to leave the EU following the result of the EU Referendum, there remains uncertainty as to the rules which may apply to the Group post-2019.

Derivatives Regulation

The Group is subject to swap regulations under the Dodd-Frank Act, including requirements relating to public and regulatory reporting, central clearing and mandatory trading on certain exchanges. U.S. and other global regulators, including the European Supervisory Authorities, have also finalised margin requirements for uncleared derivatives that apply to various entities in the Group, including the Company. Initial margin requirements will phase in between September 2016 and September 2020 depending on the parties’ trading activity, and variation margin requirements began applying to most in-scope counterparties on 1 March 2017.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

GOING CONCERN

Business risks associated with the uncertain market, and economic conditions are being actively monitored and managed by the Group. Retaining sufficient liquidity and capital to withstand these market pressures remains central to the Group's strategy. In particular, the Group's capital and liquidity is deemed sufficient to exceed regulatory minimum requirements under both a normal and in a stressed market environment for the foreseeable future. Additionally, the Group has access to further Morgan Stanley Group capital and liquidity as required.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the interim management reports and Interim Financial Statements.

Approved by the Board and signed on its behalf by



C Castello

Director

25 September 2017

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors, the names of whom are set out below, confirm that to the best of their knowledge:

- (a) the condensed set of Interim Financial Statements has been prepared in accordance with International Accounting Standard ("IAS") 34 '*Interim Financial Reporting*' as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and result of the Group; and
- (b) the interim management report includes a fair review of the information required by DTR4.2.7R of the Disclosure and Transparency Rules, being an indication of the important events that have occurred during the period and their impact on the condensed set of interim financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year.

By order of the Board on 25 September 2017



C Castello

Director

Board of Directors:

J Bloomer

D O Cannon

C Castello

T Duhon

L Guy

J Horder

A Kohli

M C Phibbs

I Plenderleith (Chairman)

R P Rooney

D A Russell

INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2017 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 19. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Company in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Company those matters we are required to state to them in an independent review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company, for our review work, for this report, or for the conclusions we have formed.

Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union. The condensed set of interim financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34 "*Interim Financial Reporting*", as adopted by the European Union.

Our responsibility


Our responsibility is to express to the Company a conclusion on the condensed set of interim financial statements in the half-yearly financial report based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical procedures and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of interim financial statements in the half-yearly financial report for the six months ended 30 June 2017 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.



Deloitte LLP
Statutory Auditor
London
25 September 2017

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED INCOME STATEMENT Six months ended 30 June 2017

		Six months ended 30 June 2017 \$millions (unaudited)	Six months ended 30 June 2016 \$millions (unaudited)
Net gains on financial instruments classified as held for trading		3,252	1,911
Net losses on financial instruments designated at fair value through profit or loss		(91)	(17)
Net gain on available-for-sale financial assets		1	-
Interest income		(31)	52
Interest expense		(743)	(344)
Other income		831	578
Other expense	2	(2,220)	(1,712)
PROFIT BEFORE TAX		<u>999</u>	<u>468</u>
Income tax expense	3	(304)	(172)
PROFIT FOR THE PERIOD		<u><u>695</u></u>	<u><u>296</u></u>
Attributable to:			
Owners of the parent		695	296
PROFIT FOR THE PERIOD		<u><u>695</u></u>	<u><u>296</u></u>

All operations were continuing in the current and prior periods.

The notes on pages 24 to 65 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Six months ended 30 June 2017

	Six months ended 30 June 2017 \$millions (unaudited)	Six months ended 30 June 2016 \$millions (unaudited)
PROFIT FOR THE PERIOD	<u>695</u>	<u>296</u>
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Items that will not be reclassified subsequently to profit or loss:		
Changes in fair value attributable to own credit risk on financial liabilities designated at fair value	(19)	(3)
Items that may be reclassified subsequently to profit or loss:		
Currency translation reserve:		
Foreign currency translation differences arising on foreign operations during the period	62	19
Available-for-sale reserve:		
Net change in fair value of available-for-sale financial assets	2	(6)
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX	<u>45</u>	<u>10</u>
TOTAL COMPREHENSIVE INCOME	<u>740</u>	<u>306</u>
Attributable to:		
Owners of the parent	736	305
Non-controlling interests	4	1
TOTAL COMPREHENSIVE INCOME	<u>740</u>	<u>306</u>

The notes on pages 24 to 65 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY Six months ended 30 June 2017

	Equity instrument	Share premium account	Currency translation reserve	Available - for-sale reserve	Capital contribution reserve	Capital redemption reserve	Debt valuation adjustment reserve	Retained earnings	Attributable to owners of the parent	Non-controlling interest	Total equity
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Balance at 1 January 2017	12,765	513	(6)	(5)	3	1,400	(45)	2,126	16,751	52	16,803
Profit for the period	-	-	-	-	-	-	-	695	695	-	695
Other comprehensive income	-	-	58	2	-	-	(19)	-	41	4	45
Total comprehensive income	-	-	58	2	-	-	(19)	695	736	4	740
Dividends	-	-	-	-	-	-	-	(86)	(86)	-	(86)
Balance at 30 June 2017 (unaudited)	12,765	513	52	(3)	3	1,400	(64)	2,735	17,401	56	17,457

	Equity instrument	Share premium account	Currency translation reserve	Available - for-sale reserve	Capital contribution reserve	Capital redemption reserve	Debt valuation adjustment reserve	Retained earnings	Attributable to owners of the parent	Non-controlling interest	Total equity
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Balance at 1 January 2016	12,765	513	(12)	3	3	1,400	-	1,790	16,462	65	16,527
Restated for adoption of new accounting standard	-	-	-	-	-	-	(3)	3	-	-	-
Profit for the period	-	-	-	-	-	-	-	296	296	-	296
Other comprehensive income	-	-	18	(6)	-	-	(3)	-	9	1	10
Total comprehensive income	-	-	18	(6)	-	-	(3)	296	305	1	306
Balance at 30 June 2016 (unaudited)	12,765	513	6	(3)	3	1,400	(6)	2,089	16,767	66	16,833

The notes on pages 24 to 65 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

Registered Number: 02068222

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION**As at 30 June 2017**

		30 June 2017	31 December 2016
		\$millions	\$millions
ASSETS	Note	(unaudited)	
Loans and receivables:			
Cash and short-term deposits		19,572	20,346
Cash collateral on securities borrowed		21,947	19,601
Securities purchased under agreements to resell		69,736	77,446
Trade receivables		61,904	51,659
Other receivables		2,547	1,480
		<u>175,706</u>	<u>170,532</u>
Financial assets classified as held for trading (of which approximately \$54,921 million (2016: \$50,011 million) were pledged to various parties)	4	255,230	248,180
Financial assets designated at fair value through profit or loss		8,181	4,312
Available-for-sale financial assets		71	29
Current tax assets		2	163
Deferred tax assets		87	84
Prepayments and accrued income		10	38
Property, plant and equipment		7	6
Intangible assets		2	2
TOTAL ASSETS		<u><u>439,296</u></u>	<u><u>423,346</u></u>
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Bank loans and overdrafts		19	25
Cash collateral on securities loaned		23,945	21,224
Securities sold under agreements to repurchase		39,327	48,416
Trade payables		86,397	85,634
Subordinated loans	6	7,000	7,906
Other payables	7	34,598	10,789
		<u>191,286</u>	<u>173,994</u>
Financial liabilities classified as held for trading	4	206,881	226,187
Financial liabilities designated at fair value through profit or loss		23,407	6,020
Provisions	8	125	85
Current tax liabilities		5	80
Deferred tax liabilities		1	11
Accruals and deferred income		129	161
Post employment benefit obligations		5	5
TOTAL LIABILITIES		<u><u>421,839</u></u>	<u><u>406,543</u></u>
EQUITY			
Equity instruments	9	12,765	12,765
Share premium account		513	513
Currency translation reserve		52	(6)
Available-for-sale-reserve		(3)	(5)
Capital contribution reserve		3	3
Capital redemption reserve		1,400	1,400
Debt valuation adjustment reserve		(64)	(45)
Retained earnings		2,735	2,126
Equity attributable to owners of the parent		<u>17,401</u>	<u>16,751</u>
Non-controlling interest		<u>56</u>	<u>52</u>
TOTAL EQUITY		<u><u>17,457</u></u>	<u><u>16,803</u></u>
TOTAL LIABILITIES AND EQUITY		<u><u>439,296</u></u>	<u><u>423,346</u></u>

The notes on pages 24 to 65 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
Six months ended 30 June 2017

	Six months ended 30 June 2017	Six months ended 30 June 2016
	\$millions (unaudited)	\$millions (unaudited)
	Note	
NET CASH FLOWS FROM OPERATING ACTIVITIES	11	1,108
INVESTING ACTIVITIES		
Purchase of property, plant and equipment		(1)
Purchase of available-for-sale financial assets		(40)
Proceeds from sale of available-for-sale financial assets		1
NET CASH FLOWS USED IN INVESTING ACTIVITIES		<u>(40)</u>
FINANCING ACTIVITIES		
Dividends paid		(119)
Repayment of subordinated loans		(5,906)
Issuance of subordinated loans		5,000
Interest on subordinated loan liabilities		(103)
NET CASH FLOWS USED IN FINANCING ACTIVITIES		<u>(1,128)</u>
NET (DECREASE)/ INCREASE IN CASH AND CASH EQUIVALENTS		(60)
Currency translation differences on foreign currency cash balances		(708)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD		<u>20,321</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD		<u>19,553</u>
		<u>11,882</u>
		<u>14,270</u>

The notes on pages 24 to 65 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

1. BASIS OF PREPARATION

a. General information

These Interim Financial Statements do not constitute statutory accounts within the meaning of Section 435 of the United Kingdom Companies Act 2006 (“Companies Act”).

Statutory accounts for the year ended 31 December 2016 were approved by the Board of Directors on 20 April 2017 and delivered to the Registrar of Companies. The auditor’s report on those accounts was not qualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act 2006. Other comparative information for the six months ended 30 June 2016 is included in certain instances.

b. Accounting policies

The Group has prepared its annual consolidated financial statements in accordance with IFRSs issued by the International Accounting Standards Board (“IASB”) as adopted by the EU, Interpretations issued by the IFRS Interpretations Committee (“IFRIC”) and the Companies Act 2006. The Interim Financial Statements have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and in accordance with IAS 34 ‘*Interim Financial Reporting*’ (“IAS 34”), as adopted by the EU.

In preparing these Interim Financial Statements the Group has applied consistently the accounting policies and methods of computation used in the Group’s annual consolidated financial statements for the year ended 31 December 2016, except where noted below.

New standards and interpretations adopted during the period

There were no standards or interpretations relevant to the Company’s/Group’s operations which were adopted during the period.

New standards and interpretations not yet adopted

At the date of authorization of these condensed consolidated financial statements, the IASB has issued standards, amendments to standards and interpretations relevant to the Group’s operations but not yet mandatory.

Accounting updates not listed below have been assessed and determined to be either not applicable or are not expected to have a significant impact to the Group’s consolidated financial statements. For further details on these updates see note 2 in the notes to the consolidated financial statements for the year ended 31 December 2016.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

New standards and interpretations not yet adopted (continued)

IFRS 9 *Financial instruments* ("IFRS 9") was issued by the IASB in November 2009, amended in November 2013, and revised and reissued by the IASB in July 2014. IFRS 9 is applicable retrospectively, except where otherwise prescribed by transitional provisions of the standard, and is effective for annual periods beginning on or after 1 January 2018. The standard was endorsed by the EU in November 2016. The Group early adopted in isolation the requirements relating to the presentation of fair value movements due to changes in credit risk on financial liabilities designated at fair value through profit or loss, but has not early adopted the remaining requirements of IFRS 9.

The aspects of IFRS 9 which are expected to have the most significant impact for the Group are its requirements relating to:

- Classification and measurement of financial assets
The classification and measurement of financial assets will depend on how these are managed (the entity's business model) and their contractual cash flow characteristics. Measurement will be at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss ('FVPL').
- Impairment of financial assets
The impairment requirements are based on expected credit losses and apply to financial assets measured at amortised cost and FVOCI, and lease receivables and certain loan commitments and financial guarantee contracts.

The Group is currently undertaking a project to implement IFRS 9. As part of this implementation certain financial instruments of the Group will likely move from amortised cost to fair value through profit or loss on transition. For financial instruments at amortised cost, the revised impairment requirements will identify whether financial assets have experienced a significant increase in credit risk since origination and estimate expected credit losses, taking account of the probability-weighted impact of multiple future economic scenarios.

Under the transitional provisions of the Standard, the Group's opening balance sheet at the date of initial application (1 January 2018) will be restated, with no restatement of comparative periods.

IFRS 15 *Revenue from Contracts with Customers* ("IFRS 15") was issued by the IASB in May 2014 for retrospective application in annual periods beginning on or after 1 January 2018. In addition, amendments to IFRS 15 were issued by the IASB in April 2016 requiring application in annual periods beginning on or after 1 January 2018. The standard and amendments were endorsed by the EU in October 2016. The Group is currently continuing to assess the impact and implement IFRS 15 which is not expected to have a significant impact on its consolidated financial statements.

IFRS 16 *Leases* ("IFRS 16") was issued by the IASB in January 2016, for retrospective application in annual periods beginning on or after 1 January 2019. Early application is permitted. The Group is currently assessing the impact of IFRS 16 on its consolidated financial statements.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

Restatement of comparative amounts

In the second half of 2016, the Group early adopted the provisions within IFRS 9 for the presentation of fair value movements due to changes in credit risk on financial liabilities designated at fair value through profit or loss (the “provisions”), without applying the other requirements of IFRS 9. The standard was adopted for the Group’s full year reporting, with effect from 1 January 2016. As a result, comparative amounts for the six months ended 30 June 2016 in the condensed consolidated financial statements have been restated to reflect adoption of the provisions with effect from 1 January 2016; a transfer from retained earnings of \$3 million at 1 January 2016 and \$3 million from total comprehensive income for the six months ended 30 June 2016 have been recorded to reflect the cumulative after tax amount of such losses within the Debt valuation adjustment reserve at 1 January 2016 and 30 June 2016, respectively.

c. Use of estimates and sources of uncertainty

The preparation of the Group’s condensed consolidated financial statements requires management to make judgements, estimates and assumptions regarding the valuation of certain financial instruments, impairment of assets, tax balances, pension obligations, the outcome of litigation, and other matters that affect the condensed consolidated financial statements and related disclosures.

The Group believes that the estimates utilised in preparing the condensed consolidated financial statements are reasonable, relevant and reliable. Actual results could differ from these estimates.

For further details on the judgements used in determining fair value of certain assets and liabilities, see accounting policy note 3(d) in the notes to the consolidated financial statements for the year ended 31 December 2016 and note 16.

For further details on the estimates used in determining tax balances, see notes 3 and 8.

For further details on the judgement and estimates used in determining provisions, see note 8.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

2. OTHER EXPENSE

	30 June 2017	30 June 2016
	\$millions	\$millions
Direct staff costs	71	80
Management charges from other Morgan Stanley Group undertakings relating to staff costs ⁽¹⁾	813	677
Management charges from other Morgan Stanley Group undertakings relating to other services ⁽²⁾	423	315
Brokerage fees	328	265
Administration and corporate services	122	105
Professional services	103	149
Other ⁽³⁾	360	121
	<u>2,220</u>	<u>1,712</u>

- (1) The increase in 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' was primarily driven by an increase in discretionary compensation partially offset by reduced salary costs. Discretionary compensation increased as a result of an increase in revenue. Salary costs decreased due to the weakening of the British Pound against the US dollar.
- (2) The increase in 'Management charges from other Morgan Stanley Group undertakings relating to other services' was principally as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing Policy, effective 1 January 2017. Refer to note 18 for more details.
- (3) 'Other' increased principally as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing Policy, effective 1 January 2017 (refer to note 18 for more details) and an increase in UK indirect tax.

3. INCOME TAX EXPENSE

The Group's tax expense has been accrued based on the expected tax rate that takes into account current expectations concerning the allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates.

The UK Bank Levy (the "Levy") is an annual charge on a bank's balance sheet. It is applied to chargeable liabilities and equity of the Group and other Morgan Stanley UK tax-resident entities and their overseas subsidiaries. Under IFRIC 21, 'Levies' the Levy is not recognised in the Interim Financial Statements since the Levy's obligating event has not yet arisen. However, for the purposes of calculating the effective tax rate in accordance with IAS 34, an adjustment has been made for the forecast Levy (since it is non-deductible for UK corporation tax purposes). As such, the Levy impacts the annual effective tax rate and the tax expense for the six months ended 30 June 2017.

During his 2016 UK Budget speech, the Chancellor of the Exchequer announced that the rate at which the Levy is applied will reduce from 0.21% to 0.10% over the period 2016-2021. While the decrease in rate, by itself, would reduce the impact of the Levy on the Group's net income and effective tax rate, the forecast Levy for 2017 is higher than 2016 due to an increase in the estimated chargeable liability.

The Group's forecast tax rate is sensitive to the non-deductibility of certain expenses (including the UK Bank Levy forecast) for tax purposes, the geographic mix of profits and tax rates in non-UK jurisdictions and the additional 8% UK banking surcharge.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

3. INCOME TAX EXPENSE (continued)

During the period the UK statutory rate, excluding the banking surcharge, was reduced to 19%. This reduction in rate applied from 1 April 2017 and affects the income tax expense for the period. A further reduction to 17% has been enacted and will be effective from 1 April 2020.

The Group's effective tax rate for the six months ended 30 June 2017 is 30.40% (six months ended 30 June 2016: 36.75%), which is higher than the standard rate of corporation tax (inclusive of the UK Banking Surcharge) in the UK of 27.25%. The main reasons for the higher effective tax rate are the higher overseas tax rates and non-deductible charges.

4. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

Financial assets and financial liabilities categorised as held for trading are summarised in the table below:

	30 June 2017	30 June 2017	31 December 2016	31 December 2016
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Government debt securities	11,729	21,896	10,052	19,476
Corporate and other debt	11,044	2,570	8,550	2,853
Corporate equities	71,739	22,444	46,025	23,278
Derivatives (see note 5)	160,718	159,971	183,553	180,580
	<u>255,230</u>	<u>206,881</u>	<u>248,180</u>	<u>226,187</u>

There are no terms and conditions of any financial asset or liability classified as held for trading that may individually significantly affect the amount, timing and certainty of future cash flows for the Group.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

5. DERIVATIVES CLASSIFIED AS HELD FOR TRADING

	30 June 2017			
	Bilateral OTC \$millions	Cleared OTC \$millions	Listed derivative contracts \$millions	Total \$millions
Derivative assets:				
Interest rate contracts	68,855	2,775	4	71,634
Credit contracts	5,591	23	-	5,614
Foreign exchange and gold contracts	47,865	554	-	48,419
Equity contracts	26,514	-	5,395	31,909
Commodity contracts	3,083	-	59	3,142
	<u>151,908</u>	<u>3,352</u>	<u>5,458</u>	<u>160,718</u>
Derivative liabilities:				
Interest rate contracts	63,759	2,231	4	65,994
Credit contracts	5,752	67	-	5,819
Foreign exchange and gold contracts	49,947	667	-	50,614
Equity contracts	29,416	-	5,056	34,472
Commodity contracts	3,034	-	38	3,072
	<u>151,908</u>	<u>2,965</u>	<u>5,098</u>	<u>159,971</u>
	31 December 2016			
	Bilateral OTC \$millions	Cleared OTC \$millions	Listed derivative contracts \$millions	Total \$millions
Derivative assets:				
Interest rate contracts	77,183	3,260	9	80,452
Credit contracts	6,152	6	-	6,158
Foreign exchange and gold contracts	65,687	1,039	-	66,726
Equity contracts	23,330	-	4,518	27,848
Commodity contracts	2,279	-	90	2,369
	<u>174,631</u>	<u>4,305</u>	<u>4,617</u>	<u>183,553</u>
Derivative liabilities:				
Interest rate contracts	72,785	3,202	4	75,991
Credit contracts	6,332	16	-	6,348
Foreign exchange and gold contracts	65,522	975	-	66,497
Equity contracts	24,949	-	4,473	29,422
Commodity contracts	2,285	-	37	2,322
	<u>171,873</u>	<u>4,193</u>	<u>4,514</u>	<u>180,580</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

6. SUBORDINATED LOANS

On 3 January 2017, a subordinated loan of \$7,906 million was reassigned from Morgan Stanley UK Financing I LP to Morgan Stanley International Finance S.A., another Morgan Stanley Group undertaking. On 8 February 2017 a new \$5,000 million subordinated loan was issued by the Group to its immediate parent undertaking, Morgan Stanley Investments (UK), at that date. \$5,906 million of the existing subordinated loan with Morgan Stanley International Finance S.A. was repaid.

Counterparty	Repayment Date	Interest Rate	30 June 2017 \$millions	31 December 2016 \$millions
Morgan Stanley Investments (UK)	21 December 2025	OBFR ⁽¹⁾ plus 2.3%	5,000	-
Morgan Stanley International Finance S.A.	31 October 2025	LIBOR ⁽²⁾ plus 1.475%	2,000	-
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR ⁽²⁾ plus 1.475%	-	7,906
			<u>7,000</u>	<u>7,906</u>

(1) Overnight Bank Funding Rate ("OBFR")

(2) London Interbank Offered Rate ("LIBOR")

7. OTHER PAYABLES

	30 June 2017 \$millions	31 December 2016 \$millions
Amounts due to other Morgan Stanley group undertakings	34,276	10,602
Other amounts payable	322	187
	<u>34,598</u>	<u>10,789</u>

The increase in other payables is driven by an increase in the long-term intercompany funding due to increases in business funding requirements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

8. PROVISIONS

	Property	Litigation	Taxes and levies	Total
	\$millions	\$millions	\$millions	\$millions
At 1 January 2017	4	9	72	85
Additional provisions	-	1	105	106
Provisions utilised	-	(9)	(44)	(53)
Foreign exchange revaluation	-	-	(16)	(16)
Reclassifications	-	1	2	3
At 30 June 2017	4	2	119	125

Litigation matters

In addition to the matters described below, in the normal course of business, the Group 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 entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress.

The Group 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 Group's business, and involving, among other matters, sales and trading activities, financial products or offerings sponsored, underwritten or sold by the Group, and accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

The Group contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the consolidated financial statements and the Group can reasonably estimate the amount of that loss, the Group accrues the estimated loss by a charge to income. The Group's future legal expenses may fluctuate from period to period, given the current environment regarding government investigations and private litigation affecting global financial services firms, including the Group.

In many proceedings and investigations, however, it is inherently difficult to determine whether any loss is probable or even possible, or to estimate the amount of any loss. The Group cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

8. PROVISIONS (CONTINUED)

Litigation matters (continued)

Subject to the foregoing, the Group believes, based on current knowledge and after consultation with counsel, that the outcome of such proceedings and investigations will not have a material adverse effect on the consolidated financial condition of the Group, although the outcome of such proceedings or investigations could be material to the Group's operating results and cash flows for a particular period depending on, among other things, the level of the Group's revenues or income for such period.

Over the last several years, the level of litigation and investigatory activity (both formal and informal) by government and self-regulatory agencies has increased materially in the financial services industry. As a result, the Group expects that it will continue to be the subject of elevated claims for damages and other relief and, while the Group has identified below updates to certain proceedings that the Group believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

On 17 July 2017, the court in Parma, Italy presiding over the criminal trial against certain present and former employees of the Morgan Stanley Group related to the bankruptcy of Parmalat in 2003 issued a decision acquitting the present and former employees of all of the charges pending against them.

On 15 April 2017, the Group, another Morgan Stanley Group affiliate and Land Salzburg agreed to resolve all claims in the actions styled *Land Salzburg v. Morgan Stanley & Co. International plc* and *Morgan Stanley Capital Services LLC and Morgan Stanley & Co. International plc v. Land Salzburg*, which agreement was subject to Land Salzburg parliamentary approval. On 31 May 2017, Land Salzburg received parliamentary approval for the resolution of all claims in such actions.

On 3 July 2017, the Group was informed that the public prosecutor for the Court of Accounts for the Republic of Italy filed a claim against the Group styled *Case No. 2012/00406/MNV*, which is pending in the Regional Prosecutor's Office at the Judicial Section of the Court of Auditors for Lazio, Italy. The claim relates to certain derivative transactions between the Republic of Italy and the Group and another Morgan Stanley Group affiliate. The transactions were originally entered into between 1999 and 2005, and were terminated in December 2011 and January 2012. The claim alleges, inter alia, that the Group was acting as an agent of the Republic of Italy, that the derivative transactions were improper and that the termination of the transactions was also improper and asserts claims for damages through an administrative process against the Group for €2.76 billion. The Group does not agree with these allegations. A hearing regarding this matter has been scheduled for 19 April 2018.

In matters styled *Case number 15/3637* and *Case number 15/4353*, the Dutch Tax Authority ("Dutch Authority") is challenging in the Dutch Tax Tribunal in Amsterdam the prior set-off by a subsidiary undertaking of the Group of approximately €124 million (plus accrued interest) of withholding tax credits against the subsidiary undertaking of the Group's corporation tax liabilities for the tax years 2007 to 2013. These matters were disclosed in note 21 (Commitments and contingencies) of the consolidated financial statements for the year ended 31 December 2016. The Dutch Authority alleges that the subsidiary undertaking of the Group was not entitled to receive the withholding tax credits on the basis, inter alia, that the subsidiary undertaking of the Group did not hold legal title to certain securities subject to withholding tax on the relevant dates. The Dutch Authority has also alleged that the subsidiary undertaking of the Group failed to provide certain information to the Dutch Authority and keep adequate books and records. The subsidiary undertaking of the Group does not agree with these allegations. A hearing regarding this matter has been scheduled on 19 September 2017.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

8. PROVISIONS (CONTINUED)

Litigation matters (continued)

Beginning in February of 2016, the Group and certain Morgan Stanley Group affiliates were named as defendants in multiple purported antitrust class actions now consolidated into a single proceeding in the United States District Court for the Southern District of New York styled *In Re: Interest Rate Swaps Antitrust Litigation*. Plaintiffs allege, inter alia, that the Group and certain Morgan Stanley Group affiliates, together with a number of other financial institution defendants violated United States and New York state antitrust laws from 2008 through December of 2016 in connection with their alleged efforts to prevent the development of electronic exchange-based platforms for interest rates swaps trading. Complaints were filed both on behalf of a purported class of investors who purchased interest rates swaps from defendants, as well as on behalf of two swap execution facilities that allegedly were thwarted by the defendants in their efforts to develop such platforms. The consolidated complaints seek, among other relief, certification of the investor class of plaintiffs and treble damages. On 28 July 2017, the court granted in part and denied in part the defendants' motion to dismiss the complaints.

Tax related provisions

The Group is subject to tax laws which are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. Specifically, in relation to the Group and Morgan Stanley Group implementing updated transfer pricing policies for certain intercompany transactions discussions are on-going with relevant taxing authorities. Management makes judgments and interpretations about the application of these inherently complex tax laws when determining the provision for taxes. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Group periodically evaluates the likelihood of assessments in each taxing jurisdiction resulting from current and subsequent years' examinations. Provisions related to potential losses that may arise from tax audits are established in accordance with the guidance on accounting for uncertain tax items. The Group has established provisions that it believes are adequate in relation to the potential for additional assessments. Whilst a range of outcomes is foreseeable, management considers the amount of the provision to be a reasonable estimate of expected future liabilities after consideration of all pertinent facts, based on the status of inquiries at the balance sheet date.

The Group self-identified an issue regarding VAT on intercompany services provided by certain overseas affiliates to the Group. The Group is reviewing the reporting of U.K. VAT as additional support service centres were added to the operations over the years, and the focus and nature of their intended services shifted among geographic locations. During the six months ended 30 June 2017, the Group has recorded a provision of \$86 million that incorporates potential additional VAT, interest and penalties for this exposure. Management is actively working with Her Majesty's Revenue and Customs to resolve this matter. The provision reflected is based on currently available information and analyses, and the review of this matter is continuing.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

9. EQUITY INSTRUMENTS

Additional Tier 1 capital

During the period, the \$1,300 million of AT1 instruments issued by the Group and previously held by Morgan Stanley UK Group were transferred to Morgan Stanley International Ltd.

10. DIVIDENDS

On 31 May 2017, the Directors approved a coupon payment on the Additional Tier 1 capital instruments of \$118,625,000 (31 December 2016: \$157,625,000 of pre-tax coupon interest on the AT1 instrument was paid on 20 December 2016) out of reserves available for distribution at 31 December 2016. The coupon was paid on 31 May 2017 and has a related tax benefit of \$33,121,579 (2016: \$40,253,052).

The Directors have not proposed the payment of an interim dividend out of reserves available at 30 June 2017 (2016: \$nil).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

11. ADDITIONAL CASH FLOW INFORMATION

	Six months ended 30 June 2017 \$millions	Six months ended 30 June 2016 \$millions
Profit for the period	695	296
Adjustments for:		
Depreciation on property, plant and equipment	-	1
Increase in impairment losses for loans and receivables	6	6
Interest income	31	(52)
Interest expense	743	344
Income tax expense	304	172
Operating cash flows before changes in operating assets and liabilities	<u>1,779</u>	<u>767</u>
Change in operating assets		
Increase in loans and receivables, excluding cash and short-term deposits	(5,761)	(20,756)
Increase in financial assets classified as held for trading	(7,050)	(52,059)
Increase in financial assets designated at fair value through profit or loss	<u>(3,869)</u>	<u>(1,830)</u>
	<u>(16,680)</u>	<u>(74,645)</u>
Change in operating liabilities		
Increase in financial liabilities at amortised cost, excluding bank loans and overdrafts	17,708	26,621
(Decrease)/ increase in financial liabilities classified as held for trading	(19,306)	49,931
Increase/ (decrease) in financial liabilities designated at fair value through profit or loss	17,367	(8)
Increase in provisions	40	1
	<u>15,809</u>	<u>76,545</u>
Interest received	(213)	103
Interest paid	(261)	(267)
Income taxes paid	(96)	(46)
Effect of foreign exchange movements	770	(5)
Net cash flows used in operating activities	<u><u>1,108</u></u>	<u><u>2,452</u></u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

12. SEGMENT REPORTING

Segment information is presented in respect of the Group's business and geographical segments. The business segments and geographical segments are based on the Group's management and internal reporting structure. Transactions between business segments are on normal commercial terms and conditions.

Business segments

Morgan Stanley structures its business segments primarily based upon the nature of the financial products and services provided to customers and Morgan Stanley's internal management structure. The Group's own business segments are consistent with those of Morgan Stanley.

Consistent with the six months ended 30 June 2016, the Group has one reportable business segment for the six months ended 30 June 2017, Institutional Securities, which provides financial advisory and capital raising services; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

Geographical segments

The Group operates in three geographic regions being EMEA, the Americas and Asia.

The following table presents selected condensed consolidated income statement and condensed consolidated statement of financial position information of the Group's operations by geographic area. The external revenues (net of interest expense) and total assets disclosed in the following table reflect the regional view of the Group's operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

Geographical Segments	EMEA		Americas		Asia		Total	
	30 June 2017	30 June 2016	30 June 2017	30 June 2016	30 June 2017	30 June 2016	30 June 2017	30 June 2016
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
External revenues net of interest	2,539	2,132	214	8	466	40	3,219	2,180
Profit before income tax	745	461	125	2	129	5	999	468
	30 June 2017	31 Dec 2016	30 June 2017	31 Dec 2016	30 June 2017	31 Dec 2016	30 June 2017	31 Dec 2016
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Total assets	325,966	296,942	53,747	58,324	59,583	68,080	439,296	423,346

The increase in Americas and Asia 'External revenues net of interest' and 'Profit before income tax' is as a result of the Group and Morgan Stanley Group updating its Global Transfer Pricing Policy, effective 1 January 2017. Refer to note 18 for more details.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT

Risk management procedures

The Group's risk management procedures are consistent with those disclosed in the Group's consolidated financial statements for the year ended 31 December 2016. The following disclosure is limited to quantitative data for each risk category and should be read in conjunction with the risk management procedures detailed in the strategic report and note 27 of the consolidated financial statements for the year ended 31 December 2016.

Market risk

Sensitivity analysis

VaR for the six months ended 30 June 2017

The table below presents the Management VaR for the Group's Trading portfolio, on a period-end, periodic average as well as the high and low basis for the six months ended 30 June 2017 and the year ended 31 December 2016.

	95% / one-day VaR for the six months ended 30 June 2017				95% / one-day VaR for the year ended 31 December 2016			
	Period end \$millions	Average \$millions	High \$millions	Low \$millions	Period end \$millions	Average \$millions	High \$millions	Low \$millions
<i>Market Risk Category:</i>								
Interest rate and credit spread	17	13	20	10	12	12	20	9
Equity price	11	13	18	9	11	11	15	9
Foreign exchange rate	6	5	9	3	3	3	6	2
Commodity price	-	1	1	-	-	1	3	-
Less: Diversification benefit ⁽¹⁾⁽²⁾	(12)	(12)	N/A	N/A	(10)	(10)	N/A	N/A
Primary Risk Categories	22	20	28	15	16	17	24	14
Credit Portfolio ⁽³⁾	5	6	8	5	7	8	10	6
Less: Diversification benefit ⁽¹⁾⁽²⁾	(3)	(4)	N/A	N/A	(6)	(5)	N/A	N/A
Total Management VaR	24	22	30	16	17	20	27	15

(1) Diversification benefit equals the difference between total trading VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits are also taken into account within each category.

(2) N/A - Not Applicable. The minimum and maximum VaR values for the total VaR and each of the component VaRs might have occurred on different days during the period and therefore the diversification benefit is not an applicable measure.

(3) The Credit Portfolio VaR is disclosed as a separate category from the Primary Risk Categories and includes loans that are carried at fair value and associated hedges as well as counterparty credit valuation adjustments and related hedges.

The Group's average VaR for Primary Risk Categories for the six months ended 30 June 2017 was \$20 million, compared with \$17 million for the year to 31 December 2016. The increase in average Management VaR for Primary Market Risk Categories is spread across underlying risk factors, including interest rates, credit spreads, equity price and foreign exchange risk.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

The average Credit Portfolio VaR for the six months ended 30 June 2017 was \$6 million, compared with \$8 million for the year to 31 December 2016. This was mainly due to a decrease in credit risk exposure to high rated corporates.

The average total Management VaR for the six months ended 30 June 2017 was \$22 million, compared with \$20 million for the year to 31 December 2016.

Non-trading risks for the six months ended 30 June 2017

The Group believes that sensitivity analysis is an appropriate representation of the Group's non-trading risks. Reflected below is this analysis, which covers substantially all of the non-trading risk in the Group's portfolio, with the exception of counterparty credit valuation adjustments, which are covered in the previous section.

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application to these positions of a parallel increase or decrease in interest rates of 50 basis points would result in a net gain or loss, respectively, of approximately \$4.9 million as at 30 June 2017, compared to a net gain or loss of \$2.0 million as at 31 December 2016.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately \$1.3 million and \$0.8 million for each 1 basis point widening in the Group's credit spread level for 30 June 2017 and 31 December 2016, respectively.

Equity investments price risk

The Group is exposed to equity price risk as a result of changes in the fair value of its investments in listed and private equities classified as available-for-sale financial assets. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues associated with a 10% decline in asset values as shown in the table below.

	30 June 2017	31 December 2016
	10% sensitivity	10% sensitivity
	\$millions	\$millions
Available-for-sale financial assets	<u>7</u>	<u>3</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

The analysis below details the foreign currency exposure for the Group, by foreign currency, relating to the retranslation of its non-US dollar denominated branches and subsidiaries.

The analysis calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency in relation to the US dollar, with all other variables held constant. This analysis does not take into account the effect of the foreign currency hedges held by other members of the Morgan Stanley Group.

	30 June 2017			31 December 2016		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions
Euro	602	12%	74	282	12%	34
Taiwan New Dollar	79	6%	5	73	6%	4
Polish Zloty	4	17%	1	3	17%	1
South Korean Won	198	8%	16	177	8%	14
Swedish Krona	13	21%	3	12	21%	3
Swiss Franc	15	12%	2	13	12%	2
	<u>911</u>		<u>101</u>	<u>560</u>		<u>58</u>

The increase in Euro exposure as at 30 June 2017 is driven by additional activity in Morgan Stanley (France) S.A.

Credit risk

Exposure to credit risk

The maximum exposure to credit risk (“gross credit exposure”) of the Group as at 30 June 2017 is disclosed in the following table, based on the carrying amounts of the financial assets which the Group believes are subject to credit risk.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit Risk (continued)

Exposure to credit risk by class

Class	30 June 2017			31 December 2016		
	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure ⁽²⁾ \$millions	Gross credit exposure ⁽¹⁾ \$millions	Credit enhancements \$millions	Net credit exposure ⁽²⁾ \$millions
Loans and receivables:						
Cash and short-term deposits	19,572	-	19,572	20,346	-	20,346
Cash collateral on securities borrowed	21,947	(21,089)	858	19,601	(18,900)	701
Securities purchased under agreements to resell	69,736	(68,320)	1,416	77,446	(75,053)	2,393
Trade receivables ⁽³⁾	61,904	-	61,904	51,659	-	51,659
Other receivables	1,388	-	1,388	858	-	858
Financial assets classified as held for trading:						
Derivatives	160,718	(152,636)	8,082	183,553	(175,809)	7,744
Financial assets designated at fair value through profit or loss	8,181	(7,834)	347	4,312	(3,697)	615
	<u>343,446</u>	<u>(249,879)</u>	<u>93,567</u>	<u>357,775</u>	<u>(273,459)</u>	<u>84,316</u>
Unrecognised financial instruments						
Guarantees	578	-	578	1,135	-	1,135
Letters of credit	1	-	1	1	-	1
Loan commitments	3,385	(175)	3,210	2,662	(777)	1,885
Underwriting commitments	994	-	994	1,309	-	1,309
Unsettled securities purchased under agreements to resell ⁽⁴⁾	32,705	-	32,705	30,121	-	30,121
	<u>381,109</u>	<u>(250,054)</u>	<u>131,055</u>	<u>393,003</u>	<u>(274,236)</u>	<u>118,767</u>

(1) The carrying amount recognised in the condensed consolidated statement of financial position best represents the Group's maximum exposure to credit risk.

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$4,470 million (31 December 2016: \$3,696 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade receivables primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within financial liabilities classified as held for trading in the condensed consolidated statement of financial position.

(4) For unsettled securities purchased under agreement to resell, collateral in the form of securities will be received at the point of settlement. Since the value of collateral is determined at a future date it is currently unquantifiable and not included in the table.

The impact of master netting arrangements and similar agreements on the Group's ability to offset financial assets and financial liabilities is disclosed in note 14.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Maximum exposure to credit risk by credit rating (1)

Credit rating	Gross credit exposure	
	30 June 2017	31 December 2016
	\$millions	\$millions
AAA	13,332	16,728
AA	79,775	75,018
A	199,847	213,176
BBB	62,053	67,212
BB	14,004	11,556
B	6,752	5,179
CCC	2,031	1,387
D	10	9
Unrated	3,305	2,738
Total	381,109	393,003

(1) Internal credit rating derived using methodologies generally consistent with those used by external rating agencies.

Financial assets past due but not impaired

At 30 June 2017, \$2,234 million of financial assets included in loans and receivables in the condensed consolidated statement of financial position were past due but not impaired (31 December 2016: \$1,414 million).

Financial assets individually impaired

Class	30 June 2017	31 December 2016
	\$millions	\$millions
Loans and receivables:		
Trade receivables	46	40

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk

Maturity analysis

30 June 2017	On demand \$millions	Less than 1 month \$millions	Equal to or more than 1 month but less than 3 months \$millions	Equal to or more than 3 months but less than 1 year \$millions	Equal to or more than 1 year but less than 5 years \$millions	Equal to or more than 5 years \$millions	Total \$millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	19	-	-	-	-	-	19
Cash collateral on securities loaned	18,309	1,164	1,419	2,248	805	-	23,945
Securities sold under agreements to repurchase	15,775	9,474	2,283	5,625	6,228	18	39,403
Trade payables	86,397	1	3	12	29	-	86,442
Other payables	3,857	103	206	1,160	28,150	2,898	36,374
Subordinated loans	-	-	-	79	1,105	8,154	9,338
Financial liabilities classified as held for trading:							
Derivatives	159,971	-	-	-	-	-	159,971
Other	46,910	-	-	-	-	-	46,910
Financial liabilities designated at fair value through profit or loss							
	19,364	4	65	815	436	2,723	23,407
Total financial liabilities	350,602	10,746	3,976	9,939	36,753	13,793	425,809
Unrecognised financial instruments							
Guarantees	576	-	-	-	2	-	578
Letters of credit	-	-	-	-	1	-	1
Loan commitments	3,385	-	-	-	-	-	3,385
Underwriting commitments	-	-	-	994	-	-	994
Unsettled securities purchased under agreements to resell ⁽¹⁾	32,670	35	-	-	-	-	32,705
Total unrecognised financial instruments	36,631	35	-	994	3	-	37,663

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 30 June 2017 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 30 June 2017, \$32,670 million settled within three business days.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

13. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

	On demand	Less than 1 month	Equal to or more than 1 month but less than 3 months	Equal to or more than 3 months but less than 1 year	Equal to or more than 1 year but less than 5 years	Equal to or more than 5 years	Total
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
31 December 2016							
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	25	-	-	-	-	-	25
Cash collateral on securities loaned	15,911	678	2,224	2,306	105	-	21,224
Securities sold under agreements to repurchase	22,188	9,549	5,683	6,614	4,379	52	48,465
Trade payables	85,634	-	4	22	-	-	85,660
Subordinated loans	-	48	-	156	1,105	9,099	10,408
Other payables	3,188	12	118	141	5,145	2,841	11,445
Financial liabilities classified as held for trading:							
Derivatives	180,580	-	-	-	-	-	180,580
Other	45,607	-	-	-	-	-	45,607
Financial liabilities designated at fair value through profit or loss	2,651	38	89	484	965	1,793	6,020
Total financial liabilities	355,784	10,325	8,118	9,723	11,699	13,785	409,434
Unrecognised financial instruments							
Guarantees	1,135	-	-	-	-	-	1,135
Letters of credit	-	-	-	-	1	-	1
Loan commitments	2,662	-	-	-	-	-	2,662
Underwriting commitments	-	-	-	1,309	-	-	1,309
Unsettled securities purchased under agreements to resell ⁽¹⁾	30,121	-	-	-	-	-	30,121
Total unrecognised financial instruments	33,918	-	-	1,309	1	-	35,228

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2016 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2016, \$30,121 million settled within three business days.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

14. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING

In the condensed consolidated statement of financial position, financial assets and financial liabilities are offset and presented on a net basis only where there is a current legally enforceable right to set off the recognised amounts and an intention to either settle on a net basis or to realise the assets and the liability simultaneously. In the absence of such conditions, financial assets and financial liabilities are presented on a gross basis.

The following tables present information about the offsetting of financial instruments and related collateral amounts. The tables do not include information about financial instruments that are subject only to a collateral agreement. The effect of master netting arrangements, collateral agreements and other credit enhancements, on the Group's exposure to credit risk is disclosed in note 13. The information below is limited to quantitative information and should be read in conjunction with note 30 of the consolidated financial statements for the year ended 31 December 2016.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

14. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ^{(2) (3)}	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(4) (5) (6)}		Net exposure ⁽⁷⁾
	\$millions	\$millions	\$millions	Financial instruments	Cash collateral	\$millions
30 June 2017						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	35,502	(13,555)	21,947	(21,089)	-	858
Securities purchased under agreement to resell	109,726	(39,990)	69,736	(68,320)	-	1,416
Financial assets classified as held for trading:						
Derivatives	215,053	(54,335)	160,718	(130,134)	(22,502)	8,082
TOTAL	360,281	(107,880)	252,401	(219,543)	(22,502)	10,356
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	37,500	(13,555)	23,945	(23,588)	-	357
Securities sold under agreement to repurchase	79,317	(39,990)	39,327	(37,885)	-	1,442
Financial liabilities classified as held for trading:						
Derivatives	211,290	(51,319)	159,971	(129,481)	(20,501)	9,989
TOTAL	328,107	(104,864)	223,243	(190,954)	(20,501)	11,788

- (1) Amounts include \$382 million of cash collateral on securities borrowed, \$1,299 million of securities purchased under agreements to resell, \$2,403 million of financial assets classified as held for trading - derivatives, \$329 million of cash collateral on securities loaned, \$1,428 million of securities sold under agreements to repurchase and \$2,498 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the condensed consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts include \$5,271 million and \$2,255 million of cash collateral related to financial instruments classified as held for trading - derivatives recognised in amounts offset in the condensed consolidated statement of financial positions for assets and liabilities respectively.
- (4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the condensed consolidated statement of financial position.
- (5) The cash collateral not offset is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (6) In addition to the balances disclosed in the table certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the condensed consolidated statement of financial position. \$209 million not presented net within the condensed consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/or in the event of default.
- (7) Intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$4,470 million of the total condensed consolidated statement of financial position, to be offset in the ordinary course of business and/or in the event of default. The additional amounts for offset would include a portion of the residual net exposure.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

14. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ^{(2) (3)}	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(4) (5) (6)}		Net exposure ⁽⁷⁾
	\$millions	\$millions	\$millions	Financial instruments	Cash collateral	\$millions
31 December 2016						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	32,385	(12,784)	19,601	(18,900)	-	701
Securities purchased under agreement to resell	107,120	(29,674)	77,446	(75,053)	-	2,393
Financial assets classified as held for trading:						
Derivatives	236,829	(53,276)	183,553	(149,865)	(25,944)	7,744
TOTAL	376,334	(95,734)	280,600	(243,818)	(25,944)	10,838
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	34,008	(12,784)	21,224	(20,228)	-	996
Securities sold under agreement to repurchase	78,091	(29,675)	48,416	(46,876)	-	1,540
Financial liabilities classified as held for trading:						
Derivatives	230,135	(49,555)	180,580	(149,813)	(19,764)	11,003
TOTAL	342,234	(92,014)	250,220	(216,917)	(19,764)	13,539

- (1) Amounts include \$427 million of cash collateral on securities borrowed, \$2,319 million of securities purchased under agreements to resell, \$2,299 million of financial assets classified as held for trading - derivatives, \$995 million of cash collateral on securities loaned, \$1,535 million of securities sold under agreements to repurchase and \$2,435 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the condensed consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts include \$5,821 million and \$2,099 million of cash collateral related to financial instruments classified as held for trading - derivatives recognised in amounts offset in the consolidated statement of financial positions for assets and liabilities respectively.
- (4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the condensed consolidated statement of financial position.
- (5) The cash collateral not offset is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (6) In addition to the balances disclosed in the table certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the consolidated statement of financial position. \$408 million not presented net within the consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.
- (7) Intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$3,696 million of the total consolidated statement of financial position, to be offset in the ordinary course of business and/ or in the event of default. The additional amounts for offset would include a portion of the residual net exposure.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

15. INTEREST IN STRUCTURED ENTITIES

The Group is involved with various special purpose entities (“SPE”) in the normal course of business. In most cases, these entities are deemed to be structured entities.

Information on certain types of structured entities is provided in the consolidated financial statements for the year ended 31 December 2016. The information below is limited to quantitative information and should be read in conjunction with note 15 of the consolidated financial statements for the year ended 31 December 2016.

Consolidated structured entities

As at 30 June 2017 and 31 December 2016, the Group did not consolidate any significant structured entities.

Unconsolidated structured entities

The Group has interests in structured entities that the Group does not control and which are therefore not consolidated.

The table below shows certain non-consolidated structured entities in which the Group had an interest at 30 June 2017 and 31 December 2016. The tables include all structured entities in which the Group has determined that its maximum exposure to loss is greater than specific thresholds or meets certain other criteria. Most of the structured entities included in the tables below are sponsored by unrelated parties; the Group’s involvement is generally the result of the Group’s secondary market-making activities.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

15. INTEREST IN STRUCTURED ENTITIES (CONTINUED)

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
30 June 2017					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	4,361	4,417	1,026	538	10,342
Maximum exposure to loss:					
Debt and equity interests	227	127	1,026	-	1,380
Derivative and other contracts	-	-	-	25	25
Total maximum exposure to loss	227	127	1,026	25	1,405
Carrying value of exposure to loss - assets ⁽¹⁾ :					
Debt and equity interests	227	127	1,026	-	1,380
Derivative and other contracts	-	25	-	-	25
Total carrying value of exposure to loss - assets	227	152	1,026	-	1,405
Carrying value of exposure to loss - liabilities ⁽¹⁾ :					
Derivatives and other contracts	-	-	-	-	-
Total carrying value of exposure to loss - liabilities	-	-	-	-	-

(1) Amounts are recognised in the condensed consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

15. INTEREST IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
31 December 2016					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	3,174	4,503	3,412	5	11,094
Maximum exposure to loss:					
Debt and equity interests	252	150	-	-	402
Derivative and other contracts	-	-	3,412	5	3,417
Total maximum exposure to loss	252	150	3,412	5	3,819
Carrying value of exposure to loss - assets ⁽¹⁾ :					
Debt and equity interests ⁽¹⁾	252	150	-	-	402
Derivative and other contracts	-	-	12	5	17
Total carrying value of exposure to loss - assets	252	150	12	5	419
Carrying value of exposure to loss - liabilities ⁽¹⁾ :					
Derivatives and other contracts	-	-	20	-	20
Total carrying value of exposure to loss - liabilities	-	-	20	-	20

(1) Amounts are recognised in the condensed consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

The Group's maximum exposure to loss often differs from the carrying value of the interests held by the Group. The maximum exposure to loss is dependent on the nature of the Group's interest in the structured entities and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Group has made in the structured entities. Liabilities issued by structured entities generally are non-recourse to the Group. Where notional amounts are utilised in quantifying maximum exposure related to derivatives, such amounts do not reflect fair value write downs already recorded by the Group.

The Group's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Group may use to hedge these risks associated with the Group's interests. In addition, the Group's maximum exposure to loss is not reduced by the amount of collateral held as part of a transaction with the structured entity or any party to the structured entity directly against a specific exposure to loss.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

15. INTEREST IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

Securitisation transactions generally involve structured entities. Primarily as a result of its secondary market-making activities, the Group owned additional securities issued by securitisation structured entities for which the maximum exposure to loss is less than specific thresholds. These additional securities which were retained in connection with transfers of assets by the Group totalled \$237 million at 30 June 2017 (31 December 2016: \$365 million). Details of the type of securities retained are shown in the table below.

	30 June 2017 \$millions	31 December 2016 \$millions
<i>Securities backed by:</i>		
Residential mortgage loans	167	159
Commercial mortgage loans	18	35
CDOs or other CLOs	51	133
Other consumer loans	1	38
	<u>237</u>	<u>365</u>

The Group's primary risk exposure is to the securities owned by the Group and issued by the structured entity, with the risk highest on the most subordinate class of beneficial interests. These securities generally are included in Financial assets classified as held for trading – corporate and other debt. The Group does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees or similar derivatives. The Group's maximum exposure to loss generally equals the fair value of the securities owned.

The Group has not provided financial support to, or otherwise agreed to be responsible for supporting financially, any unconsolidated structured entity.

Sponsored unconsolidated structured entities

Details of when the Group considers itself the sponsor of certain non-consolidated structured entities is provided in note 15 of the consolidated financial statements for the year ended 31 December 2016.

For some sponsored entities, the Group has no interest at 30 June 2017; however the Group has been involved with the structured entity through establishing the structured entity, marketing of products associated with the structured entity in its own name, and/ or through involvement in the design of the structured entity.

The loss related to sponsored entities during the six months ended 30 June 2017 was \$1.5 million (31 December 2016: loss of \$1.5 million). Gains or losses are reported under 'Net gains on financial instruments classified as held for trading' in the condensed consolidated income statement. No assets were transferred to sponsored structured entities for during the six months ended 30 June 2017 (year ended 31 December 2016: \$120 million).

16 FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Financial assets and liabilities recognised at fair value on a recurring basis

The following tables present the carrying value of the Group's financial assets and financial liabilities recognised at fair value on a recurring basis, classified according to the fair value hierarchy. The information below is limited to quantitative information and should be read in conjunction with note 31 of the consolidated financial statements for the year ended 31 December 2016.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)

30 June 2017

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant unobservable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
Government debt securities	9,947	1,779	3	11,729
Corporate and other debt	-	10,720	324	11,044
Corporate equities	71,409	250	80	71,739
Derivatives:				
Interest rate contracts	4	70,385	1,245	71,634
Credit contracts	-	5,513	101	5,614
Foreign exchange and gold contracts	-	48,373	46	48,419
Equity contracts	250	30,123	1,536	31,909
Commodity contracts	-	3,136	6	3,142
Total financial assets classified as held for trading	81,610	170,279	3,341	255,230
Financial assets designated at fair value through profit or loss	-	7,775	406	8,181
Available-for-sale financial assets:				
Corporate equities	-	-	71	71
Total financial assets measured at fair value	81,610	178,054	3,818	263,482
Financial liabilities classified as held for trading:				
Government debt securities	21,049	847	-	21,896
Corporate and other debt	-	2,562	8	2,570
Corporate equities	22,375	52	17	22,444
Derivatives:				
Interest rate contracts	4	65,002	988	65,994
Credit contracts	-	5,711	108	5,819
Foreign exchange and gold contracts	-	50,544	70	50,614
Equity contracts	404	31,905	2,163	34,472
Commodity contracts	32	3,032	8	3,072
Total financial liabilities classified as held for trading	43,864	159,655	3,362	206,881
Financial liabilities designated at fair value through profit or loss	-	22,973	434	23,407
Total financial liabilities measured at fair value	43,864	182,628	3,796	230,288

- (1) Amounts exclude the unsettled fair value of long futures contracts of \$115 million included in Trade receivables in the condensed consolidated balance sheet and short futures contracts of \$324 million at 30 June 2017 included in Trade payables in the condensed consolidated balance sheet. These contracts are primarily: classified as Level 1 in the fair value hierarchy, actively traded, and valued based on quoted prices from the exchange.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)

31 December 2016

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant unobservable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
Government debt securities	7,185	2,863	4	10,052
Corporate and other debt	-	8,332	218	8,550
Corporate equities	45,746	218	61	46,025
Derivatives:				
Interest rate contracts	9	79,664	779	80,452
Credit contracts	-	6,047	111	6,158
Foreign exchange and gold contracts	-	66,658	68	66,726
Equity contracts	329	26,350	1,169	27,848
Commodity contracts	75	2,275	19	2,369
Total financial assets classified as held for trading	53,344	192,407	2,429	248,180
Financial assets designated at fair value through profit or loss	-	4,134	178	4,312
Available-for-sale financial assets:				
Corporate equities	-	-	29	29
Total financial assets measured at fair value	53,344	196,541	2,636	252,521
Financial liabilities classified as held for trading:				
Government debt securities	17,171	2,305	-	19,476
Corporate and other debt	-	2,848	5	2,853
Corporate equities	23,217	33	28	23,278
Derivatives:				
Interest rate contracts	4	75,031	956	75,991
Credit contracts	-	6,232	116	6,348
Foreign exchange and gold contracts	-	66,443	54	66,497
Equity contracts	470	27,150	1,802	29,422
Commodity contracts	32	2,268	22	2,322
Total financial liabilities classified as held for trading	40,894	182,310	2,983	226,187
Financial liabilities designated at fair value through profit or loss	-	5,752	268	6,020
Total financial liabilities measured at fair value	40,894	188,062	3,251	232,207

- (1) Amounts exclude the unsettled fair value of long futures contracts of \$77 million included in Trade receivables in the condensed consolidated balance sheet and short futures contracts of \$8 million at 31 December 2016 included in Trade payables in the condensed consolidated balance sheet. These contracts are primarily: classified as Level 1 in the fair value hierarchy, actively traded, and valued based on quoted prices from the exchange.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Transfers between Level 1 and Level 2 of the fair value hierarchy for financial assets and liabilities recognised at fair value on a recurring basis

During the period the Group reclassified approximately \$1.6 billion (2016: \$910 million) of European government debt securities assets and \$1.3 billion (2016: \$602 million) of European government debt securities liabilities from Level 2 to Level 1 due to increased market activity in these instruments.

c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis

The following table presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the six months ended 30 June 2017. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. The realised and unrealised gains/ (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains or losses on hedging instruments that have been classified by the Group within the Level 1 and / or Level 2 categories.

Both observable and unobservable inputs may be used to determine the fair value of positions that the Group has classified within the Level 3 category. As a result, the unrealised gains/ (losses) during the period for assets and liabilities within the Level 3 category presented in the following tables may include changes in fair value during the period that were attributable to both observable and unobservable inputs.

The Morgan Stanley Group operates a number of intra-group policies to ensure arm's length pricing. Where the trading positions included in the below table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in other entities in the Morgan Stanley Group.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

c. Changes in Level 3 assets and liabilities measured at fair value on a recurring basis (continued)

30 June 2017

	Balance at 1 January 2017 \$millions	Total gains/ (losses) recognised in consolidated income statement (1) \$millions	Total gains/ (losses) recognised in consolidated statement of comprehensive income (1) \$millions	Purchases \$millions	Sales and Issuances (2) \$millions	Settlements \$millions	Net transfers in and/or (out) of Level 3 (3) \$millions	Balance at 30 June 2017 \$millions	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 30 June 2017 (4) \$millions
Financial assets classified as held for trading:									
Government debt securities	4	-	-	2	(3)	-	-	3	-
Corporate and other debt	218	16	-	163	(123)	-	50	324	7
Corporate equities	61	(1)	-	28	(68)	-	60	80	-
Total financial assets classified as held for trading	283	15	-	193	(194)	-	110	407	7
Financial assets designated at fair value through profit or loss	178	42	-	72	-	-	114	406	42
Available-for-sale financial assets:									
Corporate equities	29	-	2	40	-	-	-	71	2
Total financial assets measured at fair value	490	57	2	305	(194)	-	224	884	51
Financial liabilities classified as held for trading:									
Corporate and other debt	5	-	-	-	4	-	(1)	8	-
Corporate equities	28	-	-	(85)	1	-	73	17	-
Net derivative contracts ⁽⁵⁾	804	(332)	-	(324)	503	(1,066)	154	403	(212)
Total financial liabilities classified as held for trading	837	(332)	-	(409)	508	(1,066)	226	428	(212)
Financial liabilities designated at fair value through profit or loss	268	(13)	(2)	-	190	(32)	(7)	434	(18)
Total financial liabilities measured at fair value	1,105	(345)	(2)	(409)	698	(1,098)	219	862	(230)

(1) The total gains or (losses) are recognised in the condensed consolidated income statement and the condensed consolidated statement of comprehensive income as detailed in the financial instruments accounting policy in the Group's annual financial statements for the year ended 31 December 2016.

(2) Amounts relating to entering into net derivative contracts and financial liabilities designated at fair value through profit or loss represent issuances. Amounts for other line items represent sales.

(3) For financial assets and financial liabilities that were transferred into and out of Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the period.

(4) Amounts represent unrealised gains or (losses) for the period related to assets and liabilities still outstanding at 30 June 2017. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of comprehensive income as detailed in the financial instruments accounting policy in the Group's annual financial statements for the year ended 31 December 2016.

(5) Net derivative contracts represent Financial liabilities classified as held for trading – derivative contracts net of Financial assets classified as held for trading – derivative contracts.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

c. Changes in Level 3 assets and liabilities measured at fair value on a recurring basis (continued)

31 December 2016

	Balance at 1 January 2016	Total gains or (losses) recognised in condensed consolidated income statement ⁽¹⁾	Total gains or (losses) recognised in condensed consolidated other comprehensive income ⁽¹⁾	Purchases	Sales and issuances ⁽²⁾	Settlements	Net transfers in and / or out of Level 3 ⁽³⁾	Balance at 31 December 2016	Unrealised gains or (losses) for level 3 assets/ liabilities outstanding as at 31 December 2016 ⁽⁴⁾
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Financial assets classified as held for trading:									
Government debt securities	4	-	-	2	(4)	-	2	4	-
Corporate and other debt	576	8	-	71	(409)	-	(28)	218	(5)
Corporate equities	228	(13)	-	32	(24)	-	(162)	61	-
Total financial assets classified as held for trading	808	(5)	-	105	(437)	-	(188)	283	(5)
Financial assets designated at fair value through profit or loss									
Available-for-sale financial assets:									
Corporate equities	38	-	(8)	1	(2)	-	-	29	(8)
Total financial assets measured at fair value	1,227	2	(8)	121	(675)	-	(177)	490	(6)
Financial liabilities classified as held for trading:									
Corporate and other debt	5	-	-	(1)	1	-	-	5	-
Corporate equities	15	12	-	(3)	24	-	4	28	-
Net derivative contracts ⁽⁵⁾	1,006	212	-	(355)	543	301	(479)	804	13
Total financial liabilities classified as held for trading	1,026	224	-	(359)	568	301	(475)	837	13
Financial liabilities designated at fair value through profit or loss									
	160	8	-	-	223	(89)	(18)	268	8
Total financial liabilities measured at fair value	1,186	232	-	(359)	791	212	(493)	1,105	21

(1) The total gains or (losses) are recognised in the condensed consolidated income statement and the condensed consolidated statement of comprehensive income, as detailed in the financial instruments accounting policy (note 3(c)) in the Group's annual financial statements for the year ended 31 December 2016.

(2) Amounts relating to entering into net derivative contracts and financial liabilities designated at fair value through profit or loss represent issuances. Amounts for other line items represent sales.

(3) For financial assets and financial liabilities that were transferred into and out of Level 3 during the year, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the year.

(4) Amounts represent unrealised gains or (losses) for the year ended 31 December 2016 related to assets and liabilities still outstanding as at 31 December 2016. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of comprehensive income, as detailed in the financial instruments accounting policy in the Group's annual financial statements for the year ended 31 December 2016.

(5) Net derivative contracts represent Financial liabilities classified as held for trading – derivative contracts net of Financial assets classified as held for trading – derivative contracts.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

c. Changes in Level 3 financial assets and liabilities measured at fair value on a recurring basis (continued)

During the period, there were no material transfers from Level 2 to Level 3 or Level 3 to Level 2 of the fair value hierarchy (2016: \$nil).

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis

The following disclosures provide information on the sensitivity of fair value measurements to key inputs and assumptions.

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs

The following table provides information on the valuation techniques, significant unobservable inputs and their ranges and averages for each material category of assets and liabilities measured at fair value on a recurring basis.

The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across groups in the financial services industry because of diversity in the types of products included in each group's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs. There are no predictable relationships between multiple significant unobservable inputs attributable to a given valuation technique. A single amount is disclosed when there is no significant difference between the minimum, maximum and average (weighted average or similar average / median).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

30 June 2017	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽²⁾ (Weighted averages or simple averages/median) ⁽³⁾
ASSETS			
Financial assets classified as held for trading:			
- Corporate and other debt:			
- Residential mortgage-backed securities	33	Comparable pricing Comparable bond price	1 to 10 pts (7 pts)
- Asset-backed securities	55	Comparable pricing Comparable bond price	4 to 138 pts (91 pts)
- Corporate bonds	227	Comparable pricing Comparable bond price	3 to 133 pts (86 pts)
- Corporate equities	80	Comparable pricing Comparable equity price	100% (100%)
Financial assets designated at fair value through profit or loss:			
- Customer loans	320	Margin loan model Discount rate Option model Volatility skew	5% (5%) -1% (-1%)
- Prepaid OTC contracts	77	Discounted cash flow Recovery Rate	10% (10%)
Available-for-sale financial assets:			
- Corporate equities	71	Comparable pricing Comparable equity price	100% (100%)

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

30 June 2017	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽²⁾ (Weighted averages or simple averages/median) ⁽³⁾
LIABILITIES			
Financial liabilities classified as held for trading:			
- Net derivative contracts ⁽¹⁾⁽⁴⁾⁽⁵⁾			
- Interest rate	257	Option model	
		Inflation volatility	24% to 62% (44%/41%)
		Interest rate-foreign exchange correlation	27% to 54% (44%/44%)
		Interest rate-inflation correlation	-27% to -48% (-36%/-34%)
		Inflation curve	1% (1%/1%)
		Interest rate volatility skew	29% to 102% (44%/45%)
- Credit	(7)	Correlation model	
		Credit correlation	40% to 69% (48%)
		Comparable pricing	
		Comparable bond price	1 to 100 pts (34 pts)
- Foreign exchange and gold	(24)	Option model	
		Interest rate-foreign exchange correlation	27% to 54% (44%/44%)
		Interest rate volatility skew	29% to 102% (44%/45%)
		Deal execution probability	93% to 99% (95%/95%)
- Equity	(627)	Option model	
		At the money volatility	6% to 64% (29%)
		Volatility skew	-4% to 0% (-1%)
		Equity-equity correlation	45% to 99% (71%)
		Equity-foreign exchange correlation	-54% to -5% (-31%)
Financial liabilities designated at fair value through profit or loss:			
- Issued structured notes	(344)	Option model	
		At the money volatility	6% to 45% (28%)
		Volatility skew	-1% to 0% (-1%)
		Equity-equity correlation	46% to 73% (62%)
		Equity-foreign exchange correlation	-50% to -6% (-22%)
		Discount cash flow	
- Prepaid OTC contracts	(80)	Recovery Rate	10% (10%)

(1) Net derivative contracts represent financial liabilities classified as held for trading – derivative contracts net of financial assets classified as held for trading – derivative contracts.

(2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided when more relevant.

(4) CVA and FVA are included in fair value, but excluded from the valuation techniques and significant unobservable inputs in the previous table. CVA is a Level 3 input when the underlying counterparty credit curve is unobservable. FVA is a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

(5) Includes derivative contracts with multiple risks (i.e. hybrid products).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

31 December 2016	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽²⁾ (Weighted averages or simple averages/median) ⁽³⁾
ASSETS			
Financial assets classified as held for trading:			
- Corporate and other debt:			
- Residential mortgage-backed securities	61	Comparable pricing Comparable bond price	2 to 14 pts (7 pts)
- Asset-backed securities	43	Comparable pricing Comparable bond price	28 to 100 pts (88 pts)
- Corporate bonds	91	Comparable pricing Comparable bond price	5 to 130 pts (99 pts)
- Corporate equities	61	Comparable pricing Comparable equity price	100% (100%)
Financial assets designated at fair value through profit or loss:			
- Customer loans	152	Margin loan model Discount rate Option model Volatility skew	9% (9%) -1% (-1%)
Available-for-sale financial assets:			
- Corporate equities	29	Comparable pricing Comparable equity price	100% (100%)
LIABILITIES			
Financial liabilities classified as held for trading:			
- Corporate equities	(28)	Comparable pricing Comparable equity price	100% (100%)

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity if significant unobservable inputs (continued)

31 December 2016	Fair value \$millions	Predominant valuation techniques/ Significant unobservable inputs	Range ⁽²⁾ (Weighted averages or simple averages/median) ⁽³⁾
LIABILITIES			
Financial liabilities classified as held for trading:			
- Net derivatives contracts: ⁽¹⁾⁽⁴⁾⁽⁵⁾			
- Interest rate	(177)	Option model	
		Inflation volatility	24% to 55% (40%/39%)
		Interest rate-foreign exchange correlation	28% to 58% (44%/43%)
		Interest rate curve correlation	28% to 98% (67%/69%)
		Interest rate quanto correlation	-8% to 37% (6%/-7%)
		Interest rate curve	1.5% to 1.6% (1.5%/1.5%)
		Interest rate volatility skew	31% to 116% (47%/50%)
- Credit	(5)	Correlation model	
		Credit correlation	35% to 59% (44%)
		Comparable pricing	
		Comparable bond price	2 to 100 pts (39 pts)
- Foreign exchange and gold	14	Option model	
		Interest rate-foreign exchange correlation	28% to 58% (44%/43%)
		Interest rate volatility skew	31% to 116% (47%/50%)
		Credit-foreign exchange correlation	0% (0%)
- Equity	(633)	Option model	
		At the money volatility	16% to 66% (32%)
		Volatility skew	-2% to 0% (-1%)
		Equity-equity correlation	35% to 99% (74%)
		Equity-foreign exchange correlation	-63% to -5% (-41%)
- Commodity	(3)	Comparable pricing	
		Comparable price	\$508 to \$1,626 (\$829)
Financial liabilities designated at fair value through profit or loss:			
- Issued structured notes	(242)	Option model	
		At the money volatility	7% to 34% (29%)
		Volatility skew	-1% to 0% (-1%)
		Equity-equity correlation	46% to 98% (82%)
		Equity-foreign exchange correlation	-55% to -6% (-41%)

(1) Net derivative contracts represent financial liabilities classified as held for trading – derivative contracts net of financial assets classified as held for trading – derivative contracts.

(2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided when more relevant.

(4) CVA and FVA are included in fair value, but excluded from the valuation techniques and significant unobservable inputs in the previous table. CVA is a Level 3 input when the underlying counterparty credit curve is unobservable. FVA is a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

(5) Includes derivative contracts with multiple risks (i.e. hybrid products).

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

A description of the significant unobservable inputs and qualitative sensitivity included in the table above for all major categories of assets and liabilities is included within note 31 of the consolidated financial statements for the year ended 31 December 2016.

ii. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives

The following tables present the sensitivity of the fair value of Level 3 financial assets and financial liabilities to reasonably possible alternative assumptions, providing quantitative information on the potential variability of the fair value measurement. The information below is limited to quantitative information and should be read in conjunction with note 31 of the consolidated financial statements for the year ended 31 December 2016.

30 June 2017

	Effect of reasonably possible alternative assumptions		
	Fair value \$millions	Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
Corporate and other debt	324	11	(11)
Corporate equities	80	5	(18)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	77	102	(43)
Customer loans	320	-	(1)
Available-for-sale financial assets:			
Corporate equities	71	11	(14)
Financial liabilities classified as held for trading:			
Net derivatives contracts ⁽¹⁾⁽²⁾	403	50	(51)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	80	102	(43)
Issued structured notes	344	2	(2)

(1) Net derivative contracts represent financial liabilities classified as held for trading – derivative contracts net of financial assets classified as held for trading – derivative contracts.

(2) CVA and FVA are included in the fair value, but excluded from the effect of reasonably possible alternative assumptions in the table above. CVA is deemed to be a level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

ii. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

31 December 2016

	Fair value	Effect of reasonably possible alternative assumptions	
		Increase in	Decrease in
	\$millions	fair value	fair value
		\$millions	\$millions
Financial assets classified as held for trading:			
Corporate and other debt	218	10	(10)
Corporate equities	61	10	(13)
Financial assets designated at fair value through profit or loss:			
Customer loans	152	1	(1)
Available-for-sale financial assets:			
Corporate equities	29	6	(10)
Financial liabilities classified as held for trading:			
Corporate equities	28	-	(4)
Net derivatives contracts ⁽¹⁾⁽²⁾	804	37	(57)
Financial liabilities designated at fair value through profit or loss:			
Issued structured notes	242	2	(2)

(1) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts.

(2) CVA and FVA are included in the fair value, but excluded from the effect of reasonably possible alternative assumptions in the table above. CVA is deemed to be a level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

16. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

The amounts not recognised in the condensed consolidated income statement for the relevant period relating to the difference between the fair value at initial recognition (the transaction price) and the amounts determined at initial recognition using valuation techniques are as follows:

	30 June 2017	31 December 2016
	\$millions	\$millions
At 1 January	245	216
New transactions	87	70
Amounts recognised in the condensed consolidated income statement during the period/year	(30)	(41)
At 30 June 2017 / 31 December 2016	302	245

The balance above predominately relates to derivatives.

The condensed consolidated statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value through profit or loss', and 'Available-for-sale financial assets' include financial instruments whose fair value is based on valuation techniques using unobservable market data.

f. Assets and liabilities measured at fair value on a non-recurring basis

Non-recurring fair value measurements of assets and liabilities are those which are required or permitted in the condensed consolidated statement of financial position in particular circumstances. There were no assets or liabilities measured at fair value on a non-recurring basis during the current or prior period.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2017

17. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE

The table below presents the carrying value, fair value and fair value hierarchy category of certain financial assets and financial liabilities that are not measured at fair value in the condensed consolidated statement of financial position.

Financial assets and financial liabilities not measured at fair value for which the carrying value is considered a reasonable approximation of fair value are excluded from the table below.

	Carrying value	Fair value	Fair value measurement using:		
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	\$millions	\$millions	\$millions	\$millions	\$millions
30 June 2017					
Financial liabilities					
Subordinated loans	7,000	7,313	-	7,313	-
Other payables	30,167	30,619	-	30,619	-
Financial liabilities at 30 June 2017	<u>37,167</u>	<u>37,932</u>	<u>-</u>	<u>37,932</u>	<u>-</u>
31 December 2016					
Financial liabilities					
Other payables at 31 December 2016	<u>7,240</u>	<u>7,069</u>	<u>-</u>	<u>7,069</u>	<u>-</u>

Also included in the condensed consolidated statement of financial position is \$4,431 million (31 December 2016: \$3,616 million) of other payables where the carrying value is a reasonable approximation of fair value. The fair value of other payables is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2017

18. RELATED PARTY DISCLOSURES

The management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure arm's length pricing.

The Group receives and incurs management charges to and from other Morgan Stanley Group undertakings for infrastructure services, including the provision of staff and office facilities. For the six month period ended 30 June 2016 'management charges from other Morgan Stanley Group undertakings relating to staff costs' were \$813 million (30 June 2016: \$677 million) and 'management charges from other Morgan Stanley Group undertakings relating to other services' were \$423 million (30 June 2016: \$315 million). See note 2 for further details.

Results reflect the impact of the Group and Morgan Stanley updating its Global Transfer Pricing Policy, effective 1 January 2017. This change in transfer policy is consistent with evolving transfer pricing guidance under OECD's and evolving regulatory guidance. The transfer pricing method selected for implementation is one of the methods specified under the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This new policy is the subject of a multilateral Advanced Pricing Agreement that is currently under review by relevant tax authorities.

19. EVENTS AFTER THE REPORTING PERIOD

On 25 September 2017, the Company approved the issuance of an additional 1,000,000,000 of \$1 ordinary shares to the Company's immediate parent undertaking for total consideration of \$1,000,000,000.