Morgan Stanley (MS) Earnings Report: Q2 2015 Conference Call Transcript

The following Morgan Stanley conference call took place on July 20, 2015, 08:30 AM ET. This is a transcript of that earnings call:

Company Participants

- Kathleen McCabe; Morgan Stanley; Head - IR
- James Gorman; Morgan Stanley; Chairman, CEO
- Jon Pruzan; Morgan Stanley; CFO

Other Participants

- Glenn Schorr; Evercore ISI; Analyst
- Brennan Hawken; UBS; Analyst
- Guy Moszkowski; Autonomous Research; Analyst
- Mike Mayo; CLSA Limited; Analyst
- Christian Bolu; Credit Suisse; Analyst
- Fiona Swaffield; RBC Capital Markets; Analyst
- Steven Chubak; Nomura Securities; Analyst
- Michael Carrier; BofA Merrill Lynch; Analyst
- Matt O'Connor; Deutsche Bank; Analyst
- Jim Mitchell; Buckingham Research; Analyst
- Matt Burnell; Wells Fargo Securities, LLC; Analyst

MANAGEMENT DISCUSSION SECTION

Kathleen McCabe (Head - IR):

Good morning. This is Kathleen McCabe, Head of Investor Relations. Welcome to our second-quarter earnings call.

Today's presentation may include forward-looking statements, which reflect management's current estimates or beliefs and are subject to risks and uncertainties that may cause actual results to differ materially. The presentation may also include certain non-GAAP financial measures.

Please see our SEC filings including this quarter's earnings release and financial supplement at www.MorganStanley.com, for a reconciliation of such non-GAAP measures to the comparable GAAP figures and for a discussion of additional risks and uncertainties that may affect the future results of Morgan Stanley .

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I will now turn the call over to Chairman and Chief Executive Officer, James Gorman.

James Gorman (Chairman, CEO):

Thank you, Kathleen. Good morning, everyone. Thank you for joining us. The second quarter was very solid across our businesses. We grew earnings year over year 34% excluding DVA and the prior-year quarter net discrete tax benefit and, as a result, delivered an ROE ex DVA of 9.1% for the quarter. We also continued to execute on our strategic plan and deliver on our stated goals.

Once again equities was a notable highlight driven by strength in cash, derivatives and prime brokerage across the globe. Banking was strong. We finished the quarter ranked number one in global IPOs and number two in announced M&A. In particular we delivered strong performance in fixed income underwriting. The pipeline remains healthy.

In fixed income and commodities we continued to deliver improving results. Our fixed strategy remains unchanged and we continued to execute on our strategic plan to reshape fixed income and commodities into a more focused business.

We have reduced balance sheet, risk-weighted assets and expenses while maintaining a client focus consistent with our strategy. We believe the recent two-notch upgrade and some of the developments in the competitive landscape may give rise to additional opportunity.

In wealth management, we remain on plan and delivered a 23% margin. Consistent with our strategy, we also completed the final stage of deposit onboarding and now have close to $140 billion of deposits. We continue to deploy those deposits as part of our bank lending strategy, an important component of our future performance and growth. Finally, in investment management we delivered a strong quarter that benefited particularly from investment gains in merchant banking and real estate investing.

As recent market volatility, particularly driven by events in Greece and China has demonstrated, the near-term landscape can change quickly. This kind of short-term volatility does not change our long-term strategy. While trading performance can, of course, vary meaningfully in the near term, the stability of our fee-based businesses gives us comfort that a large portion of our business offers us a more predictable outlook. Furthermore, given our business mix, we're overweight the US and benefit from the real and sustainable recovery that is taking place. This balance positions us to continue to deliver for our clients and our shareholders.

With that let me now turn the call over to Jon to discuss the quarter in detail.

Jon Pruzan (CFO):

Thanks, James. Good morning, everyone. I will review our quarterly financial performance and business results and then James and I will be happy to take your questions. Before I discuss the individual businesses, I will first make a few comments on our overall performance.

Revenues were $9.7 billion in the second quarter or $9.6 billion excluding DVA. Revenues are up nicely this quarter, 13% versus second quarter 2014, or 12% excluding DVA. Against that revenue backdrop, we were able to keep expenses well managed, up 5% year over year, demonstrating operating leverage in our business. The efficiency ratio was 72% in the second quarter and we remain very focused on expense management, both in terms of comp and non-comp expenses.

Our effective tax rate was approximately 33% this quarter due to our geographic mix of earnings. And, given that, we would guide you to an effective tax rate of 32% for the rest of 2015. ROE was 9.9% or 9.1% ex DVA. We saw strength across certain products and geographies but still have opportunities to improve results and we are keenly focused on our goal of delivering a sustainable 10% ROE.

Now to the businesses. Our institutional securities franchise showed resiliency in the face of more challenging markets in the second quarter. We continued to see a gradual global recovery, led by developed markets.

Not surprisingly, Europe was a softer market and we expect a continuation of muted activity and volumes in the near term. We are optimistic about growth in the US and see significant client engagement in Greater China.

Revenues were $5.2 billion or $5 billion excluding DVA, down 5% and 6% versus first quarter 2015. A significant portion of the decline is attributable to our commodities business where we saw less client engagement and lower volatility. Non-interest expense was down 3% versus the first quarter. Excluding DVA, the compensation ratio was 38% below our stated target of 39%.

In Investment Banking we remain encouraged by the level of strategic activity and have seen an increase in the velocity and size of deals. Deal activity is more diversified, the composition is more varied, and we have seen more cash deals. Buyers are willing to move unilaterally and cross border activity is up. Investor reactions to strategic transactions have been positive and this has led to nearly $2 trillion in global activity year to date.

For the quarter, revenues in investment banking were $1.4 billion, up 23% sequentially. As of June 30, Morgan Stanley ranked number one in global IPOs, number two in global announced M&A and number four in US investment grade debt. Notable transactions in the quarter include an advisory. Morgan Stanley acted as financial advisor to Time-Warner Cable on the announced acquisition by Charter Communications valued at $79 billion.

In equity underwriting, Morgan Stanley as lead left bookrunner priced Fitbit's $841 million IPO. At $841 million, Fitbit is the largest consumer electronics IPO in history. This transaction highlights Morgan Stanley's continued leadership in transformative technology IPOs.

In fixed income underwriting we acted as lead left bookrunner on AbbVie's sixth tranche $16.7 billion debt offering to finance its previously announced acquisition. We delivered related debt, equity and risk management solutions around this offering.

This transaction is a great example of our ability to deliver solutions for clients across M&A, capital markets and risk products, as well as the power of our partnership with MUFG who was involved in the initial bridge loan.

Turning to the individual businesses, advisory revenues of $423 million decreased 10% versus the first quarter, driven by a decrease in the Americas and EMEA, partially offset by increases in Asia.

Underwriting revenues were strong at $1 billion, driven by a pick up in primary equity issuance and an industry record for quarterly new issue volumes for US investment grade debt, which was aided by an uptick in M&A related financing.

Equity underwriting revenues were up 59% versus first quarter, primarily reflecting creases in follow ons, secondary sales, and IPOs. Fixed income underwriting revenues were up 34% versus a strong first quarter. The pipelines are healthy, and while the third quarter historically may be seasonally lighter for capital markets, we think longer-term positive trends remain intact.

In equity sales and trading, our global footprint continues to serve us well. We saw particular strength in Asia where we have leading market position, and cash volumes were up significantly. Performance in the US continued to be strong, led by prime brokerage and derivatives.

Equity sales and trading had another excellent quarter with $2.3 billion of revenue, driven by high levels of client activity across all products. Prime brokerage revenues increased in all regions quarter over quarter, and derivative revenues remain strong but were down off of the first quarter.

Our first-half results in equities are a testament to the strength of our equity franchise and leadership team. We believe that we have a number one global position year to date driven by our focus on clients and best-in-class execution. We are confident in our position and strategy although results will be a function of client activity and volumes.

In fixed income and commodities this quarter we further executed on our stated strategy. We remain focused on reshaping and optimizing this business as well as on efficiency in how we manage all resources. For the quarter, fixed income and commodity sales and trading revenues were $1.3 billion excluding DVA, down 33% versus the first quarter. As I noted before, a significant portion of the decline is attributable to our commodities business where we saw less client engagement and lower client activity.

We also saw declines in EMEA off of a very strong first quarter which included the benefit of the start of QE. Our rates business performed well although down from the first quarter, while the environment for our traditionally strong credit businesses remain softer. We continue to be disciplined on risk-weighted assets and ended the quarter at $157 billion of FICC RWAs.

A meaningful portion of this decline was driven by a reduction in risk as client activity decreased, while Greece dominated the headlines in the middle of June as well, as our continued passive roll off. We anticipate variability in RWAs as clients reengage and reestablish risk positions while staying below our target of $180 billion.

During the quarter, consistent with our strategy of exiting physical oil, we also announced the sale of our Global Oil Merchanting business and expect that to close later this year.

We have dramatically reshaped our business at the same time that the market and our competitors are going through significant disruption, which brings both opportunities and challenges. We have reduced headcount, balance sheet and RWAs, while remaining a full-service global fixed income partner to our top clients.

Rebuilding the business takes time but year to date we have shown progress in particular in rates and foreign exchange so there's more work to be done. Other revenues are up versus last quarter driven primarily by fees and marks on our lending and event book. Lastly, average trading VaR for the second quarter was $54 million, up slightly, driven by increased client activity and choppier markets.

Turning to wealth management, our view remains positive as the recovery further plays out in the US. We see steady performance in our business with growth coming from our bank strategy and fee-based program. Revenues for the quarter were up 1% sequentially.

Asset management revenues were up 3% from last quarter driven by higher fee-based client balances from positive flows. Global-based asset inflows were $13.9 billion, bringing total fee-based client assets to $813 billion at quarter end, representing 40% of client assets. We continue to see softness in transactional revenues which were down 8% compared to last quarter as retail investor activity has yet to increase from subdued levels.

Consistent with the execution of our US bank strategy, net interest revenue increased 7% to $737 million, driven by growth in lending and realization of the forward curve in our investment securities portfolio. Wealth management lending balances grew $4 billion or 10% from the prior quarter. Non-interest expenses were essentially flat to last quarter and the compensation ratio was 57% driven by increases in non-compensable revenues. As James mentioned in his comments, the PBT margin was 23%.

Deposits in our bank deposit program were $132 billion, down versus the first quarter reflecting seasonality. Wealth management representatives were down 1% versus the first quarter. In investment management revenues were up 12% sequentially driven by gains in the real estate and merchant banking business. And total AUM ended the quarter at $403 billion.

Turning to balance sheet and capital, total assets were $825 billion at June 30, down from $829 billion at the end of the first quarter. In the last few weeks of June, the balance sheet came down as clients took risk off due to disruptions in the market. Our global liquidity reserve at the end of the quarter was $188 billion compared with $195 billion at the end of the first quarter.

Our capital ratios continued to strengthen, reflecting our best estimates of the Federal Reserve final rules, our pro forma common equity Tier 1 ratio using the Basel III fully phased-in advanced approach with 12.5% at June 30. Pro forma fully phased-in Basel III advanced RWAs are expected to be approximately $429 billion, down from $448 billion in the first quarter.

We estimate our pro forma supplementary leverage ratio under the US final rules to be approximately 5.3% at June 30, up from 5.1% at the end of the first quarter. All of these estimates are preliminary and subject to revisions. During the second quarter we repurchased $625 million of common stock or approximately 16 million shares under our 2015 CCAR approved higher level. And our Board declared a $0.15 dividend per share.

To close my prepared remarks we saw two different quarters in 2015 in terms of market dynamics, client activity, and volatility. Our global footprint and business mix were able to deliver stable results throughout these two quarters. With that we will open up the line to questions.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Your first question comes from the line of Glenn Schorr with Evercore ISI.

Glenn Schorr (Analyst - Evercore ISI):

Hi, thanks very much. You've done well across just about every business. What I'm trying to get a feel for is how much seasonality we should think about.

I know it's always hard to answer but between Asian equities so strong and second-half usual seasonality and FICC, and the big results in merchant banking and real estate, I'm just looking for any guidance on how much of that we should expect moderating in the second half just on seasonality.

Jon Pruzan (CFO):

Great. I think, as you said, Glenn, the business was much more balanced in the first half across all of our businesses and all of our products and all of our geographies in terms of seasonality. All I would say is, from a capital markets perspective, the third quarter is usually seasonally slower but that's all I would really comment.

Glenn Schorr (Analyst - Evercore ISI):

Maybe on the merchant banking and real estate, is that a function of sales or just really good environment and having things to mark up?

Jon Pruzan (CFO):

Yes, I think as you point out in merchant banking and our real estate business we did see good principal gains in the quarter. It was a combination of both marks and distributions and it's been a good environment for monetizations here.

Glenn Schorr (Analyst - Evercore ISI):

James noted the two-notch upgrade may help in FICC. Can we talk about specifically where? And maybe also just flush out within FICC, normally your great and strong credit chop, obviously that was weaker but your results held up really well, to your point on rates and FX. Do you feel like you fully transitioned to a more balanced business?

Jon Pruzan (CFO):

There were a lot of questions in there. In terms of the Moody's upgrade, as we said we've gotten some positive feedback from our clients. We were pleased with that result.

But I wouldn't necessarily tie the upgrade to any specific level of performance in FICC. The business was much more balanced in the first half across products and geographies. You did point out that our historically strong credit businesses and SBG businesses are a little bit softer. We did see strong results across regions and rates in the first half.

The FX business was strong in the first quarter given the positive trend in volatility in the US-euro FX movements. That did come down a little bit in the second quarter as currencies traded in a tighter band and there was more muted volumes, but it was still a strong quarter for us. So, I wouldn't say that we're done here but we're clearly pleased with the progress that we made and there's more to be done.

Glenn Schorr (Analyst - Evercore ISI):

Okay, thanks so much.

Operator:

Your next question comes from the line of Brennan Hawken with UBS.

Brennan Hawken (Analyst - UBS):

Good morning. Starting out in capital markets, and Glenn touched on this a little bit, Asian strength definitely a driver again this quarter. Maybe can you help us understand how much of a tail wind that was?

And then also, given some of the volatility we've seen since the end of the second quarter, how are clients reacting to that and what's your expectation for continued strength in the region?

Jon Pruzan (CFO):

Sure. First I would comment our Asia Pacific results and business were strong across all our businesses; equities, fixed income and investment banking this quarter. We do have a diversified business not only in China but across all of Asia. So, it's not just China and it's really all products.

We did benefit from activity levels being higher in China this quarter. We did see increased volatility there but given the liberalization of the capital markets in that region we have seen significant increases in investor interest in the region. It's obviously a large and important region and has significant growth opportunities there, so we would expect that level of engagement to continue.

We saw lots of volatility in the second quarter. I would say that was more broadly dominated with some macro headlines towards the end of the year, not just in China. So we did see, as we said, risk positions come down and client engagement slow down a little bit in the back half of June and early parts of July.

I would say we have started to see some of those headlines die down and a little bit more stability and some of the volatility indexes come down, particularly in US and in Europe. So, we are starting to see some more reengagement by our clients and our investors. I would say it's a little too early to say anything about the quarter but we feel good about the client activity and the client engagement.

Brennan Hawken (Analyst - UBS):

Okay, great. Thanks for that. And then on FICC, clearly year-to-date results have bounced back nicely. What's your view on returns in that business currently? Can you give us an idea of what returns you've been generating here year to date and whether or not that is what you're hoping for in an environment like this, and how much more juice there is for continued improvement there?

Jon Pruzan (CFO):

As we've mentioned many times, we've been focused on reshaping and optimizing that business. We're clearly focused on improving the ROE in that business and we think we've made real progress here in the first half.

We think there is still more opportunity. Some of those opportunities include continuation of the balance sheet optimization strategy that we have. We are very focused also on the velocity of our balance sheet. And even though we've kept a tight lid on expenses we still think there's more to be done in that area, as well.

James Gorman (Chairman, CEO):

I would just add to that, obviously, we've done a lot of internal restructuring both in cost and in balance sheet. Clearly, we have a very focused stable team running our FICC business. We saw the two-notch upgrade from Moody's .

As Jon said, you can't draw a direct line from that to activity but at worst it's neutral and at best it's more than that. And the feedback from some clients is that over time it will be additive.

And as others have observed, in the global FICC investment banking sales trading marketplace, there's clearly more turmoil in other parts of the world than there is in the US and we think there's potential for, over a period of time, share gain for our business. We take a long view on this.

We obviously report on a quarterly basis but we don't get that excited quarter to quarter. We are more focused on how we are moving this business over a four- or five-year period, and obviously the more recent results suggest it's moving in the right direction.

Brennan Hawken (Analyst - UBS):

Agreed. And then switching gears over to wealth management, the continued grind down in comp expense, is that purely mix driven? And then as we start to see some rate tail wind here, God willing, that only continues to support the mix shift, right? And then when you think about your loan to deposit ratio it's still low. So, should we think about any change in loan growth with Citi's deposits all onboarded now?

Jon Pruzan (CFO):

I think in our wealth management business the drivers are still pretty consistent with what we've seen in prior quarters both in terms of the fee-based businesses as well as the deposit deployment and improvement in NII. We think both those trends will continue.

We have been very focused on the expense side of the equation. We've been benefiting from increasing NII and therefore non-compensable revenues. I believe the comp expense ratio came in at 57% this quarter. Our stated target is 55%, so we will continue to drive towards that target. PBT margin was 23% so that was up nicely from the second quarter.

In terms of our deposit deployment strategy and our excess liquidity in our banks, we still think that has room to play out and that will be a continuation and the primary driver of our NII growth going forward. We saw $4 billion of loan lending balances increases in the wealth management business this quarter.

We saw lending balances increase about $6 billion in totality so we had about $2 billion of growth from our institutional securities clients. And we see that trend continuing, as well. So, again, a nice steady quarter in wealth management and we would expect those trends to continue.

Brennan Hawken (Analyst - UBS):

Great. Thanks for all that color and congrats on the solid momentum.

Operator:

Your next question comes from the line of Guy Moszkowski with Autonomous.

Guy Moszkowski (Analyst - Autonomous Research):

Good morning. We hear some commentary about potential for FICC share gains. Obviously there was some press a few weeks ago about whether or not there was a strategic change. At the same time I'm looking at capital balances in institutional and they're down about a couple billion dollars this quarter.

I was wondering if you could help us understand how the two things are trading off, the potential for perhaps more FICC engagement and market share and on the other hand the decline in the capital that's allocated to the institutional securities group.

James Gorman (Chairman, CEO):

Let me just start with talking about the strategic issue and given that it was in the press and it's been raised and I tried to address it in my opening comments. It's a good example don't believe everything you read in the newspaper, and I read a lot of things in the newspaper and now knowing the facts I've learned not to believe all of them.

What is true is that we did have a two-notch upgrade. What is also true is that a number of institutions are going through a relook/restructuring of their fixed income businesses, which is obviously public.

And thirdly what is true is that we have been through that process over the last several years and feel like we have the business right sized where the risk-weighted assets have come down from, I don't know, Guy, about four years ago there were $390 billion, I think, in FICC, and we just reported somewhere close in the $160 billions. It may be even lower than that.

What we've said is the strategy is not changing. That doesn't mean we won't get more velocity on sheet. That doesn't mean we're not more efficient providers. And it doesn't mean that we won't pick up share. And it doesn't mean that as these markets continued to grow off relatively low volumes there won't be more opportunity for us on the revenue side.

We're not trying to make it more complicated than that. This was a very solid quarter, not a sensational quarter in FICC, obviously. The fact we're up year over year was important but also, to be honest, a year ago, we had a relatively light quarter. We wanted to be up and we needed to be up and we proved we could be.

Guy Moszkowski (Analyst - Autonomous Research):

Just a follow-up on the reduction in capital that's allocated currently to institutional securities. Is that as simple as what you talked about in the opening remarks, that the balance sheet was smaller at the end of the quarter and it was going to bounce around that way?

Or is there something more strategic going on with respect to, for example, run-off of some of those legacy positions that you were talking about that's driving down that FICC RWA, that's driving the almost $2 billion reduction in capital in IS?

James Gorman (Chairman, CEO):

It's certainly nothing strategic going on behind it. I'll let Jon talk about where we ended with the capital in the quarter.

Jon Pruzan (CFO):

Guy, I think your first comments were accurate regarding the balance sheet usage.

Guy Moszkowski (Analyst - Autonomous Research):

Okay, fair enough. And then just a follow-up on that. A $1 billion increase in what's allocated to wealth management, whether we look at average common equity or common equity Tier 1 linked quarter. What's driving that?

Jon Pruzan (CFO):

Again, in terms of those disclosures I think you see a couple things here. The parent is increased driven by the less segment usage, as we just talked about, plus the earnings accretion that we had. And then the mix is driven by each segment's relative contribution to the total.

Guy Moszkowski (Analyst - Autonomous Research):

Fair enough. And then just one more thing that was topical for investors during the quarter based on your 10-Q. I know you addressed it a little bit at your conference a few weeks ago. But maybe you could talk a little bit about the decline in interest rate sensitivity that was evident in your Q, the degree to which that might have reflected just a difference in asset deployment strategy, securities versus loans, whatever, and whether there are any risk management elements that we need to think about with respect to the change there.

Jon Pruzan (CFO):

Sure, I think there's a couple of different questions in there and maybe I can try to address them in two parts. First would just be our overall interest rate position and how we think about NII, and then the second part of the question really around the disclosures. Let me address the first one. As you heard from James, the onboarding of the Citi deposits came to a conclusion this quarter.

We brought on a little over $4 billion in the quarter and that program has now run its course. The NII was up nicely and we expect a continuation of that trend. The primary driver of that, as we have said before, is the deposit deployment strategy.

If you look in the supplement you'll see that our investment portfolio was down about $5 billion this quarter and our lending balances were up $6 billion. I mentioned $4 billion of that from wealth management clients and $2 billion from institutional securities clients.

That's obviously critically important because, as you'll remember from our January presentation where we laid out some illustrative asset yields, you saw that our lending products were generating 150 to 250 basis points more of yield than our AFS or cash or short-term investments. That is the primary driver of the improvements in NII.

We are also starting to see the natural run-off in our investment portfolio being reinvested in higher rates and the realization of the forward curve. That's a couple billion dollars a quarter.

And then, lastly, just on our overall interest rate positioning, our NII growth and results are in line and consistent with where we were in the beginning of the year in terms of our views. On the actual disclosure that we have in the Q, a couple comments there.

First, you should know that we don't manage to any individual rate scenario or rate shock. Instead we're trying to optimize across a range of plausible outcomes. The second comment about that disclosure, as you know it's a 12-month disclosure and we're clearly focused on a longer-term view when we think about our balance sheet and our interest rate positioning. That disclosure, as you know, is an instantaneous and parallel shock above the base case, so it is our 12-months forward NII base case.

The important thing to realize there is that our base case includes two critical things. One of them is our own, which is our deposit deployment strategy, which is the primary driver of our NII growth. And the second is we use the implied forward curve.

And today the implied forward curve has 225 basis points increases in the Fed fund rates. We have captured much of our NII expectations already in our base case. And the last point I would make is that number and that disclosure is going to move around as we manage our overall interest rate risk in the Bank.

Guy Moszkowski (Analyst - Autonomous Research):

Great, that's actually all really helpful color. I appreciate you taking the time.

Operator:

Your next question comes from the line of Mike Mayo with CLSA.

Mike Mayo (Analyst - CLSA Limited):

Hi. My first question is on wealth management. You said you have $140 billion of deposits. What's left to redeploy? And we estimate a wealth management net interest margin of 2%. What would you consider a normal NIM for that business?

Jon Pruzan (CFO):

In terms of the first part of your question, Michael, I think, as we said, the deposit deployment strategy is one of the critical strategies in wealth, and we still think that has plenty of room to play out here. We still have excess liquidity in the Bank and we will be redeploying those cash balances into the lending product for the foreseeable future. I'm sorry, the second part of the question?

Mike Mayo (Analyst - CLSA Limited):

What is your NIM in the wealth management business? We're estimating 2% but do you want to clarify that? But what do you think is a normal margin for lending in wealth management?

Jon Pruzan (CFO):

That's really a hard question. As you know, we do have an overall Bank strategy. Part of that benefit of having the Bank appears in the wealth management, part of it appears in other parts of our businesses.

That's not really how we look at it.

We're obviously focused on the overall PBT in that business which came in at 23%, which, as we said before, was up nicely and we continue to hopefully make progress in that going into the future quarters.

Mike Mayo (Analyst - CLSA Limited):

So where do you hope the 23% ratio to go over time?

Jon Pruzan (CFO):

We've stated in the beginning of the year that our target is between 22% and 25% for the year. We're obviously inside of that target and we're going to continue to try to make progress there both on the revenue side and the expense side.

Mike Mayo (Analyst - CLSA Limited):

All right. Let me switch to institutional securities. Prime brokerage you said has gone up in all regions. We lack some transparency to see some of the data underneath. Can you just give us some sense as to whether it's market share or percentage increase or really just why. We know many clients left during the crisis. Is that still a factor, people coming back? Or what's the underlying reason for that growth?

Jon Pruzan (CFO):

Listen, I think the underlying reason for the growth in all of our business is our client engagement and client activity. We've just seen a significant pick up around the world and around the globe in terms of engagement with our clients. And we're there to meet our clients' needs and that's why we've seen the growth in our balances.

Mike Mayo (Analyst - CLSA Limited):

Okay. How about just a general question -- the ROE on a core basis is 9%. And that's below some of your peers. And I know the target is to get over 10% but why is the ROE still under 10% when half of your Company is a lot more annuity-like than some of your peers. Referring to wealth management and asset management being half, your ROE is still under 10%. If you were to give the three main reasons why that's the case or why it should change what would it be?

James Gorman (Chairman, CEO):

Mike, firstly, I admire your consistency in coming back to this question every quarter, and it's obviously something which remains a focus for us. Reason number one, not to be facetious, is what our earnings are. Reason number two is what our current capital is. And reason number three is what our ability to deploy that capital back to shareholders is, as driven in large part by the CCAR process.

In short, we have a high-class problem. We're not capital short. If anything, we're capital heavy. We continue to accrete capital, as we have already this year, significantly above what our presumed pay out and buyback plans are.

So, our ability to grow ROE is both a function of the improved earnings the Firm is generating and the ability to right-size our capital base for the business mix and model that we have. Through the first half of this year I think our ROE is running at about 10% not including the first-quarter tax gain which we had.

And as we've said publicly, we believe we should be running a 10%-plus ROE business. When we get to that point we'll lay out further goals and objectives above it.

But this has obviously been -- if you look back over the last four years and you strip out some of the one-time, whether it's MBIA , whether it was Revel, whether it was the treatment of the deferred comp, whether it was some of the big litigation with Department of Justice, FHFA, you take all of those things out, essentially the last four years our ROEs have gone from 2%, 4%, 6%, 8%, pretty much in lock step.

And, as I said, the first half of this year we're running right on 10% -- 9.1% this quarter, I think 11% in the first quarter. So, nothing more to say, nothing more to project. We are as intently focused on this as you are. It's a function of controlling both the numerator and the denominator, and the denominator is a little more complicated given the regulatory world we live in, as you obviously know.

Mike Mayo (Analyst - CLSA Limited):

All right, thank you.

Operator:

Your next question comes from the line of Christian Bolu with Credit Suisse.

Christian Bolu (Analyst - Credit Suisse):

Good morning Jon, James. A couple of questions on the longer-term prospects of the wealth management business. On the comp ratio, I'd just like to get your thoughts on the competitive implications of driving the ratio below 55%.

I do appreciate a lot of that is lending related but I'd imagine some of it also includes some comp rationalization. In what is a hyper-competitive environment for advisor recruitment, does a lower comp ratio affect your ability to keep or attract high-quality advisors?

James Gorman (Chairman, CEO):

Let me deal with that because its got a long-term aspect, which obviously we think a lot about. Firstly, the reduction in the comp ratio is overwhelmingly driven by the business mix as in non-compensable revenues and by the cost structure, non-compensation expenses, that we've realized some benefits and scale coming out of the integration a couple of years ago of the Smith Barney deal.

The changes to the compensation for financial advisors and support staff, actually it's been very modest. But at the same time I would say the recruiting environment, the ins and outs, has also been very modest.

It might feel hyper-competitive because some of the wires run every time somebody moves from one firm to another, they run a story on it. But actually in the size of these firms now the competitive environment on recruiting is really pretty stable.

So, that's not what's going to be the big driver here. We're not changing the compensation model for financial advisors to drive those kinds of economics. It's really business mix and it's the scalability of the business. Once you cover your fixed costs, the margins obviously improve.

Christian Bolu (Analyst - Credit Suisse):

Interesting. Maybe just another question on that business. Advisor growth remains weak. You talked about trimming the lower-producing FAs. But I'd like to get your thoughts on maybe growing that business via another transformative M&A deal.

A number of European banks have very sub-scale presence in the US, so that looks like they could fit very well with yours. I would like to get your thoughts on maybe the appetite for another deal and any pros and cons of doing a deal.

James Gorman (Chairman, CEO):

Christian, I admire the question but we obviously wouldn't talk about deals on a call, or corporate strategy like that. But suffice to say we're very conformable with the business we've got and the size of the business. And we think the opportunity to improve margin with the business we have, particularly by building out the Bank and by organic growth within the businesses, is extremely attractive to us. We had a desire to get to scale and we are well and truly at scale so we feel good about that.

Christian Bolu (Analyst - Credit Suisse):

I appreciate that. Just wanted to get maybe pros and cons of doing a deal but I hear you. And then just one last question, on other revenues within ISG, could you quantify how much loan marks contributed to revenues there?

Jon Pruzan (CFO):

Again, I think the primary driver was the marks on the loans in the event book but I think that's where we will leave it.

Christian Bolu (Analyst - Credit Suisse):

Okay, thank you guys.

Operator:

Your next question comes from the line of Fiona Swaffield with RBC.

Fiona Swaffield (Analyst - RBC Capital Markets):

Hi. I just had a quick question following up on the fixed income risk-weighted assets. How much of the fall is due to the passive roll down happening more quickly than expected? Because I think that by the end of 2015, you were still thinking you were going to have $25 billion left to roll off. Has that changed at all?

Jon Pruzan (CFO):

I would characterize a reduction in RWAs in FICC, really, a meaningful portion of that was a decrease in client activity going into and through the Greece situation. There was some passive roll offs but it was really a mix of those two things and more geared towards the risk reduction of our clients.

Fiona Swaffield (Analyst - RBC Capital Markets):

But should we still (inaudible).

Kathleen McCabe (Head - IR):

Sorry, I think we've lost you Fiona.

Fiona Swaffield (Analyst - RBC Capital Markets):

I was just checking whether we should still take the 1, 5, 7 and assume the $25 billion could roll off from the end of 2015?

Jon Pruzan (CFO):

No. I would tell you two things. One, we've got a stated target of $180 billion of FICC RWA in that business. We're going to clearly operate within that target. The actual quarter-to-quarter RWAs is really just going to be a function of the macro backdrop client activity and supporting our clients. So, that number can move around but we're clearly going to operate within our target.

Fiona Swaffield (Analyst - RBC Capital Markets):

Okay, thanks very much.

Operator:

Your next question comes from the line of Steven Chubak with Nomura.

Steven Chubak (Analyst - Nomura Securities):

Hi, good morning. I was hoping to dig a little bit deeper into the SLR in particular. It looks like you've reduced leverage exposure by 7% since the Q1 2014 peak, so continue to make good progress there.

But just given the Fed's proposal from Friday which suggested the SLR will likely be incorporated in CCAR, I just want to get a better sense as to how much incremental SLR mitigation potential you see on the horizon, especially given the backdrop for at least the planned strategy to continue to grow Morgan Stanley Bank?

Jon Pruzan (CFO):

As you noted, the SLR did increase from the 5.1% to the 5.3%. That was a combination of both movement in the numerator and the denominator. On the numerator, we obviously had the earnings accretion from the quarter.

And on the denominator, not only did the balance sheet come down but we also made some progress on the SLR add-ons. We're clearly comfortable with that ratio where it is today. That rule doesn't go into effect until 2018. And I would tell you that we're going to continue to manage our business across all of our capital ratios and continue to remain focused on having enough capital to grow our business.

Steven Chubak (Analyst - Nomura Securities):

Okay. And as a follow-up to that, Jon, just thinking more broadly, when you look at the current regulatory landscape and the multiple constraints that you're managing to, what do you believe longer term represents Morgan Stanley's binding constraint? And how does that inform your strategy in terms of where you see opportunities to better optimize those ratios?

Jon Pruzan (CFO):

Again, it's a complex question because we have multiple ratios. Clearly in terms of capital return our binding constraint is CCAR. CCAR continues to evolve year over year. And we're going to continue to do our best to manage our capital ratio so we can return capital to our shareholders as well as continue to grow our business.

Steven Chubak (Analyst - Nomura Securities):

Okay, thanks. And just one more for me on capital. With the Fed's proposal from Friday suggesting that the advanced approach will be deferred indefinitely in CCAR, I would appreciate if you could disclose, A, the current level of standardized RWAs and, B, how we should think about the trajectory in standardized RWA in the context of some of the mitigation targets that you've laid out in the past.

Jon Pruzan (CFO):

I think we mentioned in my remarks that the advanced RWAs was about $429 billion on a preliminary basis. Standardized is pretty close to that, it's about $420 billion. We've seen those numbers converge over the last several quarters.

In terms of the proposal that was put out on Friday, clearly having clarity and simplification around some of the initiatives is very helpful. The delay in the SLR, as you said, the delay in the advanced approach as well as the removal of the Basel I test is helpful for us and positive for 2016.

We spend a lot of time and energy on CCAR, and any time there are changes, we obviously have to go through a process and model validation and pattern recognition.

So, when there are fewer changes it's easier for us just to continue running those models as we've been doing in the past. But overall I think it's too early to comment on the overall 2016 CCAR. This is, A, only a proposal and, B, we haven't seen the scenarios or the final instructions.

So, while this has been positive because it keeps the model similar to what it was last year, it's too early to comment overall on the process.

Steven Chubak (Analyst - Nomura Securities):

Understood, Jon. Appreciate you taking my questions.

Operator:

Your next question comes from the line of Michael Carrier with Bank of America Merrill Lynch.

Michael Carrier (Analyst - BofA Merrill Lynch):

Good morning. Thanks, guys. The first question just on the expenses and the operating leverage, just looking year over year I think your revenues are up around 12%, expenses up 5%, the margins are around 27%, 28%.

So when you think about going forward in a positive revenue environment, I just wanted to get an update on some of the targets that you had for the comp ratios by segment. And probably more importantly on the non-comp side because that's been fairly well managed. There's obviously been some volatility around legal in the past.

But when you think about areas where you're still working on efficiencies versus some incremental spend in the business, whether it's on growth or regulatory initiatives, just wanted to get an outlook on incremental margins in a positive revenue trending environment.

Jon Pruzan (CFO):

Sure. I think there are a couple questions there. In January, James laid out specific comp targets. There were 39% in ISG. We were at 38% for the quarter. There were 55% in wealth management. As I mentioned we were 57% in the quarter. And we laid out a target of below 40% in investment management and it's running slightly above that, I think about 41%.

Again, tightly managing compensation. On non-comp in terms of targets I'm not sure we have specific targets but we, as I said, have been very focused on non-comp expenses. We've been trying to support the business growth so the level of activity will drive that number.

Obviously the level of regulatory change will also drive that number but we've been very focused on keeping a tight lid on expenses and we'll continue to do that going forward.

James Gorman (Chairman, CEO):

And I would just add that what should be obvious to everybody is these businesses are normally scalable. Once you've covered your fixed cost you'd be hard pressed to grow your non-comp expenses absent legal, you'd be hard pressed to grow it at the pace of what the revenues grow at in the last quarter. We're going to keep that discipline.

Obviously, as Jon said, there are certain parts, like brokerage and clearing, certain marketing developments, which do go up as revenues go up. But there's a heck of a lot of it that doesn't which gives you the incremental margin is always higher than the existing margin.

Michael Carrier (Analyst - BofA Merrill Lynch):

Okay, that's helpful. And then just a quick follow-up on the wealth management business. Two things there -- on the transaction revenues, what type of an environment would you start to see that pick up?

Because it's been a couple quarters. And it hasn't been just you guys, it's been more the industry. But just wanted to get what do you think the big driver of the weakness there is.

And then second is just on the DOL proposal, the comment period is getting ready to close so just wanted to get an update on your view on some of the challenges or the opportunities if that proceeds into the back half of this year.

Jon Pruzan (CFO):

Sure. In terms of the wealth business and the transaction line, as we stated, the retail investor is still somewhat on the sidelines. I think what changes that is a function of consumer confidence, whether that's acceleration of the GDP growth, whether that's rising rates. But I think we need to see some more confidence before the retail investor totally reengages. That would be on the first question.

On the second question on DOL, you did highlight that the comment period comes to a close tomorrow. As you know, that is a complicated rule, and the comment period was actually extended until tomorrow because there's been a lot of industry dialogue and a lot written on it.

FINRA Chairman Richard Ketchum recently spoke about his idea of a single standard, so to have a single standard across all products and accounts and not treat anything differently like a 401(k) or an IRA, and we think that makes sense. Our clients clearly want choice and we would support an approach that gives our ability to deliver that choice to our clients. So, we'll see where the final rule comes out.

Michael Carrier (Analyst - BofA Merrill Lynch):

Okay, thanks a lot.

Operator:

Your next question comes from the line of Matt O'Connor with Deutsche Bank.

Matt O'Connor (Analyst - Deutsche Bank):

Good morning. Most of my questions have been answered but I had a follow-up. I think I asked it last quarter. The amount of long-term debt you have coming due the next 12 months, there's a good disclosure in here showing it's $27 billion.

But what's the difference in the long-term debt rate that's on the balance sheet versus what you get on new issuance? Obviously rates have come down, the two-notch upgrade helps. How much revenue benefit or reduction in interest expense occurs as debt rolls off and you get to reissue it at a lower rate?

Jon Pruzan (CFO):

A couple things. One, you saw in the first half we issued about $23 billion. We took advantage of some very attractive markets and we tried to front load our issuance so we would expect our issuance in the back half of the year to be lower.

In terms of the rate or the cost of that debt, I think one way I look at it is if you think about the WAM of our debt stack in 2010 was about five years. So, if I look back at 2010 to look where we were issuing debt at that time, it was on an average of about Treasury plus 210, so our credit spread is about 210 basis points over. That is a debt that is maturing today.

And our credit spreads today are closer to 120, so 2 plus 120. We are clearly getting a benefit as our more expensive debt rolls off. Recognize that roll off is not our entire debt stack. We have over $155 billion of unsecured debt and so that benefit will accrue over time but that's a magnitude for you.

Matt O'Connor (Analyst - Deutsche Bank):

Okay, thank you very much.

Operator:

Your next question comes from the line of Jim Mitchell with Buckingham Research.

Jim Mitchell (Analyst - Buckingham Research):

Hi, good morning. My question was pretty similar to Matt. If you can give us an update of where you are in your target of reducing funding costs by 25% in the context of the debt issuance conversation. Are we close? 50% of the way? Just if you can give us a sense of how much more we can expect on the lower funding costs.

Jon Pruzan (CFO):

Again, I think I tried to answer that question when Matt asked it. I would just say we continue to see a benefit. And until we run through the entire debt stack we're going to just keep getting that benefit over time quarter over quarter.

Jim Mitchell (Analyst - Buckingham Research):

But you don't want to give us, like, you're 50% of the way there, 75% of the way there?

Jon Pruzan (CFO):

Correct.

Jim Mitchell (Analyst - Buckingham Research):

Okay, thanks.

Operator:

Your next question comes from the line of Matt Burnell with Wells Fargo Securities.

Matt Burnell (Analyst - Wells Fargo Securities, LLC):

Good morning. Thanks for taking my question. Jon, maybe a question for you on the wealth management loan growth and deposit growth now that the Citi transfers are effectively done.

What are you expecting for deposit growth within the Bank? And what are you expecting for the growth rate, particularly within the retail side of the loan growth in wealth management? It's been running about 40% annualized. Other than just the fact that the denominator is growing, is there any reason to think that would slow at any point over the next 6 to 12 months?

Jon Pruzan (CFO):

Again, I'll answer that last question first. The law of large numbers, that growth rate will come down. But in terms of our FA penetration and our client penetration, it continues to improve quarter over quarter. I think we've designed some very unique products for our wealth management clients and we've had really good take up both on the SBL product as well as the mortgage product.

And I think we feel good about the growth rates that we've seen and our ability to penetrate our client base. So, so we're comfortable with the growth that we've seen and we will continue to see. Then, I'm sorry, I forgot your first question.

Matt Burnell (Analyst - Wells Fargo Securities, LLC):

Just in terms of your expectations for deposit growth now that the Citi transfers are done.

Jon Pruzan (CFO):

Yes, I mentioned we did see some seasonality for tax season in the deposit number this quarter. We still have significant excess liquidity that we're going to be deploying. I think Greg has mentioned some innovation we're doing around digital cash management and payment solutions, so we think that will be ultimately a good driver for growth.

But right now in terms of our deposit balances we have excess deposits that we can deploy without requiring deposit balance. But we're going to continue to try to penetrate our client base and grow those deposits with some new products going forward.

Matt Burnell (Analyst - Wells Fargo Securities, LLC):

Okay. And then if I can just move over to the institutional securities loan portfolio, that's actually growing, in some cases, faster than in the wealth management side of things.

But I found it interesting that the percentage of the loans that are investment grade are also growing. Can you give us a little more color as to where you're seeing opportunities within the institutional securities portfolio?

Jon Pruzan (CFO):

Sure. As I mentioned, we had about $2 billion of growth in the institutional securities balances this quarter. What we've seen certainly in some of the M&A and event financing, we've seen a shift more towards investment grade borrowers.

We've seen a pick up in strategic activity so that's a driver. I would say the growth has been balanced between our products in terms of the warehouse lending facility, as well as some of our other corporate products. But that shift in investment grade is really being driven by the event book.

Matt Burnell (Analyst - Wells Fargo Securities, LLC):

Okay, thanks very much.

Kathleen McCabe (Head - IR):

Thank you, everyone, for your time. With that, we'll bring our second-quarter earnings call to a close. And we look forward to speaking to you again next quarter.