

KEYCORP /NEW/
Form 10-Q
November 08, 2006

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549
Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 30, 2006
or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From _____ To _____
Commission File Number 1-11302

(Exact name of registrant as specified in its charter)

Ohio

34-6542451

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

127 Public Square, Cleveland, Ohio

44114-1306

(Address of principal executive offices)

(Zip Code)

(216) 689-6300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Shares with a par value of \$1 each

401,580,774 Shares

(Title of class)

(Outstanding at October 31, 2006)

KEYCORP
TABLE OF CONTENTS
PART I. FINANCIAL INFORMATION

	Page Number
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets – September 30, 2006, December 31, 2005, and September 30, 2005</u>	3
<u>Consolidated Statements of Income – Three and nine months ended September 30, 2006 and 2005</u>	4
<u>Consolidated Statements of Changes in Shareholders' Equity – Nine months ended September 30, 2006 and 2005</u>	5
<u>Consolidated Statements of Cash Flow – Nine months ended September 30, 2006 and 2005</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Report of Independent Registered Public Accounting Firm</u>	34
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	35
<u>Item 3. Quantitative and Qualitative Disclosure about Market Risk</u>	73
<u>Item 4. Controls and Procedures</u>	73
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	73
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	73
<u>Item 6. Exhibits</u>	73
<u>Signature</u>	74
Exhibits	75
<u>EX-10.1</u>	
<u>EX-15</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Consolidated Balance Sheets**

<i>dollars in millions</i>	September 30, 2006 (Unaudited)	December 31, 2005	September 30, 2005 (Unaudited)
ASSETS			
Cash and due from banks	\$ 2,957	\$ 3,108	\$ 2,660
Short-term investments	1,582	1,592	2,394
Securities available for sale	7,441	7,269	7,124
Investment securities (fair value: \$42, \$92 and \$99)	41	91	98
Other investments	1,367	1,332	1,310
Loans, net of unearned income of \$2,075, \$2,153 and \$2,188	65,551	66,478	65,575
Less: Allowance for loan losses	944	966	1,093
Net loans	64,607	65,512	64,482
Loans held for sale	7,150	3,381	3,595
Premises and equipment	567	575	593
Goodwill	1,372	1,355	1,344
Other intangible assets	127	125	109
Corporate-owned life insurance	2,754	2,690	2,658
Derivative assets	915	1,039	1,132
Accrued income and other assets	5,275	5,057	4,824
Total assets	\$ 96,155	\$ 93,126	\$ 92,323
LIABILITIES			
Deposits in domestic offices:			
NOW and money market deposit accounts	\$ 25,150	\$ 24,241	\$ 23,541
Savings deposits	1,672	1,840	1,922
Certificates of deposit (\$100,000 or more)	5,734	5,156	4,783
Other time deposits	11,848	11,170	10,804
Total interest-bearing	44,404	42,407	41,050
Noninterest-bearing	13,396	13,335	12,202
Deposits in foreign office interest-bearing	3,629	3,023	4,819
Total deposits	61,429	58,765	58,071
Federal funds purchased and securities sold under repurchase agreements	4,701	4,835	3,444
Bank notes and other short-term borrowings	2,594	1,780	3,001
Derivative liabilities	844	1,060	1,075
Accrued expense and other liabilities	4,986	5,149	5,173
Long-term debt	13,654	13,939	14,037

Total liabilities	88,208	85,528	84,801
SHAREHOLDERS EQUITY			
Preferred stock, \$1 par value; authorized 25,000,000 shares, none issued			
Common shares, \$1 par value; authorized 1,400,000,000 shares; issued 491,888,780 shares	492	492	492
Capital surplus	1,588	1,534	1,517
Retained earnings	8,371	7,882	7,719
Treasury stock, at cost (89,140,338, 85,265,173 and 83,346,435 shares)	(2,434)	(2,204)	(2,133)
Accumulated other comprehensive loss	(70)	(106)	(73)
Total shareholders equity	7,947	7,598	7,522
Total liabilities and shareholders equity	\$ 96,155	\$ 93,126	\$ 92,323

See Notes to Consolidated Financial Statements (Unaudited).

Table of Contents**Consolidated Statements of Income (Unaudited)**

<i>dollars in millions, except per share amounts</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
INTEREST INCOME				
Loans	\$ 1,196	\$ 1,006	\$ 3,500	\$ 2,837
Loans held for sale	131	56	272	190
Investment securities	1	1	2	3
Securities available for sale	84	84	251	244
Short-term investments	16	15	54	37
Other investments	16	12	58	44
Total interest income	1,444	1,174	4,137	3,355
INTEREST EXPENSE				
Deposits	443	273	1,178	717
Federal funds purchased and securities sold under repurchase agreements	45	31	113	81
Bank notes and other short-term borrowings	24	22	75	58
Long-term debt	202	155	583	427
Total interest expense	714	481	1,949	1,283
NET INTEREST INCOME	730	693	2,188	2,072
Provision for loan losses	31	43	94	107
Net interest income after provision for loan losses	699	650	2,094	1,965
NONINTEREST INCOME				
Trust and investment services income	137	135	411	408
Service charges on deposit accounts	78	82	227	228
Investment banking and capital markets income	44	62	163	168
Operating lease income	58	47	166	141
Letter of credit and loan fees	48	46	133	133
Corporate-owned life insurance income	23	26	74	78
Electronic banking fees	27	24	78	70
Net gains from loan securitizations and sales	14	12	34	41
Net securities gains (losses)	(7)	3	(2)	(2)
Other income	121	94	287	252
Total noninterest income	543	531	1,571	1,517
NONINTEREST EXPENSE				
Personnel	422	414	1,258	1,190
Net occupancy	63	66	187	212
Computer processing	52	54	157	155
Operating lease expense	48	40	134	118

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Professional fees	29	29	102	87
Marketing	37	29	83	88
Equipment	26	28	78	84
Other expense	131	121	395	369
Total noninterest expense	808	781	2,394	2,303
INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE				
Income taxes	122	122	367	346
INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE				
Cumulative effect of accounting change, net of tax (see Note 1)	312	278	904	833
			5	
NET INCOME	\$ 312	\$ 278	\$ 909	\$ 833
Per common share:				
Income before cumulative effect of accounting change	\$.77	\$.68	\$ 2.23	\$ 2.04
Net income	.77	.68	2.24	2.04
Income before cumulative effect of accounting change assuming dilution	.76	.67	2.20	2.01
Net income assuming dilution	.76	.67	2.21	2.01
Cash dividends declared	.345	.325	1.035	.975
Weighted-average common shares outstanding (000)	403,780	410,456	405,218	409,166
Weighted-average common shares and potential common shares outstanding (000)	409,428	415,441	411,029	414,510

See Notes to Consolidated Financial Statements (Unaudited).

Table of Contents**Consolidated Statements of Changes in Shareholders Equity (Unaudited)**

	Common Shares Outstanding	Common Shares	Capital Surplus	Retained Earnings	Accumulated Treasury Stock at Cost	Other Comprehensive Loss	Comprehensive Income
<i>dollars in millions, except per share amounts</i>							
BALANCE AT DECEMBER 31, 2004	407,570	\$ 492	\$ 1,491	\$ 7,284	\$ (2,128)	\$ (22)	
Net income				833			\$ 833
Other comprehensive income (losses):							
Net unrealized losses on securities available for sale, net of income taxes of (\$21) ^a						(36)	(36)
Net unrealized gains on derivative financial instruments, net of income taxes of \$4						8	8
Foreign currency translation adjustments						(22)	(22)
Minimum pension liability adjustment, net of income taxes of (\$1)						(1)	(1)
Total comprehensive income							\$ 782
Deferred compensation				27			
Cash dividends declared on common shares (\$0.975 per share)				(398)			
Issuance of common shares and stock options granted under employee benefit and dividend reinvestment plans	4,722			(1)	119		
Repurchase of common shares	(3,750)				(124)		
BALANCE AT SEPTEMBER 30, 2005	408,542	\$ 492	\$ 1,517	\$ 7,719	\$ (2,133)	\$ (73)	
BALANCE AT DECEMBER 31, 2005	406,624	\$ 492	\$ 1,534	\$ 7,882	\$ (2,204)	\$ (106)	
Net income				909			\$ 909
Other comprehensive income:							
Net unrealized gains on securities available for sale, net of income taxes of \$5 ^a						6	6
Net unrealized gains on derivative financial instruments, net of income taxes						1	1
Net unrealized losses on common investment funds held in employee welfare benefits trust, net of income taxes						(1)	(1)
Foreign currency translation adjustments						30	30
Total comprehensive income							\$ 945
Deferred compensation				21			
				(420)			

Cash dividends declared on common shares (\$1.035 per share)						
Issuance of common shares and stock options granted under employee benefit and dividend reinvestment plans	8,624		33		227	
Repurchase of common shares	(12,500)				(457)	
BALANCE AT SEPTEMBER 30, 2006	402,748	\$ 492	\$ 1,588	\$ 8,371	\$ (2,434)	\$ (70)

(a) Net of reclassification adjustments.

See Notes to Consolidated Financial Statements (Unaudited).

5

Table of Contents**Consolidated Statements of Cash Flow (Unaudited)**

<i>in millions</i>	Nine months ended September 30,	
	2006	2005
OPERATING ACTIVITIES		
Net income	\$ 909	\$ 833
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	94	107
Depreciation and amortization expense	292	265
Net securities losses	2	2
Net gains from principal investing	(48)	(40)
Net gains from loan securitizations and sales	(34)	(41)
Deferred income taxes	(230)	137
Net (increase) decrease in loans held for sale	(1,295)	758
Net (increase) decrease in trading account assets	33	(255)
Other operating activities, net	(232)	(306)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	(509)	1,460
INVESTING ACTIVITIES		
Cash used in acquisitions, net of cash acquired	(34)	(32)
Net increase in other short-term investments	(23)	(667)
Purchases of securities available for sale	(2,730)	(2,623)
Proceeds from sales of securities available for sale	154	128
Proceeds from prepayments and maturities of securities available for sale	2,421	2,707
Purchases of investment securities	(2)	
Proceeds from prepayments and maturities of investment securities	53	17
Purchases of other investments	(401)	(326)
Proceeds from sales of other investments	189	226
Proceeds from prepayments and maturities of other investments	209	199
Net increase in loans, excluding acquisitions, sales and transfer	(1,990)	(2,492)
Purchases of loans	(64)	(19)
Proceeds from loan securitizations and sales	298	154
Purchases of premises and equipment	(68)	(67)
Proceeds from sales of premises and equipment	4	8
Proceeds from sales of other real estate owned	20	58
NET CASH USED IN INVESTING ACTIVITIES	(1,964)	(2,729)
FINANCING ACTIVITIES		
Net increase in deposits	2,674	244
Net increase in short-term borrowings	680	1,785
Net proceeds from issuance of long-term debt	1,609	2,504
Payments on long-term debt	(1,997)	(2,633)
Purchases of treasury shares	(457)	(124)
Net proceeds from issuance of common stock	207	97
Tax benefits in excess of recognized compensation cost for stock-based awards	26	
Cash dividends paid	(420)	(398)

NET CASH PROVIDED BY FINANCING ACTIVITIES	2,322	1,475
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	(151)	206
CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD	3,108	2,454
CASH AND DUE FROM BANKS AT END OF PERIOD	\$ 2,957	\$ 2,660

Additional disclosures relative to cash flow:

Interest paid	\$ 2,042	\$ 1,266
Income taxes paid	328	193
Noncash items:		
Loans transferred from portfolio to held for sale	\$ 2,474	
Loans transferred to other real estate owned	52	\$ 40
Assets acquired		15
Liabilities assumed		7

See Notes to Consolidated Financial Statements (Unaudited).

Table of Contents**Notes to Consolidated Financial Statements****1. Basis of Presentation**

The unaudited condensed consolidated interim financial statements include the accounts of KeyCorp and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. As used in these Notes, *KeyCorp* refers solely to the parent company and *Key* refers to the consolidated entity consisting of KeyCorp and subsidiaries.

Key consolidates any voting rights entity in which it has a controlling financial interest. In accordance with Financial Accounting Standards Board (FASB) Revised Interpretation No. 46, Consolidation of Variable Interest Entities, a variable interest entity (VIE) is consolidated if Key has a variable interest in the entity and is exposed to the majority of its expected losses and/or residual returns (i.e., Key is considered to be the primary beneficiary). Variable interests can include equity interests, subordinated debt, derivative contracts, leases, service agreements, guarantees, standby letters of credit, loan commitments, and other contracts, agreements and financial instruments.

Key uses the equity method to account for unconsolidated investments in voting rights entities or VIEs in which it has significant influence over operating and financing decisions (usually defined as a voting or economic interest of 20% to 50%, but not a controlling interest). Unconsolidated investments in voting rights entities or VIEs in which Key has a voting or economic interest of less than 20% generally are carried at cost. Investments held by KeyCorp's broker/dealer and investment company subsidiaries (primarily principal investments) are carried at estimated fair value.

Qualifying special purpose entities (SPEs), including securitization trusts, established by Key under the provisions of Statement of Financial Accounting Standards (SFAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, are not consolidated. Information on SFAS No. 140 is included in Note 1 (Summary of Significant Accounting Policies) of Key's 2005 Annual Report to Shareholders under the heading Loan Securitizations on page 59.

Management believes that the unaudited condensed consolidated interim financial statements reflect all adjustments of a normal recurring nature and disclosures that are necessary for a fair presentation of the results for the interim periods presented. Some previously reported results have been reclassified to conform to current reporting practices. During the first quarter of 2006, Key reclassified certain loans from the commercial lease financing portfolio to the commercial, financial and agricultural portfolio to more accurately reflect the nature of these receivables. Prior period balances were not reclassified as the historical data was not available. The reclassification did not have any effect on Key's total loans or net income.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year. When you read these financial statements, you should also look at the audited consolidated financial statements and related notes included in Key's 2005 Annual Report to Shareholders.

Stock-Based Compensation

Prior to January 1, 2006, Key used the fair value method of accounting as outlined in SFAS No. 123, Accounting for Stock-Based Compensation. Key had voluntarily adopted this method of accounting effective January 1, 2003, and opted to apply the new rules prospectively to all awards using one of three alternative methods of transition permitted under SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

Effective January 1, 2006, Key adopted SFAS No. 123R, Share-Based Payment, which replaces SFAS No. 123. SFAS No. 123R requires stock-based compensation to be measured using the fair value method of accounting and for the measured cost to be recognized over the period during which the recipient is required to provide service in exchange for the award. As of the effective date, Key did not have any

Table of Contents

nonvested awards outstanding that had not been previously accounted for using the fair value method. Consequently, the adoption of SFAS No. 123R did not have a significant impact on Key's financial condition or results of operations. The adoption of the new accounting standard did, however, result in a cumulative after-tax adjustment as discussed below.

SFAS No. 123R changes the manner of accounting for forfeited stock-based awards. Under the new standard, companies are no longer permitted to account for forfeitures as they occur. Companies, such as Key, that have been expensing stock-based awards and using this alternative method of accounting for forfeitures must now estimate expected forfeitures at the date the awards are granted and record compensation expense only for those that are expected to vest. As of the effective date, companies must estimate the forfeitures they expect to occur and reduce their related compensation obligation for expense previously recognized in the financial statements. The after-tax amount of this reduction must also be presented on the income statement as a cumulative effect of a change in accounting principle. Key's cumulative after-tax adjustment increased first quarter 2006 earnings by \$5 million, or \$.01 per diluted common share.

Mandatory deferred incentive compensation awards vest at the rate of 33-1/3% per year. Prior to the adoption of SFAS No. 123R, Key recognized total compensation cost for its stock-based, mandatory deferred incentive compensation awards in the plan year that the performance-related services necessary to earn the awards were rendered. Effective January 1, 2006, Key is recognizing compensation cost for these awards using the accelerated method of amortization over a period of approximately four years (the current year performance period and the three-year vesting period, which starts generally in the first quarter following the performance period). The impact of this change on Key's earnings was not material.

Also, prior to the adoption of SFAS No. 123R, Key presented all tax benefits of deductions resulting from the exercise of stock options or the issuance of shares under other stock-based compensation programs as operating cash flows in the statement of cash flows. SFAS No. 123R requires the cash flows resulting from the tax benefits of deductions in excess of the compensation cost recognized for stock-based awards to be classified as financing cash flows.

Generally, employee stock options granted by Key become exercisable at the rate of 33-1/3% per year beginning one year from their grant date and expire no later than ten years from their grant date. Key recognizes stock-based compensation expense for stock options with graded vesting using an accelerated method of amortization.

Key uses shares repurchased from time to time in accordance with its authorized repurchase program (treasury shares) for share issuances under stock-based compensation programs, other than the discounted stock purchase plan. Shares issued under this plan are purchased on the open market.

Accounting Pronouncements Adopted in 2006

Consolidation of limited partnerships. In June 2005, the FASB ratified Emerging Issues Task Force Issue No. 04-5, *Determining Whether a General Partner, or the General Partners of a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. Issue No. 04-5 was initially effective for all limited partnerships created or modified after June 29, 2005, and became effective for all other limited partnerships on January 1, 2006. Adoption of this guidance did not have a material effect on Key's financial condition or results of operations.

Accounting changes and error corrections. In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which addresses the accounting for and reporting of accounting changes and error corrections. This guidance requires retrospective application for the reporting of voluntary changes in accounting principles and changes required by an accounting pronouncement when transition provisions are not specified. SFAS No. 154 was effective for accounting changes and corrections of errors made after December 31, 2005. Adoption of this guidance did not have a material effect on Key's financial condition or results of operations.

Table of Contents

Stock-based compensation. As discussed under the heading *Stock-Based Compensation* on page 7, effective January 1, 2006, Key adopted SFAS No. 123R, which replaced SFAS No. 123. This new accounting standard changes the way in which stock-based compensation must be measured and recognized in the financial statements, and the manner in which forfeited stock-based awards must be accounted for. It also requires additional disclosures pertaining to stock-based compensation plans. The required disclosures for Key are presented under the heading referred to above and in Note 10 (*Stock-Based Compensation*), which begins on page 23.

Accounting Pronouncements Pending Adoption

Employers' accounting for defined benefit pension and other postretirement plans. In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which requires an employer to recognize an asset or liability for the overfunded or underfunded status, respectively, of its defined benefit plans. The overfunded or underfunded status is to be measured solely as the difference between the fair value of plan assets and the projected benefit obligation. In addition, any change in a plan's funded status must be recognized in comprehensive income in the year in which it occurs. Most requirements of SFAS No. 158 will be effective for fiscal years ending after December 15, 2006 (effective December 31, 2006, for Key). However, the requirement to measure plan assets and liabilities as of the end of an employer's fiscal year will not be effective until fiscal years ending after December 15, 2008 (effective December 31, 2008, for Key). Management estimates that Key will record an after-tax charge of approximately \$145 million to the accumulated other comprehensive loss component of shareholders' equity as a result of adopting this guidance for the year ending December 31, 2006. For more information about Key's defined benefit plans, see Note 16 (*Employee Benefits*), which begins on page 78 of Key's 2005 Annual Report to Shareholders.

Fair value measurements. In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 provides guidance on how to measure fair value when it is permitted or required under other accounting pronouncements. As such, this guidance does not expand the use of fair value measurements. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007 (effective January 1, 2008, for Key). Management is currently evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

Accounting for uncertain tax positions. In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the application of SFAS No. 109, *Accounting for Income Taxes*, by defining the minimum threshold that a tax position must meet before any associated benefit may be recognized in a company's financial statements. This interpretation also provides guidance on measurement and derecognition of tax benefits, and requires expanded disclosures. The interpretation will be effective for fiscal years beginning after December 15, 2006 (effective January 1, 2007, for Key). Management is currently evaluating the potential effect this guidance may have on Key's financial condition or results of operations. Additional information relating to this interpretation is included in Note 12 (*Income Taxes*), which begins on page 27.

Accounting for leveraged leases. In July 2006, the FASB issued Staff Position No. 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*, which provides additional guidance on the application of SFAS No. 13, *Accounting for Leases*. This guidance will affect when earnings from leveraged lease transactions would be recognized when there are changes or projected changes in the timing of cash flows, including changes due to or expected to be due to settlements of tax matters. Previously, leveraged lease transactions were required to be recalculated only when a change in the total cash flows occurred. This guidance will be effective for fiscal years beginning after December 15, 2006 (effective January 1, 2007, for Key). Management currently estimates that the adoption of this guidance will result in a cumulative after-tax charge to Key's retained earnings in the range of \$50 million to \$65 million. However, future earnings are expected to increase over the remaining term of the affected leases by a similar amount.

Accounting for servicing of financial assets. In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, which requires that servicing assets and liabilities be initially measured at fair value, if practicable. SFAS No. 156 also requires the subsequent remeasurement

Table of Contents

of servicing assets and liabilities at each reporting date using one of two methods: amortization over the servicing period or measurement at fair value. This guidance will be effective for fiscal years beginning after September 15, 2006 (effective January 1, 2007, for Key). Adoption of this guidance is not expected to have a material effect on Key's financial condition or results of operations.

Accounting for certain hybrid financial instruments. In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments. A hybrid financial instrument is one where a derivative is embedded in another financial instrument. SFAS No. 155 will permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This guidance will also eliminate the prohibition on a qualifying SPE from holding certain derivative financial instruments. SFAS No. 155 will be effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006 (effective January 1, 2007, for Key). Adoption of this guidance is not expected to have a material effect on Key's financial condition or results of operations.

2. Earnings Per Common Share

Key calculates its basic and diluted earnings per common share as follows:

<i>dollars in millions, except per share amounts</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
EARNINGS				
Income before cumulative effect of accounting change	\$ 312	\$ 278	\$ 904	\$ 833
Net income	312	278	909	833
WEIGHTED-AVERAGE COMMON SHARES				
Weighted-average common shares outstanding (000)	403,780	410,456	405,218	409,166
Effect of dilutive common stock options and other stock awards (000)	5,648	4,985	5,811	5,344
Weighted-average common shares and potential common shares outstanding (000)	409,428	415,441	411,029	414,510
EARNINGS PER COMMON SHARE				
Income per common share before cumulative effect of accounting change	\$.77	\$.68	\$ 2.23	\$ 2.04
Net income per common share	.77	.68	2.24	2.04
Income per common share before cumulative effect of accounting change assuming dilution	.76	.67	2.20	2.01
Net income per common share assuming dilution	.76	.67	2.21	2.01

3. Acquisitions and Divestitures

Acquisitions completed and divestitures announced by Key during 2005 and the first nine months of 2006 are summarized below. In the case of each acquisition or divestiture, the terms of the transaction either were not or are not expected to be material.

Acquisitions**Austin Capital Management, Ltd.**

On April 1, 2006, Key acquired Austin Capital Management, Ltd., an investment firm headquartered in Austin, Texas with approximately \$900 million in assets under management at the date of acquisition.

ORIX Capital Markets, LLC

On December 8, 2005, Key acquired the commercial mortgage-backed securities servicing business of ORIX Capital Markets, LLC, headquartered in Dallas, Texas. ORIX had a servicing portfolio of approximately \$27 billion at the date of acquisition.

Malone Mortgage Company

On July 1, 2005, Key acquired Malone Mortgage Company, a mortgage company headquartered in Dallas, Texas that serviced approximately \$1.3 billion in loans at the date of acquisition.

Table of Contents

Divestitures Pending as of September 30, 2006

McDonald Investments branch network

On September 6, 2006, Key announced that it has agreed to sell its McDonald Investments branch network, which includes approximately 340 financial advisors in addition to field support staff and certain fixed assets, to UBS Financial Services Inc., a subsidiary of UBS AG. Key will retain its Private Banking, Wealth Management and Trust businesses. Key will also retain its Investment Services business, which offers products such as mutual funds and annuities through its KeyCenters. The sale is expected to be completed in the first quarter of 2007.

Champion Mortgage

On August 1, 2006, Key announced that it is considering the sale of its Champion Mortgage finance business. Key has hired UBS Investment Bank to assist the Board of Directors and management with a possible sale of this business. There is no assurance that Key will enter into an agreement regarding, or consummate the sale of, this business.

Table of Contents

4. Line of Business Results

Community Banking

Regional Banking provides individuals with branch-based deposit and investment products, personal finance services and loans, including residential mortgages, home equity and various types of installment loans. This line of business also provides small businesses with deposit, investment and credit products, and business advisory services.

Regional Banking also offers financial, estate and retirement planning, and asset management services to assist high-net-worth clients with their banking, brokerage, trust, portfolio management, insurance, charitable giving and related needs.

Commercial Banking provides midsize businesses with products and services that include commercial lending, cash management, equipment leasing, investments and employee benefit programs, succession planning, capital markets, derivatives and foreign exchange.

National Banking

Real Estate Capital provides construction and interim lending, permanent debt placements and servicing, and equity and investment banking services to developers, brokers and owner-investors. This line of business deals exclusively with nonowner-occupied properties (i.e., generally properties in which the owner occupies less than 60% of the premises).

Equipment Finance meets the equipment leasing needs of companies worldwide and provides equipment manufacturers, distributors and resellers with financing options for their clients. Lease financing receivables and related revenues are assigned to other lines of business (primarily Institutional and Capital Markets, and Commercial Banking) if those businesses are principally responsible for maintaining the relationship with the client.

Institutional and Capital Markets provides products and services to large corporations, middle-market companies, financial institutions, government entities and not-for-profit organizations. These products and services include commercial lending, treasury management, investment banking, derivatives and foreign exchange, equity and debt underwriting and trading, and syndicated finance.

Through its Victory Capital Management unit, Institutional and Capital Markets also manages or gives advice regarding investment portfolios for a national client base, including corporations, labor unions, not-for-profit organizations, governments and individuals. These portfolios may be managed in separate accounts, common funds or the Victory family of mutual funds.

Consumer Finance includes Indirect Lending, Commercial Floor Plan Lending and National Home Equity.

Indirect Lending offers loans to consumers through dealers. This business unit also provides federal and private education loans to students and their parents and processes payments on loans that private schools make to parents. Commercial Floor Plan Lending finances inventory for automobile and marine dealers.

National Home Equity provides both prime and nonprime mortgage and home equity loan products to individuals. This business unit also works with home improvement contractors to provide home equity and home improvement financing solutions.

Other Segments

Other Segments consist of Corporate Treasury and Key s Principal Investing unit.

Table of Contents**Reconciling Items**

Total assets included under Reconciling Items represent primarily the unallocated portion of nonearning assets of corporate support functions. Charges related to the funding of these assets are part of net interest income and are allocated to the business segments through noninterest expense. Reconciling Items also includes intercompany eliminations and certain items that are not allocated to the business segments because they are not reflective of their normal operations.

The table that spans pages 14 and 15 shows selected financial data for each major business group for the three- and nine-month periods ended September 30, 2006 and 2005. This table is accompanied by supplementary information for each of the lines of business that comprise these groups. The information was derived from the internal financial reporting system that management uses to monitor and manage Key's financial performance. U.S. generally accepted accounting principles (GAAP) guide financial accounting, but there is no authoritative guidance for management accounting the way management uses its judgment and experience to make reporting decisions. Consequently, the line of business results Key reports may not be comparable with line of business results presented by other companies.

The selected financial data are based on internal accounting policies designed to compile results on a consistent basis and in a manner that reflects the underlying economics of the businesses. According to our policies:

w Net interest income is determined by assigning a standard cost for funds used to assets or a standard credit for funds provided to liabilities based on their assumed maturity, prepayment and/or repricing characteristics. The net effect of this funds transfer pricing is charged to the lines of business based on the total loan and deposit balances of each line.

w Indirect expenses, such as computer servicing costs and corporate overhead, are allocated based on assumptions regarding the extent to which each line actually uses the services.

w Key's consolidated provision for loan losses is allocated among the lines of business based primarily on their actual net charge-offs, adjusted periodically for loan growth and changes in risk profile. The level of the consolidated provision is based on the methodology that management uses to estimate Key's consolidated allowance for loan losses. This methodology is described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan Losses on page 59 of Key's 2005 Annual Report to Shareholders.

w Income taxes are allocated based on the statutory federal income tax rate of 35% (adjusted for tax-exempt interest income, income from corporate-owned life insurance and tax credits associated with investments in low-income housing projects) and a blended state income tax rate (net of the federal income tax benefit) of 2.5%.

w Capital is assigned based on management's assessment of economic risk factors (primarily credit, operating and market risk) directly attributable to each line.

Developing and applying the methodologies that management uses to allocate items among Key's lines of business is a dynamic process. Accordingly, financial results may be revised periodically to reflect accounting enhancements, changes in the risk profile of a particular business or changes in Key's organizational structure.

Effective January 1, 2006, Key reorganized and renamed its major business groups and some of its lines of business. The Community Banking group now includes Key businesses which operate primarily within our KeyCenter (branch) network. This group's activities are conducted through two primary lines of business: Regional Banking (including McDonald Financial Group) and Commercial Banking. Key's other major business group, National Banking, includes those corporate and consumer business units that operate both within and outside of the branch network to serve customers across the country and internationally through four primary lines of business: Real Estate Capital, Equipment Finance, Institutional and Capital Markets, and Consumer Finance. These changes are reflected in the financial data reported for all periods presented in the line of business tables.

Table of Contents

Three months ended September 30, <i>dollars in millions</i>	Community Banking		National Banking		Other Segments	
	2006	2005	2006	2005	2006	2005
SUMMARY OF OPERATIONS						
Net interest income (TE)	\$ 443	\$ 432	\$ 375	\$ 348	\$ (31)	\$ (28)
Noninterest income	228	227	256	253	56	53
Total revenue (TE) ^a	671	659	631	601	25	25
Provision for loan losses	22	26	9	17		
Depreciation and amortization expense	36	36	64	54		
Other noninterest expense	434	419	276	272	7	7
Income (loss) before income taxes (TE)	179	178	282	258	18	18
Allocated income taxes and TE adjustments	67	67	106	97	(2)	(3)
Income (loss) before cumulative effect of accounting change	112	111	176	161	20	21
Cumulative effect of accounting change						
Net income (loss)	\$ 112	\$ 111	\$ 176	\$ 161	\$ 20	\$ 21
Percent of consolidated net income	36%	40%	57%	58%	6%	7%
Percent of total segments net income	36	38	57	55	7	7
AVERAGE BALANCES						
Loans and leases	\$ 26,737	\$ 27,131	\$ 38,767	\$ 37,072	\$ 282	\$ 377
Total assets ^a	29,718	30,026	51,347	46,708	11,503	11,645
Deposits	46,987	44,705	11,068	7,785	3,543	4,589
OTHER FINANCIAL DATA						
Net loan charge-offs	\$ 22	\$ 25	\$ 21	\$ 24		
Return on average allocated equity	19.20%	19.10%	17.52%	17.10%	N/M	N/M
Average full-time equivalent employees	9,080	8,743	4,573	4,418	41	40

Nine months ended September 30, <i>dollars in millions</i>	Community Banking		National Banking		Other Segments	
	2006	2005	2006	2005	2006	2005

SUMMARY OF OPERATIONS

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Net interest income (TE)	\$ 1,311	\$ 1,260	\$ 1,126	\$ 1,051	\$ (91)	\$ (77)
Noninterest income	667	663	761	724	130	130
Total revenue (TE) ^a	1,978	1,923	1,887	1,775	39	53
Provision for loan losses	71	77	23	30		
Depreciation and amortization expense	110	106	182	159		
Other noninterest expense	1,276	1,220	836	792	21	24
Income (loss) before income taxes (TE)	521	520	846	794	18	29
Allocated income taxes and TE adjustments	195	195	317	298	(21)	(19)
Income (loss) before cumulative effect of accounting change	326	325	529	496	39	48
Cumulative effect of accounting change						
Net income (loss)	\$ 326	\$ 325	\$ 529	\$ 496	\$ 39	\$ 48

Percent of consolidated net income	36%	39%	58%	59%	4%	6%
Percent of total segments net income	37	37	59	57	4	6

AVERAGE BALANCES

Loans and leases	\$ 26,760	\$ 26,987	\$ 39,498	\$ 36,790	\$ 302	\$ 407
Total assets ^a	29,736	29,916	50,463	46,585	11,456	11,749
Deposits	46,506	43,875	10,560	7,330	3,361	5,200

OTHER FINANCIAL DATA

Net loan charge-offs	\$ 74	\$ 83	\$ 42	\$ 68		
Return on average allocated equity	18.88%	18.92%	17.93%	17.63%	N/M	N/M
Average full-time equivalent employees	8,961	8,705	4,507	4,502	40	39

(a) Substantially all revenue generated by Key's major business groups is derived from clients resident in the United States. Substantially all long-lived assets, including premises and equipment, capitalized software and goodwill, held by Key's major business groups are located in the United States.

(b) Other noninterest expense includes a \$30 million (\$19 million after tax) charge recorded during the first quarter of 2005 to adjust the accounting for rental expense associated with operating leases from an escalating to a straight-line basis.

TE = Taxable Equivalent, N/A = Not Applicable, N/M = Not Meaningful

Table of Contents

Total Segments		Reconciling Items		Key	
2006	2005	2006	2005	2006	2005
\$ 787	\$ 752	\$ (36)	\$ (26)	\$ 751	\$ 726
540	533	3	(2)	543	531
1,327	1,285	(33)	(28)	1,294	1,257
31	43			31	43
100	90			100	90
717	698	(9)	(7)	708	691
479	454	(24)	(21)	455	433
171	161	(28)	(6)	143	155
308	293	4	(15)	312	278
\$ 308	\$ 293	\$ 4	\$ (15)	\$ 312	\$ 278
99%	105%	1%	(5)%	100%	100%
100	100	N/A	N/A	N/A	N/A
\$ 65,786	\$ 64,580	\$ 224	\$ 178	\$ 66,010	\$ 64,758
92,568	88,379	2,350	2,244	94,918	90,623
61,598	57,079	(227)	(245)	61,371	56,834
\$ 43	\$ 49			\$ 43	\$ 49
18.13%	17.96%	N/M	N/M	15.88%	14.84%
13,694	13,201	6,570	6,255	20,264	19,456
Total Segments		Reconciling Items		Key	
2006	2005	2006	2005	2006	2005
\$ 2,346	\$ 2,234	\$ (87)	\$ (71)	\$ 2,259	\$ 2,163
1,558	1,517	13		1,571	1,517
3,904	3,751	(74)	(71)	3,830	3,680
94	107			94	107

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

292	265			292	265
2,133	2,036	(31)	2b	2,102	2,038
1,385	1,343	(43)	(73)	1,342	1,270
491	474	(53)	(37)	438	437
894	869	10	(36)	904	833
		5		5	
\$ 894	\$ 869	\$ 15	\$ (36)	\$ 909	\$ 833
98%	104%	2%	(4)%	100%	100%
100	100	N/A	N/A	N/A	N/A
\$ 66,560	\$ 64,184	\$ 149	\$ 162	\$ 66,709	\$ 64,346
91,655	88,250	2,250	2,248	93,905	90,498
60,427	56,405	(159)	(224)	60,268	56,181
\$ 116	\$ 151			\$ 116	\$ 151
17.87%	17.91%	N/M	N/M	15.82%	15.36%
13,508	13,246	6,466	6,262	19,974	19,508

Table of Contents

Supplementary information (Community Banking lines of business)

Three months ended September 30, <i>dollars in millions</i>	Regional Banking		Commercial Banking	
	2006	2005	2006	2005
Total revenue (TE)	\$ 570	\$ 556	\$ 101	\$ 103
Provision for loan losses	27	19	(5)	7
Noninterest expense	420	406	50	49
Net income	77	82	35	29
Average loans and leases	18,722	19,093	8,015	8,038
Average deposits	43,405	41,126	3,582	3,579
Net loan charge-offs	19	23	3	2
Return on average allocated equity	19.15%	20.55%	19.31%	15.91%
Average full-time equivalent employees	8,761	8,420	319	323

Nine months ended September 30, <i>dollars in millions</i>	Regional Banking		Commercial Banking	
	2006	2005	2006	2005
Total revenue (TE)	\$ 1,681	\$ 1,634	\$ 297	\$ 289
Provision for loan losses	73	70	(2)	7
Noninterest expense	1,235	1,187	151	139
Net income	233	235	93	90
Average loans and leases	18,756	19,169	8,004	7,818
Average deposits	42,910	40,514	3,596	3,361
Net loan charge-offs	61	70	13	13
Return on average allocated equity	19.62%	19.84%	17.25%	16.88%
Average full-time equivalent employees	8,642	8,385	319	320

Supplementary information (National Banking lines of business)

Three months ended September 30, <i>dollars in millions</i>	Real Estate Capital		Equipment Finance		Institutional and Capital Markets		Consumer Finance	
	2006	2005	2006	2005	2006	2005	2006	2005
Total revenue (TE)	\$ 169	\$ 148	\$ 137	\$ 122	\$ 188	\$ 180	\$ 137	\$ 151
Provision for loan losses	14	4	4	5	(3)	(5)	(6)	13
Noninterest expense	70	64	82	72	110	109	78	81
Net income	53	50	32	28	50	48	41	35
Average loans and leases ^a	12,854	11,265	10,108	9,133	7,377	7,316	8,428	9,358
Average loans held for sale ^a	1,022	603	6		455		4,709	2,908
Average deposits	3,598	2,100	19	14	6,704	4,986	747	685
Net loan charge-offs (recoveries)			12	11	(1)		10	13
Return on average allocated equity	18.64%	19.60%	14.73%	14.32%	18.10%	18.03%	18.09%	15.58%
Average full-time equivalent employees	970	812	927	966	1,305	1,255	1,371	1,385

Nine months ended September 30, <i>dollars in millions</i>	Real Estate Capital		Equipment Finance		Institutional and Capital Markets		Consumer Finance	
	2006	2005	2006	2005	2006	2005	2006	2005
Total revenue (TE)	\$ 498	\$ 389	\$ 397	\$ 375	\$ 578	\$ 524	\$ 414	\$ 487
Provision for loan losses	28	4	25	6	(34)	(16)	4	36
Noninterest expense	207	166	240	220	330	298	241	267
Net income	164	137	83	93	176	151	106	115
Average loans and leases ^a	12,682	10,557	9,851	8,993	7,595	7,785	9,370	9,455
Average loans held for sale ^a	765	432	16		237		3,563	3,213
Average deposits	3,428	1,783	16	12	6,394	4,896	722	639
Net loan charge-offs (recoveries)	4	7	18	14	(6)	9	26	38
Return on average allocated equity	19.65%	18.67%	13.16%	16.09%	21.69%	18.73%	15.73%	16.55%
Average full-time equivalent employees	977	781	926	982	1,264	1,221	1,340	1,518

(a) On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business. This transfer reduced average home equity loans and increased average loans held for sale by approximately \$1.6 billion for the third quarter of 2006 and approximately \$550 million for the first nine months of 2006.

TE = Taxable Equivalent

Table of Contents**5. Securities**

Key classifies each security held into one of four categories: trading, available for sale, investment or other investments.

Trading account securities. These are debt and equity securities that are purchased and held by Key with the intent of selling them in the near term. Trading account securities are reported at fair value (\$817 million at September 30, 2006, \$850 million at December 31, 2005, and \$1.1 billion at September 30, 2005) and are included in short-term investments on the balance sheet. Realized and unrealized gains and losses on trading account securities are reported in investment banking and capital markets income on the income statement.

Securities available for sale. These are securities that Key intends to hold for an indefinite period of time and that may be sold in response to changes in interest rates, prepayment risk, liquidity needs or other factors. Securities available for sale, which include debt and marketable equity securities with readily determinable fair values, are reported at fair value. Unrealized gains and losses (net of income taxes) deemed temporary are recorded in shareholders equity as a component of accumulated other comprehensive loss on the balance sheet. Unrealized losses on specific securities deemed to be other-than-temporary are included in net securities gains (losses) on the income statement, as are actual gains and losses resulting from the sales of specific securities.

When Key retains an interest in loans it securitizes, it bears risk that the loans will be prepaid (which would reduce expected interest income) or not paid at all. Key accounts for these retained interests as debt securities and classifies them as available for sale.

Other securities held in the available-for-sale portfolio are primarily marketable equity securities.

Investment securities. These are debt securities that Key has the intent and ability to hold until maturity. Debt securities are carried at cost, adjusted for amortization of premiums and accretion of discounts using the interest method. This method produces a constant rate of return on the adjusted carrying amount. Other securities held in the investment securities portfolio are foreign bonds.

Other investments. Principal investments $\frac{3}{4}$ investments in equity and mezzanine instruments made by Key's Principal Investing unit $\frac{3}{4}$ represent the majority of other investments. These securities include direct investments (investments made in a particular company), as well as indirect investments (investments made through funds that include other investors). Principal investments are predominantly made in privately held companies and are carried at fair value (\$843 million at September 30, 2006, and \$800 million at December 31, 2005, and September 30, 2005). Changes in estimated fair values and actual gains and losses on sales of principal investments are included in other income on the income statement.

In addition to principal investments, other investments include other equity and mezzanine instruments that do not have readily determinable fair values. These securities include certain real estate-related investments that are carried at estimated fair value, as well as other types of securities that generally are carried at cost. The carrying amount of the securities carried at cost is adjusted for declines in value that are considered to be other-than-temporary. These adjustments are included in investment banking and capital markets income on the income statement.

The amortized cost, unrealized gains and losses, and approximate fair value of Key's investment securities and securities available for sale are presented in the following tables. Gross unrealized gains and losses are represented by the difference between the amortized cost and the fair values of securities on the balance sheet as of the dates indicated. Accordingly, the amount of these gains and losses may change in the future as market conditions improve or worsen.

Table of Contents

<i>in millions</i>	September 30, 2006			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 220			\$ 220
States and political subdivisions	16	\$ 1		17
Collateralized mortgage obligations	6,762	13	\$ 125	6,650
Other mortgage-backed securities	210	2	3	209
Retained interests in securitizations	122	35		157
Other securities	179	9		188
Total securities available for sale	\$ 7,509	\$ 60	\$ 128	\$ 7,441
INVESTMENT SECURITIES				
States and political subdivisions	\$ 26	\$ 1		\$ 27
Other securities	15			15
Total investment securities	\$ 41	\$ 1		\$ 42
<i>in millions</i>	December 31, 2005			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 267	\$ 1		\$ 268
States and political subdivisions	17	1		18
Collateralized mortgage obligations	6,455	2	\$ 159	6,298
Other mortgage-backed securities	233	5	4	234
Retained interests in securitizations	115	67		182
Other securities	261	8		269
Total securities available for sale	\$ 7,348	\$ 84	\$ 163	\$ 7,269
INVESTMENT SECURITIES				
States and political subdivisions	\$ 35	\$ 1		\$ 36
Other securities	56			56
Total investment securities	\$ 91	\$ 1		\$ 92

<i>in millions</i>	September 30, 2005			Fair
	Amortized	Gross	Gross	Value
	Cost	Unrealized	Unrealized	
		Gains	Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 283			\$ 283
States and political subdivisions	19			19
Collateralized mortgage obligations	6,390	\$ 1	\$ 125	6,266
Other mortgage-backed securities	255	6	3	258
Retained interests in securitizations	98	73		171
Other securities	120	7		127
 Total securities available for sale	 \$ 7,165	 \$ 87	 \$ 128	 \$ 7,124
 INVESTMENT SECURITIES				
States and political subdivisions	\$ 42	\$ 1		\$ 43
Other securities	56			56
 Total investment securities	 \$ 98	 \$ 1		 \$ 99

Table of Contents**6. Loans and Loans Held for Sale**

Key's loans by category are summarized as follows:

<i>in millions</i>	September 30, 2006	December 31, 2005	September 30, 2005
Commercial, financial and agricultural ^a	\$ 21,556	\$ 20,579	\$ 19,451
Commercial real estate:			
Commercial mortgage	8,266	8,360	8,618
Construction	8,272	7,109	6,700
Total commercial real estate loans	16,538	15,469	15,318
Commercial lease financing ^a	9,860	10,352	10,339
Total commercial loans	47,954	46,400	45,108
Real estate residential mortgage	1,407	1,458	1,476
Home equity ^b	10,988	13,488	13,872
Consumer direct	1,576	1,794	1,792
Consumer indirect:			
Marine	2,982	2,715	2,676
Other	644	623	651
Total consumer indirect loans	3,626	3,338	3,327
Total consumer loans	17,597	20,078	20,467
Total loans	\$ 65,551	\$ 66,478	\$ 65,575

Key uses interest rate swaps to manage interest rate risk; these swaps modify the repricing and maturity characteristics of certain loans. For more information about such swaps, see Note 19 (Derivatives and Hedging Activities), which begins on page 87 of Key's 2005 Annual Report to Shareholders.

(a) At March 31, 2006, Key reclassified \$792 million of loans from the commercial lease financing component of the commercial loan portfolio to the commercial, financial and agricultural component to more accurately reflect the nature of these receivables. Balances presented for prior periods were not reclassified as the historical data was not available.

(b) On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.

Key's loans held for sale by category are summarized as follows:

<i>in millions</i>	September 30, 2006	December 31, 2005	September 30, 2005
Commercial, financial and agricultural	\$ 219	\$ 85	
Real estate commercial mortgage	1,062	525	\$ 416

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Real estate construction	198	51	5
Commercial lease financing	2		
Real estate residential mortgage	21	11	21
Home equity ^a	2,485		1
Education	3,147	2,687	3,123
Automobile	16	22	29
Total loans held for sale	\$ 7,150	\$ 3,381	\$ 3,595

(a) On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.

Table of Contents

Changes in the allowance for loan losses are summarized as follows:

<i>in millions</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 956	\$ 1,100	\$ 966	\$ 1,138
Charge-offs	(70)	(69)	(194)	(222)
Recoveries	27	20	78	71
Net loans charged off	(43)	(49)	(116)	(151)
Provision for loan losses	31	43	94	107
Foreign currency translation adjustment		(1)		(1)
Balance at end of period	\$ 944	\$ 1,093	\$ 944	\$ 1,093

Changes in the allowance for credit losses on lending-related commitments are summarized as follows:

<i>in millions</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 59	\$ 57	\$ 59	\$ 66
Provision (credit) for losses on lending-related commitments		2		(7)
Balance at end of period ^a	\$ 59	\$ 59	\$ 59	\$ 59

(a) Included in accrued expense and other liabilities on the consolidated balance sheet.

7. Variable Interest Entities

A VIE is a partnership, limited liability company, trust or other legal entity that meets any one of certain criteria specified in Revised Interpretation No. 46. This interpretation requires VIEs to be consolidated by the party who is exposed to the majority of the VIE's expected losses and/or residual returns (i.e., the primary beneficiary).

Key's VIEs, including those consolidated and those in which Key holds a significant interest, are summarized below.

Key defines a significant interest in a VIE as a subordinated interest that exposes Key to a significant portion, but not the majority, of the VIE's expected losses or residual returns.

<i>in millions</i>	Consolidated	Unconsolidated VIEs	
	VIEs	Total	Maximum
	Total Assets	Assets	Exposure to Loss
September 30, 2006			
Commercial paper conduit	\$ 190	N/A	N/A

Low-income housing tax credit (LIHTC) funds	353	\$	190		
LIHTC investments	N/A		741	\$	219

N/A = Not Applicable

The noncontrolling interests associated with the consolidated LIHTC guaranteed funds are considered mandatorily redeemable instruments and are recorded in accrued expense and other liabilities on the balance sheet. The FASB has indefinitely deferred the measurement and recognition provisions of SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, for mandatorily redeemable noncontrolling interests associated with finite-lived subsidiaries, such as Key's LIHTC guaranteed funds. Key currently accounts for these noncontrolling interests as minority interests and adjusts the financial statements each period for the investors' share of the funds' profits and losses. At September 30, 2006, the settlement value of these noncontrolling interests was estimated to be between \$377 million and \$448 million, while the recorded value, including reserves, totaled \$346 million.

Key's Principal Investing unit and the Real Estate Capital line of business make equity and mezzanine investments in entities, some of which are VIEs. These investments are held by nonregistered investment companies subject to the provisions of the American Institute of Certified Public Accountants (AICPA)

Table of Contents

Audit and Accounting Guide, Audits of Investment Companies. The FASB deferred the effective date of Revised Interpretation No. 46 for such nonregistered investment companies until the AICPA clarifies the scope of the Audit Guide. As a result, Key is not currently applying the accounting or disclosure provisions of Revised Interpretation No. 46 to its principal and real estate mezzanine and equity investments, which remain unconsolidated. Additional information pertaining to Revised Interpretation No. 46 and the activities of the specific VIEs with which Key is involved is provided in Note 8 (Loan Securitizations, Servicing and Variable Interest Entities) of Key's 2005 Annual Report to Shareholders under the heading Variable Interest Entities on page 71.

8. Nonperforming Assets and Past Due Loans

Impaired loans totaled \$122 million at September 30, 2006, compared to \$105 million at December 31, 2005, and \$194 million at September 30, 2005. Impaired loans averaged \$121 million for the third quarter of 2006 and \$141 million for the third quarter of 2005.

Key's nonperforming assets and past due loans were as follows:

<i>in millions</i>	September 30, 2006	December 31, 2005	September 30, 2005
Impaired loans	\$ 122	\$ 105	\$ 194
Other nonaccrual loans ^a	101	172	166
Total nonperforming loans	223	277	360
Nonperforming loans held for sale ^a	56	3	2
Other real estate owned (OREO)	52	25	29
Allowance for OREO losses	(3)	(2)	(3)
OREO, net of allowance	49	23	26
Other nonperforming assets	1	4	5
Total nonperforming assets	\$ 329	\$ 307	\$ 393
Impaired loans with a specifically allocated allowance	\$ 27	\$ 9	\$ 8
Allowance for loan losses allocated to impaired loans	12	6	4
Accruing loans past due 90 days or more	\$ 125	\$ 90	\$ 94
Accruing loans past due 30 through 89 days	715	491	550

(a) On August 1, 2006, Key transferred approximately \$55 million of home equity loans from nonperforming loans to nonperforming loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.

At September 30, 2006, Key did not have any significant commitments to lend additional funds to borrowers with loans on nonperforming status.

Key evaluates the collectibility of most impaired loans individually as described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan Losses on page 59 of Key's 2005 Annual Report to Shareholders. Key does not perform a loan-specific impairment valuation for smaller-balance, homogeneous,

nonaccrual loans (shown in the preceding table as Other nonaccrual loans). These typically are smaller-balance commercial loans and consumer loans, including residential mortgages, home equity loans and various types of installment loans. Management applies historical loss experience rates to these loans, adjusted to reflect emerging credit trends and other factors, and then allocates a portion of the allowance for loan losses to each loan type.

9. Capital Securities Issued by Unconsolidated Subsidiaries

KeyCorp owns the outstanding common stock of business trusts that issued corporation-obligated mandatorily redeemable preferred capital securities (capital securities). The trusts used the proceeds from the issuance of their capital securities and common stock to buy debentures issued by KeyCorp. These debentures are the trusts only assets; the interest payments from the debentures finance the distributions paid on the capital securities.

The capital securities provide an attractive source of funds since they constitute Tier 1 capital for regulatory reporting purposes, but have the same tax advantages as debt for federal income tax purposes. During the first quarter of 2005, the Federal Reserve Board adopted a rule that allows bank holding companies to

Table of Contents

continue to treat capital securities as Tier 1 capital, but with stricter quantitative limits that take effect after a five-year transition period ending March 31, 2009. Management believes that the new rule will not have any material effect on Key's financial condition.

To the extent the trusts have funds available to make payments, KeyCorp continues to unconditionally guarantee payment of:

w required distributions on the capital securities;

w the redemption price when a capital security is redeemed; and

w amounts due if a trust is liquidated or terminated.

During the first nine months of 2006, the business trusts did not repurchase any capital securities or related debentures. On June 20, 2006, \$250 million of securities were issued by the KeyCorp Capital VIII trust.

The debentures held by the KeyCorp Institutional Capital A and KeyCorp Institutional Capital B trusts are redeemable at the option of KeyCorp, at a premium, on or after December 1, 2006, and December 15, 2006, respectively. The capital securities are subject to mandatory redemption upon repayment of the debentures. KeyCorp intends to exercise its option to redeem the debentures held by the Capital A and Capital B trusts as soon as possible in order to minimize interest expense. Management has determined that KeyCorp will remain well-capitalized following the redemptions.

The capital securities, common stock and related debentures are summarized as follows:

<i>dollars in millions</i>	Capital Securities, Net of Discount^a	Common Stock	Principal Amount of Debentures, Net of Discount^b	Interest Rate of Capital Securities and Debentures^c	Maturity of Capital Securities and Debentures
September 30, 2006					
KeyCorp Institutional Capital A	\$ 364	\$ 11	\$ 361	7.826%	2026
KeyCorp Institutional Capital B	157	4	154	8.250	2026
KeyCorp Capital I	197	8	205	6.248	2028
KeyCorp Capital II	176	8	165	6.875	2029
KeyCorp Capital III	225	8	197	7.750	2029
KeyCorp Capital V	161	5	180	5.875	2033
KeyCorp Capital VI	72	2	77	6.125	2033
KeyCorp Capital VII	226	8	258	5.700	2035
KeyCorp Capital VIII	252		250	7.000	2066
Total	\$ 1,830	\$ 54	\$ 1,847	6.977%	
December 31, 2005					
	\$ 1,617	\$ 54	\$ 1,597	6.794%	
September 30, 2005					
	\$ 1,633	\$ 54	\$ 1,597	6.729%	

(a) The capital securities must be redeemed when the related debentures mature, or earlier if provided in the governing indenture. Each issue of capital securities carries an interest rate identical to that of the related

debenture. Included in certain capital securities at September 30, 2006, December 31, 2005, and September 30, 2005, are basis adjustments of \$37 million, \$74 million and \$90 million, respectively, related to fair value hedges. See Note 19 (Derivatives and Hedging Activities), which begins on page 87 of Key s 2005 Annual Report to Shareholders, for an explanation of fair value hedges.

- (b) KeyCorp has the right to redeem its debentures: (i) in whole or in part, on or after December 1, 2006 (for debentures owned by Capital A), December 15, 2006 (for debentures owned by Capital B), July 1, 2008 (for debentures owned by Capital I), March 18, 1999 (for debentures owned by Capital II), July 16, 1999 (for debentures owned by Capital III), July 21, 2008 (for debentures owned by Capital V), December 15, 2008 (for debentures owned by Capital VI), and June 15, 2011 (for debentures owned by Capital VIII); and, (ii) in whole at any time within 90 days after and during the continuation of a tax event, an investment company event or a capital treatment event (as defined in the applicable indenture). If the debentures purchased by Capital A or Capital B are redeemed before they mature, the redemption price will be the principal amount, plus a premium, plus any accrued but unpaid interest. If the debentures purchased by Capital I, Capital V, Capital VI, Capital VII or Capital VIII are redeemed before they mature, the redemption price will be the principal amount, plus any accrued but unpaid interest. If the debentures purchased by Capital II or Capital III are redeemed before they mature, the redemption price will be the greater of: (a) the principal amount, plus any accrued but unpaid interest or (b) the sum of the present values of principal and interest payments discounted at the Treasury Rate (as defined in the applicable indenture), plus 20 basis points (25 basis points for Capital III), plus any accrued but unpaid interest. When debentures are redeemed in response to tax or capital treatment events, the redemption price generally is slightly more favorable to KeyCorp.
- (c) The interest rates for Capital A, Capital B, Capital II, Capital III, Capital V, Capital VI, Capital VII and Capital VIII are fixed. Capital I has a floating interest rate equal to three-month LIBOR plus 74 basis points; it reprices quarterly. The rates shown as the total at September 30, 2006, December 31, 2005, and September 30, 2005, are weighted-average rates.

Table of Contents**10. Stock-Based Compensation**

Key maintains several stock-based compensation plans, which are described below. Total compensation expense for these plans was \$48 million and \$57 million for the nine-month periods ended September 30, 2006 and 2005, respectively. The total income tax benefit recognized in the income statement for these plans was \$18 million and \$21 million for the nine-month periods ended September 30, 2006 and 2005, respectively. Stock-based compensation expense related to awards granted to employees is recorded in personnel expense on the income statement, whereas compensation expense related to awards granted to directors is recorded in other expense.

Key's compensation plans allow KeyCorp to grant stock options, restricted stock, performance shares, discounted stock purchases and certain deferred compensation-related awards to eligible employees and directors. At September 30, 2006, KeyCorp had 67,945,891 common shares available for future grant under its compensation plans. In accordance with a resolution adopted by the Compensation and Organization Committee of Key's Board of Directors, KeyCorp may not grant options to purchase common shares, restricted stock or other shares under its long-term compensation plans in an amount that exceeds 6% of KeyCorp's outstanding common shares in any rolling three-year period.

Stock Option Plans

Stock options granted to employees and directors generally become exercisable at the rate of 33-1/3% per year beginning one year from their grant date and expire no later than ten years from their grant date. Exercise prices cannot be less than the fair market value of Key's common shares on the grant date. The exercise price is the average of the high and low price of Key's common shares on the date of grant by the Compensation and Organization Committee. Management estimates the fair value of options granted using the Black-Scholes option-pricing model. This model was originally developed to estimate the fair value of exchange-traded equity options, which (unlike employee stock options) have no vesting period or transferability restrictions. Because of these differences, the Black-Scholes model is not a perfect indicator of the value of an employee stock option, but it is commonly used for this purpose. The model assumes that the estimated fair value of an option is amortized as compensation expense over the option's vesting period.

The Black-Scholes model requires several assumptions, which management developed and updates based on historical trends and current market observations. The accuracy of these assumptions is critical to management's ability to estimate the fair value of options accurately. The assumptions pertaining to options issued during the nine-month periods ended September 30, 2006 and 2005, are shown in the following table.

	Nine months ended September 30,	
	2006	2005
Average option life	6.0 years	5.0 years
Future dividend yield	3.79%	3.79%
Historical share price volatility	.199	.274
Weighted-average risk-free interest rate	5.0%	4.0%

Key's annual stock option grant to its executives and certain other employees occurs in July, upon approval by the Compensation and Organization Committee.

The following table summarizes activity, pricing and other information for Key's stock options for the nine-month period ended September 30, 2006:

<i>dollars in millions, except per share amounts</i>	Number of Options	Weighted-Average Exercise Price Per Option	Weighted-Average Remaining Life (Years)	Aggregate Intrinsic Value ^a
Outstanding at December 31, 2005	37,265,859	\$ 28.35		

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Granted	6,570,364		36.38		
Exercised	(7,928,899)		26.90		
Lapsed or canceled	(889,383)		31.49		
Outstanding at September 30, 2006	35,017,941	\$	30.11	6.6	\$ 257
Expected to vest	31,582,749	\$	29.80	6.7	\$ 241
Exercisable at September 30, 2006	22,103,729	\$	27.82	5.7	\$ 213

(a) The intrinsic value of a stock option is the amount by which the fair value of the underlying stock exceeds the exercise price of the option.

Table of Contents

The weighted-average grant-date fair value of options granted during the nine-month periods ended September 30, 2006 and 2005, was \$6.32 and \$6.92, respectively. The total intrinsic value of options exercised during the nine-month periods ended September 30, 2006 and 2005, was \$76 million and \$30 million, respectively. As of September 30, 2006, unrecognized compensation cost related to nonvested options expected to vest under the plans totaled \$37 million. Management expects to recognize this cost over a weighted-average period of 2.4 years. The actual tax benefit realized for the tax deductions from options exercised totaled \$24 million and \$9 million for the nine-month periods ended September 30, 2006 and 2005, respectively.

Long-Term Incentive Compensation Program

Key's Long-Term Incentive Compensation Program (Program) rewards senior executives who are critical to Key's long-term financial success. The Program covers three-year performance cycles with a new cycle beginning each year. Awards under the Program are primarily in the form of time-lapsed restricted stock, performance-based restricted stock, and performance shares payable primarily in stock. The time-lapsed restricted stock generally vests after the end of the three-year cycle. The vesting of the performance-based restricted stock and performance shares is contingent upon the attainment of defined performance levels.

The following table summarizes activity and pricing information for the nonvested shares in the Program for the nine-month period ended September 30, 2006:

	Vesting Contingent on Service Conditions		Vesting Contingent on Performance and Service Conditions	
	Number of Nonvested Shares	Weighted- Average Grant-Date Fair Value	Number of Nonvested Shares	Weighted- Average Grant-Date Fair Value
Outstanding at December 31, 2005	476,034	\$ 31.43	1,190,458	\$ 31.05
Granted	222,797	35.42	738,002	33.51
Vested	(2,653)	33.73	(180)	35.42
Forfeited	(49,648)	32.93	(85,116)	31.79
Outstanding at September 30, 2006	646,530	\$ 32.68	1,843,164	\$ 31.99

The compensation cost of time-lapsed restricted stock awards granted under the Program is measured based on the average of the high and low trading price of Key's common shares on the grant date. The performance shares payable primarily in stock, unlike the time-lapsed and performance-based restricted stock, do not pay dividends during the vesting period. Consequently, the fair value of performance shares is measured by reducing the share price at the date of grant by the present value of estimated future dividends forgone during the vesting period, discounted at an appropriate risk-free interest rate. The weighted-average grant-date fair value of awards granted under the Program during the nine-month periods ended September 30, 2006 and 2005, was \$33.95 and \$32.28, respectively. As of September 30, 2006, unrecognized compensation cost related to nonvested shares expected to vest under the Program totaled \$21 million. Management expects to recognize this cost over a weighted-average period of 1.9 years. The total fair value of shares vested during the nine-month period ended September 30, 2006, was \$.1 million. There were no shares scheduled to vest during the nine-month period ended September 30, 2005.

Other Restricted Stock Awards

Key may also grant special time-lapsed restricted stock awards to certain executives and employees in recognition of high performance. These awards generally vest after three years of service.

The following table summarizes activity and pricing information for the nonvested shares under these awards for the nine-month period ended September 30, 2006:

	Number of Nonvested Shares	Weighted- Average Grant-Date Fair Value
Outstanding at December 31, 2005	250,948	\$ 28.78
Granted	13,379	33.22
Vested	(50,801)	27.45
Forfeited	(7,200)	27.77
Outstanding at September 30, 2006	206,326	\$ 29.49

Table of Contents

The weighted-average grant-date fair value of awards granted during the nine-month periods ended September 30, 2006 and 2005, was \$33.22 and \$31.68, respectively. As of September 30, 2006, unrecognized compensation cost related to nonvested restricted stock expected to vest under these special awards totaled \$2 million. Management expects to recognize this cost over a weighted-average period of 1.8 years. The total fair value of restricted stock vested during the nine-month periods ended September 30, 2006 and 2005, was \$2 million and \$.4 million, respectively.

Deferred Compensation Plans

Key's deferred compensation arrangements include voluntary and mandatory deferral programs, which award Key common shares to certain employees and directors. The mandatory deferral programs require that incentive compensation awards meeting specified criteria be automatically deferred. These deferred incentive awards, together with a 15% employer matching contribution, vest at the rate of 33-1/3% per year beginning one year after the deferral date. Deferrals under the voluntary programs, which include a nonqualified excess 401(k) savings plan, are immediately vested, except for any employer match. Key's excess 401(k) savings plan permits certain employees to defer up to 6% of their eligible compensation, with the entire deferral eligible for an employer match in the form of Key common shares. All other voluntary deferral programs provide an employer match ranging from 6% to 15% of the deferral, depending on the plan. The employer match under all voluntary programs generally vests after three years of service.

Several of Key's deferred compensation arrangements allow for deferrals to be redirected by participants into other investment elections outside of Key common shares, which provide for distributions payable in cash. Key accounts for these participant-directed deferred compensation arrangements as stock-based liabilities and remeasures the related compensation cost based on the most recent fair value of Key's common shares. Stock-based liabilities of \$2 million were paid during the nine-month periods ended September 30, 2006 and 2005. The compensation cost of all other nonparticipant-directed deferrals are measured based on the average of the high and low trading price of Key's common shares on the deferral date.

The following table summarizes activity and pricing information for the nonvested shares in Key's deferred compensation plans for the nine-month period ended September 30, 2006:

	Number of Nonvested Shares		Weighted-Average Grant-Date Fair Value
Outstanding at December 31, 2005	809,824	\$	31.74
Granted	687,217		36.37
Dividend equivalents	94,729		36.62
Vested	(580,818)		32.72
Forfeited	(53,900)		33.29
Outstanding at September 30, 2006	957,052	\$	34.87

The weighted-average grant-date fair value of awards granted during the nine-month periods ended September 30, 2006 and 2005, was \$36.37 and \$32.92, respectively. As of September 30, 2006, unrecognized compensation cost related to nonvested shares expected to vest under Key's deferred compensation plans totaled \$12 million. Management expects to recognize this cost over a weighted-average period of 2.4 years. The total fair value of shares vested during the nine-month periods ended September 30, 2006 and 2005, was \$21 million and \$20 million, respectively.

Discounted Stock Purchase Plan

Key's Discounted Stock Purchase Plan provides employees the opportunity to purchase Key's common shares at a 10% discount through payroll deductions or cash payments. Purchases are limited to \$10,000 in any month and \$50,000 in any calendar year and are immediately vested. To accommodate employee purchases, Key acquires shares on the open market on or around the fifteenth day of the month following the month of payment. During the nine-month period ended September 30, 2006, Key issued 102,458 shares at a weighted-average cost of \$35.86. During the nine-month period ended September 30, 2005, Key issued 107,898 shares at a weighted-average cost of \$33.07.

Information pertaining to Key's method of accounting for stock-based compensation is included in Note 1 (Basis of Presentation) under the heading Stock-Based Compensation on page 7.

Table of Contents**11. Employee Benefits****Pension Plans**

Net pension cost for all funded and unfunded plans includes the following components:

<i>in millions</i>	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Service cost of benefits earned	\$ 12	\$ 20	\$ 36	\$ 37
Interest cost on projected benefit obligation	13	22	41	43
Expected return on plan assets	(22)	(39)	(66)	(70)
Amortization of prior service benefit				(1)
Amortization of losses	8	9	23	17
Net pension cost	\$ 11	\$ 12	\$ 34	\$ 26

Other Postretirement Benefit Plans

Key sponsors a contributory postretirement healthcare plan that covers substantially all active and retired employees hired before 2001 who meet certain eligibility criteria. Key also sponsors life insurance plans covering certain grandfathered employees. These plans are principally noncontributory. Separate Voluntary Employee Beneficiary Association trusts are used to fund the healthcare plan and one of the life insurance plans.

Net postretirement benefit cost for these plans includes the following components:

<i>in millions</i>	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Service cost of benefits earned	\$ 1	\$ 1	\$ 4	\$ 3
Interest cost on accumulated postretirement benefit obligation	2	2	6	6
Expected return on plan assets	(1)	(1)	(3)	(3)
Amortization of unrecognized transition obligation	1	1	3	3
Amortization of cumulative net loss	1		2	2
Net postretirement benefit cost	\$ 4	\$ 3	\$ 12	\$ 11

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 was signed into law. The Act, which became effective January 1, 2006, introduces a prescription drug benefit under Medicare, as well as a federal subsidy to sponsors of retiree healthcare benefit plans that offer actuarially equivalent prescription drug coverage to retirees.

Based on regulations regarding the manner in which actuarial equivalence must be determined, management has determined that the prescription drug coverage related to Key's retiree healthcare benefit plan is actuarially equivalent, and that the subsidy will not have a material effect on Key's accumulated postretirement benefit obligation and net postretirement benefit cost.

Employee Benefits-Related Accounting Pronouncement Pending Adoption

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which requires an employer to recognize an asset or liability for the overfunded or underfunded status, respectively, of its defined benefit plans. The overfunded or underfunded status is to be measured solely as the difference between the fair value of plan assets and the projected benefit obligation. In addition, any change in a plan's funded status must be recognized in comprehensive income in the year in which it occurs. Most requirements of SFAS No. 158 will be effective for fiscal years ending after December 15, 2006 (effective December 31, 2006, for Key). However, the requirement to measure plan assets and liabilities as of the end of an employer's fiscal year will not be effective until fiscal years ending after December 15, 2008 (effective December 31, 2008, for Key). Management estimates that Key will record an after-tax charge of approximately \$145 million to the accumulated other comprehensive loss component of shareholders' equity as a result of adopting this guidance for the year ending December 31, 2006. For more information about Key's defined benefit plans, see Note 16 (*Employee Benefits*), which begins on page 78 of Key's 2005 Annual Report to Shareholders.

Table of Contents**12. Income Taxes****Lease Financing Transactions**

In the ordinary course of business, Key's equipment finance business unit (KEF) enters into various types of lease financing transactions. Between 1996 and 2004, KEF entered into certain lease financing transactions which may be characterized in three categories: Lease-In, Lease-Out (LILO) transactions; Qualified Technological Equipment Leases (QTEs); and Service Contract Leases.

LILO transactions are leveraged leasing transactions in which KEF leases property from an unrelated third party and then leases the property back to that party. The transaction is similar to a sale-leaseback, except that the property is leased by KEF, rather than purchased. QTE and Service Contract Leases are even more like sale-leaseback transactions as KEF is considered to be the purchaser of the equipment for tax purposes. KEF executed these three types of leasing transactions with both foreign and domestic customers that are primarily municipal authorities. LILO and Service Contract transactions involve commuter rail equipment, public utility facilities, and commercial aircraft. QTE transactions involve sophisticated high technology hardware and related software, such as telecommunications equipment. The terms of the leases range from ten to fifty years.

Like other forms of leasing transactions, LILO transactions generate income tax deductions for Key from net rental expense associated with the leased property, interest expense on nonrecourse debt incurred to fund the transaction, and transaction costs. QTE and Service Contract transactions generate rental income from the leasing of the property, as well as deductions from the depreciation of the property, interest expense on nonrecourse debt incurred to fund the transaction, and transaction costs.

LILO, QTE and Service Contract Leases were prevalent in the financial services industry and in certain other industries. The tax treatment that Key applied was based on applicable statutes, regulations, and judicial authority in effect at the time Key entered into these transactions. Subsequently, the Internal Revenue Service (IRS) has challenged the tax treatment of these transactions by a number of bank holding companies and other corporations. The IRS has completed audits of Key's income tax returns for the 1995 through 2000 tax years and has disallowed all deductions taken in tax years 1995 through 1997 pertaining to LILOs, and all deductions in tax years 1998 through 2000 that relate to LILOs, QTEs and Service Contract Leases. In addition, the IRS is currently conducting audits of Key's income tax returns for the 2001 through 2003 tax years, and Key expects that the IRS will disallow all similar deductions taken by Key in those tax years.

Key had previously appealed the examination results for the tax years 1995 through 1997, which pertained to LILOs only, to the Appeals Division of the IRS. During the fourth quarter of 2005, ongoing discussions with the Appeals Division were discontinued without having reached a resolution. In April 2006, Key received a final assessment from the IRS disallowing all LILO deductions taken in those tax years. The assessment, which relates principally to the 1997 tax year, consists of federal tax, interest and a penalty. Key paid the assessment and filed a refund claim for the total amount. Key has also filed an appeal with the Appeals Division of the IRS with regard to the proposed disallowance of LILO, QTE and Service Contract Lease deductions taken in the 1998 through 2000 tax years. The payment of the 1997 tax year assessment did not impact Key's earnings since the taxes had been included in previously recorded deferred taxes as required under GAAP. The payment of the interest and penalty did not materially impact Key's earnings, in part due to Key's tax reserves, and also because Key is recording a receivable on its balance sheet for amounts that are not charged to Key's tax reserve.

Management believes that these LILO, QTE and Service Contract Lease transactions were entered into in conformity with the tax laws in effect at the time, and Key intends to vigorously pursue the IRS appeals process and its litigation alternatives. Key cannot currently estimate the financial outcome of the appeals process and any ensuing litigation; however, if Key were not to prevail in these efforts or were to enter into a settlement agreement with the IRS, in addition to previously accrued tax amounts that would be due to the IRS, Key would owe interest and possibly penalties, which could be material in amount. Such an outcome would not have a material effect on Key's financial condition, but could have a material adverse effect on Key's results of operations in the period it occurs.

Table of Contents**Tax-Related Accounting Pronouncements Pending Adoption**

In July 2006, the FASB issued Staff Position No. 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*, which provides additional guidance on the application of SFAS No. 13, *Accounting for Leases*. This guidance will affect when earnings from leveraged lease transactions would be recognized when there are changes or projected changes in the timing of cash flows, including changes due to or expected to be due to settlements of tax matters. Previously, leveraged lease transactions were required to be recalculated only when a change in the total cash flows occurred. This guidance will be effective for fiscal years beginning after December 15, 2006 (effective January 1, 2007, for Key). Management currently estimates that the adoption of this guidance will result in a cumulative after-tax charge to Key's retained earnings in the range of \$50 million to \$65 million. However, future earnings are expected to increase over the remaining term of the affected leases by a similar amount.

In July 2006, the FASB also issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the application of SFAS No. 109, *Accounting for Income Taxes*, by defining the minimum threshold that a tax position must meet before any associated benefit may be recognized in a company's financial statements. In accordance with this guidance, a company may recognize the benefit if management concludes that the tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. If such a conclusion is reached, the tax benefit is to be measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. This interpretation also provides guidance on measurement and derecognition of tax benefits, and requires expanded disclosures. The interpretation will be effective at the beginning of the fiscal year beginning after December 15, 2006 (effective January 1, 2007, for Key). Management is currently evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

13. Contingent Liabilities and Guarantees**Legal Proceedings**

Residual value insurance litigation. Key Bank USA obtained two insurance policies from Reliance Insurance Company (*Reliance*) insuring the residual value of certain automobiles leased through Key Bank USA. The two policies (the *Policies*), the 4011 Policy and the 4019 Policy, together covered leases entered into during the period from January 1, 1997, to January 1, 2001.

The 4019 Policy contains an endorsement (*REINS-1 Endorsement*) stating that Swiss Reinsurance America Corporation (*Swiss Re*) will assume and reinsure 100% of Reliance's obligations under the 4019 Policy in the event Reliance Group Holdings (*Reliance's* parent) so-called *claims-paying ability* were to fall below investment grade. Key Bank USA also entered into an agreement (*Letter Agreement*) with Swiss Re and Reliance whereby Swiss Re agreed to issue to Key Bank USA an insurance policy on the same terms and conditions as the 4011 Policy in the event the financial condition of Reliance Group Holdings fell below a certain level. Around May 2000, the conditions under both the 4019 Policy and the Letter Agreement were triggered.

The 4011 Policy was canceled and replaced as of May 1, 2000, by a policy issued by North American Specialty Insurance Company (a subsidiary or affiliate of Swiss Re) (the *NAS Policy*). Tri-Arc Financial Services, Inc. (*Tri-Arc*) acted as agent for Reliance, Swiss Re and NAS. From February 2000 through September 2004, Key Bank USA filed claims, and since October 2004, KeyBank National Association (*KBNA*) (successor to Key Bank USA) has filed claims under the Policies, but none of these claims has been paid.

In July 2000, Key Bank USA filed a claim for arbitration against Reliance, Swiss Re, NAS and Tri-Arc seeking, among other things, a declaration of the scope of coverage under the Policies and for damages. On January 8, 2001, Reliance filed an action (litigation) against Key Bank USA in Federal District Court in Ohio seeking rescission or reformation of the Policies because they allegedly do not reflect the intent of the parties with respect to the scope of coverage and how and when claims were to be paid. Key filed an

Table of Contents

answer and counterclaim against Reliance, Swiss Re, NAS and Tri-Arc seeking, among other things, declaratory relief as to the scope of coverage under the Policies, damages for breach of contract and failure to act in good faith, and punitive damages. The parties agreed to proceed with this court action and to dismiss the arbitration without prejudice. On May 29, 2001, the Commonwealth Court of Pennsylvania entered an order placing Reliance in a court supervised rehabilitation and purporting to stay all litigation against Reliance. On July 23, 2001, the Federal District Court in Ohio stayed the litigation to allow the rehabilitator to complete her task. On October 3, 2001, the Court in Pennsylvania entered an order placing Reliance into liquidation and canceling all Reliance insurance policies as of November 2, 2001. On November 20, 2001, the Federal District Court in Ohio entered an order that, among other things, required Reliance to report to the Court on the progress of the liquidation. On January 15, 2002, Reliance filed a status report requesting the continuance of the stay for an indefinite period. On February 20, 2002, Key Bank USA asked the Court to allow the case to proceed against the parties other than Reliance, and the Court granted that motion on May 17, 2002. As of February 19, 2003, all claims against Tri-Arc were dismissed through a combination of court action and voluntary dismissal by Key Bank USA.

On August 4, 2004, the Court ruled on Key's and Swiss Re's motions for summary judgment on issues related to liability. In its written decision, which is publicly available, the Court held as a matter of law that Swiss Re breached its Letter Agreement with Key by not issuing a replacement policy covering the leases insured under Key's 4011 Policy that were booked between October 1, 1998, and April 30, 2000. With respect to Key's claims under the 4019 Policy, the Court held that Swiss Re is not entitled to judgment as a matter of law on Key's claim that Swiss Re authorized Tri-Arc to issue the REINS-1 Endorsement. The Court also held that Swiss Re is not entitled to judgment as a matter of law on Key's claim that Swiss Re acted in bad faith.

On September 29, 2006, the Court ruled on Key's and Swiss Re's motions for summary judgment on damages and other issues. In its written decision, which is publicly available, the Court dismissed Swiss Re's affirmative defenses that Key had failed to mitigate its damages and that Key had committed fraud in its submission of claims. The Court also substantially upheld Key's damages claims for losses under the Policies, previously estimated by Key to be in the range of approximately \$342 million to \$357 million.

Management believes that KBNA (successor to Key Bank USA) has valid insurance coverage or claims for damages relating to the residual value of automobiles leased through Key Bank USA during the four-year period ending January 1, 2001. Key has completed the process of submitting insurance claims for its losses to Swiss Re.

In addition to seeking recovery of residual value losses under the Policies, Key expects to seek recovery of interest, damages on Key's claim that Swiss Re acted in bad faith, and other damages attributable to Swiss Re's denial of coverage. The precise amount of those damages will be determined through further legal proceedings.

As previously reported, Key has recorded on its balance sheet a portion of the amount of the insurance claims as a receivable. Management continues to believe the amount being recorded as a receivable due from the insurance carriers is appropriate to reflect the collectibility risk associated with the insurance litigation; however, litigation is inherently not without risk, and any actual recovery from the litigation may be more or less than the receivable. While management does not expect an adverse decision, if a court were to make an adverse final determination, such result would cause Key to record a material one-time expense during the period when such determination is made. An adverse determination would not have a material effect on Key's financial condition, but could have a material adverse effect on Key's results of operations in the period it occurs.

Other litigation. In the ordinary course of business, Key is subject to legal actions that involve claims for substantial monetary relief. Based on information presently known to management, management does not believe there is any legal action to which KeyCorp or any of its subsidiaries is a party, or involving any of their properties, that, individually or in the aggregate, would reasonably be expected to have a material adverse effect on Key's financial condition.

Table of Contents**Tax Contingency**

In the ordinary course of business, Key enters into certain transactions that have tax consequences. On occasion, the IRS may challenge a particular tax position taken by Key. The IRS has completed its review of Key's tax returns for the 1995 through 2000 tax years and has disallowed all LIFO deductions taken in the 1995 through 1997 tax years and all deductions taken in the 1998 through 2000 tax years that relate to certain lease financing transactions. In addition, the IRS is currently conducting audits of the 2001 through 2003 tax years. Key expects that the IRS will disallow all similar deductions taken in those years. Further information on Key's position on these matters and on the potential implications to Key is included in Note 12 (Income Taxes) under the heading Lease Financing Transactions on page 27.

Guarantees

Key is a guarantor in various agreements with third parties. The following table shows the types of guarantees that Key had outstanding at September 30, 2006. Information pertaining to the basis for determining the liabilities recorded in connection with these guarantees is included in Note 1 (Summary of Significant Accounting Policies) under the heading Guarantees on page 61 of Key's 2005 Annual Report to Shareholders.

<i>in millions</i>	Maximum Potential Undiscounted Future Payments	Liability Recorded
Financial Guarantees:		
Standby letters of credit	\$ 12,944	\$ 34
Credit enhancement for asset-backed commercial paper conduit	28	
Recourse agreement with FNMA	630	8
Return guarantee agreement with LIHTC investors	448	41
Default guarantees	11	1
Written interest rate caps ^a	71	7
Total	\$ 14,132	\$ 91

(a) As of September 30, 2006, the weighted-average interest rate of written interest rate caps was 5.1%, and the weighted-average strike rate was 5.2%. Maximum potential undiscounted future payments were calculated assuming a 10% interest rate.

Standby letters of credit. These instruments, issued on behalf of clients, obligate Key to pay a specified third party when a client fails to repay an outstanding loan or debt instrument, or fails to perform some contractual nonfinancial obligation. Standby letters of credit are issued by many of Key's lines of business to address clients' financing needs. Any amounts drawn under standby letters of credit are treated as loans; they bear interest (generally at variable rates) and pose the same credit risk to Key as a loan. At September 30, 2006, Key's standby letters of credit had a remaining weighted-average life of 2.6 years, with remaining actual lives ranging from less than one year to as many as twelve years.

Credit enhancement for asset-backed commercial paper conduit. Key provides credit enhancement in the form of a committed facility to ensure the continuing operations of an asset-backed commercial paper conduit that is owned by a third party and administered by an unaffiliated financial institution. The commitment to provide credit enhancement extends until September 21, 2007, and specifies that in the event of default by certain borrowers whose loans are held by the conduit, Key will provide financial relief to the conduit in an amount that is based on defined criteria that consider the level of credit risk involved and other factors.

At September 30, 2006, Key's maximum potential funding requirement under the credit enhancement facility totaled \$28 million. However, there were no drawdowns under the facility during the nine-month period ended September 30, 2006. Key has no recourse or other collateral available to offset any amounts that may be funded under this credit enhancement facility. Management periodically evaluates Key's commitment to provide credit enhancement to the conduit.

Recourse agreement with Federal National Mortgage Association. KBNA participates as a lender in the Federal National Mortgage Association (FNMA) Delegated Underwriting and Servicing (DUS) program. As a condition to FNMA's delegation of responsibility for originating, underwriting and servicing mortgages, KBNA has agreed to assume a limited portion of the risk of loss during the remaining term on each commercial mortgage loan sold to FNMA. Accordingly, KBNA maintains a reserve for such potential

Table of Contents

losses in an amount estimated by management to approximate the fair value of KBNA's liability. At September 30, 2006, the outstanding commercial mortgage loans in this program had a weighted-average remaining term of 8.2 years, and the unpaid principal balance outstanding of loans sold by KBNA as a participant in this program was approximately \$2.0 billion. The maximum potential amount of undiscounted future payments that may be required under this program is generally equal to one-third of the principal balance of loans outstanding at September 30, 2006. If payment is required under this program, Key would have an interest in the collateral underlying the commercial mortgage loan on which the loss occurred.

Return guarantee agreement with LIHTC investors. Key Affordable Housing Corporation (KAHC), a subsidiary of KBNA, offered limited partnership interests to qualified investors. Partnerships formed by KAHC invested in low-income residential rental properties that qualify for federal LIHTCs under Section 42 of the Internal Revenue Code. In certain partnerships, investors pay a fee to KAHC for a guaranteed return that is based on the financial performance of the property and the property's confirmed LIHTC status throughout a fifteen-year compliance period. If KAHC defaults on its obligation, Key is obligated to make any necessary payments to investors to provide the guaranteed return. In October 2003, management elected to discontinue new partnerships under this program. No recourse or collateral is available to offset the guarantee obligation other than the underlying income stream from the properties. These guarantees have expiration dates that extend through 2018. Key meets its obligations pertaining to the guaranteed returns generally through the distribution of tax credits and deductions associated with the specific properties.

As shown in the table on page 30, KAHC maintained a reserve in the amount of \$41 million at September 30, 2006, which management believes will be sufficient to cover estimated future obligations under the guarantees. The maximum exposure to loss reflected in the preceding table represents undiscounted future payments due to investors for the return on and of their investments. In accordance with FASB Interpretation No. 45, the amount of all fees received in consideration for any return guarantee agreements entered into or modified with LIHTC investors on or after January 1, 2003, has been recognized in the liability recorded.

Various types of default guarantees. Some lines of business provide or participate in guarantees that obligate Key to perform if the debtor fails to satisfy all of its payment obligations to third parties. Key generally undertakes these guarantees to support or protect its underlying investment or where the risk profile of the debtor should provide an investment return. The terms of these default guarantees range from less than one year to as many as sixteen years. Although no collateral is held, Key would have recourse against the debtor for any payments made under a default guarantee.

Written interest rate caps. In the ordinary course of business, Key writes interest rate caps for commercial loan clients that have variable rate loans with Key and wish to limit their exposure to interest rate increases. At September 30, 2006, these caps had a weighted-average life of 2.4 years.

Key is obligated to pay the client if the applicable benchmark interest rate exceeds a specified level (known as the strike rate). These instruments are accounted for as derivatives. Key's potential amount of future payments under these obligations is mitigated by offsetting positions with third parties.

Other Off-Balance Sheet Risk

Other off-balance sheet risk stems from financial instruments that do not meet the definition of a guarantee as specified in FASB Interpretation No. 45 and from other relationships.

Significant liquidity facilities that support asset-backed commercial paper conduits. Key provides liquidity to two asset-backed commercial paper conduits that are separately owned by third parties and administered by unaffiliated financial institutions. These liquidity facilities obligate Key through November 5, 2008, and September 27, 2007, to provide funding of up to \$1.0 billion and \$287 million, respectively, if required as a result of a disruption in credit markets or other factors that preclude the issuance of

Table of Contents

commercial paper by the conduits. The amounts available to be drawn, which are based on the amount of current commitments to borrowers in each of the conduits, were \$296 million and \$284 million, respectively, at September 30, 2006, but there were no drawdowns under these committed facilities at that time. Key's commitments to provide liquidity are periodically evaluated by management.

Indemnifications provided in the ordinary course of business. Key provides certain indemnifications primarily through representations and warranties in contracts that are entered into in the ordinary course of business in connection with loan sales and other ongoing activities, as well as in connection with purchases and sales of businesses. Management's past experience with these indemnifications has been that the amounts paid, if any, have not had a significant effect on Key's financial condition or results of operations.

Intercompany guarantees. KeyCorp and certain other Key affiliates are parties to various guarantees that facilitate the ongoing business activities of other Key affiliates. These business activities encompass debt issuance, certain lease and insurance obligations, investments and securities, and certain leasing transactions involving clients.

14. Derivatives and Hedging Activities

Key, mainly through its subsidiary bank, KBNA, is party to various derivative instruments which are used for asset and liability management, credit risk management and trading purposes. The primary derivatives that Key uses are interest rate swaps, caps and futures, and foreign exchange forward contracts. All interest rate swaps and caps, and foreign exchange forward contracts held are over-the-counter instruments. Generally, these instruments help Key manage exposure to market risk, mitigate the credit risk inherent in our loan portfolio and meet client's financing needs. Market risk represents the possibility that economic value or net interest income will be adversely affected by changes in interest rates or other economic factors.

At September 30, 2006, Key had \$111 million of derivative assets and \$80 million of derivative liabilities on its balance sheet that arose from derivatives that were being used for hedging purposes. As of the same date, derivative assets and liabilities classified as trading derivatives totaled \$804 million and \$764 million, respectively. Derivative assets and liabilities are recorded at fair value on the balance sheet.

Counterparty Credit Risk

Like other financial instruments, derivatives contain an element of credit risk—the possibility that Key will incur a loss because a counterparty, which may be a bank or a broker/dealer, may fail to meet its contractual obligations. This risk is measured as the expected positive replacement value of contracts. To mitigate credit risk when managing its asset, liability and trading positions, Key deals exclusively with counterparties that have high credit ratings.

Key uses two additional means to manage exposure to credit risk on swap contracts. First, Key generally enters into bilateral collateral and master netting arrangements. These agreements provide for the net settlement of all contracts with a single counterparty in the event of default. Second, Key's Credit Administration department monitors credit risk exposure to the counterparty on each interest rate swap to determine appropriate limits on Key's total credit exposure and decide whether to demand collateral. If Key determines that collateral is required, it is generally collected immediately. Key generally holds collateral in the form of cash and highly rated treasury and agency-issued securities. At September 30, 2006, Key was party to derivative contracts with 53 different counterparties. These derivatives include interest rate swaps and caps, credit derivatives, energy derivatives and foreign exchange contracts. Among these were contracts entered into to offset the risk of client exposure. Key had aggregate exposure of \$173 million on these instruments to 24 of the 53 counterparties. However, at September 30, 2006, Key held approximately \$83 million in pooled collateral to mitigate the credit exposure associated with all of its derivative contracts, resulting in net exposure of \$90 million. The largest exposure to an individual counterparty was approximately \$37 million, of which Key secured approximately \$17 million in collateral.

Table of Contents**Asset and Liability Management**

Key uses a fair value hedging strategy to manage its exposure to interest rate risk and a cash flow hedging strategy to reduce the potential adverse impact of interest rate increases on future interest expense. For more information about these asset and liability management strategies, see Note 19 (Derivatives and Hedging Activities), which begins on page 87 of Key's 2005 Annual Report to Shareholders.

The change in accumulated other comprehensive loss resulting from cash flow hedges is as follows:

<i>in millions</i>	December 31, 2005	2006 Hedging Activity	Reclassification of Gains to Net Income	September 30, 2006
Accumulated other comprehensive loss resulting from cash flow hedges	\$ (31)	\$ 2	\$ (1)	\$ (30)

Reclassifications of gains and losses from accumulated other comprehensive loss to earnings coincide with the income statement impact of the hedged item through the payment of variable-rate interest on debt, the receipt of variable-rate interest on commercial loans and the sale or securitization of commercial real estate loans. Key expects to reclassify an estimated \$9 million of net gains on derivative instruments from accumulated other comprehensive loss to earnings during the next twelve months.

Credit Risk Management

Key uses credit derivatives, primarily credit default swaps, to mitigate our credit risk by transferring a portion of the risk associated with the underlying extension of credit to a third party. At September 30, 2006, the notional amount of credit default swaps purchased by Key was \$904 million. Key also provides credit protection through the sale of credit default swaps. These transactions generate fee income and can also be used to diversify overall exposure to credit loss. At September 30, 2006, the notional amount of credit default swaps sold by Key was \$25 million.

These derivatives are recorded on the balance sheet at fair value, which is based on the creditworthiness of the borrowers. Related gains or losses, as well as the premium paid or received for the protection, are included in the trading income component of noninterest income. Key does not apply hedge accounting to credit derivatives.

Trading Portfolio

Key's trading portfolio includes:

- interest rate swap contracts entered into to accommodate the needs of clients;
- positions with third parties that are intended to offset or mitigate the interest rate risk of client positions;
- foreign exchange forward contracts entered into to accommodate the needs of clients; and
- proprietary trading positions in financial assets and liabilities.

The fair values of these trading portfolio items are included in accrued income and other assets or accrued expense and other liabilities on the balance sheet. Adjustments to the fair values are included in investment banking and capital markets income on the income statement. Key has established a reserve in the amount of \$14 million at September 30, 2006, which management believes will be sufficient to cover estimated future losses on the trading portfolio in the event of client default. Additional information pertaining to Key's trading portfolio is summarized in Note 19 of Key's 2005 Annual Report to Shareholders.

Table of Contents

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors

KeyCorp

We have reviewed the condensed consolidated balance sheets of KeyCorp and subsidiaries (Key) as of September 30, 2006 and 2005, and the related condensed consolidated statements of income for the three-month and nine-month periods then ended, and the condensed consolidated statements of changes in shareholders equity and cash flow for the nine-month periods ended September 30, 2006 and 2005. These financial statements are the responsibility of Key s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated interim financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Key as of December 31, 2005, and the related consolidated statements of income, changes in shareholders equity, and cash flow for the year then ended not presented herein, and in our report dated February 24, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Cleveland, Ohio
November 2, 2006

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Introduction**

This section generally reviews the financial condition and results of operations of KeyCorp and its subsidiaries for the quarterly and year-to-date periods ended September 30, 2006 and 2005. Some tables may include additional periods to comply with disclosure requirements or to illustrate trends in greater depth. When you read this discussion, you should also refer to the consolidated financial statements and related notes that appear on pages 3 through 33. A description of Key's business is included under the heading "Description of Business" on page 12 of Key's 2005 Annual Report to Shareholders. This description does not reflect the reorganization and renaming of Key's major business groups and some of its lines of business that took effect January 1, 2006. For a description of these changes, see Note 4 ("Line of Business Results"), which begins on page 12.

Terminology

This report contains some shortened names and industry-specific terms. We want to explain some of these terms at the outset so you can better understand the discussion that follows.

- .. **KeyCorp** refers solely to the parent holding company.
- .. **KBNA** refers to Key's lead bank, KeyBank National Association.
- .. **Key** refers to the consolidated entity consisting of KeyCorp and its subsidiaries.
- .. A **KeyCenter** is one of Key's full-service retail banking facilities or branches.
- .. Key engages in **capital markets activities**. These activities encompass a variety of products and services. Among other things, we trade securities as a dealer, enter into derivative contracts (both to accommodate clients' financing needs and for proprietary trading purposes), and conduct transactions in foreign currencies (both to accommodate clients' needs and to benefit from fluctuations in exchange rates).
- .. All earnings per share data included in this discussion are presented on a **diluted** basis, which takes into account all common shares outstanding as well as potential common shares that could result from the exercise of outstanding stock options and other stock awards. Some of the financial information tables also include **basic** earnings per share, which takes into account only common shares outstanding.
- .. For regulatory purposes, capital is divided into two classes. Federal regulations prescribe that at least one-half of a bank or bank holding company's **total risk-based capital** must qualify as **Tier 1**. Both total and Tier 1 capital serve as bases for several measures of capital adequacy, which is an important indicator of financial stability and condition. You will find a more detailed explanation of total and Tier 1 capital and how they are calculated in the section entitled "Capital," which begins on page 58.

Long-term goals

Key's long-term goals are to achieve an annual return on average equity in the range of 16% to 18% and to grow earnings per common share at an annual rate of 8% to 10%. Our strategy for achieving these goals is described under the heading "Corporate Strategy" on page 14 of Key's 2005 Annual Report to Shareholders.

Key's earnings per common share for the first nine months of 2006 grew by 10% relative to the same period last year. This improvement was accomplished by growing revenue faster than expenses. The growth in earnings also reflected a reduction in the provision for loan losses and a prescribed change in

Table of Contents

accounting for forfeited stock-based awards that took effect on January 1, 2006. Capital that exceeds internal guidelines and minimum requirements prescribed by the regulators can be used to repurchase common shares in the open market. As a result of such repurchases, Key's weighted-average fully-diluted common shares decreased to 411,028,805 shares for the first nine months of 2006 from 414,510,144 shares for the first nine months of 2005. A lower share count can contribute to both earnings per share growth and improved returns on average equity. The change in the number of shares attributable to net share repurchase activity did not have a material effect on either of these profitability measures in either the current or prior year periods.

Forward-looking statements

This report may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements about our long-term goals, financial condition, results of operations, earnings, levels of net loan charge-offs and nonperforming assets, interest rate exposure and profitability. These statements usually can be identified by the use of forward-looking language such as our goal, our objective, our plan, will likely result, expects, plans, anticipates, intends, projects, believes, estimates, or other similar words, expressions or con verbs such as will, would, could, and should.

Forward-looking statements express management's current expectations, forecasts of future events or long-term goals and, by their nature, are subject to assumptions, risks and uncertainties. Although management believes that the expectations, forecasts and goals reflected in these forward-looking statements are reasonable, actual results could differ materially for a variety of reasons, including the following factors:

- .. Interest rates could change more quickly or more significantly than we expect, which may have an adverse effect on our financial results.
- .. Trade, monetary and fiscal policies of various governmental bodies may affect the economic environment in which we operate, as well as our financial condition and results of operations.
- .. Adversity in general economic conditions, or in the condition of the local economies or industries in which we have significant operations or assets, could, among other things, materially impact credit quality trends and our ability to generate loans.
- .. Increased competitive pressure among financial services companies may adversely affect our ability to market our products and services.
- .. It could take us longer than we anticipate to implement strategic initiatives designed to grow revenue or manage expenses; we may be unable to implement certain initiatives; or the initiatives may be unsuccessful.
- .. Acquisitions and dispositions of assets, business units or affiliates could adversely affect us in ways that management has not anticipated.
- .. We may experience operational or risk management failures due to technological or other factors.
- .. We may continue to become subject to heightened regulatory practices, requirements or expectations.
- .. We may become subject to new legal obligations or liabilities, or the unfavorable resolution of pending litigation may have an adverse effect on our financial results.
- .. Changes in the stock markets, public debt markets and other capital markets could adversely affect our ability to raise capital or other funding for liquidity and business purposes, as well as our revenues from client-based underwriting, investment banking and other capital markets businesses.

- “ Terrorist activities or military actions could disrupt the economy and the general business climate, which may have an adverse effect on our financial results or condition and that of our borrowers.
- “ We may become subject to new accounting, tax or regulatory practices or requirements.

Table of Contents**Critical accounting policies and estimates**

Key's business is dynamic and complex. Consequently, management must exercise judgment in choosing and applying accounting policies and methodologies in many areas. These choices are important; not only are they necessary to comply with U.S. generally accepted accounting principles (GAAP), they also reflect management's view of the most appropriate manner in which to record and report Key's overall financial performance. All accounting policies are important, and all policies described in Note 1 (Summary of Significant Accounting Policies), which begins on page 57 of Key's 2005 Annual Report to Shareholders, should be reviewed for a greater understanding of how Key's financial performance is recorded and reported.

In management's opinion, some accounting policies are more likely than others to have a significant effect on Key's financial results and to expose those results to potentially greater volatility. These policies apply to areas of relatively greater business importance or require management to make assumptions and estimates that affect amounts reported in the financial statements. Because these assumptions and estimates are based on current circumstances, they may change over time or prove to be inaccurate. Key relies heavily on the use of assumptions and estimates in several areas, including accounting for the allowance for loan losses; loan securitizations; contingent liabilities, guarantees and income taxes; principal investments; goodwill; and pension and other postretirement obligations. A brief discussion of each of these areas appears on pages 14 through 16 of Key's 2005 Annual Report to Shareholders. During the first nine months of 2006, there were no significant changes in the manner in which Key's critical accounting policies were applied or in which related assumptions and estimates were developed. However, as described in the section entitled Allowance for loan losses, which begins on page 65, during the third quarter of 2006, Key revised its methodology for allocating the allowance for loan losses by loan type within each of its specific lines of business. No new critical accounting policies were adopted during the current year.

Highlights of Key's Performance**Financial performance**

The primary measures of Key's financial performance for the three-month periods ended September 30, 2006, June 30, 2006, and September 30, 2005, and for the nine-month periods ended September 30, 2006 and 2005, are summarized below.

- Net income for the third quarter of 2006 was \$312 million, or \$.76 per common share, compared to \$308 million, or \$.75 per share, for the previous quarter and \$278 million, or \$.67 per share, for the third quarter of 2005. For the first nine months of 2006, net income was \$909 million, or \$2.21 per common share, compared to \$833 million, or \$2.01 per share, for the first nine months of 2005.
- Key's return on average equity was 15.88% for the third quarter of 2006, compared to a return of 16.11% for the prior quarter and 14.84% for the year-ago quarter. For the first nine months of 2006, Key's return on average equity was 15.82%, compared to 15.36% for the first nine months of 2005.
- Key's third quarter 2006 return on average total assets was 1.30%, compared to a return of 1.32% for the previous quarter and 1.22% for the third quarter of 2005. For the first nine months of 2006, Key's return on average total assets was 1.29%, compared to 1.23% for the same period last year.

Key's top four priorities for 2006 are to profitably grow revenue, institutionalize a culture of compliance and accountability, maintain a strong credit culture and improve operating leverage so that revenue growth outpaces expense growth. During the third quarter:

- Total revenue rose by \$49 million from the third quarter of 2005, due largely to solid commercial loan growth, higher income from our fee-based businesses and growth in average core deposits, which increased 8% from the third quarter of 2005. The growth in our commercial loan portfolio was

Table of Contents

geographically broad-based and spread among a number of industry sectors. The increase in fee income was attributable to a variety of sources, including trust and investment services income, income from operating leases, electronic banking fees, credit card fees and several other revenue components.

- “ We continued to make progress in strengthening our compliance and operations infrastructure designed to detect and prevent money laundering in accordance with the requirements of the Bank Secrecy Act.
- “ Asset quality remained solid. Both nonperforming assets and net loan charge-offs were down from the year-ago quarter. For the third quarter of 2006, net loan charge-offs represented .25% of Key’s average total loans.
- “ Our noninterest expense grew by \$27 million from the third quarter of 2005, due primarily to higher personnel costs, increases in marketing and operating lease expense, and a \$10 million contribution made to Key Foundation during the third quarter of 2006.

Further, we continue to effectively manage our capital through dividends paid to shareholders, share repurchases, and investing in our higher-growth businesses. During the third quarter, Key repurchased 2,500,000 of its common shares. At September 30, 2006, Key’s tangible equity to tangible assets ratio was 6.81%.

Considering recent trends, we expect Key’s earnings to be in the range of \$.72 to \$.76 per share for the fourth quarter of 2006.

The primary reasons that Key’s revenue and expense components changed from those reported for the three- and nine-month periods ended September 30, 2005, are reviewed in greater detail throughout the remainder of the Management’s Discussion & Analysis section.

Strategic developments

Key’s financial performance has improved due in part to a number of specific actions taken during 2005 and 2006 that have strengthened our market share positions and support our corporate strategy.

- “ On September 6, 2006, we entered into an agreement to sell our McDonald Investments branch network to UBS Financial Services Inc., a subsidiary of UBS AG. This network includes approximately 340 financial advisors in addition to the field support staff who work in fourteen states. The sale is expected to be completed in the first quarter of 2007.
- “ On August 1, 2006, we announced our intention to pursue a sale of the Champion Mortgage finance business.
- “ On April 1, 2006, we broadened our asset management product line by acquiring Austin Capital Management, Ltd., an investment firm headquartered in Austin, Texas with approximately \$900 million in assets under management at the date of acquisition.
- “ On December 8, 2005, we acquired the commercial mortgage-backed servicing business of ORIX Capital Markets, LLC, headquartered in Dallas, Texas. The acquisition increased our commercial mortgage servicing portfolio from \$44 billion at September 30, 2005, to more than \$70 billion at December 31, 2005. This is the sixth commercial real estate acquisition we have made since January 31, 2000, as part of our ongoing strategy to expand Key’s commercial mortgage finance and servicing capabilities.
- “ On July 1, 2005, we expanded our Federal Housing Administration (FHA) financing and servicing capabilities by acquiring Malone Mortgage Company, based in Dallas, Texas.
- “ During the first quarter of 2005, we completed the sale of \$992 million of indirect automobile loans, representing the prime segment of that portfolio. In April 2005, we completed the sale of \$635 million of loans, representing the nonprime segment. The decision to sell these loans was driven by management’s strategies for improving Key’s

returns and achieving desired interest rate and credit risk profiles.

Table of Contents

Figure 1 summarizes Key's financial performance for each of the past five quarters.

Figure 1. Selected Financial Data

<i>Dollars in millions, except per share amounts</i>	2006		2005		Nine months ended		
	Third	Second	First	Fourth	Third	September 30, 2006	2005
FOR THE PERIOD							
Interest income	\$ 1,444	\$ 1,381	\$ 1,312	\$ 1,262	\$ 1,174	\$ 4,137	\$ 3,355
Interest expense	714	651	584	544	481	1,949	1,283
Net interest income	730	730	728	718	693	2,188	2,072
Provision for loan losses	31	24	39	36	43	94	107
Noninterest income	543	547	481	561	531	1,571	1,517
Noninterest expense	808	816	770	834	781	2,394	2,303
Income before income taxes and cumulative effect of accounting change	434	437	400	409	400	1,271	1,179
Income before cumulative effect of accounting change	312	308	284	296	278	904	833
Net income	312	308	289	296	278	909	833
PER COMMON SHARE							
Income before cumulative effect of accounting change	\$.77	\$.76	\$.70	\$.72	\$.68	\$ 2.23	\$ 2.04
Net income	.77	.76	.71	.72	.68	2.24	2.04
Income before cumulative effect of accounting change assuming dilution	.76	.75	.69	.72	.67	2.20	2.01
Net income assuming dilution	.76	.75	.70	.72	.67	2.21	2.01
Cash dividends declared	.345	.345	.345	.325	.325	1.035	.975
Book value at period end	19.73	19.21	18.85	18.69	18.41	19.73	18.41
Market price:							
High	38.15	38.31	37.67	34.05	35.00	38.31	35.00
Low	34.48	34.24	32.68	30.10	31.65	32.68	31.00
Close	37.44	35.68	36.80	32.93	32.25	37.44	32.25
Weighted-average common shares outstanding (000)	403,780	404,528	407,386	408,431	410,456	405,218	409,166
Weighted-average common shares and potential common shares outstanding (000)	409,428	410,559	413,140	412,542	415,441	411,029	414,510
AT PERIOD END							
Loans	\$ 65,551	\$ 67,408	\$ 66,980	\$ 66,478	\$ 65,575	\$ 65,551	\$ 65,575
Earning assets	83,132	81,737	81,087	80,143	80,096	83,132	80,096
Total assets	96,155	94,794	93,391	93,126	92,323	96,155	92,323
Deposits	61,429	60,838	59,402	58,765	58,071	61,429	58,071
Long-term debt	13,654	14,050	14,032	13,939	14,037	13,654	14,037
Shareholders' equity	7,947	7,737	7,638	7,598	7,522	7,947	7,522
PERFORMANCE RATIOS							
Return on average total assets	1.30%	1.32%	1.26%	1.27%	1.22%	1.29%	1.23%

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Return on average equity	15.88	16.11	15.48	15.59	14.84	15.82	15.36
Net interest margin (taxable equivalent)	3.63	3.69	3.77	3.71	3.67	3.69	3.68
CAPITAL RATIOS AT PERIOD END							
Equity to assets	8.26%	8.16%	8.18%	8.16%	8.15%	8.26%	8.15%
Tangible equity to tangible assets	6.81	6.68	6.71	6.68	6.68	6.81	6.68
Tier 1 risk-based capital	8.02	7.90	7.64	7.59	7.72	8.02	7.72
Total risk-based capital	12.13	12.08	11.91	11.47	11.83	12.13	11.83
Leverage	8.89	8.82	8.52	8.53	8.60	8.89	8.60
TRUST AND BROKERAGE ASSETS							
Assets under management	\$ 84,060	\$ 80,349	\$ 79,558	\$ 77,144	\$ 76,341	\$ 84,060	\$ 76,341
Nonmanaged and brokerage assets	55,221	57,682	56,944	56,509	57,313	55,221	57,313
OTHER DATA							
Average full-time equivalent employees	20,264	19,931	19,694	19,417	19,456	19,974	19,508
KeyCenters	949	946	945	947	946	949	946

Table of Contents**Line of Business Results**

This section summarizes the financial performance and related strategic developments of Key's two major business groups: Community Banking and National Banking. To better understand this discussion, see Note 4 (Line of Business Results), which begins on page 12. Note 4 includes a brief description of the products and services offered by each of the two major business groups, more detailed financial information pertaining to the groups and their respective lines of business, and explanations of Other Segments and Reconciling Items.

Figure 2 summarizes the contribution made by each major business group to Key's taxable-equivalent revenue and net income for the three- and nine-month periods ended September 30, 2006 and 2005. Key's line of business results for all periods presented reflect a new organizational structure that took effect January 1, 2006. For a description of this change, see Note 4.

Figure 2. Major Business Groups Taxable-Equivalent Revenue and Net Income

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30, 2006	2005	Change Amount	Change Percent	September 30, 2006	2005	Change Amount	Change Percent
Revenue (taxable equivalent)								
Community Banking	\$ 671	\$ 659	\$ 12	1.8%	\$ 1,978	\$ 1,923	\$ 55	2.9%
National Banking	631	601	30	5.0	1,887	1,775	112	6.3
Other Segments	25	25			39	53	(14)	(26.4)
Total segments	1,327	1,285	42	3.3	3,904	3,751	153	4.1
Reconciling items	(33)	(28)	(5)	(17.9)	(74)	(71)	(3)	(4.2)
Total	\$ 1,294	\$ 1,257	\$ 37	2.9%	\$ 3,830	\$ 3,680	\$ 150	4.1%
Net income (loss)								
Community Banking	\$ 112	\$ 111	\$ 1	.9%	\$ 326	\$ 325	\$ 1	.3%
National Banking	176	161	15	9.3	529	496	33	6.7
Other Segments	20	21	(1)	(4.8)	39	48	(9)	(18.8)
Total segments	308	293	15	5.1	894	869	25	2.9
Reconciling items	4	(15)	19	N/M	15	(36) ^a	51	N/M
Total	\$ 312	\$ 278	\$ 34	12.2%	\$ 909	\$ 833	\$ 76	9.1%

(a) Includes a \$30 million (\$19 million after tax) charge recorded during the first quarter of 2005 to adjust the accounting for rental expense associated with operating leases from an escalating to a straight-line basis.

N/M = Not Meaningful

Community Banking

As shown in Figure 3, net income for Community Banking was \$112 million for the third quarter of 2006, up slightly from \$111 million for the year-ago quarter. Growth in net interest income, a decrease in the provision for loan losses and a slight rise in noninterest income were substantially offset by an increase in noninterest expense.

Taxable-equivalent net interest income increased by \$11 million, or 3%, from the third quarter of 2005, due to growth in average deposits, which also experienced a more favorable interest rate spread. The positive effects of these factors were moderated by a reduction in, and a tighter interest rate spread on, earning assets.

The provision for loan losses decreased by \$4 million, or 15%, as a result of an improved credit risk profile. Noninterest expense rose by \$15 million, or 3%. Increases in personnel expense and various indirect charges caused the rise.

Table of Contents

During the third quarter of 2006, Key entered into an agreement to sell the McDonald Investments branch network to UBS Financial Services Inc., a subsidiary of UBS AG. This network includes approximately 340 financial advisors in addition to the field support staff who work in fourteen states. The sale is expected to be completed in the first quarter of 2007.

Figure 3. Community Banking

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30,		Change		September 30,		Change	
	2006	2005	Amount	Percent	2006	2005	Amount	Percent
Summary of operations								
Net interest income (TE)	\$ 443	\$ 432	\$ 11	2.5%	\$ 1,311	\$ 1,260	\$ 51	4.0%
Noninterest income	228	227	1	.4	667	663	4	.6
Total revenue (TE)	671	659	12	1.8	1,978	1,923	55	2.9
Provision for loan losses	22	26	(4)	(15.4)	71	77	(6)	(7.8)
Noninterest expense	470	455	15	3.3	1,386	1,326	60	4.5
Income before income taxes (TE)	179	178	1	.6	521	520	1	.2
Allocated income taxes and TE adjustments	67	67			195	195		
Net income	\$ 112	\$ 111	\$ 1	.9%	\$ 326	\$ 325	\$ 1	.3%
Percent of consolidated net income	36%	40%	N/A	N/A	36%	39%	N/A	N/A
Average balances								
Loans and leases	\$ 26,737	\$ 27,131	\$ (394)	(1.5)%	\$ 26,760	\$ 26,987	\$ (227)	(.8)%
Total assets	29,718	30,026	(308)	(1.0)	29,736	29,916	(180)	(.6)
Deposits	46,987	44,705	2,282	5.1	46,506	43,875	2,631	6.0

TE = Taxable Equivalent, N/A = Not Applicable

Additional Community Banking Data

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30,		Change		September 30,		Change	
	2006	2005	Amount	Percent	2006	2005	Amount	Percent

Average deposits outstanding

Noninterest-bearing Money market and other savings	\$ 8,111	\$ 8,411	\$ (300)	(3.6)%	\$ 8,100	\$ 8,148	\$ (48)	(.6)%
Time	22,390	21,448	942	4.4	22,299	21,080	1,219	5.8
	16,486	14,846	1,640	11.0	16,107	14,647	1,460	10.0
Total deposits	\$ 46,987	\$ 44,705	\$ 2,282	5.1%	\$ 46,506	\$ 43,875	\$ 2,631	6.0%

Home equity loans

Average balance	\$ 10,048	\$ 10,365
Weighted-average loan-to-value ratio	70%	71%
Percent first lien positions	60	61

Other data

On-line households / household penetration	646,993 / 52%	607,127 / 49%
KeyCenters	949	946
Automated teller machines	2,099	2,185

National Banking

As shown in Figure 4, net income for National Banking was \$176 million for the third quarter of 2006, up from \$161 million for the same period last year. The improvement was due primarily to higher net interest income and a decrease in the provision for loan losses, offset in part by a rise in the level of noninterest expense.

Taxable-equivalent net interest income grew by \$27 million, or 8%, from the third quarter of 2005, reflecting strong growth in deposits, as well as average loans and leases. Deposits rose by \$3.3 billion, or 42%, from the third quarter of 2005. Average loans and leases grew by \$1.7 billion, or 5%, due largely to increases in the Real Estate Capital and Equipment Finance lines of business. The positive effects of these factors were moderated by tighter interest rate spreads on average earning assets in the Equipment Finance and Consumer Finance lines.

Noninterest income rose by \$3 million, or 1%. Higher income from operating leases, trust and investment services, and a number of other fee-based services were moderated by reductions in income from dealer trading and derivatives, and other investments. In addition, Key recorded net losses from the sales of securities, compared to net gains in the same period one year ago.

Table of Contents

The provision for loan losses decreased by \$8 million, or 47%, as a result of an improved credit risk profile. Noninterest expense increased by \$14 million, or 4%, reflecting higher costs associated with operating leases and various indirect charges.

In the current year, we have continued to take actions to improve our business mix and to support our focus on relationship businesses. During the third quarter, we announced our plans to pursue a sale of the Champion Mortgage finance business, and during the prior quarter, we expanded our asset management product line by acquiring Austin Capital Management, Ltd., an investment firm headquartered in Austin, Texas.

In addition, during the second half of 2005, we completed two acquisitions that have helped us to build upon our success in commercial mortgage origination and servicing. In the fourth quarter of 2005, we continued the expansion of our commercial mortgage servicing business by acquiring the commercial mortgage-backed servicing business of ORIX Capital Markets, LLC, headquartered in Dallas, Texas. In the third quarter, we expanded our FHA financing and servicing capabilities by acquiring Malone Mortgage Company, also based in Dallas.

Figure 4. National Banking

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30,		Change		September 30,		Change	
	2006	2005	Amount	Percent	2006	2005	Amount	Percent
Summary of operations								
Net interest income (TE)	\$ 375	\$ 348	\$ 27	7.8%	\$ 1,126	\$ 1,051	\$ 75	7.1%
Noninterest income	256	253	3	1.2	761	724	37	5.1
Total revenue (TE)	631	601	30	5.0	1,887	1,775	112	6.3
Provision for loan losses	9	17	(8)	(47.1)	23	30	(7)	(23.3)
Noninterest expense	340	326	14	4.3	1,018	951	67	7.0
Income before income taxes (TE)	282	258	24	9.3	846	794	52	6.5
Allocated income taxes and TE adjustments	106	97	9	9.3	317	298	19	6.4
Net income	\$ 176	\$ 161	\$ 15	9.3%	\$ 529	\$ 496	\$ 33	6.7%
Percent of consolidated net income	57%	58%	N/A	N/A	58%	59%	N/A	N/A
Average balances								
Loans and leases ^a	\$ 38,767	\$ 37,072	\$ 1,695	4.6%	\$ 39,498	\$ 36,790	\$ 2,708	7.4%
Loans held for sale ^a	6,192	3,511	2,681	76.4	4,581	3,645	936	25.7
Total assets	51,347	46,708	4,639	9.9	50,463	46,585	3,878	8.3
Deposits	11,068	7,785	3,283	42.2	10,560	7,330	3,230	44.1

(a)

On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business. This transfer reduced average home equity loans and increased average loans held for sale by approximately \$1.6 billion for the third quarter of 2006 and approximately \$550 million for the first nine months of 2006.

TE = Taxable Equivalent, N/A = Not Applicable

Other Segments

Other segments consist of Corporate Treasury and Key's Principal Investing unit. These segments generated net income of \$20 million for the third quarter of 2006, compared to \$21 million for the same period last year.

Table of Contents

Results of Operations

Net interest income

One of Key's principal sources of earnings is net interest income. Net interest income is the difference between interest income received on earning assets (such as loans and securities) and loan-related fee income, and interest expense paid on deposits and borrowings. There are several factors that affect net interest income, including:

- .. the volume, pricing, mix and maturity of earning assets and interest-bearing liabilities;
- .. the volume of net free funds, such as noninterest-bearing deposits and capital;
- .. the use of derivative instruments to manage interest rate risk;
- .. interest rate fluctuations and competitive conditions within the marketplace; and
- .. asset quality.

To make it easier to compare results among several periods and the yields on various types of earning assets (some of which are taxable and others which are not), we present net interest income in this discussion on a taxable-equivalent basis (i.e., as if it were all taxable and at the same rate). For example, \$100 of tax-exempt income would be presented as \$154, an amount that if taxed at the statutory federal income tax rate of 35% would yield \$100.

Figure 5, which spans pages 45 and 46, shows the various components of Key's balance sheet that affect interest income and expense, and their respective yields or rates over the past five quarters. This figure also presents a reconciliation of taxable-equivalent net interest income for each of those quarters to net interest income reported in accordance with GAAP.

Taxable-equivalent net interest income for the third quarter of 2006 was \$751 million, representing a \$25 million, or 3%, increase from the year-ago quarter. The positive effects of a 5% increase in average earning assets, an 8% increase in average core deposits and a 4% rise in average noninterest-bearing funds, more than offset the effect of lower net interest margin, which decreased 4 basis points to 3.63%. (A basis point is equal to one one-hundredth of a percentage point, meaning 4 basis points equals .04%).

The net interest margin, which is an indicator of the profitability of the earning assets portfolio, is calculated by dividing net interest income by average earning assets and annualizing the result. The decline in the net interest margin reflected the effect of a tighter interest rate spread, which represents the difference between the yield on average earning assets and the rate paid for interest-bearing funds. As shown in Figure 5, Key's interest rate spread narrowed by 25 basis points from the third quarter of 2005 as a result of competitive pressure on loan and deposit pricing, and a change in deposit mix caused by a shift in consumer funds from money market deposit accounts to time deposits. Management expects these conditions and continuation of the flat-to-inverted yield curve to maintain pressure on the net interest margin. The decrease in the net interest margin caused by the above factors was substantially offset, however, by the positive effect of an increase in the level of noninterest-bearing funds.

Average earning assets for the third quarter of 2006 totaled \$82.4 billion, which was \$3.6 billion, or 5%, higher than the third quarter 2005 level, due primarily to a 7% rise in commercial loans.

Table of Contents

Since December 31, 2004, the growth and composition of Key's loan portfolio has been affected by the following loan sales, most of which came from the held-for-sale portfolio:

- .. Key sold commercial mortgage loans of \$1.6 billion during the first nine months of 2006 and \$2.2 billion during all of 2005. Since some of these loans have been sold with limited recourse (i.e., there is a risk that Key will be held accountable for certain events or representations made in the sales), Key established and has maintained a loss reserve in an amount estimated by management to be appropriate. More information about the related recourse agreement is provided in Note 13 (Contingent Liabilities and Guarantees) under the heading Recourse agreement with Federal National Mortgage Association on page 30.
- .. Key sold education loans of \$425 million (\$90 million through securitizations) during the first nine months of 2006 and \$1.2 billion (\$937 million through securitizations) during all of 2005. Key has used the securitization market for education loans as a means of diversifying our funding sources.
- .. Key sold other loans totaling \$524 million during the first nine months of 2006 and \$2.7 billion during all of 2005. During the first quarter of 2005, Key completed the sale of \$992 million of indirect automobile loans, representing the prime segment of that portfolio. In April 2005, Key completed the sale of \$635 million of loans, representing the nonprime segment. The decision to sell these loans was driven by management's strategies for improving Key's returns and achieving desired interest rate and credit risk profiles. In addition to these completed transactions, during the third quarter of 2006 Key announced its intention to pursue a sale of the Champion Mortgage finance business.

Table of Contents**Figure 5. Average Balance Sheets, Net Interest Income and Yields/Rates**

<i>dollars in millions</i>	Third Quarter 2006			Second Quarter 2006		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS						
Loans ^{a,b}						
Commercial, financial and agricultural ^c	\$ 21,648	\$ 400	7.34%	\$ 21,970	\$ 390	7.12%
Real estate commercial mortgage	8,106	164	8.04	8,071	153	7.59
Real estate construction	7,965	171	8.51	7,570	152	8.07
Commercial lease financing ^c	9,850	144	5.83	9,764	148	6.05
Total commercial loans	47,569	879	7.34	47,375	843	7.13
Real estate residential	1,415	23	6.49	1,430	24	6.54
Home equity ^d	11,847	218	7.32	13,449	247	7.36
Consumer direct	1,585	36	9.07	1,685	41	9.64
Consumer indirect	3,594	61	6.83	3,503	57	6.66
Total consumer loans	18,441	338	7.31	20,067	369	7.37
Total loans	66,010	1,217	7.33	67,442	1,212	7.20
Loans held for sale ^d	6,201	131	8.40	3,844	73	7.64
Investment securities ^a	42	1	8.12	46	1	8.01
Securities available for sale ^e	7,216	84	4.61	7,075	84	4.71
Short-term investments	1,588	16	3.78	1,678	16	3.89
Other investments ^e	1,363	16	4.67	1,398	17	4.60
Total earning assets	82,420	1,465	7.06	81,483	1,403	6.89
Allowance for loan losses	(954)			(963)		
Accrued income and other assets	13,452			13,341		
Total assets	\$ 94,918			\$ 93,861		
LIABILITIES AND SHAREHOLDERS EQUITY						
NOW and money market deposit accounts	\$ 25,230	194	3.05	\$ 25,347	173	2.75
Savings deposits	1,700	1	.19	1,752	1	.20
Certificates of deposit (\$100,000 or more) ^f	5,517	67	4.82	5,382	61	4.54
Other time deposits	11,700	127	4.29	11,456	115	4.02
Deposits in foreign office	4,139	54	5.22	3,429	42	4.88

Total interest-bearing deposits	48,286	443	3.64	47,366	392	3.32
Federal funds purchased and securities sold under repurchase agreements	3,634	45	4.88	3,005	34	4.60
Bank notes and other short-term borrowings	2,285	24	4.29	2,497	27	4.17
Long-term debt ^f	13,763	202	5.83	14,088	198	5.59
Total interest-bearing liabilities	67,968	714	4.17	66,956	651	3.89
Noninterest-bearing deposits	13,085			13,027		
Accrued expense and other liabilities	6,068			6,211		
Shareholders' equity	7,797			7,667		
Total liabilities and shareholders' equity	\$ 94,918			\$ 93,861		
Interest rate spread (TE)			2.89%			3.00%
Net interest income (TE) and net interest margin (TE)		751	3.63%		752	3.69%
TE adjustment ^a		21			22	
Net interest income, GAAP basis		\$ 730			\$ 730	

- (a) Interest income on tax-exempt securities and loans has been adjusted to a taxable-equivalent basis using the statutory federal income tax rate of 35%.
- (b) For purposes of these computations, nonaccrual loans are included in average loan balances.
- (c) During the first quarter of 2006, Key reclassified \$760 million of average loans and related interest income from the commercial lease financing component of the commercial loan portfolio to the commercial, financial and agricultural component to more accurately reflect the nature of these receivables. Balances presented for prior periods were not reclassified as the historical data was not available.
- (d) On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business. This transfer reduced average home equity loans and increased average loans held for sale by approximately \$1.6 billion for the third quarter of 2006.
- (e) Yield is calculated on the basis of amortized cost.
- (f) Rate calculation excludes basis adjustments related to fair value hedges. See Note 19 (Derivatives and Hedging Activities), which begins on page 87 of Key's 2005 Annual Report to Shareholders, for an explanation of fair value hedges.

TE = Taxable Equivalent

Table of Contents

Figure 5. Average Balance Sheets, Net Interest Income and Yields/Rates (Continued)

First Quarter 2006			Fourth Quarter 2005			Third Quarter 2005		
Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
\$ 21,720	\$ 357	6.66%	\$ 19,992	\$ 315	6.25%	\$ 19,249	\$ 280	5.78%
8,089	144	7.23	8,580	151	6.98	8,467	136	6.42
7,312	138	7.66	6,896	129	7.42	6,388	110	6.81
9,581	143	5.98	10,285	154	6.01	10,161	158	6.19
46,702	782	6.78	45,753	749	6.51	44,265	684	6.15
1,450	23	6.33	1,460	23	6.22	1,472	23	6.13
13,433	238	7.19	13,767	242	7.00	13,888	236	6.72
1,730	41	9.66	1,785	44	9.68	1,794	40	8.96
3,367	57	6.66	3,340	56	6.71	3,339	56	6.67
19,980	359	7.26	20,352	365	7.13	20,493	355	6.86
66,682	1,141	6.92	66,105	1,114	6.70	64,758	1,039	6.37
3,692	68	7.44	3,592	64	7.05	3,521	56	6.43
61	1	6.34	95	1	5.81	76	1	7.00
7,148	83	4.61	7,034	84	4.77	7,131	84	4.65
1,753	22	5.10	2,091	19	3.53	1,972	15	3.15
1,336	25	7.13	1,297	10	3.09	1,342	12	3.25
80,672	1,340	6.70	80,214	1,292	6.40	78,800	1,207	6.08
(963)			(1,085)			(1,095)		
13,206			13,077			12,918		
\$ 92,915			\$ 92,206			\$ 90,623		
\$ 24,452	145	2.40	\$ 23,947	127	2.11	\$ 22,886	101	1.75
1,812	1	.32	1,858	1	.27	1,952	2	.29
5,407	58	4.34	5,006	51	4.06	4,928	48	3.85
11,282	104	3.73	10,951	96	3.46	10,805	87	3.21
3,354	35	4.29	3,316	34	4.03	4,048	35	3.46
46,307	343	3.00	45,078	309	2.72	44,619	273	2.43

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

3,349	34	4.06	4,309	40	3.72	3,674	31	3.28
2,550	24	3.89	2,607	24	3.67	2,841	22	3.04
13,991	183	5.27	13,860	171	4.89	13,814	155	4.50
66,197	584	3.57	65,854	544	3.28	64,948	481	2.94
12,707			12,594			12,215		
6,438			6,224			6,027		
7,573			7,534			7,433		
\$ 92,915			\$ 92,206			\$ 90,623		
		3.13%			3.12%			3.14%
	756	3.77%		748	3.71%		726	3.67%
	28			30			33	
	\$ 728			\$ 718			\$ 693	

Table of Contents

Figure 6 shows how the changes in yields or rates and average balances from the prior year affected net interest income. The section entitled Financial Condition, which begins on page 53, contains more discussion about changes in earning assets and funding sources.

Figure 6. Components of Net Interest Income Changes

<i>in millions</i>	From three months ended September 30, 2005 to three months ended September 30, 2006			From nine months ended September 30, 2005 to nine months ended September 30, 2006		
	Average Volume	Yield/ Rate	Net Change	Average Volume	Yield/ Rate	Net Change
INTEREST INCOME						
Loans	\$ 21	\$ 157	\$ 178	\$ 111	\$ 533	\$ 644
Loans held for sale	52	23	75	53	29	82
Investment securities	(1)	1		(1)	(1)	(2)
Securities available for sale	1	(1)			7	7
Short-term investments	(3)	4	1	(3)	20	17
Other investments		4	4	(1)	15	14
Total interest income (taxable equivalent)	70	188	258	159	603	762
INTEREST EXPENSE						
NOW and money market deposit accounts	11	82	93	31	248	279
Savings deposits		(1)	(1)		(1)	(1)
Certificates of deposit (\$100,000 or more)	6	13	19	15	33	48
Other time deposits	8	32	40	18	82	100
Deposits in foreign office	1	18	19	(20)	55	35
Total interest-bearing deposits	26	144	170	44	417	461
Federal funds purchased and securities sold under repurchase agreements		14	14	(15)	47	32
Bank notes and other short-term borrowings	(5)	7	2	(9)	26	17
Long-term debt	(1)	48	47	(7)	163	156
Total interest expense	20	213	233	13	653	666
Net interest income (taxable equivalent)	\$ 50	\$ (25)	\$ 25	\$ 146	\$ (50)	\$ 96

The change in interest not due solely to volume or rate has been allocated in proportion to the absolute dollar amounts of the change in each.

Noninterest income

Noninterest income for the third quarter of 2006 was \$543 million, compared to \$531 million for the same period last year. For the first nine months of the year, noninterest income was \$1.6 billion, representing an increase of \$54 million, or 4%, from the first nine months of 2005.

As shown in Figure 7, the growth in noninterest income from the year-ago quarter was attributable to higher income from several of Key's fee-based businesses and a \$21 million increase in miscellaneous income, which resulted from a variety of factors. The overall increase in noninterest income was offset in part by reductions in income from dealer trading and derivatives, and other investments, both of which are included in investment banking and capital markets income. In addition, Key recorded net losses from the sales of securities, compared to net gains in the same period one year ago.

For the year-to-date period, the growth in noninterest income from the same period last year included increases of \$25 million in operating lease income, \$12 million in insurance income, \$8 million in both electronic banking fees and net gains from principal investing, and a \$13 million increase in miscellaneous income. These positive results were moderated by a \$7 million reduction in net gains from the sales of securities and a \$5 million decrease in investment banking and capital markets income.

Table of Contents**Figure 7. Noninterest Income**

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30, 2006	2005	Change Amount	Change Percent	September 30, 2006	2005	Change Amount	Change Percent
Trust and investment services income	\$ 137	\$ 135	\$ 2	1.5%	\$ 411	\$ 408	\$ 3	.7%
Service charges on deposit accounts	78	82	(4)	(4.9)	227	228	(1)	(.4)
Investment banking and capital markets income	44	62	(18)	(29.0)	163	168	(5)	(3.0)
Operating lease income	58	47	11	23.4	166	141	25	17.7
Letter of credit and loan fees	48	46	2	4.3	133	133		
Corporate-owned life insurance income	23	26	(3)	(11.5)	74	78	(4)	(5.1)
Electronic banking fees	27	24	3	12.5	78	70	8	11.4
Net gains from loan securitizations and sales	14	12	2	16.7	34	41	(7)	(17.1)
Net securities gains (losses)	(7)	3	(10)	N/M	(2)	(2)		
Other income:								
Insurance income	18	15	3	20.0	49	37	12	32.4
Loan securitization servicing fees	5	5			15	15		
Credit card fees	8	4	4	100.0	14	12	2	16.7
Net gains from principal investing	28	29	(1)	(3.4)	48	40	8	20.0
Miscellaneous income	62	41	21	51.2	161	148	13	8.8
Total other income	121	94	27	28.7	287	252	35	13.9
Total noninterest income	\$ 543	\$ 531	\$ 12	2.3%	\$ 1,571	\$ 1,517	\$ 54	3.6%

N/M = Not Meaningful

The following discussion explains the composition of certain components of Key's noninterest income and the factors that caused those components to change.

Trust and investment services income. Trust and investment services is Key's largest source of noninterest income. The primary components of revenue generated by these services are shown in Figure 8.

Figure 8. Trust and Investment Services Income

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30, 2006	2005	Change Amount	Change Percent	September 30, 2006	2005	Change Amount	Change Percent
Brokerage commissions and fee income	\$ 56	\$ 61	\$ (5)	(8.2)%	\$ 177	\$ 186	\$ (9)	(4.8)%
Personal asset management and custody fees	39	39			116	115	1	.9
Institutional asset management and custody fees	42	35	7	20.0	118	107	11	10.3
Total trust and investment services income	\$ 137	\$ 135	\$ 2	1.5%	\$ 411	\$ 408	\$ 3	.7%

A significant portion of Key's trust and investment services income depends on the value and mix of assets under management. At September 30, 2006, Key's bank, trust and registered investment advisory subsidiaries had assets under management of \$84.1 billion, representing a 10% increase from \$76.3 billion at September 30, 2005. As shown in Figure 9, the increase was due primarily to Key's equity portfolio, reflecting improvement in the equity markets in general. Key's securities lending business and the hedge funds obtained in the acquisition of Austin Capital Management, Ltd. on April 1, 2006, also contributed to the increase.

When clients' securities are lent to a borrower, the borrower must provide Key with cash collateral, which is invested during the term of the loan. The difference between the revenue generated from the investment and the cost of the collateral is then shared with the client. This business, although profitable, generates a significantly lower rate of return (commensurate with the lower level of risk inherent in the business) than other types of assets under management.

Table of Contents**Figure 9. Assets Under Management**

<i>in millions</i>		2006			2005	
	Third	Second	First	Fourth	Third	
Assets under management by investment type:						
Equity	\$ 39,831	\$ 37,290	\$ 36,405	\$ 35,370	\$ 34,912	
Securities lending	22,699	22,827	22,985	20,938	20,702	
Fixed income	11,311	10,742	10,882	11,264	11,492	
Money market	9,298	8,590	9,286	9,572	9,235	
Hedge funds	921	900				
Total	\$ 84,060	\$ 80,349	\$ 79,558	\$ 77,144	\$ 76,341	
Proprietary mutual funds included in assets under management:						
Money market	\$ 7,520	\$ 7,014	\$ 7,606	\$ 7,884	\$ 7,549	
Equity	5,250	5,039	5,063	4,594	4,331	
Fixed income	639	653	703	722	738	
Total	\$ 13,409	\$ 12,706	\$ 13,372	\$ 13,200	\$ 12,618	

Service charges on deposit accounts. Service charges on deposit accounts decreased from the prior year, due primarily to reductions in the levels of maintenance fees and fees charged to commercial clients for cash management services. Maintenance fees decreased because a higher proportion of Key's clients have elected to use Key's free checking products. In addition, as interest rates increase, commercial clients are able to cover a larger portion of their service charges with credits earned on compensating balances.

Investment banking and capital markets income. As shown in Figure 10, the decrease in income from investment banking and capital markets activities compared to the third quarter of 2005, was due to lower income from dealer trading and derivatives, and other investments.

The decrease from the first nine months of last year was attributable to a reduction in income from dealer trading and derivatives. Results for the first nine months of 2005 included \$11 million of derivative income recorded during the first quarter in connection with the sale of Key's indirect automobile loan portfolio. This reduction was offset in part by growth in income from investment banking activities. Included in income from other investments in the current year is a \$25 million gain that resulted from the initial public offering completed by the New York Stock Exchange in March 2006. The favorable effect of this gain was offset in part during the second and third quarters by an aggregate \$4 million write-down to fair value of the shares obtained in the transaction.

Figure 10. Investment Banking and Capital Markets Income

<i>dollars in millions</i>	Three months ended		Change		Nine months ended		Change	
	September 30, 2006	September 30, 2005	Amount	Percent	September 30, 2006	September 30, 2005	Amount	Percent
Investment banking income	\$ 21	\$ 21			\$ 69	\$ 57	\$ 12	21.1%

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Dealer trading and derivatives income	7	16	\$ (9)	(56.3)%	25	45	(20)	(44.4)
Income from other investments	5	14	(9)	(64.3)	37	37		
Foreign exchange income	11	11			32	29	3	10.3
Total investment banking and capital markets income	\$ 44	\$ 62	\$ (18)	(29.0)%	\$ 163	\$ 168	\$ (5)	(3.0)%

Net gains from loan securitizations and sales. Key sells or securitizes loans to achieve desired interest rate and credit risk profiles, to improve the profitability of the overall loan portfolio or to diversify funding sources. During the first quarter of 2005, Key completed the sale of the prime segment of the indirect automobile loan portfolio, resulting in a gain of \$19 million. However, this gain was partially offset by a \$9 million impairment charge in the education lending business recorded during the same quarter. The types of loans sold during 2005 and the first nine months of 2006 are presented in Figure 15 on page 55.

Table of Contents

Net gains from principal investing. Key's principal investing income is susceptible to volatility since most of it is derived from mezzanine debt and equity investments in small to medium-sized businesses. Principal investments consist of direct and indirect investments in predominantly privately held companies. These investments are carried on the balance sheet at fair value (\$843 million at September 30, 2006, and \$800 million at September 30, 2005). Thus, the net gains presented in Figure 7 stem from changes in estimated fair values as well as actual gains on sales of principal investments. During the second quarter of 2005, Key received a \$15 million distribution in the form of dividends and interest from principal investing activities. This revenue was recorded in net interest income.

Noninterest expense

Noninterest expense for the third quarter of 2006 was \$808 million, compared to \$781 million for the third quarter of 2005. For the first nine months of the year, noninterest expense was \$2.4 billion, compared to \$2.3 billion for the first nine months of last year.

As shown in Figure 11, personnel expense rose by \$8 million, due primarily to higher costs incurred in connection with business expansion. Nonpersonnel expense grew by \$19 million, reflecting increases of \$8 million in both marketing and operating lease expense. In addition, miscellaneous expense included a \$10 million contribution made to Key Foundation during the third quarter of 2006.

For the year-to-date period, personnel expense grew by \$68 million, and nonpersonnel expense rose by \$23 million from the first nine months of 2005. The increase in nonpersonnel expense was attributable primarily to a \$16 million increase in operating lease expense and a \$15 million rise in professional fees. In addition, results for the first nine months of 2005 included a \$7 million credit to the provision for losses on lending-related commitments. These increases were substantially offset by a \$25 million reduction in net occupancy expense.

Figure 11. Noninterest Expense

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30, 2006	September 30, 2005	Change Amount	Change Percent	September 30, 2006	September 30, 2005	Change Amount	Change Percent
Personnel	\$ 422	\$ 414	\$ 8	1.9%	\$ 1,258	\$ 1,190	\$ 68	5.7%
Net occupancy	63	66	(3)	(4.5)	187	212 ^a	(25)	(11.8)
Computer processing	52	54	(2)	(3.7)	157	155	2	1.3
Operating lease expense	48	40	8	20.0	134	118	16	13.6
Professional fees	29	29			102	87	15	17.2
Marketing	37	29	8	27.6	83	88	(5)	(5.7)
Equipment	26	28	(2)	(7.1)	78	84	(6)	(7.1)
Other expense:								
Postage and delivery	13	12	1	8.3	38	37	1	2.7
Franchise and business taxes	9	8	1	12.5	29	25	4	16.0
Telecommunications	7	8	(1)	(12.5)	21	23	(2)	(8.7)
OREO expense, net	2	2			4	6	(2)	(33.3)
Provision (credit) for losses on lending-related commitments		2	(2)	(100.0)		(7)	7	100.0
Miscellaneous expense	100	89	11	12.4	303	285	18	6.3
Total other expense	131	121	10	8.3	395	369	26	7.0

Total noninterest expense	\$ 808	\$ 781	\$ 27	3.5%	\$ 2,394	\$ 2,303	\$ 91	4.0%
---------------------------	--------	--------	-------	------	----------	----------	-------	------

Average full-time equivalent employees	20,264	19,456	808	4.2%	19,974	19,508	466	2.4%
--	--------	--------	-----	------	--------	--------	-----	------

(a) Includes a charge of \$30 million recorded during the first quarter of 2005 to adjust the accounting for rental expense associated with operating leases from an escalating to a straight-line basis.

The following discussion explains the composition of certain components of Key's noninterest expense and the factors that caused those components to change.

Table of Contents

Personnel. As shown in Figure 12, personnel expense, the largest category of Key's noninterest expense, rose by \$68 million, or 6%, from the first nine months of 2005. This growth was due to additional costs incurred in connection with business expansion, offset in part by reductions in stock-based compensation and severance expense.

Figure 12. Personnel Expense

<i>dollars in millions</i>	Three months ended				Nine months ended			
	September 30,		Change		September 30,		Change	
	2006	2005	Amount	Percent	2006	2005	Amount	Percent
Salaries	\$ 241	\$ 222	\$ 19	8.6%	\$ 706	\$ 657	\$ 49	7.5%
Incentive compensation	95	99	(4)	(4.0)	274	262	12	4.6
Employee benefits	68	66	2	3.0	226	204	22	10.8
Stock-based compensation ^a	15	23	(8)	(34.8)	47	55	(8)	(14.5)
Severance	3	4	(1)	(25.0)	5	12	(7)	(58.3)
Total personnel expense	\$ 422	\$ 414	\$ 8	1.9%	\$ 1,258	\$ 1,190	\$ 68	5.7%

(a) Excludes directors' stock-based compensation of \$.3 million and \$.4 million for the three-month periods ended September 30, 2006 and 2005, respectively, and \$.9 million and \$1.2 million for the nine-month periods ended September 30, 2006 and 2005, respectively. Directors' stock-based compensation is included in the miscellaneous expense component shown in Figure 11.

Effective January 1, 2006, Key adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment. SFAS No. 123R changed the manner in which forfeited stock-based awards must be accounted for and reduced Key's stock-based compensation expense for the first nine months of 2006 by \$5 million. Additional information pertaining to this accounting change is presented in Note 1 (Basis of Presentation) under the heading Stock-Based Compensation on page 7.

For the third quarter of 2006, the average number of full-time equivalent employees was 20,264, compared to 19,931 for the second quarter of 2006 and 19,456 for the year-ago quarter.

Net occupancy. During the first quarter of 2005, the Securities and Exchange Commission issued interpretive guidance, applicable to all publicly held companies, related to the accounting for operating leases. As a result of this guidance, Key recorded a net occupancy charge of \$30 million during the first quarter of last year to adjust the accounting for rental expense associated with such leases from an escalating to a straight-line basis.

Professional fees. The \$15 million, or 17%, increase in professional fees from the first nine months of 2005 was due in part to higher costs associated with Key's efforts to strengthen its compliance controls.

Income taxes

The provision for income taxes was \$122 million for the third quarter of 2006, unchanged from the comparable period in 2005. The effective tax rate, which is the provision for income taxes as a percentage of income before income taxes, was 28.1% for the third quarter of 2006, compared to 30.5% for the year-ago quarter. For the first nine months of 2006, the provision for income taxes was \$367 million, compared to \$346 million for the first nine months of 2005. The effective tax rates for these periods were 28.9% and 29.3%, respectively.

The effective tax rates for both the current and prior year are substantially below Key's combined federal and state tax rate of 37.5%, due primarily to income from investments in tax-advantaged assets such as corporate-owned life insurance, credits associated with investments in low-income housing projects and tax deductions associated with dividends paid on Key common shares held in Key's 401(k) savings plan. In addition, a lower tax rate is applied to

portions of the equipment lease portfolio that are managed by a foreign subsidiary in a lower tax jurisdiction. Since Key intends to permanently reinvest the earnings of this foreign subsidiary overseas, no deferred income taxes are recorded on those earnings in accordance with SFAS No. 109, Accounting for Income Taxes.

Table of Contents

In the ordinary course of business, Key enters into certain transactions that have tax consequences. On occasion, the Internal Revenue Service (IRS) may challenge a particular tax position taken by Key. The IRS has completed its audits of Key s tax returns for the 1995 through 2000 tax years and has disallowed all LIFO deductions taken in the 1995 through 1997 tax years and all deductions taken in the 1998 through 2000 tax years that relate to certain lease financing transactions. In addition, the IRS is currently conducting audits of the 2001 through 2003 tax years. Key expects that the IRS will disallow all similar deductions taken in those years. Further information on Key s position on these matters and on the potential implications is included in Note 12 (Income Taxes) under the heading Lease Financing Transactions on page 27.

In July 2006, the Financial Accounting Standards Board (FASB) issued new guidance that will change the manner in which income from a leveraged lease is accounted for when there is either a change or projected change in the timing of cash flows relating to income taxes generated by the lease. In addition, the FASB concurrently issued new guidance related to the accounting for uncertain tax positions. The new guidance related to each of these matters and the anticipated effect on Key s financial results are summarized in Note 12 under the heading Tax-Related Accounting Pronouncements Pending Adoption on page 28.

Table of Contents**Financial Condition****Loans and loans held for sale**

Total loans outstanding were \$65.6 billion at September 30, 2006 and 2005, compared to \$66.5 billion at December 31, 2005. The composition of Key's loan portfolio at each of these dates is presented in Note 6 (Loans and Loans Held for Sale), which begins on page 19. Growth in our commercial loan portfolio over the past twelve months was substantially offset by a third quarter 2006 transfer of home equity loans to loans held for sale in connection with our intention to pursue a sale of the Champion Mortgage finance business.

Commercial loan portfolio. Commercial loans outstanding increased by \$2.8 billion, or 6%, from one year ago, reflecting improvement in the economy. The overall growth in the commercial loan portfolio was geographically broad-based and spread among a number of industry sectors.

Commercial real estate loans for both owner- and nonowner-occupied properties constitute one of the largest segments of Key's commercial loan portfolio. At September 30, 2006, Key's commercial real estate portfolio included mortgage loans of \$8.3 billion and construction loans of \$8.3 billion. The average size of a mortgage loan was \$.6 million, and the largest mortgage loan had a balance of \$70 million. The average size of a construction loan commitment was \$5.8 million. The largest construction loan commitment was \$107 million, of which \$106 million was outstanding. Key conducts its commercial real estate lending business through two primary sources: a thirteen-state banking franchise and Real Estate Capital, a national line of business that cultivates relationships both within and beyond the branch system. Real Estate Capital deals exclusively with nonowner-occupied properties (generally properties in which the owner occupies less than 60% of the premises) and accounted for approximately 61% of Key's total average commercial real estate loans during the third quarter of 2006. Our commercial real estate business as a whole focuses on larger real estate developers and, as shown in Figure 13, is diversified by both industry type and geographic location of the underlying collateral.

Figure 13. Commercial Real Estate Loans

September 30, 2006 <i>dollars in millions</i>	Geographic Region						Total	Percent of Total
	Northeast	Southeast	Southwest	Midwest	Central	West		
Nonowner-occupied:								
Residential properties	\$ 319	\$ 1,544	\$ 209	\$ 160	\$ 522	\$ 1,671	\$ 4,425	26.8%
Multi-family properties	223	270	166	260	491	487	1,897	11.5
Retail properties	102	286	88	410	287	300	1,473	8.9
Land and development	51	216	134	71	185	178	835	5.0
Office buildings	58	101	33	84	126	246	648	3.9
Warehouses	96	62	56	145	56	164	579	3.5
Health facilities	49	91		47	24	77	288	1.7
Manufacturing facilities	9	1	12	25	6	26	79	.5
Hotels/Motels	1	10		2	12	2	27	.2
Other	184	82	3	233	46	159	707	4.3
	1,092	2,663	701	1,437	1,755	3,310	10,958	66.3
Owner-occupied	1,128	99	50	1,872	514	1,917	5,580	33.7
Total	\$ 2,220	\$ 2,762	\$ 751	\$ 3,309	\$ 2,269	\$ 5,227	\$ 16,538	100.0%

Edgar Filing: KEYCORP /NEW/ - Form 10-Q

Nonowner-occupied: Nonperforming loans	\$	28	\$	3	\$	1	\$	32	N/M					
Accruing loans past due 90 days or more		24				7		31	N/M					
Accruing loans past due 30 through 89 days	\$	1	\$	43	\$	2	\$	12	5	\$	19	\$	82	N/M

Northeast - Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont

Southeast - Alabama, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, Washington D.C. and West Virginia

Southwest - Arizona, Nevada and New Mexico

Midwest - Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin

Central - Arkansas, Colorado, Oklahoma, Texas and Utah

West - Alaska, California, Hawaii, Montana, Oregon, Washington and Wyoming

N/M = Not Meaningful

Table of Contents

In the second half of 2005, we continued to expand our FHA financing and mortgage servicing capabilities by acquiring Malone Mortgage Company and the commercial mortgage-backed securities servicing business of ORIX Capital Markets, LLC, both headquartered in Dallas, Texas. These acquisitions added more than \$28 billion to our commercial mortgage servicing portfolio and are just two in a series of acquisitions that we have initiated over the past several years to build upon our success in the commercial mortgage business.

Management believes Key has both the scale and array of products to compete on a world-wide basis in the specialty of equipment lease financing. This business is conducted through the Equipment Finance line of business and continues to benefit from the fourth quarter 2004 acquisition of American Express Business Finance Corporation (AEBF), the equipment leasing unit of American Express' small business division. AEBF had commercial loan and lease financing receivables of approximately \$1.5 billion at the date of acquisition. During the first quarter of 2006, Key reclassified \$792 million of loans from the commercial lease financing portfolio to the commercial, financial and agricultural portfolio to more accurately reflect the nature of these receivables. Prior period balances were not reclassified as the historical data was not available.

Consumer loan portfolio. Consumer loans outstanding decreased by \$2.9 billion, or 14%, from one year ago. The decline was largely attributable to the third quarter 2006 transfer of \$2.5 billion of home equity loans to loans held for sale in connection with our intention to pursue a sale of Champion Mortgage discussed below. Home equity loan sales of \$266 million within Key's National Home Equity unit, as well as a general slowdown in the level of home equity loan originations over the past year, also contributed to the decline. Excluding loan sales, acquisitions and the transfer to loans held for sale, consumer loans would have decreased by \$217 million, or 1%, during the past twelve months. The home equity portfolio is by far the largest segment of Key's consumer loan portfolio. Key's home equity portfolio is derived primarily from our Regional Banking line of business (responsible for 91% of the home equity portfolio at September 30, 2006) and the National Home Equity unit within our Consumer Finance line of business. The National Home Equity unit has two components: Champion Mortgage, a home equity finance business, and Key Home Equity Services, which works with home improvement contractors to provide home equity and home improvement financing solutions. On August 1, 2006, Key announced that it is considering a sale of its Champion Mortgage business. Key has hired UBS Investment Bank to assist the Board of Directors and management with the possible sale of this business. There is no assurance that Key will enter into an agreement regarding, or consummate the sale of, this business.

Figure 14 summarizes Key's home equity loan portfolio at the end of each of the last five quarters, as well as certain asset quality statistics and yields on the portfolio as a whole.

Figure 14. Home Equity Loans

<i>dollars in millions</i>		2006			2005	
	Third	Second	First	Fourth	Third	
SOURCES OF LOANS						
OUTSTANDING AT PERIOD END						
Regional Banking	\$ 9,990	\$ 10,122	\$ 10,100	\$ 10,232	\$ 10,345	
Champion Mortgage ^a		2,458	2,483	2,465	2,770	
Key Home Equity Services	998	929	846	791	757	
National Home Equity unit	998	3,387	3,329	3,256	3,527	
Total	\$ 10,988	\$ 13,509	\$ 13,429	\$ 13,488	\$ 13,872	
Nonperforming loans at period end ^a	\$ 46	\$ 90	\$ 97	\$ 79	\$ 75	
Net charge-offs for the period	4	7	6	5	6	

Yield for the period	7.32%	7.36%	7.19%	7.00%	6.72%
----------------------	--------------	--------------	--------------	-------	-------

- (a) On August 1, 2006, Key transferred \$2.5 billion of home equity loans from the loan portfolio to loans held for sale and approximately \$55 million of home equity loans from nonperforming loans to nonperforming loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.

Table of Contents

Loans held for sale. As shown in Note 6, Key's loans held for sale rose to \$7.2 billion at September 30, 2006, from \$3.4 billion at December 31, 2005, and \$3.6 billion at September 30, 2005, due primarily to the third quarter 2006 transfer of home equity loans to loans held for sale. Originations in the commercial mortgage; commercial, financial and agricultural; and construction loan portfolios also contributed to the increase.

Sales and securitizations. We have continued to use alternative funding sources like loan sales and securitizations to support our loan origination capabilities. In addition, over the past several years, several acquisitions have improved our ability to originate and sell new loans, and to securitize and service loans generated by others, especially in the area of commercial real estate.

During the past twelve months, Key sold \$2.4 billion of commercial real estate loans, \$1.3 billion of education loans (\$904 million through securitizations), \$416 million of commercial loans and leases, \$355 million of residential real estate loans and \$266 million of home equity loans. Most of these sales came from the held-for-sale portfolio.

Among the factors that Key considers in determining which loans to sell or securitize are:

- whether particular lending businesses meet our performance standards or fit with our relationship banking strategy;
- our asset/liability management needs;
- whether the characteristics of a specific loan portfolio make it conducive to securitization;
- the relative cost of funds;
- the level of credit risk; and
- capital requirements.

Figure 15 summarizes Key's loan sales (including securitizations) for the first nine months of 2006 and all of 2005.

Figure 15. Loans Sold (Including Loans Held for Sale)

<i>in millions</i>	Commercial	Commercial Real Estate	Commercial Lease Financing	Residential Real Estate	Home Equity	Consumer Indirect Education	Total
2006							
Third quarter	\$ 37	\$ 679	\$ 16	\$ 109	\$ 2	\$ 143	\$ 986
Second quarter	64	483		97		110	754
First quarter	40	406	105	54		172	777
Total	\$ 141	\$ 1,568	\$ 121	\$ 260	\$ 2	\$ 425	\$ 2,517
2005							
Fourth quarter	\$ 44	\$ 792	\$ 110	\$ 95	\$ 264	\$ 834	\$ 2,139
Third quarter	40	710		99	3	\$ 111	1,011
Second quarter	21	336		99		635	1,219
First quarter	18	389		98	31	992	1,736
Total	\$ 123	\$ 2,227	\$ 110	\$ 391	\$ 298	\$ 1,738	\$ 6,105

Figure 16 shows loans that are either administered or serviced by Key, but not recorded on its balance sheet. Included are loans that have been both securitized and sold, or simply sold outright. As discussed previously, the acquisitions of Malone Mortgage Company and the commercial mortgage-backed securities servicing business of ORIX Capital Markets, LLC added more than \$28 billion to our commercial mortgage servicing portfolio during the second half of 2005.

Table of Contents**Figure 16. Loans Administered or Serviced**

<i>in millions</i>	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Commercial real estate loans	\$ 81,873	\$ 78,348	\$ 76,123	\$ 72,902	\$ 43,555
Education loans	4,640	4,806	4,992	5,083	4,518
Commercial lease financing	513	479	422	354	251
Commercial loans	252	255	247	242	233
Home equity loans	4	4	5	59	85
Total	\$ 87,282	\$ 83,892	\$ 81,789	\$ 78,640	\$ 48,642

In the event of default, Key is subject to recourse with respect to approximately \$656 million of the \$87.3 billion of loans administered or serviced at September 30, 2006. Additional information about this recourse arrangement is included in Note 13 (Contingent Liabilities and Guarantees) under the heading Recourse agreement with Federal National Mortgage Association on page 30.

Key derives income from several sources when we sell or securitize loans but retain the right to administer or service them. We earn noninterest income (recorded as other income) from servicing or administering the loans, and we earn interest income from any securitized assets we retain, and from the investment of funds generated by escrow deposits collected in connection with the servicing of commercial real estate loans. These deposits have contributed to the growth in Key s average noninterest-bearing deposits over the past twelve months.

Securities

At September 30, 2006, the securities portfolio totaled \$8.8 billion and included \$7.4 billion of securities available for sale, \$41 million of investment securities and \$1.4 billion of other investments (primarily principal investments). In comparison, the total portfolio at December 31, 2005, was \$8.7 billion, including \$7.3 billion of securities available for sale, \$91 million of investment securities and \$1.3 billion of other investments. At September 30, 2005, the securities portfolio totaled \$8.5 billion and included \$7.1 billion of securities available for sale, \$98 million of investment securities and \$1.3 billion of other investments.

Securities available for sale. The majority of Key s securities available-for-sale portfolio consists of collateralized mortgage obligations (CMO). A CMO is a debt security that is secured by a pool of mortgages or mortgage-backed securities. Key s CMOs generate interest income and serve as collateral to support certain pledging agreements. At September 30, 2006, Key had \$6.9 billion invested in CMOs and other mortgage-backed securities, compared to \$6.5 billion at December 31, 2005, and September 30, 2005. Substantially all of Key s mortgage-backed securities are issued or backed by federal agencies. The CMO securities held by Key are shorter-duration class bonds that are structured to have more predictable cash flows than longer-term class bonds.

The weighted-average maturity of Key s securities available-for-sale portfolio was 2.5 years at September 30, 2006, compared to 2.4 years at December 31, 2005, and 2.2 years at September 30, 2005.

The size and composition of Key s securities available-for-sale portfolio depend largely on management s assessment of current economic conditions, including the interest rate environment, and our needs for liquidity, as well as the extent to which we are required (or elect) to hold these assets as collateral to secure public funds and trust deposits. Although debt securities are generally used for this purpose, other assets, such as securities purchased under resale agreements, may be used temporarily when they provide more favorable yields or risks.

Figure 17 shows the composition, yields and remaining maturities of Key s securities available for sale. For more information about securities, including gross unrealized gains and losses by type of security, see Note 5 (Securities), which begins on page 17.

Table of Contents**Figure 17. Securities Available for Sale**

	U.S. Treasury, Agencies and Corporations	States and Political Subdivisions	Collateralized Mortgage Obligations ^a	Other Mortgage- Backed Securities ^a	Retained Interests in Securitized Securities ^a	Other Securities ^b	Total	Weighted- Average Yield ^c
SEPTEMBER 30, 2006								
Remaining maturity:								
One year or less	\$ 209	\$ 1	\$ 473	\$ 4	\$ 10	\$ 66	\$ 763	4.48%
After one through five years	5	4	6,175	160	77	110	6,531	4.53
After five through ten years	3	5	2	34	70	2	116	10.40
After ten years	3	7		11		10	31	6.55
Fair value	\$ 220	\$ 17	\$ 6,650	\$ 209	\$ 157	\$ 188	\$ 7,441	
Amortized cost	220	16	6,762	210	122	179	7,509	4.62%
Weighted-average yield ^c	5.05%	7.25%	4.30%	5.47%	19.54%	5.70% ^d	4.62% ^d	
Weighted-average maturity	.4 years	10.3 years	2.4 years	4.9 years	5.2 years	4.2 years	2.5 years	
DECEMBER 31, 2005								
Fair value	\$ 268	\$ 18	\$ 6,298	\$ 234	\$ 182	\$ 269	\$ 7,269	
Amortized cost	267	17	6,455	233	115	261	7,348	4.42%
SEPTEMBER 30, 2005								
Fair value	\$ 283	\$ 19	\$ 6,266	\$ 258	\$ 171	\$ 127	\$ 7,124	
Amortized cost	283	19	6,390	255	98	120	7,165	4.39%

(a) Maturity is based upon expected average lives rather than contractual terms.

(b) Includes primarily marketable equity securities.

(c) Weighted-average yields are calculated based on amortized cost. Such yields have been adjusted to a taxable-equivalent basis using the statutory federal income tax rate of 35%.

(d) Excludes securities of \$166 million at September 30, 2006, that have no stated yield.

Investment securities. Securities issued by states and political subdivisions constitute most of Key's investment securities. Figure 18 shows the composition, yields and remaining maturities of these securities.

Figure 18. Investment Securities

<i>dollars in millions</i>	States and Political Subdivisions	Other Securities	Total	Weighted- Average Yield ^a
SEPTEMBER 30, 2006				
Remaining maturity:				
One year or less	\$ 9	\$ 2	\$ 11	8.45%
After one through five years	16	13	29	6.52
After five through ten years	1		1	8.23
Amortized cost	\$ 26	\$ 15	\$ 41	7.07%
Fair value	27	15	42	
Weighted-average maturity	1.6 years	1.9 years	1.7 years	
DECEMBER 31, 2005				
Amortized cost	\$ 35	\$ 56	\$ 91	5.25%
Fair value	36	56	92	
SEPTEMBER 30, 2005				
Amortized cost	\$ 42	\$ 56	\$ 98	5.39%
Fair value	43	56	99	

(a) Weighted-average yields are calculated based on amortized cost. Such yields have been adjusted to a taxable-equivalent basis using the statutory federal income tax rate of 35%.

Other investments. Principal investments—investments in equity and mezzanine instruments made by Key’s Principal Investing unit—are carried at fair value, which aggregated \$843 million at September 30, 2006, and \$800 million at December 31, 2005, and September 30, 2005. Principal investments represent approximately 62% of other investments at September 30, 2006. These investments include direct and indirect investments—predominantly in privately held companies. Direct investments are those made in a particular company, while indirect investments are made through funds that include other investors.

Table of Contents

In addition to principal investments, other investments include other equity and mezzanine instruments that do not have readily determinable fair values. These securities include certain real estate-related investments of \$193 million at September 30, 2006, \$209 million at December 31, 2005, and \$233 million at September 30, 2005. The remaining securities consist primarily of Federal Reserve and Federal Home Loan Bank stock. This stock, which is carried at cost, totaled \$192 million at September 30, 2006, \$187 million at December 31, 2005, and \$182 million at September 30, 2005. Neither these securities nor principal investments have stated maturities.

Deposits and other sources of funds

Core deposits—domestic deposits other than certificates of deposit of \$100,000 or more—are Key's primary source of funding. These deposits generally are stable, have a relatively low cost and typically react more slowly to changes in interest rates than market-based deposits. During the third quarter of 2006, core deposits averaged \$51.7 billion and represented 63% of the funds Key used to support earning assets, compared to \$47.9 billion and 61%, respectively, during the same quarter in 2005. The composition of Key's deposits is shown in Figure 5, which spans pages 45 and 46.

The increase in the level of Key's average core deposits during the past twelve months was due to higher levels of money market deposit accounts, time deposits and noninterest-bearing deposits. These results reflect client preferences for investments that provide high levels of liquidity in a changing interest rate environment. The growth in money market deposit accounts also benefited from the introduction of new products in 2005 and 2006. Average noninterest-bearing deposits also increased because we intensified our cross-selling efforts, focused sales and marketing efforts on our free checking products, and collected more escrow deposits associated with the servicing of commercial real estate loans.

Purchased funds, comprising large certificates of deposit, deposits in the foreign branch and short-term borrowings, averaged \$15.6 billion in the third quarter of 2006, compared to \$15.5 billion during the year-ago quarter. The increase was attributable to growth in large certificates of deposits, offset in part by a decrease in bank notes and other short-term borrowings. The need for purchased funds has diminished as a result of strong core deposit growth, a higher level of capital and other interest-free funds, and loan sales.

We continue to consider loan sales and securitizations as a funding alternative when market conditions are favorable.

Capital

Shareholders' equity. Total shareholders' equity at September 30, 2006, was \$7.9 billion, up \$349 million from December 31, 2005. Factors contributing to the change in shareholders' equity during the first nine months of 2006 are shown in the Consolidated Statements of Changes in Shareholders' Equity presented on page 5.

Changes in common shares outstanding. Figure 19 shows activities that caused the change in Key's outstanding common shares over the past five quarters.

Figure 19. Changes in Common Shares Outstanding

<i>in thousands</i>	3Q06	2Q06	1Q06	4Q05	3Q05
Shares outstanding at beginning of period	402,672	405,273	406,624	408,542	408,231
Issuance of shares under employee benefit and dividend reinvestment plans	2,576	1,399	4,649	1,332	1,561
Repurchase of common shares	(2,500)	(4,000)	(6,000)	(3,250)	(1,250)
Shares outstanding at end of period	402,748	402,672	405,273	406,624	408,542

Key repurchases its common shares periodically under a repurchase program authorized by Key's Board of Directors. Key's repurchase activity for each of the three months in the quarter ended September 30, 2006, is summarized in Figure 20.

Table of Contents**Figure 20. Share Repurchases**

<i>in thousands, except per share data</i>	Number of Shares Purchased	Average Price Paid per Share	Number of Shares Purchased under a Publicly Announced Program ^a	Remaining Number of Shares that may be Purchased Under the Program as of each Month-End ^a
July 1-31, 2006				12,461
August 1-31, 2006	2,000	\$ 37.28	2,000	10,461
September 1-30, 2006	500	36.74	500	9,961
Total	2,500	\$ 37.17	2,500	

(a) In July 2004, the Board of Directors authorized the repurchase of 25,000,000 common shares, in addition to the shares remaining from a repurchase program authorized in September 2003. This action brought the total repurchase authorization to 31,961,248 shares. These shares may be repurchased in the open market or through negotiated transactions. The program does not have an expiration date.

At September 30, 2006, Key had 89,140,338 treasury shares. Management expects to reissue those shares from time-to-time to support the employee stock purchase, stock option and dividend reinvestment plans, and for other corporate purposes. During the first nine months of 2006, Key reissued 8,624,835 treasury shares.

Capital adequacy. Capital adequacy is an important indicator of financial stability and performance. Overall, Key's capital position remains strong: the ratio of total shareholders' equity to total assets was 8.26% at September 30, 2006, compared to 8.16% at December 31, 2005, and 8.15% at September 30, 2005. Key's ratio of tangible equity to tangible assets was 6.81% at September 30, 2006, slightly above our targeted range of 6.25% to 6.75%. Management believes that Key's capital position provides the flexibility to take advantage of investment opportunities, to repurchase shares when appropriate and to pay dividends.

Banking industry regulators prescribe minimum capital ratios for bank holding companies and their banking subsidiaries. Note 14 (Shareholders' Equity), which begins on page 76 of Key's 2005 Annual Report to Shareholders, explains the implications of failing to meet specific capital requirements imposed by the banking regulators.

Risk-based capital guidelines require a minimum level of capital as a percent of risk-weighted assets, which is total assets plus certain off-balance sheet items, both adjusted for predefined credit risk factors. Currently, banks and bank holding companies must maintain, at a minimum, Tier 1 capital as a percent of risk-weighted assets of 4.00%, and total capital as a percent of risk-weighted assets of 8.00%. As of September 30, 2006, Key's Tier 1 capital ratio was 8.02%, and its total capital ratio was 12.13%.

Another indicator of capital adequacy, the leverage ratio, is defined as Tier 1 capital as a percentage of average quarterly tangible assets. Leverage ratio requirements vary with the condition of the financial institution. Bank holding companies that either have the highest supervisory rating or have implemented the Federal Reserve's risk-adjusted measure for market risk - as KeyCorp has - must maintain a minimum leverage ratio of 3.00%. All other bank holding companies must maintain a minimum ratio of 4.00%. As of September 30, 2006, Key had a leverage ratio of 8.89%.

Federal bank regulators group FDIC-insured depository institutions into five categories, ranging from critically undercapitalized to well capitalized. Key's affiliate bank, KBNA, qualified as well capitalized at September 30, 2006, since it exceeded the prescribed thresholds of 10.00% for total capital, 6.00% for Tier 1 capital and 5.00% for the

leverage ratio. If these provisions applied to bank holding companies, Key would also qualify as well capitalized at September 30, 2006. The FDIC-defined capital categories serve a limited supervisory function. Investors should not treat them as a representation of the overall financial condition or prospects of KeyCorp or KBNA.

Figure 21 presents the details of Key's regulatory capital position at September 30, 2006, December 31, 2005, and September 30, 2005.

Table of Contents**Figure 21. Capital Components and Risk-Weighted Assets**

<i>dollars in millions</i>	September 30, 2006	December 31, 2005	September 30, 2005
TIER 1 CAPITAL			
Common shareholders' equity ^a	\$ 8,019	\$ 7,678	\$ 7,578
Qualifying capital securities	1,792	1,542	1,542
Less: Goodwill	1,372	1,355	1,344
Other assets ^b	179	178	162
Total Tier 1 capital	8,260	7,687	7,614
TIER 2 CAPITAL			
Allowance for losses on loans and lending-related commitments	1,003	1,025	1,152
Net unrealized gains on equity securities available for sale	4	4	3
Qualifying long-term debt	3,229	2,899	2,899
Total Tier 2 capital	4,236	3,928	4,054
Total risk-based capital	\$ 12,496	\$ 11,615	\$ 11,668
RISK-WEIGHTED ASSETS			
Risk-weighted assets on balance sheet	\$ 79,764	\$ 76,724	\$ 75,594
Risk-weighted off-balance sheet exposure	24,463	25,619	24,212
Less: Goodwill	1,372	1,355	1,344
Other assets ^b	778	785	769
Plus: Market risk-equivalent assets	941	1,064	945
Risk-weighted assets	\$ 103,018	\$ 101,267	\$ 98,638
AVERAGE QUARTERLY TOTAL ASSETS	\$ 94,918	\$ 92,206	\$ 90,623
CAPITAL RATIOS			
Tier 1 risk-based capital ratio	8.02%	7.59%	7.72%
Total risk-based capital ratio	12.13	11.47	11.83
Leverage ratio ^c	8.89	8.53	8.60

(a) Common shareholders' equity does not include net unrealized gains or losses on securities available for sale (except for net unrealized losses on marketable equity securities) or net gains or losses on cash flow hedges.

(b) Other assets deducted from Tier 1 capital and risk-weighted assets consist of intangible assets (excluding goodwill) recorded after February 19, 1992, deductible portions of purchased mortgage servicing rights and deductible portions of nonfinancial equity investments.

(c)

This ratio is Tier 1 capital divided by average quarterly total assets less goodwill, the nonqualifying intangible assets described in footnote (b), deductible portions of nonfinancial equity investments and net unrealized gains or losses on securities available for sale.

Table of Contents**Risk Management****Overview**

Certain risks are inherent in the business activities that financial services companies conduct. The ability to properly and effectively identify, measure, monitor and report such risks is essential to maintaining safety and soundness and to maximizing profitability. Management believes that the most significant risks to which Key is exposed are market risk, credit risk, liquidity risk and operational risk. Each type of risk is defined and discussed in greater detail in the remainder of this section.

Key's Board of Directors has established and follows a corporate governance program that serves as the foundation for managing and mitigating risk. In accordance with this program, the Board focuses on the interests of shareholders, encourages strong internal controls, demands management accountability, mandates adherence to Key's code of ethics and administers an annual self-assessment process. The Board has established Audit and Finance committees whose appointed members play an integral role in helping the Board meet its risk oversight responsibilities. Those committees meet jointly, as appropriate, to discuss matters that relate to each committee's responsibilities. The responsibilities of these two committees are summarized on page 38 of Key's 2005 Annual Report to Shareholders.

Market risk management

The values of some financial instruments vary not only with changes in market interest rates, but also with changes in foreign exchange rates, factors influencing valuations in the equity securities markets and other market-driven rates or prices. For example, the value of a fixed-rate bond will decline if market interest rates increase. Similarly, the value of the U.S. dollar regularly fluctuates in relation to other currencies. When the value of an instrument is tied to such external factors, the holder faces market risk. Most of Key's market risk is derived from interest rate fluctuations.

Interest rate risk management

Key's Asset/Liability Management Policy Committee (ALCO) has developed a program to measure and manage interest rate risk. This senior management committee is also responsible for approving Key's asset/liability management (A/LM) policies, overseeing the formulation and implementation of strategies to improve balance sheet positioning and earnings, and reviewing Key's sensitivity to changes in interest rates.

Factors contributing to interest rate exposure. Key uses interest rate exposure models to quantify the potential impact that a variety of possible interest rate scenarios may have on earnings and the economic value of equity. The various scenarios estimate the level of Key's interest rate exposure arising from gap risk, option risk and basis risk. Each of these types of risk is defined in the discussion of market risk management, which begins on page 38 of Key's 2005 Annual Report to Shareholders.

Measurement of short-term interest rate exposure. Key uses a simulation model to measure interest rate risk. The model estimates the impact that various changes in the overall level of market interest rates would have on net interest income over one- and two-year time periods. The results help Key develop strategies for managing exposure to interest rate risk.

Like any forecasting technique, interest rate simulation modeling is based on a large number of assumptions and judgments. Primary among these for Key are those related to loan and deposit growth, asset and liability prepayments, interest rate variations, product pricing, and on- and off-balance sheet management strategies. Management believes its assumptions are reasonable. Nevertheless, simulation modeling produces only a sophisticated estimate, not a precise calculation of exposure.

Table of Contents

Key's risk management guidelines call for preventive measures to be taken if simulation modeling demonstrates that a gradual 200 basis point increase or decrease in short-term rates over the next twelve months, defined as a stressed interest rate scenario, would adversely affect net interest income over the same period by more than 2%. Key is operating within these guidelines.

When an increase in short-term interest rates is expected to generate lower net interest income, the balance sheet is said to be liability-sensitive, meaning that rates paid on deposits and other liabilities respond more quickly to market forces than yields on loans and other assets. Conversely, when an increase in short-term interest rates is expected to generate greater net interest income, the balance sheet is said to be asset-sensitive, meaning that yields on loans and other assets respond more quickly to market forces than rates paid on deposits and other liabilities. Key has historically maintained a modest liability-sensitive position to increasing interest rates under our standard risk assessment. However, since mid-2004, Key has been operating with a relatively neutral, to slight asset-sensitive, position. Management actively monitors the risk of changes in interest rates and takes preventive actions, when deemed necessary, with the objective of assuring that net interest income at risk does not exceed internal guidelines. In addition, since rising rates typically reflect an improving economy, management expects that Key's lines of business could increase their portfolios of market-rate loans and deposits, which would mitigate the effect of rising rates on Key's interest expense.

As discussed above, since mid-2004, Key has been operating with a relatively neutral, to slight asset-sensitive, position. Deposit growth, sales of fixed-rate consumer loans, and a smaller portfolio of receive fixed A/LM interest rate swaps have contributed to this position. Additionally, management has refined simulation model assumptions to address anticipated changes in deposit pricing on select products in a very competitive marketplace. Key manages interest rate risk with a long-term perspective. Although our rate risk guidelines currently call for a relatively neutral position, our bias is to be modestly liability-sensitive in the long run.

For purposes of simulation modeling, we estimate net interest income starting with current market interest rates, and assume that those rates will not change in future periods. Then we measure the amount of net interest income at risk by assuming a gradual 200 basis point increase or decrease in the Federal Funds target rate over the next twelve months. At the same time, we adjust other market interest rates, such as U.S. Treasury, LIBOR, and interest rate swap rates, but not as dramatically. These market interest rate assumptions form the basis for our standard risk assessment in a stressed period for interest rate changes. We also assess rate risk assuming that market interest rates move faster or slower, and that the magnitude of change results in steeper or flatter yield curves. (The yield curve depicts the relationship between the yield on a particular type of security and its term to maturity.)

In addition to modeling interest rates as described above, Key models the balance sheet in three distinct ways to forecast changes over different periods and under different conditions. Our initial simulation of net interest income assumes that the composition of the balance sheet will not change over the next year. In other words, current levels of loans, deposits, investments, and other related assets and liabilities are held constant, and loans, deposits and investments that are assumed to mature or prepay are replaced with like amounts. Interest rate swaps and investments used for A/LM purposes, and term debt used for liquidity management purposes are allowed to mature without replacement. In this simulation, we are simplistically capturing the effect of hypothetical changes in interest rates on future net interest income volatility. Additionally, growth in floating-rate loans and fixed-rate deposits, which naturally reduces the amount of net interest income at risk when interest rates are rising, is not captured in this simulation.

Another simulation, using Key's most likely balance sheet, assumes that the balance sheet will grow at levels consistent with consensus economic forecasts. Investments used for A/LM purposes will be allowed to mature without replacement, and term debt used for liquidity management purposes will be incorporated to ensure a prudent level of liquidity. Forecasted loan, security, and deposit growth in the simulation model produces incremental risks, such as gap risk, option risk and basis risk, which may increase interest rate risk. To mitigate these risks, management makes assumptions about future on- and off-balance sheet management strategies. In this simulation, we are testing the sensitivity of net interest income to future

Table of Contents

balance sheet volume changes while simultaneously capturing the effect of hypothetical changes in interest rates on future net interest income volatility. As of September 30, 2006, based on the results of our simulation model, and assuming that management does not take action to alter the outcome, Key would expect net interest income to decrease by approximately .12% if short-term interest rates gradually increase by 200 basis points over the next twelve months. Conversely, if short-term interest rates gradually decrease by 200 basis points over the next twelve months, net interest income would be expected to increase by approximately .90% over the next year.

The results of the most likely balance sheet simulation form the basis for our standard risk assessment that is performed monthly and reported to Key's risk governance committees in accordance with ALCO policy. There are a variety of factors that can influence the results of the simulation. Assumptions we make about loan and deposit growth strongly influence funding, liquidity, and interest rate sensitivity. Figure 26 (Net Interest Income Volatility) on page 40 of Key's 2005 Annual Report to Shareholders illustrates the variability of the simulation results that can arise from changing certain major assumptions.

As of September 30, 2006, based on the results of a model in which we simulate the effect of a gradual 200 basis point increase in short-term interest rates only in the second year of a two-year time horizon, using the most likely balance sheet, and assuming that management does not take action to alter the outcome, Key would expect net interest income in the second year to decrease by approximately .57%. Conversely, if short-term interest rates gradually decrease by 200 basis points in the second year but remain unchanged in the first year, net interest income would be expected to increase by approximately 1.62% during the second year.

The results of the above second year scenarios reflect management's intention to gradually move to a slight liability-sensitive position to rising interest rates. Given the current expectations for unchanged-to-lower short-term interest rates, we currently plan to add moderate amounts of receive fixed/pay variable interest rate swaps during the next two quarters in support of a gradual change to liability sensitivity.

Measurement of long-term interest rate exposure. Key uses an economic value of equity model to complement short-term interest rate risk analysis. The benefit of this model is that it measures exposure to interest rate changes over time frames longer than two years. The economic value of Key's equity is determined by aggregating the present value of projected future cash flows for asset, liability and derivative positions based on the current yield curve. However, economic value does not represent the fair values of asset, liability and derivative positions since it does not consider factors like credit risk and liquidity.

Key's guidelines for risk management call for preventive measures to be taken if an immediate 200 basis point increase or decrease in interest rates is estimated to reduce the economic value of equity by more than 15%. Key is operating within these guidelines.

Management of interest rate exposure. Management uses the results of short-term and long-term interest rate exposure models to formulate strategies to improve balance sheet positioning, earnings, or both, within the bounds of Key's interest rate risk, liquidity and capital guidelines.

We actively manage our interest rate sensitivity through securities, debt issuance and derivatives. Key's two major business groups conduct activities that generally result in an asset-sensitive position. To compensate, we typically issue floating-rate debt, or fixed-rate debt swapped to floating, so that the rates paid on deposits and borrowings in the aggregate will respond more quickly to market forces. Interest rate swaps are the primary tool we use to modify our interest rate sensitivity, and our asset and liability durations.

The decision to use interest rate swaps rather than securities, debt or other on-balance sheet alternatives depends on many factors, including the mix and cost of funding sources, liquidity and capital requirements, and interest rate implications. Figure 22 shows the maturity structure for all swap positions held for A/LM purposes. These positions are used to convert the contractual interest rate index of agreed-upon amounts of assets and liabilities (i.e., notional amounts) to another interest rate index. For example, fixed-rate debt is

Table of Contents

converted to floating rate through a receive fixed, pay variable interest rate swap. For more information about how Key uses interest rate swaps to manage its balance sheet, see Note 14 (Derivatives and Hedging Activities), which begins on page 32.

Figure 22. Portfolio Swaps By Interest Rate Risk Management Strategy

<i>dollars in millions</i>	September 30, 2006					September 30, 2005	
	Notional Amount	Fair Value	Maturity (Years)	Weighted-Average Rate		Notional Amount	Fair Value
				Receive	Pay		
Receive fixed/pay variable conventional A/LM ^a	\$ 5,558		1.2	5.0%	5.4%	\$ 2,200	\$ (5)
Receive fixed/pay variable conventional debt	5,524	\$ 17	10.8	5.4	5.5	5,962	139
Pay fixed/receive variable conventional debt	998	(12)	4.8	4.3	4.2	955	(27)
Foreign currency conventional debt	2,695	27	3.2	3.9	5.6	2,441	(101)
Basis swaps ^b	300		1.5	5.4	5.3	9,500	(1)
Total portfolio swaps	\$ 15,075	\$ 32	5.3	4.9%	5.4%	\$ 21,058	\$ 5

(a) Portfolio swaps designated as A/LM are used to manage interest rate risk tied to both assets and liabilities.

(b) These portfolio swaps are not designated as hedging instruments under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities.

Key's securities and term debt portfolios are also used to manage interest rate risk. Details regarding Key's securities can be found in the discussion of securities, which begins on page 56, and in Note 5 (Securities), which begins on page 17. Collateralized mortgage obligations, the majority of which have relatively short average lives, have been used in conjunction with swaps to manage our interest rate risk position.

Trading portfolio risk management

Key's trading portfolio is described in Note 14.

Management uses a value at risk (VAR) simulation model to measure the potential adverse effect of changes in interest rates, foreign exchange rates, equity prices and credit spreads on the fair value of Key's trading portfolio. Using two years of historical information, the model estimates the potential one-day loss with a 95% confidence level. Statistically, this means that losses will exceed VAR, on average, five out of 100 trading days, or three to four times each quarter. Key's Financial Markets Committee has established VAR limits for our trading units. At September 30, 2006, the aggregate one-day trading limit set by the committee was \$4.4 million. In addition to comparing VAR exposure against limits on a daily basis, management monitors loss limits, uses sensitivity measures and conducts stress tests.

Key is operating within the above constraints. During the first nine months of 2006, Key's aggregate daily average, minimum and maximum VAR amounts were \$1.1 million, \$.7 million and \$2.1 million, respectively. During the same period last year, Key's aggregate daily average, minimum and maximum VAR amounts were \$2.3 million, \$1.0 million and \$5.3 million, respectively.

As noted in the discussion of investment banking and capital markets income on page 49, Key used interest rate swaps to manage the economic risk associated with its sale of the indirect automobile loan portfolio. Even though these derivatives were not subject to VAR trading limits, Key measured their exposure on a daily basis and the results are

included in the VAR amounts indicated above for the first nine months of 2005. The daily average, minimum and maximum VAR exposures for these derivatives were \$1.0 million, zero and \$3.6 million, respectively.

64

Table of Contents**Credit risk management**

Credit risk represents the risk of loss arising from an obligor's inability or failure to meet contractual payment or performance terms. It is inherent in the financial services industry and results from extending credit to clients, purchasing securities and entering into financial derivative contracts.

Credit policy, approval and evaluation. Key manages its credit risk exposure through a multi-faceted program. Independent committees approve both retail and commercial credit policies. Once approved, these policies are communicated throughout Key to ensure consistency in our approach to granting credit. For more information about Key's credit policies, as well as related approval and evaluation processes, see the section entitled "Credit policy, approval and evaluation," which begins on page 42 of Key's 2005 Annual Report to Shareholders.

In addition to the processes described in the Annual Report, management uses credit derivatives to mitigate Key's credit risk. One of the primary instruments used in this regard is credit default swaps. Through the purchase of these swaps, Key is able to transfer a portion of the credit risk associated with the underlying extension of credit to a third party. At September 30, 2006, credit default swaps with a notional amount of \$904 million were used to manage the credit risk associated with specific commercial lending obligations. Key may also provide credit protection through the sale of credit default swaps. These transactions generate fee income and can also be used to diversify overall exposure to credit loss. At September 30, 2006, the notional amount of credit default swaps sold by Key was \$25 million.

Credit default swaps are recorded on the balance sheet at fair value. Related gains or losses, as well as the premium paid or received for credit protection, are included in the trading income component of noninterest income. These swaps did not have a significant effect on Key's operating results for the first nine months of 2006.

Watch credits and criticized loans. Watch credits are defined as loans with the potential for further deterioration in quality due to the client's current financial condition and possible inability to perform in accordance with the terms of the loan at some point in the future. Criticized credits are loans that show additional signs of weakness which may lead to an interruption in scheduled repayments from primary sources, potentially requiring Key to rely on repayment from secondary sources, such as collateral liquidation.

The level of watch commitments increased from the third quarter of 2005 in a number of client segments across a range of loan portfolios. During that same period, however, the level of criticized commitments declined modestly, due to a number of offsetting changes across multiple portfolios. Compared to the prior quarter, the level of watch commitments decreased, primarily due to the movement of several credits from watch to criticized status. This movement resulted in an overall increase in the level of criticized commitments during the third quarter of 2006. These fluctuations in watch and criticized commitments continue to be closely monitored.

Allowance for loan losses. The allowance for loan losses at September 30, 2006, was \$944 million, or 1.44% of loans. This compares with \$966 million, or 1.45% of loans, at December 31, 2005, and \$1.093 billion, or 1.67% of loans, at September 30, 2005. The allowance includes \$12 million that was specifically allocated for impaired loans of \$27 million at September 30, 2006, compared to \$6 million that was allocated for impaired loans of \$9 million at December 31, 2005, and \$4 million that was allocated for impaired loans of \$8 million one year ago. For more information about impaired loans, see Note 8 ("Nonperforming Assets and Past Due Loans") on page 21. At September 30, 2006, the allowance for loan losses was 423.32% of nonperforming loans, compared to 348.74% at December 31, 2005, and 303.61% at September 30, 2005.

Table of Contents

Management estimates the appropriate level of the allowance for loan losses on a quarterly (and at times more frequent) basis. The methodology used is described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan Losses on page 59 of Key's 2005 Annual Report to Shareholders. Briefly, management allocates an allowance to an impaired loan by applying an assumed rate of loss to the outstanding balance based on the credit rating assigned to the loan. If the outstanding balance is greater than \$2.5 million, and the resulting allocation is deemed insufficient to cover the extent of the impairment, a specific allowance is assigned to the loan. Management estimates the extent of impairment by comparing the carrying amount of the loan with the estimated present value of its future cash flows, including, if applicable, the fair value of any collateral. The allowance for loan losses arising from nonimpaired loans is determined by applying historical loss rates to existing loans with similar risk characteristics and by exercising judgment to assess the impact of factors such as changes in economic conditions, credit policies or underwriting standards, and the level of credit risk associated with specific industries and markets. The aggregate balance of the allowance for loan losses at September 30, 2006, represents management's best estimate of the losses inherent in the loan portfolio at that date.

As shown in Figure 23, Key's allowance for loan losses decreased by \$149 million, or 14%, during the past twelve months. This reduction was attributable to improving credit quality trends, charge-offs of \$127 million recorded in the commercial passenger airline lease portfolio during the fourth quarter of 2005, and the third quarter 2006 transfer of \$2.5 billion of home equity loans from the loan portfolio to loans held for sale in connection with Key's intention to pursue a sale of the Champion Mortgage finance business.

During the third quarter of 2006, Key refined its methodology for allocating the allowance for loan losses. The refinements include a more accurate assignment of the allowance by loan type within each of the specific lines of business. Prior to this refinement, the allowance assigned to a specific line of business was allocated to the predominant loan types within the line. The allowance for loan losses at December 31, 2005, and September 30, 2005, was reallocated among the various loan types within Key's loan portfolio to reflect this refinement. The reduction in the allowance allocated to the home equity loan portfolio from December 31, 2005, to September 30, 2006, was due in part to the transfer of the Champion home equity portfolio to held-for-sale status.

Figure 23. Allocation of the Allowance for Loan Losses

	September 30, 2006			December 31, 2005			September 30, 2005		
	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	Percent of Allowance to Total Loans	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	Percent of Allowance to Total Loans	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	
Commercial, financial and agricultural	\$ 360	38.1%	32.9%	\$ 338	35.0%	31.0%	\$ 349	32.0%	29.7%
Real estate commercial mortgage	161	17.0	12.6	168	17.4	12.6	176	16.1	13.1
Real estate construction	113	12.0	12.6	94	9.7	10.7	93	8.5	10.2
Commercial lease financing	145	15.4	15.1	183	19.0	15.5	279	25.5	15.8
Total commercial loans	779	82.5	73.2	783	81.1	69.8	897	82.1	68.8

Real estate residential mortgage	13	1.4	2.1	13	1.3	2.2	14	1.3	2.3
Home equity	76	8.0	16.8	95	9.8	20.3	102	9.3	21.1
Consumer direct	28	3.0	2.4	31	3.2	2.7	34	3.1	2.7
Consumer indirect	48	5.1	5.5	44	4.6	5.0	46	4.2	5.1
Total consumer loans	165	17.5	26.8	183	18.9	30.2	196	17.9	31.2
Total	\$ 944	100.0%	100.0%	\$ 966	100.0%	100.0%	\$ 1,093	100.0%	100.0%

Net loan charge-offs. Net loan charge-offs for the third quarter of 2006 totaled \$43 million, or .25% of average loans. These results compare to net charge-offs of \$49 million, or .30% of average loans, for the same period last year. The composition of Key's loan charge-offs and recoveries by type of loan is shown in Figure 24. The decrease in net charge-offs from the year-ago quarter occurred primarily in the commercial lease financing and consumer installment portfolios.

Table of Contents**Figure 24. Summary of Loan Loss Experience**

<i>dollars in millions</i>	Three months ended		Nine months ended	
	September 30, 2006	2005	September 30, 2006	2005
Average loans outstanding during the period	\$ 66,010	\$ 64,758	\$ 66,709	\$ 64,346
Allowance for loan losses at beginning of period	\$ 956	\$ 1,100	\$ 966	\$ 1,138
Loans charged off:				
Commercial, financial and agricultural	30	14	74	58
Real estate commercial mortgage	3	4	9	16
Real estate construction	1		3	5
Total commercial real estate loans ^a	4	4	12	21
Commercial lease financing	13	18	27	43
Total commercial loans	47	36	113	122
Real estate residential mortgage	2	1	5	5
Home equity	6	7	22	20
Consumer direct	7	10	26	28
Consumer indirect	8	15	28	47
Total consumer loans	23	33	81	100
	70	69	194	222
Recoveries:				
Commercial, financial and agricultural	8	4	27	14
Real estate commercial mortgage	2	1	3	2
Real estate construction	1		1	2
Total commercial real estate loans ^a	3	1	4	4
Commercial lease financing	9	7	23	27
Total commercial loans	20	12	54	45
Real estate residential mortgage			1	1
Home equity	2	1	5	4
Consumer direct	1	2	5	6
Consumer indirect	4	5	13	15
Total consumer loans	7	8	24	26
	27	20	78	71
Net loans charged off	(43)	(49)	(116)	(151)
Provision for loan losses	31	43	94	107
Foreign currency translation adjustment		(1)		(1)

Allowance for loan losses at end of period	\$ 944	\$ 1,093	\$ 944	\$ 1,093
Net loan charge-offs to average loans	.25%	.30%	.23%	.32%
Allowance for loan losses to period-end loans	1.44	1.67	1.44	1.67
Allowance for loan losses to nonperforming loans	423.32	303.61	423.32	303.61

(a) See Figure 13 and the accompanying discussion on pages 53 and 54 for more information related to Key's commercial real estate portfolio.

Key also has a separate allowance for probable credit losses inherent in lending-related commitments. This allowance is included in accrued expense and other liabilities on the balance sheet and totaled \$59 million at September 30, 2006, and 2005. Key establishes the amount of this allowance by analyzing its lending-related commitments quarterly, or more often if deemed necessary.

Table of Contents

Nonperforming assets. Figure 25 shows the composition of Key's nonperforming assets. These assets totaled \$329 million at September 30, 2006, and represented .50% of loans, other real estate owned (known as OREO) and other nonperforming assets, compared to \$307 million, or .46%, at December 31, 2005, and \$393 million, or .60%, at September 30, 2005. During the third quarter of 2006, Key transferred approximately \$55 million of home equity loans from nonperforming loans to nonperforming loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business. This reclassification had no effect on Key's total nonperforming assets. As shown in Figure 25, nonperforming loans decreased by \$137 million over the last twelve months, primarily within the commercial lease financing portfolio. Nonperforming loans in this portfolio declined by \$131 million, due largely to the charge-off of several credits within the commercial passenger airline portfolio during the fourth quarter of 2005. The decrease in total nonperforming loans also reflects the transfer of the home equity loans discussed above. These reductions were partially offset by a higher level of nonperforming loans in the commercial real estate portfolio. At September 30, 2006, our 20 largest nonperforming loans totaled \$81 million, representing 36% of total loans on nonperforming status.

Although the level of Key's delinquent loans rose during the first nine months of 2006, these loans have been trending downward over the past several years. This trend is due largely to strategic changes in the composition of Key's loan portfolio, such as reductions in credit-only client relationships. Over the course of a normal business cycle, fluctuations in the level of Key's delinquent loans are to be expected.

Figure 25. Summary of Nonperforming Assets and Past Due Loans

<i>dollars in millions</i>	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Commercial, financial and agricultural	\$ 42	\$ 76	\$ 68	\$ 63	\$ 50
Real estate commercial mortgage	41	40	42	43	33
Real estate construction	37	4	4	2	3
Total commercial real estate loans ^a	78	44	46	45	36
Commercial lease financing	20	29	29	39	151
Total commercial loans	140	149	143	147	237
Real estate residential mortgage	29	31	43	41	40
Home equity ^b	46	90	97	79	75
Consumer direct	2	3	6	2	3
Consumer indirect	6	6	6	8	5
Total consumer loans	83	130	152	130	123
Total nonperforming loans	223	279	295	277	360
Nonperforming loans held for sale ^b	56	1	2	3	2
OREO	52	26	21	25	29
Allowance for OREO losses	(3)	(1)	(1)	(2)	(3)
OREO, net of allowance	49	25	20	23	26
Other nonperforming assets ^c	1	3	3	4	5

Total nonperforming assets	\$	329	\$	308	\$	320	\$	307	\$	393
Accruing loans past due 90 days or more	\$	125	\$	119	\$	107	\$	90	\$	94
Accruing loans past due 30 through 89 days		715		600		498		491		550
Nonperforming loans to period-end portfolio loans		.34%		.41%		.44%		.42%		.55%
Nonperforming assets to period-end portfolio loans plus OREO and other nonperforming assets		.50		.46		.48		.46		.60

- (a) See Figure 13 and the accompanying discussion on pages 53 and 54 for more information related to Key's commercial real estate portfolio.
- (b) On August 1, 2006, Key transferred approximately \$55 million of home equity loans from nonperforming loans to nonperforming loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.
- (c) Primarily collateralized mortgage-backed securities.

Table of Contents

Credit exposure by industry classification inherent in the largest sector of Key's loan portfolio, commercial, financial and agricultural loans, is presented in Figure 26. The types of activity that caused the change in Key's nonperforming loans during each of the last two quarters are summarized in Figure 27.

Figure 26. Commercial, Financial and Agricultural Loans

September 30, 2006	Total Commitments ^a	Loans Outstanding	Nonperforming Loans	
			Amount	% of Loans Outstanding
<i>dollars in millions</i>				
Industry classification:				
Manufacturing	\$ 10,807	\$ 3,822	\$ 3	.08%
Services	9,746	3,118	12	.38
Retail trade	5,956	3,280	2	.06
Financial services	5,276	2,225	1	.04
Public utilities	3,884	606		
Property management	3,597	1,569		
Wholesale trade	3,201	1,528	2	.13
Building contractors	2,494	1,212	3	.25
Transportation	2,240	1,558	5	.32
Insurance	2,143	126		
Public administration	1,060	399		
Agriculture/forestry/ fishing	916	589	2	.34
Communications	880	293		
Mining	657	228		
Individuals	48	24		
Other	1,666	979	12	1.23
Total	\$ 54,571	\$ 21,556	\$ 42	.19%

(a) Total commitments include unfunded loan commitments, unfunded letters of credit (net of amounts conveyed to others) and loans outstanding.

Figure 27. Summary of Changes in Nonperforming Loans

<i>in millions</i>	2006			
	Third	Second	First	2005 Fourth
Balance at beginning of period	\$ 279	\$ 295	\$ 277	\$ 360
Loans placed on nonaccrual status	134	98	100	142
Charge-offs	(70)	(59)	(65)	(187)
Loans sold	(22)	(6)	(2)	(2)
Payments	(43)	(45)	(15)	(27)
Transfer to held-for-sale portfolio ^a	(55)			
Transfers to OREO		(4)		
Loans returned to accrual status				(9)
Balance at end of period	\$ 223	\$ 279	\$ 295	\$ 277

- (a) On August 1, 2006, Key transferred approximately \$55 million of home equity loans from nonperforming loans to nonperforming loans held for sale in connection with its intention to pursue a sale of the Champion Mortgage finance business.

Liquidity risk management

Key defines liquidity as the ongoing ability to accommodate liability maturities and deposit withdrawals, meet contractual obligations, and fund asset growth and new business transactions at a reasonable cost, in a timely manner and without adverse consequences. Liquidity management involves maintaining sufficient and diverse sources of funding to accommodate planned as well as unanticipated changes in assets and liabilities under both normal and adverse conditions.

Key manages liquidity for all of its affiliates on an integrated basis. This approach considers the unique funding sources available to each entity and the differences in their capabilities to manage through adverse conditions. It also recognizes that the access of all affiliates to money market funding would be similarly affected by adverse market conditions or other events that could negatively affect the level or cost of

Table of Contents

liquidity. As part of the management process, we have established guidelines or target ranges that relate to the maturities of various types of wholesale borrowings, such as money market funding and term debt. In addition, we assess our needs for future reliance on wholesale borrowings, and then develop strategies to address those needs. Moreover, Key will, on occasion, guarantee a subsidiary's obligations in transactions with third parties. Management closely monitors the extension of such guarantees to ensure that Key will retain ample liquidity in the event it must step in to provide financial support.

Key's liquidity could be adversely affected by both direct and indirect circumstances. An example of a direct (but hypothetical) event would be a downgrade in Key's public credit rating by a rating agency due to deterioration in asset quality, a large charge to earnings, a decline in profitability or other financial measures, or a significant merger or acquisition. Examples of indirect (but hypothetical) events unrelated to Key that could have an effect on Key's access to liquidity would be terrorism or war, natural disasters, political events, or the default or bankruptcy of a major corporation, mutual fund or hedge fund. Similarly, market speculation or rumors about Key or the banking industry in general may adversely affect the cost and availability of normal funding sources.

In accordance with A/LM policy, Key performs stress tests to consider the effect that a potential downgrade in its debt ratings could have on liquidity over various time periods. These debt ratings, which are presented in Figure 28 on page 72, have a direct impact on our cost of funds and our ability to raise funds under normal as well as adverse conditions. The results of our stress tests indicate that, following the occurrence of an adverse event, Key can continue to meet its financial obligations and to fund its operations for at least one year. The stress test scenarios include major disruptions of our access to funding markets and consider the potential adverse effect of core client activity on cash flows. To compensate for the effect of these activities, alternative sources of liquidity are incorporated into the analysis over different time periods to project how we would manage fluctuations on the balance sheet. Several alternatives for enhancing Key's liquidity are actively managed on a regular basis. These include emphasizing client deposit generation, securitization market alternatives, loan sales, extending the maturity of wholesale borrowings, purchasing deposits from other banks, and developing relationships with fixed income investors. Key also measures its capacity to borrow using various debt instruments and funding markets.

Key also maintains a liquidity contingency plan that outlines the process for addressing a liquidity crisis. The plan provides for an evaluation of funding sources under various market conditions. It also assigns specific roles and responsibilities for effectively managing liquidity through a problem period. Key has access to various sources of money market funding (such as federal funds purchased, securities sold under repurchase agreements, eurodollars and commercial paper) and also can borrow from the Federal Reserve Bank's discount window to meet short-term liquidity requirements. Key did not have any borrowings from the Federal Reserve Bank outstanding at September 30, 2006. Key monitors its funding sources and measures its capacity to obtain funds in a variety of wholesale funding markets. This is done with the objective of maintaining an appropriate mix of funds considering both cost and availability. We use several tools as described on page 47 of Key's 2005 Annual Report to Shareholders to actively manage and maintain sufficient liquidity on an ongoing basis.

In addition to cash flows from operations, Key's cash flows come from both investing and financing activities. Since December 31, 2004, the primary sources of cash from investing activities have been the prepayments and maturities of securities available for sale. Investing activities that have required the greatest use of cash include lending and purchases of new securities.

Since December 31, 2004, the primary sources of cash from financing activities have been the growth in deposits, the issuance of long-term debt and the use of short-term borrowings. Significant outlays of cash since December 31, 2004, have been made to repay debt issued in prior periods.

The Consolidated Statements of Cash Flow on page 6 summarize Key's sources and uses of cash by type of activity for the nine-month periods ended September 30, 2006 and 2005.

Table of Contents**Liquidity for KeyCorp (the parent company)**

The parent company has sufficient liquidity when it can service its debt, support customary corporate operations and activities (including acquisitions), at a reasonable cost, in a timely manner and without adverse consequences, and pay dividends to shareholders.

A primary tool used by management to assess our parent company liquidity is our net short-term cash position, which measures the ability to fund debt maturing in twelve months or less with existing liquid assets. Another key measure of parent company liquidity is the liquidity gap, which represents the difference between projected liquid assets and anticipated financial obligations over specified time horizons. We generally rely upon the issuance of term debt to manage the liquidity gap within targeted ranges assigned to various time periods.

The parent has met its liquidity requirements principally through regular dividends from KBNA. Federal banking law limits the amount of capital distributions that a bank can make to its holding company without prior regulatory approval. A national bank's dividend paying capacity is affected by several factors, including net profits (as defined by statute) for the two previous calendar years and for the current year up to the date of dividend declaration.

During the first nine months of 2006, KBNA paid the parent a total of \$840 million in dividends, and nonbank subsidiaries paid the parent a total of \$11 million in dividends. As of the close of business on September 30, 2006, KBNA had an additional \$270 million available to pay dividends to the parent company without prior regulatory approval and without affecting its status as well-capitalized under the FDIC-defined capital categories. The parent company generally maintains excess funds in short-term investments in an amount sufficient to meet projected debt maturities over the next twelve months. At September 30, 2006, the parent company held \$2.2 billion in short-term investments, which we projected to be sufficient to meet our debt repayment obligations over a period of approximately 31 months.

Additional sources of liquidity

Management has implemented several programs that enable the parent company and KBNA to raise funding in the public and private markets when necessary. The proceeds from most of these programs can be used for general corporate purposes, including acquisitions. Each of the programs is replaced or renewed as needed. There are no restrictive financial covenants in any of these programs.

Bank note program. KBNA's bank note program provides for the issuance of both long- and short-term debt of up to \$20.0 billion. During the first nine months of 2006, there were \$500 million of notes issued under this program. These notes have original maturities in excess of one year and are included in long-term debt. At September 30, 2006, \$18.7 billion was available for future issuance.

Euro medium-term note program. Under Key's euro medium-term note program, the parent company and KBNA may issue both long- and short-term debt of up to \$10.0 billion in the aggregate (\$9.0 billion by KBNA and \$1.0 billion by the parent company). The notes are offered exclusively to non-U.S. investors and can be denominated in U.S. dollars and foreign currencies. During the first nine months of 2006, there were \$26 million of notes issued under this program. At September 30, 2006, \$6.8 billion was available for future issuance.

KeyCorp medium-term note program. In January 2005, the parent company registered \$2.9 billion of securities under a shelf registration statement filed with the SEC. Of this amount, \$1.9 billion has been allocated for the issuance of both long- and short-term debt in the form of medium-term notes. During the first nine months of 2006, there were \$750 million of notes issued under this program. At September 30, 2006, unused capacity under this registration statement totaled \$1.9 billion.

Table of Contents

Commercial paper. The parent company has a commercial paper program that provides funding availability of up to \$500 million. As of September 30, 2006, there were no borrowings outstanding under this program.

KBNA has a separate commercial paper program at a Canadian subsidiary that provides funding availability of up to C\$1.0 billion in Canadian currency. The borrowings under this program can be denominated in Canadian or U.S. dollars. As of September 30, 2006, borrowings outstanding under this commercial paper program totaled C\$728 million in Canadian currency and \$103 million in U.S. currency (equivalent to C\$115 million in Canadian currency).

Key's debt ratings are shown in Figure 28. Management believes that these debt ratings, under normal conditions in the capital markets, allow for future offerings of securities by the parent company or KBNA that would be marketable to investors at a competitive cost.

Figure 28. Debt Ratings

September 30, 2006	Short-term Borrowings	Senior Long-Term Debt	Subordinated Long-Term Debt	Capital Securities
KeyCorp (the parent company)				
Standard & Poor's	A-2	A-	BBB+	BBB
Moody's	P-1	A2	A3	A3
Fitch	F1	A	A-	A-
KBNA				
Standard & Poor's	A-1	A	A-	N/A
Moody's	P-1	A1	A2	N/A
Fitch	F1	A	A-	N/A
Key Nova Scotia Funding Company (KNSF)				
Dominion Bond Rating Service ^a	R-1 (middle)	N/A	N/A	N/A

(a) Reflects the guarantee by KBNA of KNSF's issuance of Canadian commercial paper.

N/A=Not Applicable

Operational risk management

Key, like all businesses, is subject to operational risk, which represents the risk of loss resulting from human error, inadequate or failed internal processes and systems, and external events. Operational risk also encompasses compliance (legal) risk, which is the risk of loss from violations of, or noncompliance with, laws, rules and regulations, prescribed practices or ethical standards. Resulting losses could take the form of explicit charges, increased operational costs, harm to Key's reputation or forgone opportunities. Key seeks to mitigate operational risk through a system of internal controls. For more information on Key's efforts to monitor and manage its operational risk, see pages 48 and 49 of Key's 2005 Annual Report to Shareholders.

Regulatory agreements. On October 17, 2005, KeyCorp entered into a memorandum of understanding with the Federal Reserve Bank of Cleveland (FRBC), and KBNA entered into a consent order with the Comptroller of the Currency (OCC), concerning compliance-related matters, particularly arising under the Bank Secrecy Act. Management does not expect these actions to have a material effect on Key's operating results; neither the OCC nor the FRBC imposed a fine or civil money penalty in the matter. As part of the consent order and memorandum of understanding, Key has agreed to continue to strengthen its anti-money laundering and other compliance controls. We believe we have made significant progress in this regard and continue to work on making the necessary improvements. Specifically, we have continued to enhance related training for our employees, upgrade our client due diligence procedures and install advanced technologies.

Table of Contents

Item 3. Quantitative and Qualitative Disclosure about Market Risk

The information presented in the Market Risk Management section, which begins on page 61 of the Management's Discussion and Analysis of Financial Condition and Results of Operations, is incorporated herein by reference.

Item 4. Controls and Procedures

As of the end of the period covered by this report, KeyCorp carried out an evaluation, under the supervision and with the participation of KeyCorp's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of KeyCorp's disclosure controls and procedures. Based upon that evaluation, KeyCorp's Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective, in all material respects, as of the end of the period covered by this report. No changes were made to KeyCorp's internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during the last fiscal quarter that materially affected, or are reasonably likely to materially affect, KeyCorp's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information presented in the Legal Proceedings section of Note 13 (Contingent Liabilities and Guarantees), which begins on page 28 of the Notes to Consolidated Financial Statements, is incorporated herein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The information presented in Figure 20 on page 59 of the Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 6. Exhibits

10.1 Change of Control Agreement between KeyCorp and Beth Mooney, effective July 21, 2006.

15 Acknowledgment of Independent Registered Public Accounting Firm.

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Information Available on Website

KeyCorp makes available free of charge on its website, www.Key.com, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports as soon as reasonably practicable after KeyCorp electronically files such material with, or furnishes it to, the Securities and Exchange Commission.

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KEYCORP

(Registrant)

Date: November 7, 2006

/s/ Robert L. Morris

By: Robert L. Morris
Executive Vice President
and Chief Accounting Officer

74