UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended February 28, 2005

OR

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

For the transition period from __________ to __________

Commission file number 1-11758

Morgan Stanley
(Exact Name of Registrant as Specified in its Charter)

Delaware **(State of Incorporation)**	**36-3145972** **(I.R.S. Employer Identification No.)**
1585 Broadway **New York, NY** **(Address of Principal Executive Offices)**	**10036** **(Zip Code)**

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

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

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

As of March 31, 2005, there were 1,095,598,019 shares of the Registrant's Common Stock, par value $.01 per share, outstanding.

MORGAN STANLEY

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Quarter Ended February 28, 2005

AVAILABLE INFORMATION

The Company files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy any document the Company files with the SEC at the SEC's public reference room at 450 Fifth Street, NW, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including the Company) file electronically with the SEC. The SEC's internet site is *www.sec.gov*.

The Company's internet site is *www.morganstanley.com*. You can access the Company's Investor Relations webpage through its internet site, *www.morganstanley.com,* by clicking on the "About the Company" link to the heading "Investor Relations." You can also access its Investor Relations webpage directly at *www.morganstanley.com/about/ir*. The Company makes available free of charge, on or through its Investor Relations webpage, its proxy statements, annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. The Company also makes available, through its Investor

Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of the Company's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

The Company also has a Corporate Governance webpage. You can access the Company's Corporate Governance webpage through its internet site, *www.morganstanley.com,* by clicking on the "About the Company" link to the heading "Inside the Company." You can also access its Corporate Governance webpage directly at *www.morganstanley.com/about/inside/governance*. The Company posts the following on its Corporate Governance webpage:

- Composite Certificate of Incorporation,
- Bylaws,
- Charters for its Audit Committee, Compensation Committee and Nominating and Governance Committee,
- Corporate Governance Policies,
- Policy Regarding Shareholder Communication with the Board of Directors,
- Policy Regarding Director Candidates Recommended by Shareholders,
- Policy Regarding Corporate Political Contributions,
- Policy Regarding Shareholder Rights Plan, and
- Code of Ethics and Business Conduct.

The information on the Company's internet site is not incorporated by reference into this report. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations at 1585 Broadway, New York, NY 10036 (212-761-4000).

Item 1.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in millions, except share data)

	February 28, 2005	November 30, 2004
	(unaudited)	
Assets		
Cash and cash equivalents	$ 34,068	$ 32,811
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (including securities at fair value of $27,566 at February 28, 2005 and $27,219 at November 30, 2004)	37,576	36,742
Financial instruments owned (approximately $109 billion and $91 billion were pledged to various parties at February 28, 2005 and November 30, 2004, respectively):		
U.S. government and agency securities	38,556	26,201
Other sovereign government obligations	23,296	19,782
Corporate and other debt	88,599	80,306
Corporate equities	35,402	27,608
Derivative contracts	43,001	49,475
Physical commodities	1,354	1,224
Total financial instruments owned	230,208	204,596
Securities purchased under agreements to resell	143,462	123,041
Securities received as collateral	38,657	37,848
Securities borrowed	207,985	208,349
Receivables:		
Consumer loans (net of allowances of $854 at February 28, 2005 and $943 at November 30, 2004)	18,785	20,226
Customers, net	58,606	45,561
Brokers, dealers and clearing organizations	10,052	12,707
Fees, interest and other	4,649	5,801
Office facilities, at cost (less accumulated depreciation of $2,856 at February 28, 2005 and $2,780 at November 30, 2004)	2,663	2,605
Aircraft under operating leases (less accumulated depreciation of $1,232 at February 28, 2005 and $1,174 at November 30, 2004)	3,755	3,926
Goodwill and intangible assets	2,563	2,199
Other assets	9,181	9,101
Total assets	$802,210	$745,513

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION—(Continued)
(dollars in millions, except share data)

	February 28, 2005	November 30, 2004
	(unaudited)	
Liabilities and Shareholders' Equity		
Commercial paper and other short-term borrowings	$ 30,792	$ 36,303
Deposits	13,950	13,777
Financial instruments sold, not yet purchased:		
U.S. government and agency securities	17,490	12,664
Other sovereign government obligations	20,134	14,787
Corporate and other debt	8,619	9,641
Corporate equities	32,978	27,332
Derivative contracts	37,389	43,540
Physical commodities	3,303	3,351
Total financial instruments sold, not yet purchased	119,913	111,315
Securities sold under agreements to repurchase	206,547	188,645
Obligation to return securities received as collateral	38,657	37,848
Securities loaned	121,158	97,146
Payables:		
Customers	115,868	115,653
Brokers, dealers and clearing organizations	5,775	4,550
Interest and dividends	3,308	3,068
Other liabilities and accrued expenses	13,331	13,650
Long-term borrowings	104,350	95,286
	773,649	717,241
Capital Units	66	66
Commitments and contingencies		
Shareholders' equity:		
Common stock, $0.01 par value;		
Shares authorized: 3,500,000,000 at February 28, 2005 and November 30, 2004;		
Shares issued: 1,211,701,552 at February 28, 2005 and November 30, 2004;		
Shares outstanding: 1,103,263,369 at February 28, 2005 and 1,087,087,116 at November 30, 2004	12	12
Paid-in capital	1,800	2,088
Retained earnings	32,527	31,426
Employee stock trust	3,719	3,824
Accumulated other comprehensive income (loss)	(54)	(56)
Subtotal	38,004	37,294
Common stock held in treasury, at cost, $0.01 par value; 108,438,183 shares at February 28, 2005 and 124,614,436 shares at November 30, 2004.	(5,790)	(6,614)
Common stock issued to employee trust	(3,719)	(2,474)
Total shareholders' equity	28,495	28,206
Total liabilities and shareholders' equity	$802,210	$745,513

See Notes to Condensed Consolidated Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(dollars in millions, except share and per share data)

	Three Months Ended February 28, 2005 (unaudited)	Three Months Ended February 29, 2004 (unaudited)
Revenues:		
Investment banking	$ 821	$ 829
Principal transactions:		
Trading	1,850	1,832
Investments	117	29
Commissions	824	868
Fees:		
Asset management, distribution and administration	1,178	1,093
Merchant, cardmember and other	308	337
Servicing	526	572
Interest and dividends	5,843	3,782
Other	174	133
Total revenues	11,641	9,475
Interest expense	4,660	2,972
Provision for consumer loan losses	135	262
Net revenues	6,846	6,241
Non-interest expenses:		
Compensation and benefits	2,861	2,712
Occupancy and equipment	333	200
Brokerage, clearing and exchange fees	260	224
Information processing and communications	342	320
Marketing and business development	259	254
Professional services	380	318
Other	573	300
September 11th related insurance recoveries, net	(251)	—
Total non-interest expenses	4,757	4,328
Income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change, net	2,089	1,913
Losses from unconsolidated investees	73	93
Provision for income taxes	671	551
Dividends on preferred securities subject to mandatory redemption	—	45
Income from continuing operations before cumulative effect of accounting change, net	1,345	1,224
Discontinued operations:		
Income from discontinued operations	13	3
Provision for income taxes	(5)	(1)
Income on discontinued operations	8	2
Cumulative effect of accounting change, net	49	—
Net income	$ 1,402	$ 1,226
Earnings per basic share:		
Income from continuing operations before cumulative effect of accounting change	$ 1.25	$ 1.14
Income from discontinued operations	0.01	—
Cumulative effect of accounting change, net	0.05	—
Earnings per basic share	$ 1.31	$ 1.14
Earnings per diluted share:		
Income from continuing operations before cumulative effect of accounting change	$ 1.23	$ 1.11
Income from discontinued operations	0.01	—
Cumulative effect of accounting change, net	0.05	—
Earnings per diluted share	$ 1.29	$ 1.11
Average common shares outstanding:		
Basic	1,069,097,162	1,078,718,046
Diluted	1,090,166,326	1,106,000,596

See Notes to Condensed Consolidated Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(dollars in millions)

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(unaudited)	
Net income	$1,402	$1,226
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	(4)	43
Net change in cash flow hedges	6	14
Comprehensive income	$1,404	$1,283

See Notes to Condensed Consolidated Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in millions)

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 1,402	$ 1,226
Income on discontinued operations	(8)	(2)
Cumulative effect of accounting change, net	(49)	—
Income from continuing operations	1,345	1,224
Adjustments to reconcile net income to net cash used for operating activities:		
Non-cash charges (credits) included in net income:		
Compensation payable in common stock and options	202	65
Depreciation and amortization	231	167
Provision for consumer loan losses	135	262
Lease adjustment	109	—
Insurance settlement	(251)	—
Changes in assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated under federal and other regulations	(834)	2,358
Financial instruments owned, net of financial instruments sold, not yet purchased	(17,682)	2,876
Securities borrowed, net of securities loaned	24,376	(13,435)
Receivables and other assets	(9,418)	(12,438)
Payables and other liabilities	1,305	182
Net cash used for operating activities	(482)	(18,739)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Office facilities and aircraft under operating leases	(78)	(61)
Purchase of PULSE, net of cash acquired	(279)	—
Net principal disbursed on consumer loans	(3,386)	73
Sales of consumer loans	4,692	3,196
Sale of interest in POSIT	90	—
Insurance settlement	60	—
Net cash provided by investing activities	1,099	3,208
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (payments for) proceeds from:		
Short-term borrowings	(5,511)	(1,182)
Securities sold under agreements to repurchase, net of securities purchased under agreements to resell and certain derivatives financing activities	(2,052)	12,533
Deposits	173	(721)
Tax benefits associated with stock-based awards	231	62
Net proceeds from:		
Issuance of common stock	212	107
Issuance of long-term borrowings	12,604	13,519
Payments for:		
Repayments of long-term borrowings	(3,344)	(4,646)
Repurchases of common stock	(1,372)	—
Cash dividends	(301)	(273)
Net cash provided by financing activities	640	19,399
Net increase in cash and cash equivalents	1,257	3,868
Cash and cash equivalents, at beginning of period	32,811	29,692
Cash and cash equivalents, at end of period	$ 34,068	$ 33,560

See Notes to Condensed Consolidated Financial Statements.

1. Introduction and Basis of Presentation.

The Company. Morgan Stanley (the "Company") is a global financial services firm that maintains leading market positions in each of its business segments—Institutional Securities, Individual Investor Group, Investment Management and Credit Services. The Company's Institutional Securities business includes securities underwriting and distribution; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; sales, trading, financing and market-making activities in equity securities and related products and fixed income securities and related products, including foreign exchange and commodities; principal investing and real estate investment management; aircraft financing activities; providing benchmark indices and risk management analytics; and research. The Company's Individual Investor Group business provides comprehensive brokerage, investment and financial services designed to accommodate individual investment goals and risk profiles. The Company's Investment Management business provides global asset management products and services for individual and institutional investors through three principal distribution channels: a proprietary channel consisting of the Company's representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; and the Company's institutional channel. The Company's Credit Services business offers Discover®-branded cards and other consumer finance products and services, including residential mortgage loans, and includes the operations of Discover Network, a network of merchant and cash access locations based predominantly in the U.S., and PULSE EFT Association, Inc. ("PULSE®"), a U.S.-based automated teller machine/debit network. Morgan Stanley-branded credit cards and personal loan products that are offered in the U.K. are also included in the Credit Services business segment. The Company provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

Basis of Financial Information. The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, consumer loan loss levels, the outcome of litigation, and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. The Company's policy is to consolidate all entities in which it owns more than 50% of the outstanding voting stock unless it does not control the entity. In accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," as revised, the Company also consolidates any variable interest entities for which it is the primary beneficiary (see Note 12). For investments in companies in which the Company has significant influence over operating and financial decisions (generally defined as owning a voting or economic interest of 20% to 50%), the Company applies the equity method of accounting. In those cases where the Company's investment is less than 20% and significant influence does not exist, such investments are carried at cost.

The Company's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated ("MS&Co."), Morgan Stanley & Co. International Limited ("MSIL"), Morgan Stanley Japan Limited ("MSJL"), Morgan Stanley DW Inc. ("MSDWI"), Morgan Stanley Investment Advisors Inc. and NOVUS Credit Services Inc.

Certain reclassifications have been made to prior-year amounts to conform to the current year's presentation. All material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2004 (the "Form 10-K"). The condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are, in the opinion of management, necessary for the fair statement of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

Discontinued Operations. Revenues and expenses associated with certain aircraft designated as "held for sale" have been classified as discontinued operations for all periods presented in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." See Note 17 for additional information on discontinued operations.

Revenue Recognition.

Investment Banking. Underwriting revenues and fees for merger, acquisition and advisory assignments are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred to match revenue recognition. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

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

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

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

Consumer Loans. Consumer loans, which consist primarily of general purpose credit card, mortgage and consumer installment loans, are reported at their principal amounts outstanding less applicable allowances. Interest on consumer loans is recorded to income as earned. Interest is accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account becomes 180 days past due, except in the case of bankruptcies, deceased cardmembers and fraudulent transactions, where loans are charged off earlier. The interest portion of charged-off credit card loans is written off against interest revenue. Origination costs related to the issuance of credit cards are charged to earnings over periods not exceeding 12 months.

Financial Instruments Used for Trading and Investment. Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected in principal trading revenues in the condensed consolidated statements of income. Loans and lending commitments associated with the Company's lending activities also are recorded at fair value. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased are generally based on observable market prices, observable market parameters or derived from such prices or parameters based on bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased. In the case of financial instruments transacted on recognized exchanges the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Bid prices represent the highest price a buyer is willing to pay for a financial instrument at a particular time. Ask prices represent the lowest price a seller is willing to accept for a financial instrument at a particular time.

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

The price transparency of the particular product will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly traded or not quoted will generally have reduced to no price transparency.

The fair value of over-the-counter ("OTC") derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Interest and dividend revenue and interest expense arising from financial instruments used in trading activities are reflected in the condensed consolidated statements of income as interest and dividend revenue or interest expense. Purchases and sales of financial instruments and related expenses are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company's dealings in OTC financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

Effective December 1, 2004 the Company has elected, under FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," to net cash collateral paid or received against its derivatives inventory under credit support annexes, which the Company views as conditional contracts, to legally enforceable master netting agreements. The Company believes the accounting treatment is preferable as compared to a gross basis as it is a better representation of its credit exposure and how it manages its credit risk related to these derivative contracts. Amounts as of November 30, 2004 have been reclassified to conform to the current presentation. The amounts netted at February 28, 2005 and November 30, 2004 were $16.3 billion and $17.6 billion, respectively, which reduced Financial instruments owned—derivative contracts and Payables to customers, and $13.8 billion and $12.3 billion, respectively, which reduced Financial instruments sold, not yet purchased—derivative contracts and Receivables from customers.

Equity securities purchased in connection with private equity and other principal investment activities initially are carried in the condensed consolidated financial statements at their original costs, which approximate fair value. The carrying value of such equity securities is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by observable market prices or transactions that directly affect the value of such equity securities. Downward adjustments relating to such equity securities are made in the event that the Company determines that the fair value is less than the carrying value. The Company's partnership interests, including general partnership and limited partnership interests in real estate funds, are included within Other assets in the condensed consolidated statements of financial condition and are recorded at fair value based upon changes in the fair value of the underlying partnership's net assets.

Financial Instruments Used for Asset and Liability Management. The Company enters into various derivative financial instruments for non-trading purposes. These instruments are included within Financial instruments owned—derivative contracts or Financial instruments sold, not yet purchased—derivative contracts within the condensed consolidated statements of financial condition and include interest rate swaps, foreign currency swaps, equity swaps and foreign exchange forwards. The Company uses interest rate and currency swaps and equity derivatives to manage interest rate, currency and equity price risk arising from certain liabilities. The Company also utilizes interest rate swaps to match the repricing characteristics of consumer loans with those of the borrowings that fund these loans. Certain of these derivative financial instruments are designated and qualify as fair value hedges and cash flow hedges in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

The Company's designated fair value hedges consist primarily of hedges of fixed rate borrowings, including fixed rate borrowings that fund consumer loans. The Company's designated cash flow hedges consist primarily of hedges of floating rate borrowings in connection with its aircraft financing business. In general, interest rate exposure in this business arises to the extent that the interest obligations associated with debt used to finance the Company's aircraft portfolio do not correlate with the aircraft rental payments received by the Company. The Company's objective is to manage the exposure created by its floating interest rate obligations given that future lease rates on new leases may not be repriced at levels that fully reflect changes in market interest rates. The Company utilizes interest rate swaps to minimize the risk created by its longer-term floating rate interest obligations and measures that risk by reference to the duration of those obligations and the expected sensitivity of future lease rates to future market interest rates.

For qualifying fair value hedges, the changes in the fair value of the derivative and the gain or loss on the hedged asset or liability relating to the risk being hedged are recorded currently in earnings. These amounts are recorded in interest expense and provide offset of one another. For qualifying cash flow hedges, the changes in the fair value of the derivative are recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and amounts in Accumulated other comprehensive income (loss) are reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Ineffectiveness relating to fair value and cash flow hedges, if any, is recorded within interest expense. The impact of hedge ineffectiveness on the condensed consolidated statements of income was not material for all periods presented.

The Company also utilizes foreign exchange forward contracts to manage the currency exposure relating to its net monetary investments in non-U.S. dollar functional currency operations. The gain or loss from revaluing these contracts is deferred and reported within Accumulated other comprehensive income in Shareholders' equity, net of tax effects, with the related unrealized amounts due from or to counterparties included in Financial instruments owned or Financial instruments sold, not yet purchased. The interest elements (forward points) on these foreign exchange forward contracts are recorded in earnings.

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

Aircraft under Operating Leases. Revenue from aircraft under operating leases is recognized on a straight-line basis over the lease term. Certain lease contracts may require the lessee to make separate payments for flight hours and passenger miles flown. In such instances, the Company recognizes these other revenues as they are earned in accordance with the terms of the applicable lease contract.

Aircraft under operating leases that are to be held and used are stated at cost less accumulated depreciation and impairment charges. Depreciation is calculated on a straight-line basis over the estimated useful life of the aircraft asset, which is generally 25 years from the date of manufacture. In accordance with SFAS No. 144, the Company's aircraft that are to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of the aircraft may not be recoverable (see Note 16).

Aircraft under operating leases that fulfill the criteria to be classified as held for sale in accordance with SFAS No. 144 are stated at the lower of carrying value (i.e., cost less accumulated depreciation and impairment charges) or fair value less estimated cost to sell. After an aircraft is designated as held for sale, no further depreciation expense is recorded. The Company recognizes a charge for any initial or subsequent write-down to fair value less estimated cost to sell (see Note 16). A gain is recognized for any subsequent increase in fair value less cost to sell but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). A gain or loss not previously recognized that results from the sale of an aircraft is recognized at the date of sale.

Stock-Based Compensation. Effective December 1, 2002, the Company adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123," using the prospective adoption method for both deferred stock and stock options. Effective December 1, 2004, the Company early adopted SFAS No. 123 (revised) ("SFAS No. 123R"), "Share-Based Payment," which revised the fair value based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified SFAS No. 123's guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS No. 123R also amended SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as financing cash inflows rather than as a reduction of taxes paid, which is included within operating cash flows.

Upon adoption of SFAS 123R using the modified prospective approach, the Company recognized an $80 million gain ($49 million after-tax) as a cumulative effect of a change in accounting principle resulting from the requirement to estimate forfeitures at the date of grant instead of recognizing them as incurred. The cumulative effect gain increased both basic and diluted earnings per share by $.05.

In addition, based upon the terms of the Company's equity-based compensation program, the Company will no longer be able to recognize a portion of the award in the year of grant under SFAS No. 123R as previously allowed under SFAS 123. As a result, fiscal 2005 compensation expense will include the amortization of fiscal 2003 and fiscal 2004 awards but will not include any amortization for fiscal 2005 awards. This will have the effect of reducing compensation expense in fiscal 2005. If SFAS No. 123R were not in effect, fiscal 2005's compensation expense would have included three years of amortization (i.e., for awards granted in fiscal 2003, fiscal 2004 and fiscal 2005). In addition, the fiscal 2005 year-end awards, which will begin to be amortized in fiscal 2006, will be amortized over a shorter period (2 and 3 years) as compared with awards granted in fiscal 2004 and fiscal 2003 (3 and 4 years).

2. Goodwill and Intangible Assets.

During the first quarter of fiscal 2005, the Company completed the annual goodwill impairment test that is required by SFAS No. 142, "Goodwill and Other Intangible Assets." The Company's testing did not indicate any goodwill impairment.

Changes in the carrying amount of the Company's goodwill and intangible assets for the three month period ended February 28, 2005 were as follows:

	Institutional Securities	Individual Investor Group	Investment Management	Credit Services(1)	Total
			(dollars in millions)		
Goodwill:					
Balance as of November 30, 2004	$319	$583	$966	$—	$1,868
Translation adjustments	—	1	—	—	1
Goodwill acquired during the year and other(2)	125	—	—	230	355
Balance as of February 28, 2005	$444	$584	$966	$230	$2,224
Intangible assets:					
Balance as of November 30, 2004	$331	$—	$—	$—	$ 331
Intangible assets sold(3)	(75)	—	—	—	(75)
Intangible assets acquired	—	—	—	91	91
Amortization expense	(7)	—	—	(1)	(8)
Balance as of February 28, 2005	$249	$—	$—	$ 90	$ 339

(1) Represents goodwill and intangible assets acquired in connection with the acquisition of PULSE (see Note 18).
(2) Institutional Securities activity includes adjustments to goodwill related to the sale of the Company's interest in POSIT (see Note 18) and for the recognition of deferred tax liabilities in connection with the Company's acquisition of Barra, Inc.
(3) Related to the sale of the Company's interest in POSIT (see Note 18).

3. Securities Financing and Securitization Transactions.

Securities purchased under agreements to resell ("reverse repurchase agreements") and Securities sold under agreements to repurchase ("repurchase agreements"), principally government and agency securities, are treated as financing transactions and are carried at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase agreements and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. The Company's policy is to take possession of securities purchased under agreements to resell. Securities borrowed and Securities loaned also are treated as financing transactions and are carried at the amounts of cash collateral advanced and received in connection with the transactions.

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

	At February 28, 2005	At November 30, 2004
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities	$10,383	$ 6,283
Other sovereign government obligations	284	249
Corporate and other debt	19,966	15,564
Corporate equities	3,433	2,754
Total	$34,066	$24,850

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, finance the Company's inventory positions, acquire securities to cover short positions and settle other securities obligations and to accommodate customers' needs. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed transactions and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending transactions or for delivery to counterparties to cover short positions. At February 28, 2005 and November 30, 2004, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was $775 billion and $750 billion, respectively, and the fair value of the portion that has been sold or repledged was $661 billion and $679 billion, respectively.

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

In connection with its Institutional Securities business, the Company engages in securitization activities related to residential and commercial mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial assets. These assets are carried at fair value, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income. Retained interests in securitized financial assets associated with the Institutional Securities business were approximately $3.2 billion at February 28, 2005, the majority of which were related to residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan securitization transactions. Net gains at the time of securitization were not material in the quarter ended February 28, 2005. The assumptions that the Company used to determine the fair value of its retained interests at the time of securitization related to those transactions that occurred during the quarter ended February 28, 2005 were not materially different from the assumptions included in the table below. Additionally, as indicated in the table below, the Company's exposure to credit losses related to these retained interests was not material to the Company's results of operations.

The following table presents information on the Company's residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions at February 28, 2005 were as follows (dollars in millions):

	Residential Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Commercial Mortgage Loans
Retained interests (carrying amount/fair value)	$ 1,646	$ 1,149	$ 217
Weighted average life (in months)	35	89	82
Credit losses (rate per annum)(1)	0.00-3.50%	—	0.20-2.00%
Impact on fair value of 10% adverse change	$ (58)	$ —	$ —
Impact on fair value of 20% adverse change	$ (113)	$ —	$ —
Weighted average discount rate (rate per annum)	10.01%	6.07%	6.47%
Impact on fair value of 10% adverse change	$ (22)	$ (33)	$ (6)
Impact on fair value of 20% adverse change	$ (44)	$ (64)	$ (12)
Prepayment speed assumption(2)(3)	287-2250PSA	149-495PSA	—
Impact on fair value of 10% adverse change	$ (18)	$ (11)	$ —
Impact on fair value of 20% adverse change	$ (19)	$ (30)	$ —

(1) Commercial mortgage loans credit losses round to less than $1 million.
(2) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.
(3) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

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

In connection with its Institutional Securities business, during the quarters ended February 28, 2005 and February 29, 2004, the Company received proceeds from new securitization transactions of $18 billion and $12 billion, respectively, and cash flows from retained interests in securitization transactions of $2,187 million and $852 million, respectively.

4. Consumer Loans.

Consumer loans were as follows:

	At February 28, 2005	At November 30, 2004
	(dollars in millions)	
General purpose credit card, mortgage and consumer installment	$19,639	$21,169
Less:		
Allowance for consumer loan losses	854	943
Consumer loans, net	$18,785	$20,226

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

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Balance at beginning of period	$943	$1,002
Additions:		
Provision for consumer loan losses	135	262
Deductions:		
Charge-offs	260	291
Recoveries	(36)	(31)
Net charge-offs	224	260
Balance at end of period	$854	$1,004

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

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Interest accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction of Interest revenue)	$56	$59
Cardmember fees accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction to Merchant, cardmember and other fee revenue)	$33	$40

At February 28, 2005, the Company had commitments to extend credit for consumer loans of approximately $265 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness.

The Company received net proceeds from consumer loan sales of $4,692 million in the quarter ended February 28, 2005 and $3,196 million in the quarter ended February 29, 2004.

Credit Card Securitization Activities. The Company's retained interests in credit card asset securitizations include undivided seller's interests, accrued interest receivable on securitized credit card receivables, cash collateral accounts, servicing rights and rights to any excess cash flows ("Residual Interests") remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses. The undivided seller's interests less an applicable allowance for loan losses is recorded in Consumer loans. The Company's undivided seller's interests rank *pari passu* with investors' interests in the securitization trusts, and the remaining retained interests are subordinate to investors' interests. Accrued interest receivable and cash collateral accounts are recorded in Other assets at amounts that approximate fair value. The Company receives annual servicing fees of 2% of the investor principal balance outstanding. The Company does not recognize servicing assets or servicing liabilities for servicing rights since the servicing contracts provide only adequate compensation (as defined in SFAS No. 140, "Accounting for Transfers and Servicing of Financial

Assets and Extinguishments of Liabilities") to the Company for performing the servicing. Residual Interests are recorded in Other assets and classified as trading and reflected at fair value with changes in fair value recorded currently in earnings. At February 28, 2005, the Company had $9.8 billion of retained interests, including $6.7 billion of undivided seller's interests, in credit card asset securitizations. The retained interests are subject to credit, payment and interest rate risks on the transferred credit card assets. The investors and the securitization trusts have no recourse to the Company's other assets for failure of cardmembers to pay when due.

During the quarters ended February 28, 2005 and February 29, 2004, the Company completed credit card asset securitizations of $3.4 billion and $1.9 billion, respectively, and recognized net securitization gains of $32 million and $19 million, respectively, as servicing fees in the condensed consolidated statements of income. The uncollected balances of securitized general purpose credit card loans were $28.9 billion and $28.5 billion at February 28, 2005 and November 30, 2004, respectively.

Key economic assumptions used in measuring the Residual Interests at the date of securitization resulting from credit card asset securitizations completed during the quarters ended February 28, 2005 and February 29, 2004 were as follows:

	Three Months Ended	
	February 28, 2005	February 29, 2004
Weighted average life (in months)	5.9	6.1
Payment rate (rate per month)	18.52%	18.00%
Credit losses (rate per annum)	6.00%	6.90%
Discount rate (rate per annum)	12.00%	14.00%

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

	At February 28, 2005
Residual Interests (carrying amount/fair value)	$ 281
Weighted average life (in months)	5.3
Weighted average payment rate (rate per month)	19.39%
Impact on fair value of 10% adverse change	$ (19)
Impact on fair value of 20% adverse change	$ (36)
Weighted average credit losses (rate per annum)	5.68%
Impact on fair value of 10% adverse change	$ (60)
Impact on fair value of 20% adverse change	$ (121)
Weighted average discount rate (rate per annum)	11.00%
Impact on fair value of 10% adverse change	$ (2)
Impact on fair value of 20% adverse change	$ (4)

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

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

	Three Months Ended	
	February 28, 2005	February 29, 2004
Proceeds from new credit card asset securitizations	$ 3.4	$ 1.9
Proceeds from collections reinvested in previous credit card asset securitizations	$14.5	$16.4
Contractual servicing fees received	$ 0.1	$ 0.2
Cash flows received from retained interests	$ 0.5	$ 0.4

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

	At February 28, 2005		Three Months Ended February 28, 2005	
	Loans Outstanding	Loans Delinquent	Average Loans	Net Principal Credit Losses
Managed general purpose credit card loans	$47,770	$2,023	$48,930	$625
Less: Securitized general purpose credit card loans	28,862			
Owned general purpose credit card loans	$18,908			

5. Long-Term Borrowings.

Long-term borrowings at February 28, 2005 scheduled to mature within one year aggregated $10,681 million.

During the quarter ended February 28, 2005, the Company issued senior notes aggregating $12,480 million, including non-U.S. dollar currency notes aggregating $2,725 million. The Company has entered into certain transactions to obtain floating interest rates based primarily on short-term London Interbank Offered Rates trading levels. Maturities in the aggregate of these notes by fiscal year are as follows: 2005, $3 million; 2006, $1,579 million; 2007, $1,304 million; 2008, $3,393 million; 2009, $639 million; and thereafter, $5,562 million. In the quarter ended February 28, 2005, $3,344 million of senior notes were repaid.

The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 5 years at February 28, 2005.

6. Capital Units.

The Company has Capital Units outstanding that were issued by the Company and Morgan Stanley Finance plc ("MSF"), a U.K. subsidiary. A Capital Unit consists of (a) a Subordinated Debenture of MSF guaranteed by the Company and maturing in 2017 and (b) a related Purchase Contract issued by the Company, which may be accelerated by the Company, requiring the holder to purchase one Depositary Share representing shares of the Company's Cumulative Preferred Stock. The aggregate amount of Capital Units outstanding was $66 million at both February 28, 2005 and November 30, 2004.

7. Common Stock and Shareholders' Equity.

Regulatory Requirements. MS&Co. and MSDWI are registered broker-dealers and registered futures commission merchants and, accordingly, are subject to the minimum net capital requirements of the SEC, the NYSE and the Commodity Futures Trading Commission. MS&Co. and MSDWI have consistently operated in excess of these requirements. MS&Co.'s net capital totaled $2,703 million at February 28, 2005, which exceeded the amount required by $1,847 million. MSDWI's net capital totaled $1,140 million at February 28, 2005, which exceeded the amount required by $1,051 million. MSIL, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJL, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIL and MSJL have consistently operated in excess of their respective regulatory capital requirements.

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation (the "FDIC") and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1 capital, as defined, to average assets ("leverage ratio"), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets ("Tier 1 risk-weighted capital ratio") and (c) 8% of total capital, as defined, to risk-weighted assets ("total risk-weighted capital ratio"). At February 28, 2005, the leverage ratio, Tier 1 risk-weighted capital ratio and total risk-weighted capital ratio of each of the Company's FDIC-insured financial institutions exceeded these regulatory minimums.

Certain other U.S. and non-U.S. subsidiaries are subject to various securities, commodities and banking regulations, and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. These subsidiaries have consistently operated in excess of their local capital adequacy requirements. Morgan Stanley Derivative Products Inc., the Company's triple-A rated derivative products subsidiary, maintains certain operating restrictions that have been reviewed by various rating agencies.

Treasury Shares. During the quarter ended February 28, 2005, the Company purchased approximately $1,372 million of its common stock through a combination of open market purchases and employee purchases at an average cost of $56.02 per share. During the quarter ended February 29, 2004, the Company did not purchase any of its common stock.

8. Earnings per Share.

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

	Three Months Ended	
	February 28, 2005	February 29, 2004
Basic EPS:		
Income from continuing operations before cumulative effect of accounting change	$1,345	$1,224
Income on discontinued operations	8	2
Cumulative effect of accounting change	49	—
Net income applicable to common shareholders	$1,402	$1,226
Weighted average common shares outstanding	1,069	1,079
Basic earnings per common share:		
Income from continuing operations before cumulative effect of accounting change	$ 1.25	$ 1.14
Income on discontinued operations	0.01	—
Cumulative effect of accounting change	0.05	—
Basic EPS	$ 1.31	$ 1.14
Diluted EPS:		
Net income applicable to common shareholders	$1,402	$1,226
Weighted average common shares outstanding	1,069	1,079
Effect of dilutive securities:		
Stock options	21	27
Weighted average common shares outstanding and common stock equivalents	1,090	1,106
Diluted earnings per common share:		
Income from continuing operations before cumulative effect of accounting change	$ 1.23	$ 1.11
Income on discontinued operations	0.01	—
Cumulative effect of accounting change	0.05	—
Diluted EPS	$ 1.29	$ 1.11

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

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(shares in millions)	
Number of antidilutive securities (including stock options and restricted stock units) outstanding at end of period	112	70

Cash dividends declared per common share were $0.27 and $0.25 for the three months ended February 28, 2005 and February 29, 2004, respectively.

9. Commitments and Contingencies.

Letters of Credit. At February 28, 2005 and November 30, 2004, the Company had approximately $8.9 billion and $8.5 billion, respectively, of letters of credit outstanding to satisfy various collateral requirements.

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

The aggregate amount of the investment grade and non-investment grade lending commitments are shown below:

	At February 28, 2005	At November 30, 2004
	(dollars in millions)	
Investment grade lending commitments	$18,716	$18,989
Non-investment grade lending commitments	1,965	1,409
Total	$20,681	$20,398

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

The Company has commitments to fund other less liquid investments, including at February 28, 2005, $157 million in connection with principal investment and private equity activities. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit to clients that may subject the Company to increased credit and liquidity risks.

At February 28, 2005, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately $80 billion and $63 billion, respectively.

Legal. In addition to the matters described in the Form 10-K, in the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress. The Company is also involved, from time to time, in other reviews, investigations and proceedings by governmental and self-regulatory agencies (both formal and informal) regarding the Company's business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. The number of these investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

The Company contests liability and/or the amount of damages in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, and except as described in the paragraph below, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of each such pending matter will not have a material adverse effect on the condensed consolidated financial condition of the Company, although the outcome could be material to the Company's or a business segment's operating results for a particular future period, depending on, among other things, the level of the Company's or a business segment's income for such period.

The outcome of the litigation captioned *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.*, which began trial in April 2005 in state court in Palm Beach County, Florida, could have a material adverse effect on the condensed consolidated financial condition of the Company and/or the Company's or a business segment's operating results for a particular future period. The litigation stems from the March 1998 sale by Coleman (Parent) Holdings, Inc. ("CPH") to Sunbeam Corporation of CPH's 82% interest in The Coleman Company. As part of the consideration for the sale, CPH received shares of Sunbeam stock, as well as cash and the assumption of debt. Sunbeam subsequently filed for bankruptcy after the revelation of alleged fraudulent accounting practices on the part of Sunbeam and its auditors, Arthur Andersen. CPH's amended complaint alleges that the Company, as Sunbeam's financial adviser, conspired with Sunbeam and aided and abetted Sunbeam's fraud. On March 23, 2005, the court ordered that portions of the amended complaint, which set forth the primary allegations of CPH against MS&Co, be read at trial to the jury and that the jury be instructed that those allegations are deemed established for all purposes of the action. The court also ordered that a statement summarizing the court's findings with respect to MS&Co. discovery misconduct be read to the jury and that the jury be instructed that it may consider that statement in determining whether an award of punitive damages is appropriate. While the amount of a final award, if any, cannot be determined and could exceed CPH's current damages claim, CPH currently seeks compensatory damages of approximately $680 million, punitive damages of approximately $2.0 billion, attorneys' fees and other relief, including prejudgment interest. The Company has established legal reserves of $360 million (included within Other expenses) in relation to this matter. The Company believes that, in the event of an adverse verdict, MS&Co. has grounds for appeal, which MS&Co. would pursue.

Legal reserves have been established in accordance with SFAS No. 5, "Accounting for Contingencies." Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

10. Derivative Contracts.

In the normal course of business, the Company enters into a variety of derivative contracts related to financial instruments and commodities. The Company uses these instruments for trading and investment purposes, as well as for asset and liability management (see Note 1). These instruments generally represent future commitments to swap interest payment streams, exchange currencies or purchase or sell other financial instruments on specific terms at specified future dates. Many of these products have maturities that do not extend beyond one year, although swaps and options and warrants on equities typically have longer maturities. For further discussion of these matters, refer to Note 11 to the consolidated financial statements for the fiscal year ended November 30, 2004, included in the Form 10-K.

The fair value (carrying amount) of derivative instruments represents the amount at which the derivative could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale, and is further described in Note 1. Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts ultimately may result in cash settlements exceeding fair value amounts recognized in the condensed consolidated statements of financial condition. The amounts in the following table represent unrealized gains and losses on exchange traded and OTC options and other contracts (including interest rate, foreign exchange, and other forward contracts and swaps) for derivatives for trading and investment and for asset and liability management, net of offsetting positions in situations where netting is appropriate. The asset amounts are not reported net of non-cash collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses.

Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary. The Company believes the ultimate settlement of the transactions outstanding at February 28, 2005 will not have a material effect on the Company's financial condition.

The Company's derivatives (both listed and OTC) at February 28, 2005 and November 30, 2004 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

	February 28, 2005(1)		At November 30, 2004(1)	
	Assets	Liabilities	Assets	Liabilities
	(dollars in millions)			
Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	$22,006	$15,988	$22,998	$18,797
Foreign exchange forward contracts and options	5,442	5,882	9,285	8,668
Equity securities contracts (including equity swaps, warrants and options)	6,151	7,940	5,898	7,373
Commodity forwards, options and swaps	9,402	7,579	11,294	8,702
Total	$43,001	$37,389	$49,475	$43,540

(1) Effective December 1, 2004 the Company has elected to net cash collateral paid or received against its derivatives inventory under credit support annexes. See Note 1.

11. Segment Information.

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

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

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

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

Three Months Ended February 28, 2005	Institutional Securities	Individual Investor Group	Investment Management	Credit Services	Intersegment Eliminations	Total
			(dollars in millions)			
Net revenues excluding net interest	$3,173	$1,163	$695	$701	$ (69)	$5,663
Net interest	812	75	1	295	—	1,183
Net revenues	$3,985	$1,238	$696	$996	$ (69)	$6,846
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	$1,045	$ 353	$287	$380	$ 24	$2,089
Losses from unconsolidated investees	73	—	—	—	—	73
Income from continuing operations before taxes and cumulative effect of accounting change, net(1)(2)	$ 972	$ 353	$287	$380	$ 24	$2,016

Three Months Ended February 29, 2004(3)	Institutional Securities	Individual Investor Group	Investment Management	Credit Services	Intersegment Eliminations	Total
			(dollars in millions)			
Net revenues excluding net interest	$ 3,060	$ 1,151	$ 642	$ 652	$ (74)	$ 5,431
Net interest	444	60	—	306	—	810
Net revenues	$ 3,504	$ 1,211	$ 642	$ 958	$ (74)	$ 6,241
Income from continuing operations before losses from unconsolidated investees, income taxes and dividends on preferred securities subject to mandatory redemption	$ 1,183	$ 166	$ 170	$ 365	$ 29	$ 1,913
Losses from unconsolidated investees	93	—	—	—	—	93
Dividends on preferred securities subject to mandatory redemption	45	—	—	—	—	45
Income from continuing operations before taxes(1)	$ 1,045	$ 166	$ 170	$ 365	$ 29	$ 1,775

Total Assets(4)	Institutional Securities	Individual Investor Group	Investment Management	Credit Services	Intersegment Eliminations	Total
			(dollars in millions)			
At February 28, 2005	$755,592	$18,418	$3,897	$24,492	$(189)	$802,210
At November 30, 2004(3)	$698,743	$17,839	$3,759	$25,385	$(213)	$745,513

(1) See Note 17 for a discussion of discontinued operations.
(2) See Note 1 for a discussion of the cumulative effect of accounting change, net.
(3) Certain reclassifications have been made to prior-period amounts to conform to the current year's presentation.
(4) Corporate assets have been fully allocated to the Company's business segments.

12. Variable Interest Entities.

In January 2003, the FASB issued FIN 46, which clarified the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties ("variable interest entities"). Variable interest entities ("VIE") are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. Under FIN 46, the primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests. FIN 46 also requires disclosures about VIEs. In December 2003, the FASB issued a revision of FIN 46 to address certain technical corrections and implementation issues.

The Company is involved with various entities in the normal course of business that may be deemed to be VIEs and may hold interests therein, including debt securities, interest-only strip investments and derivative instruments that may be considered variable interests. Transactions associated with these entities include asset- and mortgage-backed securitizations and structured financings (including collateralized debt, bond or loan obligations and credit-linked notes). The Company engages in these transactions principally to facilitate client needs and as a means of selling financial assets. The Company consolidates entities in which it has a controlling financial interest in accordance with accounting principles generally accepted in the U.S. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), which includes the credit card asset securitization master trusts (see Note 4), the Company does not consolidate the entity.

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

Institutional Securities. At February 28, 2005, in connection with its Institutional Securities business, the aggregate size of VIEs, including financial asset-backed securitization, collateralized debt obligation, credit-linked note, structured note, municipal bond trust, loan issuing, commodities monetization, equity-linked note and exchangeable trust entities, for which the Company was the primary beneficiary of the entities was approximately $4.7 billion, which is the carrying amount of the consolidated assets recorded as Financial instruments owned that are collateral for the entities' obligations. The nature and purpose of these entities that the Company consolidated were to issue a series of notes to investors that provide the investors a return based on the holdings of the entities. These transactions were executed to facilitate client investment objectives. The structured note, equity-linked note, certain credit-linked note, certain financial asset-backed securitization and municipal bond transactions also were executed as a means of selling financial assets. The Company holds either the entire class or a majority of the class of subordinated notes or entered into a derivative instrument with the VIE, which bears the majority of the expected losses or receives a majority of the expected residual returns of the entities. The Company consolidates these entities, in accordance with its consolidation accounting policy, and as a result eliminates all intercompany transactions, including derivatives and other intercompany transactions such as fees received to underwrite the notes or to structure the transactions. The Company accounts for the assets held by the entities as Financial instruments owned and the liabilities of the entities as financings. For those liabilities that include an embedded derivative, the Company has bifurcated such derivative in accordance with SFAS No. 133, as amended. The beneficial interests of these consolidated entities are payable solely from the cash flows of the assets held by the VIE.

At February 28, 2005, also in connection with its Institutional Securities business, the aggregate size of the entities for which the Company holds significant variable interests, which consist of subordinated and other classes of beneficial interests, derivative instruments, limited partnership investments and secondary guarantees, was approximately $27.3 billion. The Company's variable interests associated with these entities, primarily credit-linked note, structured note, loan and bond issuing, collateralized debt obligation, financial asset-backed securitization, mortgage-backed securitization and tax credit limited liability entities, including investments in affordable housing tax credit funds and underlying synthetic fuel production plants, were approximately $11.3 billion consisting primarily of senior beneficial interests, which represent the Company's maximum exposure to loss at February 28, 2005. The Company may hedge the risks inherent in its variable interest holdings, thereby reducing its exposure to loss. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company utilizes to hedge these risks.

13. Guarantees.

FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," requires the Company to disclose information about its obligations under certain guarantee arrangements. FIN 45 defines guarantees as contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or non-occurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. FIN 45 also defines guarantees as contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement as well as indirect guarantees of the indebtedness of others.

Derivative Contracts. Under FIN 45, certain derivative contracts meet the accounting definition of a guarantee, including certain written options, contingent forward contracts and credit default swaps. Although the Company's derivative arrangements do not specifically identify whether the derivative counterparty retains the underlying asset, liability or equity security, the Company has disclosed information regarding all derivative contracts that could meet the FIN 45 definition of a guarantee. The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

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

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

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

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

The table below summarizes certain information regarding these guarantees at February 28, 2005:

	Maximum Potential Payout/Notional						
	Years to Maturity						
Type of Guarantee	**Less than 1**	**1-3**	**3-5**	**Over 5**	**Total**	**Carrying Amount**	**Collateral/ Recourse**
	(dollars in millions)						
Derivative contracts	$432,465	$331,975	$299,229	$303,765	$1,367,434	$14,461	$119
Standby letters of credit and other financial guarantees	540	247	100	41	928	8	159
Market value guarantees	13	37	237	593	880	50	63
Liquidity facilities	1,289	489	49	126	1,953	—	—

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

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

General Partner Guarantees. As a general partner in certain private equity and real estate partnerships, the Company receives distributions from the partnerships according to the provisions of the partnership agreements. The Company may, from time to time, be required to return all or a portion of such distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in various partnership agreements, subject to certain limitations. The maximum potential amount of future payments that the Company could be required to make under these provisions at February 28, 2005 and November 30, 2004 was $286 million and $265 million, respectively. As of February 28, 2005 and November 30, 2004, the Company's accrued liability for distributions that the Company has determined it is probable it will be required to refund based on the applicable refund criteria specified in the various partnership agreements was $70 million and $68 million, respectively.

Securitized Asset Guarantees. As part of the Company's Institutional Securities and Credit Services securitization activities, the Company provides representations and warranties that certain securitized assets conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met, and to the extent the Company has acquired such assets to be securitized from other parties, the Company seeks to obtain its own representations and warranties regarding the assets. The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. Also, in connection with originations of residential mortgage loans under the Company's FlexSource® program, the Company may permit borrowers to pledge marketable securities as collateral instead of requiring cash down payments for the purchase of the underlying residential property. Upon sale of the residential mortgage loans, the Company may provide a surety bond that reimburses the purchasers for shortfalls in the borrowers' securities accounts up to certain limits if the collateral maintained in the securities accounts (along with the associated real estate collateral) is insufficient to cover losses that purchasers experience as a result of defaults by borrowers on the underlying residential mortgage loans. The Company requires the borrowers to meet daily collateral calls to ensure the marketable securities pledged in lieu of a cash down payment are sufficient. At February 28, 2005 and November 30, 2004, the maximum potential amount of future payments the Company may be required to make under its surety bond was $201 million and $198 million, respectively. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these representations and warranties and reimbursement agreements and believes that the probability of any payments under these arrangements is remote.

Merchant Chargeback Guarantees. In connection with its Credit Services business, the Company owns and operates merchant processing services in the U.S. related to its general purpose credit cards. As a merchant processor in the U.S. and an issuer of credit cards in the U.K., the Company is contingently liable for processed credit card sales transactions in the event of a dispute between the cardmember and a merchant. If a dispute is resolved in the cardmember's favor, the Company will credit or refund the amount to the cardmember and charge back the transaction to the merchant. If the Company is unable to collect the amount from the merchant, the Company will bear the loss for the amount credited or refunded to the cardmember. In most instances, a payment requirement by the Company is unlikely to arise because most products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion. However, where the product or service is not provided until some later date following the purchase, the likelihood of payment by the Company increases. The maximum potential amount of future payments related to this contingent liability is estimated to be the total cardmember sales transaction volume to date that could qualify as a valid disputed transaction under the Company's merchant processing network and cardmember agreements; however, the Company believes that this amount is not representative of the Company's actual potential loss exposure based on the Company's historical experience. This amount cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees during the quarters ended February 28, 2005 and February 29, 2004:

	Three Months Ended	
	February 28, 2005	**February 29, 2004**
Losses related to merchant chargebacks (dollars in millions)	$ 2	$ 1
Aggregate credit card transaction volume (dollars in billions)	25.9	24.2

The amount of the liability related to the Company's credit cardmember merchant guarantee was not material at February 28, 2005. The Company mitigates this risk by withholding settlement from merchants or obtaining escrow deposits from certain merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services. The table below provides information regarding the settlement withholdings and escrow deposits:

	At February 28, 2005	At November 30, 2004
	(dollars in millions)	
Settlement withholdings and escrow deposits	$58	$53

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

14. Investments in Unconsolidated Investees.

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

In the quarters ended February 28, 2005 and February 29, 2004, the losses from unconsolidated investees were more than offset by the respective tax credits and tax benefits on the losses. The table below provides information regarding the losses from unconsolidated investees, tax credits and tax benefits on the losses:

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Losses from unconsolidated investees	$73	$ 93
Tax credits	78	104
Tax benefits on losses	29	31

IRS field auditors are contesting the placed-in-service date of several synthetic fuel facilities owned by one of the Company's unconsolidated investees (the "LLC"). To qualify for the tax credits under Section 29 of the Internal Revenue Code, the production facility must have been placed in service before July 1, 1998. The LLC is vigorously contesting the IRS proposed position. If the IRS ultimately prevails, it could have an adverse effect on the Company's tax liability or results of operations. The Company has recognized cumulative tax credits of approximately $110 million associated with the LLC's synthetic fuel facilities.

15. Employee Benefit Plans.

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

The components of the Company's net periodic benefit expense were as follows:

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Service cost, benefits earned during the period	$ 33	$ 28
Interest cost on projected benefit obligation	35	33
Expected return on plan assets	(32)	(32)
Net amortization and other	9	6
Net periodic benefit expense	$ 45	$ 35

16. Aircraft under Operating Leases.

In accordance with SFAS No. 144, the Company's aircraft are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an aircraft may not be recoverable. During the second quarter of fiscal 2004, the Company evaluated various financing strategies for its aircraft financing business. As part of that evaluation and to determine the potential debt ratings associated with the financing strategies, the Company commissioned appraisals of the aircraft portfolio from three independent aircraft appraisal firms. The appraisals indicated a decrease in the aircraft portfolio average market value of 12% from the appraisals obtained at the date of the prior impairment charge (May 31, 2003). In accordance with SFAS No. 144, the Company considered the decline in appraisal values a significant decrease in the market price of its aircraft portfolio and thus a trigger event to test for impairment in the carrying value of its aircraft.

In accordance with SFAS No. 144, the Company tested each of its aircraft for impairment by comparing each aircraft's projected undiscounted cash flows with its respective carrying value. For those aircraft for which impairment was indicated (because the projected undiscounted cash flows were less than the carrying value), the Company adjusted the carrying value of each aircraft to its fair value if lower than the carrying value. To determine each aircraft's fair value, the Company used the market value appraisals provided by independent appraisers (BK Associates, Inc., Morten Beyer & Agnew, Inc. and Airclaims Limited). As a result of this review, the Company recorded a non-cash pre-tax asset impairment charge of $109 million (of which $2 million is included in loss from discontinued operations) in the second quarter of fiscal 2004 based on the average of the market value appraisals provided by the three independent appraisers. The impairment charge was primarily concentrated in two particular types of aircraft, the MD-83 and A300-600R, which contributed approximately $85 million of the total $109 million charge. The decrease in the projected undiscounted cash flows and the significant decline in the appraisal values for these aircraft reflects, among other things, a very small operator base and therefore limited opportunities to lease such aircraft.

If the Company liquidated its aircraft portfolio ($3.8 billion carrying value at February 28, 2005) at this time, which is not currently contemplated, the Company believes that, based upon the range of values provided by independent appraisers, the Company would realize a value for its entire fleet that is substantially lower than the carrying value of the fleet. The most recent (May 2004) portfolio appraisal market values, based on the above three appraisals, range from a high of $3.6 billion to a low of $2.6 billion with an average of $3.0 billion. The Company has not recorded an impairment charge for the entire difference between the carrying value and the appraisal values because there was no indication of impairment for the majority of the individual aircraft as their projected undiscounted cash flows exceeded their respective carrying values.

17. Discontinued Operations.

During fiscal 2004, the Company entered into agreements for the sale of certain aircraft and, accordingly, such aircraft had been designated as "held for sale" in accordance with SFAS No. 144. The revenues and expenses associated with these aircraft have been classified as discontinued operations for all periods presented. As of February 3, 2005, all of these aircraft were sold.

The Company recorded pre-tax income on discontinued operations of $13 million and $3 million for the three months ended February 28, 2005 and February 29, 2004, respectively.

18. Business Acquisition and Sale.

On January 12, 2005, the Company completed the acquisition of PULSE, a U.S.-based automated teller machine/debit network currently serving banks, credit unions and savings institutions. As of the date of acquisition, the results of PULSE are included within the Credit Services business segment. The acquisition price was approximately $311 million, of which $280 million was paid in cash during the quarter. The Company recorded goodwill and other intangible assets of $321 million in connection with the acquisition.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition. The allocation of the purchase price is subject to refinement.

	At January 12, 2005
	(dollars in millions)
Cash and cash equivalents	$ 1
Receivables	22
Office facilities	14
Other assets	14
Amortizable intangible assets	91
Goodwill	230
Total assets acquired	372
Total liabilities assumed	61
Net assets acquired	$311

The $91 million of acquired amortizable intangible assets include customer relationships of $88 million (19-year estimated useful life) and trademarks of $3 million (25-year estimated useful life).

Amortization expense associated with intangible assets acquired in connection with the acquisition of PULSE is estimated to be approximately $6 million per year over the next five fiscal years.

In February 2005, the Company sold its 50% interest in POSIT, an equity crossing system that matches institutional buyers and sellers, to Investment Technology Group, Inc. The Company acquired the POSIT interest as part of its acquisition of Barra, Inc. in June 2004. As a result of the sale, the net carrying amount of intangible assets decreased by approximately $75 million (see Note 2).

19. Income Tax Examinations.

The Company is under continuous examination by the Internal Revenue Service (the "IRS") and other tax authorities in certain countries, such as Japan and the United Kingdom, and states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1994-1998. The Company currently expects this IRS examination to be substantially completed in fiscal 2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations. Tax reserves have been established, which the Company believes to be adequate in relation to the potential for additional assessments. Once established, reserves are adjusted only when there is more information available or when an event occurs necessitating a change to the reserves. The resolution of tax matters will not have a material effect on the condensed consolidated financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statement of income for a particular future period and on the Company's effective tax rate.

20. Insurance Settlement.

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

In the first quarter of fiscal 2005, the Company settled its claim with its insurance carriers related to the events of September 11, 2001. The Company recorded a pre-tax gain of $251 million as the insurance recovery was in excess of previously recognized costs related to the terrorist attacks (primarily write-offs of leasehold improvements and destroyed technology and telecommunications equipment in the World Trade Center complex, employee relocation and certain other employee-related expenditures, and other business recovery costs).

The pre-tax gain, which was recorded as a reduction to non-interest expenses, is included within the Individual Investor Group ($198 million), Investment Management ($43 million) and Institutional Securities ($10 million) segments. The insurance settlement was allocated to the respective segments in accordance with the relative damages sustained by each segment.

21. Lease Adjustment.

Prior to the first quarter of fiscal 2005, the Company was not recording the effects of scheduled rent increases and rent-free periods for certain real estate leases on a straight-line basis. In addition, the Company had been accounting for certain tenant improvement allowances as reductions to the related leasehold improvements instead of recording funds received as deferred rent and amortizing them as reductions to lease expense over the lease term. In the first quarter of fiscal 2005, the Company changed its method of accounting for these rent escalation clauses, rent-free periods and tenant improvement allowances to properly reflect lease expense over the lease term on a straight-line basis. The cumulative effect of this correction resulted in the Company recording $109 million of additional rent expense in the first quarter of fiscal 2005. The impact of this change was included within non-interest expenses and reduced income before taxes within the Institutional Securities ($71 million), Individual Investor Group ($29 million), Investment Management ($5 million) and Credit Services ($4 million) segments. The impact of this correction to the current period and prior periods was not material to the pre-tax income of each of the segments or to the Company.

22. Subsequent Event.

On April 4, 2005, the Company announced that its board of directors has authorized management to pursue a spin-off of Discover Financial Services. Management's recommendations are to be reported to the board for final determination. This decision is designed to maximize shareholder value in the Discover Card division, and allow management of that business to capitalize on the momentum both in performance and in the opportunities opening up in the payments market, and to further intensify the Company's focus on the high return growth opportunities within its integrated securities businesses.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries ("Morgan Stanley") as of February 28, 2005, and the related condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended February 28, 2005 and February 29, 2004. These interim financial statements are the responsibility of the management of Morgan Stanley.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of Morgan Stanley and subsidiaries as of November 30, 2004, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for the fiscal year then ended (not presented herein) included in Morgan Stanley's Annual Report on Form 10-K for the fiscal year ended November 30, 2004; and, in our report dated February 7, 2005, (which report contains an explanatory paragraph relating to the adoption of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123," in 2003), we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2004 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

As discussed in Note 1 to the condensed consolidated interim financial statements, effective December 1, 2004, Morgan Stanley adopted SFAS No. 123R, "Share-based Payment."

/s/ DELOITTE & TOUCHE LLP

New York, New York
April 4, 2005

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

Introduction.

Morgan Stanley (the "Company") is a global financial services firm that maintains leading market positions in each of its business segments—Institutional Securities, Individual Investor Group, Investment Management and Credit Services. The Company's Institutional Securities business includes securities underwriting and distribution; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; sales, trading, financing and market-making activities in equity securities and related products and fixed income securities and related products, including foreign exchange and commodities; principal investing and real estate investment management; aircraft financing activities; providing benchmark indices and risk management analytics; and research. The Company's Individual Investor Group business provides comprehensive brokerage, investment and financial services designed to accommodate individual investment goals and risk profiles. The Company's Investment Management business provides global asset management products and services for individual and institutional investors through three principal distribution channels: a proprietary channel consisting of the Company's representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; and the Company's institutional channel. The Company's Credit Services business offers Discover®-branded cards and other consumer finance products and services, including residential mortgage loans, and includes the operations of Discover Network, a network of merchant and cash access locations based predominantly in the U.S., and PULSE EFT Association, Inc. ("PULSE®"), a U.S.-based automated teller machine/debit network. Morgan Stanley-branded credit cards and personal loan products that are offered in the U.K. are also included in the Credit Services business segment. The Company provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

On April 4, 2005, the Company announced that its board of directors has authorized management to pursue a spin-off of Discover Financial Services. Management's recommendations are to be reported to the board for final determination. This decision is designed to maximize shareholder value in the Discover Card division, and allow management of that business to capitalize on the momentum both in performance and in the opportunities opening up in the payments market, and to further intensify the Company's focus on the high return growth opportunities within its integrated securities businesses.

The Company also previously announced that it will combine its Institutional Securities, Individual Investor Group and Investment Management businesses under co-presidents. The Company believes the re-organization will raise its operating leverage across these business units.

The discussion of the Company's results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company's future results, please see "Forward-Looking Statements" immediately preceding Part I, Item 1, "Competition" and "Regulation" in Part I, Item 1, "Certain Factors Affecting Results of Operations" under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 and other items throughout the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2004 (the "Form 10-K").

The Company's results of operations for the quarters ended February 28, 2005 and February 29, 2004 are discussed below.

Results of Operations.

Executive Summary.

Financial Information.

	Three Months Ended February 28, 2005	Three Months Ended February 29, 2004(1)
Net revenues (dollars in millions):		
Institutional Securities	$ 3,985	$ 3,504
Individual Investor Group	1,238	1,211
Investment Management	696	642
Credit Services	996	958
Intersegment Eliminations	(69)	(74)
Consolidated net revenues	$ 6,846	$ 6,241
Income before taxes(2) (dollars in millions):		
Institutional Securities	$ 1,045	$ 1,183
Individual Investor Group	353	166
Investment Management	287	170
Credit Services	380	365
Intersegment Eliminations	24	29
Consolidated income before taxes	$ 2,089	$ 1,913
Consolidated net income (dollars in millions)	$ 1,402	$ 1,226
Basic earnings per common share:		
Income from continuing operations before cumulative effect of accounting change, net	$ 1.25	$ 1.14
Income from discontinued operations	0.01	—
Cumulative effect of accounting change, net	0.05	—
Basic earnings per common share	$ 1.31	$ 1.14
Diluted earnings per common share:		
Income from continuing operations before cumulative effect of accounting change, net	$ 1.23	$ 1.11
Income from discontinued operations	0.01	—
Cumulative effect of accounting change, net	0.05	—
Diluted earnings per common share	$ 1.29	$ 1.11
Statistical Data.		
Book value per common share(3)	$ 25.83	$ 23.75
Return on average common equity	19.7%	19.2%
Effective income tax rate	33.5%	31.0%
Consolidated assets under management or supervision (dollars in billions):		
Equity	$ 272	$ 231
Fixed income	123	124
Money market	88	65
Other(4)	93	85
Total(5)	$ 576	$ 505
Worldwide employees	53,718	50,979

Statistical Data (Continued).

	Three Months Ended	
	February 28, 2005	February 29, 2004(1)
Institutional Securities:		
Mergers and acquisitions completed transactions (dollars in billions)(6):		
Global market volume	$ 29.3	$ 15.6
Market share	17.7%	12.8%
Rank	8	5
Mergers and acquisitions announced transactions (dollars in billions)(6):		
Global market volume	$ 109.5	$ 104.6
Market share	31.7%	31.8%
Rank	3	3
Global equity and equity-linked issues (dollars in billions)(6):		
Global market volume	$ 8.9	$ 12.2
Market share	13.0%	14.2%
Rank	2	1
Global debt issues (dollars in billions)(6):		
Global market volume	$ 67.3	$ 62.6
Market share	6.8%	6.5%
Rank	3	6
Pre-tax profit margin(7)	26%	33%
Individual Investor Group:		
Global representatives	10,471	10,832
Annualized net revenue per global representative (dollars in thousands)(8)	$ 462	$ 442
Total client assets (dollars in billions)	$ 618	$ 595
Fee-based assets as a percentage of total client assets	27%	24%
Pre-tax profit margin(7)	29%	14%
Investment Management:		
Assets under management or supervision (dollars in billions)	$ 427	$ 380
Percent of fund assets in top half of Lipper rankings(9)	79%	54 %
Pre-tax profit margin(7)	41%	27%
Pre-tax profit margin(7) (excluding private equity)	38%	29%
Credit Services (dollars in millions, unless otherwise noted)(10):		
Period-end credit card loans—Owned	$18,908	$15,850
Period-end credit card loans—Managed	$47,770	$47,336
Average credit card loans—Owned	$19,210	$17,880
Average credit card loans—Managed	$48,930	$48,667
Net principal charge-off rate—Owned	4.62%	5.81%
Net principal charge-off rate—Managed	5.11%	6.31%
Transaction volume (dollars in billions)	$ 25.9	$ 24.2
Pre-tax profit margin(7)	38%	38%

(1) Certain prior-period information has been reclassified to conform to the current year's presentation.
(2) Amounts represent income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption, discontinued operations and cumulative effect of accounting change, net.
(3) Book value per common share equals shareholders' equity of $28,495 million at February 28, 2005 and $26,064 million at February 29, 2004, divided by common shares outstanding of 1,103 million at February 28, 2005 and 1,098 million at February 29, 2004.
(4) Amounts include alternative investment vehicles.
(5) Revenues and expenses associated with these assets are included in the Company's Investment Management, Individual Investor Group and Institutional Securities segments.
(6) Source: Thomson Financial, data as of March 9, 2005—The data for the three months ended February 28, 2005 and February 29, 2004 are for the periods from January 1 to February 28, 2005 and January 1 to February 29, 2004, respectively, as Thomson Financial presents this data on a calendar-year basis.
(7) Percentages represent income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net as a percentage of net revenues.
(8) Annualized Individual Investor Group net revenues divided by average global representative headcount.
(9) Source: Lipper, one-year performance as of February 28, 2005 and February 29, 2004, respectively.
(10) Managed data include owned and securitized credit card loans. For an explanation of managed data and a reconciliation of credit card loan and asset quality data, see "Credit Services—Managed General Purpose Credit Card Loan Data" herein.

First Quarter 2005 Performance.

Company Results. The Company recorded net income of $1,402 million and diluted earnings per share of $1.29 for the quarter ended February 28, 2005, increases of 14% and 16%, respectively, from the comparable fiscal 2004 period. The quarter's results included a $49 million (after-tax) benefit from the cumulative effect of an accounting change for equity-based compensation resulting from the Company's adoption of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised) ("SFAS No. 123R"), "Share-Based Payment." Net revenues (total revenues less interest expense and the provision for loan losses) rose 10% from last year's first quarter to $6.8 billion and the return on average common equity was 19.7% compared with 19.2% in the first quarter of last year.

Non-interest expenses of $4.8 billion increased 10% from the prior year, including a $360 million charge related to the Coleman litigation matter (see "Legal Proceedings" in Part II, Item 1), as well as a cumulative $109 million expense as a result of a correction in the method of accounting for certain real estate leases (see "Lease Adjustment" herein). Non-interest expenses were reduced by $251 million resulting from the settlement of the Company's insurance claims related to the events of September 11, 2001 (see "Insurance Settlement" herein).

The Company's effective tax rate was 33.5% for the first quarter of fiscal 2005 versus 31.0% in the first quarter of fiscal 2004. The increase primarily reflects a combination of higher earnings and the geographic mix of these earnings. The increased earnings lowered the benefits from domestic tax credits and tax exempt income.

Institutional Securities. The Company's Institutional Securities business recorded income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of an accounting change, net of $1.0 billion, a 12% decrease from last year's first quarter. Net revenues rose 14% to $4.0 billion, driven by record fixed income sales and trading revenues and higher equity sales and trading revenues. The increase in net revenues was more than offset by higher non-interest expenses, which rose 27% to $2.9 billion and included $360 million in legal expenses related to the Coleman litigation matter and $71 million for the lease adjustment.

Advisory revenues rose 9% from last year's first quarter to $254 million, reflecting higher merger, acquisition and restructuring revenues across several sectors. Underwriting revenues decreased 4% from last year's first quarter to $488 million as lower equity underwriting revenues were partially offset by higher fixed income underwriting revenues.

Fixed income sales and trading net revenues were a record $2.0 billion, up 21% from a strong first quarter of fiscal 2004. The increase was broad-based, with strong performances from interest rate and currency products, credit products and commodities products. Interest rate and currency products benefited from new transaction activity, increased client flows and successful interest rate, foreign exchange and volatility trading in active markets. Credit products benefited from the continued tightening in global credit spreads, successful distressed credit trading and strong securitized products performance. The higher revenues in commodities were attributable to electricity and natural gas activities. Equity sales and trading net revenues were $1.2 billion, a 10% increase from a year ago and the highest since the second quarter of fiscal 2001. Record revenues in the Company's prime brokerage business contributed to the increase. Despite lower volatilities, higher revenues were also achieved from derivatives products, largely due to strong customer flows.

Individual Investor Group. The Individual Investor Group recorded pre-tax income of $353 million, a 113% increase from the first quarter of fiscal 2004, largely driven by a reduction in non-interest expenses resulting from its allocation of $198 million of the Company's insurance settlement, which more than offset its lease adjustment charge of $29 million. Net revenues increased from a year ago and reached their highest level in nearly four years. Net revenues were $1.2 billion, a 2% increase from last year's first quarter, reflecting higher asset management, distribution and administration fees as client assets in fee-based accounts increased. Total client assets were $618 billion, up 4% from a year ago. In addition, client assets in fee-based accounts rose 16%

to $166 billion at February 28, 2005 and increased as a percentage of total client assets to 27% from 24% in the prior year period. At quarter-end, the number of global representatives was 10,471, a decrease of 361 over the past year, largely driven by the restructuring of the Company's training program that caused a lag in hiring, and consequently, a decline in graduating trainees this quarter.

Investment Management. Investment Management recorded pre-tax income of $287 million, a 69% increase from last year's first quarter. The increase reflected an 8% increase in net revenues to $696 million driven by higher investment gains. Non-interest expenses fell 13% to $409 million, largely due to a reduction of $43 million from its allocation of the Company's insurance settlement and lower legal and regulatory costs. Assets under management within Investment Management were $427 billion, up $47 billion, or 12%, from the first quarter of last year. The increase resulted from both market appreciation and positive net flows. Higher asset management and administration fees, driven by the increase in assets under management, were offset by a decline in performance and distribution fees. Investment gains for the quarter were $64 million, up from $9 million a year ago. The increase was primarily related to net gains on certain investments in the Company's private equity portfolio, including Triana Energy Holdings, LLC ("Triana").

Credit Services. Credit Services pre-tax income was a record $380 million, an increase of 4% from the first quarter of fiscal 2004. The increase in earnings was driven by a lower provision for consumer loan losses, reflecting lower charge-offs coupled with a $90 million reduction in the allowance for consumer loan losses, which more than offset lower merchant, cardmember and other fees. Non-interest expenses were 4% higher than a year ago as higher compensation expense was partially offset by lower other expenses. The managed credit card net charge-off rate for the first quarter decreased 120 basis points from a year ago to 5.11%, benefiting from the Company's credit quality and collection initiatives and an industry-wide improvement in credit quality. The managed over 30-day delinquency rate for the first quarter decreased 156 basis points from a year ago to 4.24%, and the managed over 90-day delinquency rate was 81 basis points lower than a year ago at 2.05%. Managed credit card loans were $47.8 billion at quarter-end, an increase of 1% from a year ago. The Company completed its acquisition of PULSE during the quarter.

Business Outlook.

Entering the second quarter of fiscal 2005, global economic and market conditions were generally favorable, although investors remain concerned about the pace of global economic growth, corporate profits, investor and consumer confidence levels, higher oil prices, inflation, a record U.S. federal budget deficit and high levels of geopolitical risk.

Global Market and Economic Conditions in the Quarter Ended February 28, 2005.

The generally favorable global economic conditions that existed throughout most of fiscal 2004 continued into the first quarter of fiscal 2005, driven particularly by the U.S. and China, although the pace of expansion diminished.

In the U.S., the economy continued to benefit from accommodative fiscal and monetary policies, supported by productivity gains. Corporate earnings were generally strong, consumer spending rose and the U.S. unemployment rate remained at 5.4%. The equity markets lacked direction during the first quarter of fiscal 2005, as the positive economic developments and earnings outlook were offset by concerns over higher energy prices and a growing U.S. federal budget deficit. In response to indications of increasing inflationary pressures, the Federal Reserve Board (the "Fed") raised both the overnight lending rate and the discount rate on two separate occasions by an aggregate of 0.50%. Subsequent to quarter-end, the Fed raised both the overnight lending rate and the discount rate by an additional 0.25%.

In Europe, economic growth remained sluggish, and although inflation remained stable, consistently higher oil prices had a considerable impact on growth. The European Central Bank (the "ECB") left the benchmark interest rate unchanged during the first quarter of fiscal 2005. The ECB remains concerned about inflation and the strength of the euro relative to the U.S. dollar and its negative impact on export demand. In the U.K., economic growth was moderate, while there were some indications of a slowdown in the housing market and growth in consumer consumption was mixed. During the first quarter of fiscal 2005, the Bank of England left the benchmark interest rate unchanged.

In Japan, the economic recovery stalled, as growth in the level of exports and industrial production showed signs of abating. In addition, the rising value of the Japanese yen against the U.S. dollar and higher oil prices diminished demand for exports. In China, economic growth remained rapid although the pace of expansion moderated. Economies elsewhere in Asia also generally improved.

Business Segments.

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

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Investment Management to the Individual Investor Group associated with sales of certain products and the related compensation costs paid to Individual Investor Group's global representatives. Income before taxes recorded in Intersegment Eliminations was $24 million in the quarter ended February 28, 2005 and $29 million in the quarter ended February 29, 2004.

Certain reclassifications have been made to prior-period segment amounts to conform to the current year's presentation.

INSTITUTIONAL SECURITIES

INCOME STATEMENT INFORMATION

	Three Months Ended February 28, 2005	Three Months Ended February 29, 2004
	(dollars in millions)	
Revenues:		
Investment banking	$ 742	$ 739
Principal transactions:		
Trading	1,730	1,691
Investments	55	16
Commissions	503	505
Asset management, distribution and administration fees	34	34
Interest and dividends	5,265	3,225
Other	109	75
Total revenues	8,438	6,285
Interest expense	4,453	2,781
Net revenues	3,985	3,504
Total non-interest expenses	2,940	2,321
Income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change, net	1,045	1,183
Losses from unconsolidated investees	73	93
Dividends on preferred securities subject to mandatory redemption	—	45
Income from continuing operations before income taxes and cumulative effect of accounting change, net	$ 972	$1,045

Investment Banking. Investment banking revenues for the quarter were relatively unchanged from the comparable period of fiscal 2004. Advisory fees from merger, acquisition and restructuring transactions were $254 million, an increase of 9% from the comparable period of fiscal 2004, while industry-wide completion volumes were essentially flat over the same period. The increase in revenues reflected higher merger, acquisition and restructuring revenues across several sectors, including energy and utilities, transportation, healthcare and basic materials, partially offset by lower revenues from the financial services sector. Underwriting revenues were $488 million, a decrease of 4% from the comparable period of fiscal 2004. Equity underwriting revenues were $202 million, a decrease of 36% from the exceptionally strong results recorded in the first quarter of fiscal 2004, as compared with a 15% decline in industry-wide activity, primarily reflecting lower transaction volume. The Company's equity underwriting revenues reflected decreases from the financial services, technology and industrial sectors, partially offset by higher equity underwriting revenues in the energy and utilities sectors. Fixed income underwriting revenues increased 48% to $286 million as compared with a 3% increase in industry-wide activity as conditions in the global fixed income markets remained favorable in the first quarter of fiscal 2005. The increase primarily reflected higher revenues from non-investment grade fixed income underwriting transactions.

At February 28, 2005, the backlog of equity underwriting transactions was down slightly as compared with the prior year, while the backlog of fixed income underwriting transactions was relatively unchanged. The backlog of merger, acquisition and restructuring transactions was higher at February 28, 2005 as compared with the first quarter of fiscal 2004. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval, or a decision on the part of the parties involved not to pursue a transaction.

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

Sales and trading revenues include the following:

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Equity	$1,214	$1,105
Fixed income(1)	1,996	1,651

(1) Amounts include revenues from interest rate and currency products, credit products and commodities. Amounts exclude revenues from aircraft financing and corporate lending activities.

Total sales and trading revenues increased 15%, reflecting higher fixed income and equity sales and trading revenues.

Equity sales and trading revenues increased 10%, representing the highest level of revenues recorded since the second quarter of fiscal 2001. Record revenues in the prime brokerage business were a substantial contributor to the increase, reflecting growth in global customer balances and new customer activity. Revenues from equity derivatives increased due to strong customer flows despite a continuing decline in market volatility. Revenues from equity cash products rose primarily due to higher market volumes, particularly in Europe. Commission revenues, however, continued to be affected by intense competition and a continued shift toward electronic trading.

Fixed income sales and trading revenues increased to a record level, up 21% from a strong first quarter of fiscal 2004, due to new transaction activity, increased customer flows and successful trading results in a number of active markets. The increase in revenues was broad-based and included higher revenues from interest rate and currency products, credit products and commodities products. Interest rate and currency product revenues increased 29%, primarily due to higher revenues from emerging market fixed income securities and interest rate derivatives, reflecting strong new transaction activity and favorable interest rate and volatility positioning as yield curves flattened and volatilities declined. The increase in emerging market products was also due to favorable trading results in emerging market currencies. Credit product revenues increased 16% to a record level and benefited from continued tightening in global credit spreads, improved results from distressed debt trading and a strong demand for securitized products as the Company benefited from increased securitization flows. Commodities revenues increased 13%, primarily attributable to electricity and natural gas activities, which were partially offset by a decline in revenues from oil liquid products.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net interest expense associated with the Company's aircraft financing activities, as well as net revenues from corporate lending activities. In the quarter ended February 28, 2005, revenues from corporate lending activities decreased by approximately $30 million, reflecting mark-to-market valuations associated with new loans made in the first quarter of fiscal 2005.

Principal Transactions-Investments. Principal transaction net investment revenue aggregating $55 million was recognized in the quarter ended February 28, 2005 as compared with $16 million in the quarter ended February 29, 2004. The increase was primarily related to net gains associated with the Company's principal investment activities.

Other. Other revenues increased 45% driven by revenues associated with Barra, Inc., which was acquired on June 3, 2004. Net rental and other revenues associated with the Company's aircraft financing activities were relatively unchanged in comparison with the prior year period.

Conditions in the commercial aircraft industry were generally more favorable in the first quarter of fiscal 2005 as compared with the first quarter of fiscal 2004. Operating lease rates from the Company's aircraft financing activities continued to improve during the first quarter of fiscal 2005 for many aircraft types. At quarter-end, all of the Company's aircraft were either leased or committed to a lease transaction; however, unanticipated events, including the sale of additional aircraft or impairment charges, could have an adverse impact on the results of the aircraft financing business. For additional information on the aircraft financing business, see "Discontinued Operations" herein.

Non-Interest Expenses. Non-interest expenses increased 27%. Compensation and benefits expense increased 8% due to higher incentive-based compensation accruals resulting from higher net revenues. Excluding compensation and benefits expense, non-interest expenses increased 70%. Occupancy and equipment expense increased 101%, primarily due to a correction in the method of accounting for certain real estate leases (see "Lease Adjustment" herein). Brokerage, clearing and exchange fees increased 14%, primarily reflecting increased fixed income trading activity. Professional services expense increased 31%, primarily due to higher consulting and legal costs. Other expenses increased 267%, driven by a $360 million charge related to the Coleman litigation (see Note 9 to the condensed consolidated financial statements and "Legal Proceedings" in Part II, Item 1).

INDIVIDUAL INVESTOR GROUP

INCOME STATEMENT INFORMATION

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Revenues:		
Investment banking	$ 71	$ 77
Principal transactions:		
Trading	120	141
Investments	(2)	4
Commissions	329	385
Asset management, distribution and administration fees	581	492
Interest and dividends	135	93
Other	64	52
Total revenues	1,298	1,244
Interest expense	60	33
Net revenues	1,238	1,211
Total non-interest expenses	885	1,045
Income before taxes and cumulative effect of accounting change, net	$ 353	$ 166

Investment Banking. Investment banking revenues decreased 8% primarily due to lower revenues from fixed income underwriting transactions, partially offset by higher revenues from equity underwriting transactions.

Principal Transactions. Principal transaction trading revenues decreased 15% primarily due to lower revenues from fixed income products, reflecting lower customer transaction activity in corporate, municipal and government fixed income securities.

Commissions. Commission revenues decreased 15% due to lower transaction volumes reflecting lower individual investor participation in the U.S. equity markets as compared with the prior year.

Net Interest. Net interest revenues increased 25%, primarily due to higher net interest revenues from brokerage services provided to individual customers as a result of more favorable net interest spreads earned on client margin activity.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees increased 18%. An increase in client asset balances resulted in higher fees from investors electing fee-based pricing arrangements, including separately managed accounts.

Client asset balances increased to $618 billion at February 28, 2005 from $595 billion at February 29, 2004. The increase was due to net new assets and market appreciation, reflecting improvement in the global financial markets over the twelve-month period. Client assets in fee-based accounts rose 16% to $166 billion at February 28, 2005 and increased as a percentage of total client assets to 27% from 24% in the prior year period.

Other. Other revenues increased 23%, primarily due to higher revenues from certain customer service and account fees.

Non-Interest Expenses. Non-interest expenses decreased 15%, primarily due to the Individual Investor Group's share ($198 million) of the insurance settlement related to the events of September 11, 2001 (see "Insurance Settlement" herein). Excluding the insurance settlement, non-interest expenses increased 4%. Occupancy and equipment expense increased 46% primarily due to a $29 million charge for the correction in the method of accounting for certain real estate leases (see "Lease Adjustment" herein). Professional services expense increased 28%, largely due to higher sub-advisory fees associated with increased asset and revenue growth, as well as higher legal fees. Other expenses decreased 23%, primarily resulting from a decrease in litigation expense as the prior year's expenses included an accrual of approximately $30 million related to legal matters within the branch system.

INVESTMENT MANAGEMENT

INCOME STATEMENT INFORMATION

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Revenues:		
Investment banking	$ 11	$ 13
Principal transactions:		
Investments	64	9
Commissions	7	7
Asset management, distribution and administration fees	605	604
Interest and dividends	3	2
Other	8	9
Total revenues	698	644
Interest expense	2	2
Net revenues	696	642
Total non-interest expenses	409	472
Income before taxes and cumulative effect of accounting change, net	$287	$170

Investment Banking. Investment banking revenues decreased 15% reflecting lower fees from Unit Investment Trust sales.

Principal Transactions. Principal transaction net investment gains aggregating $64 million were recognized in the quarter ended February 28, 2005 as compared with gains of $9 million in the quarter ended February 29, 2004. The increase was primarily related to net gains on certain investments in the Company's private equity portfolio, including Triana.

Asset Management, Distribution and Administration Fees.

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

	At February 28, 2005	At February 29, 2004	Average for the Three Months Ended February 28, 2005	Average for the Three Months Ended February 29, 2004
	(dollars in billions)			
Assets under management or supervision by distribution channel:				
Retail	$201	$200	$202	$198
Institutional	226	180	225	172
Total	$427	$380	$427	$370
Assets under management or supervision by asset class:				
Equity	$209	$186	$205	$178
Fixed income	108	111	112	111
Money market	84	62	83	61
Other(1)	26	21	27	20
Total	$427	$380	$427	$370

(1) Amounts include alternative investment vehicles.

Activity in Investment Management's customer assets under management or supervision were as follows (dollars in billions):

	Three Months Ended	
	February 28, 2005	February 29, 2004
Balance at beginning of period	$424	$357
Net flows excluding money markets	(8)	2
Net flows from money markets	1	1
Net market appreciation	10	20
Total net increase	3	23
Balance at end of period	$427	$380

Asset management, distribution and administration fees were relatively unchanged, as higher fund management and administration fees associated with a 15% increase in average assets under management or supervision were offset by lower distribution and performance fees. In addition, although average equity assets under management increased 15%, a greater proportion of these assets were in products generating lower fees as compared with the prior year period. As of February 28, 2005, customer assets under management or supervision increased $47 billion from February 29, 2004. The net increase was primarily due to an increase in institutional assets, reflecting an increase in sales of liquidity products and market appreciation.

Non-Interest Expenses. Non-interest expenses decreased 13%. The decrease was primarily due to Investment Management's share ($43 million) of the insurance settlement related to the events of September 11, 2001 (see "Insurance Settlement" herein). Excluding the insurance settlement, non-interest expenses decreased 4%. Compensation and benefits expense increased 5%, primarily reflecting higher incentive-based compensation accruals due to higher net revenues. Brokerage, clearing and exchange fees decreased 5%, primarily reflecting lower amortization expense associated with certain open-ended funds. The decrease in amortization expense reflected a lower level of deferred costs in recent periods due to a decrease in sales of certain open-ended funds. Occupancy and equipment expense increased 25% due to a correction in the method of accounting for certain real estate leases (see "Lease Adjustment" herein). Other expenses decreased 163%, including a reduction in legal reserves resulting from the resolution of certain legal matters.

CREDIT SERVICES

INCOME STATEMENT INFORMATION

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Fees:		
Merchant, cardmember and other	$308	$337
Servicing	526	572
Other	2	5
Total non-interest revenues	836	914
Interest revenue	468	480
Interest expense	173	174
Net interest income	295	306
Provision for consumer loan losses	135	262
Net credit income	160	44
Net revenues	996	958
Total non-interest expenses	616	593
Income before taxes and cumulative effect of accounting change, net	$380	$365

Merchant, Cardmember and Other Fees. Merchant, cardmember and other fees decreased 9%. The decrease was due to higher net cardmember rewards, the allocation of interchange revenues to certain securitization transactions and lower overlimit fees, partially offset by higher merchant discount revenues, transaction processing revenues and balance transfer fees. The increase in net cardmember rewards reflected the impact of promotional programs and record sales volume. The decline in overlimit fees reflected a decline in the number of accounts charged an overlimit fee, partially offset by lower charge-offs of such fees. Overlimit fees declined due to fewer overlimit accounts and the Company's modification of its overlimit fee policies and procedures in response to industry-wide regulatory guidance. The increase in merchant discount revenues reflected record sales volume. The increase in transaction processing revenues was related to PULSE, which was acquired on January 12, 2005 (see "Business Acquisition and Sale" herein). Balance transfer fees increased as a result of the Company's continued focus on improving balance transfer profitability.

Servicing Fees.

The table below presents the components of servicing fees:

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
Merchant, cardmember and other fees	$171	$ 182
Other revenue	57	30
Total non-interest revenues	228	212
Interest revenue	948	1,044
Interest expense	247	176
Net interest income	701	868
Provision for consumer loan losses	403	508
Net credit income	298	360
Servicing fees	$526	$ 572

Servicing fees decreased 8% primarily due to lower cardmember fees and net interest cash flows, partially offset by higher interchange revenue, a lower provision for consumer loan losses, and higher Other revenue. Cardmember fees declined due to lower late payment and overlimit fees, partially offset by lower fee net charge-offs. The decrease in net interest cash flows was largely attributable to a lower yield on securitized general purpose credit card loans and a higher weighted average coupon rate paid to investors, as well as a lower level of average securitized general purpose credit card loans. The decrease in the provision for consumer loan losses was primarily attributable to a lower rate of net principal charge-offs related to the securitized general purpose credit card loan portfolio. The increase in the Other revenue component of servicing fees was attributable to higher levels of general purpose credit card and mortgage loan securitization transactions, partially offset by lower mortgage whole loan sales.

The following table presents net proceeds received from consumer loan sales:

	Three Months Ended	
	February 28, 2005	February 29, 2004
	(dollars in millions)	
General purpose credit card asset securitizations	$3,419	$1,946
Mortgage loan securitization	754	—
Mortgage whole loan sales	519	1,250
Net proceeds from consumer loan sales	$4,692	$3,196

The credit card asset securitization transactions completed in the quarter ended February 28, 2005 have expected maturities ranging from approximately three to five years from the date of issuance. The mortgage loan securitization transaction completed in the quarter ended February 28, 2005 has an expected maturity of approximately eight years from the date of issuance.

Net Interest Income. Net interest income decreased 4% due to a lower interest spread resulting primarily from a decline in interest revenue. The decline in interest revenue was primarily due to a lower yield on general purpose credit card loans, reflecting a higher level of general purpose credit card loans subject to promotional interest rates, coupled with a decline in loans subject to higher rates as a result of improved credit quality. The decline in interest revenue was partially offset by an increase in average general purpose credit card loans.

The following tables present analyses of Credit Services average balance sheets and interest rates for the quarters ended February 28, 2005 and February 29, 2004 and changes in net interest income during those periods:

Average Balance Sheet Analysis.

	Three Months Ended					
	February 28, 2005			February 29, 2004		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest
	(dollars in millions)					
ASSETS						
Interest earning assets:						
General purpose credit card loans	$19,210	9.07%	$ 430	$17,880	10.13%	$ 450
Other consumer loans	1,233	5.81	18	1,351	5.28	18
Investment securities	131	0.66	—	104	0.78	—
Other	2,560	3.22	20	2,680	1.81	12
Total interest earning assets	23,134	8.20	468	22,015	8.77	480
Allowance for loan losses	(939)			(996)		
Non-interest earning assets	2,973			2,474		
Total assets	$25,168			$23,493		
LIABILITIES AND SHAREHOLDER'S EQUITY						
Interest bearing liabilities:						
Interest bearing deposits						
Savings	$ 646	2.08%	$ 4	$ 739	0.85%	$ 2
Brokered	8,818	4.54	99	9,583	5.12	122
Other time	3,118	3.18	24	1,964	3.45	17
Total interest bearing deposits	12,582	4.08	127	12,286	4.60	141
Other borrowings	5,603	3.38	46	4,967	2.70	33
Total interest bearing liabilities	18,185	3.86	173	17,253	4.05	174
Shareholder's equity/other liabilities	6,983			6,240		
Total liabilities and shareholder's equity	$25,168			$23,493		
Net interest income			$ 295			$ 306
Net interest margin(1)			5.17%			5.60%
Interest rate spread(2)		4.34%			4.72%	

(1) Net interest margin represents net interest income as a percentage of total interest earning assets.

(2) Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

Rate/Volume Analysis.

Increase/(Decrease) due to Changes in:	Three Months Ended February 28, 2005 vs. February 29, 2004		
	Volume	Rate	Total
	(dollars in millions)		
Interest Revenue			
General purpose credit card loans	$ 32	$(52)	$ (20)
Other consumer loans	(2)	2	—
Other	(1)	9	8
Total interest revenue	23	(35)	(12)
Interest Expense			
Interest bearing deposits:			
Savings	—	2	2
Brokered	(10)	(13)	(23)
Other time	9	(2)	7
Total interest bearing deposits	3	(17)	(14)
Other borrowings	4	9	13
Total interest expense	9	(10)	(1)
Net interest income	$ 14	$(25)	$ (11)

In response to industry-wide regulatory guidance, the Company has increased minimum payment requirements on certain general purpose credit card loans and is reviewing minimum payment requirements on other general purpose credit card loans. Bank regulators have broad discretion to change the guidance or its application, and changes in such guidance or its application by the regulators could impact minimum payment requirements. A change in minimum payment requirements may impact future levels of general purpose credit card loans and related interest and fee revenue and charge-offs.

Provision for Consumer Loan Losses. The provision for consumer loan losses decreased 48% due to a $90 million reduction in the allowance for consumer loan losses and lower net principal charge-offs resulting from continued improvement in credit quality.

Delinquencies and Charge-offs. Delinquency rates in both the over 30- and over 90-day categories and net principal charge-off rates were lower for both the owned and managed portfolios, reflecting improvements in portfolio credit quality (see “Managed General Purpose Credit Card Loan Data” herein).

Non-Interest Expenses. Non-interest expenses increased 4%, primarily attributable to higher compensation and benefits expense. Compensation and benefits expense increased 11%, reflecting an increase in compensation expense, partially due to higher employment levels. Excluding compensation and benefits expense, non-interest expenses were relatively unchanged. Professional services expenses increased 6% due to an increase in consulting fees associated with the acquisition of PULSE (see “Business Acquisition and Sale” herein). Other expenses decreased 10%, primarily reflecting a decrease in certain operating expenses, including lower losses associated with cardmember fraud.

Managed General Purpose Credit Card Loan Data. The Company analyzes its financial performance on both a “managed” loan basis and as reported under U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) (“owned” loan basis). Managed loan data assume that the Company’s securitized loan receivables have not been sold and present the results of the securitized loan receivables in the same manner as the Company’s owned loans. The Company operates its Credit Services business and analyzes its financial performance on a managed basis. Accordingly, underwriting and servicing standards are comparable for both owned and securitized loans.

The Company believes that managed loan information is useful to investors because it provides information regarding the quality of loan origination and credit performance of the entire managed portfolio and allows investors to understand the related credit risks inherent in owned loans and retained interests in securitizations. In addition, investors often request information on a managed basis, which provides a more meaningful comparison with industry competitors.

The following table provides a reconciliation of owned and managed average loan balances, interest yields and interest rate spreads for the periods indicated:

Reconciliation of General Purpose Credit Card Loan Data (dollars in millions)

	Three Months Ended					
	February 28, 2005			February 29, 2004		
	Average Balance	Interest Yield	Interest Rate Spread	Average Balance	Interest Yield	Interest Rate Spread
General Purpose Credit Card Loans:						
Owned	$19,210	9.07%	5.21%	$17,880	10.13%	6.08%
Securitized	29,720	12.63%	9.44%	30,787	13.40%	11.20%
Managed	$48,930	11.23%	7.79%	$48,667	12.20%	9.35%

The following tables present a reconciliation of owned and managed general purpose credit card loans and delinquency and net charge-off rates.

Reconciliation of General Purpose Credit Card Loan Asset Quality Data (dollars in millions)

	Three Months Ended					
	February 28, 2005			February 29, 2004		
		Delinquency Rates			Delinquency Rates	
	Period End Loans	Over 30 Days	Over 90 Days	Period End Loans	Over 30 Days	Over 90 Days
General Purpose Credit Card Loans:						
Owned	$18,908	3.75%	1.81%	$15,850	5.17%	2.54%
Securitized	28,862	4.55%	2.20%	31,486	6.11%	3.01%
Managed	$47,770	4.24%	2.05%	$47,336	5.80%	2.86%

	Three Months Ended	
	February 28, 2005	February 29, 2004
Net Principal Charge-offs:		
Owned	4.62%	5.81%
Securitized	5.43%	6.60%
Managed	5.11%	6.31%
Net Total Charge-offs (inclusive of interest and fees):		
Owned	6.47%	7.98%
Securitized	7.79%	9.55%
Managed	7.27%	8.97%

Other Items.

Business Acquisition and Sale.

On January 12, 2005, the Company completed the acquisition of PULSE, a U.S.-based automated teller machine/debit network currently serving banks, credit unions and savings institutions. The Company believes that the combination of the PULSE network and the Discover Network will create a leading electronic payments company offering a full range of products and services for financial institutions, consumers and merchants. As of the date of acquisition, the results of PULSE are included within the Credit Services business segment. The Company recorded goodwill and other intangible assets of $321 million in connection with the acquisition (see Note 18 to the condensed consolidated financial statements).

In February 2005, the Company sold its 50% interest in POSIT, an equity crossing system that matches institutional buyers and sellers, to Investment Technology Group, Inc. The Company acquired the POSIT interest as part of its acquisition of Barra, Inc. in June 2004. As a result of the sale, the net carrying amount of intangible assets decreased by approximately $75 million (see Note 2 to the condensed consolidated financial statements).

Insurance Settlement.

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

In the first quarter of fiscal 2005, the Company settled its claim with its insurance carriers related to the events of September 11, 2001. The Company recorded a pre-tax gain of $251 million as the insurance recovery was in excess of previously recognized costs related to the terrorist attacks (primarily write-offs of leasehold improvements and destroyed technology and telecommunications equipment in the World Trade Center complex, employee relocation and certain other employee-related expenditures, and other business recovery costs).

The pre-tax gain, which was recorded as a reduction to non-interest expenses, is included within the Individual Investor Group ($198 million), Investment Management ($43 million) and Institutional Securities ($10 million) segments. The insurance settlement was allocated to the respective segments in accordance with the relative damages sustained by each segment.

Stock-Based Compensation.

Effective December 1, 2002, the Company adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123," using the prospective adoption method for both deferred stock and stock options. Effective December 1, 2004, the Company early adopted SFAS No. 123R, which revised the fair value based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified SFAS No. 123's guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS No. 123R also amended SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as financing cash inflows rather than as a reduction of taxes paid, which is included within operating cash flows.

Upon adoption of SFAS 123R using the modified prospective approach, the Company recognized an $80 million gain ($49 million after-tax) as a cumulative effect of a change in accounting principle resulting from the requirement to estimate forfeitures at the date of grant instead of recognizing them as incurred. The cumulative effect gain increased both basic and diluted earnings per share by $.05. In addition, excess tax benefits associated with stock-based compensation awards are now included within cash flows from financing activities in the condensed consolidated statements of cash flows.

In addition, based upon the terms of the Company's equity-based compensation program, the Company will no longer be able to recognize a portion of the award in the year of grant under SFAS No. 123R as previously allowed under SFAS 123. As a result, fiscal 2005 compensation expense will include the amortization of fiscal 2003 and fiscal 2004 awards but will not include any amortization for fiscal 2005 awards. This will have the effect of reducing compensation expense in fiscal 2005. If SFAS No. 123R were not in effect, fiscal 2005's compensation expense would have included three years of amortization (i.e., for awards granted in fiscal 2003, fiscal 2004 and fiscal 2005). In addition, the fiscal 2005 year-end awards, which will begin to be amortized in fiscal 2006, will be amortized over a shorter period (2 and 3 years) as compared with awards granted in fiscal 2004 and fiscal 2003 (3 and 4 years).

Lease Adjustment.

Prior to the first quarter of fiscal 2005, the Company was not recording the effects of scheduled rent increases and rent-free periods for certain real estate leases on a straight-line basis. In addition, the Company had been accounting for certain tenant improvement allowances as reductions to the related leasehold improvements instead of recording funds received as deferred rent and amortizing them as reductions to lease expense over the lease term. In the first quarter of fiscal 2005, the Company changed its method of accounting for these rent escalation clauses, rent-free periods and tenant improvement allowances to properly reflect lease expense over the lease term on a straight-line basis. The cumulative effect of this correction resulted in the Company recording $109 million of additional rent expense in the first quarter of fiscal 2005. The impact of this change was included within non-interest expenses and reduced income before taxes within the Institutional Securities ($71 million), Individual Investor Group ($29 million), Investment Management ($5 million) and Credit Services ($4 million) segments. The impact of this correction to the current period and prior periods was not material to the pre-tax income of each of the segments or to the Company.

Discontinued Operations.

During fiscal 2004, the Company entered into agreements for the sale of certain aircraft and, accordingly, such aircraft had been designated as "held for sale" in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). The revenues and expenses associated with these aircraft have been classified as discontinued operations for all periods presented. As of February 3, 2005, all of these aircraft were sold. The Company may sell additional aircraft from time to time.

The Company recorded pre-tax income on discontinued operations of $13 million and $3 million for the three months ended February 28, 2005 and February 29, 2004, respectively.

Income Tax Examinations.

The Company is under continuous examination by the Internal Revenue Service (the "IRS") and other tax authorities in certain countries, such as Japan and the United Kingdom, and states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1994-1998. The Company currently expects this IRS examination to be substantially completed in fiscal 2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations. Tax reserves have been established, which the Company believes to be adequate in relation to the potential for additional assessments. Once established, reserves are adjusted only when there is more information available or when an event occurs necessitating a change to the reserves. The resolution of tax matters will not have a material effect on the condensed consolidated financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statement of income for a particular future period and on the Company's effective tax rate.

American Jobs Creation Act of 2004.

In December 2004, the Financial Accounting Standards Board ("FASB") issued Staff Position ("FSP") No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004." The American Jobs Creation Act of 2004 (the "Act"), signed into law on October 22, 2004, provides for a special one-time tax deduction, or dividend received deduction ("DRD"), of 85% of qualifying foreign earnings that are repatriated in either a company's last tax year that began before the enactment date or the first tax year that begins during the one-year period beginning on the enactment date. FSP 109-2 provides entities additional time to assess the effect of repatriating foreign earnings under the Act for purposes of applying SFAS No. 109, "Accounting for Income Taxes," which typically requires the effect of a new tax law to be recorded in the period of enactment. The Company will elect, if applicable, to apply the DRD to qualifying dividends of foreign earnings repatriated in its fiscal year ending November 30, 2005.

Cash Collateral Netting.

Effective December 1, 2004 the Company has elected, under FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," to net cash collateral paid or received against its derivatives inventory under credit support annexes, which the Company views as conditional contracts, to legally enforceable master netting agreements. The Company believes the accounting treatment is preferable as compared to a gross basis as it is a better representation of its credit exposure and how it manages its credit risk related to these derivative contracts. Amounts as of November 30, 2004 have been reclassified to conform to the current presentation. The amounts netted at February 28, 2005 and November 30, 2004 were $16.3 billion and $17.6 billion, respectively, which reduced Financial instruments owned—derivative contracts and Payables to customers, and $13.8 billion and $12.3 billion, respectively, which reduced Financial instruments sold, not yet purchased—derivative contracts and Receivables from customers.

Critical Accounting Policies.

The condensed consolidated financial statements are prepared in accordance with U.S. GAAP, which require the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements for the fiscal year ended November 30, 2004 included in the Form 10-K), the following may involve a higher degree of judgment and complexity.

Fair Value of Financial Instruments. Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected in principal trading revenues in the condensed consolidated statements of income. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased are generally based on observable market prices, observable market parameters or derived from such prices or parameters based on bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased. In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Bid prices represent the highest price a buyer is willing to pay for a financial instrument at a particular time. Ask prices represent the lowest price a seller is willing to accept for a financial instrument at a particular time.

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

The price transparency of the particular product will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly traded or not quoted will generally have reduced to no price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced for periods of time during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market-makers willing to purchase and sell a product provides a source of transparency for products that otherwise are not actively quoted or during periods of market dislocation.

The Company's cash products include securities issued by the U.S. government and its agencies, other sovereign debt obligations, corporate and other debt securities, corporate equity securities, exchange traded funds and physical commodities. The fair value of these products is based principally on observable market prices or is derived using observable market parameters. These products generally do not entail a significant degree of judgment in determining fair value. Examples of products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters include securities issued by the U.S. government and its agencies, exchange traded corporate equity securities, most municipal debt securities, most corporate debt securities, most high-yield debt securities, physical commodities, certain tradable loan products and most mortgage-backed securities.

In certain circumstances, principally involving loan products and other financial instruments held for securitization transactions, the Company determines fair value from within the range of bid and ask prices such that fair value indicates the value likely to be realized in a current market transaction. Bid prices reflect the price that the Company and others pay, or stand ready to pay, to originators of such assets. Ask prices represent the prices that the Company and others require to sell such assets to the entities that acquire the financial instruments for purposes of completing the securitization transactions. Generally, the fair value of such acquired assets is based upon the bid price in the market for the instrument or similar instruments. In general, the loans and similar assets are valued at bid pricing levels until structuring of the related securitization is substantially complete and such that the value likely to be realized in a current transaction is consistent with the price that a securitization entity will pay to acquire the financial instruments. Factors affecting securitized value and investor demand relating specifically to loan products include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratio, investor demand and credit enhancement levels.

In addition, some cash products exhibit little or no price transparency, and the determination of the fair value requires more judgment. Examples of cash products with little or no price transparency include certain high-yield debt, certain collateralized mortgage obligations, certain tradable loan products, distressed debt securities (i.e., securities of issuers encountering financial difficulties, including bankruptcy or insolvency) and equity securities that are not publicly traded. Generally, the fair value of these types of cash products is determined using one of several valuation techniques appropriate for the product, which can include cash flow analysis, revenue or net income analysis, default recovery analysis (i.e., analysis of the likelihood of default and the potential for recovery) and other analyses applied consistently.

The following table presents the valuation of the Company's cash products by level of price transparency (dollars in millions):

	At February 28, 2005		At November 30, 2004	
	Assets	**Liabilities**	**Assets**	**Liabilities**
Observable market prices, parameters or derived from observable prices or parameters	$173,265	$81,648	$145,327	$66,948
Reduced or no price transparency	13,942	876	9,794	827
Total	$187,207	$82,524	$155,121	$67,775

The Company's derivative products include exchange traded and OTC derivatives. Exchange traded derivatives have valuation attributes similar to the cash products valued using observable market prices or market parameters described above. OTC derivatives, whose fair value is derived using pricing models, include a wide variety of instruments, such as interest rate swap and option contracts, foreign currency option contracts, credit and equity swap and option contracts, and commodity swap and option contracts.

The following table presents the fair value of the Company's exchange traded and OTC derivative assets and liabilities (dollars in millions):

	At February 28, 2005		At November 30, 2004	
	Assets	**Liabilities**	**Assets**	**Liabilities**
Exchange traded	$ 2,773	$ 5,229	$ 2,754	$ 4,815
OTC(1)	40,228	32,160	46,721	38,725
Total	$43,001	$37,389	$49,475	$43,540

(1) Effective December 1, 2004 the Company has elected to net cash collateral paid or received against its derivatives inventory under credit support annexes. See "Cash Collateral Netting" herein.

The fair value of OTC derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swap and option contracts. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category. Other derivative products, typically the newest and most complex products, will require more judgment in the implementation of the modeling technique applied due to the complexity of the modeling assumptions and the reduced price transparency surrounding the model's market parameters. The Company manages its market exposure for OTC derivative products primarily by entering into offsetting derivative contracts or other related financial instruments. The Company's trading divisions, the Financial Control Department and the Market Risk Department continuously monitor the price changes of the OTC derivatives in relation to the offsetting positions. For a further discussion of the price transparency of the Company's OTC derivative products, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Credit Risk" in Part II, Item 7A of the Form 10-K.

The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable market prices or market-based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model. Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral ("margining") based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the Company's recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This information is then used to evaluate the fair value of these OTC derivative products. For more information regarding the Company's risk management practices, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A of the Form 10-K.

Transfers of Financial Assets. The Company engages in securitization activities in connection with certain of its businesses. Gains and losses from securitizations are recognized in the condensed consolidated statements of income when the Company relinquishes control of the transferred financial assets in accordance with SFAS

No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125," and other related pronouncements. The gain or loss on the sale of financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale.

In connection with its Institutional Securities business, the Company engages in securitization transactions to facilitate client needs and as a means of selling financial assets. The Company recognizes any interests in the transferred assets and any liabilities incurred in securitization transactions in its condensed consolidated statements of financial condition at fair value. Subsequently, changes in the fair value of such interests are recognized in the condensed consolidated statements of income.

In connection with its Credit Services business, the Company periodically sells consumer loans through asset securitizations and continues to service these loans. The present value of the future net servicing revenues that the Company estimates it will receive over the term of the securitized loans is recognized in income as the loans are securitized. A corresponding asset also is recorded and then amortized as a charge to income over the term of the securitized loans. The securitization gain or loss involves the Company's best estimates of key assumptions, including forecasted credit losses, payment rates, forward yield curves and appropriate discount rates. The use of different estimates or assumptions could produce different financial results.

Allowance for Consumer Loan Losses. The allowance for consumer loan losses in the Company's Credit Services business is established through a charge to the provision for consumer loan losses. Provisions are made to reserve for estimated losses in outstanding loan balances. The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is primarily applicable to the owned homogeneous consumer credit card loan portfolio that is evaluated quarterly for adequacy.

In calculating the allowance for consumer loan losses, the Company uses a systematic and consistently applied approach. The Company regularly performs a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge-off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact future credit loss experience, including current economic conditions, recent trends in delinquencies and bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level. The use of different estimates or assumptions could produce different provisions for consumer loan losses (see "Credit Services—Provision for Consumer Loan Losses" herein).

Aircraft under Operating Leases. The Company's aircraft portfolio has consisted of aircraft to be held and used and aircraft that are to be disposed of by sale ("held for sale").

Aircraft under operating leases that are to be held and used are stated at cost less accumulated depreciation and impairment charges. Depreciation is calculated on a straight-line basis over the estimated useful life of the aircraft asset, which is generally 25 years from the date of manufacture. In accordance with SFAS No. 144, the Company's aircraft that are to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of the aircraft may not be recoverable. Under SFAS No. 144, the carrying value of an aircraft may not be recoverable if its projected undiscounted cash flows are less than its carrying value. If an aircraft's projected undiscounted cash flows are less than its carrying value, the Company will recognize an impairment charge equal to the excess of the carrying value over the fair value of the aircraft. The fair value of the Company's impaired aircraft is based upon the average market appraisal values obtained from independent appraisal companies. Estimates of future cash flows associated with the aircraft assets as well as the appraisals of fair value are critical to the determination of whether an impairment exists and the amount of the impairment charge, if any (see Note 16 to the condensed consolidated financial statements).

Aircraft under operating leases that fulfill the criteria to be classified as held for sale in accordance with SFAS No. 144 are stated at the lower of carrying value (i.e., cost less accumulated depreciation and impairment charges) or fair value less estimated cost to sell. Depreciation expense is not recorded for aircraft that are classified as held for sale. The Company will recognize a charge for any initial or subsequent write-down to fair value less estimated cost to sell (see Note 16 to the condensed consolidated financial statements). A gain would be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell).

Liquidity and Capital Resources.

The Company's senior management establishes the overall liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Company's asset and liability position. These committees, along with the Company's Treasury Department and other control groups, also assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its consolidated balance sheet, liquidity and capital structure, thereby helping to ensure that its business activities are integrated with the Company's liquidity and capital policies.

The Company's liquidity and funding risk management policies are designed to mitigate the potential risk that the Company may be unable to access adequate financing to service its financial obligations when they come due without material, adverse franchise or business impact. The key objectives of the liquidity and funding risk management framework are to support the successful execution of the Company's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of financial distress. The principal elements of the Company's liquidity framework are the cash capital policy, the liquidity reserve and stress testing through the contingency funding plan. Comprehensive financing guidelines (collateralized funding, long-term funding strategy, surplus capacity, diversification, staggered maturities and committed credit facilities) support the Company's target liquidity profile.

For a more detailed summary of the Company's Liquidity and Capital Policies and funding sources, including committed credit facilities and off-balance sheet funding, refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources" in Part II, Item 7 of the Form 10-K.

The Balance Sheet.

The Company monitors and evaluates the composition and size of its balance sheet. Given the nature of the Company's market making and customer financing activities, the overall size of the balance sheet fluctuates from time to time. A substantial portion of the Company's total assets consists of highly liquid marketable securities and short-term receivables arising principally from its Institutional Securities sales and trading activities. The highly liquid nature of these assets provides the Company with flexibility in financing and managing its business.

The Company's total assets increased to $802.2 billion at February 28, 2005 from $745.5 billion at November 30, 2004. The increase was primarily due to increases in securities purchased under agreements to resell, financial instruments owned (largely driven by increases in U.S. government and agency securities, corporate and other debt and corporate equities, partially offset by a decrease in derivative contracts) and receivables from customers. The increase in securities purchased under agreements to resell and receivables from customers was largely due to growth in the Company's financing related activities.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company's overall liquidity and capital policies. The Company views the adjusted leverage ratio as a more relevant measure of financial risk when comparing financial services firms and evaluating leverage trends. The Company has adopted a definition of adjusted assets that excludes certain self-funded assets considered to have minimal market, credit and/or liquidity risk. These low-risk assets generally are attributable to the Company's matched book and securities lending businesses. Adjusted assets are calculated by reducing gross assets by aggregate resale agreements and securities borrowed less non-derivative short positions and assets recorded under certain provisions of SFAS No. 140 and FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), as revised. The adjusted leverage ratio reflects the deduction from shareholders' equity of the amount of equity used to support goodwill and intangible assets (as the Company does not view this amount of equity as available to support its risk capital needs). In addition, the Company views junior subordinated debt issued to capital trusts as a component of its capital base given the inherent characteristics of the securities. These characteristics include the long dated nature (final maturity at issuance of 30 years extendible at the Company's option by a further 19 years), the Company's ability to defer coupon interest for up to 20 consecutive quarters and the subordinated nature of the obligations in the capital structure. The Company also receives rating agency equity credit for these securities.

The following table sets forth the Company's total assets, adjusted assets and leverage ratios as of February 28, 2005 and November 30, 2004 and for the average month-end balances during the quarter ended February 28, 2005:

	Balance at		Average Month-End Balance
	February 28, 2005	November 30, 2004	For the Quarter Ended February 28, 2005
	(dollars in millions, except ratio data)		
Total assets(1)	$ 802,210	$ 745,513	$ 777,734
Less: Securities purchased under agreements to resell	(143,462)	(123,041)	(136,830)
Securities borrowed	(207,985)	(208,349)	(210,608)
Add: Financial instruments sold, not yet purchased	119,913	111,315	121,061
Less: Derivative contracts sold, not yet purchased	(37,389)	(43,540)	(40,598)
Subtotal	533,287	481,898	510,759
Less: Segregated customer cash and securities balances	(26,461)	(26,534)	(27,510)
Assets recorded under certain provisions of SFAS No. 140 and FIN 46, as revised	(57,042)	(44,895)	(48,024)
Goodwill and intangible assets	(2,563)	(2,199)	(2,343)
Adjusted assets	$ 447,221	$ 408,270	$ 432,882
Shareholders' equity	$ 28,495	$ 28,206	$ 28,423
Junior subordinated debt issued to capital trusts	2,833	2,897	2,879
Subtotal	31,328	31,103	31,302
Less: Goodwill and intangible assets	(2,563)	(2,199)	(2,343)
Tangible shareholders' equity	$ 28,765	$ 28,904	$ 28,959
Leverage ratio(2)	27.9x	25.8x	26.9x
Adjusted leverage ratio(3)	15.5x	14.1x	14.9x

(1) Effective December 1, 2004 the Company has elected to net cash collateral paid or received against its derivatives inventory under credit support annexes. See "Cash Collateral Netting" herein.
(2) Leverage ratio equals total assets divided by tangible shareholders' equity.
(3) Adjusted leverage ratio equals adjusted assets divided by tangible shareholders' equity.

Activity in the Quarter Ended February 28, 2005.

The Company's total capital consists of equity capital combined with long-term borrowings (debt obligations scheduled to mature in more than 12 months), junior subordinated debt issued to capital trusts, and Capital Units. At February 28, 2005, total capital was $122.2 billion, an increase of $11.4 billion from November 30, 2004.

During the quarter ended February 28, 2005, the Company issued senior notes aggregating $12.5 billion, including non-U.S. dollar currency notes aggregating $2.7 billion. In connection with the note issuances, the Company has entered into certain transactions to obtain floating interest rates based primarily on short-term London Interbank Offered Rates ("LIBOR") trading levels. At February 28, 2005, the aggregate outstanding principal amount of the Company's Senior Indebtedness (as defined in the Company's public debt shelf registration statements) was approximately $126 billion (including guaranteed obligations of the indebtedness of subsidiaries). The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 5 years at February 28, 2005.

During the quarter ended February 28, 2005, the Company purchased approximately $1,372 million of its common stock (approximately 24 million shares) through a combination of open market purchases and employee purchases at an average cost of $56.02 (see also "Changes in Securities, Use of Proceeds and Issuer Repurchases of Equity Securities" in Part II, Item 2).

Liquidity Management Policies.

The primary goal of the Company's liquidity and funding activities is to ensure adequate financing over a wide range of potential credit ratings and market environments. Given the highly liquid nature of the Company's balance sheet, day-to-day funding requirements are largely fulfilled through the use of stable collateralized financing. The Company has centralized management of credit-sensitive unsecured funding sources in the Treasury Department. In order to meet target liquidity requirements and withstand an unforeseen contraction in credit availability, the Company has designed a liquidity management framework.

Liquidity Management Framework:	Designed to:
Contingency Funding Plan	Ascertain the Company's ability to manage a prolonged liquidity contraction and provide a course of action over a one-year time period to ensure orderly functioning of the businesses. The contingency funding plan sets forth the process and the internal and external communication flows necessary to ensure effective management of the contingency event. Analytical processes exist to periodically evaluate and report the liquidity risk exposures of the organization under management-defined scenarios.
Cash Capital	Ensure that the Company can fund its balance sheet while repaying its financial obligations maturing within one year without issuing new unsecured debt. The Company attempts to achieve this by maintaining sufficient cash capital (long-term debt and equity capital) to finance illiquid assets and the portion of its securities inventory that is not expected to be financed on a secured basis in a credit-stressed environment.
Liquidity Reserve	Maintain, at all times, a liquidity reserve composed of immediately available cash and cash equivalents and a pool of unencumbered securities that can be sold or pledged to provide same-day liquidity to the Company. The reserve is periodically assessed and determined based on day-to-day funding requirements and strategic liquidity targets. The liquidity reserve averaged approximately $43 billion during the quarter ended February 28, 2005.

Liquidity Reserve.

The Company seeks to maintain a target liquidity reserve which is sized to cover daily funding needs and to meet strategic liquidity targets, including coverage of a significant portion of expected cash outflows over a short-term horizon in a potential liquidity crisis. Prior to fiscal 2004, this liquidity reserve was held in the form of cash deposited with banks. Beginning in late fiscal 2004, this liquidity reserve was increased and separated into a cash component and a pool of unencumbered securities. The pool of unencumbered securities, against which funding can be raised, is managed on a global basis, and securities for the pool are chosen accordingly. The U.S. component, held in the form of a reverse repurchase agreement at the parent company, consists largely of U.S. government bonds and at February 28, 2005 was approximately $13 billion and averaged approximately $14 billion during the quarter. The non-U.S. component consists of European government bonds and other high-quality collateral. The parent company cash component of the liquidity reserve at February 28, 2005 was approximately $19 billion and averaged approximately $17 billion during the quarter. The Company believes that diversifying the form in which its liquidity reserve (cash and securities) is maintained enhances its ability to quickly and efficiently source funding in a stressed environment. The Company's funding requirements and target liquidity reserve may vary based on changes in the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

Credit Ratings.

The Company's reliance on external sources to finance a significant portion of its day-to-day operations makes access to global sources of financing important. The cost and availability of unsecured financing generally are dependent on the Company's short-term and long-term credit ratings. Factors that are significant to the determination of the Company's credit ratings or otherwise affect its ability to raise short-term and long-term financing include the Company's level and volatility of earnings, relative positions in the markets in which it operates, geographic and product diversification, risk management policies, cash liquidity, capital structure, corporate lending credit risk, and legal and regulatory developments. In addition, continuing consolidation in the credit card industry presents Discover Card with stronger competitors that may challenge future growth. A deterioration in any of the previously mentioned factors or combination of these factors may lead rating agencies to downgrade the credit ratings of the Company, thereby increasing the cost to the Company in obtaining unsecured funding. In addition, the Company's debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as OTC derivative transactions, including credit derivatives and interest rate swaps.

In connection with certain OTC trading agreements and certain other agreements associated with the Institutional Securities business, the Company would be required to provide additional collateral to certain counterparties in the event of a downgrade by either Moody's Investors Service or Standard & Poor's. At February 28, 2005, the amount of additional collateral that would be required in the event of a one-notch downgrade of the Company's senior debt credit rating was approximately $844 million. Of this amount, $382 million relates to bilateral arrangements between the Company and other parties where upon the downgrade of one party, the downgraded party must deliver incremental collateral to the other. These bilateral downgrade arrangements are a risk management tool used extensively by the Company as credit exposures are reduced if counterparties are downgraded.

As of April 5, 2005, the Company's credit ratings were as follows:

	Commercial Paper	Senior Debt
Dominion Bond Rating Service Limited(1)	R-1 (middle)	AA (low)
Fitch Ratings	F1+	AA-
Moody's Investors Service(2)	P-1	Aa3
Rating and Investment Information, Inc.	a-1+	AA
Standard & Poor's(3)	A-1	A+

(1) On April 5, 2005, Dominion Bond Rating Service Limited changed the outlook on the Company's senior debt ratings from Stable to Negative.
(2) On April 5, 2005, Moody's Investors Service changed the outlook on the Company's senior debt ratings from Stable to Negative.
(3) On March 30, 2005, Standard & Poor's changed the outlook on the Company's senior debt ratings from Positive to Stable.

Commitments.

The Company's commitments associated with outstanding letters of credit, principal investments and private equity activities, and lending and financing commitments as of February 28, 2005 are summarized below by period of expiration. Since commitments associated with letters of credit and lending and financing arrangements may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Fiscal 2005	Fiscal 2006-2007	Fiscal 2008-2009	Thereafter	Total
	(dollars in millions)				
Letters of credit(1)	$ 7,650	$1,242	$ —	$ —	$ 8,892
Principal investment and private equity activities	69	6	76	6	157
Investment grade lending commitments(2)(3)	5,637	3,733	8,779	567	18,716
Non-investment grade lending commitments(2)(3)	227	563	544	631	1,965
Commitments for secured lending transactions(4)	6,356	3,379	133	174	10,042
Commitments to purchase mortgage loans(5)	3,078	—	—	—	3,078
Total(6)	$23,017	$8,923	$9,532	$1,378	$42,850

(1) This amount represents the Company's outstanding letters of credit, which are primarily used to satisfy various collateral requirements.
(2) The Company's investment grade and non-investment grade lending commitments are made in connection with its corporate lending activities. See "Less Liquid Assets—Lending Activities" herein.
(3) Credit ratings are determined by the Company's Institutional Credit Department using methodologies generally consistent with those employed by external rating agencies. Credit ratings of BB+ or lower are considered non-investment grade.
(4) This amount represents lending commitments extended by the Company to companies that are secured by assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide for over-collateralization based upon the creditworthiness of the borrower.
(5) This amount represents the Company's forward purchase contracts involving mortgage loans.
(6) See Note 9 to the condensed consolidated financial statements.

The table above does not include commitments to extend credit for consumer loans of approximately $265 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness (see Note 4 to the condensed consolidated financial statements). In addition, in the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company's condensed consolidated financial statements.

At February 28, 2005, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately $80 billion and $63 billion, respectively.

Less Liquid Assets.

At February 28, 2005, certain assets of the Company, such as real property, equipment and leasehold improvements of $2.7 billion, aircraft assets of $3.8 billion, and goodwill and intangible assets of $2.6 billion, were illiquid. Certain equity investments made in connection with the Company's private equity and other principal investment activities, certain high-yield debt securities, certain collateralized mortgage obligations and mortgage-related loan products, bridge financings, and certain senior secured loans and positions also are not highly liquid.

At February 28, 2005, the Company had aggregate principal investments associated with its private equity and other principal investment activities (including direct investments and partnership interests) with a carrying value of approximately $1.5 billion, of which approximately $800 million represented the Company's investments in its real estate funds.

High-Yield Instruments. In connection with the Company's fixed income securities activities, the Company underwrites, trades, invests and makes markets in non-investment grade instruments ("high-yield instruments"). For purposes of this discussion, high-yield instruments are defined as fixed income, emerging market, preferred equity securities and distressed debt rated BB+ or lower (or equivalent ratings by recognized credit rating agencies) as well as non-rated securities which, in the opinion of the Company, contain credit risks associated with non-investment grade instruments. For purposes of this discussion, positions associated with the Company's credit derivatives business are not included because reporting gross market value exposures would not accurately reflect the risks associated with these positions due to the manner in which they are risk-managed. High-yield instruments generally involve greater risk than investment grade securities due to the lower credit ratings of the issuers, which typically have relatively high levels of indebtedness and, therefore, are more sensitive to adverse economic conditions. In addition, the market for high-yield instruments can be characterized as having periods of higher volatility and reduced liquidity. The Company monitors total inventory positions and risk concentrations for high-yield instruments in a manner consistent with the Company's market risk management policies and control structure. The Company manages its aggregate and single-issuer net exposure through the use of derivatives and other financial instruments. The Company records high-yield instruments at fair value. Unrealized gains and losses are recognized currently in the condensed consolidated statements of income.

The fair value of the Company's high-yield instruments owned and high-yield instruments sold, not yet purchased are shown below:

	At February 28, 2005	At November 30, 2004
	(dollars in billions)	
High-yield instruments owned	$11.2	$7.2
High-yield instruments sold, not yet purchased	2.2	2.4

Lending Activities. In connection with certain of its Institutional business activities, the Company provides loans or lending commitments (including bridge financing) to selected clients. The borrowers may be rated investment grade or non-investment grade. These loans and commitments have varying terms, may be senior or subordinated, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated or traded by the Company. For further information on these activities, see "Quantitative and Qualitative Disclosures about Market Risk—Credit Risk" in Part I, Item 3.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market Risk. The Company (other than Credit Services) uses 99%/One-Day Value-at-Risk ("VaR") as one of a range of risk management tools. VaR values should be interpreted in light of the method's strengths and limitations. A small proportion of trading positions generating market risk is not included in VaR (e.g., certain credit default baskets), and the modeling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce significantly different VaR results from those produced using more precise measures. For a further discussion of the Company's VaR methodology and its limitations, and the Company's risk management policies and control structure, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A of the Form 10-K.

The tables below present the following: the Company's quarter-end Aggregate (Trading and Non-trading), Trading, and Non-trading VaR (see Table 1 below); the Company's quarterly average, high, and low Trading VaR (see Table 2 below); and the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (99% vs. 95%) for the VaR statistic or a shorter historical time series (four years vs. one year) of market data upon which it bases its simulations (see Table 3 below). Non-trading VaR incorporates certain non-trading positions which are not included in Trading VaR; these include (a) the funding liabilities related to institutional trading positions and (b) public-company equity positions recorded as principal investments by the Company.

The table below presents VaR for each of the Company's primary risk exposures and on an aggregate basis at February 28, 2005 and November 30, 2004:

	Aggregate (Trading and Non-trading)		Trading		Non-trading	
Table 1: 99% Total VaR	**99%/One-Day VaR at**		**99%/One-Day VaR at**		**99%/One-Day VaR at**	
Primary Market Risk Category	**February 28, 2005**	**November 30, 2004**	**February 28, 2005**	**November 30, 2004**	**February 28, 2005**	**November 30, 2004**
Interest rate and credit spread	$ 66	$ 71	$ 60	$ 53	$ 13	$ 30
Equity price	40	42	37	38	5	5
Foreign exchange rate	17	10	17	10	—	—
Commodity price	35	27	35	27	—	—
Subtotal	158	150	149	128	18	35
Less diversification benefit(1)	62	56	60	48	2	5
Total VaR	$ 96	$ 94	$ 89	$ 80	$ 16	$ 30

(1) Diversification benefit equals the difference between Total 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 also are taken into account within each category.

The Company's Aggregate VaR and Trading VaR at February 28, 2005 were $96 million and $89 million, respectively. At February 28, 2005, Non-trading VaR decreased to $16 million from $30 million at November 30, 2004 driven predominantly by a decrease in interest rate exposures from certain longer-dated interest rate liabilities.

The Company views average Trading VaR as more representative of trends in the business than VaR at any single point in time. Table 2 below, which presents the high, low and average 99%/one-day Trading VaR during the quarters ended February 28, 2005 and November 30, 2004, represents substantially all of the Company's trading activities. Certain market risks included in the period-end Aggregate VaR discussed above are excluded from these measures (e.g., equity price risk in public company equity positions recorded as principal investments by the Company and certain funding liabilities related to trading positions).

Average Trading VaR for the quarter ended February 28, 2005 increased to $96 million from $80 million for the quarter ended November 30, 2004, reflecting an increase in interest rate and credit spread VaR driven by increased exposures to credit-sensitive instruments (e.g., corporate debt securities) and to interest rate levels.

Table 2: 99% High/Low/Average Trading VaR

	Daily 99%/One-Day VaR for the Quarter Ended February 28, 2005			Daily 99%/One-Day VaR for the Quarter Ended November 30, 2004		
Primary Market Risk Category	**High**	**Low**	**Average**	**High**	**Low**	**Average**
	(dollars in millions)					
Interest rate and credit spread	$ 77	$52	$66	$59	$45	$51
Equity price	48	34	41	48	28	37
Foreign exchange rate	19	7	12	16	6	10
Commodity price	40	30	34	39	25	30
Trading VaR	$107	$84	$96	$89	$69	$80

VaR Statistics for Comparisons with Other Global Financial Services Firms

VaR statistics are not readily comparable across firms because of differences in the breadth of products included in the VaR model, the statistical assumptions made when simulating changes in market factors, as well as in the methods used to approximate portfolio revaluations under the simulated market conditions. These differences can result in materially different VaR estimates for similar portfolios. As a result, VaR statistics are more reliable and relevant when used as indicators of trends in risk-taking within a firm rather than as a basis for inferring differences in risk-taking across firms. Table 3 below presents the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (99% vs. 95%) for the VaR statistic or a shorter historical time series (four years vs. one year) of market data upon which it bases its simulations:

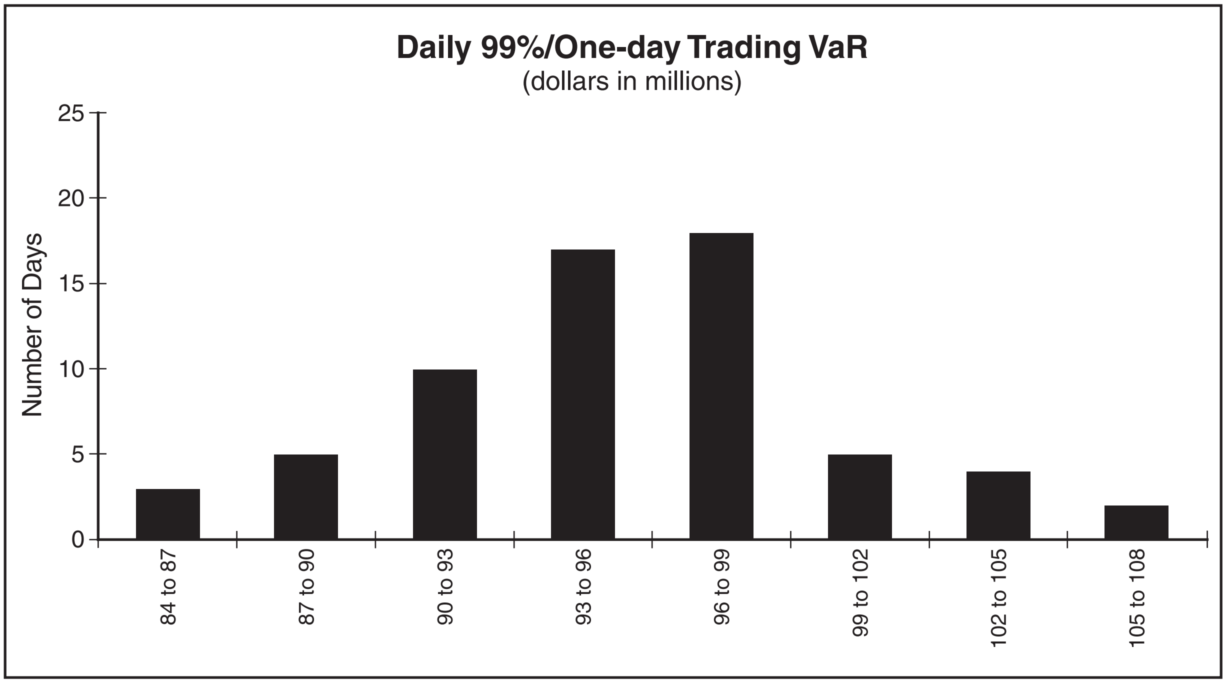
Table 3: Average 99% and 95% Trading VaR with Four-Year/One-Year Historical Time Series

	Average 99%/One-Day VaR for the Quarter Ended February 28, 2005		Average 95%/One-Day VaR for the Quarter Ended February 28, 2005	
Primary Market Risk Category	**Four-Year Factor History**	**One-Year Factor History**	**Four-Year Factor History**	**One-Year Factor History**
	(dollars in millions)			
Interest rate and credit spread	$66	$66	$42	$43
Equity price	41	36	29	25
Foreign exchange rate	12	12	8	8
Commodity price	34	32	23	21
Trading VaR	$96	$89	$66	$60

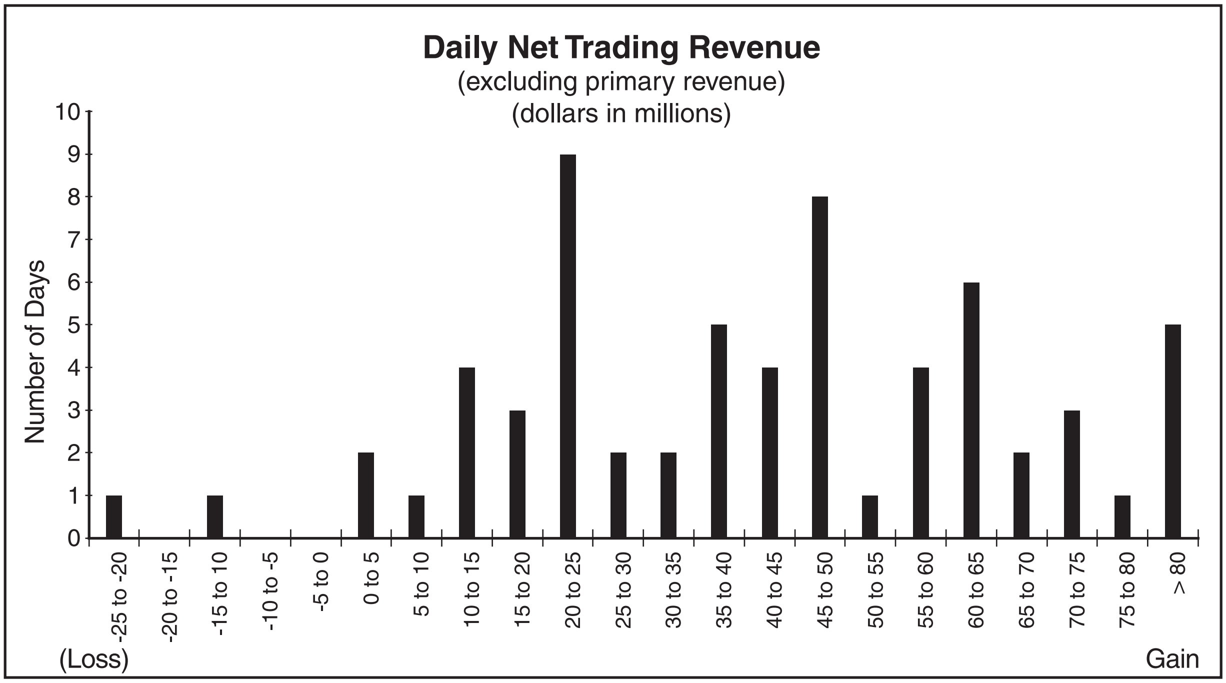
In addition, if the Company were to report Trading VaR (using a four-year historical time series) with respect to a 10-day holding period, the Company's 99% and 95% Average Trading VaR for the quarter ended February 28, 2005 would have been $302 million and $208 million, respectively.

Distribution of VaR Statistics and Net Revenues for the quarter ended February 28, 2005

As shown in Table 2 above, the Company's average 99%/one-day Trading VaR for the quarter ended February 28, 2005 was $96 million. Around this average, the Company's Trading VaR varied from day to day. The histogram below presents the distribution of the Company's daily 99%/one-day Trading VaR and illustrates that for more than 92% of trading days during the quarter ended February 28, 2005, Trading VaR ranged between $87 million and $105 million.



One method of evaluating the reasonableness of the Company's VaR model as a measure of the Company's potential volatility of net revenue is to compare the VaR with actual trading revenue. Assuming no intra-day trading, for a 99%/one-day VaR, the expected number of times that trading losses should exceed VaR during the fiscal year is three, and, in general, if trading losses were to exceed VaR more than five times in a year, the accuracy of the VaR model could be questioned. Accordingly, the Company evaluates the reasonableness of its VaR model by comparing the potential declines in portfolio values generated by the model with actual trading results. The histogram below shows the distribution of daily net revenue during the quarter ended February 28, 2005 for the Company's trading businesses (including net interest and commissions but excluding primary and prime brokerage revenue credited to the trading businesses). There were no days during the quarter ended February 28, 2005 in which the Company incurred daily trading losses in excess of the 99%/one-day Trading VaR.



As of February 28, 2005, interest rate risk exposure associated with the Company's consumer lending activities, included within Credit Services, as measured by the reduction in pre-tax income resulting from a hypothetical, immediate 100 basis point increase in interest rates, had not changed significantly from November 30, 2004.

Credit Risk.

For a further discussion of the Company's credit risks, see "Quantitative and Qualitative Disclosures about Market Risks—Credit Risk" in Part II, Item 7A of the Form 10-K. In addition, for a discussion of the Company's corporate lending activities, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Less Liquid Assets—Lending Activities" herein.

Credit Exposure-Lending. At February 28, 2005 and November 30, 2004, the aggregate value of investment grade loans and positions was $1.5 billion and $1.2 billion, respectively, and the aggregate value of non-investment grade loans and positions was $1.0 billion and $0.5 billion, respectively. At February 28, 2005 and November 30, 2004, the aggregate value of lending commitments outstanding was $20.7 billion and $20.4 billion, respectively. In connection with these business activities (which include funded loans and lending commitments), the Company had hedges with a notional amount of $13.1 billion and $11.6 billion at February 28, 2005 and November 30, 2004, respectively, including both internal and external hedges utilized by the lending business. The table below shows the Company's credit exposure from its lending positions and commitments as of February 28, 2005:

Lending Commitments and Funded Loans

Credit Rating(1)	Years to Maturity				Total Lending Exposure(2)	Funded Loans
	Less than 1	1-3	3-5	Over 5		
	(dollars in millions)					
AAA	$ 252	$ 164	$ 133	$ —	$ 549	$ 31
AA	1,648	472	1,200	64	3,384	—
A	2,251	1,270	4,069	59	7,649	221
BBB	1,769	2,432	3,935	543	8,679	1,293
Non-investment grade	371	633	901	1,035	2,940	975
Total	$6,291	$4,971	$10,238	$1,701	$23,201	$2,520
Notional amount of hedges owned					$13,094	

(1) Obligor credit ratings are determined by the Institutional Credit Department ("Institutional Credit") using methodologies generally consistent with those employed by external rating agencies.

(2) Total Lending Exposure includes both lending commitments and funded loans.

Credit Exposure-Derivatives. The table below presents a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at February 28, 2005. Fair value represents the risk reduction arising from master netting agreements, including cash collateral received or paid where applicable and, in the final column, net of non-cash collateral received (principally U.S. government and agency securities):

OTC Derivative Products—Financial Instruments Owned(1)

Credit Rating(2)	Years to Maturity: Less than 1	1-3	3-5	Over 5	Cross-Maturity and Cash Collateral Netting(3)	Net Exposure Post Cash Collateral	Net Exposure Post Cash and Non-cash Collateral
				(dollars in millions)			
AAA	$ 1,643	$ 2,978	$2,119	$ 6,028	$ (6,369)	$ 6,399	$ 6,149
AA	10,791	3,454	2,942	11,391	(16,273)	12,305	10,775
A	4,437	2,295	2,017	4,804	(4,914)	8,639	7,148
BBB	3,834	2,170	1,357	5,589	(4,953)	7,997	5,746
Non-investment grade	2,352	1,085	863	1,136	(2,007)	3,429	1,575
Unrated(4)	1,161	419	243	150	(514)	1,459	246
Total	$24,218	$12,401	$9,541	$29,098	$(35,030)	$40,228	$31,639

(1) Fair values shown present the Company's exposure to counterparties related to the Company's OTC derivative products. The table does not include the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company's lending activities.

(2) Obligor credit ratings are determined by Institutional Credit using methodologies generally consistent with those employed by external rating agencies.

(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists. See "Cash Collateral Netting" herein.

(4) In lieu of making an individual assessment of the creditworthiness of unrated companies, the Company makes a determination that the collateral held with respect to such obligations is sufficient to cover a substantial portion of its exposure. In making this determination, the Company takes into account various factors, including legal uncertainties and market volatility.

The following tables summarize the fair values of the Company's OTC derivative products recorded in Financial instruments owned and Financial instruments sold, not yet purchased by product category and maturity at February 28, 2005, including on a net basis, where applicable, reflecting the fair value of related non-cash collateral for financial instruments owned:

OTC Derivative Products—Financial Instruments Owned

Product Type	Years to Maturity: Less than 1	1-3	3-5	Over 5	Cross-Maturity and Cash Collateral Netting(1)	Net Exposure Post Cash Collateral	Net Exposure Post Cash and Non-cash Collateral
				(dollars in millions)			
Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	$ 4,604	$ 7,068	$7,749	$26,384	$(23,918)	$21,887	$18,678
Foreign exchange forward contracts and options	11,708	857	92	17	(7,242)	5,432	4,680
Equity securities contracts (including equity swaps, warrants and options)	1,655	977	559	1,189	(808)	3,572	1,165
Commodity forwards, options and swaps	6,251	3,499	1,141	1,508	(3,062)	9,337	7,116
Total	$24,218	$12,401	$9,541	$29,098	$(35,030)	$40,228	$31,639

(1) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists. See "Cash Collateral Netting" herein.

OTC Derivative Products—Financial Instruments Sold, Not Yet Purchased

Product Type	Years to Maturity: Less than 1	1-3	3-5	Over 5	Cross-Maturity and Cash Collateral Netting(1)	Total
			(dollars in millions)			
Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	$ 4,978	$ 6,529	$7,546	$17,654	$(20,767)	$15,940
Foreign exchange forward contracts and options	12,614	810	49	38	(7,637)	5,874
Equity securities contracts (including equity swaps, warrants and options)	1,323	1,243	694	324	(443)	3,141
Commodity forwards, options and swaps	5,220	3,721	1,202	674	(3,612)	7,205
Total	$24,135	$12,303	$9,491	$18,690	$(32,459)	$32,160

(1) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category where appropriate. Cash collateral paid is netted on a counterparty basis, provided legal right of offset exists. See "Cash Collateral Netting" herein.

The Company's derivatives (both listed and OTC) at February 28, 2005 and November 30, 2004 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

Product Type(1)	At February 28, 2005 Assets	At February 28, 2005 Liabilities	At November 30, 2004 Assets	At November 30, 2004 Liabilities
	(dollars in millions)			
Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	$22,006	$15,988	$22,998	$18,797
Foreign exchange forward contracts and options	5,442	5,882	9,285	8,668
Equity securities contracts (including equity swaps, warrants and options)	6,151	7,940	5,898	7,373
Commodity forwards, options and swaps	9,402	7,579	11,294	8,702
Total	$43,001	$37,389	$49,475	$43,540

(1) Effective December 1, 2004 the Company has elected to net cash collateral paid or received against its derivatives inventory under credit support annexes. See "Cash Collateral Netting" herein.

Each category of OTC derivative products in the above tables includes a variety of instruments, which can differ substantially in their characteristics. Instruments in each category can be denominated in U.S. dollars or in one or more non-U.S. currencies.

The fair values recorded in the above tables are determined by the Company using various pricing models. For a discussion of fair value as it affects the condensed consolidated financial statements, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies" in Part I, Item 2 and Note 1 to the condensed consolidated financial statements. As discussed under "Critical Accounting Policies," the structure of the transaction, including its maturity, is one of several important factors that may impact the price transparency. The impact of maturity on price transparency can differ significantly among product categories. For example, single currency and multi-currency interest rate derivative products involving highly standardized terms and the major currencies (e.g., the U.S. dollar or the euro) will generally have greater price transparency from published external sources even in maturity ranges beyond 20 years. Credit derivatives with highly standardized terms and liquid underlying reference instruments can have price transparency from published external sources in a maturity ranging up to 10 years, while equity and foreign exchange derivative products with standardized terms in major currencies can have price transparency from published external sources within a two-year maturity range. Commodity derivatives with standardized terms and delivery locations can have price transparency from published external sources within various maturity ranges up to 10 years, depending on the commodity. In most instances of limited price transparency based on published external sources, dealers in these markets, in their capacities as market-makers and liquidity providers, provide price transparency beyond the above maturity ranges.

Country Exposure. The Company monitors its credit exposure and risk to individual countries. Credit exposure to a country arises from the Company's lending activities and derivatives activities in a country. At February 28, 2005, approximately 6% of the Company's total credit exposure (including loans, lending commitments and derivative contracts) was to emerging markets, and no one emerging market country accounted for more than 1% of the Company's total credit exposure. The Company defines emerging markets to include all countries that are not members of the Organization for Economic Co-operation and Development ("OECD"), excluding the Cayman Islands and the Channel Islands, and those OECD countries rated below "A" by Institutional Credit. These country credit ratings are derived using methodologies generally consistent with those employed by external rating agencies.

Industry Exposure. The Company also monitors its credit exposure and risk to individual industries. At February 28, 2005, the Company's material credit exposure (including loans, lending commitments and derivative contracts) was to financial institutions, sovereign-related entities, and the energy and food and beverage sectors.

Item 4. Controls and Procedures

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

No change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) occurred during the period covered by this report that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II OTHER INFORMATION

Item 1. Legal Proceedings

(a) The following is a new matter reported by the Company.

Email Retention Matter.

On January 14, 2005, the Company received written notification that the staff of the Division of Enforcement of the SEC had made a preliminary determination to recommend that the SEC pursue an action against the Company for purported violations of Sections 17(a) and 17(b) of the Exchange Act (and related regulations) and a December 3, 2002 Cease and Desist Order relating to the Company's retention of emails. On February 10, 2005, the Company submitted its response, setting forth the reasons why, in the Company's view, an enforcement action is not justified. The Company has submitted additional letters since its February 10 response. The SEC's investigation continues.

(b) The following developments have occurred with respect to certain matters previously reported in the Company's Form 10-K.

IPO Allocation Matters.

Since November 2004, purported assignees of various issuers who were sued in and agreed to settle claims in *In re Initial Public Offering Securities Litigation* have filed suit against several members of the underwriting syndicate, including the Company, alleging that underwriters breached the underwriting agreement and related duties by allocating shares in each company's IPO to customers who allegedly paid the underwriters "excess compensation." The assignment was conferred in the issuers' settlement, and the assignee-plaintiffs have moved to stay the actions pending approval of the issuers' settlement, while the Company has moved to dismiss the cases.

Mutual Fund Matters.

Sales Practices. On March 27, 2005, in the *Massachusetts Securities Division* matter, the hearing officer issued two decisions dismissing all charges against the Company and the branch manager.

On March 9, 2005, in *In re Morgan Stanley and Van Kampen Mutual Funds Securities Litigation*, plaintiffs filed a Motion for Leave to file a Supplemental Pleading that would, among other things, expand the allegations and alleged class to encompass the sale of certain non-proprietary mutual funds.

Late Trading and Market Timing. On February 22, 2005, in *Starr v. Van Kampen Investments Inc.*, *et al.*, plaintiffs re-filed the derivative claims relating to market timing and late trading in the United States District Court for the District of Maryland (the "Maryland District Court") as part of the *In re Mutual Funds Investment Litigation* already pending in the Maryland District Court. On April 4, 2005, defendants moved to dismiss the complaint.

On February 28, 2005, in *Lepera v. Invesco Funds Group, Inc., et al.*, and *Riggs v. Massachusetts Financial Services Company, et al.*, MSDWI joined other defendants in moving to dismiss these complaints.

On April 5, 2005, in *Jackson v. Van Kampen Series Fund, Inc. and Van Kampen Investment Advisory Corp.*, the U.S. Court of Appeals for the Seventh Circuit reversed the district court's decision remanding the case from federal to state court, and instructed the district court to dismiss plaintiff's state law claims.

Other. On March 14, 2005, in *Abrams v. Van Kampen Funds Inc., et al.*, the parties agreed in principle to settle the matter.

Coleman Litigation.

On February 17, 2005, Coleman (Parent) Holdings, Inc. ("CPH") filed a first amended complaint dropping claims for fraudulent misrepresentation and negligent misrepresentation and re-asserting claims for aiding and abetting fraud and conspiracy. On February 28, 2005, the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida denied the Company's motion to dismiss the first amended complaint. On March 1, 2005, in response to a motion for entry of default judgment filed by CPH, the court entered an order shifting the burden of proof to the Company in connection with certain elements of CPH's claims and imposing a monetary sanction against the Company for certain of CPH's costs and fees. On March 23, 2005, the court granted, in part, a renewed motion for entry of default judgment against the Company. The court ordered that portions of CPH's amended complaint against the Company be read at trial to the jury and that the jury be instructed that the facts alleged in such portions of the complaint, which set forth the primary allegations of CPH against the Company, are deemed established for all purposes of the action. The court also ordered that a statement summarizing the court's findings with respect to the Company's discovery misconduct be read to the jury and that the jury be instructed that it may consider that statement in determining whether an award of punitive damages is appropriate. While the amount of the final award, if any, cannot be determined and could exceed CPH's current damages claim, CPH currently seeks compensatory damages of approximately $680 million and punitive damages of approximately $2.0 billion, attorneys' fees and other relief, including prejudgment interest. Trial began in April 2005.

With respect to the separate litigation filed by the Company against various Arthur Andersen entities and individuals, on December 2, 2004, the court granted a motion to dismiss filed by AWSC Societe Cooperative, En Liquidacion. On February 8, 2005, the court denied motions to dismiss filed by Arthur Andersen LLP and certain of its former partners. Motions to dismiss filed by other defendants are still pending.

Carlos Soto Matter.

On February 18, 2005, the Company and another entity filed a Joint Motion for Entry of an Agreed Order of Restitution with the U.S. District Court for the District of Puerto Rico.

Parmalat Matter.

On March 17, 2005, magistrates in Milan, Italy announced they had concluded their investigation of alleged market-rigging by several financial institutions and employees of those institutions, including the Company and two of its employees, and that they intend to seek indictments against those financial institutions and employees.

Indonesian Litigation.

In January 2005, an additional proceeding was filed in the Indonesian District Courts by Indah Kiat International Finance Company BV, a member of the Asia Pulp & Paper Group and the issuer of the 1994 bond issue, against the Company and other defendants, making allegations similar to those in the November 2003 claim brought by PT Indah Kiat. Plaintiff seeks damages in respect of losses allegedly suffered.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth the information with respect to purchases made by or on behalf of the Company of the Company's common stock during the quarter ended February 28, 2005.

Issuer Purchases of Equity Securities
(dollars in millions, except per share amounts)

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs (C)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
Month #1 (December 1, 2004—December 31, 2004)				
Equity Anti-dilution Program (A)	2,776,402	$55.3036	2,776,402	(A)
Capital Management Program (B)	—	N/A	—	$ 600
Employee Transactions (D)	310,550	$54.5679	N/A	N/A
Month #2 (January 1, 2005—January 31, 2005)				
Equity Anti-dilution Program (A)	15,388,755	$55.5606	15,388,755	(A)
Capital Management Program (B)	—	N/A	—	$ 600
Employee Transactions (D)	1,358,407	$55.8685	N/A	N/A
Month #3 (February 1, 2005—February 28, 2005)				
Equity Anti-dilution Program (A)	6,325,915	$57.4689	6,325,915	(A)
Capital Management Program (B)	—	N/A	—	$ 600
Employee Transactions (D)	180,458	$57.1181	N/A	N/A
Total				
Equity Anti-dilution Program (A)	24,491,072	$56.0244	24,491,072	(A)
Capital Management Program (B)	—	N/A	—	$600
Employee Transactions (D)	1,849,415	$55.7721	N/A	N/A

(A) The Company's board of directors authorized this program to purchase common stock to help offset the dilutive impact of grants and exercises of awards under the Company's equity-based compensation and benefit plans. The program was publicly announced on January 7, 1999 and has no set expiration or termination date. There is no maximum amount of shares that may be purchased under the program.

(B) The Company's board of directors authorized this program to purchase common stock for capital management purposes. The program was publicly announced on February 12, 1998 at which time up to $3 billion of stock was authorized to be purchased. The program was subsequently increased by $1 billion on December 18, 1998, $1 billion on December 20, 1999 and $1.5 billion on June 20, 2000. This program has a remaining capacity of $600 million at February 28, 2005 and has no set expiration or termination date.

(C) Share purchases under publicly announced programs are made pursuant to open-market purchases, Rule 10b5-1 plans or privately negotiated transactions (including with employee benefit plans) as market conditions warrant and at prices the Company deems appropriate. During the quarter ended February 28, 2005, approximately 5 million shares were purchased from employees under the Company's publicly announced programs.

(D) Includes: (1) shares delivered or attested to in satisfaction of the exercise price and/or tax withholding obligations by holders of employee stock options (granted under employee stock compensation plans) who exercised options; (2) restricted shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon vesting and release of restricted shares; and (3) shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units. The Company's employee stock compensation plans provide that the value of the shares delivered or attested, or withheld, shall be the average of the high and low price of the Company's common stock on the date the relevant transaction occurs.

Item 4. Submission of Matters to a Vote of Security Holders

The annual meeting of stockholders of the Company was held on March 15, 2005.

The stockholders voted on proposals to elect one class of directors for a three-year term; to ratify the appointment of Deloitte & Touche LLP as independent auditors and to amend the certificate of incorporation to institute annual election of directors.

The stockholders also acted on a stockholder proposal seeking to limit the compensation of the Chief Executive Officer.

The stockholders' vote ratified the appointment of the independent auditors and approved the amendment to the certificate of incorporation. All nominees for election to the board were elected to the terms of office set forth in the Proxy Statement dated February 15, 2005. In addition, Philip J. Purcell, Edward A. Brennan, Howard J. Davies, C. Robert Kidder, John W. Madigan, Michael A. Miles, and Klaus Zumwinkel will continue to serve on the board. The stockholder proposal was defeated. The number of votes cast for, against or withheld, and the number of abstentions with respect to each proposal, is set forth below. The Company's independent inspectors of election reported the vote of the stockholders as follows:

	For	Against/ Withheld	Abstain	Broker Non-vote
Election of Directors:				
Nominee:				
John E. Jacob	842,490,188	141,807,697	*	*
Charles F. Knight	841,009,397	143,288,488	*	*
Miles L. Marsh	841,474,505	142,823,380	*	*
Laura D'Andrea Tyson	904,771,444	79,526,441	*	*
Ratification of Independent Auditors:	932,541,891	26,321,002	25,461,991	*
Amend the Certificate of Incorporation to Institute Annual Election of Directors	937,741,204	20,009,981	26,546,699	*
Stockholder Proposal:	113,872,624	657,825,127	34,722,700	177,827,434

* Not applicable.

Item 6. Exhibits

An exhibit index has been filed as part of this Report on Page E-1.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MORGAN STANLEY
(Registrant)

By: /s/ DAVID H. SIDWELL
David H. Sidwell,
Chief Financial Officer

By: /s/ DAVID S. MOSER
David S. Moser,
Principal Accounting Officer

Date: April 6, 2005

EXHIBIT INDEX

MORGAN STANLEY

Quarter Ended February 28, 2005

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation, as amended to date.
3.2	Amended and Restated By laws (incorporated by reference to Exhibit 3 to the Company's Current Report on Form 8-K dated April 2, 2005).
10.1	Amendment to Morgan Stanley 401(k) Plan.
10.2	Amendment to Morgan Stanley 401(k) Plan.
11	Statement Re: Computation of Earnings Per Common Share (The calculation of per share earnings is in Part I, Item 1, Note 8 to the Condensed Consolidated Financial Statements (Earnings per Share) and is omitted in accordance with Section (b)(11) of Item 601 of Regulation S-K).
12	Statement Re: Computation of Ratio of Earnings to Fixed Charges and Computation of Ratio of Earnings to Fixed Charges and Preferred Stock Dividends.
15	Letter of awareness from Deloitte & Touche LLP, dated April 6, 2005, concerning unaudited interim financial information.
18	Letter Re: Change in Accounting Principles.
23.1	Consent of BK Associates, Inc.
23.2	Consent of Morten Beyer & Agnew, Inc.
23.3	Consent of Airclaims Limited.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.