

April 16, 2010

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments on the two consultative documents issued by the Basel Committee in December 2009, entitled: *Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring* ("the Proposals"). These documents contain proposed changes to the regulatory capital, liquidity and funding requirements, which are part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the Financial Stability Board and the G20 leaders.

Key Points

We support these initiatives and want to ensure that these changes improve the strength of the financial system. However, the Proposals, as written, will likely make the financial system more fragile and further hamper an economic recovery. We believe there are four overarching issues with these proposals: risks are double counted, they lack risk sensitivity, require calibration and the timeline is unrealistic.

Double Counting: Individual risks should be identified and appropriately capitalized against, once. Instances occur in the current proposals where risks are capitalized against multiple times. For example, the Proposals double count the counterparty risk faced by banks that mark-to-market CVA. The 1-year VaR of the CVA contains credit losses that are capitalized via EPE-based charges. The risks need to be carefully reviewed, so that there is a one-to-one correspondence between a capital charge and an unexpected loss.

Lack of Risk Sensitivity : The Proposals also have the potential to create perverse incentives for financial institutions. One of the innovations of the Basel II Accord was to make greater use of the assessments of risk provided by banks' internal systems as inputs to capital calculations. These latest proposals introduce elements that are not consistent with how firms manage their risk and as a result, would force them to make sub-optimal decisions from an economic perspective.

Calibration: The Proposals have the potential to be overly conservative and drive certain financial products/services to shadow banking institutions. As the cost of certain activities becomes excessive, institutions outside the regulators' purview will be the only ones that are economically able to provide these products/services to clients. Thus, the proposals need to be calibrated so that the regulatory capital is proportionate to the underlying economic risks.

Unrealistic Timeline: We believe the proposed timeline to implement these changes is unrealistic. In our view, these proposals need significant modifications and further Quantitative Impact Studies (QIS) to

ensure that they will strengthen the banking sector. To issue a fully calibrated set of standards by the end of 2010, does not provide the time necessary for appropriate review and analysis.

The below is a summary of Morgan Stanley's key recommendations in regards to the proposals on the Counterparty Credit Risk charges, Liquidity Ratios, Leverage Ratio and Quality of Capital.

Counterparty Credit Risk:

We recommend that the regulatory capital treatment of portfolios of counterparty risks that are marked to market and managed within a trading book regime be consistent with other similar risks of the trading book.

Specifically, we recommend that the regulatory capital on counterparty risks should be assessed by including the CVA (and all its single-name, credit index and other hedges) in the trading VaR, stressed VaR, and IRC frameworks.

In this way, the CVA risks and hedges would be treated as integral parts of the full trading book and would be measured within the full trading book context.

The banking book EPE-based charge should be eliminated. It is inconsistent with the economics and risk management of counterparty risks that are marked to market and hedged.

Liquidity Ratios:

Liquidity Coverage Ratio

We recommend modifying the Liquidity Ratios outlined under BCBS 165 to ensure that they accurately reflect the lessons learned during the crisis and enable institutions to incorporate securities into the ratio that were shown to be liquid during a stress event.

Under the Firm's proposal, the Stock of High Quality liquid assets, a component of the Liquidity Coverage Ratio, would include securities issued by a broader range of entities, such as Agency Securities. Further, unencumbered high quality assets sourced via a reverse repo, should be provided equal treatment versus cash and unencumbered assets.

In addition, financial instruments sold and customer payables are not considered in the equation, therefore creating an imbalance when calculating the ratio, i.e. inflows are misrepresented on a contractual unwind of reverse repo and securities borrowed.

Net Stable Funding Ratio

We also recommend modifying certain factors of the Net Stable Funding Ratio, to more accurately reflect the funding requirement for these products. The Required Stable Funding factor (RSF) for secured loans, e.g. reverse repos, securities borrowed and margin lending, should be zero if a firm can demonstrate the securities are either secure funded or covering short positions. This would be consistent with the Available Stable Funding factor (ASF) for these transactions.

The ASF for derivative payables should be set to 100%, for those derivative cash flows that have a maturity greater than 1 year. Similarly, the RSF for derivatives receivables, should be adjusted so that it is 0% for derivative cash flows with a maturity greater than 1 year.

Leverage:

We recommend that the Leverage Ratio should use Tier 1 Capital as a basis for the calculation and take into account existing risk management tools that are proven to be effective, including counterparty netting and margin agreements. Further, we believe that credit derivatives should be treated as any other derivative and that exchange traded derivatives and OTC trades cleared through a central counterparty should be reflected in the calculation through the use of the on-balance sheet values, only.

Finally, until the Leverage Ratio metric is calibrated, it should remain within Pillar 2 and should not be moved to Pillar 1 without further consultation with the industry.

Quality of Capital

We recommend modifying the Quality of Capital proposal to include the following:

- 1) **Minority Interest:** In eliminating Non-Controlling Interest (NCI) from the common equity component of Tier 1, the Committee should exclude the deduction of the consolidated goodwill and intangibles associated with the NCI, which carries no economic risk to the Firm.
- 2) **Hybrid Instruments:** Morgan Stanley believes that properly structured hybrid securities (long dated, non-cumulative, no incentive to redeem other than economic, minimum replacement clauses) are valuable forms of capital and should be included as part of Tier 1 Equity.

Comments and Recommendations

The text below describes our views in more detail on four key areas within the proposals: 1) Counterparty Credit Risk; 2) Liquidity; 3) Leverage; and 4) Quality of Capital.

Counterparty Credit Risk:

Summary

We appreciate the challenges associated with capitalizing counterparty risk. In our view, the capital calculated under current Basel 2 rules on counterparty risk is already overstated. This is because of the lack of proper recognition of the counterparty risk hedges in the IMM framework and the inclusion of the hedges in the trading book without the offsetting CVA exposures (split hedge problem). The new proposal will make the matter worse by exaggerating the measures of counterparty risk and capital in all dimensions.

We understand the supervisors' concerns on (1) P&L volatility of CVA (2) model uncertainty (3) potential fluctuations of counterparty risk profiles in the future. CVA is a derivative pricing concept involving multiple underlying risk factors and, in that sense, it is not different from credit derivatives or equity options which contain credit or equity risk as well as interest rate risk. Therefore we recommend the full integration of CVA into trading VaR and stressed VaR subject to the regular process of VaR model approval for the trading book. Bringing the CVA into the trading VaR framework is essential to properly reflect hedging activities of CVA. Morgan Stanley measures and manages counterparty risk (CVA) and other traded credit risks (bonds, CDS and loans) within a single framework of traded risk.

The Basel 2's IMM framework needs to reflect the fact that CVA marks-to-market the counterparty risk. The VaR and stressed VaR of the CVA capture all market risks of CVA except for jump-to-default and migrations over one year. The regulatory capital framework should not double count the same risk in the IMM and CVA VaR capital charges. Hence we recommend that the additional jump-to-default/migration capital charge, beyond CVA VaR and stressed VaR, should be based on a proper IRC framework that would include jump-to-default and migrations.

We do recognize the need to make the capital rules conservative. The ideal capital rule needs to (1) reflect the economic risk and the experience during stressed market periods and require an appropriate level of capital compared with such experience (2) create the correct incentive for the banking industry to manage risk in a prudent manner. The proposal fails on both fronts because (1) it does not reflect the economic risk and experience of Morgan Stanley through the crisis and the capital requirement is absolutely excessive (2) it introduces incorrect measures of counterparty risk and creates distorted incentives to hedge those exposures.

Below we discuss these important issues in more detail.

Materiality of the capital increase

The proposed rules in BCBS 164 will increase our Basel 2 / IMM capital on counterparty risk by a very large factor, due to:

- Capital add-on to capture the mark-to-market risk of CVA based on a stylized, standalone 1-year, 99% VaR
- Increase in EPEs and EADs due to various changes in the calculations:

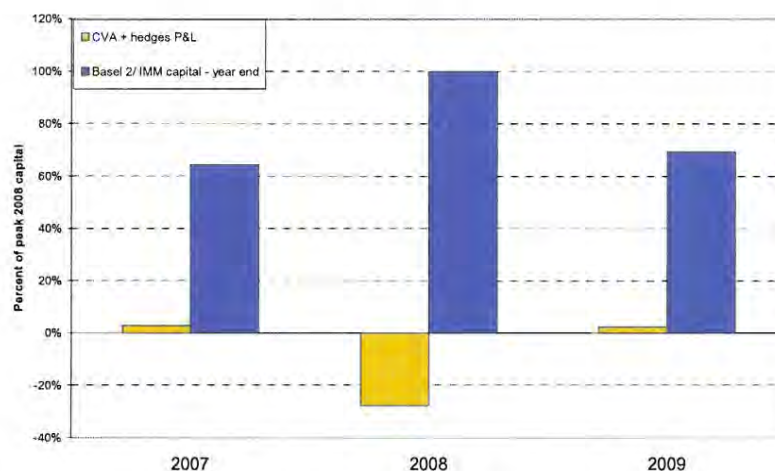
- Calculation of EPEs and EADs with stressed market inputs using volatilities and correlations estimated over a 3-year period that includes the 1-year period used to calculate stressed VaR. The capital charge on counterparty risk will be the maximum of the calculation with current and stressed inputs
- Extension of the risk period for collateralized OTC derivatives and SFT for large netting sets (> 5000 trades) or which contain illiquid collateral or hard to replace derivatives. Netting sets that have more than two margin disputes over the last two quarters will have risk period multiplied by 2 for the next two quarters
- No benefit for rating downgrade triggers in the calculation of EPE
- Increase in the RWs due to a scaling factor of 1.25 applied to the correlations of large regulated financial institutions (assets > \$25B) and all unregulated financial institutions (e.g. hedge funds)

The capital increase is disproportionately large when compared to the all-in losses that we experienced during the 2007-8 financial crisis.

The graph below shows the P&L of our OTC derivatives counterparty risk management activities (including CVA marking-to-market, default losses and net of hedges) compared to the Basel 2 / IMM regulatory capital on OTC derivative counterparty risk for the crisis period.

(The Morgan Stanley's own-credit component of the CVA and its hedges are not included in the P&L figures below. The dollar numbers were converted to percentages of the our Basel 2 / IMM capital at the end of 2008.)

CVA P&L and Basel 2 / IMM Capital on OTC Derivatives Counterparty Risk
(2007-2009)



Observe that in 2008, the worst year of the crisis for our CVA risk management activity, we lost 28% of the Basel 2 / IMM capital as of the end of 2008.

Under the proposed rules, the Basel 2 / IMM capital on counterparty risk would increase by a large factor and become even more disproportional to the experienced losses than under current rules.

Our recommended approach is consistent with current CVA risk management practice

Over the past 12 years, Morgan Stanley (similarly to other large derivative dealers) has spent substantial resources to enhance its capabilities to measure, price and manage counterparty credit risks. During this same period, the expanding credit derivative market (esp. for vanilla index and single-name CDSs) has created opportunities for the risk management of counterparty credit risk as a trading book operation with active hedging.

We have built a sophisticated risk management system for CVA and we have established CVA trading desks that are dedicated to the pricing and management of our counterparty risks. These desks have executed large amounts of hedges against the CVAs, to the tune of tens of billion of dollars in CDS notional amounts as well as interest rate, foreign exchange and commodity derivatives.

Banks that, like us, marked to market their CVAs experienced severe CVA volatility during the 2007-8 financial crisis. The variability of the banks' CVAs reflected the turbulence in the markets. Banks that actively hedged their CVAs performed much better than the ones that did not hedge.

Recommendation

We recommend that the regulatory capital treatment of portfolios of counterparty risks that are marked to market and managed within a full trading book regime be consistent with other similar risks (liquid and less liquid) that exist in the trading book.

Specifically, we recommend that the regulatory capital on counterparty risks should be assessed by including the CVA (and all its single-name, credit index and other hedges) in the trading VaR, stressed VaR, and IRC frameworks.

In this way, the CVA risks and hedges would be treated as integral parts of the full trading book and would be measured within the full trading book context.

The banking book EPE-based charge should be eliminated.

It is inconsistent with the economics and with the risk management of counterparty risks that are marked to market and hedged.

Notice that:

- The majority of our CVA and CVA sensitivity to counterparty spreads corresponds to counterparties whose credit is traded in the market. Those names are directly hedgeable. The remaining amount is marked and hedged with proxy credit curves, sometimes anchored on credit indices.
- We measure and manage CVA risks as integral parts of our overall trading risks. The hedges of the CVA, including credit and other risk factors (driving underlying exposures), are already part of the trading book. Currently, this creates a severe split-hedge problem with the CVA naked hedges being charged in the trading book.
- The modeling of CVA within the trading book framework is not more complex than the modeling of other hybrid credit risks that exist in the trading book. In that sense, VaR and IRC of CVA are not more complex than the current applications of those models to other derivative products in the trading book. Some banks (like us) already include CVA and its hedges in their internally used VaR models.

- The IRC framework is analogous to the IRB ASRF model that is used to calculate the RWs in the banking book but it has the advantage that it captures the concentrations (granularity) of the portfolio of exposures. The liquidity horizons of the various CVA risks and the dependencies between market prices and counterparty credit need to be modeled appropriately to capture the right- and wrong-way risk effects. The counterparty exposures in the IRC model could be the EEPE reduced appropriately by hedges. We believe that a properly designed IRC framework is a key platform to capitalize credit risks in the trading book and should be able to capture the relevant risks of the CVA.
- Finally: as important as the level of capital that banks should hold, it is the allocation of that capital relative to the nature and size of the underlying economic risks. If the capital rule is simplistic and risk-insensitive it will distort relative prices and will create uneconomic incentives that will lead capital-optimizing banks to pursue strategies that are sub-optimal and ultimately will result in large costs to society.

Key defects and potential improvements to BCBS 164 proposal on VaR of CVA

Below we discuss our major concerns with respect to the BCBS 164 proposals and we suggest improvements that are consistent with our recommended approach described above:

- *The bond-equivalent is a poor approximation of the actual risks of the CVA especially because of the use of stressed EPE, $\text{Alpha} = 1.4$ and longest netting set's M*

Bond equivalent risk representation is incomplete and imperfect. The CVA is sensitive to changes in the credit spread of counterparty and to the changes in the underlying market-driven exposures. The bond-equivalent approximation is a poor representation of the actual risks of the CVA: it does not capture the risks of the underlying exposures and it captures imperfectly the risk to spread of the counterparty.

In the actual CVA calculation, the expected exposures are not stressed and they are not multiplied by Alpha.

Also, in the proposed methodology, the longest netting set's M determines the maturity of equivalent zero-coupon bonds for all net sets comprising a counterparty. This materially distorts the risk measure of netting sets that have small M and large EAD (see Appendix 1).

The combination of those calculation features results in a substantially erroneous representation of CVA risks.

Improvement: allow banks to use their own CVA pricing models to calculate the risk sensitivities with respect to credit spreads and to other underlying risks.

- *CVA hedges are considered only partially*

CVA risk management uses various types of hedges beyond single-name credit hedges. Typically, CVA desks use single-name and index CDSs, CCDSs, interest-rate swaps, swaptions, caps, FX forwards and options, commodities swaps, futures and forwards, stocks, stock options, etc...

All those hedges are currently "naked" in the trading book, creating a large "split hedge" problem and disincentive to CVA hedging.

Improvement: allow banks to count all their hedges against CVA in the calculation of CVA VaR and regulatory capital more generally.

- *Standalone calculation is inconsistent with the treatment of other market risks and leaves CVA hedges naked in the trading book*

Standalone CVA VaR penalizes banks that hedge CVA. The hedges are already in trading book naked, split from the offsetting CVA exposures. This creates a large disincentive to hedge CVA.

Improvement: allow banks to integrate CVA in their trading book VaR to offset properly the hedges that already exist in there.

- *5 times 10-day VaR multiplied is inconsistent with the treatment of other market risks and leaves hedges naked in the trading book*

1-year, 99% VaR multiplied (or not) is inconsistent with other market risks.

Improvement: allow banks to calculate 10-day VaR multiplied by 3.

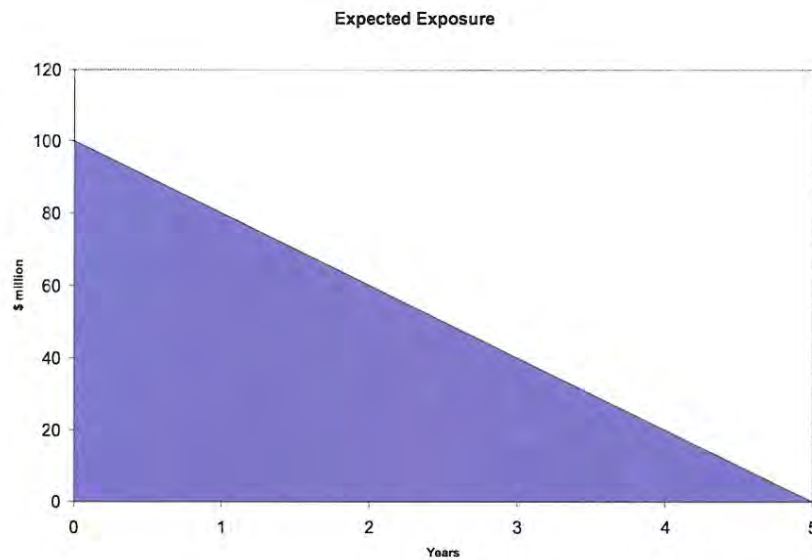
Appendix 1

Zero-Coupon Bond: A Poor Approximation of CVA Risk

The purpose of the simple examples below is to show how crude and erroneous the bond-equivalent spread pv01 approximation is relative to the correct CVA spread pv01. We believe that the QIS4 comprehensive results will confirm this point quite strongly.

Example A

Consider the expected exposure profile of the bank's exposure to counterparty XYZ. The shape of the exposure profile below is typical of counterparties with large portfolios of trades. As time evolves, the expected exposure declines because the in-the-money cash flows roll off.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

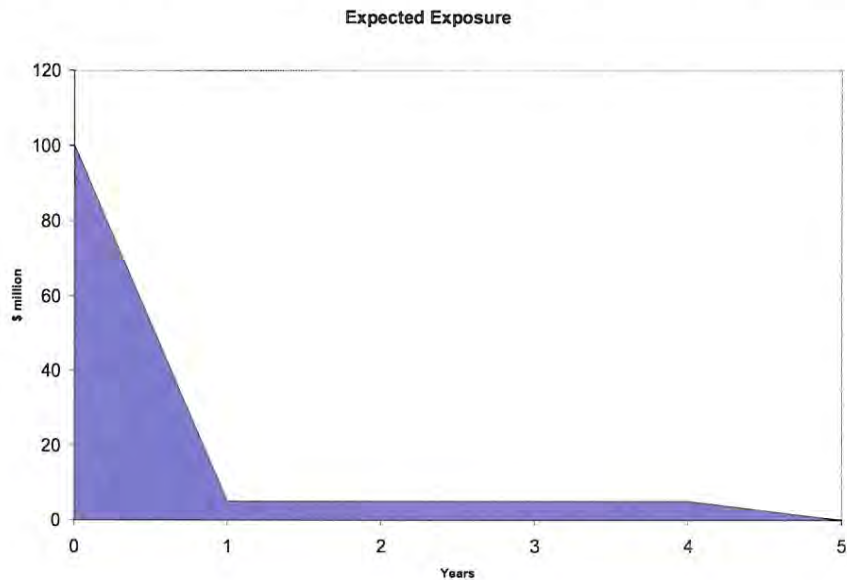
We calculate:

- CVA = \$4.49 M
- The spread PV01 of the CVA is \$0.0215 M per bp.
- The spread PV01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent spread pv01 is 2.4 times the correct CVA spread pv01.

Example B

Consider the expected exposure profile of the bank's exposure to counterparty ABC. This profile is typical of counterparties with whom we have many short-term trades and a small number of long-term ones.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$1.30 M
- The spread PV01 of the CVA is \$0.0063 M per bp.
- The spread PV01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent spread pv01 is 8.1 times the correct CVA spread pv01.

Liquidity:

We agree with the proposal for the introduction of liquidity ratios as part of Basel II, both a short term liquidity coverage ratio and longer term stable funding ratio to ensure effective liquidity management. However, the asset classes included in the equations and associated factors require careful examination. The results need to be properly calibrated and consistent with how liquidity risk is managed. If not, the capital markets and global economy may be adversely affected.

Both of the ratios are discussed in more detail below.

Liquidity Coverage Ratio

In principal, the Liquidity Coverage Ratio (LCR) provides a reasonable method for ensuring that firms are funding themselves appropriately. However, the assets considered liquid are too narrowly defined and may potentially have unintended market consequences that exacerbate a market crisis.

The proposed definition of the Stock of High Quality Liquid Assets, the numerator in the LCR, focuses the eligible assets on sovereign debt. This will cause banks to alter their investment strategy, investing in sovereigns over other high quality paper. Right now, thanks to various governmental efforts to support national economies, there is a large supply of sovereign debt that can be used for this purpose in most, but not all, markets. However, once governments stabilize their economies and efforts are made to reduce national debt, a shortage of available assets that are considered eligible could develop. As the LCR assumes all firms are undergoing stress at the same time, all firms might need to liquidate the same assets, driving down prices.

In addition, the current definition of unencumbered high quality assets does not truly represent the spectrum of repo-able collateral that could raise liquidity during a crisis. For example, inclusion of securities issued by Government Sponsored Entities (GSE), such as Agency Securities (and agency enhanced securities), should be considered as they were shown to be liquid securities throughout the crisis.

This is shown through an increase in volumes, a narrowing of spreads and the strong trading infrastructure in place for these securities.

Volumes	According to the DTCC, the clearance and settlement of mortgage-backed securities increased \$2.2tn from August 2008 to September 2009 and \$0.6tn from September 2008 to October 2008.
Pricing	Whereas US Agencies and Agency mortgage backed collateral traded 10-15bps above Treasuries pre-crisis, the spreads tightened to 1-2 bps above Treasuries in the fall of 2008. Spreads remain at this level today.
Infrastructure	These asset classes remained highly liquid throughout the crisis due to the well-established, robust market infrastructure, trader anonymity and guaranteed settlement upon confirmation.

As a result, we propose a factor for these securities within a range of 100%, which is applied to fully guaranteed sovereign debt, and 80%, currently proposed for corporate bonds rated AA or higher.

Further, unencumbered high quality assets sourced via a reverse repo, should be provided equal treatment versus cash and unencumbered assets.

The fact that a firm owns a high quality asset or sources it via a reverse repo, should not influence the level of liquidity support it provides an institution. Reverse repos represent a superior form of liquidity reserve as not only can a reverse repo provide access to a high quality asset, it also offers a contractual unwind within 24 hours, ensuring access to deployable liquidity day-over-day and intraday. An unencumbered asset still would need to be converted into cash through a sale or a repo, which would take a longer time to settle.

The current liquidity coverage ratio would assume 0% in the net inflows component of the denominator that is detrimental to firms who employ this reliable form of investment against highly liquid collateral as a liquidity investment and cash management technique. During normal and stressed environments overnight repurchase agreements collateralized against highly liquid collateral provide on demand liquidity and flexibility to meet anticipated and unanticipated cash outflows.

In addition, careful consideration should be given to the assumption around reverse repos and securities borrowed pertaining to net inflows. If a security is lent out and then the same security is borrowed through a reverse repo, the unwind of this transaction will typically be done simultaneously. Thus, the transactions create a cash neutral event. Therefore, when a security borrowed is covering a short it should not receive the 100% benefit of a cash inflow.

Net Stable Funding Ratio

The Net Stable Funding Ratio (NSFR) is a reasonable test for liquidity, however, the elements included in the ratio are too restrictive and the factors are assigned inconsistently. The treatment of repos and reverses in the stable funding ratio is unclear, however it seems that they are a component of the Required Stable Funding amount and thus, require funding greater than one year. However, much of the volume in these books is matched, where reverse repos are matched off with repos and short covering and thus, are self-funding. The same argument can be made for other forms of secured lending, where the asset is funded with a liability of greater maturity, e.g. margin lending.

Thus, the Required Stable Funding factor (RSF) for these transactions should be zero, which would be consistent with the Available Stable Funding factor (ASF) (on the liabilities side of the balance sheet) for these transactions.

In addition, in the current proposal, the derivatives payables and receivables are handled inconsistently. A typical swap book will be comprised of a series of bi-lateral transactions, and as a result, provides a self-funding mechanism for the portfolio. However, the RSF for derivatives contracts is 100% where the ASF is 0%, thus, not giving any credit for the derivative payables.

We propose to amend the ASF for derivatives with cashflows greater than 1 year to 100% so that the true nature of these transactions is properly reflected. Similarly, we propose that the RSF for derivatives contracts with maturity greater than 1 year should be 0%. These two changes are consistent with the spirit of the rule, that cashflows greater than 1-year, do not require stable funding.

Leverage Ratio:

We support the notion of instituting a leverage metric. However, we believe that the ratio should be based on Tier 1 Capital, consistent with existing risk management tools that are proven to be effective and modified for certain products to reflect their risk profile. Lastly, we believe the leverage metric should remain within Pillar 2.

The calculation of the leverage ratio based solely on the predominant form of Tier 1 would be, in our view, excessively narrow and has the potential to severely constrain banking activity. Given the effort to strengthen the definition of Tier 1 and its predominant components, Total Tier 1 would provide a sound basis for the calculation of a leverage ratio.

Counterparty netting, margin agreements and credit risk mitigants are established risk management tools that should be incorporated in the ratio. The treatment of counterparty netting and margin agreements within the proposal is extremely conservative and will inaccurately represent the true leverage of the Firm. The vast majority of counterparty exposures are governed by master netting agreements, which have proven to be a prudent risk management mechanism.

The Firm has established robust processes and controls around the enforceability of these counterparty netting agreements. This includes an enforceability rating, based on legal advice, indicating whether a contract will be enforceable or not. This rating mechanism was proven to be very accurate during the crisis as there was never an instance where a contract, with a rating of enforceable, was unenforceable when contested in court.

Similarly, BCBS 164 would not recognize physical or financial collateral, guarantees, or credit risk mitigation in calculating on-balance sheet exposure amounts for purposes of the leverage ratio. This would ignore prudent risk management practices and restrict the banks from engaging in businesses which would otherwise have been conducted profitably and with relatively low risk levels as a result of the credit mitigants in place.

In addition, adjustments should be made to the treatment of credit derivatives, exchange traded derivatives and those OTC trades cleared through central counterparties to reflect their unique risk profiles. The proposed rule would treat written credit derivatives separately from other derivatives, applying a credit conversion factor of 100%. However, the fundamental nature of the exposure of a written credit derivative, being price movements of the underlying financial instrument, are identical to all other derivatives. The nature of the leverage associated with a written credit derivative is no different, and as a result, there is no basis for adopting an approach different to that for other derivatives.

The implicit requirement to calculate a potential future exposure for exchange traded derivatives and OTC trades cleared through a central counterparty is inconsistent with the risk profile of these transactions. There is an established process for mitigating counterparty credit risk through the receipt of initial and daily mark-to-market margining requirements as well as mutualized guarantee fund arrangements. To the extent that the exchange guarantees settlement for all clearing participants, potential future exposures are fully mitigated. Therefore, we recommend that such derivative trades be reflected in the calculation through the use of the on-balance sheet values, only.

Finally, until the Leverage Ratio metric is calibrated, it should remain within Pillar 2 and should not be moved to Pillar 1 without further consultation with the industry. The effectiveness of the proposed ratio as a backstop can only be ensured if it is applied with judgment and under a comprehensive supervisory dialogue between individual firms and their supervisors, consistent with Pillar 2.

Quality of Capital:

Morgan Stanley agrees that it is important for financial firms to have a strong capital base to ensure long-term stability and sustainable growth. However, the revisions to the Basel II Accord need to be consistent with the varying accounting standards that exist as well as the specific features of certain instruments for inclusion within the core capital base.

Minority interests:

Morgan Stanley understands the Committee's position that minority interests are not available to support the institution as a whole and should therefore be eliminated from the regulatory capital calculations.

Morgan Stanley believes strongly that regulatory capital should accurately reflect the inherent risks of its balance sheet. In eliminating minority interests from the common equity component of Tier 1, the Firm believes the Committee should also exclude capital deductions, such as goodwill and intangibles, related to minority interests that do not represent risks to the consolidating entity.

In certain jurisdictions, such as the US, recent changes in accounting (Full Fair Value methodology) dictate that acquisitions of between 50% and 100% of a company require that goodwill and other intangibles be recorded as if a 100% stake were nevertheless acquired. This practice may differ from other jurisdictions in which the acquirer may select the accounting treatment to be applied and may result in very different regulatory treatment for the same economic exposure.

The application of the Full Fair Value method results in a consolidation of all assets, liabilities, and goodwill and intangibles, including that attributable to the partner's minority investment. Currently, this consolidation is offset by the inclusion of minority interests in Tier 1 Capital. The proposed elimination of minority interests from Tier 1 capital without also excluding the impact of the deductions would misalign the risks of the venture with the regulatory treatment.

While the full risk of the venture is currently reflected on the consolidated balance sheet, the consolidating firm's risk is limited only to its pro-rata share of any loss. In other words, in the event of partial or full impairment, the consolidating entity's income statement and common equity would only reflect its pro-rata share of the loss.

Hybrid instruments:

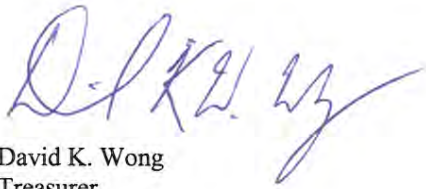
Morgan Stanley believes that properly structured hybrid securities (long dated, non-cumulative, no incentive to redeem other than economic, minimum replacement clauses) are valuable forms of capital and should be included as part of Tier 1 capital.

Properly structured hybrid capital securities have demonstrated the ability to absorb losses through the deferral of payments over long periods of time. Moreover, banks have demonstrated that it is possible to convert these securities into common equity in stress situations.

Should the Committee nevertheless decide to exclude these types of capital from Tier 1 capital, reasonable grandfathering periods (e.g. 10 years) should apply to allow banks and markets sufficient time to respond to these changes.

We want to thank the Committee again for the opportunity to provide our comments. Please feel free to contact us if you have any questions.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'D. K. Wong'.

David K. Wong
Treasurer

A handwritten signature in blue ink, appearing to read 'Keishi Hotsuki'.

Keishi Hotsuki
Head of Market Risk Department