Good morning. This is Celeste Brown, Head of Investor Relations. Welcome to our fourth quarter earnings call. Today's presentation may include forward-looking statements, which reflect management's current estimates or beliefs and are subject to risks and uncertainties that may cause actual results to differ materially. This presentation may also include certain non-GAAP financial measures. Please see our SEC filings at morganstanley.com for a reconciliation of such non-GAAP measures to the comparable GAAP figures and for a discussion of additional risks and uncertainties that may affect the future results of Morgan Stanley. This presentation, which is copyrighted by Morgan Stanley and may not be duplicated or reproduced without our consent, is not an offer to buy or sell any security or instrument.

I will now turn the call over to Chairman and Chief Executive Officer, James Gorman, who will speak to the slides available on our website and filed with our current report on Form 8-K this morning.

James P. Gorman

Good morning, and thank you, Celeste. As we close the door on 2012 and open one on 2013, I want to share my thoughts with you on the state of Morgan Stanley and where we're headed. To do so, we're going to have a different kind of earnings call. I'll give you a strategic update, and we'll have a dozen or so slides, which we've prepared for you to follow along with, and they're on the website, as Celeste said. Then Ruth is going to take you through the normal quarterly review, and we'll both take questions at the end.

Why are we doing it this way today? It's because we believe Morgan Stanley is at a turning point. Importantly, we see a clear path to meeting and then exceeding our cost of equity, and we want to lay it out for you.

While we live in a world of continued regulatory uncertainty as we wait final rules on derivatives reform, Volcker and resolution authority, which will bring significant changes to the markets, we are controlling what we can control. We have strong and leading capital ratios, we have a clear path for wealth management and we're being aggressive with our cost base. We have reduced fixed income risk-weighted assets even faster than we had initially planned and have a clear path to what we consider to be the end state in that business.

We've been carefully trying to balance being aggressive where we can, and you can see this in our expense cuts and RWA reductions, but not making decisions that might seem wise in the very short term but may in fact be harmful to medium- and long-term shareholder value. I will outline the 5 strategic initiatives that led us to meeting and -- that will lead us to meeting and achieving our cost of capital. And again, you can follow along with the available slides.

Let me go into greater detail on what we're doing to drive higher returns. First, wealth management. Subject to CCAR approval, we intend to own 100% of wealth management this year. There are numerous benefits associated with owning 100%, including year 1 incremental earnings comparable to the capital required to buy the remaining 35%, driven by the elimination of NCI, contractual revenue upside and some expense savings from the elimination of the JV structure. We will also increase our stable deposit funding and have significant other opportunities.

We have previously laid out a mid-teen margin goal for the middle of this year. We reached and exceeded that goal in the fourth quarter of 2012. We believe that in the future we can drive margins to the high teens and above with modest revenue growth, although please keep in mind the first quarter margin is seasonally lower. With 3 quarters -- 3 years of integration behind us, we are extraordinarily excited about the potential for this business.

The second major driver of high returns is fixed income. Since the financial crisis, we've reduced risk-weighted assets and capital in the Fixed Income business. At their peak, these risk-weighted assets were close to $500 billion. And in the third quarter 2011, before the MBIA transaction, they were approximately $390 billion. This past summer, we laid out a series of RWA targets, including $280 billion at the end of 2013 and $255 billion at the end of 2014. As of the end of 2012, we have, in fact, reached our 2013 targets as we exited the year at $280 billion.

Today, we're establishing lower targets for 2013 and 2014 and providing you with our 2016 target, which we believe will reflect end-state capital and risk-weighted asset levels in this business. The end state will be less than $200 billion of RWAs, down from $390 billion in the third quarter of 2011, and as a result, $18 billion or less of capital, down from $35 billion. Our targets reflect some reinvestment in areas that are important to our clients.

The RWA reductions largely represent runoff. We do not expect the reductions to impair revenues as we run them down. We are committed to having a full service Institutional Securities business, one that is increasingly integrated with our Wealth Management business. We need all 3 of our institutional businesses to be appropriately sized to service our clients.

As we have told you, we have been exiting products in areas which are not strategically rational from a client or franchise perspective. We continue to adapt our offerings and expect the business to continue to evolve as we have more regulatory certainty. We're confident with the steps we've taken to position Institutional Securities for the future.

The third major driver of higher returns is, of course, expenses. One of the things that is little understood about Morgan Stanley is how much money we've been spending on our infrastructure since becoming a financial holding company. We've made great progress in regards to that spending and expect our compensation and non-compensation expenses to decline beyond what we accomplished in 2012, assuming a flat revenue environment. The reductions will be augmented by the expense savings we have discussed with you in the past, as well as new initiatives we have recently undertaken and which I will now discuss today.

On Slide 8, you can follow it where we laid out our best estimates for the net impact of our cost reduction plans over the next 2 years, assuming a flat revenue environment and flat markets. We expect that some of our actions should result in a $1.6 billion decline from 2012 reported expenses to 2014 full year expenses. This reduction is on top of the $500 million already recognized in 2012, reflecting some reinvestment in growth areas that more than offset by our efforts to take out costs.

An important driver of the cost reductions is the 6,000 heads we've taken out of the business in the last 12 months, thereby reducing significant fixed salary and benefit costs. Our expense reductions reflect multiple work streams. Prior to today, we've told you about our reengineering efforts, GWM cost actions and headcount reduction efforts. Some of those cost cuts, as I said, are already reflected in our numbers and more will be recognized over time.

However recently initiated, but as part of our ongoing geographic footprint review, we are reducing and resizing some of our international focus -- some of our international offices so that we can focus mainly on our institutional client coverage and advisory services. These moves enhance the importance of regional centers such as New York, London and Hong Kong. Specifically, in Russia and the Middle East, we're downsizing our local presence in sales and trading, redeploying certain of those resources back to our regional centers. It allows us to cover our key clients in a more efficient manner while reducing middle office expenses.

In other parts of our network, in Europe and Asia, we've made decisions to streamline our footprint, defer expansion plans and exit certain parts of our business. These changes are part of an ongoing evolution as a global institution to depend more on regional centers.

These changes drive efficiencies because functions can be executed more economically from the regional centers due to our centralized trading platforms, execution teams, infrastructure and support. For the purpose of this presentation, we're not counting on a recovery in revenues. If that happens, obviously, our variable expenses, for example, brokerage and clearing, would grow. However, our overall expense ratios should improve if revenues increase. We will continue to look for additional areas to reduce expenses and push beyond 2014.

The fourth driver of higher returns is growth, growth that is not market-dependent, that is unique to Morgan Stanley and in which we do have a high degree of confidence. You're already aware of our focus on our market share in the institutional business, the interest rate and equity market sensitivity in Wealth Management, as well as the contractual upside associated with owning 100% of the Wealth Management joint venture. However, today, we want to speak about 2 additional significant growth opportunities that will drive growth in both institutional and Wealth Management.

First, we believe there's revenue upside and expense savings for both ISG and Wealth Management as we more closely align those businesses. They launched a joint effort in September 2012 to increase collaboration between the businesses. There are currently over 35 initiatives in various stages of execution, and we expect initial impact from this effort in 2013, with upside over the next 10 years -- next 3 years. We lay out those categories on Slide 10, but let me give you a couple of examples.

We're consolidating some of our research efforts across the firm. We've moved some sales and trading management and product execution into Wealth Management. The opportunities in fixed income in particular are very compelling. Among several of those, we recently announced a middle markets fixed income platform. We moved several thousand fixed income clients and a number of salespeople to Wealth Management to increase the intensity of the coverage of those clients and to free up capacity on the institutional side. We're already seeing some positive results. To improve operating efficiency, we believe opportunities exist to eliminate overlapping back-office trading support functions and enhance risk management.

Finally, in the organizational coordination category, we believe there's tremendous opportunity to integrate the senior relationship management effort into Wealth Management. Significant business partners for Wealth Management are very often top clients of the institutional business.

Second area of growth comes from execution of our bank strategy as we're now on a path of having approximately $140 billion in deposits. We've previously discussed opportunities in Wealth Management where we believe our lending product penetration is 500 basis points below our peers. However, there's also upside for Institutional Securities beyond lower funding costs for lending, derivatives and other products. We believe there are substantial opportunities to expand in commercial lending, though consistent of course with our existing skill set and risk management capabilities.

Most importantly, let me now turn to returns. Our focus is to drive higher returns for shareholders through sustainably improving our ROE to levels equal to or in excess of our cost of equity even without a cyclical recovery. Assuming no change in market conditions, normalizing for the CVA drag we saw this year, the Wealth Management buy-in and contractual upside, our expense initiatives and some progress towards our firm-specific growth initiatives, we believe we can reach ROEs of approximately 9% and ROTEs of 11%. Returning excess capital would get us to 10% levels on ROE and 12% on an ROTE basis. And obviously, an improved operating environment would drive upside beyond those numbers, respectively.

Regarding capital, we have unambiguously moved from a position of shoring up capital through preferred conversions and accreting capital through RWA reductions and earnings to a phase where we believe we're well capitalized. Over the next few years, we will build substantial incremental excess capital in addition to quarterly earnings accretion, driven by additional RWA reductions and reductions in capital in Merchant Banking and Real Estate, consistent with the Volcker Rule.

There is no question that we will return some of this capital. The question is when. Our very near-term focus is acquiring the balance of the Wealth Management joint venture. We'll reinvest some of the capital freed up from some of these opportunities that I've previously described, though the overwhelming amount will be returned to shareholders as soon as it's practical. As always, all capital actions are subject to regulatory approval.

In closing, I want to emphasize that we're working aggressively to drive higher returns. We continue to augment our recent efforts with additional RWA reductions, increased expense savings, additional areas in which we are outright reducing optionality and new efforts to drive revenues higher that are unique to Morgan Stanley. I've also shared with you our thoughts on capital returns.

We've been making tough decisions as and when we have clarity in regards to capital, businesses and people, and we'll continue to do so as regulatory uncertainty lifts. I am confident that we're on a path to increasing shareholder value that will be evident regardless of the macro environment.

Investment banks play an important role in facilitating capital to meet client needs. We believe these needs will grow substantially over the next decade, and we will continue to be a leader. The leadership of this firm has never been more integrated in my time with Morgan Stanley, and I'm very excited about our future.

Thank you. Let me pass it on to Ruth to talk about the fourth quarter.

Ruth Porat

Good morning. I will provide both GAAP results and results excluding the effect of DVA. We have provided reconciliations in the footnotes to the earnings release to reconcile these non-GAAP measures.

DVA in the quarter was a loss of $511 million, with $330 million in fixed income sales and trading and $181 million in equity sales and trading. Excluding the impact of DVA, firm-wide revenues were $7.5 billion, essentially flat to the third quarter.

Non-interest expense was $6.1 billion, down 10% versus the third quarter. Compensation expense was $3.6 billion this quarter, down 8% versus Q3. Non-compensation expense was $2.5 billion, down 13% from last quarter.

The effective tax rate from continuing operations for the fourth quarter was 11.1%. In our tax line this quarter, we reversed certain tax reserves as a result of new information from IRS exams that resulted in a benefit of $299 million. In addition, we recorded an out-of-period net tax provision of $144 million to adjust previously recorded deferred tax assets principally associated with partnership investments in the Asset Management segment. We are also reviewing the firm's deferred tax accounts.

Earnings from continuing operations applicable to Morgan Stanley common shareholders were approximately $867 million. Earnings from continuing operations per diluted share were $0.45 after preferred dividends. On a reported or GAAP basis, firm-wide revenues for the quarter were $7 billion.

Earnings from continuing operations applicable to Morgan Stanley common shareholders were $547 million. Reported earnings from continuing operations per diluted share were $0.28 after preferred dividends. Book value at the end of the quarter was $30.65 per share. Tangible book value was $26.81 per share. Included in the discontinued operations is $115 million associated with the Saxon settlement.

Turning to the balance sheet, our total assets were $782 billion at December 31, up from $765 billion last quarter. Deposits were $83 billion versus $71 billion at the end of the third quarter, driven primarily by retail investors moving to cash towards the end of the quarter and also by the deposits associated with the 14% acquisition of the Wealth Management joint venture.

Our liquidity reserve was $182 billion at the end of the quarter, up $12 billion versus last quarter. And as of January 16, our liquidity was $189 billion. Although calculations are not final, we believe that our Tier 1 common ratio under Basel I will be approximately 14.7%, and our Tier 1 capital ratio will be approximately 17.9%. Risk-weighted assets under Basel I are expected to be approximately $306 billion at December 31.

Subject to final rule making and reflecting our best assessment of the rules, our pro forma Tier 1 common ratio under Basel III was 9.5% as of the end of the fourth quarter.

Let me now discuss our businesses in detail. In Institutional Securities, revenues, excluding DVA, were $3.5 billion, down 5% sequentially. Non-interest expense was $2.9 billion, down 12% versus the third quarter.

Compensation was $1.5 billion for the fourth quarter, reflecting a 43% ratio, excluding DVA. Non-compensation expense of $1.4 billion decreased 15% from last quarter. The business reported a pretax profit of $568 million, excluding the impact of DVA. Including the impact of DVA, the business reported a pretax profit of $57 million.

In investment banking, revenues of $1.2 billion were up 26% versus last quarter. According to Thomson Reuters, Morgan Stanley ranked #1 in global IPOs, #2 in global announced M&A, #2 in global equity and #4 in U.S. dollar investment-grade debt at the end of the fourth quarter. Notable transactions included: in equity underwriting, the $733 million IPO of Workday, which was the largest tech IPO since May; in advisory, we acted as lead strategic advisor to ICE on the $8.2 billion definitive agreement to acquire NYSE Euronext; and in debt underwriting, the AbbVie spin financing, including a $14.7 billion in bonds and $7.5 billion event loan and a $4.9 billion tender, the largest U.S. dollar investment-grade offering ever.

Advisory revenues of $454 million were up 34% versus the third quarter, driven by increased revenues in the Americas. Equity underwriting revenues were $237 million, a 19% increase from the third quarter, reflecting increased revenues in EMEA and the Americas.

Fixed income underwriting revenues of $534 million were up 24% versus last quarter and were our highest reported revenues, reflecting increases in investment-grade bond issuance and loan syndication fees.

Equity sales and trading revenues, excluding DVA, were $1.27 billion, an increase of 4% from last quarter. Derivatives had the strongest fourth quarter since 2008, reflecting increased market activity and strength across regions.

Prime brokerage revenues were consistent with the third quarter as average client balances increased moderately. Revenues and cash equities were up slightly, driven by higher market volumes in the Americas and Asia.

Fixed Income and Commodities sales and trading revenues, excluding DVA, were $811 million. Revenues decreased versus our third quarter results as commodities experienced meaningfully lower revenues and a difficult market. CVA, net of hedges, continued to be a drag this quarter due in part to the tightening of our credit spreads.

Less favorable market conditions drove lower rates revenues. However, client volumes held up relatively well across businesses in the quarter, and results also reflect growth in the credit corporate business. Other sales and trading reflects negative revenues of $35 million compared with negative revenues of $162 million last quarter.

Turning to VAR. In our supplement, we provided VAR measures under both our current and previous VAR model for this quarter, the prior quarter and the prior year. Average trading VAR for the fourth quarter was $78 million versus $63 million in the third quarter.

Turning to Global Wealth Management. Revenues of $3.5 billion were up 4% compared to the prior quarter. Asset Management revenues were up, reflecting higher managed money balances. Transaction revenues increased 4% from last quarter, consisting primarily of commissions of $579 million, which increased 11%, reflecting higher activity levels by retail investors as they partially reallocated from securities into cash; investment banking-related fees of $209 million, which increased 5% versus last quarter, driven by closed-end fund activity; and trading revenues of $288 million, which were down 8% versus the third quarter, reflecting markdowns in our deferred compensation plans.

Non-interest expense was $2.9 billion, down 7% from last quarter. The compensation ratio was 57% versus 61% in the third quarter, reflecting year-end true ups. Non-compensation expense was $901 million, down 14% versus last quarter, reflecting the absence of non-recurring items reported in 3Q. The PBT margin was 17%, a record since the inception of the joint venture. We reported profit before tax of $581 million in the fourth quarter.

Total client assets were flat at $1.8 trillion, primarily reflecting the minimal impact of market conditions on asset levels and positive flows. Global fee-based asset inflows were $4 billion. Fee-based assets under management increased to $573 billion at quarter end. Global representatives were 16,780, consistent with the third quarter. Bank deposits were $131 billion, with approximately $72 billion held in Morgan Stanley banks.

Asset Management revenues of $599 million were down from $631 million in the third quarter due primarily to lower merchant banking principal investment gains. In Traditional Asset Management, revenues of $376 million were flat to the third quarter. In Real Estate Investing, revenues of $127 million were up versus last quarter. Due to the ownership structure of these funds, the majority of these revenues are passed to third-party investors in the Non-controlling Interest line.

In Merchant Banking, revenues were $96 million compared with $134 million in the third quarter, driven primarily by lower principal investment gains. Compensation expense was $168 million in the quarter, down from $241 million in the third quarter. Profit before tax was $221 million, up from $198 million last quarter. NCI was $49 million versus $50 million last quarter. Total assets under management increased to $338 billion, driven by net inflows of $1 billion and market appreciation.

Let me end with a brief summary of our outlook. In Investment Banking, the advisory pipeline is healthy. Equity underwriting is increasing after a very muted 2012. Although fixed income underwriting reached a record level for us in the fourth quarter, it is important to note that the strength of underwriting was achieved with only modest acquisition finance, which suggests that activity can remain strong, especially if advisory picks up. Sales and trading activity should benefit from ongoing global healing, most notably in Europe and Asia.

And with respect to Wealth Management, we are pleased with the ongoing momentum in the business, with profitability reflecting the benefit of being on one platform, although keep in mind that the first quarter has seasonally higher compensation expense and 2 fewer trading days.

Thank you for listening, and James and I will now take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] The first question will come from Howard Chen with Crédit Suisse.

Howard Chen - Crédit Suisse AG, Research Division

With respect to expenses, the cost reduction targets in a flattish revenue environment is a really strong statement and a helpful benchmark for us. I'm curious, James, how do you broadly think about the incremental margins or returns in a potentially better revenue environment? For example, if revenues were up 10% with a similar business mix, how much do you think would drop to the bottom line?

James P. Gorman

Boy, that's not one I'm going to wing. Look, maybe put pencil to paper. We've been operating so much under the basis that there won't be increased revenues. Obviously, the world is going to evolve, so at some point, that's not true. But our approach is being what can we control? How do we drive up margins in a flat revenue environment? And obviously, through the expense line is how we're doing that. By definition, if we hold the line on our fixed costs, which I think we've been very disciplined about on a go-forward basis, one would assume the incremental dollar revenue would throw off a higher incremental margin than the previous dollar revenue. But I got to go on -- we'd have to go and look at it business by business.

Howard Chen - Crédit Suisse AG, Research Division

And we saw some really nice expense control within Global Wealth Management. Specific to compensation, you've noted in the past the limited flexibility you might have due to the grid-like comp structure. So I'm curious, what's driving that comp accrual lower in 2012? And how sustainable should we think of that?

Ruth Porat

The main driver of the reduction in the comp ratio is the fact that we are done with integration. As we've talked about on so many calls over the years, the integration expense was running ballpark $80 million to $100 million a quarter until we completed the integration at the end of the second quarter then dropped down in the third and fourth quarter, taper down. That's one major benefit. The second is that as a result of being on one platform, we're able to consolidate a number of back offices and management layers, the items that we outlined really on the third quarter call. And so that's sustainable as well. I think the fourth quarter compensation benefited a bit by what is typical year-end true up, true down. Sometimes it benefits the comp ratio, other times, it doesn't. I think it's fair to say near term, the ratio is likely to be in the 60% range. But very much to your point, there really -- there are a couple of drivers that will reduce that comp ratio more. One is as we're continuing to build out the lending product, the lending product is a non-compensable revenue. It does provide a lift to the margin and drives -- that alone drives the margin into the 50s. And then, again, a better operating environment. In particular, any kind of rate increase has a meaningful benefit to the margin in the business, and that helps as well. So we're good at where we are here, holds you kind of in the first quarter near term to that 15% margin for the reasons I described, with upside.

Howard Chen - Crédit Suisse AG, Research Division

And then just finally for me, can you discuss your wholesale funding plans over the next 2 years? I think you have maybe $45 billion-ish maturing through 2014. How much would you like rolled off, and how do you think that funding schedule potentially change as you buy in the rest of the JV this year?

Ruth Porat

Sure. There are a couple of variables to that. We're obviously sitting here, as I noted, with liquidity at higher levels, about $189 billion. So there's some flex in there. We have reduced outstanding indebtedness, outstanding debt this year, unsecured debt by about $19 billion, very much to your point about the changing composition of the balance sheet. And then as we buy in the balance of the wealth management business, the deposits, as I think you know, come on, we'll get about $15 billion when we complete the 35%, but the balance of it comes on ratably over a 2-year period of time. The total size of those deposits is ballpark $140 billion, part of which will be used to support growth in the institutional business. So the 3 components of it will be wealth management lending, institutional lending and other bank-appropriate businesses moving into the bank. As we do that, we get dollar-for-dollar substitution, reducing unsecured debt requirements and replacing them with deposit funding. So all of those provides a bit of flexibility with respect to the magnitude of unsecured debt or wholesale funding that will be required on a go-forward basis.

Operator

The next question will come from Glenn Schorr with Nomura.

Glenn Schorr - Nomura Securities Co. Ltd., Research Division

So I appreciate the further detail on the RWA wind-down. I guess a 2-part question is I'm assuming that it's all passive, but if you look at it, what it does imply, and you guys are by no means alone here, there's $80 billion of RWA that are clogging up the system that have no real revenue impact. So the 2-parter is, one, can anything in the market conditions change that to make there be a positive or a negative revenue impact? Or are we kind of locked and loaded and just waiting for wind-down? And part 2 is what does that RWA wind-down plan imply at all? Does it have revenue implications for fixed income as that plays out?

Ruth Porat

So Glenn, when we put out the initial forecast for risk-weighted assets and RWA reduction, we were looking at -- there are obviously 3 levels -- levers. There's passive mitigation, active mitigation and model approval. And the guidance last summer was primarily based on passive mitigation, just scheduled roll-offs to maturity sub-positions [ph]. I've had some active, but it was primarily passive. What we've done through the back half of 2012 was accomplished through active mitigation. In other words, we pulled forward some of the passive mitigation that was embedded in that earlier forecast, but it was through active mitigation that we ended the year at $280 billion of risk-weighted assets and were able to pull forward our forecast by a year. And the way we've been accomplishing the active mitigation is, really, with minimal P&L impact, and that's the way we're continuing to look at it. We're really reducing capital behind positions that are -- in areas that are not revenue-accretive longer term.

Glenn Schorr - Nomura Securities Co. Ltd., Research Division

So just making sure I got it right, any way you slice it, as the RWA runoff, good or bad market conditions, it's going to have no revenue impact.

Ruth Porat

I said it's minimal revenue impact. That's the way we've been looking at it. And I think you had one other part of your question I didn't quite address. The reason we've been able to accomplish this pull-forward is this is, as you know, a real priority for us. We have strict governance around it. Our senior leadership team is very committed to it, and that's enabled us to pull forward, through active mitigation, more reduction in 2012 and set us up for this decline as we're looking at in '13 and beyond, at minimal P&L impact.

Glenn Schorr - Nomura Securities Co. Ltd., Research Division

Got it. Ruth, you've mentioned the 43% true comp ratio at ISG. I'm assuming that was the year, not the quarter, correct?

Ruth Porat

Correct.

Glenn Schorr - Nomura Securities Co. Ltd., Research Division

Okay. And that's come down and I think the shareholders be cool with that. We've seen some stuff in the press about changes on the deferral. Not something normally I'd ask you to comment on, but I'm just curious on the impact on future periods. So the change in deferred, I've seen this happen in the past at some other companies. How much of a contingent liability does that create on the go-forward? Or is it not material to the overall story?

Ruth Porat

Well, a couple of things in terms of the compensation structure. So we did change the comp structure again this year. We raised the total compensation level at which deferrals start, so over 82% of people don't have deferrals, and it's really -- think of it as those who are in the earlier parts of their careers. So it's really for the more senior people that we have deferrals. The vesting schedule is still over 3 years, and it's the combination of cash and equity, which we think further enhances alignments of interest. But as we talked about on calls last year, we said the absolute amount of deferrals would be going down. It is continuing to go down. The actual amount of deferrals in 2013 is lower than 2012, and the aggregate amount continues to decline. And I think as important, as James noted in his comments, when you combine that with the actions we've taken reducing headcount, base and benefits are also meaningfully lower. We're paying 6,000 fewer people in 2013. And then you add that to things like location sourcing. So kind of that fixed element of it, if that's where you framed it, is declining.

Glenn Schorr - Nomura Securities Co. Ltd., Research Division

Now that's super helpful. And then last one for me, commodities, specifically, and I appreciate the environment has been a soft one, and I've seen it everywhere. Is the business actually changed such that maybe it doesn't fit inside a broker-dealer anymore? In other words, would private equity be a better owner? It seems -- curious if you would allocate, I'm sure you won't, but I'll try, the risk-weighted assets associated with it? It feels like, wow, 3 out of 4 quarters this year were pretty soft. In other words, in your mind, is it cyclical versus something changed?

Ruth Porat

Yes, there were some quite specific issues in the environment that affected commodities this quarter, in particular. I mean, as you know well, our business is both physical and trading, and it's also primarily oil and power. And when you combine storm-related dislocation, continued backwardation with lower prices affecting our storage business and then the lower volatility, we had a series of things that resulted in, basically, de minimis revenues in commodities this quarter, very unusual one over time. So we do think there's quite a cyclical element to it, storm-related element to it, however you want to frame it.

James P. Gorman

Yes, I'd just add firstly, to put the quarter in context, and I know the second quarter was also challenging, you have to go back to 1995, I think, to find quarters like that. So it was fairly aberrant. These businesses don't turn that quickly on a dime, good or bad. We have a tremendous Commodities business, tremendous team. They had an aberrant environment, difficult environment, difficult quarter, and we moved on past that. On the broader strategic things, I mean, if we could find a structure that was more advantageous for everybody, we'd do that, and obviously, as we've said publicly, we're open to that. But this is not because we don't think it's a great business. We're just constantly looking at the combination of capital, liquidity, funding and the mix of those 3 things and trying to figure out the best way to move forward.

Operator

The next question will come from Mike Mayo with CLSA.

Michael Mayo - CLSA Asia-Pacific Markets, Research Division

I think this goes in the category of good progress but could it be better. So starting with Slide 12, you identify targets for return on tangible equity at 11%, going to 12% at some point, but you don't put a time frame around that. Can you give us any better sense of timing when you expect to achieve that?

Ruth Porat

What we tried to do, Mike, was lay out in the deck the key components that are embedded in that 9%, so the expense initiatives, the capital efficiency, the drivers in wealth management and Institutional Securities. So just focusing on the expense -- well, let's start from the top. Wealth initiative and the buy-in there, as James said, that's one item that we put into CCAR. That's with a focus to accomplish as soon as possible, subject to regulatory approval. And the benefit, to be clear, of the wealth management buy-in is not just the incremental 35% earnings but the contractual upside once we own 100% results in earnings that are about the same as that which we get from retaining the NCI. And then on top of that, when you're talking about ROE, clearly, as I've been talking about for many quarters, we've been holding capital against the stake. So that's deadweight capital. We'll finally get not just the NCI but that contractual earnings against it. That's helpful and that's submitted within our CCAR now. The expense initiatives, as we outlined on the chart, are over the next 2 years. And so you can see the $1.6 billion reduction in the 2-year period of time. I think the RWA reductions, we're continuing to focus on that near term and the growth initiatives as well. So we're not putting a specific timeline on it, but try to guide you there with the way we laid out the other key drivers of the upside.

Michael Mayo - CLSA Asia-Pacific Markets, Research Division

And for the expense reduction, now that is a big number, $1.6 billion, but you've made such good progress here recently that if you annualize fourth quarter results, I guess that's just $400 million incremental per year. Am I doing the math correctly, or how should I think about that?

Ruth Porat

Well, the reason we pulled it all together in $1.6 billion, as we've been talking to you over the last year or 2 about a number of different initiatives, the Office of Re-engineering, the wealth management efforts, the headcount reduction, so the goal was to pull everything together with a holistic view of it. As it relates to reengineering, which is both comp and non-comp, we targeted a $1.4 billion run rate reduction by 2014 and a $500 million run rate reduction by the end of 2012. Our expenses in aggregate are down $500 million between 2011 and 2012, a little different mix there but down by that $500 million. So now when you layer on top of it the integration in wealth management, the benefit from the consolidation steps, the headcount reduction, line by line buildup takes you to that $1.6 billion over the 2-year period of time. So I wouldn't say annualize the 2011 over 2012 reduction. This is really by initiative, takes you to the $1.6 billion over that period of time based on our best estimates, what we know now and, as we said, assuming a flat revenue environment.

Michael Mayo - CLSA Asia-Pacific Markets, Research Division

And the wealth management margin, great, you're 17%, but I guess your target is still mid-teens. So why not increase the targets?

Ruth Porat

We're keeping it for now at the mid-teens target, and we're pleased with the 17% and all that we had to do with the franchise completing the integration that set us up to achieve the 17% margin. But as I said previously, we wouldn't guide you to hold that 17% in the first quarter for a couple of reasons. One, there are fewer trading days, and it is seasonally slightly higher comp ratio. So holding the comp ratio, at least near term, in that 60% range, implying sort of a 15-ish percent margin near term, we think, is prudent, appropriate. But again, for the reasons we've talked about, namely the expense savings through consolidation, coupled with the upside we see with our growth in lending, that should take you to higher levels. And if you have any lift at all from the environment, in particular, on the rate side, it does as well. But we're going to hold for now to the mid-teens and wait to see those play out over time.

Michael Mayo - CLSA Asia-Pacific Markets, Research Division

And then lastly, backlogs, you said equity underwriting is higher. Is that link quarter, year-over-year or both? And can you also give those -- that information for total investment banking?

Ruth Porat

So the equity pipeline is up going into the year, so quarter-over-quarter, and as I said, it's driven by greater activity in Europe and Asia, in particular. Those were pretty muted throughout 2012. So with the healthier backdrop, in particular, in Europe, we're looking for more activity. And then -- I'm sorry, the second part of your question was...

Michael Mayo - CLSA Asia-Pacific Markets, Research Division

Just backlogs, any other color you can give. So that's equity. What about fixed income?

Ruth Porat

Fixed income tends to have a slightly shorter pipeline. It has been a very constructive environment for refinancing. I think there have been some debate as to was activity pulled into the fourth quarter from the first quarter. Our view very much is it was not. This was just good refinancing effort and corporate clients being opportunistic because of low rates, and so there is more to come. We think that although you never want to forecast an extension off of a record quarter, the offset to any kind of declines there. In fact, the M&A market remains as constructive as it appears we could see some more event lending activity, in particular, non investment-grade activity. So I don't want to suggest that you should extrapolate off of the fourth quarter, given it was a record, but we feel good about the ongoing interest by clients in financing activity.

Operator

The next question will come from Brennan Hawken with UBS.

Brennan Hawken - UBS Investment Bank, Research Division

Quick question here. The roughly $50 billion of RWA reduction that we're going from current to year-end '14, have you guys provided the risk weights for those assets? And if not, would you do so?

Ruth Porat

We have not. We thought we were actually being quite expansive breaking out the risk weights by category. We've given you some of the product areas, but we have not broken it out more than that.

Brennan Hawken - UBS Investment Bank, Research Division

Okay. And then I assume in the run-off that you guys had, even though you had some opportunistic active runoff here this quarter, that the forward look is still all passive. Is that right?

Ruth Porat

It's overwhelmingly passive, just as we built up the first forecast. And I think one of the potentially obvious points is given the focus in governance around RWA reduction, we were able to pull forward and execute. And again, there's only so many times you can pull things forward. But this is primarily passive mitigation at this point with a focus on trying to continue to accelerate some of the active.

Brennan Hawken - UBS Investment Bank, Research Division

Okay. And I'm sorry if I missed this, but can you or have you quantified the revenue opportunity that's in the order flow capture once you guys own all of MSSB?

Ruth Porat

We haven't broken out the order flow agreement separately, but when you take the order flow agreement, the return on higher deposits, very importantly, assuming that those additional deposits, near term, merely fund the AFS portfolio and the reduction of the expenses associated with running a joint venture like extra reporting and other items like that, those 3 items in the aggregate are about comparable to the earnings from the 35%. And again, a couple of items. One, that's, again, assuming that if we're just putting that into an AFS portfolio, clearly, as we're lending it out there, it's greater returns. And that's the key point.

Brennan Hawken - UBS Investment Bank, Research Division

Sure. So as we're modeling this, a check figure would be maybe to watch the -- take a look at the NCI and double it effectively. And then as along as we're getting that kind of upside, then we're in the right ballpark.

Ruth Porat

Yes. I think one thing you probably want to look at is the slide that James walked you through. We indicated that the incremental capital, ballpark $400 million, and that the earnings in the first year, ballpark the same number. So we're kind of helping you triangulate right back to those -- how much that will bring.

Brennan Hawken - UBS Investment Bank, Research Division

Okay. Yes, I appreciate that. And then just last one for me. On the wealth management business, can you give some color around risk appetite and what you guys are seeing around all this noise out of D.C.? Is it impacting risk appetites there? Are you starting to see a little relief now that we've moved past some of it or at least people might realize that noise and all that out of D.C. are just a permanent part of the landscape at this point?

James P. Gorman

Let me take a cut at that because I've been pretty involved with some of the stuff going on in the fiscal side and trying to get the temperature of the retail investor. I would say that somewhere around early December, there was a shift in tone and a pickup in activity and by definition, a pickup in risk appetite. So investors were re-engaging. Businesses of this size and this geographic dispersity don't move dramatically month to month, but there was definitely a tonal shift. I think it's too early, obviously, in this quarter to say much about that. But it feels similar, and the more progress that we have on the fiscal front, the more confidence investors will have to get out there and invest. The other thing you have to look at, Brennan, is that the 401(k) plans are up materially last year, so the wealth impact of people is up materially. They get to the end of the year, they see their 401(k) holding is up, on average, equity side, up 15%. That has a real driving factor around investment behavior. So I think we -- my personal view is that absent a reversal in the U.S. economy, which I don't anticipate, or a complete mess up in Washington, which I don't anticipate because they're making progress, I think we've passed the bottom.

Brennan Hawken - UBS Investment Bank, Research Division

Well, you can never not count on a complete mess up out of Washington.

Operator

The next question will come from Guy Moszkowski with Autonomous Research.

Guy Moszkowski - Autonomous Research LLP

On the lending in Global Wealth Management, do you have a target loan-to-deposit ratio that you'd like to move towards?

Ruth Porat

At this point, we don't. I think the main point to note is we do have the largest retail distribution system. And as James noted, we think there's real upside because only 5% of our clients are currently using our lending suite. It's ballpark 10% for our peers, and that's just because historically, this hasn't been a strategic focus for us. So our deposits will be growing to about $140 billion post-acquisition. We think we have real meaningful upside there. It wouldn't be fully utilized just on the wealth management side, at least in the very near term. We're continuing to be quite prudent about the way we're growing that portfolio. And that's why when we talk about deposit growth, it's not just with respect to wealth management, but it's also what we're doing on the institutional side with relationship lending and event lending and with additional products moving into the bank, bank-appropriate products such as things like commercial real estate lending or asset-based lending with our existing corporate clients.

Guy Moszkowski - Autonomous Research LLP

Fair enough. On your Slide 7, James, on the FICC discussion, the RWA net reduction of $30 billion through sort of the net of strategic reductions and growth, is there any way that we can get under that just to see how you're thinking about how you would shift emphasis on the business within FICC?

Ruth Porat

The focus within FICC is very consistent with what we've been talking about for quite some time. And so there are areas of growth within those core product areas we're continuing to be active in rates and have invested in it at foreign exchange. Similarly, we're continuing to benefit from the electronic trading platform. In fact, we set new records internally for trade volumes last quarter. Credit remains important to us. We're very active in mortgages. So it continues to be in the areas that we've spoken about, and we just wanted to leave some cushion for ongoing growth there, which is part of the plan.

Guy Moszkowski - Autonomous Research LLP

Sure, that's helpful. On Page 12 of the slides, can you give us a sense for how much of getting to that 9% ROE with no change in market conditions would be contingent on getting to the FICC market share targets that you've laid out in the past?

Ruth Porat

We've tried to give as many levers as we can. We are still committed to the market share gains, the 2% market share gains that we've talked about. We're also very focused on the returns in the business, and you can see that with what we've done on RWA reduction, but I haven't broken that out.

James P. Gorman

Yes, but it sounds like fundamentally, you did assume in that analysis that you did gain those couple of points of share.

Ruth Porat

No, because what we have here as first bullet is -- no change in market conditions, is essentially just a flat revenue environment and then layer in the actions that we've put into this slide deck here.

Guy Moszkowski - Autonomous Research LLP

Okay. So you don't assume that you have any meaningful share gain within the context of the flat market? I just want to make sure I understand what your assumptions are.

Ruth Porat

Yes. We have 2 -- let me be very clear here. For purposes of the slide and the 9%, we've delineated the steps that we're taking, assuming no change in market condition. For purposes of the way we're running the business and the way our business leaders think about the business, of course, we're continuing to pursue the market share gains for all the reasons that we've talked about. I was answering 2 questions, I apologize.

Guy Moszkowski - Autonomous Research LLP

No, but now it's clear. That helps a lot. And then finally, just not to harp on this margin target on GWM, but it almost sounds like you want to raise the target there, except that you don't want to do that in the face of some seasonality in the first quarter on the expense base, and I understand that. But should we be thinking that it goes up, that the target goes up beyond the first quarter?

James P. Gorman

Let me have a go at this. I mean, listen. Firstly, one quarter is 13 weeks. So let's not get too wound up about precisely where we are. As Ruth said, there's some seasonality. We were criticized in the past for laying out a 20% margin 4 years ago for this business. We didn't anticipate a very difficult market. We didn't anticipate 0 interest rates, and we're guilty as charged. So we said we would deliver in this business mid-teen margins by the middle of next year, and that's what we're focused on. So let's revisit it, Guy, when we get to the mid-teen margins in the middle of next year.

Operator

The final question will come from Fiona Swaffield with RBC Bank of Canada.

Fiona Swaffield - RBC Capital Markets, LLC, Research Division

I just wanted to ask on your Basel III capital ratio and what you think your target is now post -- do you think -- I noticed somewhere there was a 9% yield to investment bank in the capital allocation on the risk-weighted assets side. And then secondly, just within your Slide 12, when you talked about 1% accretion from returning excess capital, I mean, that seems quite low. Is that just in 1 year, or could you just talk a bit more about that?

Ruth Porat

Certainly. So we're assuming that we'll run at a buffer above the requirements. So with our GCP buffer, that would put us at about 8.5%, run at a buffer above that. We're obviously looking to continue to accrete capital which will take those ratios up, in particular, with what we're doing on the RWA reduction side. And then the question really becomes over what time do we -- are we returning capital, and that's a function of earnings in the regulatory environment. And it's also how do we look to reinvest some of that capital in our business. I mean, there's some pretty obvious areas with $140 billion of deposits coming on and the opportunity to grow the suite of lending products, as I've talked about, both wealth management and institutional. Some of it goes behind that. But we have not laid out a timeline for the return of capital, and we'll leave it to you to model in how much upside, incremental upside there is over what period of time returning excess capital.

Well, with that, we thank you very much for joining our fourth quarter call and look forward to speaking to you in 13 weeks.