

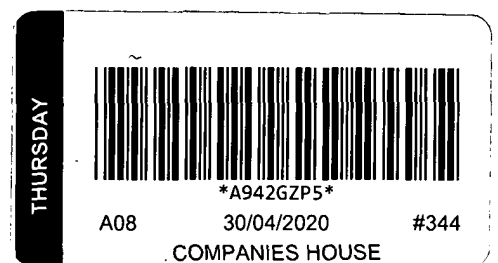
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MORGAN STANLEY BANK INTERNATIONAL LIMITED

Report and financial statements

31 December 2019



MORGAN STANLEY BANK INTERNATIONAL LIMITED

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MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

The Directors present their Strategic report for Morgan Stanley Bank International Limited (the “Company”) for the year ended 31 December 2019.

COMPANY OVERVIEW

The principal activity of the Company is the provision of financial services to corporations, governments and financial institutions. The Company operates branches in South Korea, Italy and Germany.

The Company is authorised by the Prudential Regulation Authority (“PRA”) and regulated by the Financial Conduct Authority (“FCA”) and the PRA.

There have not been any changes in the Company’s principal activity in the year and no significant change in the Company’s principal activity is expected.

The Company’s ultimate parent undertaking and controlling entity is Morgan Stanley, which, together with the Company and Morgan Stanley’s other subsidiary undertakings, form the “Morgan Stanley Group”. The Company is also a wholly owned indirect subsidiary of Morgan Stanley International Limited (“MSI”).

The Morgan Stanley Group is a global financial services firm that maintains significant market positions in each of its business segments: Institutional Securities, Wealth Management and Investment Management. The Morgan Stanley Group provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. The Company provides financial advisory services; corporate lending; sales, trading, financing and market-making activities in fixed income securities, including foreign exchange; and investment activities.

From a governance perspective, the Company’s Board of Directors is assisted in discharging its responsibilities via the MSI Audit, Risk, Remuneration and Nomination Governance Committees. In addition, the Company and MSI have Division-level, Management-level and Executive-level Committees that report up to the Boards in line with established escalation processes. The corporate governance structure between MSI and the Company is described in further detail within the Corporate Governance Framework section on pages 18 to 19.

Certain disclosures required by relevant accounting frameworks in relation to the Company’s financial risk management have been presented alongside other risk management information in this Strategic Report. Such disclosures are identified as audited. All other information in the Strategic Report is unaudited.

BUSINESS ENVIRONMENT AND PERFORMANCE

Business environment

Global market and economic conditions

Global economic growth slowed to 3.0% in 2019 from 3.7% in 2018. The slowdown was broad-based across both developed and emerging markets, with growth in developed markets slowing to 1.7% in 2019 from 2.1% in 2018, while in emerging markets, growth softened to 3.9% in 2019 from 4.8% in 2018. Trade tensions weighed heavily on global growth through the year via the related impact on corporate sentiment and capital spending, as well as on the manufacturing and trade sectors. In response to the growth headwinds, both monetary and fiscal policies were eased. In particular, the Federal Reserve cut interest rates by 75bps in the second half of the year and resumed an expansion of its balance sheet in response to tightening liquidity conditions. The European Central Bank (“ECB”) announced a series of easing measures in the second half of the year, cutting rates by 10bps, introducing a two-tier system for excess reserve holdings, and restarting quantitative easing. The Bank of England (“BOE”) held rates unchanged against a backdrop of weak global growth and Brexit-related uncertainty. China’s policymakers implemented both fiscal and monetary easing measures throughout the year, including government bond issuance and interest rate reform. Other major central banks, including the Central Bank of Russia, the Reserve Bank of India, the Central Bank of Brazil (“CBB”), and the Bank of Korea (“BoK”), also cut interest rates to multi-year lows.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

BUSINESS ENVIRONMENT AND PERFORMANCE (CONTINUED)

Business Environment (continued)

Global market and economic conditions (continued)

The strong start to 2020 following fading trade tensions and sizeable policy easing has been quickly superseded by the impact of COVID-19 (coronavirus). The 2020 global economic growth forecast is now a contraction of 1.9% for the year versus the pre-COVID-19 growth forecast of 3.2% for the year with the first half of the year now to contract by 3.3% followed by a recovery in the second half. The sharp deterioration of economic growth in 2020 is broad-based in both developed markets and emerging markets. In developed markets, 2020 growth is expected to contract by 4.6% for the year versus the pre-COVID-19 forecast of an expansion of 1.3% for the year. In emerging markets, 2020 growth is forecasted to contract by 0.1% for the year versus the pre-COVID-19 forecasted expansion of 4.4%. In response to this sharp deterioration in the growth outlook, both monetary and fiscal policies are on a further easing path. In particular, the Federal Reserve has cut interest rates by 150bp to the zero lower bound, restarted quantitative easing of at least \$700 billion, opened up swap lines with the world's major central banks and established various lending facilities. The ECB announced additional quantitative easing of €120 billion on March 12 and announced again one week later the €750 billion Pandemic Emergency Purchase Program. The Bank of Japan expanded its quantitative easing program with more proactive purchase of exchange-traded funds and Japanese Real Estate Investment Trusts and increased its purchase of commercial paper and corporate bonds. The BOE has also cut interest rates to the lower bound and started quantitative easing of £200 billion. Other world major central banks, such as the BoK and the BCB, have cut interest rates to multi-year lows as well. On the fiscal side, governments around the globe have announced aggressive fiscal stimulus, including both direct spending and liquidity injection. China's policy-makers pre-approved another local government bond issuance of around Rmb850 billion ahead of the annual National People's Conference meeting, and in the US, the government passed a large fiscal stimulus of around \$2 trillion.

Emergence of COVID-19

The coronavirus disease (COVID-19) pandemic has, and will likely continue to, severely impact global economic conditions, resulting in substantial volatility in the global financial markets, increased unemployment, and operational challenges such as the temporary closures of businesses, sheltering-in-place directives and increased remote work protocols. Governments and central banks around the world have reacted to the economic crisis caused by the pandemic by implementing stimulus and liquidity programs and cutting interest rates, though it is unclear whether these or future actions will be successful in countering the economic disruption. If the pandemic is prolonged or the actions of governments and central banks are unsuccessful, the adverse impact on the global economy will deepen, and the future results of operations and financial condition of Morgan Stanley and the Company will be adversely affected.

Since the emergence of the pandemic each business segment of Morgan Stanley and the business of the Company has been impacted and such impact will likely be greater in the future if conditions persist (e.g., decline and volatility of asset prices, reduction in interest rates, widening of credit spreads, credit deterioration, market volatility and reduced investment banking advisory activity). Operationally, although Morgan Stanley and the Company have initiated a work remotely protocol and restricted business travel and have not experienced any significant loss of operational capability, if significant portions of Morgan Stanley's or the Company's workforce, including key personnel, are unable to work effectively because of illness, government actions, or other restrictions in connection with the pandemic, the business impact of the pandemic could be exacerbated.

While the emergence of the COVID-19 pandemic has negatively impacted the results of Morgan Stanley, the extent to which it, and the related global economic crisis, affects the businesses, the results of operations and financial condition, as well as the regulatory capital and liquidity ratios of Morgan Stanley and the Company, will depend on future developments that are highly uncertain and cannot be predicted, including the scope and duration of the pandemic and any recovery period, future actions taken by governmental authorities, central banks and other third parties in response to the pandemic, and the effects on our customers, counterparties, employees and third-party service providers. Morgan Stanley and the Company continue to use their Risk Management framework, including Stress testing, to understand the attendant uncertainties and their potential impact on our operations, liquidity and capital. Morgan Stanley is maintaining an active dialogue with all its relevant global regulators during this period.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

BUSINESS ENVIRONMENT AND PERFORMANCE (CONTINUED)

Business Environment (continued)

UK withdrawal from the EU

On January 31, 2020, the United Kingdom (the “UK”) withdrew from the European Union (the “EU”) under the terms of a withdrawal agreement between the UK and the EU. The withdrawal agreement provides for a transition period to the end of December 2020, during which time the UK will continue to apply EU law as if it were a member state, and UK firms' passporting rights to provide financial services in EU jurisdictions will continue. Under the terms of the withdrawal agreement the UK and the EU may agree to an extension of the transition period for up to two years.

With respect to financial services, the withdrawal agreement provides that the UK and the EU will endeavour to conclude whether they will grant each other equivalence under European financial regulations. Equivalence would provide a degree of access to EU markets for UK financial firms such as the Company, although the extent and duration of such access remains subject to negotiation. If equivalence (or any alternative arrangement) is not agreed, the Morgan Stanley Group's UK licensed entities, including the Company, may be unable to provide regulated services in many EU jurisdictions from the end of December 2020.

Potential effects of the UK exit from the EU and potential mitigation actions may vary considerably depending on the nature of the future trading arrangements between the UK and the EU.

The Morgan Stanley Group has prepared its European operations to be able to do business with its clients in the EU regardless of whether or not equivalence (or an alternative arrangement for financial services) is granted. Changes have been made to European operations in an effort to ensure that the Morgan Stanley Group can continue to provide cross-border banking and investment and other services in EU member states without the need for separate regulatory authorisations in each member state through the use of EU “passporting” from within the EU where necessary.

These changes include use of a new licenced investment firm, Morgan Stanley Europe S.E. (“MSESE”), based in Germany, which is passported throughout the EU and serves EU-based clients where required; and the existing EU German licensed bank Morgan Stanley Bank AG (“MSBAG”), which will provide licensable banking activities where required. In addition, a new holding company for this structure has been incorporated Morgan Stanley Europe Holding SE. The Morgan Stanley Group will also serve EU clients out of branches of these entities in the EU and existing regulated operations in France and Spain as necessary.

This new operating model went live in the first quarter of 2019, with MSESE commencing cash securities and derivatives trading. The Morgan Stanley Group is continuing to build out the capabilities of its EU entities. In addition, the Morgan Stanley Group expects that certain lending activities currently transacted by the Company may in the future move to MSBAG. The extent and timing of these moves will depend on client preferences and on licensing rules, which in turn will depend on the form of any future trading agreement between the UK and the EU in relation to financial services.

Following the reorganisations mentioned above, the Company's principal activity and risks remain unchanged and the majority of current profitability and balance sheet remain within the Company.

As a result of the political uncertainty described above, it is currently unclear what the final post-Brexit structure of European operations will be for the Morgan Stanley Group overall. Given the potential negative disruption to regional and global financial markets, results of Morgan Stanley's operations and business prospects could be negatively affected.

Geopolitical risk in Korea

The Company has material exposure to South Korea arising from the business of its South Korean branch. The Company continues to closely monitor and control its exposures to South Korea.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

BUSINESS ENVIRONMENT AND PERFORMANCE (CONTINUED)

Performance

The Board of Directors monitors the results of the Company by reference to a range of performance and risk based metrics. For the Risk metrics, refer to the Risk Management section from page 9 to 14 of the Strategic Report. Certain performance metrics are shown below:

Key performance indicators

In £'000	2019	2018
Return on shareholders' equity		
Equity shareholders' funds at the beginning of the year	674,193	654,676
Profit after tax	38,122	27,693
Return on shareholders' equity	5.7%	4.2%
Tier 1 capital ratio		
Risk weighted assets ("RWAs")	2,836,626	3,349,595
Tier 1 capital	593,318	578,569
Tier 1 capital ratio	20.9%	17.3%
Leverage ratio		
Leverage exposure	3,635,898	3,222,897
Tier 1 capital	593,318	578,569
Leverage ratio	16.3%	18.0%
Liquidity coverage ratio		
Average liquidity buffer - High quality liquid assets ⁽¹⁾	1,220,056	875,591
Average liquidity coverage ratio	210%	166%

⁽¹⁾ Metric is reported to the regulator in USD. Amount disclosed above has been converted into GBP using an average GBP / USD exchange rate for the year.

Movements in Key Performance Indicators are primarily explained in the movements in the financial statement components in the following section 'Overview of 2019 financial results'.

The Company has consistently been, and continues to be, in excess of required minimum regulatory ratios for capital and liquidity. Further information on how the Company manages these resources is outlined in the section 'Liquidity and Capital Resources management and regulation'.

Other performance indicators

in £'000	2019	2018
Return on assets		
Total assets at the beginning of the year	5,178,705	5,321,350
Profit after tax	38,122	27,693
Return on assets	0.7%	0.5%

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

BUSINESS ENVIRONMENT AND PERFORMANCE (CONTINUED)

Performance (continued)

Overview of 2019 Financial Results

Income statement

Set out below is an overview of the Company's financial results for the year ended 31 December 2019 and 31 December 2018.

in £'000	Year ended 31 December 2019	Year ended 31 December 2018	Increase/ (decrease)	Variance %
Net revenues⁽¹⁾	128,282	119,549	8,733	7%
Staff related expenses	(43,704)	(32,939)	10,765	33%
Non-staff related expenses	(39,476)	(49,695)	(10,219)	(21)%
Operating expenses⁽²⁾	83,180	82,634	546	<1%
Net reversal of impairment	20	160	(140)	(88)%
Profit before tax	45,122	37,075	8,047	22%
Income tax expense	(7,000)	(9,382)	(2,382)	(25)%
Profit after tax	38,122	27,693	10,429	38%

(1) Net revenue refers to the aggregate of 'Interest receivable and similar income', 'Interest payable and similar charges', 'Fee and commission income', 'Fee and commission expense', 'Net trading income', and 'Net income from other financial instruments held at fair value'.

(2) Operating expenses refers to the aggregate of 'Administrative expenses' and 'Depreciation of tangible fixed assets'.

The income statement for the year is set out on page 33.

The Company reported a 38% increase in profit after tax for the year, as net revenues increased while operating expenses were broadly in line with the prior year.

Net revenues

The increase in net revenues was primarily driven by higher credit product trading revenues due to an upturn in the current macroeconomic environment, increasing client activity and tightening of credit spreads in 2019. This was partially offset by reduced corporate lending fee revenue as a result of lower lending activity in 2019.

Operating expenses

The increase in staff related expenses was primarily driven by a change in headcount mix as well as increase in staff numbers.

The non-staff related expenses decrease was primarily driven by lower costs linked to the lower corporate lending activity.

Income tax expense

The Company's tax expense represents an effective tax rate of 15.5% (2018: 25.3%) which is lower than the statutory rate (inclusive of the UK Banking surcharge) of 27% (2018: 27%), primarily due to group relief received in the year. The main reason for the lower effective tax rate from the prior year is due to a reduction in the company's non-deductible expenses for tax purposes.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**STRATEGIC REPORT****BUSINESS ENVIRONMENT AND PERFORMANCE (CONTINUED)****Performance (continued)****Overview of 2019 Financial Results (continued)***Balance sheet*

in £'000	2019	2018	Increase/ (decrease)	variance %
Secured financing	1,480,900	1,280,633	200,267	16%
Trading financial assets	3,446,503	3,290,194	156,309	5%
All other assets	569,853	607,878	(38,025)	(6)%
Total Assets	5,497,256	5,178,705	318,551	6%
Customer accounts	1,331,496	1,072,143	259,353	24%
Trading financial liabilities	2,762,477	2,528,574	233,903	9%
All other liabilities	690,314	903,795	(213,481)	(24)%
Total Liabilities	4,784,287	4,504,512	279,775	6%
Total Equity	712,969	674,193	38,776	6%

The statement of financial position at the year end is set out on page 36.

Assets

The increase in 'Trading financial assets' is driven by derivative assets as a result of fair value movements. The increase in 'Secured financing' reflects the increase in reverse repurchase agreements held for liquidity. 'All other assets' remained broadly flat with an increase in 'Cash and balances at central banks' from higher deposits placed with the Bank of Italy being partially offset by a decrease in 'Loans and advances to customers' due to a decrease in derivative collateral pledged relating to the changes in underlying derivative exposures.

Liabilities

The increase in 'Customer accounts' reflects the increased borrowing from other Morgan Stanley Group undertakings to fund the increase in reverse repurchase agreements held for liquidity. The increase in 'Trading financial liabilities' is driven by derivative liabilities as a result of fair value movements. This is partially offset by a decrease in 'All other liabilities' from lower 'Deposits by banks' due to a decrease in derivative collateral received relating to the changes in underlying derivative exposures.

Equity

Total Equity increased primarily due to the profit after tax for the year.

Key accounting policies and judgements

In the preparation of the financial results throughout 2019 in accordance with FRS 101 as issued by the IASB and as adopted by the EU, management is required to make accounting estimates and assumptions (see note 2 for further details). Of the significant accounting policies (see note 3), the following policy involved a higher degree of judgement and complexity, and consequentially greater consideration by management.

Valuation of financial instruments at fair value

The Company consider the key valuation metrics and judgements involved in the determination of the fair value of financial instruments. To the extent that the fair value is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgement.

Management reviewed key valuation metrics, assumptions and methodologies involved in the determination of the fair value of financial instruments and determined that the valuations were reasonable.

Refer to accounting policy note 3(d) for more detail on the Company's fair value measurement and valuation methods.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

LIQUIDITY AND CAPITAL RESOURCE MANAGEMENT AND REGULATION

The Company manages its liquidity and capital reserves through internal management frameworks and practices, and ongoing compliance with implemented and upcoming regulatory standards. The EMEA Assets and Liabilities Committee (“EMEA ALCO”) is responsible for liquidity and capital management.

Liquidity and funding risk management framework

The primary goal of the Company’s liquidity management framework is to ensure that the Company has access to adequate funding across a wide range of market conditions and time horizons. The framework is designed to enable the Company to fulfil its financial obligations and support the execution of its business strategies. The Company’s key components of liquidity risk management include its Required Liquidity Framework, Liquidity Stress Testing and Liquidity Reserve, which are further described in note 34.

Regulatory liquidity framework

The Basel Committee on Banking Supervision (the “Basel Committee”) has developed the Liquidity Coverage Ratio (“LCR”) for use in liquidity risk supervision.

The LCR was developed to ensure banking organisations have sufficient high quality liquid assets to cover net cash outflows arising from significant stress over 30 calendar days. This standard’s objective is to promote the short-term resilience of the liquidity risk profile of banking organisations. The Company is in compliance with the minimum LCR requirement of 100% as detailed in the LCR Delegated Act adopted by the European Commission.

The Company is subject to Pillar II requirements, assessed by the PRA, for risks not covered in the LCR (Pillar I). These risks are identified by the firm and documented by the Internal Liquidity Adequacy Assessment Process (“ILAAP”) that is then reviewed and assessed by the PRA as part of the Liquidity Supervisory Review Process (“L-SREP”). As a result the Company is required to hold sufficient liquidity in the form of High Quality Liquid Assets (“HQLA”) to meet both Pillar I and Pillar II.

£’000	2019	2018
High quality liquid assets	1,557,844	1,168,953
Liquidity Coverage ratio	210%	166%

Capital management

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

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

The MSI Group, for which the Company is a subsidiary, conducts an Internal Capital Adequacy Assessment Process (“ICAAP”) at least annually to meet its obligations under CRD IV and the requirements of the PRA. The Company is part of the MSI Group. The ICAAP is one of the key tools used to inform the MSI Group’s capital adequacy assessment, planning and management.

See note 40 for further details on the ICAAP and the Company’s capital management.

Regulatory capital framework

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

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

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

LIQUIDITY AND CAPITAL RESOURCE MANAGEMENT AND REGULATION (CONTINUED)

Resolution and recovery planning

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

The Morgan Stanley Group has developed a resolution plan in accordance with the requirements of Section 165(d) of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations adopted by the Federal Reserve Board and the Federal Deposit Insurance Corporation. The resolution plan presents the Firm's strategy for resolution of the Firm upon material financial distress or failure.

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

Regulatory developments

Finalising Basel III Reforms

In December 2017, the Basel Committee released the final part of its Basel III reform package. The key amendments provide updates to the standardised measures for calculating capital requirements and include an RWA floor, calculated as 72.5% of total standardised RWA.

In January 2019, the Basel Committee published its revised final standard on the minimum capital requirements for market, also known as the Fundamental Review of the Trading Book ("FRTB"). The new regime:

- Clarifies the boundary between the banking book and trading book;
- Provides capital requirements for non-modellable risk factors;
- Introduces an internal models approach that uses expected shortfall methods; and
- Establishes a more risk-sensitive standardised approach that acts as a fallback for the internal models method.

Given that the above proposals will need to be transposed into national/EU law, the timing and impact of the final outcome remains uncertain.

Amendments to the Capital Requirements Regulation

In June 2019, the European Commission published the final rules, known as CRD V and CRR II that amend the existing prudential regime (CRR and CRD IV), and the BRRD.

The CRD V/CRR II package includes: Total Loss Absorbing Capacity ("TLAC"), FRTB, Standardised Approach to Counterparty Credit Risk, Net Stable Funding Ratio, revised leverage ratio, revised Large Exposure Framework, Intermediate Parent Undertaking requirement, and revised Pillar 3 disclosure requirements.

Final rules are effective 27 June 2019; however, implementation dates are staggered over a four year period, with TLAC applying from 27 June 2019 and the majority of new requirements applying from 28 June 2021.

Expected Replacement of London Interbank Offered Rate ("LIBOR")

Central banks around the world, including the Federal Reserve, the Bank of England, and the European Central Bank, have commissioned working groups of market participants and official sector representatives to replace LIBOR and replace or reform other interest rate benchmarks (collectively, the "IBORs"). A transition away from the widespread use of such rates to alternative rates and other potential interest rate benchmark reforms has begun and will continue over the course of the next few years. For example, the FCA, which regulates LIBOR, has announced that it has commitments from panel banks to continue to contribute to LIBOR through the end of 2021, but that it will not use its powers to compel contributions beyond such date. As a result, there is considerable uncertainty regarding the publication of LIBOR beyond 2021, and regulators globally have continued to emphasise the need for the industry to plan accordingly.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

LIQUIDITY AND CAPITAL RESOURCE MANAGEMENT AND REGULATION (CONTINUED)

Regulatory developments (continued)

Expected Replacement of LIBOR (continued)

The Morgan Stanley Group's transition plan includes a number of key steps, including continued engagement with central bank and industry working groups and regulators (including participation and leadership on key committees), active client engagement, internal operational readiness, and risk management, among other things, to promote the transition to alternative reference. The transition plan is overseen by a global steering committee, with senior management oversight. The transition away from Libor is complex and could have a range of impacts on our business, financial condition and results of operations. As part of the global initiative, Morgan Stanley is identifying, assessing and monitoring risks associated with the expected discontinuation or unavailability of one or more of the IBORs.

Financial risks from climate change

In April 2019, the PRA issued a supervisory statement on enhancing banks' and insurers' approaches to managing financial risks from climate change. The Company is considering the impact of this statement on its longer term strategy and how it manages the financial risks of climate change in line with its risk management framework.

RISK MANAGEMENT

Risk is an inherent part of the Company's business activity. The Company seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities, in accordance with defined policies and procedures.

The Board of Directors is assisted in its oversight of the Company's risk management by the MSI Audit and the EMEA Risk Committee in addition to a number of management level committees. The corporate governance structure between MSI and the Company is described in further detail within the 'Corporate Governance Framework' section on pages 18 to 19.

More detailed qualitative and quantitative disclosures about the Company's management of and exposure to financial risks are included in note 34 to the financial statements.

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities, correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

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

Sound market risk management is an integral part of the Company's culture. The Company is responsible for ensuring that market risk exposures are well-managed and monitored. The Company also ensures transparency of material market risks, monitors compliance with established limits, and escalates risk concentrations to appropriate senior management.

Market risk management policies and procedures for the Company are consistent with those of the Morgan Stanley Group and include escalation to the Company's Board of Directors and appropriate senior management personnel.

More detailed qualitative and quantitative disclosures about the Company's management of and exposure to market risks, including the use of Value at Risk ("VaR") based risk measures, are included in note 34 to the financial statements.

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Company. The Company primarily incurs credit risk exposure to institutions and sophisticated investors mainly through its Institutional Securities business segment.

Credit risk management policies and procedures for the Company are consistent with those of the Morgan Stanley Group and include escalation to the Company's Board of Directors and appropriate senior management personnel.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

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

Note 3 of the financial statements provides information on the Company's expected credit loss ("ECL") measurement in accordance with IFRS 9 '*Financial Instruments*' ("IFRS 9").

Country risk exposure

Country risk is the risk that events in, or affecting, a foreign country might adversely affect the Company. "Foreign country" means any country other than the UK. Sovereign Risk, by contrast, is the risk that a government will be unwilling or unable to meet its debt obligations, or renege on the debt it guarantees. Sovereign Risk is single-name risk for a sovereign government, its agencies and guaranteed entities.

Country risk exposure is measured in accordance with the Company's internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Morgan Stanley Group actively manages country risk exposure through a comprehensive risk management framework that combines credit and market fundamentals and allows the Morgan Stanley Group to effectively identify, monitor and limit country risk.

The Morgan Stanley Group's obligor credit evaluation process may also identify indirect exposures whereby an obligor has vulnerability or exposure to another country or jurisdiction. Examples of indirect exposures include mutual funds that invest in a single country, offshore companies whose assets reside in another country to that of the offshore jurisdiction and finance company subsidiaries of corporations. Indirect exposures identified through the credit evaluation process may result in a reclassification of country of risk.

Stress testing is one of the Morgan Stanley Group's principal risk management tools, used to identify and assess the impact of severe stresses on its portfolios. A number of different scenarios are used to measure the impact on credit risks and market risks stemming from negative economic and political scenarios, including possible contagion effects where appropriate. The results of the stress tests, may result in the amendment of limits or exposure mitigation.

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

Each reference entity within an index is allocated to that reference entity's country of risk. Index exposures are allocated to the underlying reference entities in proportion to the notional weighting of each reference entity in the index, adjusted for any fair value receivable / payable for that reference entity. Where credit risk crosses multiple jurisdictions, for example, a credit default swap ("CDS") purchased from an issuer in a specific country that references bonds issued by an entity in a different country, the fair value of the CDS is reflected in the Net counterparty exposure column based on the country of the CDS issuer. Further, the notional amount of the CDS, adjusted for the fair value of the receivable / payable, is reflected in the Net Inventory column, based on the country of the underlying reference entity.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Country risk exposure (continued)

Five largest non-UK country risk net exposures

Country	Net Inventory ⁽¹⁾ £'000	Net Counterparty Exposure ⁽²⁾ £'000	Funded Lending £'000	Unfunded Commitments £'000	Exposure Before Hedges £'000	Hedges ⁽³⁾ £'000	Net Exposure ⁽⁴⁾ £'000
France:							
Sovereigns	-	-	-	-	-	-	-
Non-Sovereigns	(3,156)	566	3,399	560,088	560,897	(66,824)	494,073
	<u>(3,156)</u>	<u>566</u>	<u>3,399</u>	<u>560,088</u>	<u>560,897</u>	<u>(66,824)</u>	<u>494,073</u>
Italy:							
Sovereigns	-	-	-	-	-	-	-
Non-Sovereigns	99,637	-	63,751	152,248	315,636	(13,901)	301,735
	<u>99,637</u>	<u>-</u>	<u>63,751</u>	<u>152,248</u>	<u>315,636</u>	<u>(13,901)</u>	<u>301,735</u>
Korea, Republic of:							
Sovereigns	125,891	333	-	-	126,224	(19,598)	106,626
Non-Sovereigns	-	96,782	-	-	96,782	(12,205)	84,577
	<u>125,891</u>	<u>97,115</u>	<u>-</u>	<u>-</u>	<u>223,006</u>	<u>(31,803)</u>	<u>191,203</u>
United States:							
Sovereigns	-	-	-	-	-	-	-
Non-Sovereigns	26,379	714	-	62,616	89,709	(5,098)	84,611
	<u>26,379</u>	<u>714</u>	<u>-</u>	<u>62,616</u>	<u>89,709</u>	<u>(5,098)</u>	<u>84,611</u>
Spain:							
Sovereigns	-	-	-	-	-	-	-
Non-Sovereigns	12,431	-	-	59,047	71,478	(15,422)	56,056
	<u>12,431</u>	<u>-</u>	<u>-</u>	<u>59,047</u>	<u>71,478</u>	<u>(15,422)</u>	<u>56,056</u>

- (1) Net inventory represents exposure to both long and short single-name and index positions (i.e. loans, bonds and CDS based on notional assuming zero recovery adjusted for any fair value receivable or payable).
- (2) Net counterparty exposure (i.e. repurchase transactions and over-the-counter ("OTC") derivatives) take into consideration legally enforceable master netting agreements and collateral.
- (3) Represents CDS hedges (purchased and sold) on net counterparty exposure and lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Company. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) In addition, as at 31 December 2019, the Company had exposure to these countries for overnight deposits with banks of approximately £56,324,000.

Liquidity risk

Liquidity risk refers to the risk that the Company will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity risk also encompasses the Company's ability (or perceived ability) to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten the Company's viability as a going concern as well as the associated funding risks triggered by the market or idiosyncratic stress events that may cause unexpected changes in funding needs or an inability to raise new funding. Generally, the Company incurs liquidity and funding risk as a result of its trading, investing, and client facilitation activities.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

RISK MANAGEMENT (CONTINUED)

Operational risk

Operational risk refers to the risk of loss, or of damage to the Company's reputation, resulting from inadequate or failed processes, from human factors or from external events (e.g., fraud, theft, legal and compliance risks, cyber-attacks or damage to physical assets). Operational risk relates to the following risk event categories as defined by Basel Capital Standards: internal fraud; external fraud, employment practices and workplace safety; clients, products and business practices; business disruption and system failure; damage to physical assets; and execution, delivery and process management. Legal and compliance risk is discussed on page 14 under 'Legal, regulatory and compliance risk'.

The Company may incur operational risk across the full scope of its business activities, including revenue-generating activities (e.g., sales and trading) and support and control groups (e.g., information technology and trade processing).

The Company has established an operational risk framework to identify, measure, monitor and control risk across the Company. This framework is consistent with the framework established by the Morgan Stanley Group and includes escalation to the Company's Board of Directors and appropriate senior management personnel. Effective operational risk management is essential to reducing the impact of operational risk incidents and mitigating legal and reputational risks. The framework is continually evolving to reflect changes in the Company and to respond to the changing regulatory and business environment.

The Company has implemented operational risk data and assessment systems to monitor and analyse internal and external operational risk events, to assess business environment and internal control factors and to perform scenario analysis. The collected data elements are incorporated in the operational risk capital model. The model encompasses both quantitative and qualitative elements. Internal loss data and scenario analysis results are direct inputs to the capital model, while external operational incidents, business environment and internal control factors are evaluated as part of the scenario analysis process.

In addition, the Company employs a variety of risk processes and mitigants to manage its operational risk exposures. These include a governance framework, a comprehensive risk management program and insurance. Operational risks and associated risk exposures are assessed relative to the risk tolerance reviewed and confirmed by the Board and are prioritised accordingly.

The breadth and variety of operational risk are such that the types of mitigating activities are wide-ranging. Examples of activities include continuous enhancement of defenses against cyberattacks; use of legal agreements and contracts to transfer and / or limit operational risk exposures; due diligence; implementation of enhanced policies and procedures; exception management processing controls; and segregation of duties.

Primary responsibility for the management of operational risk is with the business segments, the control groups and the business managers therein. The business managers maintain processes and controls designed to identify, assess, manage, mitigate and report operational risk. Each of the business segments has a designated operational risk coordinator. The operational risk coordinator regularly reviews operational risk issues and reports to the Company's senior management within each business. Each control group also has a designated operational risk coordinator and a forum for discussing operational risk matters with the Company's senior management. Oversight of operational risk is provided by the Operational Risk Oversight Committee, regional risk committees and senior management. In the event of a merger; joint venture; divestiture; reorganisation; or creation of a new legal entity, a new product or a business activity, operational risks are considered, and any necessary changes in processes or controls are implemented.

The Operational Risk Department provides independent oversight of operational risk and assesses measures and monitors operational risk against tolerance. The Operational Risk Department works with the business divisions and control groups to help ensure a transparent, consistent and comprehensive framework for managing operational risk within each area and across the Company.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

RISK MANAGEMENT (CONTINUED)

Operational risk (continued)

The Operational Risk Department scope includes oversight of technology risk, cybersecurity risk, information security risk, fraud risk management and prevention programme and third party risk management (supplier and affiliate risk oversight and assessment). Furthermore, the Operational Risk Department supports the collection and reporting of operational risk incidents and the execution of operational risk assessments; provides the infrastructure needed for risk measurement and risk management; and ensures ongoing validation and verification of the Company's advanced measurement approach for operational risk capital.

Business Continuity Management maintains programmes for business continuity management and technology disaster recovery that facilitate activities designed to mitigate risk to the Morgan Stanley Group during a business continuity event. A business continuity event is an interruption with potential impact to normal business activity of the Company's people, operations, technology, suppliers and/or facilities. The business continuity management programme's core functions are business continuity planning and crisis management. As part of business continuity planning, business divisions and control groups maintain business continuity plans identifying processes and strategies to continue business critical processes during a business continuity event. Crisis management is the process of identifying and managing the Company's operations during business continuity events. Disaster recovery plans supporting business continuity are in place for critical facilities and resources across the Company.

In connection with its ongoing operations, the Company utilises the services of third party suppliers, which it anticipates will continue and may increase in the future. These services include, for example, outsourced processing and support functions and consulting and other professional services. The Company's risk-based approach to managing exposure to these services includes performance of due diligence, implementation of service level and other contractual agreements, consideration of operational risk and ongoing monitoring of the third party suppliers' performance. The Company maintains a third party risk programme with appropriate governance, policies, procedures, and supporting technology that supports alignment with our risk tolerance and is designed to meet regulatory requirements. The third party risk programme includes the adoption of appropriate risk management controls and practices through the supplier management lifecycle including, but not limited to assessment of information security, service failure, financial stability, disaster recoverability, reputational risk, contractual risk and safeguards against corruption.

Conduct risk

Conduct risk is defined as the risk arising from misconduct by individual employees or contingent workers (collectively, "Covered Persons") or groups of Covered Persons, or the risk arising from conduct by the Morgan Stanley Group where the outcome has an adverse impact on clients, markets or the Morgan Stanley Group's reputation. Conduct includes both intentional and unintentional behaviours.

The MSI Group has no risk appetite for Conduct Risk. It acknowledges, however, that Conduct Risk remains inherent in doing business and thus cannot be entirely eliminated.

The MSI Group has an approved Conduct Risk Management Policy. The Policy covers the two main strands of Morgan Stanley's Conduct Risk management:

- Managing the risk posed by the MSI Group's business activity, for example risks posed by the MSI Group strategy or risks created in the execution of that strategy; and
- Managing the risk that employees of the MSI Group pose, for example risks arising from poor culture or failure to consider the Morgan Stanley Group's values when conducting duties.

The policy sets out four statements outlining what the MSI Group must do to manage Conduct Risk:

- Identification and Assessment: Business and Support units must identify and assess the Conduct Risks which arise from their current or planned strategies and activities.
- Management: Internal controls and processes must be implemented to manage Conduct Risks identified. Reasonable steps must be taken to ensure effectiveness.
- Incidents: Areas must identify and record Conduct Risk Incidents.
- Escalation & Reporting: Processes must be established to report risks and incidents, ensuring prompt escalation and appropriate notification.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

RISK MANAGEMENT (CONTINUED)

Operational risk (continued)

Conduct risk (continued)

Furthermore, the policy sets out key roles and responsibilities and a framework identifying key functions and processes for the good management of Conduct Risk. The framework also sets out various key support and governance mechanisms, such as the production of key metrics and management information, and the establishment of a Conduct Risk Committee to oversee the management of Conduct Risk and the implementation of the framework.

Legal, regulatory and compliance risk

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

The Company, principally through the Morgan Stanley Group's Legal and Compliance Division, has established procedures based on legal and regulatory requirements on a worldwide basis that are designed to facilitate compliance with applicable statutory and regulatory requirements and to require that the Company's policies relating to business conduct, ethics and practices are followed globally.

In addition, the Company has established procedures to mitigate the risk that a counterparty's performance obligations will be unenforceable, including consideration of counterparty legal authority and capacity, adequacy of legal documentation, the permissibility of a transaction under applicable law and whether applicable bankruptcy or insolvency laws limit or alter contractual remedies. The heightened legal and regulatory focus on the financial services and banking industries globally presents a continuing business challenge for the Company.

Cyber and information security risk management

As a general matter, the financial services industry faces increased global regulatory focus regarding cyber and information security risk management practices. Many aspects of the businesses are subject to cybersecurity legal and regulatory requirements enacted by U.S. federal and state governments and other non-U.S. jurisdictions in Europe and Asia. These laws are aimed at codifying basic cybersecurity protections and mandating data breach notification requirements.

The Company maintains a programme that oversees our cyber and information security risks. Our cybersecurity and information security policies, procedures and technologies are designed to protect the Company's information assets against unauthorised disclosure, modification or misuse and are also designed to address regulatory requirements. These policies and procedures cover a broad range of areas, including: identification of internal and external threats, access control, data security, protective controls, detection of malicious or unauthorised activity, incident response, and recovery planning.

Certain of the Company's businesses are also subject to privacy and data protection information security legal requirements concerning the use and protection of certain customer information. For example, the General Data Protection Regulation ("GDPR") came into effect in the EU on 25 May 2018 as a replacement for the EU Data Protection Directive. The GDPR imposes mandatory breach notification obligations, including significant fines for noncompliance, enhanced governance and accountability requirements and has extraterritorial impact. In addition, other jurisdictions have adopted or are proposing GDPR or similar standards, such as Australia, Singapore, Japan, Columbia, Argentina, India, Turkey, Hong Kong and Switzerland.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

CORPORATE RESPONSIBILITY

Culture, values and conduct of employees

All employees of the Morgan Stanley Group are accountable for conducting themselves in accordance with the Morgan Stanley Group's core values *Putting Clients First, Doing the Right Thing, Leading with Exceptional Ideas, and Giving Back*. The Morgan Stanley Group's core values drive a shared set of behaviours and attributes that help employees make decisions consistent with the expectations of our clients, shareholders, regulators, Board of Directors and the public. The Morgan Stanley Group is committed to reinforcing and confirming adherence to the core values through our governance framework, tone from the top, management oversight, risk management and controls, and a three lines of defence structure (business, control functions such as Risk Management and Compliance, and Internal Audit).

The Morgan Stanley Group's Board is responsible for overseeing the Morgan Stanley Group's practices and procedures relating to culture, values and conduct, as set forth in the Morgan Stanley Group's Corporate Governance Policies. The Morgan Stanley Group's Culture, Values and Conduct Committee is the senior management committee that oversees the Firmwide culture, values and conduct program; and complements ongoing business and region-specific culture initiatives. A fundamental building block of this program is the Morgan Stanley Group's Code of Conduct (the "Code"), which establishes standards for employee conduct that further reinforce the Morgan Stanley Group's commitment to integrity and ethical conduct. Every new hire and every employee annually must attest to their understanding of and adherence to the Code. The Morgan Stanley UK Group's Conduct Risk Management Policy also sets out a consistent framework for managing Conduct Risk (i.e. the risk arising from misconduct by employees or contingent workers) and Conduct Risk incidents.

If an employee believes his or her own, or someone else's, behaviour may violate a law, regulation or the principles of conduct in the Code of Conduct, the employee must promptly inform his or her supervisor, the designated contact for a specific policy or procedure, a member of the Legal and Compliance Division, his or her Human Resources Representative, or call the Integrity Hotline. Supervisors are required to monitor their employees' conduct, notify appropriate persons with any concerns escalated to them and identify and take action to stop any misconduct. All calls to the hotline are treated confidentially, and employees may remain anonymous if they wish. All matters are addressed promptly and tracked to completion by the Compliance Department.

Each year, Managing Directors and other senior staff lead mandatory Firmwide culture conversations, engaging employees and onsite contingent workers in a dialogue about appropriate conduct, behaviour and decision-making. Case studies and other reference materials used during the sessions encourage robust discussion on sustaining the Morgan Stanley Group's culture, and attendance is tracked to ensure participation.

The annual employee performance evaluation process includes an evaluation of employee conduct related to risk management practices and the Morgan Stanley Group's expectations. The Morgan Stanley Group also has several mutually reinforcing processes to identify employee conduct that may have an impact on employment status, current and / or prior year compensation. For example, the Global Incentive Compensation Discretion Policy sets forth standards for managers when making annual compensation decisions and specifically requires managers to consider whether their employees effectively managed and / or supervised risk control practices during the performance year. Management committees from control functions periodically meet to discuss employees whose conduct does not meet the Firm's standards. These results are incorporated in the employees' performance evaluation, which links to compensation and promotion decisions.

The Morgan Stanley Group's clawback and cancellation provisions, which permit recovery of deferred incentive compensation and cover a broad scope of employee conduct, including any act or omission (including with respect to direct supervisory responsibilities) that constitutes a breach of obligation to the Morgan Stanley Group or causes a restatement of the Morgan Stanley Group's financial results, constitutes a violation of the Morgan Stanley Group's global risk management principles, policies and standards, or causes a loss of revenue associated with a position on which the employee was paid and the employee operated outside of internal control policies. Additional information in relation to the Firm's remuneration policies can be found in Morgan Stanley International Limited Group CRR 450 disclosure.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

SECTION 172 (1) STATEMENT

Directors of the Company are required to act in a way that they consider, in good faith, to be most likely to promote the success of the Company for the benefit of its members as a whole, and in so doing have regard, among other matters to:

- the likely consequences of any decision in the long term;
- the interests of the Company's employees;
- the need to foster the Company's business relationships with suppliers, customers and others;
- the impact of the Company's operations on the community and the environment;
- the desirability of the Company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the Company.

To assist them in discharging their duty under s172 Companies Act 2006, directors undertake a number of stakeholder engagement activities to provide them with the information they need to understand the views of stakeholders. This information helps directors to have regard to stakeholder interest, and the likely long term consequences, including to the reputation of the Company, when making decisions and setting strategy. The Company's key stakeholders were considered in 2019 and they are listed below with examples of the stakeholder engagement activities that took place in 2019.

Employees: During 2019, directors continued a programme of "open door" sessions at which MSI Group employees, including those working for the Company's business, were encouraged to ask questions about the business, its strategy, performance, current initiatives and the role of the Board. These sessions provide directors with the opportunity to gather feedback from employees. Many of the directors also sit on the board of directors of MSI. In this role, they receive the results of the MSI Group employee engagement survey which is used to formally capture employee views, is a key tool for understanding employee interests and concerns and informs management actions. They also considered employee culture and conduct when reviewing the EMEA Culture Plan. For more information on the practices and procedures relating to culture, values and employee conduct see page 15. The CEO of the Company reported to the Board on employee feedback obtained from visits to overseas offices of its subsidiary, Morgan Stanley Bank International (China) Limited ("MSBIC").

Suppliers: In 2019, the Board (via the MSI Risk Committee) received an overview of the MSI Group's relationships with key suppliers as part of a focus on Financial Markets Infrastructure and discussed relationships with suppliers in the context of changes to outsourcing regulations and an enhanced focus on operational resilience. The Board also received regular reporting on key outsourcing relationships specific to the Company's business.

Clients: Throughout the year, the Board received regular reports from its business areas and branches on the competitive landscape and the plans in place to respond to changing client demands which gave the Board insight into client issues and concerns. The Board also considered the competitive landscape and client interests when reviewing the Company's strategy.

Community and Environment: Morgan Stanley is committed to giving back to the communities in which it operates. Board members engage directly with the local community as part of the Morgan Stanley's Global Volunteering month. Morgan Stanley also seeks to integrate sustainability considerations into business strategies, products and services thought leadership and operations. The Board (via the MSI Risk Committee) has considered climate change risk in response to regulatory developments in this area. For more information on this see page 9.

Regulators: In 2019, the Board has continued to receive regular updates on key regulatory issues and a number of the directors meet regularly with both the PRA and FCA, through Continuous Assessment and Proactive Engagement meetings. The Board also receives updates on interactions with key regulators in the regions in which the Company and MSBIC operates, e.g. the China Banking and Insurance Regulatory Commission.

Investors: The Chair of the Board also chairs the MSI Board and a number of the directors of the Company also sit on the MSI Board, with some chairing the MSI Board Committees. Through these appointments, these directors are able to provide the Board with insights on MSI's views and priorities. Insights into the views of Morgan Stanley and its shareholders are obtained through regular interactions between the Chairman and other non-executive directors and Morgan Stanley non-executive directors.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

STRATEGIC REPORT

SECTION 172 (1) STATEMENT (CONTINUED)

When making decisions, the Board considers the insights obtained through relevant stakeholder engagement activities as well as the need to maintain a reputation for high standards of business conduct and the long term consequence of its decisions. A principal decision taken by the Board in 2019 was to facilitate the implementation of an MSI Group reorganisation needed for Morgan Stanley's European operations in preparation for the UK's withdrawal from the EU. When making this decision, the interests of the Company's clients and the Firm's ability to meet their needs now and longer term, post-Brexit, were an important consideration as were the long term consequences of not proceeding with the restructure and the potential impact this could have on the reputation of the Company and Morgan Stanley Group. The interests of employees, suppliers, shareholders and regulators were also considered.

Approved by the Board and signed on its behalf by:

DocuSigned by:

DE3D3BFF099E494...
Kim Lazaroo
21 April 2020

MORGAN STANLEY BANK INTERNATIONAL LIMITED

CORPORATE GOVERNANCE

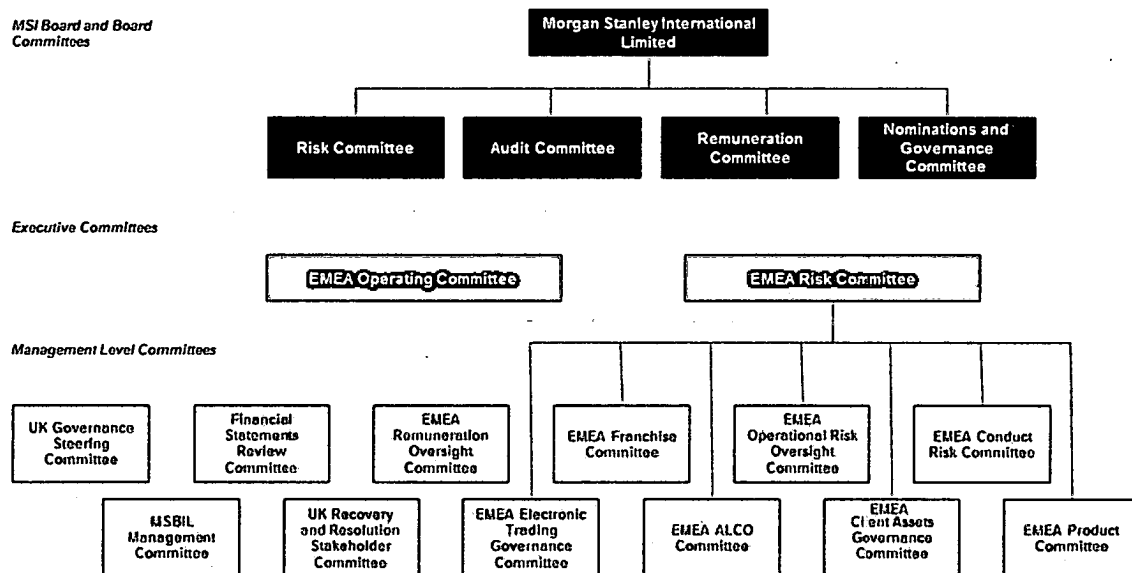
CORPORATE GOVERNANCE FRAMEWORK

Board of Directors is assisted in discharging its responsibilities via the MSI Audit, Risk, Remuneration and Nomination Governance Committees. In addition, the Company and MSI have Division-level, Management-level and Executive-level Committees that report up to the Boards in line with established escalation processes. The Board and management committee structure applicable to the oversight of the Company's risk management is described below.

EMEA executive and risk focused management committees

Day to day management of the Company's business is delegated to key EMEA Executive Management Committees: the EMEA Operating Committee and EMEA Risk Committee. These Executive Committees are the most senior MSI Group executive management committees and have responsibility for overseeing business performance, operations and risks identified in relation to the MSI Group. The Executive Committees are supported in their oversight of specific areas of the MSI Group's activities by the management committees.

MSI Board Committee Structure and EMEA Executive Management Structure



MSI board committees

The **MSI Risk Committee** is appointed by the MSI Board to assist and provide guidance to the MSI Board on the management of financial and non-financial risks, including: (i) risk strategy and appetite; (ii) risk identification and management; (iii) risk governance framework and policies; (iv) measurement of risk and risk tolerance levels and limits; (v) risk culture; and (vi) financial resource management and capital; and recovery and resolution. The MSI Risk Committee met 10 times in 2019. The MSI Risk Committee review detailed risk reports including but not limited to, portfolio risk, market risk, credit risk, operational risk, e-trading risk, liquidity risk, conduct risk, franchise risk, product governance and model changes.

The MSI Committee's focus during the year included:

- The MSI Group risk appetite framework and appetite statement, including the risk framework in place for certain new or expanding types of business;
- Operational risks including cyber risk and third party vendor risk;
- Oversight of material risk events;
- Areas of regulatory focus and corresponding risk projects.

The **MSI Audit Committee** is appointed by the MSI Board to assist and provide guidance to the MSI Board in monitoring: (i) financial reporting; (ii) internal controls; (iii) legal and regulatory compliance; (iv) internal audit; and (v) external auditors.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

CORPORATE GOVERNANCE

COPORATE GOVERNANCE FRAMEWORK (CONTINUED)

MSI board committees (continued)

In addition to the Risk and Audit Committees, the MSI Board has also appointed a **MSI Nomination and Governance Committee** and a **MSI Remuneration Committee**.

Executive and risk focused committees

The **EMEA Operating Committee** is the forum for key decisions regarding matters affecting the operations and performance of the MSI Group and is responsible for the execution of strategy. The Committee provides oversight of: (i) strategy; (ii) financial performance; (iii) risk and control; (iv) operational, legal and regulatory matters; and (v) human resources.

The **EMEA Risk Committee** ("EMEA RC") assists in the oversight of the MSI Group's management of risk (including both financial and non-financial risks). The Committee provides oversight of: (i) risk strategy and appetite; (ii) risk identification and measurement; (iii) risk framework and policies; (iv) culture; and (v) financial resource management.

Management level committees (associated with risk governance)

The **EMEA Franchise Committee** assists in the oversight of potentially significant franchise risks including by reviewing relevant activities, transactions and clients, and reviewing the franchise implications of situations that involve suitability or conflict of interest concerns.

The **EMEA ALCO** assists the EMEA RC to oversee the capital adequacy, including the risk of excessive leverage, and liquidity risk management of the MSI Group.

The **EMEA Operational Risk Oversight Committee** provides guidance to the EMEA RC in relation to the oversight of the management of the operational risk of the MSI Group.

The **EMEA Client Assets Governance Committee** provides support for the MSI Group's compliance with Client Assets Sourcebook ("CASS") requirements, and acts as the principal body for providing governance of CASS related issues, being responsible for co-ordinating the approach to managing Client Money and Client Assets.

The **EMEA Conduct Risk Committee** assists the EMEA RC in the oversight and management of conduct risk within the MSI Group.

The **EMEA Electronic Trading Governance Committee** reviews and challenges the controls applicable to the electronic trading business. Further, the Committee monitors the risk appetite and limits set by the EMEA RC which is applicable to electronic trading, and provides a forum to oversee the resolution of identified control issues in an appropriate and timely manner, escalating matters to the EMEA RC as necessary.

The **EMEA Product Committee** assists the EMEA RC in discharging its responsibilities for the oversight of approvals of new products and the oversight of product governance. In particular, the EMEA Product Committee reviews and challenges Heightened Risk New Product Approval proposals and provides recommendations to the EMEA RC.

Other Management level committees

The **Company Management Committee** assists and provides guidance to the Chief Executive Officer of the Company in matters relating to the management of the Company's business and strategy, and oversight of its capital and liquidity management and systems and controls.

The **EMEA Financial Statement Review Committee** is appointed to review certain external financial reporting, which includes the financial statements and Pillar 3 disclosures of MSI and its EMEA regulated subsidiaries and their branches.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

CORPORATE GOVERNANCE

DIRECTORS' REPORT

The Directors present their report and audited financial statements (which comprise the income statement, the statement of comprehensive income, the statement of changes in equity, the statement of financial position, and the related notes, 1 to 46) for the Company for the year ended 31 December 2019.

Results and Dividends

The profit for the year, after tax, was £38,122,000 (2018: £27,693,000).

During the year no dividends were paid or proposed (2018: £nil).

Regulation, Risk Management, Branches and Future Developments

Information regarding regulation, risk management, branches and future developments has been included in the Strategic report.

Stakeholder Relationships and Engagement

Details of engagement activities undertaken by the Board in 2019 with suppliers, clients and other stakeholders and how they inform decision making are provided in the s172(1) Statement beginning on page 16.

Pillar 3 Disclosures

The regulatory disclosures made in order to comply with the EU Directive and Regulation implementing the Basel capital framework ("the Pillar 3 disclosures") are available on the Morgan Stanley website (see note 40 for further details).

Country-by-Country Reporting

The disclosures made in order to comply with the Capital Requirements (Country-by-Country Reporting) Regulations 2013 in respect of the year ended 31 December 2019 will be made available on the Morgan Stanley website (see note 40 for further details).

Directors

The following Directors held office throughout the year and to the date of approval of this report (except where otherwise shown):

S P Ball	(appointed on 21 March 2019)
J W Bloomer	(Chairman)
D O Cannon	
C Castello	(resigned on 31 January 2019)
M J DeFilippo	
T L Duhon	
L Guy	
J Horder	(resigned on 19 March 2019)
A Kohli	
K M Lazaroo	(appointed on 22 February 2019)
M C Phibbs	
N P Whyte	

MORGAN STANLEY BANK INTERNATIONAL LIMITED

CORPORATE GOVERNANCE

DIRECTORS' REPORT (CONTINUED)

Directors' and Officers' Liability Insurance

Directors' and Officers' Liability Insurance is taken out by Morgan Stanley, the Company's ultimate parent undertaking, for the benefit of the Directors and Officers of the Company and its subsidiary undertaking.

Directors' Indemnity

Qualifying third party indemnity provisions (as defined in section 234 of the Companies Act 2006) were in force during the year and up to and including the date of the Directors' report for the benefit of the Directors of the Company and its subsidiary undertaking.

Events after the Reporting Date

Since the balance sheet date the emergence of the coronavirus disease (COVID-19) pandemic has, and will likely continue to, severely impact global economic conditions, resulting in substantial volatility in the global financial markets and operational challenges. The extent of the impact is highly uncertain and cannot be predicted and could adversely affect the future operations and financial condition of Morgan Stanley and the Company. For further detail, refer to the 'Emergence of COVID-19' section on page 2 of the Strategic Report.

Employees

Both the Company and the Morgan Stanley Group place considerable value on the investment in their employees and have continued their practice of keeping employees informed on matters affecting them. Employees are encouraged to present their suggestions and views on the Morgan Stanley Group's performance to management and employees participate directly in the success of the business through the Morgan Stanley Group's various compensation incentive plans.

Every effort is also made to ensure that disabled applicants, or those existing employees who are disabled or may have become disabled, are treated as fairly as possible on terms comparable with those of other employees. Appropriate training is arranged for disabled persons, including retraining for alternative work for employees who become disabled, to promote their career development within the organisation.

Going Concern

Business risks associated with the uncertain market and economic conditions are being actively monitored and managed by the Company. Retaining sufficient capital and liquidity to withstand these market pressures remains central to the Company's strategy. In particular, the Company's capital and liquidity is deemed sufficient to exceed regulatory minimums under both a normal and in a stressed market environment, including the current and potential stresses of COVID-19 (coronavirus) and Brexit for the foreseeable future. The existing and potential effects of COVID-19 on the business of the Company have been considered as part of the going concern analysis, including impact on operational capacity, access to liquidity and capital, contractual obligations, asset valuations and other critical accounting judgements and key sources of estimation uncertainty. Additionally, the specific impact of Brexit on the business of the Company has been considered. The Company has access to further Morgan Stanley Group capital and liquidity as required.

Taking the above factors into consideration, the Directors believe it is reasonable to assume that the Company will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the annual report and financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

CORPORATE GOVERNANCE

DIRECTORS' REPORT (CONTINUED)

Auditor

Deloitte LLP have expressed their willingness to continue in office as auditor of the Company and, under Sections 485 to 488 of the Companies Act 2006, will be deemed to be re-appointed.

Statement as to disclosure of information to auditor

Each of the persons who are Directors of the Company at the date when this report is approved confirms that:

- so far as each of the Directors is aware, there is no relevant audit information (being information needed by the Company's auditor in connection with preparing their report) of which the Company's auditor is unaware; and
- each of the Directors has taken all the steps that he / she ought to have taken as a Director to make himself / herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

COPERATE GOVERNANCE

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), including Financial Reporting Standard 101 *Reduced Disclosure Framework* ("FRS 101"). Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether United Kingdom Accounting Standards, including FRS 101, have been followed; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Approved by the Board and signed on its behalf by:

DocuSigned by:



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Kim Lazaroo

21 April 2020

MORGAN STANLEY BANK INTERNATIONAL LIMITED
INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED

REPORT ON THE AUDIT OF THE FINANCIAL STATEMENTS

Opinion

In our opinion the financial statements:

- give a true and fair view of the state of Morgan Stanley Bank International Limited's ("the Company") affairs as at 31 December 2019 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice including Financial Reporting Standard ("FRS") 101 "Reduced Disclosure Framework"; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements of the Company which comprise:

- Income statement;
- Statement of comprehensive income;
- Statement of changes in equity;
- Statement of financial position; and
- Relevant notes 1 to 46 to the financial statements.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards including FRS 101 "Reduced Disclosure Framework" (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's ("FRC") Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the Company.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	<p>The key audit matters that we identified in the current year were:</p> <ul style="list-style-type: none"> • Valuation of Level 3 financial instruments; • Impact of Covid-19 on the financial statements
Materiality	<p>The materiality that we used the current year was £3.3 million, which was determined on the basis of 0.5% of Total Equity.</p>
Scoping	<p>The planning and scoping of our audit considers the Company's position in the wider Morgan Stanley business, organisational structure and global operating model. This model comprises a common control structure for key business processes and internal controls over financial reporting.</p> <p>Based on this global operating model, our audit scope is globally integrated with various audit testing procedures performed by our component auditor, Deloitte & Touche LLP, US, the lead auditor of the ultimate parent company, Morgan Stanley.</p>

MORGAN STANLEY BANK INTERNATIONAL LIMITED**INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED**

Significant changes in our approach	<p>Given the rapid spread of Covid-19 and the ongoing uncertainty surrounding its impact, we have focused a greater degree of effort on the Directors' judgements in relation to:</p> <ul style="list-style-type: none"> the disclosure of Covid-19 as a non-adjusting post balance sheet event; and the potential impact on future earnings, capital and liquidity, which are considered by the Directors in their assessment of the Company's ability to continue to adopt the going concern basis over a period of at least 12 months from the date of approval of the Financial Statements. <p>In accordance with this greater level of effort, we have identified a new key audit matter in the period relating to the impact of Covid-19 on the financial statements.</p> <p>In addition to the new key audit matter in the current year we no longer consider the following as a key audit matter.</p> <p>The completeness and accuracy of intercompany transactions is not reported as a key audit matter. This is due to improvements in the control environment and associated governance and as such is not deemed a significant risk to the audit in the current year. There are no other significant changes in our approach apart from the change in key audit matter.</p>
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Conclusions relating to going concern

We are required by ISAs (UK) to report in respect of the following matters where:

- the directors' use of the going concern basis of accounting in preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

We have nothing to report in respect of these matters.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Valuation of Level 3 financial instruments	
Relevant references in the financial statements	<ul style="list-style-type: none"> Note 2 – Basis of Preparation – Critical judgements and key sources of estimation uncertainty Note 3 – Summary of significant accounting policies <ul style="list-style-type: none"> (d) Fair value Note 38 – Assets and liabilities measured at fair value (a) (c) (d) (e) (f)

MORGAN STANLEY BANK INTERNATIONAL LIMITED**INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED**

Key audit matter description	<p>The Company's trading and financing activities will at times result in the Company carrying material financial asset and liability positions having limited price transparency. These financial instruments generally include derivative, security or lending positions spanning a broad array of product types. Under IFRS 13 <i>Fair Value Measurement</i>, these financial instruments are generally classified as Level 3 financial assets or liabilities.</p> <p>Unlike other financial instruments whose values or inputs are readily observable and therefore more easily independently corroborated, the valuation of financial instruments classified as Level 3 are inherently subjective, and often involve the use of proprietary valuation models whose underlying algorithms and valuation methodologies are complex. This degree of subjectivity may also give rise to potential fraud through management intentionally manipulating fair values or incorporating management bias in determining fair values. Auditing the Company's valuation of Level 3 financial instruments is therefore subjective and presents certain challenges in evaluating the appropriateness of the Company's valuation judgements and estimates.</p> <p>Significant judgements made by the Company include the derivation of key model inputs which are not observable in the marketplace and the underlying valuation methodologies used by the pricing model to determine an appropriate fair value. Evaluating these judgements is subjective and complex, and requires the auditor to possess certain skills and expertise to effectively challenge the significant judgements made by management when pricing such instruments.</p> <p>As at 31 December 2019, the Company's total financial assets and liabilities measured at fair value were £5,001 million and £2,764 million, respectively, of which Level 3 financial assets and liabilities were £354 million and £199 million, respectively.</p>
How the scope of our audit responded to the key audit matter	<p>To address the complexities associated with auditing the value of Level 3 financial instruments, our team included valuation specialists having significant quantitative and modelling expertise to assist in performing our audit procedures. Our valuation audit procedures included the following:</p> <ul style="list-style-type: none"> • We obtained an understanding and tested Morgan Stanley's valuation controls including the: <ul style="list-style-type: none"> - Model Risk Management control, which is designed to review a model's theoretical soundness and the appropriateness of its valuation methodology and calibration techniques developed by the business units. - Price Verification control, which is designed to review the appropriateness of valuation methodologies to derive model inputs which are not observable and determine whether such methodologies are consistent with how a market participant would arrive at the unobservable input. • We also performed the following procedures on a sample of transactions in line with our audit methodology: <ul style="list-style-type: none"> - Evaluated management's valuation methodologies, including the input assumptions, against the expected assumptions of other market participants leveraging relevant external data. - Assessed the consistency by which Company management has applied significant and unobservable valuation assumptions. - Performed a retrospective assessment of management's valuation estimate by comparing such estimate against relevant subsequent transactions.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED**

	<ul style="list-style-type: none"> - Developed independent valuation estimates, using externally sourced inputs and challenger models, and used such estimates to further evaluate management's fair value measurement by investigating the differences between our estimate and that of Morgan Stanley, including; comparing the fair value estimate with similar transactions; and, evaluating management's assumptions associated with the unobservable input. - Assessment of financial statement disclosures related to financial instruments measured at fair value, to include the aspects of this which provide information on the sensitivity of fair value measurements to key inputs and assumptions.
Key observations	Based on our audit procedures performed, we concluded that the valuation of Level 3 financial instruments was appropriate.

Impact of Covid-19 on the financial statements	
Relevant references in the financial statements	<p>Company financial statements:</p> <ul style="list-style-type: none"> • Note 2 – The going concern assumption; • Note 46 – Events after the reporting period.
Key audit matter description	<p>The rapid spread and ongoing uncertainty surrounding the impact of Covid-19 has led to additional disclosure in the financial statements and required the Directors' to critically assess the Company's ability to continue as a going concern over a period of at least 12 months from the date of approval of the Financial Statements.</p> <p>In making their assessment, the Directors concluded that the impact of Covid-19 on the business is a non-adjusting post balance sheet event, the full impact of which cannot be reliably estimated at this stage, and concluded based on the available information that the going concern basis of accounting continues to be appropriate.</p> <p>The Directors have disclosed their explanations and conclusions on going concern basis and the key matters considered, including judgements in relation to the ongoing confidence in the Company's capital solvency and liquidity positions involving stress and sensitivity analysis performed by management, as well as the capability of the business continuity plans in place, over the assessment period.</p>
How the scope of our audit responded to the key audit matter	<p>In response to the significant economic disruption associated with the Covid-19 pandemic we focused our audit effort to understand whether there was a material uncertainty over the Company's ability to continue as a going concern over a period of at least twelve months from the date of approval of the Financial Statements.</p> <p>In forming our conclusion, we reviewed Management's going concern analysis of the Company's solvency, liquidity and funding forecast position. Specific procedures included:</p> <ul style="list-style-type: none"> • Reviewed the sensitivity analysis, including the associated macro-economic assumptions and understood the impact on the headroom available against minimum regulatory requirements; • Reviewed the liquidity and funding analysis performed by the Company and understood the forecast changes to the Company's liquidity and funding plan; • Understood Management's business continuity plans and subsequent changes to those plans as a consequence of a prolonged impact from the Covid-19 pandemic;

MORGAN STANLEY BANK INTERNATIONAL LIMITED**INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED**

	<ul style="list-style-type: none"> Reviewed the most recent Board minutes and regulatory correspondence to identify items of interest and understood Management's assessment of the impact of the significant business developments that occurred after the year end; and Assessed the adequacy of the disclosures in relation to events after the reporting date and going concern.
Key observations	<p>Based on our audit procedures performed, we concluded that:</p> <ul style="list-style-type: none"> adequate disclosures have been provided in relation to events after the reporting date; and as set out in our Conclusions related to going concern above, we have no matters to report in respect of the use of the going concern basis of accounting in preparation of the financial statements.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced.

We use materiality both in planning the scope of our audit work and in evaluating the results of our work. Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Materiality	£3.3 million (2018: £3.3 million)
Basis for determining materiality	The materiality of £3.3 million represents 0.5% (2018: 0.5%) of Total Equity.
Rationale for the benchmark applied	We have considered Total Equity to be the most appropriate benchmark as the Company is wholly owned by the ultimate parent entity Morgan Stanley and is a regulated entity where its capital position is of importance to the key users of the financial statements. These key users include regulators and the ultimate parent entity.

We set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole. Performance materiality was set at 70% of materiality for the 2019 audit (2018: 70%). In determining performance materiality, we considered the following factors:

- our risk assessment, including our assessment of the Company's overall control environment and that we consider it appropriate to rely on controls over a number of business processes; and
- our past experience of the audit, which has indicated a low number of corrected and uncorrected misstatements identified in prior periods.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £165,000 (2018: £165,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED

An overview of the scope of our audit

Identification and scoping of components

Morgan Stanley is a globally managed business with a global operating model in which major classes of transactions are subject to a common control processing environment irrespective of product, region or legal entity. Given this global operating model for the Company, we audit certain controls, financial reporting processes and balances utilising component auditors in New York.

We instructed our component auditor, Deloitte & Touche LLP, US to perform their audit procedures at a materiality level of £2.8million (2018: £2.8 million).

Involvement with component auditor

We exercised oversight over the work of our component auditor by remaining in active dialogue at regular intervals throughout the duration of the audit. We attended the audit planning meetings in New York, involved our component auditor in our team briefing and issued a set of instructions setting out the audit work and the specified audit procedures we requested them to undertake. We visited the component auditor throughout the year to oversee and review the work performed in support of our audit. Where restrictions were placed on our ability to travel internationally post year end due to Covid-19 we undertook remote reviews. We also formally received audit clearance documentation confirming that they had performed the audit and the specified audit procedures in accordance with our instructions.

Audit procedures undertaken at the Company level

We designed our audit approach for the Company based on our understanding of the business undertaken by the Company and our independent assessment of the risks of material misstatement arising in the financial statements. These procedures included, amongst others, auditing the consolidation of the Company's results and the preparation of the financial statements as well as obtaining an understanding and testing of relevant controls over the financial reporting process.

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information, except to the extent otherwise explicitly stated in our report, and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in respect of these matters.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud and non-compliance with laws and regulations are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Extent to which the audit was considered capable of detecting irregularities, including fraud

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, we considered the following:

- the nature of the industry and sector, control environment and business performance including the design of the company's remuneration policies, key drivers for directors' remuneration, bonus levels and performance targets;
- results of our enquiries of management, internal audit and the audit committee about their own identification and assessment of the risks of irregularities;
- any matters we identified having obtained and reviewed the company's documentation of their policies and procedures relating to:
 - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
 - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud;
 - the internal controls established to mitigate risks of fraud or non-compliance with laws and regulations
- the matters discussed among the audit engagement team including significant component audit teams and involving relevant internal specialists, including tax, valuations, IT and industry specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud.

As a result of these procedures, we considered the opportunities and incentives that may exist within the organisation for fraud and identified the greatest potential for fraud in the following area: valuation of Level 3 financial instruments. In common with all audits under ISAs (UK), we are also required to perform specific procedures to respond to the risk of management override.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY BANK INTERNATIONAL LIMITED

We also obtained an understanding of the legal and regulatory frameworks that the company operates in, focusing on provisions of those laws and regulations that had a direct effect on the determination of material amounts and disclosures in the financial statements. The key laws and regulations we considered in this context included the UK Companies Act. In addition, we considered provisions of other laws and regulations that do not have a direct effect on the financial statements but compliance with which may be fundamental to the company's ability to operate or to avoid a material penalty. These included the company's operating licence and regulatory solvency requirements.

Audit response to risks identified

As a result of performing the above, the valuation of Level 3 financial instruments is a key audit matter related to the potential risk of fraud. The key audit matters section of our report explains the matter in more detail and also describes the specific procedures we performed in response to that key audit matter.

In addition to the above, our procedures to respond to risks identified included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with provisions of relevant laws and regulations described as having a direct effect on the financial statements;
- enquiring of management, the audit committee and in-house and external legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with HMRC and other regulatory authorities including the PRA and the FCA; and
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists and significant component audit team, and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the Company and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the directors' report.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or

MORGAN STANLEY BANK INTERNATIONAL LIMITED
INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN
STANLEY BANK INTERNATIONAL LIMITED

- the financial statements are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made.

We have nothing to report in respect of this matter.

Other matters

Auditor tenure

Following the recommendation of the Audit Committee of the Company, we were appointed by the Board of Directors on 26 April 1999 to audit the financial statements for the year ended 30 November 1999 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 21 years, covering the years ended 30 November 1999 to 31 December 2019.

Consistency of the audit report with the additional report to the Audit Committee

Our audit opinion is consistent with the additional report to the Audit Committee we are required to provide in accordance with ISAs (UK).

Use of our report

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Rizwan Majid, ACA (Senior Statutory Auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom
21 April 2020

MORGAN STANLEY BANK INTERNATIONAL LIMITED**INCOME STATEMENT****Year ended 31 December 2019**

	Notes	2019 £'000	2018 £'000
Interest receivable and similar income	4	46,585	34,101
Interest payable and similar charges	5	(34,627)	(33,005)
NET INTEREST INCOME		<u>11,958</u>	<u>1,096</u>
Fees and commissions income	6	69,862	81,612
Fees and commissions expense	7	(10,179)	(8,658)
Net trading income		56,209	46,548
Net income / (loss) from other financial instruments held at fair value	8	432	(1,049)
Net reversal of impairment on financial instruments	9	20	160
Administrative expenses	10	(81,870)	(82,152)
Depreciation of tangible fixed assets	19	(1,310)	(482)
PROFIT BEFORE TAXATION		<u>45,122</u>	<u>37,075</u>
Income tax expense	11	(7,000)	(9,382)
PROFIT FOR THE YEAR		<u><u>38,122</u></u>	<u><u>27,693</u></u>

All results were derived from continuing operations.

The notes on pages 37 to 104 form an integral part of the financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**STATEMENT OF COMPREHENSIVE INCOME****Year ended 31 December 2019**

	Notes	2019 £'000	2018 £'000
PROFIT FOR THE YEAR		38,122	27,693
OTHER COMPREHENSIVE INCOME / (LOSS) AFTER INCOME TAX			
Items that will not be reclassified subsequently to profit or loss:			
Remeasurement of net defined benefit liability	11	(174)	2
Items that may be reclassified subsequently to profit or loss:			
Foreign currency revaluation reserve:			
Foreign currency translation differences arising on foreign operations		(12,707)	2,752
Gain / (loss) arising on hedging instruments designated in net investment hedges	29	13,535	(10,070)
OTHER COMPREHENSIVE INCOME / (LOSS) AFTER INCOME TAX		654	(7,316)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR ATTRIBUTABLE TO THE OWNERS OF THE COMPANY		<u>38,776</u>	<u>20,377</u>

The notes on pages 37 to 104 form an integral part of the financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**STATEMENT OF CHANGES IN EQUITY****Year ended 31 December 2019**

	Note	Called up share capital £'000	Capital contribution reserve £'000	Foreign currency revaluation reserve £'000	Profit and loss account £'000	Total equity shareholders' funds £'000
Balance at 1 January 2018		340,000	89,654	43,119	181,903	654,676
Impact of adoption of new accounting standards					(860)	(860)
Profit for the year		-	-	-	27,693	27,693
Other comprehensive income		-	-	(7,318)	2	(7,316)
Total comprehensive income		-	-	(7,318)	26,835	19,517
Balance at 31 December 2018		340,000	89,654	35,801	208,738	674,193
Profit for the year		-	-	-	38,122	38,122
Other comprehensive income:						
Remeasurement of net defined benefit liability	11	-	-	-	(174)	(174)
Foreign currency revaluation reserve:						
Foreign currency translation differences arising on foreign operations		-	-	(12,707)	-	(12,707)
Gain arising on hedging instruments designated in net investment hedges	29	-	-	13,535	-	13,535
Total comprehensive income for the year		-	-	828	(174)	654
Balance at 31 December 2019		<u>340,000</u>	<u>89,654</u>	<u>36,629</u>	<u>246,686</u>	<u>712,969</u>

The notes on pages 37 to 104 form an integral part of the financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

Registered Number 3722571

STATEMENT OF FINANCIAL POSITION**As at 31 December 2019**

ASSETS	Notes	2019 £'000	2018 £'000
Cash and balances at central banks		122,601	15
Secured financing	13	1,480,900	1,280,633
Loans and advances to banks	14	131,940	107,412
Loans and advances to customers	15	180,250	363,113
Trading financial assets (of which £77,903,000 (2018: £52,205,000) were pledged to various parties)	16	3,446,503	3,290,194
Investment securities	17	6,557	-
Other receivables	20	10,013	16,071
Investment in subsidiary undertaking	18	105,374	105,374
Tangible fixed assets	19	3,618	898
Current tax assets		3,654	5,844
Deferred tax assets	21	5,401	8,596
Other assets	22	445	555
TOTAL ASSETS		5,497,256	5,178,705
EQUITY AND LIABILITIES			
Deposits by banks	23	135,962	323,778
Customer accounts	24	1,331,496	1,072,143
Secured borrowing	13	273,663	258,331
Trading financial liabilities	16	2,762,477	2,528,574
Other payables	25	13,919	42,337
Other liabilities	26	11,790	14,202
Current tax liabilities		4,047	14,560
Retirement benefit liability	44	557	429
Provisions for liabilities and charges	41	376	158
Subordinated loans	27	250,000	250,000
Called up share capital	28	340,000	340,000
Capital contribution reserve		89,654	89,654
Foreign currency revaluation reserve		36,629	35,801
Profit and loss account		246,686	208,738
Equity shareholders' funds		712,969	674,193
TOTAL EQUITY AND LIABILITIES		5,497,256	5,178,705
MEMORANDUM ITEMS			
Commitments	32	4,220,964	3,347,034

These financial statements were approved by the Board and authorised for issue on 20 April 2020.

Signed on behalf of the Board

DocuSigned by:

kim lazaro

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Kim Lazaro

The notes on pages 37 to 104 form an integral part of the financial statements.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

1. CORPORATE INFORMATION

The Company is incorporated and domiciled in England, United Kingdom, at the following registered address 25 Cabot Square, Canary Wharf, London, E14 4QA. The Company is a private company and is limited by shares. The registered number of the Company is 3722571.

The Company's immediate parent undertaking is Morgan Stanley Investments (UK), which has its registered office at 20 Bank Street, Canary Wharf, London, E14 4AD and is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff, CF14 3UZ.

The Company's ultimate parent undertaking and controlling entity and the largest and smallest group of which the Company is a member and for which group financial statements are prepared is Morgan Stanley which, together with the Company and Morgan Stanley's other subsidiary undertakings, form the Morgan Stanley Group. Morgan Stanley has its registered office c/o The Corporation Trust Company, The Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States of America and is incorporated in the state of Delaware, in the United States of America. Copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

2. BASIS OF PREPARATION

The Company is not required to prepare consolidated financial statements by virtue of the exemption under section 401 of the Companies Act 2006. The results of the Company are included within the financial statements of Morgan Stanley, which has prepared consolidated financial statements for the year ended 31 December 2019. The financial statements therefore present information about the Company as an individual entity and not about its group.

Statement of compliance

These financial statements are prepared in accordance with UK Generally Accepted Accounting Practice (UK Accounting Standards and applicable law), including FRS 101.

The Company meets the definition of a qualifying entity and is a Financial Institution as defined in Financial Reporting Standard 100 *Application of Financial Reporting Requirements*. The Company has taken advantage of certain disclosure exemptions under FRS 101 in relation to share-based payments, fair value measurement (as applicable to assets and liabilities other than financial instruments), revenue from contracts with customers, presentation of comparative information in respect of certain assets and shares outstanding, presentation of a cash-flow statement, accounting standards not yet effective and related party transactions.

Where relevant, equivalent disclosures have been provided in the group financial statements of Morgan Stanley, in which the Company is consolidated. Copies of Morgan Stanley's financial statements can be obtained as detailed at note 1.

New standards and interpretations adopted during the year

The following standards, amendments to standards and interpretation relevant to the Company's operations were adopted during the year. Except where otherwise stated, they did not have a material impact on the Company's financial statements.

IFRS 16 '*Leases*' ("IFRS 16") was issued by the IASB in January 2016. The standard was endorsed by the EU in November 2017. This accounting update requires lessees to recognise in the statement of financial position all leases with terms exceeding one year, and results in the recognition of a right of use ("ROU") asset and corresponding lease liability for all such leases, including those previously classified as operating leases.

The Company adopted this standard using the modified retrospective method of adoption, which resulted in the recognition of additional ROU assets and lease liabilities for leases existing at, or entered into after, January 1, 2019. Comparative amounts have not been restated and comparative amounts in relation to leasing activity reflect those determined and disclosed in accordance with International Accounting Standard 17 '*Leases*'. There was no resultant cumulative effect adjustment arising on adoption of the standard.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

2. BASIS OF PREPARATION (CONTINUED)

New standards and interpretations adopted during the year (continued)

Adoption of the standard required the Company to make certain judgments and elect certain other practical expedients. The Company applied the following practical expedient when applying IFRS 16 on the transition date:

- application of IFRS 16 only to contracts that were previously identified as leases. Contracts that were not previously identified as leases were not reassessed for the existence of a lease.

When measuring the lease liabilities, the Company discounted lease payments using its incremental borrowing rate determined as at 1 January 2019. The weighted average rate applied as of this date is 2.9%.

The lease payments include:

- fixed payments (including in-substance fixed payments) less any lease incentives receivable;
- variable lease payments that depend on an index or a rate;
- amounts expected to be paid under residual value guarantees;
- the exercise price of a purchase option reasonably certain to be exercised by the Company; and
- payments of penalties for terminating a lease, if the lease term reflects the Company exercising the option to terminate.

Variable lease payments that reflect changes in market rental rates are initially measured using the market rental rates as at the commencement date. Variable lease payments that do not depend on an index or a rate are not included in the measurement of lease liabilities and right-of-use assets, and are recognised as expense in the period on which the event or condition that triggers the payment occurs.

The operating leases' minimum lease payments disclosed as at 31 December 2018 in the Company's financial statements differ from the lease liabilities recognised as at 1 January 2019 primarily because IFRS 16 requires the lease payments to be discounted when measuring the lease liabilities.

An amendment to IAS 19 '*Plan Amendment, Curtailment or Settlement*' was issued by the IASB in February 2018, for retrospective application to plan amendments, curtailments or settlements occurring on or after 1 January 2019. The amendment was endorsed by the EU in March 2019.

As part of the 2015-2017 Annual Improvements Cycle published in December 2017, the IASB made amendments to the following standards that are relevant to the Company's operations: IAS 12 '*Income Taxes*' and IAS 23 '*Borrowing Costs*', for application in accounting periods beginning on or after 1 January 2019. The amendments were endorsed by the EU in March 2019.

IFRIC 23 '*Uncertainty over Income Tax Treatments*' was issued by the IASB in June 2017 for application in accounting periods beginning on or after 1 January 2019. The interpretation was endorsed by the EU in October 2018.

There were no other standards, amendments to standards or interpretations relevant to the Company's operations which were adopted during the year.

Basis of measurement

The financial statements of the Company are prepared under the historical cost basis except for certain financial instruments that have been measured at fair value as explained in the accounting policies below, and in accordance with applicable United Kingdom Accounting Standards including, FRS 101, and UK company law.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

2. BASIS OF PREPARATION (CONTINUED)

Net investment hedging

The Company conducts a portion of its business through branches with non-Sterling functional currencies ('foreign operations'). This creates foreign currency exposures, a portion of which the Company elects to manage via its net investment hedging program. The net investment hedging program is designed to mitigate the effect of the foreign currency risk arising from the translation of the net assets of the South Korean branch into the Company's functional currency, which is presented in the foreign currency revaluation reserve. The Company designates a portion of the opening net assets as the hedged item for the duration of one month. The spot elements of foreign exchange forward contracts are designated as the hedging instruments. Gains or losses on the hedging instrument relating to the effective portion of net investment hedging relationships are deferred to the foreign currency revaluation reserve until the disposal of the foreign operation.

A qualitative assessment of the economic relationship between the hedged item and the hedging instrument is performed by comparing the economic terms which affect the amount of the foreign currency risk arising from the translation of the net assets from the South Korean branch ("hedged item") to those which affect the amount of the foreign exchange risk arising from the foreign exchange forward contracts ("hedging instrument"). Generally it is expected that the foreign currency exposure resulting from the translation of the foreign operation and the spot element of the foreign exchange forward contracts will have values which will move in opposite directions because of the same underlying foreign currency risk. The hedge ratio is the ratio between the notional amount of the foreign exchange currency contracts entered into and the notional amount of the net assets of the foreign operation designated in the hedge, which are expected to be equal amounts.

The Company does not expect any ineffectiveness in the year as all of the critical terms of the hedged exposure and the designated instruments, including the hedge ratio and the foreign exchange risk being hedged are matched.

Critical accounting judgements and key sources of estimation uncertainty

In preparing the financial statements, the Company makes judgements and estimates that affect the application of accounting policies and reported amounts.

Critical accounting judgements are key decisions made by management in the application of the Company's accounting policies, other than those involving estimations, which have the most significant effect on the amounts recognised in the financial statements.

Key sources of estimation uncertainty represent assumptions and estimations made by management that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year.

The critical judgements in applying the Company's accounting policies are as follows:

- *Recognition and measurement of tax balances:* Judgements are used in determining what tax-deductible losses are to be surrendered to other members of the Morgan Stanley UK tax group and whether there will be sufficient taxable profits in future years to recognise deferred tax assets. See note 21.

The critical sources of estimation uncertainty are as follows:

- *Valuation of Level 3 financial instruments:* Valuation techniques used to measure the fair value of instruments categorised in Level 3 of the fair value hierarchy are dependent on unobservable parameters, and as such require the application of judgement, involving estimations and assumptions. The fair value for these financial instruments has been determined using parameters appropriate for the valuation methodology based on prevailing market evidence. It is recognised that the unobservable parameters could have a range of reasonably possible alternative values. See accounting policy note 3(d) and note 38 (d) 'Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives'.
- *Measurement of litigation provisions:* Estimates are used in the calculation provisions, which are calculated based on the net present value of expected future cash flows, although the Company recognises that it is inherently difficult to estimate the amount of the future losses in certain instances. See note 41.

The Company evaluates the critical accounting judgements and accounting estimates on an ongoing basis and believes that these are reasonable.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

2. BASIS OF PREPARATION (CONTINUED)

The going concern assumption

The Company's business activities, together with the factors likely to affect its future development, performance and position, and the Company's objectives, policies and processes for managing its capital; its financial risk management objectives; and its exposures to credit risk and liquidity risk, are reflected in the Strategic report on pages 1 to 17, and as set out in the Strategic report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy.

Specifically, the existing and potential effects of COVID-19 (coronavirus) on the operational capacity of the business, access to liquidity and capital, contractual obligations, asset valuations and other critical accounting judgements and key sources of estimation uncertainty have been considered on page 2. Additionally, the specific impact of Brexit on the business of the Company has been considered on pages 2-3. The notes to the financial statements include details of its financial instruments and provide further information, not included in the Strategic Report, on its credit risk and liquidity risk.

Taking the above factors into consideration, the Directors believe it is reasonable to assume that the Company will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Functional currency

Items included in the financial statements are measured and presented in pounds sterling ("sterling"), the currency of the primary economic environment in which the Company operates.

All currency amounts in the financial statements and Strategic and Directors' reports are rounded to the nearest thousand pounds sterling.

b. Foreign currencies

All monetary assets and liabilities denominated in currencies other than sterling are translated into sterling at the rates ruling at the reporting date. Transactions and non-monetary assets and liabilities denominated in currencies other than sterling are recorded at the rates prevailing at the dates of the transactions. Assets and liabilities of foreign operations are translated into sterling using the closing rate method. Translation differences arising from the net investment in the foreign operations are taken to the 'Foreign currency revaluation reserve'. All other translation differences are taken through the income statement. Exchange differences recognised in the income statement are presented in 'Interest receivable and similar income' or 'Interest payable and similar charges', except where noted in 3(c) below.

c. Financial instruments

i) Financial instruments mandatorily at fair value through profit and loss

Trading financial instruments

Trading financial instruments include government debt securities and corporate and other debt where the Company acquires the financial asset or financial liability for the purpose of selling or repurchasing in the near term or is part of a portfolio for which there is evidence of short term profit taking, and all derivative contracts.

Purchases and sales of non-derivative financial instruments classified as held for trading are initially recorded on settlement date at fair value (see note 3(d) below). For purchases of non-derivative financial instruments classified as held for trading, from the date that the terms are agreed (trade date) until the settlement date, the Company recognises any unrealised fair value changes in the statement of financial position as 'Trading financial instruments' with corresponding profit or loss recognised within the income statement in 'Net trading income'.

For sales of non-derivative financial instruments the resulting financial instrument is de-recognised from the statement of financial position upon settlement date.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

i) Financial instruments mandatorily at fair value through profit and loss (continued)

Trading financial instruments (continued)

Derivatives are initially recognised on trade date at fair value. All subsequent changes in fair value and dividends are reflected in the income statement in 'Net trading income'. Interest income and expense and foreign exchange differences are recognised in the income statement in 'Interest receivable and similar income' or 'Interest payable and similar charges'.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. For all trading financial instruments, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the income statement in 'Other expenses' within 'Administrative expenses'.

Non-trading financial assets at fair value through profit or loss

Non-trading financial assets at fair value through profit or loss ("FVPL") include secured financing transactions such as securities purchased under agreements to resell, corporate loans measured at fair value and investment securities.

Non-trading financial assets at FVPL are principally financial assets where the Company makes decisions based upon the assets' fair values and are generally recognised on settlement date at fair value (see note 3(d) below), since they are neither regular way nor are they derivatives. From the date the terms are agreed (trade date), until the financial asset is funded (settlement date), the Company recognises any unrealised fair value changes in the financial asset as non-trading financial assets at FVPL. On settlement date, the fair value of consideration given is recognised as a non-trading financial asset at FVPL.

All subsequent changes in fair value are reflected in the income statement in 'Net income / (expense) from other financial instruments held at fair value'. Interest income and expense and foreign exchange differences are recognised in the income statement in 'Interest receivable and similar income' and 'Interest payable and similar charges'.

For all non-trading financial assets at FVPL, transaction costs are excluded from the initial fair value measurement of the financial assets. These costs are recognised in the income statement in 'Other expense' within 'Administrative expenses'.

ii) Financial instruments designated at fair value through profit or loss

Financial instruments designated at FVPL include unfunded loan commitments which are mandatorily at FVPL once funded.

The company has designated certain financial liabilities at FVPL where the financial liability forms part of a group of financial assets or financial liabilities or both which are managed, evaluated and reported internally on a fair value basis.

From the date the transaction in a financial instrument designated at FVPL is entered into (trade date) until settlement date, the Company recognises any unrealised fair value changes in the contract as financial instruments designated at FVPL in the statement of financial position. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at FVPL (see note 3(d) below).

iii) Investments in subsidiary undertakings

Subsidiaries are entities over which the Company has control. The Company controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

iii) Investments in subsidiary undertakings (continued)

Investment in subsidiaries, are stated at cost, less provision for any impairment. Impairment losses on investments in subsidiaries are measured as the difference between cost and the current estimated recoverable amount and are reflected against the carrying amount of the impaired asset on the statement of financial position. Dividends, impairment losses and reversals of impairment losses are recognised in the income statement in 'Net gains / (losses) from investments in subsidiaries'. Dividends from investments which would be classified as financial liabilities by the investee are classified as interest and recognised in the income statement in 'Interest receivable and similar income'.

iv) Financial assets and financial liabilities at amortised cost

Financial assets at amortised cost include 'Cash and balances at central banks', 'Loans and advances to banks' and 'Loans and advances to customers'.

Financial assets are recognised at amortised cost when the Company's business model objective is to collect the contractual cash flows of the assets and where these cash flows are solely payments of principal and interest on the principal amount outstanding until maturity. Such assets are recognised when the Company becomes a party to the contractual provisions of the instrument. The instruments are initially measured at fair value (see note 3(d) below) and subsequently measured at amortised cost less ECL allowance. Interest is recognised in the income statement in 'Interest receivable and similar income', using the effective interest rate ("EIR") method as described below. Transaction costs that are directly attributable to the acquisition of the financial asset are added to the fair value on initial recognition. ECL and reversals thereof are recognised in the income statement in 'Net impairment loss / net reversal of impairment on financial instruments'.

Financial liabilities at amortised cost include 'Deposits by banks', 'Customer accounts' and 'Secured borrowing'. These are initially recognised on settlement date at fair value (see note 3(d) below) and subsequently measured at amortised cost. Interest is recognised in the income statement in 'Interest payable and similar charges' using the EIR method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

The EIR method is a method of calculating the amortised cost of a financial instrument (or group of financial instruments) and of allocating the interest income or interest expense over the expected life of the financial instrument. The EIR is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial instrument (or, where appropriate a shorter period) to the carrying amount of the financial instrument. The EIR is established on initial recognition of the financial instrument. The calculation of the EIR includes all fees and commissions paid or received, transaction costs, and discounts or premiums that are an integral part of the EIR.

v) Secured financing and secured borrowings

In the course of financing its business and as part of its trading activities, the Company enters into arrangements which involve the sale of securities with agreements to repurchase and the purchase of securities with resale agreements. Securities received by the Company under resale arrangements are generally not recognised on the statement of financial position. Securities pledged or sold by the Company under sale repurchase agreements are generally not derecognised from the statement of financial position.

In relation to secured financing, cash collateral balances receivable and accrued interest arising under resale agreements are classified as 'Non-trading at FVPL' as they are managed on a fair value basis.

In relation to secured borrowing, cash collateral balances repayable and accrued interest under repurchase agreements are classified as 'Financial liabilities at amortised cost' and the related securities, where owned by the Company, are included in 'Trading financial assets'.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value

Fair value measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e. the “exit price”) in an orderly transaction between market participants at the measurement date.

Fair value is a market-based measure considered from the perspective of a market participant rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, assumptions are set to reflect those that the Company believes market participants would use in pricing the asset or liability at the measurement date.

Where the Company manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the Company measures the fair value of that group of financial instruments consistently with how market participants would price the net risk exposure at the measurement date.

In determining fair value, the Company uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that requires the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability that were developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect assumptions the Company believes other market participants would use in pricing the asset or liability, that are developed based on the best information available in the circumstances.

The fair value hierarchy is broken down into three levels based on the observability of inputs as follows, with Level 1 being the highest and Level 3 being the lowest level:

- Level 1 - Quoted prices (unadjusted) in an active market for identical assets or liabilities

Valuations based on quoted prices in active markets that the Morgan Stanley Group has the ability to access for identical assets or liabilities. Valuation adjustments, block discounts and discounts for equity-specific restrictions that would not transfer to market participants are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgement.

- Level 2 - Valuation techniques using observable inputs

Valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

- Level 3 - Valuation techniques with significant unobservable inputs.

Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the product. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgement. Accordingly, the degree of judgement exercised by the Company in determining fair value is greatest for instruments categorised in Level 3 of the fair value hierarchy.

The Company considers prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or from Level 2 to Level 3 of the fair value hierarchy.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the total fair value amount is disclosed in the level appropriate for the lowest level input that is significant to the total fair value of the asset or liability.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Fair value measurement (continued)

The Company incorporates funding valuation adjustments ("FVA") into the fair value measurements of OTC uncollateralised or partially collateralised derivatives and in collateralised derivatives where the terms of the agreement do not permit the re-use of the collateral received. In general, FVA reflects a market funding risk premium inherent in the noted derivative instruments. The methodology for measuring FVA leverages the Company's existing credit-related valuation adjustment calculation methodologies, which apply to both assets and liabilities.

For assets and liabilities that are transferred between levels in the fair value hierarchy during the period, fair values are ascribed as if the assets or liabilities had been transferred as of the beginning of the period.

Valuation techniques

Many cash instruments and OTC derivative contracts have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that a party is willing to pay for an asset. Ask prices represent the lowest price that a party is willing to accept for an asset. The Company carries positions at the point within the bid-ask range that meets its best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

Fair value for many cash instruments and OTC derivative contracts is derived using pricing models. Pricing models take into account the contract terms, as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, creditworthiness of the Company, option volatility and currency rates.

Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk and funding.

Adjustments for liquidity risk adjust model-derived mid-market amounts of Level 2 and Level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions.

The Company applies credit-related valuation adjustments to its OTC derivatives. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit rating is considered when measuring fair value. In determining the expected exposure the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party CDS spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Company also considers collateral held and legally enforceable master netting agreements that mitigate its exposure to each counterparty.

Adjustments for model uncertainty are taken for positions where underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible.

The Company may apply concentration adjustments to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation process

The Valuation Control ("VC") within Finance is responsible for the Company's fair value valuation policies, processes and procedures. VC is independent of the business units and reports to the Chief Financial Officer of the Morgan Stanley Group ("CFO"), who has final authority over the valuation of the Company's financial instruments. VC implements valuation control processes designed to validate the fair value of the Company's financial instruments measured at fair value including those derived from pricing models.

Model Review.

VC, in conjunction with the Model Risk Management Department ("MRM"), which reports to the Chief Risk Officer of the Morgan Stanley Group ("CRO"), independently reviews valuation models' theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VC reviews the appropriateness of the proposed valuation methodology to determine that it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilised in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VC develops a methodology to independently verify the fair value generated by the business unit's valuation models. The Company generally subjects valuations and models to a review process initially and on a periodic basis thereafter.

Independent Price Verification.

The business units are responsible for determining the fair value of financial instruments using approved valuation models and valuation methodologies. Generally on a monthly basis, VC independently validates the fair values of financial instruments determined using valuation models by determining the appropriateness of the inputs used by the business units and by testing compliance with the documented valuation methodologies approved in the model review process described above.

The results of this independent price verification and any adjustments made by VC to the fair value generated by the business units are presented to management of the Morgan Stanley Group's three business segments (i.e. Institutional Securities, Wealth Management and Investment Management), the CFO and the CRO on a regular basis.

VC uses recently executed transactions, other observable market data such as exchange data, broker/ dealer quotes, third-party pricing vendors and aggregation services for validating the fair values of financial instruments generated using valuation models. VC assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources are evaluated using a number of approaches; for example, by corroborating the external sources' prices to executed trades, by analysing the methodology and assumptions used by the external source to generate a price and / or by evaluating how active the third-party pricing source (or originating sources used by the third-party pricing source) is in the market. Based on this analysis, VC generates a ranking of the observable market data designed to ensure that the highest-ranked market data source is used to validate the business unit's fair value of financial instruments.

VC reviews the models and valuation methodology used to price new material Level 2 and Level 3 transactions and both Finance and MRM must approve the fair value of the trade that is initially recognised.

Level 3 Transactions.

VC reviews the business unit's valuation techniques to assess whether these are consistent with market participant assumptions.

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Company recognises a gain or loss on inception of the transaction.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Gains and losses on inception (continued)

When the use of unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial gain or loss indicated by the valuation technique as at the transaction date is not recognised immediately in the income statement but is deferred and recognised over the life of the instrument or at the earlier of when the unobservable market data become observable, maturity or disposal of the instrument.

e. Modification and derecognition of financial assets and liabilities

The Company derecognises a financial asset when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risk and rewards of ownership of the asset.

If the asset has been transferred, and the Company neither transfers nor retains substantially all of the risks and rewards of the asset, then the Company determines whether it has retained control of the asset.

If the Company has retained control of the asset, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset. If the Company has not retained control of the asset, it derecognises the asset and separately recognises any rights or obligations created or retained in the transfer.

The renegotiation or modification of the contractual cash flows of a financial instrument can lead to derecognition where the modification is “substantial”, determined by qualitative assessment of whether the revised contractual terms of a financial instrument, such as a loan, are significantly different from those of the original financial instrument. In the event that the qualitative assessment is unclear, a quantitative 10% cash flow test is performed.

Where modifications do not result in derecognition of the financial instrument, the gross carrying amount of the financial instrument is recalculated and a modification gain/ (loss) is recognised in the income statement.

Upon derecognition of a financial instrument, the difference between the previous carrying amount and the sum of any consideration received, is recognised in the income statement within ‘Net gains / (losses) on derecognition of financial assets measured at amortised cost’.

The Company derecognises financial liabilities when the Company’s obligations are discharged or cancelled or when they expire.

f. Impairment of financial instruments

The Company recognises loss allowances for ECL for the following financial instruments that are not measured at FVPL:

- financial assets measured at amortised cost;
- loan commitments, except those that can be net settled in cash or with another financial instrument.

Measurement of ECL

For financial assets, ECL are the present value of cash shortfalls (i.e. the difference between contractual and expected cash flows) over the expected life of the financial instrument, discounted at the asset’s EIR.

Where a financial asset is credit-impaired at the reporting date, the ECL is measured as the difference between the asset’s gross carrying amount and the present value of future cash flows, discounted at the original EIR.

For in scope loan commitments, ECL are the present value of the cash shortfalls (i.e. the difference between contractual and expected cash flows), assuming that the loan is drawn down.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

f. Impairment of financial instruments (continued)

Measurement of ECL (continued)

The Company applies a three stage approach to measuring ECL based on the change in credit risk since initial recognition:

- Stage 1: if the credit risk of the financial instrument at the reporting date has not increased significantly since initial recognition then the loss allowance is calculated as the lifetime cash shortfalls that will result if a default occurs in the next 12 months, weighted by the probability of that default occurring.
- Stage 2: if there has been a significant increase in credit risk ("SICR") since initial recognition, the loss allowance is calculated as the ECL over the remaining life of the financial instrument. If it is subsequently determined that there has no longer been a SICR since initial recognition, then the loss allowance reverts to reflecting 12 month expected losses.
- Stage 3: if there has been a SICR since initial recognition and the financial instrument is deemed credit-impaired (see below for definition of credit-impaired), the loss allowance is calculated as the ECL over the remaining life of the financial instrument. If it is subsequently determined that there has no longer been a SICR since initial recognition, then the loss allowance reverts to reflecting 12 month expected losses.

Assessment of SICR

When assessing SICR, the Company considers both quantitative and qualitative information and analysis based on the Company's historical experience and expert credit risk assessment, including forward-looking information.

The probability of default ("PD") is derived from internal credit rating grades (based on available information about the borrower) and multiple forward-looking macroeconomic scenarios which are probability weighted. Credit risk is considered to have increased significantly if the PD has significantly increased at the reporting date relative to the PD of the facility, at the date of initial recognition. The assessment of whether a change in PD is "significant" is based both on a consideration of the relative change in PD and on qualitative indicators of the credit risk of the facility, which indicate whether a loan is performing or in difficulty. In addition, as a backstop, the Company considers that SICR has occurred in all cases when an asset is more than 30 days past due ("DPD").

The Company's accounting policy is to not use the 'low' credit risk practical expedient. As a result, the Company monitors all financial instruments which are subject to impairment for SICR, with the exception of trade receivables presented within loans and advances and other receivables, for which a lifetime ECL is always calculated.

In general, ECL are measured so that they reflect:

- a) A probability-weighted range of possible outcomes;
- b) The time value of money; and
- c) Relevant information relating to past, current and future economic conditions.

Calculation of ECL

ECL are calculated using three main components:

- PD: for accounting purposes, the 12 month and lifetime PD represent the expected point-in-time probability of a default over the next 12 months and over the remaining lifetime of the financial instrument respectively, based on conditions existing at the balance sheet date and future economic conditions.
- Expected loss given default ("LGD"): the LGD represents expected loss conditional on default, taking into account the mitigating effect of collateral, including the expected value of the collateral when realised and the time value of money.
- Estimated exposure at default ("EAD"): this represents the expected EAD, taking into account the expected repayment of principal and interest from the balance sheet date to the default event together with any expected drawdowns of the facility over that period.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

f. Impairment of financial instruments (continued)

Calculation of ECL (continued)

These parameters are generally derived from internally developed statistical models, incorporating historical, current and forward-looking macro-economic data and country risk expert judgement. The macro-economic scenarios are reviewed quarterly.

The 12 month ECL is equal to the sum over the next 12 months of quarterly PD multiplied by LGD and EAD, with such expected losses being discounted at the EIR. Lifetime ECL is calculated using the discounted present value of total quarterly PDs multiplied by LGD and EAD, over the full remaining life of the facility.

When measuring ECL, the Company considers multiple scenarios, except where practical expedients are used to determine ECL. Practical expedients are used where they are consistent with the principles described above. Where there is a history of no credit losses, and where this is expected to persist into the future for structural or other reasons, such as collateral or other credit enhancement, it is determined that the ECL for a financial instrument is *de minimis* (highly immaterial) and it may not be necessary to recognise the ECL.

The Company measures ECL on an individual asset basis and has no purchased or originated credit-impaired financial assets.

If a financial asset has been the subject of modification which does not lead to its derecognition (refer to note 3(e)), SICR is assessed by comparing the risk of default of the financial instrument, based on the modified terms at the reporting date, with the risk of default of the financial instrument at inception, based on the financial instrument's original, unmodified, terms.

Where the modification of contractual cash flows of a financial asset leads to its derecognition and the recognition of a new asset (refer to note 3(e)), the date of modification is treated as the date of initial recognition for the new financial asset when determining whether a SICR has occurred for that modified financial asset. In rare circumstances, after modification, the new asset is considered to be credit impaired, in which case it is treated as an asset which was credit-impaired at origination.

More information on measurement of ECL is provided in note 34 'Financial Risk Management'.

Presentation of ECL

ECL is recognised in the income statement within 'Net reversal of impairment on financial instruments'. ECL on financial assets measured at amortised cost, are presented as an ECL allowance. The allowance reduces the net carrying amount on the face of the statement of financial position. ECLs on loan commitments and financial guarantee contracts are presented as a provision in the statement of financial position, i.e. as a liability.

Credit-impaired financial instruments

In assessing the impairment of financial instruments under the ECL model, the Company defines credit-impaired financial instruments in accordance with Credit Risk Management Department's policies and procedures. A financial instrument is credit-impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the agreement.

Definition of Default

In assessing the impairment of financial instruments under the ECL model, the Company defines default in accordance with Credit Risk Management Department's policies and procedures. This considers whether the borrower is unlikely to pay its credit obligations to the Company in full and takes into account qualitative indicators, such as breaches of covenants. The definition of default also includes a presumption that a financial asset which is more than 90 DPD has defaulted.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

f. Impairment of financial instruments (continued)

Write-offs

Loans and debt securities are written off (either partially or in full) when they are deemed uncollectible which generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted. Such determination is based on an indication that the borrower can no longer pay the obligation, or that the proceeds from collateral will not be sufficient to pay the loan. Partial write-offs are made when a portion of the loan is uncollectable. However, financial assets that are written off could still be subject to enforcement activities for recoveries of amounts due. If the amount to be written off is greater than the accumulated loss allowance, the difference is reflected directly in the income statement within 'Net reversal of impairment on financial instruments' and is not recognised in the loss allowance account. Any subsequent recoveries are credited to 'Net reversal of impairment on financial instruments' within the income statement.

g. Impairment of non-financial assets

Non-financial assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Such impairment losses are recognised in the income statement within 'Administrative expenses' and are recognised against the carrying amount of the impaired asset on the statement of financial position. Non-financial assets, other than goodwill, that have suffered an impairment are reviewed for possible reversal of the impairment at the end of each reporting period.

h. Fees and commissions

Fees and commissions classified within 'Fees and commissions income' in the income statement include syndication and arrangement fees, account servicing fees, and management charges to other Morgan Stanley Group undertakings.

- Syndication fees are generally not an integral part of the effective interest rate and are recognised as the related services are performed.
- Arrangement fees are recognised as the related services are performed where there is no ongoing contractual obligation for the Company. Where there is an ongoing contractual obligation for the Company, fees are recognised over the term of the commitment on a straight-line basis where the commitment is not expected to be drawn or deferred until drawdown and included in the effective interest rate where the commitment is expected to be drawn.
- Account servicing fees include loan commitment and utilisation fees. These fees are recognised over the term of the commitment on a straight-line basis where the commitment is not expected to be drawn. Where the commitment is expected to be drawn, the fees are deferred until drawdown and included in the effective interest rate.

Fees and commissions classified within 'Fees and commissions expense' include transaction and service fees. These amounts are recognised as the related services are received.

i. Tangible fixed assets

Tangible fixed assets are stated at cost net of depreciation and any provision for impairment in value (see note 3(g) above), which are included within 'Depreciation of tangible fixed assets' and 'Administrative expenses', respectively, in the income statement.

Depreciation is provided on tangible fixed assets at rates calculated to write off the cost of the assets on a straight-line basis over their expected useful lives as follows:

Leasehold improvements	-	shorter of remaining lease term and 10 years
Fixtures, fittings and equipment	-	1-8 years

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

i. Tangible fixed assets (continued)

The carrying amount of an item a tangible fixed asset shall be derecognised on disposal or when no further economic benefits are expected from its use or disposal. Gains and losses on disposals are determined by comparing proceeds with carrying amount.

j. Leases

Applicable from 1 January 2019

For leases whose original lease term exceeds one year, ROU assets and lease liabilities are initially recognised based on the present value of the lease payments over the lease term. The discount rate used in determining the present value is the Company's incremental borrowing rate. The ROU asset also includes any prepaid lease payments and initial direct costs incurred and is reduced to reflect lease incentives received. The interest on lease liabilities is accrued at a constant periodic rate of interest on the remaining balance of the lease liability. The liability is remeasured when there is a change in future lease payments arising from a change in an index or rate or from a market rent review. Additionally, the lease liability is remeasured if the Company changes its assessment of whether it will exercise an extension or termination option or undertakes certain modifications of the lease. The ROU asset is depreciated on a straight line basis from the lease commencement date to the earlier of the end of its useful life or the end of the lease term. Depreciation of ROU assets is presented within 'Depreciation of tangible fixed assets'. In addition, the ROU asset is tested for impairment losses where there is an impairment event.

The Company evaluates contracts greater than one year to determine whether they contain lease components at inception. Where contracts contain both lease and non-lease components, they are accounted for as a single lease.

The Company presents ROU assets within the 'Tangible fixed assets' line and lease liabilities within the 'Other payables' line of the statement of financial position.

Applicable until 31 December 2018

Rentals payable under operating leases are charged to 'Administrative expenses' in the income statement on a straight line basis over the lease term. Lease incentives are allocated on a straight line basis over the lease term as a reduction to rental expense.

k. Provisions, contingent liabilities and commitments

Provisions are recognised when the Company has a present obligation as a result of a past event, when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and when a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the year end date, taking into account the risks and uncertainties surrounding the obligation.

The expected credit loss allowance on loan commitments and financial guarantees is presented in the statement of financial position as 'Provisions for liabilities and charges'.

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the company or a present obligation that arises from past events but is not recognised because either an outflow of economic benefits is not probable or the amount of the obligation cannot be reliably measured.

A commitment is any legal obligation to potentially make or receive cash payments or transfer cash.

Contingent liabilities and commitments are not recognised in the financial statements. However, disclosure is made unless the probability of settlement is remote.

l. Business disposals

When a business is sold or transferred to another entity under common control, any difference between the consideration received and the aggregate book value of the assets and liabilities of the disposed of business is recorded as an adjustment to the profit and loss account within equity.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

m. Income tax

The tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is calculated based on taxable profit for the year. Taxable profit may differ from profit before taxation as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date. Current tax is charged or credited in the income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the current tax is also recorded within other comprehensive income or equity respectively.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each reporting date and limited to the extent that it is probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the deferred tax is reflected within other comprehensive income or equity, respectively.

Current tax assets are offset against current tax liabilities when there is a legally enforceable right to set off current tax assets against current tax liabilities and the Company intends to settle its current tax assets and current tax liabilities on a net basis or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and current tax liabilities on a net basis.

n. Employee compensation plans

i) Equity-settled share-based compensation plans

Morgan Stanley issues awards in the form of restricted stock units ("RSUs") to employees of the Morgan Stanley Group for services rendered to the Company. Awards are equity-settled and the cost of the equity-based transactions with employees is measured based on the fair value of the equity instruments at grant date. The fair value of RSUs is based on the market price of Morgan Stanley common stock on the date the award is granted, measured as the volume-weighted average price on the date of grant ("VWAP"). The fair value of RSUs not entitled to dividends until conversion is measured at VWAP reduced by the present value of dividends expected to be paid on the underlying shares prior to scheduled conversion date.

Awards generally contain clawback and cancellation provisions. Certain awards provide Morgan Stanley the discretion to cancel all or a portion of the award under specified circumstances. Compensation expense for these awards is adjusted for changes in the fair value of the Morgan Stanley's common stock until conversion.

The Company recognises compensation cost over the relevant vesting period for each separately vesting portion of the award. An estimation of awards that will be forfeited prior to vesting due to the failure to satisfy service conditions is considered in calculating the total compensation cost to be amortised over the relevant vesting period.

Under Group chargeback arrangements, the Company pays Morgan Stanley for the procurement of shares. The Company pays Morgan Stanley the grant date fair value and any subsequent movement in fair value up to the time of delivery to the employees.

Share based compensation expense is recorded within 'Administrative expenses' in the income statement.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

n. Employee compensation plans (continued)

ii) Deferred cash-based compensation plans

Morgan Stanley awards deferred cash-based compensation on behalf of the Company for the benefit of employees, providing a return to the participating employees based upon the performance of various referenced investments. Compensation expense for deferred cash-based compensation awards is calculated based on the notional value of the award granted, adjusted for changes in the fair value of the referenced investments that employees select.

The Company recognises compensation cost over the relevant vesting period for each separately vesting portion of the award. Forfeitures due to failure to satisfy service conditions are accounted for as they occur.

Deferred cash-based compensation expense is recorded within 'Administrative expenses' in the income statement. The liability for the awards is measured at fair value and is included within 'Other liabilities' in the statement of financial position.

The Company enters into a variety of derivative contracts with other Morgan Stanley Group undertakings to economically hedge the exposure created by these deferred compensation plans. The derivatives are recognised within 'Trading financial assets and / or liabilities' in the statement of financial position and the related gains and losses are recorded within 'Net trading income' in the income statement.

Although changes in compensation expense resulting from changes in the fair value of the referenced investments will generally be offset by changes in the fair value of derivative transactions entered into by the Company, there is typically a timing difference between the immediate recognition of gains and losses on the derivatives and the deferred recognition of the related compensation expense over the vesting period.

o. Post-employment benefits

The Company operates defined contribution plans and defined benefit post-employment plans.

Contributions due in relation to the Company's defined contribution post-employment plans are recognised in 'Administrative expenses' in the income statement when payable.

A full actuarial valuation of the defined benefit section of the Plan ("the DB Plan") is conducted at least every three years. The full actuarial valuation provides both an accounting valuation and a funding valuation for the DB Plan.

For accounting valuation purposes, the plan obligations of the Company's DB Plan are measured on an actuarial basis in accordance with the advice of an independent qualified actuary using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the plan liabilities. Plan assets are measured at their fair value at the reporting date. A surplus or deficit of plan assets over liabilities is recognised in the statement of financial position as an asset or liability respectively. If the fair value of the plan assets is higher than the present value of the defined benefit obligation, the measurement of the resulting defined benefit asset is limited to the asset ceiling. The asset ceiling is the present value of economic benefits that are unconditionally available to the Company in the form of refunds from the plan or reductions in future contributions to the plan and the related adjustment is recognised in other comprehensive income. In order to calculate the present value of economic benefits, the Company determines whether any minimum funding requirement contribution would be available to the Company if the contribution creates or increases an existing surplus.

Past service costs and net interest on the defined benefit obligation / asset are charged to 'Direct staff costs' in 'Administrative expenses'. Remeasurements that arise in calculating the Company's obligation in respect of a plan are recognised in other comprehensive income in the period in which they occur.

Details of the plans are given in note 44 to these financial statements.

p. Offsetting of financial assets and financial liabilities

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

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****4. INTEREST RECEIVABLE AND SIMILAR INCOME**

The table below presents interest receivable and similar income by accounting classification. Interest receivable and similar income is calculated using the EIR method for financial assets measured at amortised cost. Interest receivable and similar income includes realised interest on financial assets measured at FVPL.

	2019	2018
	£'000	£'000
Financial assets measured at amortised cost		
Interest income on loans and advances to customers	1,039	2,458
Interest income on loans and advances to banks	1,113	215
Interest income on other loans to Morgan Stanley Group undertakings	4,065	6,258
Other interest income	116	55
Financial asset not measured at FVPL	6,333	8,986
Trading financial assets		
Interest income on trading financial assets	25,193	14,319
Other interest income	(1,174)	(1,191)
Non-trading financial assets at FVPL		
Interest income on secured financing with Morgan Stanley Group undertakings	16,233	11,987
Financial assets measured at FVPL	40,252	25,115
Total interest income	46,585	34,101

The company has no credit-impaired financial assets in the current or prior year and therefore, there is no interest income relating to credit-impaired financial assets in the current or prior year.

No other gains or losses have been recognised in respect of financial assets measured at amortised cost other than those disclosed in 'Interest receivable and similar income' and reversals of impairment losses disclosed in 'Net reversal of impairment on financial instruments' (note 9).

5. INTEREST PAYABLE AND SIMILAR CHARGES

The table below presents interest payable and similar charges by accounting classification. Interest payable and similar charges are calculated using the effective interest method for financial liabilities measured at amortised cost.

	2019	2018
	£'000	£'000
Financial liabilities measured at amortised cost		
Deposit interest	4,173	6,212
Interest expense on repurchase agreements and other secured borrowing with external counterparties	6,732	7,506
Interest expense on repurchase agreements and other secured borrowing with Morgan Stanley Group undertakings	1,106	1,175
Interest expense on other loans from Morgan Stanley Group undertakings	20,494	14,300
Interest expense on lease liabilities	31	-
Other interest expense	-	36
Foreign exchange losses	2,091	3,776
Financial liabilities measured at amortised cost	34,627	33,005
Total interest expense	34,627	33,005

No other gains or losses have been recognised in respect of financial liabilities measured at amortised cost other than as disclosed in 'Interest payable and similar charges' within the income statement.

Included in 'Interest expense on other loans from Morgan Stanley Group undertakings' is £7,074,000 (2018: £6,701,000) in respect of subordinated liabilities.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****6. FEES AND COMMISSIONS INCOME**

	2019	2018
	£'000	£'000
Syndication and arrangement fees	38,212	52,130
Account servicing fees	1,192	1,412
Management charges to other Morgan Stanley Group undertakings	30,458	28,070
	<u>69,862</u>	<u>81,612</u>

All syndication and arrangement fee income arises from unfunded loan commitments that the Company has either arranged on behalf of another Morgan Stanley Group undertaking or has a continuing obligation.

7. FEES AND COMMISSIONS EXPENSE

	2019	2018
	£'000	£'000
Transaction and service fees	<u>10,179</u>	<u>8,658</u>

The fees and commissions expense primarily arises from financial assets at fair value through profit or loss.

8. NET INCOME / (LOSS) FROM OTHER FINANCIAL INSTRUMENTS HELD AT FAIR VALUE

	2019	2018
	£'000	£'000
Net gains / (losses) on:		
Non-trading financial assets at FVPL		
Secured financing	(331)	(209)
Loans and advances to customers	(847)	176
Investment securities	(350)	-
	<u>(1,528)</u>	<u>(33)</u>
Financial liabilities designated at FVPL		
Loan commitments	<u>1,960</u>	<u>(1,016)</u>
	<u>1,960</u>	<u>(1,016)</u>
	<u>432</u>	<u>(1,049)</u>

9. NET REVERSAL OF IMPAIRMENT ON FINANCIAL INSTRUMENTS

The following table shows the net ECL reversal for the year.

	2019	2018
	£'000	£'000
Loans and advances to customers	-	21
Loan commitments	<u>20</u>	<u>139</u>
	<u>20</u>	<u>160</u>

There were no write-offs during the current and prior year.

All of the above impairment losses were calculated on an individual basis. No collective impairment assessments were made during the year or prior year.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****10. ADMINISTRATIVE EXPENSES**

	2019	2018
	£'000	£'000
Direct staff costs	22,315	17,847
Management recharges from other Morgan Stanley Group undertakings relating to staff costs	21,389	15,092
Management recharges from other Morgan Stanley Group undertakings relating to other services	30,529	40,888
Bank levy	206	339
Operating lease rentals	-	960
Auditor's remuneration:		
Fees payable for the audit of the Company's annual financial statements	350	340
Other expenses	7,081	6,686
	<u>81,870</u>	<u>82,152</u>

The Company has not incurred any fees for non-audit services provided to the Company by the Company's auditor in the current or prior year.

The average number of employees of the Company, including the Directors, is analysed below:

	2019	2018
	Number	Number
Support services	45	44
Institutional securities and investment management	40	33
	<u>85</u>	<u>77</u>

The costs of the direct staff, including the Directors, are analysed below:

	2019	2018
	£'000	£'000
Wages and salaries	18,582	14,902
Social security costs	2,693	1,949
Pension costs	1,040	996
	<u>22,315</u>	<u>17,847</u>

In addition to the direct staff costs above, the Company incurred recharges in respect of staff costs from other Morgan Stanley Group undertakings.

The amount of remuneration received by Directors in respect of their services to the Company is disclosed in note 45, 'Related Party Disclosures'.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****11. TAX ON PROFIT ON ORDINARY ACTIVITIES****Analysis of expense in the year**

	2019	2018
	£'000	£'000
Current tax expense		
UK corporation tax at 27% (2018: 27%)		
• Current year	2,951	3,870
• Adjustment in respect of prior years	(329)	(38)
Foreign Tax		
• Current year	1,605	1,356
• Adjustment in respect of prior years	-	(770)
Total current tax	<u>4,227</u>	<u>4,418</u>
Deferred tax expense / (benefit)		
Origination and reversal of temporary differences	2,641	2,651
Adjustment in respect of prior years	(236)	2,211
Effect of changes in tax rates	368	102
Total deferred tax	<u>2,773</u>	<u>4,964</u>
Income tax expense	<u><u>7,000</u></u>	<u><u>9,382</u></u>

The Company made an election to exclude foreign branch profits and losses from UK corporation tax in respect of the accounting period beginning 1 January 2016 onwards.

Finance (No.2) Act 2015 reduced the UK main rate of corporation tax to 17% with effect from 1 April 2020. However, following the UK Budget on 11 March 2020 and subsequent resolutions given statutory effect under the Provisional Collection of Taxes Act 1968, for the financial year 2020 the UK statutory rate is 19%. While this change does not affect the income tax charge for the year, it will affect future periods. See Note 21 Deferred Tax Assets for further details. In addition, Finance (No.2) Act 2015 introduced an 8% corporation tax surcharge on the profits of banking companies with effect from 1 January 2016 which impacts the current tax charge in the current and comparative years.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****11. TAX ON PROFIT ON ORDINARY ACTIVITIES (CONTINUED)****Reconciliation of effective tax rate**

The Company's tax rate is sensitive to the geographic mix of profits and tax rates, reflecting a combination of: a) higher rates e.g. Italy; b) lower rates e.g. Korea; and c) variable rates, such as in the UK, where the statutory rate is 19%, however, the Company incurs an additional 8% banking surcharge.

The main differences between the Company's tax charge and the tax charge that would have been calculated from applying the average standard rate of corporation tax in the UK for the year of 27% (2018: 27%) are explained below:

	2019	2018
	£'000	£'000
Profit before tax	45,122	37,075
Income tax using the average standard rate of corporation tax in the UK of 27% (2018: 27%)	12,183	10,019
Impact on tax of:		
Expenses not deductible for tax purposes	837	3,178
Group relief received for no consideration	(7,008)	(6,805)
Foreign tax prior year adjustments	(236)	1,441
Higher rate taxes on overseas earnings	1,185	1,485
Adjustment to the tax expense in respect of prior years	(329)	(38)
Effect of tax rate change	368	102
Total income tax expense in the income statement	7,000	9,382

In addition to the amount charged to the income statement, the aggregate amount of current and deferred tax relating to each component of other comprehensive income was as follows:

	2019			2018		
	Before tax	Tax	Net of tax	Before tax	Tax	Net of tax
	£'000	(expense)	£'000	£'000	(expense)	£'000
Remeasurement of net defined benefit liability	(174)	-	(174)	2	-	2

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES BY MEASUREMENT CATEGORY

The following table analyses financial assets and financial liabilities as presented in the statement of financial position by IFRS 9 classifications.

2019	FVPL (mandatorily) £'000	FVPL (designated) £'000	Amortised cost £'000	Total £'000
Cash and balances at central banks	-	-	122,601	122,601
Secured financing	1,480,900	-	-	1,480,900
Loans and advances to banks	-	-	131,940	131,940
Loans and advances to customers	67,171	-	113,079	180,250
Trading financial assets	3,446,503	-	-	3,446,503
Investment securities	6,557	-	-	6,557
Other receivables	-	-	10,013	10,013
Total financial assets	5,001,131	-	377,633	5,378,764
Deposits by banks	-	-	135,962	135,962
Customer accounts	-	-	1,331,496	1,331,496
Secured borrowing	-	-	273,663	273,663
Trading financial liabilities	2,762,477	-	-	2,762,477
Other payables	-	1,907	12,012	13,919
Subordinated loans	-	-	250,000	250,000
Total financial liabilities	2,762,477	1,907	2,003,133	4,767,517

2018	FVPL (mandatorily) £'000	FVPL (designated) £'000	Amortised cost £'000	Total £'000
Cash and balances at central banks	-	-	15	15
Secured financing	1,280,633	-	-	1,280,633
Loans and advances to banks	-	-	107,412	107,412
Loans and advances to customers	5,575	-	357,538	363,113
Trading financial assets	3,290,194	-	-	3,290,194
Other receivables	-	-	16,071	16,071
Total financial assets	4,576,402	-	481,036	5,057,438
Deposits by banks	-	-	323,778	323,778
Customer accounts	-	-	1,072,143	1,072,143
Secured borrowing	-	-	258,331	258,331
Trading financial liabilities	2,528,574	-	-	2,528,574
Other payables	-	3,175	39,162	42,337
Subordinated loans	-	-	250,000	250,000
Total financial liabilities	2,528,574	3,175	1,943,414	4,475,163

Financial liabilities designated at FVPL

The financial liabilities shown in the tables above which are designated at FVPL relate to unfunded loan commitments which are mandatorily at FVPL once funded as they are part of a group of financial assets which are managed and evaluated on a fair value basis.

There are no terms and conditions of any financial liability designated at FVPL that may individually significantly affect the amount timing and certainty of future cash flows for the Company.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES BY MEASUREMENT CATEGORY (CONTINUED)****Financial liabilities designated at FVPL (continued)**

There were no significant gains or losses attributable to changes in own credit risk for financial liabilities designated at FVPL in the current or prior year. The Company determines the amount of changes in fair value attributable to changes in counterparty credit risk, as relating to financial assets and financial liabilities designated at FVPL, by first determining the fair value including the impact of counterparty credit risk or own credit risk, and then deducting those changes in fair value representing managed market risk. The Company considers that this approach most faithfully represents the amount of change in fair value due to both counterparty credit risk and the Company's own credit risk.

13. SECURED FINANCING AND SECURED BORROWING

	2019	2018
	£'000	£'000
Assets		
Non-trading FVPL		
Reverse repurchase agreements		
- Due from Morgan Stanley Group undertakings	1,480,900	1,280,633
Total Assets	<u>1,480,900</u>	<u>1,280,633</u>
Liabilities		
Financial liabilities at amortised cost		
Repurchase agreements and other secured borrowing		
- Due to Morgan Stanley Group undertakings	27,120	28,459
- Due to external counterparties - banks	246,543	229,872
Total Liabilities	<u>273,663</u>	<u>258,331</u>

There were no assets or liabilities falling due after more than five years in both the current and prior year.

14. LOANS AND ADVANCES TO BANKS

	2019	2018
	£'000	£'000
Financial assets at amortised cost		
Remaining maturity:		
• On demand or at short notice	131,940	107,412
Amounts include:		
Due from Morgan Stanley Group undertakings	795	1,288

Loans and advances to banks are all unsubordinated.

There were no impairment loss allowances for loans and advances to banks at 31 December 2019 (2018: £nil).

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****15. LOANS AND ADVANCES TO CUSTOMERS**

	2019	2018
	£'000	£'000
Financial assets at amortised cost		
Remaining maturity:		
• On demand or at short notice	99,771	339,472
• More than one year but not more than five years	13,308	18,066
Total financial assets at amortised cost	<u>113,079</u>	<u>357,538</u>
Amounts include:		
Due from Morgan Stanley Group undertakings	<u>84,642</u>	<u>325,693</u>
Financial assets at FVPL		
Remaining maturity:		
• More than one year but not more than five years	67,171	5,575
Total financial assets at FVPL	<u>67,171</u>	<u>5,575</u>
Total loans and advances to customers	<u>180,250</u>	<u>363,113</u>

Loans and advances to customers are all unsubordinated.

16. TRADING FINANCIAL ASSETS AND LIABILITIES

Trading financial assets and trading financial liabilities are summarised as follows:

	2019		2018	
	Assets	Liabilities	Assets	Liabilities
	£'000	£'000	£'000	£'000
Fair value				
Government debt securities	343,850	-	345,391	-
Corporate and other debt	367,263	-	410,033	-
Corporate equities	-	-	2,802	-
Derivative financial instruments (listed and OTC):				
• Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	2,731,157	2,759,046	2,502,708	2,502,492
• Fair value of loans pending settlement	3,162	2,360	16,769	13,591
• Commodity forwards, options and swaps	1,071	1,071	12,491	12,491
Total trading financial instruments	<u>3,446,503</u>	<u>2,762,477</u>	<u>3,290,194</u>	<u>2,528,574</u>

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

Details of above assets pledged as collateral are disclosed in 'Transfers of financial assets, including pledges of collateral' (note 35).

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****17. INVESTMENT SECURITIES**

	2019 £'000	2018 £'000
Investment securities (FVPL – non-trading)		
Corporate and other debt	2,311	-
Corporate equities	4,246	-
Total investment securities	<u>6,557</u>	<u>-</u>

All investments classified as 'Investment securities (FVPL – non-trading)' are unlisted.

Details of the investments in 'Investment securities (FVPL – non-trading)' by the Company at 31 December 2019 are as follows:

Name of Company	Country of undertaking's registered office	Type of shares held	Proportion of shares held	Proportion of voting rights held	Nature of business
LDC (Nursing Homes) Holdco Limited	Jersey	Ordinary	<20%	<20%	Holding Company
FB Lux Holdings, S.C.A.	Luxembourg	Preference	<20%	<20%	Holding Company

18. INVESTMENT IN SUBSIDIARY UNDERTAKING

Cost and net book value	Subsidiary undertaking £'000
At 31 December 2019 and 31 December 2018	<u>105,374</u>

Details of all investments in subsidiaries of the Company at 31 December 2019 and 31 December 2018 are as follows:

Name of Company	Address of undertaking's registered office	Type of interest held	Proportion of capital held	Proportion of voting rights held	Nature of business
Morgan Stanley Bank International (China) Limited	Yuecai Building, No. 188 Jingshan Road Jida, Zhuhai Guangdong Province China	Membership interest	100%	100%	Bank company

The investment was unimpaired at 31 December 2019 and 31 December 2018.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****19. TANGIBLE FIXED ASSETS**

	Leasehold improvements £'000	Fixtures, fittings and equipment £'000	Right-of-use assets - Property £'000	Total £'000
Cost				
At 1 January 2019	9,214	8,399	-	17,613
Impact of adoption of IFRS 16	-	-	3,521	3,521
Additions	559	181	14	754
Disposals	-	(2)	(2)	(4)
Foreign exchange revaluation on assets held in overseas branches	(564)	(497)	(216)	(1,277)
At 31 December 2019	<u>9,209</u>	<u>8,081</u>	<u>3,317</u>	<u>20,607</u>
Depreciation				
At 1 January 2019	8,642	8,073	-	16,715
Charge for the year	279	126	905	1,310
Disposals	-	(2)	-	(2)
Foreign exchange revaluation on assets held in overseas branches	(519)	(476)	(39)	(1,034)
At 31 December 2019	<u>8,402</u>	<u>7,721</u>	<u>866</u>	<u>16,989</u>
Carrying amount				
At 31 December 2019	<u>807</u>	<u>360</u>	<u>2,451</u>	<u>3,618</u>

20. OTHER RECEIVABLES

	2019 £'000	2018 £'000
Financial assets classified as amortised cost		
Interest and fee income receivable	3,886	7,366
Other receivables	<u>6,127</u>	<u>8,705</u>
Total other receivables	<u>10,013</u>	<u>16,071</u>

21. DEFERRED TAX

Deferred taxes are calculated on all temporary differences under the liability method. The movement in the deferred tax account is as follows:

	Deferred tax asset 2019 £'000	Deferred tax asset 2018 £'000
At 1 January	8,596	13,102
Reclassification	-	(176)
Amount recognised in other comprehensive income	78	346
Amount recognised in the income statement	(2,405)	(4,862)
Impact of change in UK corporation tax rate	(368)	(102)
Foreign exchange revaluation	(500)	288
At 31 December	<u>5,401</u>	<u>8,596</u>

There was no deferred tax liability in the current or prior year.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

21. DEFERRED TAX (CONTINUED)

For the purpose of presentation in the statement of financial position, certain deferred tax assets and liabilities have been offset. The deferred tax included in the statement of financial position and changes recorded in 'Income tax expense' are as follows:

	Deferred tax asset	Deferred tax liability	Income statement	Deferred tax asset	Deferred tax liability	Income statement
	2019	2019	2019	2018	2018	2018
	£'000	£'000	£'000	£'000	£'000	£'000
Deferred compensation	484	-	(112)	312	-	1,711
Unrealised (losses) / gains	(1,202)	-	3,632	2,623	-	6,198
Tax losses carried forward	3,823	-	(1,010)	3,036	-	(3,036)
Other timing differences	2,296	-	263	2,625	-	91
	<u>5,401</u>	<u>-</u>	<u>2,773</u>	<u>8,596</u>	<u>-</u>	<u>4,964</u>

The deferred tax assets recognised are based on management assessment that it is probable that the Company will have taxable profits against which the temporary differences can be utilised.

Finance (No.2) Act 2015 reduced the UK main rate of corporation tax to 17% with effect from 1 April 2020. However, following the UK Budget on 11 March 2020 and subsequent resolutions given statutory effect under the Provisional Collection of Taxes Act 1968, for the financial years 2020 and 2021 the UK statutory rate is 19%. Had this change in rate been effective at the balance sheet date for 2020 and subsequent years, due to revaluation the net deferred tax asset recognised at 31 December 2019 would have been £5,425,000.

The majority of deferred tax assets are in respect of the company's foreign branches and therefore recognised at the local applicable tax rates (Italy 33%, Korea 22% and Germany 32%) and not the UK tax rates disclosed above.

22. OTHER ASSETS

All other assets relate entirely to prepayments and accrued income in the current and prior year.

23. DEPOSITS BY BANKS

	2019 £'000	2018 £'000
Financial liabilities at amortised cost		
Remaining maturity:		
• On demand or at short notice	<u>135,962</u>	<u>323,778</u>
Amounts include:		
Due to Morgan Stanley Group undertakings	<u>1,234</u>	<u>185</u>

24. CUSTOMER ACCOUNTS

	2019 £'000	2018 £'000
Financial liabilities at amortised cost		
Remaining maturity:		
• On demand or at short notice	226,594	85,952
• More than a year but not more than five years	1,104,902	986,191
	<u>1,331,496</u>	<u>1,072,143</u>
Amounts include:		
Due to Morgan Stanley Group undertakings	<u>1,327,779</u>	<u>1,057,486</u>

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****25. OTHER PAYABLES**

	2019	2018
	£'000	£'000
Financial liabilities at amortised cost		
Customer payables	2,749	5,450
Lease liabilities	2,491	-
Other payables	6,772	33,712
	<u>12,012</u>	<u>39,162</u>
Financial liabilities designated at FVPL		
Other payables	1,907	3,175
	<u>1,907</u>	<u>3,175</u>
Total other payables	<u>13,919</u>	<u>42,337</u>

26. OTHER LIABILITIES

All other liabilities relate entirely to accruals and deferred income in the current and prior year.

27. SUBORDINATED LOANS

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment Date	Interest Rate	Currency	2019	2018
				£'000	£'000
Morgan Stanley Investments (UK)	21 December 2025	SONIA plus 2.121%	GBP	<u>250,000</u>	<u>250,000</u>

All amounts outstanding under subordinated loan agreements are repayable on the repayment date. Any repayment of subordinated debt prior to contractual maturity would require mutual agreement between the Company and the lender and prior supervisory consent.

The Company has not defaulted on principal, interest or made any other breaches with respect to its subordinated loans during the year.

28. EQUITY**Ordinary share capital**

	Ordinary shares of £1 each	Ordinary shares of £1 each
	Number	£'000
Allotted and fully paid		
At 1 January and 31 December 2019	<u>340,000,000</u>	<u>340,000</u>

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled, on a show of hands, to one vote and, on a poll, one vote per share at meetings of the shareholders of the Company. All shares rank equally with regard to the Company's residual assets.

Reserves*Foreign currency revaluation reserve*

The 'Foreign currency revaluation reserve' comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations denominated in currencies other than sterling.

The Company hedges foreign exchange exposure arising from its South Korean branch operations by utilising forward foreign currency exchange contracts with another Morgan Stanley Group undertaking. See note 29 for further details.

Capital contribution reserve

The 'Capital contribution reserve' represents amounts received from the Company's former parent undertaking.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****29. NET INVESTMENT HEDGING**

As at 31 December 2019, the notional amount of the foreign exchange forward contracts designated as hedging instruments in net investment hedges of foreign exchange price risk is £171,561,000 (2018: £179,829,000). These designated instruments are presented within trading financial assets and liabilities in the statement of financial position. The carrying amount of these designated hedging instruments as at 31 December 2019 is a net asset of £1,807,000 (2018: net liability of £2,215,000), which comprises £5,117,000 of financial assets (2018: £31,000) and £3,310,000 of financial liabilities (2018: £2,246,000).

The change in the value of the spot elements of foreign exchange forward contracts which were designated in net investment hedging relationships during the period was a £13,535,000 gain (2018: £10,070,000 loss), which has been recognised in the foreign currency revaluation reserve.

The change in the value of the hedged items which were designated in net investment hedging relationships during the period was a £13,535,000 loss (2018: £9,494,000 gain). No hedge ineffectiveness arose in the period. The effects of exchange rate timing differences are recognised in the foreign currency revaluation reserve.

As at 31 December 2019, a balance of £3,465,000 loss (2018: £9,494,000 gain) in the foreign currency revaluation reserve relates to hedged items which were designated in continuing hedging relationships as at the balance sheet date. There are no amounts in the foreign currency revaluation reserve relating to hedged items for which hedge accounting is no longer applied.

No amounts were reclassified from the foreign currency revaluation reserve to the income statement in the year.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****30. EXPECTED MATURITY OF ASSETS AND LIABILITIES**

The table below shows an analysis of assets and liabilities analysed according to when they are expected to be recovered, realised or settled.

At 31 December 2019

	Less than or equal to twelve months	More than twelve months	Total
	£'000	£'000	£'000
ASSETS			
Cash and balances at central banks	122,601	-	122,601
Secured financing	1,480,900	-	1,480,900
Loans and advances to banks	131,940	-	131,940
Loans and advances to customers	99,771	80,479	180,250
Trading financial assets	3,446,503	-	3,446,503
Investment security	-	6,557	6,557
Other receivables	10,013	-	10,013
Investment in subsidiary undertaking	-	105,374	105,374
Tangible fixed assets	-	3,618	3,618
Current tax assets	3,654	-	3,654
Deferred tax assets	2,392	3,009	5,401
Other assets	445	-	445
	<u>5,298,219</u>	<u>199,037</u>	<u>5,497,256</u>
LIABILITIES			
Deposits by banks	135,962	-	135,962
Customer accounts	226,594	1,104,902	1,331,496
Secured borrowing	246,543	27,120	273,663
Trading financial liabilities	2,762,477	-	2,762,477
Other payables	12,275	1,644	13,919
Other liabilities	11,790	-	11,790
Current tax liabilities	4,047	-	4,047
Retirement benefit liability	-	557	557
Provisions for liabilities and charges	240	136	376
Subordinated loans	-	250,000	250,000
	<u>3,399,928</u>	<u>1,384,359</u>	<u>4,784,287</u>

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****30. EXPECTED MATURITY OF ASSETS AND LIABILITIES (CONTINUED)****At 31 December 2018**

	Less than or equal to twelve months	More than twelve months	Total
ASSETS	£'000	£'000	£'000
Cash and balances at central banks	15	-	15
Secured financing	1,064,266	216,367	1,280,633
Loans and advances to banks	107,412	-	107,412
Loans and advances to customers	339,472	23,641	363,113
Trading financial assets	3,290,194	-	3,290,194
Other receivables	16,071	-	16,071
Investment in subsidiary undertaking	-	105,374	105,374
Tangible fixed assets	-	898	898
Current tax assets	5,844	-	5,844
Deferred tax assets	2,693	5,903	8,596
Other assets	555	-	555
	<u>4,826,522</u>	<u>352,183</u>	<u>5,178,705</u>
LIABILITIES			
Deposits by banks	323,778	-	323,778
Customer accounts	85,952	986,191	1,072,143
Secured borrowing	14,317	244,014	258,331
Trading financial liabilities	2,528,574	-	2,528,574
Current tax liabilities	14,560	-	14,560
Other payables	42,337	-	42,337
Other liabilities	14,202	-	14,202
Retirement benefit liability	-	429	429
Provisions for liabilities and charges	-	158	158
Subordinated loans	-	250,000	250,000
	<u>3,023,720</u>	<u>1,480,792</u>	<u>4,504,512</u>

Total financial liabilities of £250,000,000 (2018: £250,000,000), included in the above, fall due for payment after more than five years from the reporting date. Of this, £nil (2018: £nil) is payable by instalments.

Included within 'Customer accounts' are amounts of £128,075,000 (2018: £62,144,000) representing cash collateral received as security for open trading positions held with other Morgan Stanley Group undertakings.

31. SEGMENT REPORTING

Segment information is presented in respect of the Company's business and geographical segments.

Business segments

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

The Company has one reportable business segment, Institutional Securities, which provides sales and trading and other services to corporations, governments and financial institutions. Sales and trading services include sales, financing and market-making activities in fixed income products, including foreign exchange, credit and commodities. Other services include corporate lending activities.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****31. SEGMENT REPORTING (CONTINUED)****Geographical segments**

The Company operates in two geographic regions as listed below:

- EMEA
- Asia

The following table presents selected income statement information by geographic area. The revenues net of loan losses presented below is based on the origin of the income, which is not materially different to the revenues based on the destination of income.

31 December 2019	EMEA £'000	Asia £'000	Total £'000
External revenues net of loan losses	<u>114,423</u>	<u>13,879</u>	<u>128,302</u>
31 December 2018	EMEA £'000	Asia £'000	Total £'000
External revenues net of loan losses	<u>105,556</u>	<u>14,153</u>	<u>119,709</u>

32. COMMITMENTS

At 31 December, the Company had the following outstanding commitments from off-balance sheet financial instruments:

<i>Commitments ⁽¹⁾</i>	2019 £'000	2018 £'000
Letters of credit	99,391	1,708
Undrawn loan commitments due to expire:		
- On demand or at short notice	194,727	-
- More than three months but not more than one year	704,182	366,416
- More than one year but not more than five years	2,833,776	2,407,814
- More than five years	149,585	65,728
	<u>3,882,270</u>	<u>2,839,958</u>
Loans pending settlement	239,303	505,368
	<u>4,220,964</u>	<u>3,347,034</u>

⁽¹⁾ On balance sheet commitments include undrawn loan commitments and letters of credit designated at fair value and loans pending settlement.

Letters of credit and loan commitments

The above amounts represent the maximum amount that the Company could have to pay. The Company does not expect that all of the cash flows associated with loan commitments and letters of credit will be required. At 31 December 2019, the Company had £2,936,959,000 (2018: £1,810,660,000) of undrawn loan commitments which were sub-participated to another Morgan Stanley Group undertaking. The Company also sub-participated £79,458,000 (2018: £1,708,000) of letters of credit to another Morgan Stanley undertaking at 31 December 2019.

Loans pending settlement

The above amount represents the value of loan purchases which have been entered into before year end (trade date), but which will not be recognised in the balance sheet until settlement date, which is after year end.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

33. LEASES

Leases

The Company's leases are primarily real estate leases. The firm has made the election to include the non-lease component when computing the ROU asset and liability.

Extension and termination options

Certain real estate leases contain extension and termination options to provide additional operational flexibility. Extension and termination options that are at the option of the lessee are included in the assessment of the lease term where the extensions are considered reasonably certain of being exercised or where termination options are considered reasonably certain not to be exercised. Where the option is controlled by the lessor, the lease term assumes that extension options will be exercised and that termination options will not be exercised.

Lessee disclosures

The Statement of Financial Position includes ROU assets within 'Tangible fixed assets' (note 19) and lease liabilities within 'Other payables' (note 25).

The Income Statement includes depreciation of right-of-use assets within 'Depreciation of tangible fixed assets' and interest expense on lease liabilities within 'Interest payable and similar charges' (note 5).

The total cash outflow relating to leases was £893,000 during the year.

Maturity analysis of lease liabilities

The following table represents lease liabilities analysed according to their earliest contractual maturity.

	On demand £'000	Less than 1 month £'000	1 month - 3 months £'000	3 months - 1 year £'000	1 year - 5 years £'000	Greater than 5 years £'000	Total £'000
31 December 2019							
Lease liabilities	-	79	157	650	1,644	-	2,530

34. FINANCIAL RISK MANAGEMENT

Significant risks faced by the Company resulting from its trading, financing and investment activities are set out below.

Credit risk

Credit risk management

The Company may incur credit risk in its Institutional Securities business segment through a variety of activities, including but not limited to, the following:

- entering into derivative contracts under which counterparties have obligations to make payments to the Company;
- extending credit to clients through lending commitments;
- providing short or long-term funding that is secured by physical or financial collateral whose value may at times be insufficient to fully cover the repayment amount;
- posting margin and / or collateral to banks, securities firms and other financial counterparties;
- placing funds on deposit at other financial institutions to support the Company's settlement obligations; and
- investing or trading in securities and loan pools, whereby the value of these assets may fluctuate based on realised or expected defaults on the underlying obligations or loans.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Monitoring and Control

In order to help protect the Company from losses, the Credit Risk Management Department establishes firm-wide practices to evaluate, monitor and control credit risk at the transaction, obligor and portfolio levels. The Credit Risk Management Department approves extensions of credit, evaluates the creditworthiness of the Company's counterparties and borrowers on a regular basis, and helps ensure that credit exposure is actively monitored and managed. The evaluation of counterparties and borrowers includes an assessment of the probability that an obligor will default on its financial obligations and any subsequent losses that may occur when an obligor defaults. In addition, credit risk exposure is actively managed by credit professionals and committees within the Credit Risk Management Department and through various risk committees, whose membership includes individuals from the Credit Risk Management Department.

A Credit Limits Framework is also utilised to manage credit risk levels across the Company. The Credit Limits Framework is calibrated within the Company's risk tolerance and includes single-name limits and portfolio concentration limits by country and industry. The Credit Risk Management Department helps ensure timely and transparent communication of material credit risks, compliance with established limits and escalation of risk concentrations to appropriate senior management.

The Credit Risk Management Department also works closely with the Market Risk Department ("MRD") and applicable business units to monitor risk exposures and to perform stress tests to identify, analyse and control credit risk concentrations arising from the Company's lending and trading activities. The stress tests shock market factors (e.g. interest rates, commodity prices, credit spreads), risk parameters (e.g. default probabilities and LGD), in order to assess the impact of stresses on exposures, profit and loss, and the Company's capital position. Stress tests are conducted in accordance with established Company policies and procedures.

Credit Evaluation

The evaluation of corporate and institutional counterparties includes assigning obligor credit ratings, which reflect an assessment of an obligor's PD and LGD. An obligor credit rating can be categorised into Investment grade, Non-investment grade and Default. Credit evaluations typically involve the assessment of financial statements, leverage, liquidity, capital strength, asset composition and quality, market capitalisation, access to capital markets, the adequacy of collateral, if applicable, and in the case of certain loans, cash flow projections and debt service requirements. The Credit Risk Management Department also evaluates strategy, market position, industry dynamics, management and other factors that could affect the obligor's risk profile. Additionally, the Credit Risk Management Department evaluates the relative position of the Company's exposure in the borrower's capital structure and relative recovery prospects, as well as adequacy of collateral (if applicable) and other structural elements of the particular transaction.

In addition to assessing and monitoring its credit exposure and risk at the individual obligor level, the Company also reviews its credit exposure and risk to geographic regions. As at 31 December 2019, credit exposure was concentrated in Western European countries. Sovereign ceiling ratings i.e. the maximum credit rating that can be assigned to a counterparty with a designated country of risk are derived using methodologies generally consistent with those employed by external rating agencies.

The Company also reviews its credit exposure and risk to certain types of customers. As at 31 December 2019, the Company's material credit exposures were to corporate entities and financial institutions, and to a lesser extent, sovereign-related entities.

Risk Mitigation

The Company employs a range of policies and practices to mitigate credit risk, the most common being acceptance of collateral for funds advanced. The main types of collateral held are cash or similar highly-liquid assets. The Company has internal policies on the acceptability of specific classes of collateral or credit risk mitigation. The Company closely monitors collateral held for financial assets considered to be credit-impaired, as in such cases it is considered more likely that the Company will take possession of collateral to mitigate potential credit losses. The Company does not hold financial assets considered to be credit-impaired in the current or prior year.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Risk Mitigation (continued)

Loans and advances – external counterparties

In connection with certain of its Institutional Securities business segment activities, the Company provides short- and long-term funding to a diverse group of corporate and other institutional clients through loans or lending commitments (including bridge financing). Such loans and lending commitments can generally be classified as either “relationship-driven” or “event-driven”. These loans and lending commitments may have varying terms; may be senior or subordinated; may be secured or unsecured; are generally contingent upon representations, warranties and contractual conditions applicable to the borrower; and may be syndicated, traded or pledged by the Company.

The Company’s corporate lending credit exposure is primarily from loans and lending commitments used for general corporate purposes, working capital and liquidity purposes and typically consists of revolving lines of credit, letter of credit facilities and term loans. Event-driven loans and lending commitments refer to activities associated with a particular event or transaction, such as to support client merger, acquisition or recapitalisation activities. These loans are typically syndicated or sold to third party institutional investors, and consist of term loans and bridge loans.

Typically, relationship-driven loans and commitments are made to borrowers considered to be of high credit quality, and as such, are generally unsecured. Event-driven loans are typically secured by the assets of the borrower, ordinarily in the form of unquoted equity securities, or non-current or non-financial assets in the funded entity. Such security provides the Company with the ability to liquidate the security in the event of borrower default.

To manage the credit risk of its lending portfolio, the Company uses judgement and statistical tools and models to derive counterparty ratings and internal credit risk measures. The rating process typically includes analysis of the borrower’s financial statements, evaluation of its market position, strategy, management, legal and environmental issues, and consideration of industry dynamics affecting its performance. Other internal credit risk measures used and monitored by the Company include:

- PD: from assessing the credit quality of the borrower;
- EAD: an estimate of what the outstanding balance will be if the borrower does default; and
- LGD: an estimate of the value of the unrecovered portion of the loan, including expected recovery costs, should the borrower default.

Loans and advances – Morgan Stanley Group undertakings

The Company also provides funding to other Morgan Stanley Group subsidiaries. In connection with the master loan agreement between the Company and Morgan Stanley, Morgan Stanley provides a guarantee over any funding provided by the Company to other Morgan Stanley Group subsidiaries up to a limit of USD 5,000,000,000.

Derivatives

The Company may seek to mitigate credit risk from its derivative activities in multiple ways, including collateral provisions, guarantees and hedges. At the transaction level, the Company seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Company actively hedges its exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. The Company generally enters into master netting agreements and collateral arrangements with counterparties. These agreements provide the Company with the ability to demand collateral, as well as to liquidate collateral and offset receivables and payables covered under the same master netting agreement in the event of counterparty default. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Risk Mitigation (continued)

Reverse repurchase agreements

The Company manages credit exposure arising from reverse repurchase agreements transactions by, in appropriate circumstances, entering into master netting agreements with counterparties that provide the Company, in the event of a counterparty default with the right to net a counterparty's rights and obligations under such agreement and liquidate and set off collateral held by the Company against the net amount owed by the counterparty. Under these reverse repurchase agreements transactions, the Company receives collateral, including sovereign government securities. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to be provided under the applicable agreement to ensure such transactions are adequately collateralised.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Company as at 31 December 2019 is disclosed in the following page based on the carrying amounts of the financial assets and the maximum amount that the Company could have to pay in relation to unrecognised financial instruments, which the Company believes are subject to credit risk. The table includes financial instruments subject to ECL and not subject to ECL. Those financial instruments that bear credit risk but are not subject to ECL are subsequently measured at fair value. Exposure arising from financial instruments not recognised on the statement of financial position is measured as the maximum amount that the Company could have to pay, which may be significantly greater than the amount that would be recognised as a liability.

Where the Company enters into credit enhancements, including receiving cash and security as collateral, master netting agreements and financial guarantees, to manage the credit exposure on these financial instruments, the financial effect of the credit enhancements is also disclosed below. The net credit exposure represents the credit exposure remaining after the effect of the credit enhancements.

The "unrated" balance in 'Maximum exposure to credit risk by credit rating' represents the pool of counterparties that either do not require a rating or are under review in accordance with the Morgan Stanley Group's rating policies. These counterparties individually generate no material credit exposure and this pool is highly diversified, monitored and subject to limits.

Trading financial assets, excluding derivatives, are subject to traded credit risk through exposure to the issuer of the financial asset; the Company manages this issuer credit risk through its market risk management infrastructure and this traded credit risk is incorporated within the VaR based risk measures included in the market risk disclosure.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

	Gross credit exposure ⁽¹⁾ £'000	2019 Credit enhancements £'000	Net credit exposure £'000	Gross credit exposure ⁽¹⁾ £'000	2018 Credit enhancements £'000	Net credit exposure £'000
Subject to ECL:						
Cash and balances at central banks	122,601	-	122,601	15	-	15
Loans and advances to banks						
- External counterparties	131,145	-	131,145	106,124	-	106,124
- Morgan Stanley Group undertakings	795	(795)	-	1,288	(1,288)	-
Loans and advances to customers						
- External counterparties ⁽²⁾	28,437	-	28,437	31,845	-	31,845
- Morgan Stanley Group undertakings	84,642	(84,642)	-	325,693	(325,693)	-
Other receivables	10,013	-	10,013	16,071	-	16,071
Not subject to ECL ⁽⁴⁾:						
Secured financing						
- Morgan Stanley Group undertakings	1,480,900	(1,480,900)	-	1,280,633	(1,280,633)	-
Loans and advances to customers						
- External counterparties ⁽²⁾	67,171	-	67,171	5,575	-	5,575
Trading financial assets						
- Derivatives	2,735,390	(2,708,712)	26,678	2,531,968	(2,479,072)	52,896
	4,661,094	(4,275,049)	386,045	4,299,212	(4,086,686)	212,526
Unrecognised financial instruments						
Subject to ECL:						
Loan commitments ⁽³⁾	1,081,069	(429,418)	651,651	1,022,542	(210,175)	812,367
Letters of credit	98,382	(78,449)	19,933	683	(683)	-
Not subject to ECL ⁽⁵⁾:						
Loan commitments ⁽³⁾ :	2,801,191	(2,630,886)	170,305	1,817,387	(1,783,925)	33,462
Letters of credit	1,009	(1,009)	-	1,025	(1,025)	-
	8,642,745	(7,414,811)	1,227,934	7,140,849	(6,082,494)	1,058,355

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

⁽²⁾ Includes gross credit exposure of £24,323,000 (2018: £21,989,000) on secured loans. The value of security has not been included as a credit enhancement.

⁽³⁾ Includes gross credit exposure of £24,273,000 (2018: £1,051,000) on secured loan commitments. The value of security has not been included as a credit enhancement.

⁽⁴⁾ Financial assets measured at FVPL are not subject to ECL.

⁽⁵⁾ Loan commitments measured at FVPL are not subject to ECL.

Exposure to credit risk by internal rating grades

Internal credit ratings are derived using methodologies generally consistent with those used by external agencies.

Investment grade: AAA - BBB

Non-investment grade: BB - CCC

Default: D

The table below shows the gross carrying amount and, in the case of unrecognised financial instruments, nominal amounts by internal rating grade. All exposures subject to ECL are Stage 1, unless otherwise shown.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by internal rating grades (continued)

Until 31 December 2018, unless credit-impaired, the Company had reported all trade receivables as stage 2 for the purpose of the disclosure below, reflecting the Company's accounting policy to measure lifetime credit losses on trade receivables under the simplified approach. From 1 January 2019, the Company has continued to apply the simplified approach but, notwithstanding the recognition of lifetime credit losses under the simplified approach, has revised the presentation of these balances such that trade receivables are now reported as stage 1 where they are not credit-impaired.

The Company believes that this presentation, which is more consistent with industry practice for such disclosures, better reflects the credit risk associated with such assets, notwithstanding the fact that a lifetime approach is used for their ECL measurement and provides more relevant information. This change has also been applied to the prior year disclosure below. There is no impact on the reported level of ECLs as a consequence of this presentational change.

At 31 December 2019 in £'000	AAA	AA	A	BBB	Total Investment Grade	Non- Investment Grade	Unrated	Total Gross Carrying Amount	Loss Allowance	Total Carrying Amount
Subject to ECL:										
Cash and balances at central banks	84,642	37,959	-	-	122,601	-	-	122,601	-	122,601
Loans and advances to banks	2,827	46,262	54,714	28,129	131,932	8	-	131,940	-	131,940
Loans and advances to customers	-	8,594	83,665	7,513	99,772	13,307	-	113,079	-	113,079
Other receivables	-	1,480	3,640	110	5,230	1,353	-	6,583	-	6,583
Total subject to ECL	87,469	94,295	142,019	35,752	359,535	14,668	-	374,203	-	374,203
Not subject to ECL:										
Trading financial assets - derivatives	318,396	142,433	2,174,838	83,985	2,719,652	15,738	-	2,735,390	-	2,735,390
Secured financing	-	-	1,480,900	-	1,480,900	-	-	1,480,900	-	1,480,900
Loans and advances to customers	-	-	-	-	-	67,171	-	67,171	-	67,171
Total not subject to ECL	318,396	142,433	3,655,738	83,985	4,200,552	82,909	-	4,283,461	-	4,283,461
Unrecognised financial instruments subject to ECL:										
Loan commitments	-	64,345	646,447	285,459	996,251	84,828	-	1,081,079	(10)	1,081,069
Letters of credit	-	-	97,710	-	97,710	672	-	98,382	-	98,382
Total unrecognised financial instruments subject to ECL	-	64,345	744,157	285,459	1,093,961	85,500	-	1,179,461	(10)	1,179,451
Unrecognised financial instruments not subject to ECL:										
Loan commitments	-	423,321	891,594	877,357	2,192,272	594,753	14,166	2,801,191	-	2,801,191
Letters of credit	-	-	-	-	-	1,009	-	1,009	-	1,009
Total unrecognised financial instruments not subject to ECL	-	423,321	891,594	877,357	2,192,272	595,762	14,166	2,802,200	-	2,802,200

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by internal rating grades (continued)

At 31 December 2018 in £'000	AAA	AA	A	BBB	Total Investment Grade	Non- Investment Grade	Unrated ⁽¹⁾	Total Gross Carrying Amount	Loss Allowance	Total Carrying Amount
Subject to ECL:										
Cash and balances at central banks	-	-	15	-	15	-	-	15	-	15
Loans and advances to banks	-	952	50,031	13,258	64,241	2	-	64,243	-	64,243
Loans and advances to customers	-	13,526	325,827	114	339,467	18,066	5	357,538	-	357,538
Other receivables	-	8	5,247	146	5,401	719	9,951	16,071	-	16,071
Total subject to ECL	-	14,486	381,120	13,518	409,124	18,787	9,956	437,867	-	437,867
Not subject to ECL:										
Trading financial assets - derivatives	261,546	52,321	2,081,571	110,676	2,506,114	25,854	-	2,531,968	-	2,531,968
Secured financing	-	-	1,280,633	-	1,280,633	-	-	1,280,633	-	1,280,633
Loans and advances to customers	-	-	-	-	-	5,575	-	5,575	-	5,575
Total not subject to ECL	261,546	52,321	3,362,204	110,676	3,786,747	31,429	-	3,818,176	-	3,818,176
Unrecognised financial instruments subject to ECL:										
Loan commitments	-	68,254	386,570	493,344	948,168	74,403	-	1,022,571	(29)	1,022,542
Letters of credit	-	-	-	-	-	683	-	683	-	683
Total unrecognised financial instruments subject to ECL	-	68,254	386,570	493,344	948,168	75,086	-	1,023,254	(29)	1,023,225
Unrecognised financial instruments not subject to ECL:										
Loan commitments	-	449,039	660,753	483,974	1,593,766	204,979	18,642	1,817,387	-	1,817,387
Letters of credit	-	-	-	-	-	1,025	-	1,025	-	1,025
Total unrecognised financial instruments not subject to ECL	-	449,039	660,753	483,974	1,593,766	206,004	18,462	1,818,412	-	1,818,412

(1) For the unrated trade receivables, a lifetime ECL is always calculated without considering whether SICR has occurred.

ECL

There have been no changes made to estimation techniques or significant assumptions for estimating impairment during the year. There were no modifications to financial assets during the year or since origination and therefore modifications have not impacted ECL staging. As at 31 December 2019, there is no collateral held against credit-impaired assets (2018: nil). There are no financial assets which have been written off during the year ended 31 December 2019 (2018: nil).

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Reconciliations of gross carrying amount and ECL

	Stage 1		Stage 2		Stage 3		Total	
	Gross carrying / nominal amount	Allowance for ECL	Gross carrying / nominal amount	Allowance for ECL	Gross carrying / nominal amount	Allowance for ECL	Gross carrying / nominal amount	Allowance for ECL
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Loans and advances to customers								
As at 1 January 2019	18,065	-	-	-	-	-	18,065	-
Derecognised due to repayment	(4,052)	-	-	-	-	-	(4,052)	-
FX movements	(705)	-	-	-	-	-	(705)	-
As at 31 December 2019	13,308	-	-	-	-	-	13,308	-
As at 1 January 2018	20,797	1	487	20	-	-	21,284	21
Derecognised due to repayment or disposal	(4,002)	-	(516)	(21)	-	-	(4,518)	(21)
FX movements	1,270	-	29	-	-	-	1,299	-
Changes in credit risk	-	(1)	-	1	-	-	-	-
As at 31 December 2018	18,065	-	-	-	-	-	18,065	-
Loan commitments								
As at 1 January 2019	812,396	29	-	-	-	-	812,396	29
New loan commitments originated or purchased	363,218	3	-	-	-	-	363,218	3
Derecognised due to cancellation, maturity or refinancing of facility	(516,345)	(4)	-	-	-	-	(516,345)	(4)
FX movements	(7,608)	(1)	-	-	-	-	(7,608)	(1)
Changes in credit risk	-	(17)	-	-	-	-	-	(17)
As at 31 December 2019	651,661	10	-	-	-	-	651,661	10
As at 1 January 2018	1,075,308	38	9,465	111	-	-	1,084,773	149
New loan commitments originated or purchased	279,455	5	-	-	-	-	279,455	5
Derecognised due to cancellation, maturity or refinancing of facility	(585,213)	(9)	(10,043)	(118)	-	-	(595,256)	(127)
FX movements	42,846	-	578	-	-	-	43,424	-
Changes in credit risk	-	(5)	-	7	-	-	-	2
As at 31 December 2018	812,396	29	-	-	-	-	812,396	29
Letters of credit								
As at 1 January 2019	-	-	-	-	-	-	-	-
New letters of credit originated	21,566	-	-	-	-	-	21,566	-
FX movements	(1,633)	-	-	-	-	-	(1,633)	-
As at 31 December 2019	19,933	-	-	-	-	-	19,933	-
As at 1 January 2018	-	-	1,605	19	-	-	1,605	19
Derecognised due to cancellation	-	-	(1,703)	(20)	-	-	(1,703)	(20)
FX movements	-	-	98	-	-	-	98	-
Changes in credit risk	-	-	-	1	-	-	-	1
As at 31 December 2018	-	-	-	-	-	-	-	-

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Reconciliations of gross carrying amount and ECL (continued)

The above gross carrying amount of loans and advances to customers at amortised cost excludes £99,771,000 (2018: £339,473,000) of financial assets measured at amortised cost and therefore in scope for impairment but for which it has been assessed that the corresponding ECL is immaterial. There is also £242,263,000 (2018: £123,498,000) of other financial assets at amortised cost where the corresponding ECL is immaterial. These assessments have been based on a variety of factors including the short dated nature of the assets and a lack of historical credit losses.

The gross credit exposure of loan commitments and letters of credit at amortised cost above excludes £429,418,000 (2018: £210,175,000) and £78,449,000 (2018: £683,000) of sub participated loan commitments and letters of credit, respectively, due to the risk of double default which reduces credit exposure to a *de minimis* amount.

Liquidity risk

The Morgan Stanley Group's Liquidity Risk Management Framework is critical to helping ensure that the Company maintains sufficient liquidity reserves and durable funding sources to meet its daily obligations and to withstand unanticipated stress events. The Liquidity Risk Department is a distinct area in Risk Management, which oversees and monitors liquidity risk. The Liquidity Risk Department ensures transparency of material liquidity risks, compliance with established risk limits and escalation of risk concentrations to appropriate senior management. To execute these responsibilities, the Liquidity Risk Department:

- Establishes limits in line with the Morgan Stanley Group's risk appetite;
- Identifies and analyses emerging liquidity risks to ensure such risks are appropriately mitigated;
- Monitors and reports risk exposures against metrics and limits, and;
- Reviews the methodologies and assumptions underpinning the Morgan Stanley Group's Liquidity Stress Tests to ensure sufficient liquidity and funding under a range of adverse scenarios.

The liquidity risks identified by these processes are summarised in reports produced by the Liquidity Risk Department that are circulated to and discussed with the EMEA ALCO, EMEA Risk Committee and the MSI Risk Committee as appropriate.

The Treasury Department and applicable business units have primary responsibility for evaluating, monitoring and controlling the liquidity risks arising from the Morgan Stanley Group's business activities, and for maintaining processes and controls to manage the key risks inherent in their respective areas. The Liquidity Risk Department coordinates with the Treasury Department and these business units to help ensure a consistent and comprehensive framework for managing liquidity risk across the Morgan Stanley Group.

The Company's liquidity and funding risk management policies and procedures are consistent with those of the Morgan Stanley Group. The Board of Directors of the Company is ultimately responsible for establishing the liquidity risk tolerance and ensuring the Company's liquidity risk is appropriately managed. In addition to the internal liquidity risk management framework, the Company is locally subject to the liquidity regulations prescribed by the PRA. The Company has daily monitoring and reporting processes in place to ensure compliance with its regulatory requirements.

The following principles guide the Company's liquidity risk management framework:

- Sufficient liquid assets should be maintained to cover maturing liabilities and other planned and contingent outflows;
- Maturity profile of assets and liabilities should be aligned, with limited reliance on short-term funding;
- Source, counterparty, currency, region and term of funding should be diversified; and
- Liquidity Stress Tests should anticipate, and account for, periods of limited access to funding.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Required Liquidity Framework

The Required Liquidity Framework establishes the amount of liquidity the Company must hold in both normal and stressed environments to ensure that its financial condition and overall soundness is not adversely affected by an inability (or perceived inability) to meet its financial obligations in a timely manner. The Required Liquidity Framework considers the most constraining liquidity requirement to satisfy all regulatory and internal limits at a Morgan Stanley Group and legal entity level.

Liquidity Stress Tests

The Company uses Liquidity Stress Tests to model external and intercompany liquidity flows across multiple scenarios and a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events of different severity and duration. The methodology, implementation, production and analysis of the Company's Liquidity Stress Tests are important components of the Required Liquidity Framework.

Liquidity Stress Tests are produced for the Company to capture specific cash requirements and cash availability. The Liquidity Stress Tests assume that a legal entity will use its own liquidity first to fund its obligations before drawing liquidity from its ultimate parent undertaking, Morgan Stanley. Morgan Stanley will support its subsidiaries and will not have access to subsidiaries' liquidity reserves that are subject to any regulatory, legal or tax constraints. In addition to the assumptions underpinning the Liquidity Stress Tests, the Company takes into consideration settlement risk related to intra-day settlement and clearing of securities and financing activities.

At 31 December 2019 and 31 December 2018, the Company maintained sufficient liquidity to meet current and contingent funding obligations as modelled in its Liquidity Stress Tests.

Liquidity Reserve

The Company maintains sufficient liquidity reserves ("Liquidity Reserve") to cover daily funding needs and to meet strategic liquidity targets sized by the Required Liquidity Framework and Liquidity Stress Tests. The size of the Liquidity Reserve is actively managed by the Company considering the following components: unsecured debt maturity profile, balance sheet size and composition, funding needs in a stressed environment inclusive of contingent cash outflows and collateral requirements. In addition, the Company's Liquidity Reserve includes a discretionary surplus based on risk tolerance and is subject to change depending on market and entity-specific events. The Liquidity Reserve consists of cash and unencumbered securities sourced from trading assets, investment securities and securities received as collateral.

The Company holds its own Liquidity Reserve which is composed of diversified cash and cash equivalents and highly liquid unencumbered securities. Eligible unencumbered securities include US government securities in addition to non-US government securities.

Funding management

The Company manages its funding in a manner that reduces the risk of disruption to the Company's operations. The Company pursues a strategy of diversification of secured and unsecured funding sources (by product, investor and region) and attempts to ensure that the tenor of its liabilities equals or exceeds the expected holding period of the assets being financed.

The Company funds itself through diverse sources. These sources include the Company's equity capital, borrowings and securities sold under agreement to repurchase ("secured borrowing").

Balance sheet management

In managing both the Morgan Stanley Group's and the Company's funding risk the composition and size of the entire balance sheet, not just financial liabilities, is monitored and evaluated. The liquid nature of the marketable securities and short-term receivables arising principally from sales and trading activities in the Institutional Securities business provides the Morgan Stanley Group and the Company with flexibility in managing the composition and size of its balance sheet.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****34. FINANCIAL RISK MANAGEMENT (CONTINUED)****Liquidity risk (continued)***Maturity analysis*

In the following maturity analysis of financial liabilities, derivative contracts are presented at fair value, consistent with how these financial liabilities are managed, and disclosed on demand. All other amounts represent undiscounted cash flows payable by the Company arising from its financial liabilities to earliest contractual maturities as at 31 December 2019 and 31 December 2018. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Company to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Company.

31 December 2019	On demand £'000	Less than 1 month £'000	1 month - 3 months £'000	3 months - 1 year £'000	1 year - 5 years £'000	Greater than 5 years £'000	Total £'000
Financial liabilities							
Deposits by banks							
- External counterparties	134,728	-	-	-	-	-	134,728
- Morgan Stanley Group undertakings	1,234	-	-	-	-	-	1,234
Customer accounts							
- External counterparties	3,717	-	-	-	-	-	3,717
- Morgan Stanley Group undertakings	222,877	-	-	-	1,104,902	-	1,327,779
Secured borrowing							
- External counterparties	39,200	-	-	207,343	-	-	246,543
- Morgan Stanley Group undertakings	-	-	-	-	27,120	-	27,120
Other financial liabilities	-	11,507	157	650	1,644	-	13,958
Subordinated liabilities	-	-	-	5,894	28,308	258,046	292,248
Trading financial liabilities							
Derivatives	2,762,477	-	-	-	-	-	2,762,477
Total financial liabilities	3,164,233	11,507	157	213,887	1,161,974	258,046	4,809,804
Unrecognised financial instruments							
Letters of credit	99,391	-	-	-	-	-	99,391
Loan commitments	4,121,573	-	-	-	-	-	4,121,573
Total unrecognised financial instruments	4,220,964	-	-	-	-	-	4,220,964

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****34. FINANCIAL RISK MANAGEMENT (CONTINUED)****Liquidity risk (continued)***Maturity analysis (continued)*

	On demand £'000	Less than 1 month £'000	1 month - 3 months £'000	3 months - 1 year £'000	1 year - 5 years £'000	Greater than 5 years £'000	Total £'000
31 December 2018							
Financial liabilities							
Deposits by banks							
- External counterparties	323,593	-	-	-	-	-	323,593
- Morgan Stanley Group undertakings	185	-	-	-	-	-	185
Customer accounts							
- External counterparties	14,657	-	-	-	-	-	14,657
- Morgan Stanley Group undertakings	71,295	-	-	-	986,191	-	1,057,486
Secured borrowing							
- External counterparties	14,101	-	-	-	215,771	-	229,872
- Morgan Stanley Group undertakings	216	-	-	-	28,243	-	28,459
Other financial liabilities	-	42,337	-	-	-	-	42,337
Subordinated liabilities	-	-	-	5,854	28,208	265,089	299,151
Trading financial liabilities							
Derivatives	2,528,574	-	-	-	-	-	2,528,574
Total financial liabilities	2,952,621	42,337	-	5,854	1,258,413	265,089	4,524,314
Unrecognised financial instruments							
Letters of credit	1,708	-	-	-	-	-	1,708
Loan commitments	3,345,326	-	-	-	-	-	3,345,326
Lease commitments	-	88	177	794	518	5	1,582
Total unrecognised financial instruments	3,347,034	88	177	794	518	5	3,348,616

The Company does not expect that all of the cash flows associated with letters of credits and loan commitments will be required.

Market risk

To execute these responsibilities, the Company monitors its market risk against limits on aggregate risk exposures, performs a variety of risk analyses including monitoring VaR and stress testing analyses, routinely reports risk summaries and maintains the VaR and scenario analysis methodologies. The material risks identified by these processes are summarised and reported to senior management.

The market risk management policies and procedures for the Company are consistent with those of the Morgan Stanley Group and include escalation to the Company's Board of Directors and appropriate management personnel.

Primary market risk exposures and market risk management

During the year, the Company had exposures to a wide range of market risk factors related to the global markets in which it conducts its trading activities. These market risk factors include interest rate risk, credit spread risk, and exposure to foreign exchange rates.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

The Company is exposed to interest rate and credit spread risk as well as associated implied volatility risks, as a result of its market-making activities in interest rate or credit sensitive financial instruments (e.g. risk arising from changes in the level or implied volatility of interest rates, the timing of mortgage prepayments, the shape of the yield curve and credit spreads). The activities from which those exposures arise and the markets in which the Company is active include, but are not limited to, the following: interest rate and credit derivatives; corporate and government debt across both developed and emerging markets and asset-backed debt (including mortgage-related securities).

The Company is exposed to foreign exchange rate and implied volatility risk as a result of making markets in foreign currencies and foreign currency derivatives, from maintaining foreign exchange positions and from holding non-sterling denominated financial instruments.

The Company manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g. futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that is being hedged. The Company manages and monitors its market risk exposures, including outright and basis risks, in such a way as to maintain a portfolio that the Company believes is well-diversified in the aggregate with respect to market risk factors and that reflects the Company's aggregate risk tolerance, as established by the Company's Board of Directors. The effectiveness of hedges and mitigants is monitored using processes such as risk and limit reporting.

Aggregate market risk limits have been approved for the Company in line with the risk appetite set by the Board of Directors. Additional market risk limits are assigned, as appropriate, to trading desks, products and / or regions and are commensurate with the aggregate. The MRD monitors market risk measures against limits in accordance with policies set by the Board of Directors and senior management.

Trading Risks

The statistical technique known as VaR is one of the tools used to measure, monitor and review the market risk exposures of its trading portfolios. The MRD calculates and distributes daily VaR-based risk measures to various levels of management.

VaR methodology, assumptions and limitations

The Company calculates VaR using a model based on historical simulation for general market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. Market risk factors' daily moves are modelled either as difference changes or relative changes, dependent on the most suitable stochastic process (normal or lognormal diffusion process) to describe the daily risk factor changes. The model constructs a distribution of hypothetical daily changes in the value of trading portfolios based on: historical observation of daily changes in key market indices or other market risk factors; and information on the sensitivity of the portfolio values to these market risk factor changes.

The basic methodology for VaR at Morgan Stanley is historical simulation. A set of internal processes and controls ensure that all trading positions booked by the Company are being included in VaR. VaR for risk management purposes ("Management VaR") is computed at a 95% level of confidence over a one day time horizon, which is a useful indicator of possible trading losses resulting from adverse daily market moves. The 95% / one-day VaR corresponds to the unrealised loss in portfolio value that, based on historically observed market risk factor movements, could have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Trading Risks (continued)

VaR methodology, assumptions and limitations (continued)

The Company uses VaR as one of a range of risk management tools. Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of market risks and portfolio assets. One key feature of the VaR model is that it reflects portfolio diversification or hedging activities. However, VaR has various limitations, which include but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behaviour or reflect the historical distribution of results beyond the 95% confidence interval; and reporting of losses in a single day, which does not reflect the risk of positions that cannot be liquidated or hedged in one day. A small proportion of market risk generated by trading positions is not modelled into VaR. The modelling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures. VaR is most appropriate as a risk measure for trading positions in liquid financial markets and will understate the risk associated with severe events, such as periods of extreme illiquidity. The Company is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. This process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, quantification of risk not captured in VaR, and control at the trading desk, division, entity and Company levels.

The Company is committed to continuous review and enhancement of VaR methodologies and assumptions in order to capture evolving risks associated with changes in market structure and dynamics. As part of regular process improvement, additional systematic and name-specific risk factors may be added to improve the VaR model's ability to more accurately estimate risks to specific asset classes or industry sectors.

Since the reported VaR statistics reported below are estimates based on historical data, VaR should not be viewed as predictive of the Company's future revenues or financial performance or of its ability to manage risk. There can be no assurance that the Company's actual losses on a particular day will not exceed the VaR amounts indicated in the following paragraphs or that such losses will not occur more than five times in 100 trading days for a 95% / one-day VaR. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

VaR statistics are not readily comparable across firms because of differences in the firms' portfolios, modelling assumptions and methodologies. These differences can result in materially different VaR estimates across firms for similar portfolios. The impact of such differences varies depending on the factor history assumptions, the frequency with which the factor history is updated and the confidence level. As a result, VaR statistics are more useful when interpreted as indicators of trends in a firm's risk profile rather than as an absolute measure of risk to be compared across firms.

Sensitivity analysis

VaR for the year ended 31 December 2019

The table below presents the Management VaR for the Company's trading portfolio on a year-end, annual average and annual high and low basis for 31 December 2019 and 31 December 2018.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Trading Risks (continued)

Sensitivity analysis (continued)

95% VaR⁽¹⁾

	95% / one-day VaR 2019				95% / one-day VaR 2018			
	Period end £'000	Average £'000	High £'000	Low £'000	Period end £'000	Average £'000	High £'000	Low £'000
<i>Market risk category:</i>								
Interest rate and credit spread	934	720	1,063	532	588	617	996	439
Foreign exchange rate	28	151	678	8	190	168	550	6
Less diversification benefit ^{(2) (3)}	(31)	(138)	N/A	N/A	(153)	(150)	N/A	N/A
Primary risk categories VaR	931	733	1,062	534	625	635	1,063	450
Credit Portfolio VaR ⁽⁴⁾	134	105	374	68	100	132	261	89
Less diversification benefit ^{(2) (3)}	(96)	(93)	N/A	N/A	(86)	(126)	N/A	N/A
Total Management VaR	969	745	1,071	538	639	641	1,057	457

(1) 95% VaR is calculated over a one day time horizon in USD which is converted to GBP using daily spot GBP/USD foreign exchange rates

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

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

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

The Company's average VaR for Primary Risk Categories for 2019 was £733,000 compared with £635,000 for 2018. The increase in average VaR for Primary Risk Categories was primarily due to increased exposure to interest rate and credit spread risk.

The average Credit Portfolio VaR for 2019 was £105,000 compared with £132,000 for 2018. The decrease was driven by exposure changes during 2019.

The average total VaR for 2019 was £745,000 compared with £641,000 for 2018.

Non-Trading Risks

The Company believes that sensitivity analysis is an appropriate representation of the Company's non-trading risks. The following sensitivity analyses cover substantially all of the non-trading risk in the Company's portfolio with the exception of counterparty credit valuation adjustments, covered in the previous section.

Interest rate risk

The Company's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in market interest rates of 200 basis point increase or decrease to these positions would result in a net gain or loss of approximately £3,128,000 (2018: £3,829,000) in the income statement.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

34. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Non-Trading Risks (continued)

Currency risk

The Company has foreign currency exposure arising from its branches where those branches operate in currencies other than sterling. During 2019, the movement in the foreign currency revaluation reserve was a £828,000 gain (2018: loss of £7,318,000). The Company elects to manage some of its currency exposure via a net investment hedging program. Under this program, net gains or losses on the effective portions of the spot elements of the designated forward foreign exchange contracts are deferred to the foreign currency revaluation reserve until the disposal of the branch. See note 2 and 29 for details.

The Company also has foreign currency exposure arising from its trading activities and assets and liabilities in currencies other than sterling, which it actively manages by hedging with other Morgan Stanley Group undertakings. The residual currency risk for the Company from this activity is not material.

35. TRANSFERS OF FINANCIAL ASSETS, INCLUDING PLEDGES OF COLLATERAL

Transferred financial assets that are not derecognised in their entirety

In the ordinary course of business, the Company enters into various arrangements including selling securities under agreements to repurchase, purchasing securities under agreements to resell to, amongst other things, settle other securities obligations, accommodate customers' needs and finance the Company's inventory positions.

The Company pledges certain financial instruments to collateralise repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as trading financial instruments (pledged to various parties) in the statement of financial position. The Company has determined that it retains substantially all the risks and rewards of these financial instruments including credit risk, settlement risk, country risk and market risk, and therefore has not derecognised them. In addition, it recognises a financial liability in respect of the consideration received.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for derivative transactions or otherwise, as well as certain sales of securities with related transactions, such as derivatives, that result in the Company retaining substantially all the risks and rewards of the financial assets transferred. In addition, it recognises a financial liability in respect of the consideration received.

All of these transactions are mostly conducted under standard agreements used by financial market participants and are undertaken with counterparties subject to the Company's normal credit risk control processes. The resulting credit exposures are controlled by daily monitoring and collateralisation of the positions. The carrying amount of the associated financial liabilities related to financial assets transferred that continue to be recognised approximate the carrying amount of those transferred assets.

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes remain recognised on the statement of financial position.

	2019 £'000	2018 £'000
Trading financial assets		
Government debt securities	<u>144,652</u>	<u>129,975</u>

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

36. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Company's policy is generally to take possession of securities received as collateral and securities purchased under agreements to resell. The Company monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralised. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. These transactions are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under these arrangements as at 31 December 2019 was £1,540,355,000 (2018: £1,327,779,000). Of this amount £1,474,061,000 (2018: £1,281,291,000) has been sold or repledged to third parties in connection with financing activities.

37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING

In order to manage credit exposure arising from its business activities, the Company applies various credit risk management policies and procedures, see note 34 for further details. Primarily in connection with securities purchased under agreements to resell and securities sold under agreements to repurchase and derivative transactions, the Company enters into master netting arrangements and collateral arrangements with its counterparties. These agreements provide the Company with the right, in the ordinary course of business and / or in the event of a counterparty default (such as bankruptcy or a counterparty's failure to pay or perform), to net a counterparty's rights and obligations under such agreement and, in the event of counterparty default, set off collateral held by the Company against the net amount owed by the counterparty.

However, in certain circumstances, the Company may not have such an agreement in place; the relevant insolvency regime (which is based on type of counterparty entity and the jurisdiction of organisation of the counterparty) may not support the enforceability of the agreement; or the Company may not have sought legal advice to support the enforceability of the agreement.

The Company's policy is generally to take possession of securities purchased under agreements to resell, and to receive securities and cash posted as collateral (with rights of rehypothecation). In certain cases the Company may be permitted to post collateral to a third party custodian under a tri-party arrangement that enables the Company to take control of such collateral in the event of a counterparty default. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral as provided under the applicable agreement to ensure such transactions are adequately collateralised, or the return of excess collateral.

The risk related to a decline in the market value of collateral (pledged or received) is managed by setting appropriate market-based haircuts. Increases in collateral margin calls on secured financing due to market value declines may be mitigated by increases in collateral margin calls on securities purchased under agreements to resell and securities borrowed transactions with similar quality collateral. Additionally, the Company may request lower quality collateral pledged be replaced with higher quality collateral through collateral substitution rights in the underlying agreements.

The Company actively manages its secured financing in a manner that reduces the potential refinancing risk of secured financing for less liquid assets. The Company considers the quality of collateral when negotiating collateral eligibility with counterparties, as defined by its fundability criteria. The Company utilises shorter-term secured financing for highly liquid assets and has established longer tenor limits for less liquid assets, for which funding may be at risk in the event of a market disruption.

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

The following tables present information about the offsetting of financial instruments and related collateral amounts. The tables do not include information about financial instruments that are subject only to a collateral agreement. The effect of master netting arrangements, collateral agreements and other credit enhancements, on the Company's exposure to credit risk is disclosed in note 34.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****37. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING
(CONTINUED)**

	Gross amounts	Amounts offset ⁽¹⁾	Net amounts presented in the statement of financial position ⁽²⁾	Amounts not offset in the statement of financial position ⁽⁴⁾		Net exposure ⁽⁵⁾
	£'000	£'000	£'000	Financial instruments £'000	Cash collateral ⁽³⁾ £'000	£'000
31 December 2019						
Assets						
Secured financing:						
Reverse repurchase agreements	1,480,900	-	1,480,900	(1,480,900)	-	-
Trading financial assets:						
Derivatives	3,149,594	(414,204)	2,735,390	(2,421,469)	(287,243)	26,678
TOTAL	4,630,494	(414,204)	4,216,290	(3,902,369)	(287,243)	26,678
Liabilities						
Secured borrowing:						
Repurchase agreements and other secured borrowing	273,663	-	273,663	(267,133)	-	6,530
Trading financial liabilities:						
Derivatives	3,173,251	(410,774)	2,762,477	(2,412,723)	(228,595)	121,159
TOTAL	3,446,914	(410,774)	3,036,140	(2,679,856)	(228,595)	127,689
31 December 2018						
Assets						
Secured financing:						
Reverse repurchase agreements	1,280,633	-	1,280,633	(1,280,633)	-	-
Trading financial assets:						
Derivatives	2,531,968	-	2,531,968	(2,113,352)	(365,720)	52,896
TOTAL	3,812,601	-	3,812,601	(3,393,985)	(365,720)	52,896
Liabilities						
Secured borrowing:						
Repurchase agreements and other secured borrowing	258,331	-	258,331	(251,282)	-	7,049
Trading financial liabilities:						
Derivatives	2,528,574	-	2,528,574	(2,132,376)	(336,088)	60,110
TOTAL	2,786,905	-	2,786,905	(2,383,658)	(336,088)	67,159

(1) Amounts include £10,845,000 of cash collateral related to trading financial assets – derivatives and £7,416,000 related to trading financial liabilities – derivatives, respectively, recognised in amounts offset in the statement of financial position.

(2) Amounts include £127,000 (2018: £nil) of derivative assets, £6,530,000 (2018: £7,049,000) of securities sold under agreements to repurchase and £1,000 (2018: £nil) of derivative liabilities which are either not subject to master netting agreements or collateral agreement or are subject to such agreement but the Company has not determined the agreement to be legally enforceable.

(3) Cash collateral not offset is recognised in the statement of financial position within loans and advances to banks, loans and advances to customers, other receivables, deposits by banks and customer accounts.

(4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Company to be legally enforceable, but do not meet all criteria required for net presentation within the statement of financial position.

(5) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional £3,271,000 (2018: £1,704,000) to be offset in the ordinary course of business and / or in the event of default.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE

As disclosed in note 2 Statement of Compliance, the Company is exempt from certain disclosure requirements of IFRS 13 'Fair value measurement' to the extent that they apply to assets and liabilities other than financial instruments. As such the disclosure included in this note relates only to financial instruments.

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

The following tables present the carrying value of the Company's financial assets and financial liabilities recognised at fair value on a recurring basis, classified according to the fair value hierarchy.

2019

	Quoted prices in active market (Level 1) £'000	Valuation techniques using observable inputs (Level 2) £'000	Valuation techniques with significant unobservable inputs (Level 3) £'000	Total £'000
Trading financial assets:				
- Government debt securities	-	343,850	-	343,850
- Corporate and other debt	-	228,298	138,965	367,263
- Derivatives	-	2,537,733	197,657	2,735,390
Total trading financial assets	-	3,109,881	336,622	3,446,503
Secured financing:				
- Securities purchased under agreements to resell	-	1,480,900	-	1,480,900
Loans and advances to customers:				
- Corporate loans	-	56,103	11,068	67,171
Investment securities:				
- Corporate and other debt	-	-	2,311	2,311
- Corporate equities	-	-	4,246	4,246
Total investment securities	-	-	6,557	6,557
Total financial assets measured at fair value	-	4,646,884	354,247	5,001,131
Trading financial liabilities:				
- Derivatives	-	2,563,669	198,808	2,762,477
Total trading financial liabilities	-	2,563,669	198,808	2,762,477
Other payables:				
- Unfunded loan commitments	-	1,652	255	1,907
Total financial liabilities measured at fair value	-	2,565,321	199,063	2,764,384

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

2018

	Quoted prices in active market (Level 1) £'000	Valuation techniques using observable inputs (Level 2) £'000	Valuation techniques with significant unobservable inputs (Level 3) £'000	Total £'000
Trading financial assets:				
- Government debt securities	64,003	281,388	-	345,391
- Corporate and other debt	-	266,202	143,831	410,033
- Corporate equities	-	-	2,802	2,802
- Derivatives	-	2,438,708	93,260	2,531,968
Total trading financial assets	64,003	2,986,298	239,893	3,290,194
Secured financing:				
- Securities purchased under agreements to resell	-	1,280,633	-	1,280,633
Loans and advances to customers:				
- Corporate loans	-	-	5,575	5,575
Total financial assets measured at fair value	64,003	4,266,931	245,468	4,576,402
Trading financial liabilities:				
- Derivatives	-	2,437,517	91,057	2,528,574
Total trading financial liabilities	-	2,437,517	91,057	2,528,574
Other payables:				
- Unfunded loan commitments	-	2,827	348	3,175
Total financial liabilities measured at fair value	-	2,440,344	91,405	2,531,749

The Company's valuation approach and fair value hierarchy categorisation for certain significant classes of financial instruments recognised at fair value on a recurring basis are as follows:

Asset and Liability / Valuation Technique	Valuation Hierarchy Classification
Government debt securities	
US Treasury Securities	• Level 1
• Fair value is determined using quoted market prices	
Non-US Sovereign Government Obligations	
• Fair value is determined using quoted prices in active markets when available. When not available, quoted prices in less-active markets are used. In the absence of position-specific quoted prices, fair value may be determined through benchmarking from comparable instruments.	• Generally Level 1 • Level 2 – if the market is less active or prices are dispersed • Level 3 – in instances where the prices are unobservable

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

Asset and Liability / Valuation Technique	Valuation Hierarchy Classification
Corporate and Other Debt	
Loans and Lending Commitments	
<ul style="list-style-type: none"> Fair value of corporate loans is determined using recently executed transactions, market price quotations (where observable), implied yields from comparable debt or market observable CDS spread levels obtained from independent external parties such as vendors and brokers adjusted for any basis difference between cash and derivative instruments, along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. Fair value of contingent corporate lending commitments is determined by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of loans and lending commitments also takes into account fee income that is considered an attribute of the contract. 	<ul style="list-style-type: none"> Level 2 – if value based on observable market data for comparable instruments. Level 3 – in instances where prices or significant spread inputs are unobservable.
Corporate Equities and Equity investments	
<ul style="list-style-type: none"> Other equity investments (including direct investments in equity securities as well as various investment management funds, which include investments made in connection with certain employee deferred compensation plans) – initially, the transaction price is generally considered by the Company as the exit price and is its best estimate of fair value. After initial recognition, in determining the fair value of non-exchange-traded, internally and externally managed funds, the Company generally considers the Net Asset Value of the fund provided by the fund manager to be the best estimate of fair value. For non-exchange-traded investments either held directly or held within internally managed funds, fair value after initial recognition is based on an assessment of each underlying investment, considering rounds of financing and third-party transactions, discounted cash flow analyses and market based information, including comparable Company transactions, trading multiples and changes in market outlook, among other factors. Exchange-traded direct equity investments are generally valued based on quoted prices from the exchange. 	<ul style="list-style-type: none"> Level 3 - exchange-traded securities if not actively traded or if undergoing an aged mergers and acquisitions event or corporate action, and non-exchange-traded direct equity investments and investments in various investment management funds where round of financing or third party transactions are not available.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

Asset and Liability / Valuation Technique	Valuation Hierarchy Classification
Derivatives	
OTC Derivative Contracts (continued)	
<ul style="list-style-type: none"> OTC Derivative Contracts include forward, swap and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices or commodity prices. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modelled using a series of techniques including closed-form analytic formulas, such as the Black-Scholes option-pricing model, simulation models or a combination thereof. Many pricing models do not entail material subjectivity as the methodologies employed do not necessitate significant judgement, since model inputs may be observed from actively quoted markets, as is the case for generic interest rate swaps, many equity, commodity and foreign currency option contracts and certain credit default swaps. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. More complex OTC derivative products are typically less liquid and require more judgement in the implementation of the valuation technique since direct trading activity or quotes are unobservable. This includes certain types of interest rate derivatives with both volatility and correlation exposure, equity, commodity or foreign currency derivatives that are either longer-dated or include exposure to multiple underlyings and credit derivatives, including credit default swaps on certain mortgage or asset-backed securities, basket CDS. Where required inputs are unobservable, relationships to observable data points, based on historical and / or implied observations, may be employed as a technique to estimate the model input values. 	<ul style="list-style-type: none"> Generally Level 2 - OTC derivative products valued using observable inputs, or where the unobservable input is not deemed significant Level 3 – OTC derivative products for which the unobservable input is deemed significant
Securities purchased under agreements to resell	
<ul style="list-style-type: none"> Fair value is computed using a standard cash flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are the incremental spread over the overnight indexed swap rate for a specific collateral rate (which refers to the rate applicable to a specific type of security pledged as collateral). 	<ul style="list-style-type: none"> Generally Level 2

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

There were no material transfers between Level 1 and Level 2 of the fair value hierarchy during the current or prior year.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

The following tables present the changes in the fair value of the Company's Level 3 financial assets and financial liabilities for the years ended 31 December 2019 and 31 December 2018. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains / (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains / (losses) on hedging instruments that have been classified by the Company within the Level 1 and / or Level 2 categories.

The unrealised gains / (losses) during the year for assets and liabilities within the Level 3 category presented in the following tables herein may include changes in fair value during the period that were attributable to both observable and unobservable inputs.

The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the below table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in the Company.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

2019

	Balance at 1 January 2019	Total gains or (losses) recognised in income statement ⁽¹⁾	Purchases	Sales and issuances ⁽²⁾	Settlements	Net transfers in and / or out of Level 3 ⁽³⁾	Balance at 31 December 2019	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2019 ⁽⁴⁾
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Trading financial assets:								
-Corporate and other debt	143,831	10,869	118,198	(134,068)	-	135	138,965	5,741
-Corporate equities	2,802	-	-	(2,802)	-	-	-	-
-Net derivative contracts ⁽⁴⁾⁽⁵⁾	2,202	5,309	-	-	(9,823)	1,161	(1,151)	2,719
Total trading financial assets	148,835	16,178	118,198	(136,870)	(9,823)	1,296	137,814	8,460
Loans and advances to customers:								
-Corporate loans	5,575	(815)	9,634	(3,326)	-	-	11,068	(820)
Investment securities:								
-Corporate and other debt	-	(347)	2,802	(144)	-	-	2,311	-
-Corporate equities	-	-	4,246	-	-	-	4,246	-
Total investment securities	-	(347)	7,048	(144)	-	-	6,557	-
Total financial asset measured at fair value	154,410	15,016	134,880	(140,340)	(9,823)	1,296	155,439	7,640
Other payables:								
-Unfunded loan commitments	348	-	-	299	-	(392)	255	-
Total financial liabilities measured at fair value	348	-	-	299	-	(392)	255	-

(1) The total gains or (losses) are recognised in the income statement and the statement of comprehensive income as detailed in the financial instruments accounting policy (note 3(c)).

(2) Amounts related to corporate and other debt represents sales.

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

(4) Amounts represent unrealised gains or (losses) for the year ended 31 December 2019 related to assets and liabilities still outstanding at 31 December 2019. The unrealised gains or (losses) are recognised in the income statement or statement of comprehensive income as detailed in the financial instruments accounting policy (note 3(c)).

(5) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

During the year, the Company reclassified £135,000 (2018: £10,957,000) of corporate and other debt and £1,158,000 (2018: £nil) of net derivative contracts from Level 2 to Level 3.

During the year, the Company reclassified £nil (2018: £1,379,000) of corporate and other debt and £3,000 (2018: £1,332,000) of net derivative contracts from Level 3 to Level 2.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

2018	Balance at 1 January 2018	Total gains or (losses) recognised in income statement ⁽¹⁾	Purchases	Sales and issuances ⁽²⁾	Settlements	Net transfers in and / or out of Level 3 ⁽³⁾	Balance at 31 December 2018	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2018 ⁽⁴⁾
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Trading financial assets:								
-Corporate and other debt	90,336	5,319	110,989	(78,850)	6,459	9,578	143,831	5,639
-Corporate equities	-	2,661	15	-	126	-	2,802	2,660
-Net derivative contracts ⁽⁴⁾⁽⁵⁾	327	6,041	-	(8,429)	5,595	(1,332)	2,202	5,263
Total trading financial assets	90,663	14,021	111,004	(87,279)	12,180	8,246	148,835	13,562
Loans and advances to customers:								
-Corporate loans	-	9	5,566	-	-	-	5,575	9
Total financial asset measured at fair value	90,663	14,030	116,570	(87,279)	12,180	8,246	154,410	13,571
Other payables:								
-Unfunded loan commitments	-	315	-	-	-	33	348	315
Total financial liabilities measured at fair value	-	315	-	-	-	33	348	315

(1) The total gains or (losses) are recognised in the income statement and the statement of comprehensive income as detailed in the financial instruments accounting policy (note 3(c)).

(2) Amounts related to entering into net derivative contracts represent issuances. Amounts related to corporate and other debt represents sales.

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

(4) Amounts represent unrealised gains or (losses) for the year ended 31 December 2018 related to assets and liabilities still outstanding at 31 December 2018. The unrealised gains or (losses) are recognised in the income statement or statement of comprehensive income as detailed in the financial instruments accounting policy (note 3(c)).

(5) Net derivative contracts represent trading financial assets – derivative contracts net of trading financial liabilities – derivative contracts.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

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

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

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

The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory of financial instruments. Further, the range of unobservable inputs may differ across groups in the financial services industry because of diversity in the types of products included in each group's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs. There are no predictable relationships between multiple significant unobservable inputs attributable to a given valuation technique.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

	Fair value		Valuation techniques		Predominant valuation technique / Significant unobservable inputs		Range ⁽¹⁾		Average ⁽¹⁾	
	2019 £'000	2018 £'000	2019	2018	2019	2018	2019	2018	2019	2018
Trading financial assets:										
- Corporate and other debt:										
- Corporate loans	138,965	143,831	Comparable pricing	Comparable pricing	Comparable loan price	Comparable loan price	9 to 100 points	9 to 100 points	77.68 points	70.18 points
- Corporate equities:										
- Corporate equities	-	2,802	N/A	Comparable pricing	N/A	Comparable equity price	N/A	31%	N/A	31%
Loans and advances to customers:										
- Corporate loans	11,068	5,575	Comparable pricing	Comparable pricing	Comparable loan price	Comparable loan price	90 to 100 points	98 to 100 points	92.9 points	99.7 points
Investment securities:										
- Corporate and other debt	2,311	-	Comparable pricing	N/A	Comparable debt price	N/A	100%	N/A	100%	N/A
- Corporate equities	4,246	-	Comparable pricing	N/A	Comparable equity price	N/A	0.02 points	N/A	0.02 points	N/A
Trading financial liabilities:										
- Net derivative contracts ⁽²⁾⁽⁴⁾										
- Interest rate	(1,151)	2,202	Option Model	Option Model	Interest rate quanto correlation	Interest rate quanto correlation	-32% to 80%	-32% to 68%	Mean 25%, Median 27%	Mean 16%, Median 19%
Other payables:										
- Unfunded loan commitments	255	348	N/A	Comparable pricing	N/A	Comparable loan price	N/A	98 points	N/A	98 points

Points are a percentage of par.

(1) A single amount is disclosed for range and average when there is no significant difference between the minimum, maximum and average. Amounts represent weighted averages except where simple averages and the median of the inputs are provided when more relevant.

(2) Net derivative contracts represent trading financial assets – derivative contracts net of trading financial liabilities – derivative contracts.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

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

Significant Unobservable Inputs – Description and Sensitivity

An increase (decrease) to the following significant unobservable inputs would generally result in a higher (lower) fair value:

- Comparable loan price: A pricing input used when prices for the identical instrument are not available. Significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments. Valuation using comparable instruments can be done by calculating an implied yield (or spread over a liquid benchmark) from the price of a comparable loan, then adjusting that yield (or spread) to derive a value for the loan. The adjustment to yield (or spread) should account for relevant differences in the loans such as maturity or credit quality. Alternatively, a price-to-price basis can be assumed between the comparable instrument and loan being valued in order to establish the value of the loan.
- Comparable equity price: A price derived from equity raises, share buybacks and external bid levels, etc. A discount or premium may be included in the fair value estimate.

An increase (decrease) to the following significant unobservable inputs would generally result in an impact to the fair value. But the magnitude and direction of the impact would depend on whether the Company is long or short exposure:

- Correlation: A pricing input where the payoff is driven by more than one underlying risk. Correlation is a measure of the relationship between the movements of two variables (i.e. how the change in one variable influences a change in the other variable).

2. Sensitivity of fair values to changing significant assumptions to reasonably priced alternatives

As detailed in note 2, the valuation of Level 3 financial instruments requires the application of critical judgement, involving estimations and assumptions and it is recognised that there could be range of reasonably possible alternative values.

The Company has reviewed the unobservable parameters to identify those which would change the fair value measurement significantly if replaced by a reasonably possible alternative assumption.

In estimating the potential variability, the unobservable parameters were varied individually using statistical techniques and historic data. The potential variability estimated is likely to be greater than the actual uncertainty relating to the financial instruments as any diversification effect has been excluded.

The following table presents the potential impact of both favourable and unfavourable changes, both of which would be reflected in the income statement.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****38. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)****d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)**

	31 December 2019		31 December 2018	
	Favourable changes £'000	Unfavourable changes £'000	Favourable changes £'000	Unfavourable changes £'000
Trading financial assets:				
- Corporate and other debt	3,580	(3,467)	5,983	(5,983)
- Corporate equities	-	-	189	(189)
- Net derivative contracts ⁽¹⁾	13,810	(13,810)	-	-
Loans and advances to customers:				
- Corporate loans	238	(238)	1,084	(661)
Investment securities:				
- Corporate and other debt	185	(832)	-	-
- Corporate equities	1,931	(1,931)	-	-
Other payables:				
- Unfunded loan commitments	-	-	572	(572)
	<u>19,744</u>	<u>20,278</u>	<u>7,828</u>	<u>(7,405)</u>

(1) Net derivative contracts represent trading financial liabilities – derivative contracts net of trading financial assets – derivative contracts.

e. Financial instruments valued using unobservable market data

There are no amounts not recognised in the income statement relating to the difference between the fair value at initial recognition (the transaction price) and the amounts determined at initial recognition using valuation techniques.

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

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

39. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE

As disclosed in note 2 Statement of compliance, the Company is exempt from certain disclosure requirements of IFRS 13 to the extent that they apply to assets and liabilities other than financial instruments. As such the disclosure included in this note relates only to financial instruments.

The tables on the following page present the carrying value, fair value and fair value hierarchy category of certain financial assets and financial liabilities that are not measured at fair value in the statement of financial position.

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

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

39. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE (CONTINUED)

31 December 2019

	Carrying value	Fair value	Fair value measurement using:		
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	£'000	£'000	£'000	£'000	£'000
Financial liabilities					
Customer accounts	1,104,902	1,120,629	-	1,120,629	-
Subordinated loans	250,000	265,102	-	265,102	-

31 December 2018

	Carrying value	Fair value	Fair value measurement using:		
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	£'000	£'000	£'000	£'000	£'000
Financial liabilities					
Customer accounts	986,191	1,282,854	-	1,282,854	-
Subordinated loans	250,000	246,667	-	246,667	-

The fair value of subordinated loans has been determined based on the assumption that all subordinated loans are held to maturity.

40. CAPITAL MANAGEMENT

The MSI Group ICAAP:

- Is designed to ensure the risks to which the MSI Group is exposed are appropriately capitalised and risk managed, including those risks that are either not captured, or not fully captured under Pillar 1;
- Uses stress testing to size a capital buffer aimed at ensuring the MSI Group will continue to operate above regulatory requirements under a range of severe but plausible stress scenarios; and
- Assesses capital adequacy under normal and stressed operating environments over the 3 year capital planning horizon to ensure the MSI Group maintains a capital position in line with pre-and above post-stress minimum levels.

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

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

The capital managed by the Company broadly includes ordinary share capital, capital contributions, subordinated debt and reserves. In order to maintain or adjust its capital structure, the Company may adjust the amount of dividends paid, return capital to its shareholder, issue new shares, issue or repay subordinated debt or sell assets to reduce debt. Details of its managed capital are set out in the table below, with details of the Company's capital as measured in accordance with CRD IV rules shown within the Strategic report on pages 1 to 17.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****40. CAPITAL MANAGEMENT (CONTINUED)**

The Company manages the following items as capital:

	2019	2018
	£'000	£'000
Ordinary share capital	340,000	340,000
Capital contribution reserve	89,654	89,654
Subordinated debt	250,000	250,000
Reserves	283,315	244,539
	<u>962,969</u>	<u>924,193</u>

Pillar 3 disclosures

The Company is captured in the MSI Group Pillar 3 disclosures which allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms required by the UK implementation of Basel capital standards. The Pillar 3 disclosures for the MSI Group, which are unaudited, can be found at www.morganstanley.com/investorrelations.

Capital Requirements Country-by-Country Reporting

The Company is included in the MSI Group consolidated disclosure in order to comply with the provisions of Statutory Instrument 2013 No.3118 Capital Requirements (Country-by-Country Reporting) Regulations 2013, which implements in the UK the requirements set out in Article 89 of the Capital Requirements Directive (Directive 2013/36/EU). The MSI Group disclosures for the year ended 31 December 2019 will be made available by 31 December 2020 on the Morgan Stanley website at www.morganstanley.com/investorrelations, where the 2018 disclosure for the MSI Group can also be found.

41. PROVISIONS FOR LIABILITY CHARGES

	2019	2018
	£'000	£'000
Loan commitments issued	10	29
Provisions recognised under IAS 37	366	129
Total	<u>376</u>	<u>158</u>

Loan commitments issued

The amount in respect of the loan commitments issued represents the ECL provision. Refer to note 34 for an analysis of the movement in the ECL provision in the year.

Provisions recognised under IAS 37

The following table sets out the provisions recognised under IAS 37.

	Property	Other	Total
	£'000	£'000	£'000
At 1 January 2019	129	-	129
Additional provisions	-	240	240
Effect of unwinding discount rate	(3)	-	(3)
At 31 December 2019	<u>126</u>	<u>240</u>	<u>366</u>

Property

Property provisions represent the net present value of expected future costs of excess office space (net of expected sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Property, plant and equipment' (note 19).

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

41. PROVISIONS FOR LIABILITY CHARGES (CONTINUED)

Other provisions

Other provisions in the year represent the expected obligation relating to complaints received in respect to the Company's former credit card business, which was sold in 2007.

Litigation Liabilities

In addition to the matters described below, in the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company's business, and involving, among other matters, sales and trading activities, financial products or offerings sponsored, underwritten or sold by the Company, and accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

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

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

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

While the Company has identified below certain proceedings that the Company believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

41. PROVISIONS FOR LIABILITY CHARGES (CONTINUED)

Litigation Liabilities (continued)

On 11 October 2011, an Italian financial institution, Banco Popolare Società Cooperativa ("Banco Popolare"), filed a civil claim against the Company and another Morgan Stanley Group affiliate in the Milan courts, styled Banco Popolare Società Cooperativa v Morgan Stanley & Co. International plc & others, related to its purchase of €100 million of bonds issued by Parmalat. The claim asserted by Banco Popolare alleges, among other things, that the Company and another Morgan Stanley Group affiliate was aware of Parmalat's impending insolvency and conspired with others to deceive Banco Popolare into buying bonds by concealing both Parmalat's true financial condition and certain features of the bonds from the market and Banco Popolare. Banco Popolare seeks damages of €76 million (approximately \$85 million) plus damages for loss of opportunity and moral damages. The Company and another Morgan Stanley Group affiliate filed its answer on 20 April 2012. On 11 September 2018, the court dismissed in full the claim against the Company and another Morgan Stanley Group affiliate. On 11 March 2019, the plaintiff filed an appeal in the Court of Appeal of Milan. On 31 May 2019, the Company and another Morgan Stanley Group affiliate filed its response to the plaintiff's appeal. An appeal hearing is scheduled to take place on 16 September 2020.

42. ASSETS AND LIABILITIES DENOMINATED IN STERLING AND FOREIGN CURRENCIES

	2019 £'000	2018 £'000
Denominated in:		
Sterling	852,091	435,986
Currencies other than sterling	4,645,165	4,742,719
Total assets	5,497,256	5,178,705
Denominated in:		
Sterling	852,553	434,936
Currencies other than sterling	4,644,703	4,743,769
Total equity and liabilities	5,497,256	5,178,705

43. EMPLOYEE COMPENSATION PLANS

Morgan Stanley maintains various equity-settled share-based and cash based deferred compensation plans for the benefit of certain current and former employees.

Equity-settled share-based compensation plans

Morgan Stanley has granted RSU awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain employees' incentive compensation, with awards made in the form of restricted common stock. Awards under these plans are generally subject to vesting over time, generally six months to seven years, and are generally contingent upon continued employment and subject to restrictions on sale, transfer or assignment until conversion to common stock. All, or a portion of, an award may be cancelled if employment is terminated before the end of the relevant vesting period, and after the vesting period in certain situations. Recipients of equity-based awards may have voting rights, at Morgan Stanley's discretion, and generally receive dividend equivalents if the awards vest, unless this is prohibited by regulation.

Deferred cash-based compensation plans

Morgan Stanley has granted deferred cash-based compensation awards to certain employees which defer a portion of the employees' discretionary compensation. The plans generally provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which normally ranges from one to seven years from the date of grant. All, or a portion of, an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

MORGAN STANLEY BANK INTERNATIONAL LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2019

43. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Plans operated by fellow Morgan Stanley undertakings

As explained in note 10, the Company utilises the services of staff who are employed by other Morgan Stanley Group undertakings. Management charges are incurred in respect of these employee services which include the cost of equity-settled share based compensation plans and deferred cash-based compensation plans.

44. POST-EMPLOYMENT BENEFITS

Defined contribution plans

The Italian and South Korean Branches of the Company participate in defined contribution schemes, both of which require contributions to be made to funds held in trust, separate from the assets of the Company.

The Company pays fixed contributions to the funds, with no legal or constructive obligation to pay further contributions.

The defined contribution pension charge recognised within 'Direct staff costs' in 'Administrative expenses' in the income statement was £1,124,000 for the year (2018: £958,000) of which £138,000 was accrued at 31 December 2019 (2018: £157,000).

Defined benefit plans

The Company also operates several Morgan Stanley defined benefit plans, which provide post-employment benefits that are based on length of service and salary. The Company's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The Company operates the following defined benefit plans (the "Plans"):

- Morgan Stanley Bank International Limited – Milan Branch Leaving Indemnity Plan
- Morgan Stanley Bank International Limited – German Branch General Plan ("GP plan")
- Morgan Stanley Bank International Limited – German Branch Deferred Compensation Plan ("DCP plan")

The Milan Branch Leaving Indemnity Plan is closed to the accrual of future benefits and no further benefit has been attributed to service during the current or prior reporting period. The defined benefit obligation is an actuarial measure of the present value of benefits for service already rendered and includes no assumption for future salary increases.

The German GP plan provides post-employment benefits to members on retirement dependent on years of service and salary. The plan was open to all permanent employees of German Companies until 2013 when it was closed to new members but remained open to future accrual of benefit for existing members. The GP defined benefit obligation is an actuarial measure of the present value of benefits for service rendered and includes assumptions for salary and inflation increases.

The German DCP plan is a voluntary compensation deferral plan available to certain German employees which closed in 2005. The plan pays a lump sum upon retirement equal to the amount deferred plus a guaranteed interest rate.

The most recent full actuarial valuations of the scheme assets and the present value of the defined benefit obligation were carried out at 31 December 2019. The liabilities of the Plans are measured by discounting the best estimate of future cash flows to be paid out by the Plans using the projected unit method.

At the statement of financial position date the accumulated benefit obligation across the defined benefit plans was £779,000 (2018: £552,000).

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****44. POST-EMPLOYMENT BENEFITS (CONTINUED)****Post-employment benefit obligation**

The following table provides a summary of the present value of the defined benefit obligation and fair value of plan assets included in the statement of financial position:

	2019	2018
	£'000	£'000
Present value of funded defined benefit obligation	(78)	(68)
Fair value of plan assets	29	28
Deficit of funded defined benefit plans	(49)	(40)
Present value of unfunded obligations	(730)	(512)
Net liability	(779)	(552)

A reimbursement right asset of £306,000 (2018: £321,000) is recognised within 'Other receivables', reflecting the expectation the Company will be reimbursed under insurance policies for some of the expenditure required to settle the obligations of the German Branch General Plan.

The total defined benefit plan expense recognised in the income statement was £32,000 gain (2018: £17,000 loss). Of this expense for the year, £11,000 (2018: £11,000) has been included in 'Administrative expenses – direct staff costs' and a £43,000 gain (2018: £6,000 loss) has been included in 'Interest payable and similar charges – foreign exchange losses'. Actuarial losses of £261,000 (2018: £9,000 losses) have been recognised in the 'Statement of comprehensive income'.

Plans operated by fellow Morgan Stanley undertakings

In addition to the above, along with a number of other Morgan Stanley Group companies, the Company incurs management charges from fellow Morgan Stanley undertakings in respect of post-employment benefits provided to staff utilised by the Company but employed by other Morgan Stanley entities. These management recharges include post-employment benefit costs related to the Morgan Stanley UK Group Pension Plan ('the Plan') operated by Morgan Stanley UK Limited. The Plan is a defined contribution scheme with a closed defined benefit section.

45. RELATED PARTY DISCLOSURES**Directors' Remuneration**

The Company paid no remuneration to its Directors during the current or prior year. The charges in respect of Directors' qualifying services to the Company have been borne by another Morgan Stanley Group undertaking.

The amount of remuneration received by Directors in respect of their qualifying services to the Company is disclosed below:

	2019	2018
	£'000	£'000
Aggregate remuneration	744	965
Long-term incentive schemes	44	101
Company contributions to pension schemes	11	10
	<u>799</u>	<u>1,076</u>

Disclosures in respect of the highest paid**Director:**

Aggregate remuneration	314	306
Long-term incentive schemes	14	21
Company contributions to pension schemes	7	7

Directors' remuneration has been calculated as the sum of cash, bonuses, and benefits in kind.

MORGAN STANLEY BANK INTERNATIONAL LIMITED**NOTES TO THE FINANCIAL STATEMENTS****Year ended 31 December 2019****45. RELATED PARTY DISCLOSURES (CONTINUED)****Directors' Remuneration (continued)**

All Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group's equity-based long term incentive schemes. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares awarded, nor the gains made on exercise of share options. During the year seven Directors received restricted stock unit awards in respect of qualifying services (2018: five), including the highest paid Director in both 2018 and 2019.

The value of assets (other than shares or share options) awarded under other long-term incentive schemes has been included in the above disclosures when the awards vest, which is generally within three years from the date of the award.

Two Directors has benefits accruing under a Morgan Stanley non-UK defined benefit scheme (2018: one).

The Morgan Stanley Group operates a defined contribution pension scheme, the Morgan Stanley UK Group Pension Plan. There are four Directors to whom retirement benefits are accruing under this UK defined contribution scheme (2018: three). Two Directors have benefits accruing under a non-UK defined contribution scheme (2018: two).

The Company has not provided any loans or other credit advances to its Directors during the year (2018: £nil).

46. EVENTS AFTER THE REPORTING PERIOD

Since the balance sheet date the emergence of the coronavirus disease (COVID-19) pandemic has, and will likely continue to, severely impact global economic conditions, resulting in substantial volatility in the global financial markets and operational challenges. The extent of the impact is highly uncertain and cannot be predicted and could adversely affect the future operations and financial condition of Morgan Stanley and the Company. For further detail, refer to the 'Emergence of COVID-19' section on page 2 of the Strategic Report.