Good morning. This is Celeste Mellet Brown, Head of Investor Relations. Welcome to our SFirst 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. The 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'll now turn the call over to Chairman and Chief Executive Officer, James Gorman.

James Gorman

Thank you, Celeste. Good morning, everyone and thank you for joining us. We will again review the progress we've made towards the six strategic priorities we delineated in January that will drive our return on equity and return on tangible equity, excluding DVA to greater than 10% and 12% respectively.

We're pleased with the progress we made during the quarter and we met or exceeded several of the goals. Let me just go through them quickly. First was to acquire 100% of the Wealth Management joint venture. As you know we closed on the final 35% of that joint venture on the last business day of the quarter. As we've taken you through the benefits numerous times, I'm not going to spell them out again. Suffice it to say however the deal was a game changer for this firm and for our shareholders, now and for decades to come.

Secondly, we put out a goal to achieve Wealth Management margins through expense management and through revenue growth. In addition to owning 100% of the business, one of the key drivers for our way upside is the revenue and margin upside in the Wealth Management business. Both were higher this quarter. The margin of 18.5% represented the fifth consecutive quarter of margin improvement, excluding non-recurring costs associated with the integration in Q3 2012.

We reached our highest margin level since the first quarter of 2008. In addition, we increased our margin goals for the Wealth Management business at our financials conference in June to 20% to 22% by the end of 2015 without the benefit of high rates of markets and more than 23% if markets or rates increase. Why the increase? The margins reflect the simple math of the upside from 100% with ongoing investment in the business, using the first quarter of 2013 results as a base.

Our third objective was to significantly reduce RWAs in fixed income and commodities. We continued to make progress regarding our fixed income RWA reductions, ending the quarter at $239 billion, down from the first quarter. We continue to expect fixed income RWAs to be below $200 billion by the end of 2016.

Our fourth goal was to drive expenses lower in 2013, 2014 and beyond. We're on track to meet our expense reduction targets and Ruth will take you through this in more detail. As you can clearly see, our expense ratios have improved as we said they would with revenue growth.

Our fifth point was to grow earnings through Morgan Stanley's specific opportunities. We recently received approximately $16 billion of deposits in the initial wave due to us now that we' own 100% of Wealth Management. The team is executing against our plan to prudently deploy those deposits in support of loan growth in both institutional securities and wealth management. Now that we own 100%, we can execute on more of the initiatives we have in place to better align institutional and wealth management, including a deeper partnership between the businesses and their trading days. Because order flows no longer split with our former partner, we expect deeper and more efficient markets to both our institutional and retail clients, as well as greater revenue opportunity for fixed income, in addition to the order flow benefit we discussed [with you] for Wealth Management. We're also looking forward to launching new products and increasing the efficiency of firm funding.

So our sixth point asked, what did it all add up to? Well, despite difficult markets, our results this quarter evidenced strength and resilience. Revenues in all of our major businesses were up double digits year over year, with Institutional Securities excluding DVA, up 40% and Investment Management up 48%. In addition, we're pleased to commence the share repurchase we announced this morning, which will offset some of the dilution relating to employee stock programs and also benefit ROE. We recently received a non-objection from the Federal Reserve to return 1% of our tier-1 capital and will execute on the buyback in the forthcoming quarters.

We've been on a long journey to generate stronger, more sustainable, long term returns with businesses that balance each other in volatile markets. With the acquisition of 100% of Wealth Management, that business model is solidly in place. Our Wealth Management business complements our leading institutional securities business and the adjacencies across the entire platform will drive upside for all of Morgan Stanley. We have strength across areas of fixed income and are consistently in the top three in equity underwriting and M&A lead tables with increasing momentum in fixed income underwriting. Our investment banking franchise is a leader globally and we demonstrated the power of our footprint with important cross-border deal announcements in the quarter.

I would now like to draw particular attention to our institutional equities franchise which consistently ranks top two globally in market and wallet share. In the second quarter we continued to execute extremely well against challenging markets. In the cash product we benefitted from the hybrid voice and electronic model centered around integrated client coverage. We approached this business with the delivery of research driven content, market insight, and state of the art trading technology to a wide variety of client types. Our electronic offering spends cash, synthetic cash and derivatives, and has more than doubled market share over the last three years.

In equity derivates, our team is capitalizing on the investments we have made over the last several years driven by the breadth of our client reach, deepening relationships and partnerships across the firm, and ongoing strong risk management. And last but not least, in prime brokerage with significant balances we have a practice focused on market access, service excellence and innovative solutions for clients, all leading to an outstanding performance by institutional equities this quarter.

With Morgan Stanley's global reach, we are confident there is continued upside for this business and for the firm.

Thank you. And I will now turn the call over to Ruth and look forward to your questions later on.

Ruth Porat

Good morning. I will provide both GAAP results and results excluding the effective DVA. We have provided reconciliations in the footnotes to the earnings release to reconcile these non-GAAP measures. The impact of DVA in the quarter was $175 million with $114 million in equity sales and trading and $61 million in fixed-income sales and trading. Excluding the impact of DVA, firm wide revenues were $8.3 billion, down approximately 2% versus the first quarter. The effective tax rate from continuing operations for the second quarter was 31%.

Earnings from continuing operations applicable to Morgan Stanley common shareholder, excluding DVA, were approximately $720 million which included a negative adjustment of $152 million related to the acquisition of the remaining 35% stake in the wealth management joint venture. Earnings from continuing operations per diluted share excluding DVA was $0.37 after preferred dividends. EPS included a negative adjustment of $0.08 per share from the acquisition of the remainder of the wealth management joint venture.

On a GAAP basis, including the impact of DVA, firm wide revenues for the quarter were $8.5 billion. Earnings from continuing operations applicable to Morgan Stanley common shareholders were $831 million. Reported earnings from continuing operations per diluted share also inclusive of the negative adjustment of $0.08, were $0.43 per share after preferred dividends. Book value at the end of the quarter was $31.48 per share, tangible book value was $26.27 per share reflecting a reduction of $1.49 due to the completion of the acquisition of the wealth management joint venture partially offset by earnings.

Turning to the balance sheet. Our total assets were $806 billion at June 30, essentially flat versus last quarter. Deposits were $82 billion, basically unchanged from the prior quarter. Quarter end deposits did not reflect the first tranche of deposits that are transferred to Morgan Stanley in conjunction with the acquisition of the remainder of the joint venture. The initial deposits come in on a lag basis with $16 billion transferred this week. We will receive the remaining deposits on a monthly basis through the middle of 2015.

Our liquidity reserve at the end of the quarter was $181 billion compared with $186 billion at the end of the first quarter. The decline was driven by a reduction in bank liquidity as we deployed excess liquidity to support loan growth. Although our calculations are not final, we believe that our Tier 1 common ratio under Basel 1 will be approximately 11.8%, and our Tier 1 capital ratio will be approximately 14.1%. Risk-weighted assets under Basel 1 and including the final marker risk rules are expected to be approximately $404 billion at June 30.

Reflecting our best assessment and expectations of the recently received Federal Reserve rules, our pro forma Tier 1 common ratio under Basel III was 9.9% as of the end of the second quarter. We know that this ratio reflects our best interpretation at this time and it's subject to change as we further study the new rules. We estimate our pro-forma supplementary leverage ratio to be 4.2%. This estimate reflects the most recent United States proposed regulatory rules for the numerator and the denominator and is also subject to change as we study the guidelines. We have a clearly identified path to exceed in 2015 to 5% regulatory requirements.

Turning to expenses, total expenses this quarter were $6.7 billion, up 2% versus the first quarter, with compensation expense down 3% and non-compensation expense up 11%. Relative to the expense reduction targets that we articulated in January, we remain on track as best evidenced by our expense ratios relative to our 2014 target. Recall that we expected that some of our expense reduction effort to result in $1.6 billion decline from 2012 reported expenses to 2014 full year expenses. Our $1.6 billion target was set based on revenue consistent with 2012 levels, notwithstanding our expectations for growth. Thus we further indicated that on higher revenues our variable expenses would grow, but the overall expense ratio would improve.

Our revenues excluding DVA were up 8% in the first half while expenses were up 5%. Excluding higher litigation costs, our expenses would have been up 2%. Our $1.6 billion cost reduction target on flat revenues implied an expense ratio of approximately 79% for the firm for 2014. We are at that level in the first half of 2013 and would be even better than 79% without higher litigation, with still more expense savings to be realized over time. As a reminder our target for two year target and expenses have and will likely continue to vary from quarter-to-quarter. Recall that we had some non-recurring expenses in the second half of last year.

In addition, we had severance and certain wealth management items in our result in the first half of this year. Our targets include an expectation for continued elevated legal expenses, but of course those tend to be lofty and difficult to forecast. We continue to work through our cost cutting programs and they will drive operating leverage through the end of 2014.

Let me now discuss our businesses in detail. In Institutional Securities, revenue excluding DDA were $4.2 billion down 5% sequentially. Non-interest expense was $3.4 billion, up 3% versus the first quarter. Compensation was $1.8 billion for the second quarter, down 7% versus the first quarter, reflecting a 42% ratio excluding DDA. Non-compensation expense of $1.6 billion increased 16% from last quarter, driven by increased litigation expense as well as revenue and activity related costs. The business reported a pretax profit of 4785 million, excluding the impact of DVA. Including the impact of DVA, the business reported a pretax profit of $960 million.

In investment banking, revenues of $1.1 billion were up 14% versus last quarter, with strong growth in EMEA. According to Thomson Reuters, Morgan Stanley ranked number two in global completed M&A, number three in announced M&A, number two in global IPOs and number three in global equity at the end of the second quarter.

Notable transactions included, in advisory, Morgan Stanley acted as lead financial advisor to Kabel Deutschland on the proposed €10.7 billion takeover offer from Vodafone. In equity underwriting, Morgan Stanley successfully priced the $4 billion IPO of Suntory Beverage & Food Limited. Morgan Stanley acted as joint global coordinator and [lead left] book runner on the international tranche. Our JV partner MUFG also acted as joint book runner on the domestic tranche. And in debt underwriting Morgan Stanley acted as an active book runner on Petrobras Jumbo $11 billion fixed tranche senior notes offering as well as Chevron's $6 billion four tranche senior notes offering.

Advisory revenues of $333 million were up 33% versus our first quarter results, driven by cross border activity and improved performance in EMEA and the Americas. Equity underwriting revenues were $327 million, up 16% versus the first quarter, driven by a significant increase in IPO activity and the highest level of sponsor related activity in several years. We had strength in the Americas and Asia, particularly Japan. Fixed income underwriting revenues were $418 million, up 2% versus a strong first quarter driven by loan syndication fees.

Equity sales and trading revenues excluding DVA were $1.8 billion, an increase of 13% from last quarter. Equity revenues were up broadly across products, regions and client segments versus the first quarter. Client revenues were the highest level in over a year driven by higher market volumes, increased volatility and greater prime brokerage balances. In cash equities, the revenue increase was driven by continued strong market share and volume growth, in particular in the Americas. Derivatives revenues were up versus last quarter with strength across regions particularly in Japan and the Americas and in part driven by higher volatility. Prime brokerage revenues also increased driven by increased activity during the European dividend season and higher client balances which increased with overall market levels.

Fixed income and commodities sales and trading revenues excluding DVA were $1.2 billion. Fixed income revenues decreased versus the first quarter due to higher volatility that resulted in lower client activity. However, a reduction in our risk levels during this period helped offset price volatility. FX delivered its fourth consecutive quarter of revenue gains benefiting from ongoing strong contribution from the firm's electronic trading platform. Commodities results were up meaningfully versus the first quarter benefiting in particular from increased client activity in North American power and natural gas as well as precious metals volatility.

Generally, however, the oil liquids market which overtime has been the most important driver of our commodities business, continues to operate at historically low levels. Finally, there was a modest CVA benefit in the quarter. Other sales and trading negative revenues of $57 million compared with positive revenues of $73 million last quarter. Average trading VAR for the second quarter was $61 million versus $72 million in the first quarter driven by a reduction in risk in May in fixed income and commodities.

Turning to wealth management. We achieved revenues of $3.5 billion in the second quarter, a record level. Asset management revenues of $1.9 billion were consistent with the first quarter, benefiting from higher market levels that were offset by lower deposit referral fees due to a rate reset late in the first quarter. Transaction revenues decreased 7% from last quarter consisting primarily of commissions of $567 million which were flat to the prior quarter.

Investment banking related fees of $258 million, down 6% versus last quarter, reflecting lower new issue volumes. And trading revenues of $223 million which were down 25% versus the first quarter, reflecting the impact of lower activity due to difficult market conditions in June. Net interest revenue increased 8% to $446 million driven primarily by growth in our lending product. Other revenue increased to $139 million in the quarter, primarily due to a gain on the sale of our global stock plan business and our investment portfolio gains.

Non-interest expense was $2.9 billion, flat to last quarter. The compensation ratio was 58% versus 60% in the first quarter, reflecting a higher level of net interest income and higher non-compensable revenues in the other revenue line. Non-compensation expense was $834 million up 3% versus last quarter due to a number of expense items incurred in conjunction with the closing of the wealth management joint venture, including software write offs, branch consolidation and increased advertising expenses. The PBT margin was 18.5%. Profit before tax and the PBT margin benefited modestly from the net impact of the unusual revenue expenses in the quarter. Profit before tax was $655 million, the highest level of absolute profitability since the inception of the joint venture.

We reported non-controlling interest of $100 million in the quarter, reflecting a full quarter of earnings. Prospectively we will not have the NCI deduction.

Total client assets were basically flat to 1Q at $1.8 trillion. Global fee based asset inflows were $10 billion. Fee based assets under management increased to $629 billion at quarter end. Global representatives were 16,321 up slightly from the first quarter. Bank deposits were 127 billion effectively flat to 1Q. Approximately $70 billion were held in Morgan Stanly Bank. As mentioned previously, we received the first wave of deposits associated with the final 35% ownership this week.

Investment management revenues of $673 million were up 4% versus the first quarter. In traditional asset management, revenues of $419 million were up from the first quarter, driven by higher performance fees and asset management and administration fees. In real estate investing revenues decreased 11% versus the first quarter when the firm realized strong, principal investment gains. 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 up 31% compared to the first quarter driven by higher principal investment gains.

Expenses were $513 million, up 12% from the first quarter, reflecting a change in revenue mix. Profit before tax was $160 million, down 14% sequentially. NCI was 421 million versus $51 million last quarter. Total assets under management increased to $347 billion driven net inflows of $9.8 billion.

In terms of our outlook, in the U.S, positive economic data suggests that headwinds are abating. Improving employment, signs of strength and discretionary consumer spending, a healthy outlook for housing and a declining deficit are encouraging signs for our clients and our businesses. Recent Federal Reserve guidance is also constructive, in particular its emphasis on interest rate policy. Institutional clients are repositioning in response to the Fed comments. Equity activity in the U.S. remains strong with U.S. Equity viewed as a relative safe heaven. Our M&A pipeline remains healthy with corporate clients increasingly focused on executing strategic priorities ahead of potential rising rates. And our retail clients remain engaged in the markets.

In the Eurozone our outlook for GDP remains subdued. We expect to see higher activity levels, but only relative to anemic lows in recent periods. Japanese markets remained strong and we are well positioned to give partnership with MUFG. In short we benefit from our leading positions globally, our franchise momentum continues and we are increasingly leveraging strengths within business unit to the benefit of the entire firm.

Thank you for joining us and James and I will now take your questions.

Question-and-Answer Session

Operator

(Operator Instructions). The first question will come from Mike Carrier with Merrill Lynch.

Michael Carrier - Bank of America Merrill Lynch

Maybe first question just on the wealth management business, so you're hitting the margins, you do the buy in. The one area that it just seems like for that business it still looks little bit on the lower side would just be on the returns and grant this quarter. There is a lot of charges and you don't get the full benefit. But it just seems like even on an adjusted basis, it might be in that 7% to 8%. Just going forward, what's the driver there of improving those returns? Obviously as the margins pick up, that's going to benefit it. But just what's the long-term opportunity for the return in the Wealth Management business?

Ruth Porat

Well a couple of points, given there was an acquisition, there is goodwill associated with it. So the return on tangible equity in the business is about 30% today. And we do see the profitability, the profit margin and the returns on that business increasing. So up nicely year-over-year increased versus the last quarter and really reflects the ongoing strength on the revenue line, the benefit as the cost moves that we've made on expense line. I did call out that there were some higher expenses this quarter, but fundamentally the benefit on the expense line. And we do see longer term upside as we continue to execute on the lending products. So again upside from lending. We revised our target to 20%-22% by the end of 2015. And again to be clear, that was with no assumption about higher equity market levels or rate changes and we expect that we would be above 23% with the benefits of market and rates.

The other thing I would note is that this quarter we did take the charge associated with buying in the balance of the wealth management business. That's $152 million charge, so the return on equity excluding that 10%, but again I would focus you to the return on tangible equity given the acquisition.

Michael Carrier - Bank of America Merrill Lynch

Okay. That's helpful. And then maybe just as a follow up on the capital side. So you gave the color on the leverage, you know ratio and the outlook in terms of 2015. In terms of -- how do you get there? What are the different leverage points that you have? And then any impact on the revenues of the business. And the probably more importantly, given that you have got the buybacks this quarter and for the rest of the year, how do you think that plays in? Because obviously their earnings power is improving, the leverage ratio is lower, but you are getting some buyback opportunity. So when you think about buybacks going into '14 and '15, any view on that just given the different dynamics. Thanks.

Ruth Porat

Sure. So let me start with the leverage ratios. I indicated we estimate we are spot at about 4.2% this quarter and as I said we expect to be above 15% in 2015. We do see opportunities with both the numerator and the denominator, and most important they are very consistent with the strategy against which we have been executing. So starting with the denominator where we see a big opportunity, there are a couple of things to note. First, with our focus on reducing risk-weighted assets in fixed income, this is not model approval but passive and active mitigation and as a result we are taking balance sheet down because there is a relationship between risk-weighted assets and gross balance sheet. So that's the first point. And as we repeatedly said, we are taking risk-weighted assets down in areas that are not accretive to revenues. So we don't see that as impacting the business.

The second is our focus on central clearing. We have talked about that on many calls. We have invested meaningfully in central clearing. We are well positioned to increase the volume of our derivatives through central clearing and back-loading old trades leads to an elimination of the gross up in the denominator. We are obviously accreting capital which benefits the numerator. So when you incorporate those items, 500 million share repurchase we talked about and then assumption that we do continue to return capital on the future, that takes us to this glide path to above 5% in 2015.

Now to be clear, on top of those items we do believe there are additional opportunities to reduce the denominator but it's too early to quantify. A couple of examples. With banks on both sides of the Atlantic focused on reducing balance sheet, we believe there could be lower derivatives notionals by compressing offsetting trades between clients and counterparties for non-clearable derivatives. A second opportunity is more upside in central clearing. In our calculation, we only incorporated our expectation for the amount to be cleared in the next 12 months. We didn't go beyond one year. This is an important area and so we do see, again, upside in the reduction in the denominator from the amount that's centrally cleared.

And then finally, consistent with all that we have been doing to optimize capital, business unit leaders have the analytics to optimize the returns, we have talked about this in the past. We charge them for the capital balance sheet and liquidity needed to support their business. And when you look at the way we are organized with our bank resource management effort, we've talked about that in the past, BRM. It's a centralized resource governance structure. We are well positioned to make appropriate resource allocation adjustments. So we do feel good about the strength of our capital base. We have baked in returning more capital into that calculation and I would note that we are already above 6% at the bank.

Operator

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

Guy Moszkowski - Autonomous Research

Very encouraging to see the buyback. Can we assume that, that was something that was approved as part of your approvals process with Fed just ahead of the joint venture buy-in?

Ruth Porat

So, just to break it down, in the 2013 CCAR, the only request we put in, as we've talked about on prior calls, was for the wealth management acquisitions given how strategically important that is. And there is a provision though within CCAR, once you have capital approval you can apply for an additional 1% of tier 1 capital for capital action. So upon closing it, I think this is where you are going, but just to make sure I'm very clear on it, as we went to the final closing of the wealth Management acquisition, we put in the request to use this incremental 1% of tier-1 capital for capital actions. We thought it was the logical next step and are pleased to have the approval, no objection and to be commencing the share repurchase. It hasn't yet started. We just got approval for it, so it gives the ability to use it as James said in his opening comments.

James Gorman

I think, Guy, that the key first I'd say consistently is to focus on the strategic platform, get Morgan Stanley in the shape that it needs to be in for the next decade and more. And then the financial management through buybacks and other capital actions obviously follow from that. So were very careful to make sure we got the deal done even though it was a modest capital outlay of $400 and some million before started anything on the capital action. And we've taken this first step and obviously we're pleased to do it.

Guy Moszkowski - Autonomous Research

But just to follow up on it then, as we think about the platform and the capital that's needed in it, I look at the capital allocations that you give for the different business unit, which is as I told before a very, very helpful disclosure which a lot of people don't do. So thanks for that. I noticed that you brought the capital in ISG down this quarter by a little over $1 billion.

And with the accumulation of retained earnings you brought the parent unallocated capital up by a little over 2 billion. Are we supposed to read or can we read anything into that and to what you think you need for the different business platforms and how much you might be accumulating for ultimate return?

Ruth Porat

Let me first clarify what's in the allocation of required capital. So you’re absolutely right, the parent capital number went up. The allocation is based on the final Basel I, Basel 1 plus 2.5 if you want to call it that. And with the reduction in risk weighted assets and fixed income that we require less capital in fixed income, which is why the ISG number went down and the parent number went up, accretion of earnings plus the reduction of capital required in the business. Now the way we are managing the business is with the Basel III lens as we’ve talked about and we will shift this table to Basel III as soon we are -- the industry is reporting on the Basel III basis completely. But fundamentally, what you see here is that we are continuing to accrete capital. That's why we said we believe we are increasing our degrees of flexibility that's reflected in our Basel III tier-1 common ratio and in particular the clarity we think we have with the execution path on the leverage ratio. So directionally, yes, and then the numbers have changed a little as we move to Basel III.

Operator

The next question will come from Howard Chen with Credit Suisse.

Howard Chen - Credit Suisse

Congratulations on the buyback and results. On the core client fixed franchises, it's been a challenging backdrop, but I think you've expressed some level of disappointment on absolute basis, and the results somewhat like it appears. As you looked at broader fixed franchise performance, what do you attribute under performance to? And what's within your control from here to improve those results and the trajectory of it?

Ruth Porat

Well, it was a tough quarter. We reduced risk in May given our concerns about the potential market volatility within fixed income products. You can see that. When you look at VAR, we ended the quarter with VAR down about 15%. And as I noted risk weighted assets were down, down to $239 billion. In our view it does set us up well going forward to support higher client activity. And we do -- I think that we have upside in quite a number of the products areas. And we’re continuing to benefit from the leadership positions across our franchise given the benefit of adjacencies.

James Gorman

I would just add how there is a little bit of an obsession comparing for size. We don't frankly compare for size. We have a different structure business from a lot of other institutions for very important reasons. We’re not a global commercial bank in the traditional sense. So we’re always going to have smaller foreign exchange and rates businesses. But we focus on our returns. We’ve been through a period where we had to clean up a lot of stuff that we had. We did that going back to MBIA and longer. We had to then build out our flow footprint which we’ve been doing over the last couple of years. And now the business is aligned the way we like it. We’re now working on each of those paths as we laid out at the last analyst call getting to their individual returns. The sum aggregate obviously gives us a decent return for the business. So, we’re much more focused on returns that on size.

Howard Chen - Credit Suisse

Understood, thanks. And then switching gears over to GWM. Ruth, asset administration fees grew but may be not as much as we expected with the lag pricing dynamic. So, I was just hoping you could walk through the dynamics of the moving parts of the referral fees this quarter? And any other notable trends ex the referral fees that you might have seen through the business?

Ruth Porat

Well, you went right to the key point which was the referral fees. That referral fee is set on an annual basis and it's based on rates at the time. It was reset late in the first quarter. So this is the first full quarter of the lower deposit referral fees. It gets reset again next year. And the deposit referral fee, just like the higher FDIC fee as well, both of those roll off as the deposits roll over to Morgan Stanley.

Howard Chen - Credit Suisse

And then my final question, thanks for all the thoughts on the supplemental leverage ratio, just, if I heard you correctly, it sounds, Ruth, like most of the mitigating actions you could take are mostly on fixed income. And I guess when I take a step back, I inherently think of yourselves in trading franchise, equity is being inherently more levered business than fix. So how do we kind of marry that with you having fantastic equities results with that inherently being a higher leverage business with you achieving the glide path, if that makes sense? Thanks.

Ruth Porat

So a couple of things. One, we are managing a leverage-based capital -- looking at both leverage-based capital and risk-based capital and a portfolio actually, when you manage those two, results in the highest overall return. Second, on the gross up. In terms of the gross up for the balance sheet, the areas that we're running down are areas entirely consistent, as I said, with the strategy we're executing upon. So back to James' comment that we are not focused on fixed income size for size's sake, we are looking at the returns on the business. And so the run down in risk-weighted assets enables us to focus on the areas that are core to our client franchise where we are continuing to put risk behind clients and the reduction in denominator associated with the move to central clearing. Again, we have repeatedly said on calls that we believe that central clearing is not only good for the market because it increases transparency and standardization, but it does play to Morgan Stanley's strength because it's less about competing on size of the balance sheet and more about content and service and execution. So we were moving in that direction in any event and the opportunity to back load old trades in the central clearing and thereby reduce the denominator, again, consistent with our ability to have a right, a focused, fixed income business that plays to our strength and again benefits from all that we are doing across the franchise.

Howard Chen - Credit Suisse

Okay. Maybe just one follow-up on that. I guess what I am asking is, it doesn't sound like there is a high level of concern that this supplemental leverage ratio and mitigating to that will disrupt these great results, share gains that you have all made in the equities business over the last few years?

Ruth Porat

I know as I said, I think what the elegance of the rundown to 2014, if that's the right word to use, is it is consistent with the strategy that we have already articulated and against which we're executing. And our equities franchise is a stellar franchise, continued strength across products and geographies, balanced across the franchise and so again able to continue to execute.

Operator

The next question will come from Mike Mayo with CLSA.

Michael Mayo - CLSA

I just wanted to clarify, Ruth, when you said getting the leverage ratio of 5% that has an assumption for return of capital in the future. What did you mean by that?

Ruth Porat

We included an assumption but I don't want to prejudge where 2014 CCAR comes out, and given flexibility that we have as I enumerated the various other items to further reduce denominator. We have built in levels of flexibility so that again it will be based on where CCAR is at the end of this year and managing the mix of levers that we have. But I noted it because 500 million is a good first step in terms of a share repurchase and it is a tool that we believe we've built flexibility to use on a go forward basis, but don't want to prejudge 2014 CCAR by putting a number out there.

James Gorman

I would just point out though, since the last CCAR we have had earnings of 800, round numbers, 800 of [BM2] and 900. So we are obviously accreting reasonably healthy levels of capital quarter-by-quarter.

Michael Mayo - CLSA

Still on the topic of capital, the ROE is about half of where your target is. Any general thoughts on how you’re going to improve the ROE from where it is in this quarter?

Ruth Porat

Yeah. So James laid out in January the six point ROE plan and as he said we've already made progress, substantial progress on a number of the items. Completing the Wealth Management acquisition obviously a key step. The earnings this quarter don't have to benefit of that incremental 35% we closed on the last day of the quarter. That starts July 1. The revenue and margin upside, we've delivered, but as we indicated we think there is more upside there. The reduction in risk weighted assets in fixed income, we’re very much on track, if not ahead of track and we do believe that there is upside in that business. We're continuing to execute on the wealth management -- sorry, on the expense ratios.

And expenses were a bit higher this quarter as we noted. Litigation was a bit higher and again we're on a good trajectory to have tighter expense ratios as we go through to 2014. We’re executing on our on the bank strategy which again gives us some upside and capital as well. So the ROE this quarter was obviously also depressed by the charge associated with buying in the Wealth Management business. But when you roll those items together, excluding the charge about 6% and then we see upside from the six items that we've consistently taken you back to.

James Gorman

Mike, I'd just say there is nothing that we have seen in this quarter that changes our view on what we laid out on our ROE projections. We stand by them.

Michael Mayo - CLSA

And you mentioned backlogs a little bit, but could you elaborate a little bit more?

Ruth Porat

Sure. The pipeline does remain healthy. U.S. Activities is strong as I did note. Europe is up, but that's versus a very week prior 12 months. Japan continues to be strong. Emerging markets are mixed. China is slow. Brazil has a big pipeline, but as challenged. We think that's on pause at least for now. But we’re seeing greater opportunity in Asia Pacific. So it's very country specific. I think the intriguing element is this backlog in M&A which has been sitting for quite some time and I’ve said on prior calls we attribute that to CEO confidence. But what we are increasingly hearing is reassessments of timing, in particular as Fed comments are that any moves are data dependent. Where there are signs of improvements in the economy, that isn't inspiring, in conjunction with concern about higher rates and what that means is if there is a delay. So we are hopeful to see that backlog start moving through the execution. The drivers today on activity have been more cross-border as I noted in the sponsor and activist related activity. The equity pipeline is stable. It’s skewed more towards the U.S., Mexico and Japan.

Michael Mayo - CLSA

And two more smaller ones. Litigation, how much was it this quarter and where do you expect that to go and what's normal?

Ruth Porat

So the second quarter was up a 140 relative to the first quarter. It's proven to be an ongoing cost for the industry associated with all the pre-crisis matters. It's proven to be lumpy, tough to forecast. But we called it out in terms of the expense comparison, because at some point the financial crisis is behind the industry and these start to abate. And just to give a sense, first half this year versus first half last year we were up $250 million.

Michael Mayo - CLSA

And then lastly your VAR was down, at some others, it was up. What is that? Is that just a more cautious risk profile or is this just temporary?

Ruth Porat

The VAR was down in particular on the interest rate and credit line. And that really goes to my comments that we reduced risk in May given concerns about potential market volatility within fixed income products. And I think the team did a good job managing that, but it does set us up well to put to support client activity this quarter going forward. We have capacity there.

Operator

The next question will come from Brennan Hawken with UBS.

Brennan Hawken - UBS

So a quick one on leverage. Does the new rule change your view on moving derivatives over to the bank sub?

Ruth Porat

That's a great question because I indicated that we’re above 6% at the bank now. And the way we are looking at it, it's obviously just come out and it's still in the proposal stage. But if we move derivative to the bank, we get a dollar for dollar benefit because we’re not obviously funding them with unsecured any more, but with deposits. So there is some optimization there. And I think the way we are thinking about it is client preference, efficiency, logic of it, how the market is evolving, we have some capacity in the bank that we have a clear flight path for the holding company. So it's much more about looking at the specific asset classes and assessing it and it's too early to actually answer it more specifically than that.

Brennan Hawken - UBS

That's fair. So, switching gears then, I guess as you guys continue to work to improve margins in wealth management, is there a way we should think about FA headcount going forward?

Ruth Porat

Well, FA headcount is up a bit this quarter. We continue to be very focused on FA productivity which as I noted is at a record high. And kind of in and around this level is logical and again our focus is primarily on FA productivity. So it's not a line in the sand here.

James Gorman

It will bounce around a little bit quarter-to-quarter. Honestly, I wouldn't think about it too much.

Brennan Hawken - UBS

But really productivity is probably the bigger driver in the way that we should think about it more so than actually the number it has?

Ruth Porat

Yes.

James Gorman

By far.

Brennan Hawken - UBS

Great. And then last one from me. As NII becomes sort of more important to you all and the asset leverage increases paying a lot more attention to that, and so this question is a little dated, but I kind of not pay as much attention to [NII] guys for a while. It seems as though NII and ISG has been really weak since 2008. What's been behind that? Is there any way to think about that or what are the drivers there?

Ruth Porat

No, I think your opening comments actually answered it. NIM is much more a banking book than a trading book concept and so it's much more relevant for the wealth management business and it has been improving nicely and should continue to as we deploy deposits. So really it's less relevant in the trading business.

Brennan Hawken - UBS

Okay. And on the [latter] business, the wealth management business, we have seen kind of a move here in the two and three year treasury. Is there any benefit that we can expect down the line for you guys from that move or is the deposit investment for shorter and only really like the six months LIBOR would have an impact?

Ruth Porat

Yeah, we've indicated that it really is -- we focus on the much shorter end. So the first 150 basis points in Fed funds is about $1.1 billion in PBT for the business. To the extent we're seeing rising rates because there is improving economic activity, that's constructive for all of the businesses but the guidance that we provided was really anchored at the short-end.

Operator

The next question will come from Jim Mitchell with Buckingham.

James Mitchell - Buckingham Research

Could I just ask a follow up question on the derivatives business as you move to central clearing. We talk a lot about the numerator benefit, but have you done any work trying to figure out what the, if any, capital benefit would be on a Basel III basis and going to moving more and more of the derivatives to centralized clearing platform?

Ruth Porat

Still too early.

James Mitchell - Buckingham Research

But is it at least -- it makes sense that you get some benefit or there is just no way to tell at all.

Ruth Porat

No, our assumption is there is some benefit. There is benefit to it. And trying to quantify it for our call, it's too early, or to estimate (inaudible) capital, too early.

James Mitchell - Buckingham Research

Okay. And just a follow-up on the spread question on the deposits. As you pull in $55 billion over the next 24 months. How do we think about, you talked about your leverage is more in the short-end, but in the near-term I assume you are putting it mostly in the AFS portfolio.

Ruth Porat

Correct.

James Mitchell - Buckingham Research

And with the backup in yields in the intermediate bond area, wouldn’t you get some benefit. I know your target was 1% spread before the rate spike, should we be assuming a little bit better than that?

Ruth Porat

We are still fairly short and it's been our philosophy given we have been in the low interest rate environment is to keep duration short, given the inevitable rise in rates would prove to be a financial drag, and I think that was the right thing to do.

Operator

The next question will come from Roger Freeman with Barclays.

Roger Freeman - Barclays Capital

I guess just on the FICC business, you are talking about risk having come down in May, with markets more normalized this sort of the level of liquidity provision going up. And what was -- the client may just the volatility or I know you had some management changes too so I'm not sure if that's factored in there.

Ruth Porat

I was concerned from the team about potential market volatility and just thinking that was it prudent risk management to bring risk down in the business given that concern. And we're pleased that they did.

Roger Freeman - Barclays Capital

And market normalcy has returned from your perspective so far as where it seems like we learn that from others?

Ruth Porat

It does seem that way, yes.

Roger Freeman - Barclays Capital

And just back on the buyback and CCAR, I know you've probably said what you can, but just thinking about the 1%, is that a mechanical outcome of this provision to be able to apply for that and not to read into that one way or another as to the Fed's thinking on approving capital stock buyback requests with say your leverage ratio where it is against the target? Are they separate issues?

Ruth Porat

Well, there’s the provision that you have the opportunity to apply to use 1% of your tier-1 capital, but it's still an approval. And so we're pleased to receive the approval no objection and to be able to proceed.

Roger Freeman - Barclays Capital

And I guess the only other on the clearing rollout, how's that in the swaps businesses. How's that going from your perspective? And it seems like what we’re hearing from others is no real impact on customer volumes. Have you found the same thing?

Ruth Porat

Yes. The big event was obviously category two. The move went well. Clients are ready. We didn't have operational issues. We do think the staggered rollout of clients was constructive between category one and category two. At this point it's premature to judge I think the impact fully on market activity because there were so many other exogenous events. But it went well and we feel we are well positioned.

Operator

The next question will come from Fiona Swaffield with RBC.

Fiona Swaffield - RBC Capital Markets

Two things. Firstly on the Basel III look through the 9.9 versus Q1. I don't know if you could talk about the numerator and the denominator, because the RWAs keep on going down in fixed income, but there seems to be something offsetting it was the first question. And the second question was the total exposure number. So the supplementary leverage ratio exposure and the move to that through to full. If we look back and you have that big reduction in FICC Basel III RWAs, could you tell us where the exposure would have been or the leverage ratio would have been at the bottom, just to work out what the correlation is potentially?

Ruth Porat

Okay. So, on the first question, the Basel III firm wide RWAs are $426 billion. Some of the movement between the first quarter and the second quarter obviously there is earnings accretion. There was obviously the charge associated with the Wealth Management acquisition and then just finalization of the rules. That gets you to the 9.9%. And then could you repeat the question regarding the leverage ratio?

Fiona Swaffield - RBC Capital Markets

I'm just trying to understand the moving parts on the total exposure, because we've obviously seen the fixed income RWAs come down a lot in the last 18 months and you're getting more towards the end of that process. So how much is the total exposure going down is really due to the fixed income? Is it -- those total exposure numbers would have been much higher before you started reducing the fixed income book.

Ruth Porat

It would have been much higher before we started reducing the fixed income book. And I think the two buckets that I broke out, one, the RWA reduction and the RWAs in fixed income were $390 billion at the peak. They're down to $239 billion and most of that really is in areas that are relevant to the growth subs, in particular our structure credit, credit correlation business. So yes, we've absolutely benefited from what we're doing and we continue to be on an execution perhaps to take it down even more, which is what gives us the confidence we can continue to do so. And then similarly, we've moved, already moved quite a bit. We were early in central clearing. And so we're already seeing some benefit in the denominator from the move to central clearing and look forward to continuing to execute on that portion.

Operator

The final question will come from Matt Burnell with Wells Fargo.

Matthew Burnell - Wells Fargo Securities

Good morning. Thanks for taking my question. I appreciate the disclosure, particularly specific to Wealth Management loans on page 12. I guess I'm just curious as to if there is any dollar target or growth target of those loans now that you've got deposits obviously flowing in from the MSSB transaction, given your ongoing statements about trying to grow the spread revenue within wealth management?

Ruth Porat

So, I may give you a somewhat unsatisfactory answer because I'm not going to be able to quantify it by buckets, and the reason is, we've said consistently that we are leading with credit risk management and that it will be a prudent build-out of the portfolio and that is how we are continuing to build it. So, the deposits are going to continue to grow and support growth and lending product both for wealth management and institutional securities. And on the wealth management side, the biggest growth is on the securities based lending and secondarily on residential mortgages. We have 5% penetration of our clients relative to our peers who have 10%. So, our view is that there is tremendous upside. We've got a tailwind there but we're, again, leading with prudent steady growth and that's going to be the continued philosophy around it.

And then on the institutional side, that's also how we are going to be utilizing some of the deposits. We do get a funding benefit when we move dollar for dollar funding benefit when we substitute unsecured debt with the more efficient deposits. So, certain product does move to the bank and obviously our relationship or maybe not obviously, our relationship in that lending is in the bank. And then we have an attractive opportunity growing bank appropriate product in the bank. So areas where we already have very strong teams, domain expertise, client base, like commercial real estate lending, asset-based funding, project finance, we can grow the lending suite, an area we hadn't here too far been focused on. So, it is a real diversified portfolio of assets supporting growth on both wealth management and the institutional securities businesses that we'll build over time. And we'll be sharing more about the bank and the bank strategy over time given the growth that we are seeing there.

Matthew Burnell - Wells Fargo Securities

Then just switching gears a little bit, James, maybe a question for you in terms of how you are thinking about the long-term total payout ratio of the firm given that you've now taken a big step towards that with the announcement of the 500 million share buyback?

James Gorman

Well, as I say, journey of the 1,000 miles begins with a single step and we've had our first step, that's really what mattered. We don't want to get ahead of that obviously. It's what payout ratios are. It's going to be a function of where absolute earnings are and managing against the changing regulatory environment. But what we wanted to do is put ourselves in a position where we could launch a buyback and begin that process which is what we did.