September 30, 2025

Edward Pick
Chairman of the Board and Chief Executive Officer
Morgan Stanley
1585 Broadway
New York, New York 10036

Subject: Response to request for reconsideration of Morgan Stanley's preliminary stress capital buffer requirement, pursuant to the Board's capital plan rules

Dear Mr. Pick:

This letter is in response to the request by Morgan Stanley for reconsideration of the preliminary stress capital buffer ("SCB") requirement provided to Morgan Stanley by the Board on June 27, 2025.[1] For the reasons stated below, the Board has modified the preliminary SCB requirement previously provided to Morgan Stanley from 5.1 percent to 4.3 percent. With respect to the request for an informal hearing in connection with the request for reconsideration, the Board has not ordered an informal hearing. In connection with these actions, the Board has extended, until October 3, 2025, the deadline to provide Morgan Stanley with its final SCB requirement.

I. Background

The Board's capital plan rules establish the process for determining an SCB requirement.[2] Pursuant to the rules, the Board generally will provide a firm with notice of its preliminary SCB requirement by June 30 of each year in which the firm submits an annual

[1] The Board previously responded to Morgan Stanley in a letter from Benjamin McDonough dated September 26, 2025 ("September 26 Letter"). This letter, which makes technical corrections to the September 26 Letter, supersedes that document.

[2] 12 CFR 225.8; 12 CFR 238.170.

capital plan.[3] On June 27, the Board provided Morgan Stanley with notice of a preliminary SCB requirement for 2025 of 5.1 percent.[4]

The capital plan rules permit a firm to request reconsideration of the preliminary SCB requirement within 15 calendar days of receiving notice thereof.[5] A firm may include a request for an informal hearing on the firm's request for reconsideration.[6] Morgan Stanley requested an extension of time until July 14, 2025, to request reconsideration, and the Secretary of the Board, acting under delegated authority from the Board, granted the request.[7]

Morgan Stanley requested reconsideration of its preliminary SCB requirement on July 14, including a request for an informal hearing. The capital plan rules generally provide that the Board will notify a firm of the Board's decision to affirm or modify the firm's SCB requirement within 30 calendar days of receipt of the firm's request for reconsideration, or within 30 days of the conclusion of an informal hearing regarding such a request.[8] Morgan Stanley has requested that the Board suspend, until September 26, the time period for action by the Board under section 225.8(i)(5) of Regulation Y.[9]

In each year in which a firm submits an annual capital plan, the Board generally will provide the firm with a final SCB requirement, as well as confirmation of the firm's final planned capital distributions for that year, by August 31.[10] Due to the request for reconsideration, the Board has extended, until October 3, 2025, the deadline to provide Morgan Stanley with its final SCB requirement. Unless otherwise determined by the Board, the final planned capital distributions and final SCB requirement for a given year become effective October 1 of that year.[11] An SCB requirement that becomes effective will remain effective until superseded.[12]

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[3] 12 CFR 225.8(h)(1); 12 CFR 238.170(h)(1).

[4] See email regarding 2025 Stress Test Results (June 27, 2025).

[5] 12 CFR 225.8(h)(2)(i) and (i)(2); 12 CFR 238.170(h)(2)(i) and (i)(2).

[6] 12 CFR 225.8(i)(3)(ii); 12 CFR 238.170(i)(3)(ii).

[7] See email from Andrew Nash (Morgan Stanley) to Julie Anthony, dated July 11, 2025 (requesting an extension); see email from Julie Anthony to Andrew Nash (Morgan Stanley), dated July 14, 2025 (communicating approval of the extension by the Secretary of the Board, acting under authority delegated by the Board).

[8] 12 CFR 225.8(i)(5); 12 CFR 238.170(i)(5).

[9] See email from Andrew Nash (Morgan Stanley) to Asad Kudiya, dated September 8, 2025.

[10] 12 CFR 225.8(h)(4)(i); 12 CFR 238.170(h)(4)(i).

[11] 12 CFR 225.8(h)(4)(ii)(A); 12 CFR 238.170(h)(4)(ii)(A).

[12] 12 CFR 225.8(h)(4)(ii)(B); 12 CFR 238.170(h)(4)(ii)(B).

II. Stress Testing Framework

The SCB requirement is based, in part, on the results of a supervisory stress test conducted by the Board. Specifically, a firm's SCB requirement is the greater of 2.5 percent or the following calculation: (1) the difference between the firm's starting and minimum projected common equity tier 1 ("CET1") capital ratios under the severely adverse scenario in a supervisory stress test conducted by the Board plus (2) the sum of the dollar amount of the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon[13] as a percentage of risk-weighted assets.[14] The SCB requirement provided to Morgan Stanley on June 27 was calculated based on 2025 supervisory stress test results released by the Board.[15]

The results of the Board's supervisory stress tests are projected using a set of models developed or selected by the Federal Reserve that take as inputs (1) the supervisory scenarios created by the Federal Reserve and (2) firm-provided data on the firm's financial condition and risk characteristics. The Board has adopted two statements of policy to provide firms and the public with transparency regarding the stress tests. The Board's Scenario Design Policy Statement outlines the process through which the Board develops the macroeconomic scenarios and additional scenario components for the company-run and supervisory stress tests,[16] and the Stress Testing Policy Statement describes the principles, policies, and procedures that guide the development, implementation, and validation of the models used in the supervisory stress test.[17] Consistent with the principles described in the Stress Testing Policy Statement, the Federal Reserve designed the system of models so they would result in projections that are (1) from an independent supervisory perspective; (2) forward-looking; (3) consistent and comparable across covered companies; (4) generated from simple approaches, where appropriate; (5) robust and stable; (6) conservative; and (7) able to capture the effect of economic stress.[18]

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[13] The planning horizon is the period of at least nine consecutive quarters over which the relevant projections extend, beginning with the quarter preceding the quarter in which the firm submits its capital plan.

[14] 12 CFR 225.8(f)(2); 12 CFR 238.170(f)(2).

[15] See Board of Governors of the Federal Reserve System, *2025 Federal Reserve Stress Test Results* (June 2025), available at https://www.federalreserve.gov/publications/files/2025-dfast-results-20250627.pdf.

[16] 12 CFR part 252, Appendix A.

[17] 12 CFR part 252, Appendix B.

[18] 12 CFR part 252, Appendix B, at 1.

The Federal Reserve's models rely on detailed portfolio data provided by firms but generally do not rely on models or estimates provided by firms, consistent with the modeling principle that emphasizes an independent perspective.

The Federal Reserve generally develops its models under an industry-level approach that is calibrated using data from many financial institutions. This approach reflects modeling principles that favor models resulting in consistent, comparable, and forward-looking projections. The Federal Reserve models the response of specific portfolios and instruments to variations in macroeconomic and financial-scenario variables such that differences across firms are driven by differences in firm-specific input data, as opposed to differences in model parameters and specifications. As a result, two firms with the same portfolio receive the same results for that portfolio in the supervisory stress test, facilitating the comparability of results. In addition, the industry-level approach promotes a forward-looking stress test, as it results in models that do not assume that historical patterns will necessarily continue into the future for individual firms. These policies also help to ensure that consistent and comparable supervisory models are forward-looking, robust, and stable.[19]

III. Discussion

As required by the Board's capital plan rules, Morgan Stanley's request for reconsideration of its preliminary SCB requirement included a detailed explanation of why it contends that reconsideration should be granted.[20] Morgan Stanley also submitted supplemental information related to its reconsideration request on September 3, 2025 (the Supplement). The Board is not required to consider arguments that are not discussed in a firm's initial request for

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[19] While the Federal Reserve limits the use of firm-specific fixed effects and the use of dummy variables indicating a loan vintage or specific year, it makes exceptions where appropriate. For example, the Federal Reserve may use firm-specific indicator variables, firm-provided estimates, or third-party models or data in instances in which it is not possible or appropriate to create a supervisory model for use in the stress test, including when supervisory data are insufficient to support an independently modeled estimate of losses or revenues. However, the Federal Reserve does not adjust supervisory projections for individual firms or implement firm-specific overlays in the supervisory stress test. This policy ensures that the supervisory stress test results are determined solely by supervisory models and firm-specific input data. The Federal Reserve has instituted a policy of not using additional input data submitted by one or more of the covered companies unless comparable data can be collected from all the firms that have material exposure in a given area. 12 CFR part 252, Appendix B, at 2.8.

[20] See 12 CFR 225.8(i)(3)(i).

reconsideration.[21] In this case, the Board has evaluated the arguments in the Supplement and has discretion to consider them in its assessment of the reconsideration request.

To ensure that review of Morgan Stanley's request would be conducted with an independent perspective, a group of experts within the Federal Reserve System—who are independent of the staff responsible for developing and running the stress test models and providing firms with their preliminary SCB requirements—analyzed the arguments made by Morgan Stanley in favor of reconsideration of its preliminary SCB requirement.[22] With respect to each of the issues raised in the request by Morgan Stanley, the experts considered all aspects of the request, including, among other things, whether the request pointed to any errors in the firm's stress test results (including whether the input data to the stress test was treated appropriately) and whether each stress test model identified in the firm's request is operating as intended, within the bounds of the Board's published policies. The information in this letter regarding the Board's stress testing policies and supervisory modeling practices was previously publicly disclosed, consistent with the Board's practice to increase the transparency of the stress testing program.[23]

As discussed above, Morgan Stanley's request for reconsideration included a request for an informal hearing. The Board has determined not to grant Morgan Stanley's request for an informal hearing regarding its request for reconsideration.[24] The informal hearing process is intended to ensure that a firm is able to present its arguments to the Federal Reserve and to provide an opportunity for both the firm and the Federal Reserve to ask any questions regarding the request, including questions regarding disputed issues of material fact. Federal Reserve staff has met with representatives from Morgan Stanley several times to discuss the request for reconsideration. The firm described its arguments for reconsideration in the meetings, and both the firm and Federal Reserve staff had the opportunity to ask questions orally and in written format. In light of these circumstances and because there are no outstanding disputed issues of

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[21] See 12 CFR 225.8(i)(3)(i) (stating that a request for reconsideration must include a detailed explanation of the reasons why reconsideration should be granted).

[22] This group is composed of staff members from across the Federal Reserve System who are subject-matter experts and are not involved in supervisory modeling. This group's model validation process includes reviews of model performance; conceptual soundness; and the processes, procedures, and controls used in model development, implementation, and the production of results. See Board of Governors of the Federal Reserve System, *2025 Supervisory Stress Test Methodology* at 5–6 (June 2025), available at https://www.federalreserve.gov/publications/files/2025-june-supervisory-stress-test-methodology.pdf.

[23] See supra notes 16 and 17.

[24] See 12 CFR 225.8(i)(4)(i) (providing that the Board has sole discretion regarding whether to order an informal hearing).

material fact,[25] the Board has not ordered an informal hearing regarding Morgan Stanley's request.

In its request, Morgan Stanley argued that (1) its compensation expenses were overstated because the Federal Reserve did not sufficiently account for the mechanical decline in its variable compensation expenses during economic downturns; (2) noninterest expense projections should be adjusted downward to reflect declines in the firm's volume-driven, transaction-related expenses and discretionary spending during economic stress; (3) operational risk modeling should use firm characteristics, not firm asset size, to proxy for financial risk; (4) trading losses were double-counted in the projections of trading mark-to-market losses and PPNR [redacted]; (5) the stress test results implausibly overestimated the firm's losses in the "other losses / gains" category and inappropriately frontloaded these losses [redacted]; (6) the Federal Reserve misstated the firm's quarterly tax expense by incorrectly applying the change in valuation allowance; (7) the LCPD recovery rate, which is assumed to be 10 percent for all firms, should vary based on a firm's largest counterparty and exposure type; (8) the exclusion of private equity shocks but not private equity hedges from the GMS component in 2025 benefited firms [redacted]; (9) the Federal Reserve's use of the GMS scenario given the atypical trading positions of some firms on the GMS as-of date produced "arbitrary and capricious" results; and (10) [redacted].

In the Supplement, Morgan Stanley provided additional detail on its LCPD argument (see (7), above), arguing that the Board should apply a higher recovery rate to a firm whose largest counterparty is [redacted]. Morgan Stanley also argued for the first time that (11) the PPNR projections of wealth management and asset management revenues are inaccurately calibrated using macroeconomic variable sensitivities from industry-wide investment banking data; (12) the stress test's interest rate expense projections do not account for Morgan Stanley's floating rate liability mix, which would result in lower expenses as rates decline; (13) the Board may have overestimated trading stress losses by using an approach that may not fully capture the complexities of the underlying assets in its calculation of trading MtM losses and inappropriately including private equity positions in the projection of trading issuer default losses (IDL) despite the exclusion of private equity shocks from the GMS component; and (14) loss projections for "Other Loans" should assign *de minimis* loss rates to Morgan Stanley's [redacted].

As discussed in detail below, with respect to Morgan Stanley's fifth and seventh arguments, the Board determined that the models at issue did not function correctly to generate

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[25] See 12 CFR 225.8(i)(4).

stressed projections that appropriately reflect the firm's risk profile, warranting modifications to the firm's SCB requirement. However, with respect to Morgan Stanley's other arguments, the Board did not identify any errors in Morgan Stanley's stress test results and has determined that the models operated as intended, within the bounds of the Board's published policies.

1. *Compensation-related expenses*

Morgan Stanley argued that the Federal Reserve overstated the firm's compensation-related expenses because the PPNR model did not account for financial advisor variable compensation, deferred cash-based compensation, or carried interest compensation, all of which, the firm asserts, would decline automatically during economic downturns under the contractual terms governing these expenses.

Specifically, Morgan Stanley argued that the structure of its financial advisor variable compensation program would reduce its total compensation expenses under stress. According to the firm, these advisors, who are employed in the firm's wealth management business line, are compensated according to a standardized, fixed formula that ties compensation to identifiable revenues. Morgan Stanley argued that a severe economic downturn, as reflected in the stress test's severely adverse scenario, would reduce client asset valuations and related revenues, and thus, lead to an associated reduction in financial advisor compensation. In its 2025 projections, Morgan Stanley estimated that decreased compensation for financial advisors would result in a [redacted] reduction in its total compensation expenses. As part of the release of 2024 stress test results, the Federal Reserve had announced it would implement material model adjustments to account for the sensitivity of variable commission-based compensation to deteriorations in economic conditions and would phase in such changes over two stress test cycles, as is required for material model adjustments.[26] Morgan Stanley did not believe these adjustments were sufficient and, further, asked that any such adjustments be implemented in full for the 2025 stress test, in anticipation of implementation of the Board's proposed rulemaking to average SCB requirements over two years.

Morgan Stanley also argued that its projected compensation expenses should be lower due to the structure of its deferred cash-based compensation programs (DCPs). The firm represented that it sponsors several DCPs through which current and former employees may allocate deferred compensation awards among a preselected set of notional investments. The firm then hedges resulting market exposures through direct investments; consequently, changes in compensation expense resulting from changes in the fair value of investments are generally offset by changes in the fair value of related hedged investments in net revenues. Morgan Stanley argued that, during an economic downturn that produces declining asset values, related

[26] *2024 Supervisory Stress Test Results*, at 8.

compensation expenses would similarly decrease. The firm estimated that, for the 2025 stress test, its compensation expenses should have been approximately [redacted] lower [redacted] of the severely adverse scenario due to the structure of its DCPs.

Finally, Morgan Stanley argued that its carried interest compensation program would also result in declines in compensation expenses in adverse economic conditions. The firm stated that, as the general partner of certain investment funds, it is compensated through carried interest performance fee revenue, which is earned when fund performance exceeds a contractual performance benchmark. In turn, fund management employees at Morgan Stanley may participate in carried interest compensation plans, which determine compensation using fund-specific, formulaic percentages of carried interest revenues. Therefore, the firm asserts, during a downturn that results in declining asset valuations, the value of accrued carried interest would decrease, resulting in a corresponding decline in compensation liability. While the firm acknowledged that the Federal Reserve made changes to project losses on private equity exposures in the macroeconomic scenario, rather than the GMS component of the 2025 stress test, it argued that these changes failed to capture the offsetting reduction in related compensation liability. The firm estimated that carried interest compensation dynamics should have lowered its compensation expenses by [redacted] in the 2025 stress test.

The PPNR model was used to project Morgan Stanley's compensation-related expenses. This aspect of the PPNR model was developed using a statistical regression approach based on historic compensation behaviors across multiple firms. The approach does not account for the planned or predetermined actions of individual firms during a downturn. The estimation data does not distinguish between variable and fixed compensation expenses and includes firms with different compensation strategies and variable compensation usage. To account for potential differences in sensitivity of the variable pay cash component of compensation to the macroeconomic scenarios, an overlay adjustment was utilized starting in 2024 to reduce each firm's compensation expense. For purposes of the 2025 stress test projections, the Federal Reserve expanded this adjustment to include commissions, and stated that the expanded adjustment would be phased in over the 2025 and 2026 stress test cycle.[27]

The Board determined that the PPNR model functioned as intended to produce projections of Morgan Stanley's compensation expenses and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on these arguments.

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[27] *2025 Supervisory Stress Test Methodology* at 95. As described in the Stress Testing Policy Statement, highly material changes to the supervisory stress test models are phased in over two years to reduce year-over-year volatility stemming from updates to the supervisory models. <u>See</u> 12 CFR part 252, Appendix B, at 2.3.

2. Non-compensation-related expenses

Morgan Stanley argued that the 2025 stress test overestimated its non-compensation-related expenses by inappropriately holding noninterest expense projections constant in the severely adverse scenario. Morgan Stanley represented that its transaction-related expenses (e.g., brokerage, clearing, and execution and other volume-driven, noninterest expenses) would decline in periods of economic stress due to lower transaction and execution volumes. Morgan Stanley also argued that its discretionary spending, [redacted], would similarly decline. The firm estimated that it would reduce spending on [redacted] of the severely adverse scenario.

These expenses were projected within the Noninterest Expense (NIE) PPNR component. Because this component does not exhibit clear and stable relationships with macroeconomic conditions the model is constructed as an eight-quarter median to capture the firm's recent actual expense behavior and trends. The model was not intended to capture movements in expenses directly related to the macroeconomic environment as asserted by the firm. The Board determined that the NIE PPNR model functioned as intended to produce projections of Morgan Stanley's non-compensation-related expenses and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

3. Operational losses

Morgan Stanley asserted that the Federal Reserve overstated the firm's operational risk losses and did not account for its business mix or internal controls. The firm contended that the Board's use of total assets as a proxy for operational risk in regression and historical simulation models overstated the firm's projected losses. Morgan Stanley observes that, in the 2025 supervisory stress test, the industry ratio of projected operational risk losses to assets was 0.88 percent, and argued that this loss rate assumption was inappropriate for the firm, which had an actual operational loss-to-asset ratio of [redacted]. Overall, the firm's projected operational risk losses in the 2025 supervisory stress test were approximately [redacted] higher than losses projected by the firm.

The Operational Risk models rely on a combination of industry operational loss experiences and firms' total assets. The Federal Reserve uses total assets as a key driver of loss projections in the Operational Risk model based on observed loss patterns over a long historical period. Because the models are constructed at an industry level, the models are not intended to explicitly capture each firm's business mix and internal controls.

The Board determined that the Operational Risk model functioned as intended to produce projections of Morgan Stanley's operational risk losses and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

4. *Trading mark-to-market losses and PPNR*

Morgan Stanley contended that the Federal Reserve double-counted the firm's trading losses across the mark-to-market loss in the GMS calculation and the PPNR calculation. Specifically, the firm argued that the same projected trading losses associated with its Fixed Income Division flowed through both the mark-to-market loss and PPNR models and were overly weighted in mark-to-market losses. Morgan Stanley represented that correcting the alleged double-count would increase the firm's fixed income trading revenue by [redacted] or more [redacted] of its 2025 stress test results.

The Board assessed the projections of trading losses produced by the PPNR trading revenue model and the trading mark-to-market loss from the GMS. While the GMS may project certain losses that are also captured in the PPNR trading revenue model, it is consistent with the stated purpose to stress positions separately from the macroeconomic scenario. The GMS component is intended as an "exogenous" component of the supervisory stress test that is "independent of the macroeconomic and financial market environments" in the supervisory stress scenarios.[28] The GMS can be considered as an additive rather than as a complementary component that may compound or lessen the stresses introduced in the macroeconomic scenario.[29]

The Board determined that the GMS component and PPNR trading revenue model functioned as intended to produce projections of Morgan Stanley's trading losses and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

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[28] 12 CFR part 252, Appendix B, at 2.5(a).

[29] For example, the market shock component "may not be always directionally consistent with the macroeconomic scenario." In particular, because the market shock aims to "mimic the effects of a sudden market dislocation, while the macroeconomic scenarios are designed to provide a description of the real economy over two or more years, assumed economic conditions can move in significantly different ways." 12 CFR part 252, Appendix A, at 6(b).

5. Other losses/gains

Morgan Stanley argued that the 2025 stress test results overstated the firm's calculated losses in the "other losses / gains" category, which reflects losses on held-for-sale and fair value option loans, and overallocated these losses [redacted]. The firm stated that [redacted] of the firm's estimated losses in "other losses /gains," projected by the Federal Reserve [redacted], were attributable to these positions, and that this amount was [redacted] higher than the firm's projections using the same scenario-specific credit spread stresses. The firm asserted that, based on its understanding of the Federal Reserve's models, this result would require a credit spread widening that is nearly an order of magnitude larger than the highest intra-quarter widening value observed in historical data.

Due to the LGD and LEQ assumptions and the unique composition of Morgan Stanley's FVO loan portfolio, estimated losses were disproportionately frontloaded in the projection horizon. Therefore, the Board determined that the model was unable to generate stressed projections that aligned with the stated purposes of the model, and as a result, the FVO loan model did not function correctly to generate stressed projections that appropriately reflect the firm's risk profile. The Board adjusted the treatment of Morgan Stanley's FVO portfolio in the 2025 supervisory stress test by adopting lower LGD and LEQ assumptions, which are calibrated to historical data from the firm and across large banks and reflective of stressed loss experience. The Board took this adjustment into account in modifying Morgan Stanley's preliminary SCB requirement.

6. Taxation-related projections, inclusive of valuation allowance

Morgan Stanley argued in its reconsideration request that the Federal Reserve misstated the firm's quarterly tax expense by incorrectly applying changes to the deferred tax asset valuation allowance, which is comprised of a calculation that evaluates whether a firm will have sufficient taxable income to realize its deferred tax assets. The firm represented that the Federal Reserve appeared to have used pre-tax book income rather than taxable income adjusted for allowance for loan losses and private equity losses to calculate sufficient income over the next year. Morgan Stanley asserted that the correct calculation of quarterly tax expense would have provided the firm with sufficient taxable income to realize more of its deferred tax assets and would result in an approximately [redacted] higher tax provision benefit.

The capital calculator model used taxable income to generate the change in the valuation allowance. Consistent with the methodology disclosure, the Federal Reserve calculates taxable income as PPNR less credit losses on held-to-maturity and available-for-sale securities, net charge-offs on loans measured at amortized cost, and other losses, including trading and counterparty losses and losses on held-for-sale and fair-value option loans.

The Board determined that the capital calculation model functioned as intended to produce projections of Morgan Stanley's quarterly tax expense and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

7. Largest Counterparty Default recovery rate assumption

Morgan Stanley argued that the Federal Reserve's assumption of a 10 percent recovery rate when calculating LCPD losses was inappropriate and that the assigned recovery rate should vary according to counterparty type and exposure type. In particular, Morgan Stanley stated that the 10 percent recovery rate was miscalibrated given the credit profile of its largest counterparty in the 2025 stress test and the nature of the firm's exposures. In the Supplement, Morgan Stanley further argued that the Board should apply a higher recovery rate to a firm whose largest counterparty is [redacted].

The Largest Counterparty Default model is consistently applied across all firms, including through its assumption of a 10 percent recovery rate following the default of the firm's largest counterparty. The 10 percent LCPD recovery rate assumption is generated from an estimate of a potential stressed recovery rate for an undiversified credit exposure under severe market conditions.[30] The LCPD model "seeks to ensure that covered companies can absorb losses associated with the default of any counterparty," and, as such, assumes a conservative LCPD recovery rate.[31]

The Largest Counterparty Default model of the stress test excludes certain sovereign entities (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), certain multinational development banks and supranational entities (International Bank for Reconstruction and Development, International Monetary Fund, Bank for International Settlements, European Commission, and European Central Bank), and qualifying central counterparties from the selection of a firm's largest counterparty.

The Board evaluated whether it was appropriate to include the largest counterparty of Morgan Stanley in the Largest Counterparty Default Model. The Board has determined that it would have been more consistent with the purpose of the model to exclude the largest counterparty of Morgan Stanley given the similarity to the counterparties discussed above. The Board, therefore, has determined that the model was unable to generate stressed projections that aligned with the stated purposes of the model, and as a result, the Largest Counterparty Default

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[30] *2025 Supervisory Stress Test Methodology* at 63, n.98.

[31] 12 CFR part 252, Appendix B, at 2.5(a).

model did not function correctly to generate stressed projections that appropriately reflect the firm's risk profile. Accordingly, the Board adjusted the Largest Counterparty Default model by excluding Morgan Stanley's largest counterparty and instead considering its next-largest counterparty to be the largest counterparty for purposes of that component. The Board took this adjustment into account in modifying Morgan Stanley's preliminary SCB requirement.

8–10. Private Equity-related data reporting; Positioning in the trading book; [redacted]

Morgan Stanley raises three additional arguments. First, Morgan Stanley argued that it may have received higher losses relative to other firms in the 2025 stress test in part because of a change in the treatment of private equity shocks and hedges. The firm stated that the Federal Reserve excluded private equity shocks from the GMS component in the 2025 stress test but did not remove related private equity hedges. As a consequence of this change, firms [redacted] may have benefited because their hedges received GMS treatment, resulting in larger gains, while these same firms' private equity positions received lower losses.

Second, Morgan Stanley argued that the Board's use of a GMS scenario that benefited certain firms with atypical trading positions on the GMS as-of date produced "arbitrary and capricious" outcomes. According to the firm, while the Board did not have trading book portfolio data when it announced the GMS as-of date, it did have this data when it published the GMS scenario, creating "'winners and losers' ... based on the variable composition and directionality of each institution's trading portfolio." Morgan Stanley asserts that its results misstate its risk profile, relative to its peers, and are, therefore, arbitrary and capricious.

[redacted]

With respect to these three arguments, Morgan Stanley does not assert that the challenged aspects of the 2025 stress test affected the calculation of the preliminary SCB requirement provided to the firm on June 27. Therefore, the Board did not modify Morgan Stanley's SCB requirement in response to these arguments.[32]

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[32] See 12 CFR 225.8(i)(3)(i); 12 CFR 238.170(i)(3)(i).

Nonetheless, the Board assessed each of these arguments, and has determined that Morgan Stanley's preliminary SCB requirement was calculated correctly and that the models implicated by these arguments functioned correctly, in a manner consistent with the Board's published policies and public Methodology Disclosure.

11. Wealth and investment management revenue projections

In the Supplement, Morgan Stanley asserted that the Board uses macroeconomic variable sensitivities derived using investment banking revenues to project revenue for its wealth and investment management activities. Morgan Stanley argued that, because investment banking revenues are significantly more volatile than wealth or investment management revenues, the use of these macroeconomic sensitivities resulted in an underestimate of Morgan Stanley's revenue.

Projections for noninterest income from investment banking revenues were generated using the Investment Banking Fees model. For large firms, noninterest income from investment banking fees is modeled in aggregate and is projected using an autoregressive model specification that includes macroeconomic variables, seasonality indicators, and firm-specific fixed effects.

The Board determined that the Investment Banking Fees model functioned as intended to produce projections of Morgan Stanley's wealth management and investment management revenues, and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

12. Interest expense projections

Morgan Stanley argued in the Supplement that the Board overestimated its interest expenses in the stress test because it did not account for the composition of Morgan Stanley's interest rate liabilities. Specifically, Morgan Stanley argued that, because [redacted] of its interest rate liabilities are floating rate liabilities, declines in interest rates would also result in a decrease in interest rate expenses.

Projections for interest expenses were generated using the PPNR interest expense models, which include six components.[33] The Board determined that the PPNR interest expense models functioned as intended to produce projections of Morgan Stanley's portfolio and that there were

[33] These components are (1) domestic time deposits, (2) federal funds and repurchase agreements, (3) foreign deposits, (4) other domestic deposits, (5) subordinated debt, and (6) trading liabilities, other borrowed money, and all other interest expenses.

no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

13. MtM and IDL trading stress losses

In the Supplement, Morgan Stanley argued that the Board overestimated its trading stress losses by [redacted]. Morgan Stanley argued that the Board may have inaccurately calculated trading MtM losses by using an approach that may not fully capture the complexities of the underlying assets in its calculation of trading MtM losses. Morgan Stanley also argued that the Board may have overestimated its trading IDL losses by inappropriately including private equity positions in its trading IDL projections, despite the Board's representation that private equity shocks would not be included in the 2025 GMS component.

The trading MtM losses projections were generated using the Trading MtM model. The Board also reviewed the manner in which the trading incremental default loss model treated the private equity positions reported by Morgan Stanley. The Board determined that the trading MtM and IDL models functioned as intended to produce projections of Morgan Stanley's portfolio and that there were no errors in the calculations. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

14. Other loans

Morgan Stanley argued in the Supplement that the Board overstated its losses from the "Other Loans" category by applying an inappropriately high loss rate. In particular, Morgan Stanley represented that most of its "Other Loans" were comprised of [redacted] Morgan Stanley argued that these portfolios should be assigned *de minimis* loss rates even under severe stress.

The Board determined that the wholesale model functioned as intended to produce projections of Morgan Stanley's other loans losses and that there were no errors in the calculation. Therefore, the Board did not modify Morgan Stanley's preliminary SCB requirement based on this argument.

IV. Conclusion

After consideration of the Board's stress testing policies and all relevant facts, including the information provided in the request, the Supplement, and other supervisory information, and consistent with the Board's regulations, the Board has modified the preliminary SCB requirement provided to Morgan Stanley, on June 27, 2025, from 5.1 percent to 4.3 percent.[34]

The Board is focused on continually improving the stress testing framework, including the Board's supervisory models.[35] In December 2024, the Board issued a press release noting that it intends to seek public comment on changes to improve the transparency of the stress tests and reduce the volatility of the associated capital buffer requirements.[36] Following the publication of the models, the Board will review any public comments received in order to consider further model improvements.

The preliminary SCB requirement for Morgan Stanley is 4.3 percent. By September 30, 2025, Morgan Stanley should notify the Board of any adjustments to its planned capital distributions for the fourth through seventh quarters of the planning horizon under the internal baseline scenario.[37] Unless otherwise determined by the Board, the firm will be provided with its final SCB requirement and confirmation of its final planned capital distributions by October 3, 2025.

Please contact Julie Anthony, Senior Special Counsel, at julie.j.anthony@frb.gov with any questions.

Sincerely yours,

(Signed) Benjamin W. McDonough

Benjamin W. McDonough
Deputy Secretary of the Board

cc: Yanhui Wang, Institutional Supervision Program Director
Federal Reserve Bank of New York

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[34] The Board has authority to establish capital requirements for supervised firms as it deems necessary or appropriate. See, e.g., 12 U.S.C. §§ 3907(a)(2); 1467a(g)(1); 1844(b).

[35] In evaluating any of its supervisory models, the Board follows the processes for development, implementation, and validation of its supervisory models, as outlined in the Board's Stress Testing Policy Statement.

[36] See Board of Governors of the Federal Reserve System, Press Release, dated December 23, 2024, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20241223a.htm.

[37] See 12 CFR 225.8(h)(2)(ii).