

KEYCORP /NEW/
Form 10-Q
August 08, 2007

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 June 30, 2007
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

390,382,146 Shares

(Title of class)

(Outstanding at July 31, 2007)

KEYCORP
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

	<u>Page Nu</u>
<u>1. Financial Statements</u>	
<u>Consolidated Balance Sheets $\frac{3}{4}$ June 30, 2007 (Unaudited), December 31, 2006, and June 30, 2006 (Unaudited)</u>	3
<u>Consolidated Statements of Income (Unaudited) $\frac{3}{4}$ Three and six months ended June 30, 2007 and 2006</u>	4
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) $\frac{3}{4}$ Six months ended June 30, 2007 and 2006</u>	5
<u>Consolidated Statements of Cash Flows (Unaudited) $\frac{3}{4}$ Six months ended June 30, 2007 and 2006</u>	6
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	7
<u>Report of Independent Registered Public Accounting Firm</u>	34
<u>2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	35
<u>3. Quantitative and Qualitative Disclosure about Market Risk</u>	72
<u>4. Controls and Procedures</u>	72

PART II. OTHER INFORMATION

<u>1. Legal Proceedings</u>	72
<u>2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	72
<u>4. Submission of Matters to a Vote of Security Holders</u>	72
<u>6. Exhibits</u>	73
<u>Signature</u>	74
<u>Exhibits</u>	75
<u>1</u>	
<u>5</u>	
<u>1.1</u>	
<u>1.2</u>	
<u>2.1</u>	
<u>2.2</u>	

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

<i>dollars in millions</i>	June 30, 2007 (Unaudited)	December 31, 2006	June 30, 2006 (Unaudited)
ASSETS			
Cash and due from banks	\$ 1,818	\$ 2,264	\$ 2,814
Short-term investments	1,632	1,407	1,577
Securities available for sale	7,819	7,827	7,140
Investment securities (fair value: \$37, \$42 and \$45)	37	41	44
Other investments	1,602	1,352	1,379
Loans, net of unearned income of \$2,146, \$2,136 and \$2,078	66,692	65,826	67,408
Less: Allowance for loan losses	945	944	956
Net loans	65,747	64,882	66,452
Loans held for sale	4,546	3,637	4,189
Premises and equipment	600	595	557
Operating lease assets	1,110	1,124	1,043
Goodwill	1,202	1,202	1,372
Other intangible assets	110	120	132
Corporate-owned life insurance	2,822	2,782	2,732
Derivative assets	1,160	1,091	1,016
Accrued income and other assets	3,871	4,013	4,347
Total assets	\$ 94,076	\$ 92,337	\$ 94,794
LIABILITIES			
Deposits in domestic offices:			
NOW and money market deposit accounts	\$ 23,315	\$ 24,340	\$ 25,291
Savings deposits	1,613	1,642	1,751
Certificates of deposit (\$100,000 or more)	6,197	5,941	5,224
Other time deposits	11,832	11,956	11,542
Total interest-bearing deposits	42,957	43,879	43,808
Noninterest-bearing deposits	14,199	13,553	13,268
Deposits in foreign office ³ / ₄ interest-bearing	3,443	1,684	3,762
Total deposits	60,599	59,116	60,838
Federal funds purchased and securities sold under repurchase agreements	4,362	3,643	3,654
Bank notes and other short-term borrowings	2,631	1,192	2,360
Derivative liabilities	1,119	922	1,156
Accrued expense and other liabilities	5,083	5,228	4,999
Long-term debt	12,581	14,533	14,050

Total liabilities	86,375	84,634	87,057
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	1,652	1,602	1,577
Retained earnings	8,720	8,377	8,199
Treasury stock, at cost (102,527,008, 92,735,595 and 89,217,117 shares)	(2,994)	(2,584)	(2,411)
Accumulated other comprehensive loss	(169)	(184)	(120)
Total shareholders equity	7,701	7,703	7,737
Total liabilities and shareholders equity	\$ 94,076	\$ 92,337	\$ 94,794

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		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
INTEREST INCOME				
Loans	\$ 1,176	\$ 1,136	\$ 2,337	\$ 2,196
Loans held for sale	82	73	157	141
Investment securities		1	1	1
Securities available for sale	106	84	206	167
Short-term investments	16	16	34	31
Other investments	15	17	28	42
Total interest income	1,395	1,327	2,763	2,578
INTEREST EXPENSE				
Deposits	447	378	880	708
Federal funds purchased and securities sold under repurchase agreements	59	20	108	40
Bank notes and other short-term borrowings	18	27	29	51
Long-term debt	185	198	381	381
Total interest expense	709	623	1,398	1,180
NET INTEREST INCOME				
Provision for loan losses	53	23	97	62
Net interest income after provision for loan losses	633	681	1,268	1,336
NONINTEREST INCOME				
Trust and investment services income	115	139	240	274
Service charges on deposit accounts	84	77	159	149
Investment banking and capital markets income	52	57	96	117
Operating lease income	66	56	130	108
Letter of credit and loan fees	45	45	83	85
Corporate-owned life insurance income	32	26	57	51
Electronic banking fees	25	27	49	51
Net gains from loan securitizations and sales	33	10	42	20
Net securities gains (losses)	2	4	(45)	5
Gain on sale of McDonald Investments branch network			171	
Other income	195	104	321	166
Total noninterest income	649	545	1,303	1,026
NONINTEREST EXPENSE				
Personnel	411	427	839	827
Net occupancy	59	59	122	120

Computer processing	49	49	100	105
Operating lease expense	55	45	107	86
Professional fees	26	40	52	73
Equipment	24	26	49	52
Marketing	20	23	39	38
Other expense	171	129	291	249
Total noninterest expense	815	798	1,599	1,550
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE				
	467	428	972	812
Income taxes	130	125	277	235
INCOME FROM CONTINUING OPERATIONS BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE				
	337	303	695	577
(Loss) income from discontinued operations, net of taxes of (\$2), \$4, (\$7) and \$10, respectively (see Note 3)	(3)	5	(11)	15
INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE				
	334	308	684	592
Cumulative effect of accounting change, net of taxes (see Note 1)				5
NET INCOME	\$ 334	\$ 308	\$ 684	\$ 592
Per common share:				
Income from continuing operations before cumulative effect of accounting change	\$.86	\$.75	\$ 1.76	\$ 1.42
Income before cumulative effect of accounting change	.85	.76	1.73	1.46
Net income	.85	.76	1.73	1.47
Per common share assuming dilution:				
Income from continuing operations before cumulative effect of accounting change	\$.85	\$.74	\$ 1.74	\$ 1.40
Income before cumulative effect of accounting change	.84	.75	1.71	1.44
Net income	.84	.75	1.71	1.45
Cash dividends declared per common share	\$.365	\$.345	\$.73	\$.69
Weighted-average common shares outstanding (000)	392,045	404,528	394,944	405,949
Weighted-average common shares and potential common shares outstanding (000)	396,918	410,559	400,180	411,842

See Notes to Consolidated Financial Statements (Unaudited).

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

	Common Share Outstanding (000)	Common Shares	Capital Surplus	Retained Earnings	Accumulated		
					Treasury Stock at Cost	Other Comprehensive Loss	
<i>dollars in millions, except per share amounts</i>							
BALANCE AT DECEMBER 31, 2005	406,624	\$ 492	\$ 1,534	\$ 7,882	\$ (2,204)	\$ (106)	
Net income				597			\$ 597
Other comprehensive income (losses):							
Net unrealized losses on securities available for sale, net of income taxes of (\$33) ^a						(55)	(55)
Net unrealized gains on derivative financial instruments, net of income taxes of \$5						9	9
Net unrealized losses on common investments held in employee welfare benefits trust, net of income taxes						(1)	(1)
Foreign currency translation adjustments						33	33
Total comprehensive income							\$ 583
Deferred compensation				19			
Cash dividends declared on common shares (\$.69 per share)				(280)			
Issuance of common shares for stock options and other employee benefit plans	6,048		24		158		
Repurchase of common shares	(10,000)				(365)		
BALANCE AT JUNE 30, 2006	402,672	\$ 492	\$ 1,577	\$ 8,199	\$ (2,411)	\$ (120)	
BALANCE AT DECEMBER 31, 2006	399,153	\$ 492	\$ 1,602	\$ 8,377	\$ (2,584)	\$ (184)	
Cumulative effect of adopting FSP 13-2, net of income taxes of (\$2) (see Note 1)				(52)			
Cumulative effect of adopting FIN 48, net of income taxes of (\$1) (see Note 1)				(1)			
BALANCE AT JANUARY 1, 2007				8,324			
Net income				684			\$ 684
Other comprehensive income (losses):							
Net unrealized losses on securities available for sale, net of income taxes of (\$12) ^a						(19)	(19)
Net unrealized gains on derivative financial instruments, net of income taxes of \$6						10	10
Foreign currency translation adjustments						14	14
Net pension and postretirement benefit costs, net of income taxes						10	10

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

<i>in millions</i>	Six months ended June 30,	
	2007	2006
OPERATING ACTIVITIES		
Net income	\$ 684	\$ 597
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	97	63
Depreciation and amortization expense	209	190
Litigation reserve	42	
Net securities (gains) losses	45	(5)
Gain from sale of McDonald Investments branch network	(171)	
Gains related to MasterCard Incorporated shares	(40)	(9)
Gain from settlement of automobile residual value insurance litigation	(26)	
Net gains from principal investing	(119)	(20)
Net gains from loan securitizations and sales	(42)	(20)
Loss from sale of discontinued operations	2	
Proceeds from settlement of automobile residual value insurance litigation	279	
Deferred income taxes	(56)	(195)
Net increase in loans held for sale	(909)	(808)
Net (increase) decrease in trading account assets	(82)	47
Other operating activities, net	(343)	(250)
NET CASH USED IN OPERATING ACTIVITIES	(430)	(410)
INVESTING ACTIVITIES		
Cash used in acquisitions, net of cash acquired		(34)
Proceeds from sale of McDonald Investments branch network, net of retention payments	199	
Proceeds from sale of Mastercard Incorporated shares	40	
Net increase in other short-term investments	(143)	(32)
Purchases of securities available for sale	(3,955)	(1,760)
Proceeds from sales of securities available for sale	2,449	71
Proceeds from prepayments and maturities of securities available for sale	1,443	1,735
Purchases of investment securities		(2)
Proceeds from prepayments and maturities of investment securities	4	49
Purchases of other investments	(363)	(269)
Proceeds from sales of other investments	213	103
Proceeds from prepayments and maturities of other investments	64	147
Net increase in loans, excluding acquisitions, sales and transfers	(1,309)	(1,238)
Purchases of loans	(56)	(60)
Proceeds from loan securitizations and sales	287	229
Purchases of premises and equipment	(58)	(32)
Proceeds from sales of premises and equipment	1	2
Proceeds from sales of other real estate owned	45	15
NET CASH USED IN INVESTING ACTIVITIES	(1,139)	(1,076)
FINANCING ACTIVITIES		

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

Net increase in deposits	1,479	2,084
Net increase (decrease) in short-term borrowings	2,158	(601)
Net proceeds from issuance of long-term debt	39	1,345
Payments on long-term debt	(1,845)	(1,148)
Purchases of treasury shares	(526)	(365)
Net proceeds from issuance of common stock	93	138
Tax benefits in excess of recognized compensation cost for stock-based awards	11	19
Cash dividends paid	(286)	(280)
NET CASH PROVIDED BY FINANCING ACTIVITIES	1,123	1,192
NET DECREASE IN CASH AND DUE FROM BANKS	(446)	(294)
CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD	2,264	3,108
CASH AND DUE FROM BANKS AT END OF PERIOD	\$ 1,818	\$ 2,814
Additional disclosures relative to cash flows:		
Interest paid	\$ 1,416	\$ 1,283
Income taxes paid	135	311
Noncash items:		
Loans transferred to other real estate owned	\$ 20	\$ 19

See Notes to Consolidated Financial Statements (Unaudited).

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

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 its subsidiaries.

The consolidated financial statements include any voting rights entity in which Key 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. See Note 8 (Variable Interest Entities) on page 22 for information on Key s involvement with VIEs.

Management uses the equity method to account for unconsolidated investments in voting rights entities or VIEs in which Key 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 registered 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 2006 Annual Report to Shareholders under the heading Loan Securitizations on page 69.

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.

The results of operations for the interim period are not necessarily indicative of the results of operations to be expected for the full year. The interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in Key s 2006 Annual Report to Shareholders.

Servicing Assets

Key s servicing assets, which totaled \$303 million at June 30, 2007, \$282 million at December 31, 2006, and \$256 million at June 30, 2006, are included in accrued income and other assets on the balance sheet. Key services both mortgage and education loans. Servicing assets at June 30, 2007, include \$272 million related to mortgage loan servicing and \$31 million related to education loan servicing.

Effective January 1, 2007, Key adopted SFAS No. 156, Accounting for Servicing of Financial Assets - an Amendment of FASB Statement No. 140, which requires that newly purchased or retained servicing assets and liabilities be initially measured at fair value, if practicable. SFAS No. 156 also requires the subsequent remeasurement of servicing assets and liabilities at each reporting date using one of two methods: amortization over the servicing period or measurement at fair value.

Table of Contents

When no ready market value such as quoted market prices or prices based on sales or purchases of similar assets is available to determine the fair value of servicing assets, the fair value is determined by estimating the present value of future cash flows associated with servicing the loans. The estimate is based on a number of assumptions, including the cost of servicing, discount rate, prepayment rate and default rate.

Key has elected to subsequently remeasure servicing assets using the amortization method. The amortization of servicing assets is determined in proportion to, and over the period of, the estimated net servicing income and is recorded in other income on the income statement.

In accordance with SFAS No. 140, the initial value of servicing assets purchased or retained prior to January 1, 2007, was determined by allocating the amount of the assets sold or securitized to the retained interests and the assets sold based on their relative fair values at the date of transfer. These servicing assets are reported at the lower of amortized cost or fair value.

Servicing assets are evaluated quarterly for possible impairment by classifying the assets based on the types of loans serviced and their associated interest rates, and estimating the fair value of each class. If the evaluation indicates that the carrying amount of the servicing assets exceeds their fair value, the carrying amount is reduced through a charge to income in the amount of such excess. There was no servicing asset impairment in the six-month periods ended June 30, 2007 and 2006. Additional information pertaining to servicing assets is included in Note 7 (Mortgage Servicing Assets), which begins on page 21.

Stock-Based Compensation

Effective January 1, 2006, Key adopted SFAS No. 123R, Share-Based Payment, which replaced SFAS No. 123. SFAS 123R requires stock-based compensation to be measured using the fair value method of accounting, with the measured cost to be recognized over the period during which the recipient is required to provide service in exchange for the award. SFAS No. 123R also 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. Instead, companies that had been 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 had to estimate expected forfeitures and reduce their related compensation obligation for expense previously recognized in the financial statements. The after-tax amount of this reduction is 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.

Accounting Pronouncements Adopted in 2007

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 affects when earnings from leveraged lease transactions will be recognized, and requires a lessor to recalculate its recognition of lease income when there are changes or projected changes in the timing of cash flows, including changes due to final or expected settlements of tax matters. Previously, leveraged lease transactions were required to be recalculated only when a change in the total projected net income from the lease occurred. This guidance became effective for fiscal years beginning after December 15, 2006 (effective January 1, 2007, for Key). Adoption of this guidance resulted in a cumulative after-tax charge of \$52 million to Key's retained earnings. Future earnings are expected to increase over the remaining term of the affected leases by a similar amount. Additional information related to Staff Position No. 13-2 is included in Note 12 (Income Taxes) under the heading Tax-Related Accounting Pronouncements Adopted in 2007 on page 26.

Table of Contents

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 for the associated tax benefit to be recognized in a company's financial statements. It also provides guidance on measurement and derecognition of tax benefits, and requires expanded disclosures. The interpretation became effective for fiscal years beginning after December 15, 2006 (effective January 1, 2007, for Key). Adoption of this guidance did not have a material impact on Key's financial condition or results of operations. Additional information related to this interpretation is included in Note 12 under the heading Tax-Related Accounting Pronouncements Adopted in 2007.

Accounting for servicing of financial assets. As discussed under the heading Servicing Assets on page 7, effective January 1, 2007, Key adopted SFAS No. 156, which requires that servicing assets and liabilities be initially measured at fair value, if practicable. SFAS No. 156 also requires the subsequent remeasurement of servicing assets and liabilities at each reporting date using one of two methods: amortization over the servicing period or measurement at fair value. Adoption of this guidance did not have a material effect on Key's financial condition or results of operations. Additional information related to SFAS No. 156 is included in Note 7.

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 in which a derivative is embedded in another financial instrument. SFAS No. 155 permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require the financial instrument and derivative to be separated. This guidance eliminates the prohibition on a qualifying SPE from holding certain derivative financial instruments. SFAS No. 155 became 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 did not have a material effect on Key's financial condition or results of operations.

Accounting Pronouncements Pending Adoption

Accounting for investment companies. In June 2007, the Accounting Standards Executive Committee, under the auspices of the FASB, issued Statement of Position (SOP) No. 07-1, Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. The new pronouncement provides guidance for determining whether an entity is within the scope of the Guide and whether the specialized industry accounting principles of the Guide should be applied by a parent company in accounting for an investment company subsidiary. SOP No. 07-1 will be effective for fiscal years beginning on or after December 15, 2007 (effective January 1, 2008, for Key). Management is evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

Investment companies under Revised Interpretation No. 46. In May 2007, the FASB issued Staff Position FIN 46(R)-7, Application of FASB Interpretation No. 46(R) to Investment Companies. The new pronouncement provides an exception to the scope of Revised Interpretation No. 46 for investment companies within the scope of SOP No. 07-1. Staff Position FIN 46(R)-7 will be effective for fiscal years beginning on or after December 15, 2007 (effective January 1, 2008, for Key). Management is evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

Fair value option for financial assets and financial liabilities. In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This guidance provides an option to selectively report financial assets and liabilities at fair value, and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 will be effective for fiscal years beginning after November 15, 2007 (effective January 1, 2008, for Key). Management is evaluating whether this fair value option will be used for any of Key's financial assets or liabilities, and the resulting effect on Key's financial condition or results of operations.

Table of Contents

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. This guidance applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007 (effective January 1, 2008, for Key). Management is evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

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. Except for the measurement requirement, Key adopted this accounting guidance as of December 31, 2006. Additional information regarding the adoption of SFAS No. 158 is included in Note 1 (Summary of Significant Accounting Policies) under the heading Accounting Pronouncements Adopted in 2006 on page 72 of Key's 2006 Annual Report to Shareholders. The requirement to measure plan assets and benefit obligations as of the end of an employer's fiscal year is effective for years ending after December 15, 2008 with earlier application encouraged (no later than December 31, 2008, 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's basic and diluted earnings per common share are calculated as follows:

<i>dollars in millions, except per share amounts</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
EARNINGS				
Income from continuing operations before cumulative effect of accounting change	\$ 337	\$ 303	\$ 695	\$ 577
(Loss) income from discontinued operations, net of taxes	(3)	5	(11)	15
Income before cumulative effect of accounting change	334	308	684	592
Net income	334	308	684	597
WEIGHTED-AVERAGE COMMON SHARES				
Weighted-average common shares outstanding (000)	392,045	404,528	394,944	405,949
Effect of dilutive common stock options and other stock awards (000)	4,873	6,031	5,236	5,893
Weighted-average common shares and potential common shares outstanding (000)	396,918	410,559	400,180	411,842
EARNINGS PER COMMON SHARE				
Income per common share from continuing operations before cumulative effect of accounting change	\$.86	\$.75	\$ 1.76	\$ 1.42
(Loss) income per common share from discontinued operations	(.01)	.01	(.03)	.04
Income per common share before cumulative effect of accounting change	.85	.76	1.73	1.46
Net income per common share	.85	.76	1.73	1.47
Income per common share from continuing operations before cumulative effect of accounting change assuming dilution	\$.85	\$.74	\$ 1.74	\$ 1.40

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

(Loss) income per common share from discontinued operations assuming dilution	(.01)	.01	(.03)	.04
Income per common share before cumulative effect of accounting change assuming dilution	.84	.75	1.71	1.44
Net income per common share assuming dilution	.84	.75	1.71	1.45

Table of Contents**3. Acquisitions and Divestitures**

Acquisitions and divestitures either completed by Key during 2006 and the first six months of 2007, or pending completion, are summarized below.

Acquisition**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. Austin specializes in selecting and managing hedge fund investments for its principally institutional customer base. The terms of the acquisition were not material.

Divestitures**Champion Mortgage**

On February 28, 2007, Key sold the Champion Mortgage loan origination platform to an affiliate of Fortress Investment Group LLC, a global alternative investment and asset management firm, for cash proceeds of \$.5 million. On November 29, 2006, Key sold the nonprime mortgage loan portfolio held by the Champion Mortgage finance business to a wholly-owned subsidiary of HSBC Finance Corporation for cash proceeds of \$2.5 billion. The loan portfolio totaled \$2.5 billion at the date of sale.

As a result of these actions, Key has applied discontinued operations accounting to this business for all periods presented in this report. The results of the discontinued Champion Mortgage finance business are presented on one line as (loss) income from discontinued operations, net of taxes in the Consolidated Statements of Income on page 4. The components of (loss) income from discontinued operations are as follows:

<i>in millions</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
(Loss) income, net of taxes of (\$1), \$4, (\$3) and \$10, respectively ^a	\$ (2)	\$ 5	\$ (6)	\$ 15
Loss on disposal, net of taxes of (\$1)			(1)	
Disposal transaction costs, net of taxes of (\$1) and (\$3), respectively	(1)		(4)	
(Loss) income from discontinued operations	\$ (3)	\$ 5	\$ (11)	\$ 15

(a) Includes after-tax charges of \$.07 million and \$18 million for the three-month periods ended June 30, 2007 and 2006, respectively, and \$.7 million and \$35 million for the six-month periods ended June 30, 2007 and 2006, respectively, determined by applying a matched funds transfer pricing methodology to the liabilities assumed necessary to support Champion's operations.

The discontinued assets and liabilities of Champion Mortgage included in the Consolidated Balance Sheets on page 3 are as follows:

<i>in millions</i>	June	December	June 30,
	30,	31,	
	2007	2006	2006
Loans	\$ 9	\$ 10	\$ 2,454
Loans held for sale		179	
Accrued income and other assets	2	22	234

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

Total assets	\$ 11	\$ 211	\$ 2,688
Deposits		\$ 88	\$ 9
Accrued expense and other liabilities	\$ 14	17	6
Total liabilities	\$ 14	\$ 105	\$ 15

Table of Contents

McDonald Investments branch network

On February 9, 2007, McDonald Investments Inc., a wholly-owned subsidiary of KeyCorp, sold its branch network, which included approximately 570 financial advisors and field support staff, and certain fixed assets, to UBS Financial Services Inc., a subsidiary of UBS AG. Key received cash proceeds of \$219 million, which may be subject to further adjustment under the terms of the sales agreement. As a result of the sale, Key recorded a gain of \$171 million (\$107 million after tax, \$.26 per diluted common share). Key has retained the corporate and institutional businesses, including Institutional Equities and Equity Research, Debt Capital Markets and Investment Banking. In addition, KeyBank National Association (KBNA), KeyCorp s subsidiary bank, will continue the Wealth Management, Trust and Private Banking businesses. On April 16, 2007, Key renamed its registered broker/dealer through which its corporate and institutional investment banking and securities businesses operate. The new name is KeyBanc Capital Markets Inc.

Acquisitions Pending

Tuition Management Systems, Inc.

On August 1, 2007, Key entered into a definitive agreement to acquire Tuition Management Systems, Inc. (TMS), one of the nation s largest providers of outsourced tuition planning, billing, counseling, payment and related technology services. Headquartered in Warwick, Rhode Island, TMS serves more than 700 colleges, universities, elementary and secondary educational institutions. The terms of the transaction, which is expected to close in the third quarter of 2007, are not material.

U.S.B. Holding Co., Inc.

On July 26, 2007, Key entered into a definitive agreement to acquire U.S.B. Holding Co., Inc. (U.S.B.), the holding company for Union State Bank, a state-chartered commercial bank headquartered in Orangeburg, New York, with 31 branches. U.S.B. has assets of approximately \$3 billion and deposits of approximately \$2 billion. Under the terms of the agreement, each share of U.S.B. common stock will be exchanged at the closing for .455 KeyCorp common shares and \$8.925 in cash. Based on the closing price of KeyCorp common shares on July 26, 2007 (the last trading day preceding the announcement of the agreement), the transaction would be valued at approximately \$575 million. The transaction is expected to close within six months of the date of the agreement, subject to approval by U.S.B. shareholders and banking regulators.

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, 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, investment and employee benefit programs, succession planning, access to 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 at least 50% of the debt service is provided by rental income from nonaffiliated third parties).

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, Home Equity Services and Business Services.

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.

Home Equity Services works with home improvement contractors to provide home equity and home improvement financing solutions.

Business Services provides payroll processing solutions for businesses of all sizes.

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 primarily represent 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 do not reflect their normal operations.

The table that spans pages 15 and 16 shows selected financial data for each major business group for the three- and six-month periods ended June 30, 2007 and 2006. This table is accompanied by supplementary information for each of the lines of business that make up 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 Key's policies:

- .. Net interest income is determined by assigning a standard cost for funds used or a standard credit for funds provided 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.
- .. 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.
- .. Key's consolidated provision for loan losses is allocated among the lines of business primarily based 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 69 of Key's 2006 Annual Report to Shareholders.
- .. 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%.
- .. 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, 2007, Key reorganized the following business units within its lines of business:

- .. The Mortgage Services unit, previously included under the Consumer Finance line of business within the National Banking group, has been moved to the Regional Banking line of business within the Community Banking group.
- .. In light of the Champion divestiture, the National Home Equity unit, previously included under the Consumer Finance line of business within the National Banking group, has been eliminated and replaced by the remaining Home Equity Services unit.
- .. Business Services has been added as a unit under the Consumer Finance line of business within the National Banking group.

Table of Contents

Three months ended June 30, <i>dollars in millions</i>	Community Banking		National Banking		Other Segments	
	2007	2006	2007	2006	2007	2006
SUMMARY OF OPERATIONS						
Net interest income (TE)	\$ 420	\$ 436	\$ 348	\$ 349	\$ (29)	\$ (30)
Noninterest income	204	236	282	247	121	51
Total revenue (TE) ^a	624	672	630	596	92	21
Provision for loan losses	21	21	32	2		
Depreciation and amortization expense	33	36	71	61		
Other noninterest expense	415	455	257	252	33^e	7
Income (loss) from continuing operations before income taxes (TE)	155	160	270	281	59	14
Allocated income taxes and TE adjustments	58	60	101	105	10	(5)
Income from continuing operations	97	100	169	176	49	19
(Loss) income from discontinued operations, net of taxes			(3)	5		
Net income	\$ 97	\$ 100	\$ 166	\$ 181	\$ 49	\$ 19
Percent of consolidated income from continuing operations	29%	33%	50%	58%	14%	6%
Percent of total segments income from continuing operations	31	34	54	60	15	6
AVERAGE BALANCES ^b						
Loans and leases	\$ 26,551	\$ 26,830	\$ 39,348	\$ 37,730	\$ 266	\$ 301
Total assets ^a	29,291	29,918	49,639	47,682	12,387	11,395
Deposits	46,171	46,675	12,036	10,633	2,361	1,827
OTHER FINANCIAL DATA						
Net loan charge-offs	\$ 26	\$ 24	\$ 27	\$ 10		
Return on average allocated equity ^b	15.80%	16.09%	16.43%	18.55%	N/M	N/M
Return on average allocated equity	15.80	16.09	16.14	17.93	N/M	N/M
Average full-time equivalent employees	8,202	8,782	3,830	4,231	43	39

Six months ended June 30,	Community Banking	National Banking	Other Segments
<p>(a) Substantially all revenue generated by Key's major business groups is derived from clients with residency 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.</p>			
<p>(b) From continuing operations.</p>			
<p>(c) Community Banking results for the first quarter of 2007 include a \$171 million (\$107 million after tax) gain from the February 9 sale of the McDonald Investments branch network. See Note 3 (Acquisitions and Divestitures), which begins on page 11, for more information</p>			

pertaining to
this transaction.

- (d) National Banking results for the first quarter of 2007 include a \$26 million (\$17 million after tax) gain from the settlement of the residual value insurance litigation.

- (e) Other Segments results for the second quarter of 2007 include a \$26 million (\$16 million after tax) charge for litigation. This charge and the litigation charge referred to in note (f) below comprise the \$42 million charge recorded in connection with the Honsador litigation disclosed in Note 13 (Contingent Liabilities and Guarantees), which begins on page 28. Results for the first quarter of 2007 include a \$49 million (\$31 million after tax) loss from the

repositioning of
the securities
portfolio.

- (f) Reconciling
Items for the
second quarter
of 2007 and
2006 include
gains of
\$40 million
(\$25 million
after tax) and
\$9 million
(\$6 million after
tax),
respectively,
related to
MasterCard
Incorporated
shares. Results
for the second
quarter of 2007
also include a
\$16 million
(\$10 million
after tax) charge
for litigation.

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

Table of Contents

Total Segments		Reconciling Items		Key	
2007	2006	2007	2006	2007	2006
\$ 739	\$ 755	\$ (33)	\$ (29)	\$ 706	\$ 726
607	534	42f	11f	649	545
1,346	1,289	9	(18)	1,355	1,271
53	23			53	23
104	97			104	97
705	714	6f	(13)	711	701
484	455	3	(5)	487	450
169	160	(19)	(13)	150	147
315	295	22	8	337	303
(3)	5			(3)	5
\$ 312	\$ 300	\$ 22	\$ 8	\$ 334	\$ 308
93%	97%	7%	3%	100%	100%
100	100	N/A	N/A	N/A	N/A
\$ 66,165	\$ 64,861	\$ 150	\$ 135	\$ 66,315	\$ 64,996
91,317	88,995	2,095	2,221	93,412	91,216
60,568	59,135	(171)	(68)	60,397	59,067
\$ 53	\$ 34			\$ 53	\$ 34
17.88%	17.57%	N/M	N/M	17.66%	15.85%
17.71	17.24	N/M	N/M	17.50	16.11
12,075	13,052	6,813	6,879	18,888	19,931
Total Segments		Reconciling Items		Key	
2007	2006	2007	2006	2007	2006
\$ 1,470	\$ 1,500	\$ (64)	\$ (52)	\$ 1,406	\$ 1,448
1,261	1,014	42f	12f	1,303	1,026

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

2,731	2,514	(22)	(40)	2,709	2,474
97	62			97	62
209	190			209	190
1,394	1,384	(4)f	(24)	1,390	1,360
1,031	878	(18)	(16)	1,013	862
365	308	(47)	(23)	318	285
666	570	29	7	695	577
(11)	15			(11)	15
655	585	29	7	684	592
			5		5
\$ 655	\$ 585	\$ 29	\$ 12	\$ 684	\$ 597
96%	99%	4%	1%	100%	100%
100	100	N/A	N/A	N/A	N/A
\$ 65,872	\$ 64,500	\$ 122	\$ 110	\$ 65,994	\$ 64,610
90,668	88,537	2,090	2,195	92,758	90,732
60,266	58,500	(185)	(125)	60,081	58,375
\$ 97	\$ 73			\$ 97	\$ 73
19.20%	17.08%	N/M	N/M	18.35%	15.40%
18.88	16.90	N/M	N/M	18.06	15.80
12,476	12,976	6,866	6,837	19,342	19,813

Table of Contents

Supplementary information (Community Banking lines of business)

Three months ended June 30, <i>dollars in millions</i>	Regional Banking		Commercial Banking	
	2007	2006	2007	2006
Total revenue (TE)	\$ 530	\$ 573	\$ 94	\$ 99
Provision for loan losses	19	19	2	2
Noninterest expense	400	439	48	52
Net income	69	72	28	28
Average loans and leases	18,433	18,854	8,118	7,976
Average deposits	42,694	43,145	3,477	3,530
Net loan charge-offs	19	21	7	3
Return on average allocated equity	16.07%	16.46%	15.16%	15.22%
Average full-time equivalent employees	7,883	8,454	319	328

Six months ended June 30, <i>dollars in millions</i>	Regional Banking		Commercial Banking	
	2007	2006	2007	2006
Total revenue (TE)	\$ 1,237	\$ 1,128	\$ 187	\$ 193
Provision (credit) for loan losses	39	41	(3)	8
Noninterest expense	819	846	98	101
Net income	237	151	57	52
Average loans and leases	18,443	18,869	8,046	7,929
Average deposits	42,852	42,721	3,523	3,534
Net loan charge-offs	38	42	7	10
Return on average allocated equity	27.63%	17.26%	15.70%	14.25%
Average full-time equivalent employees	8,088	8,386	321	319

Supplementary information (National Banking lines of business)

Three months ended June 30, <i>dollars in millions</i>	Real Estate Capital		Equipment Finance		Institutional and Capital Markets		Consumer Finance	
	2007	2006	2007	2006	2007	2006	2007	2006
Total revenue (TE)	\$ 188	\$ 176	\$ 155	\$ 136	\$ 189	\$ 192	\$ 98	\$ 92
Provision (credit) for loan losses	8		16	2		(4)	8	4
Noninterest expense	78	72	93	76	116	117	41	48
Income from continuing operations	64	65	29	36	45	48	31	27
Net income	64	65	29	36	45	48	28	32
Average loans and leases ^a	12,827	12,719	10,609	9,871	7,454	7,601	8,458	7,539
Average loans held for sale ^a	1,241	692	10	34	468	139	2,658	2,956
Average deposits ^a	4,865	3,467	16	14	6,728	6,676	427	476
Net loan charge-offs (recoveries)	3	2	16	3		(2)	8	7

Return on average allocated equity ^a	19.55%	21.80%	13.08%	17.15%	15.15%	17.57%	16.99%	16.14%
Return on average allocated equity	19.55	21.80	13.08	17.15	15.15	17.57	15.34	14.04
Average full-time equivalent employees	991	980	971	915	1,302	1,296	566	1,040

Six months ended June 30, <i>dollars in millions</i>	Real Estate Capital		Equipment Finance		Institutional and Capital Markets		Consumer Finance	
	2007	2006	2007	2006	2007	2006	2007	2006
Total revenue (TE)	\$ 355	\$ 331	\$ 289	\$ 259	\$ 372	\$ 401	\$ 219	\$ 188
Provision (credit) for loan losses	9	1	29	4	(1)	(5)	24	13
Noninterest expense	149	135	178	148	234	235	83	94
Income from continuing operations	123	122	51	67	87	108	70	51
Net income	123	122	51	67	87	108	59	66
Average loans and leases ^a	12,791	12,594	10,544	9,721	7,446	7,715	8,329	7,360
Average loans held for sale ^a	1,193	635	7	21	305	125	2,643	2,971
Average deposits ^a	4,583	3,341	14	14	6,610	6,464	429	475
Net loan charge-offs (recoveries)	4	4	29	6	1	(5)	18	16
Return on average allocated equity ^a	19.42%	20.76%	11.59%	16.10%	14.83%	19.71%	19.58%	15.37%
Return on average allocated equity	19.42	20.76	11.59	16.10	14.83	19.71	16.50	14.51
Average full-time equivalent employees	981	981	961	925	1,327	1,295	755	1,031

(a) From continuing operations.

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 Key purchases and holds with the intent of selling them in the near term. Trading account securities are reported at fair value (\$994 million at June 30, 2007, \$912 million at December 31, 2006, and \$803 million at June 30, 2006) 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 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 primarily 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 61% of other investments at June 30, 2007. 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 (\$975 million at June 30, 2007, \$830 million at December 31, 2006, and \$846 million at June 30, 2006). 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. Neither these securities nor principal investments have stated maturities.

The amortized cost, unrealized gains and losses, and approximate fair value of Key's securities available for sale and investment securities are presented in the following tables. Gross unrealized gains and losses are represented by the difference between the amortized cost and the fair value 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>	June 30, 2007			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 18			\$ 18
States and political subdivisions	13			13
Collateralized mortgage obligations	6,421	\$ 3	\$ 111	6,313
Other mortgage-backed securities	1,133	2	22	1,113
Retained interests in securitizations	146	47		193
Other securities	150	19		169
Total securities available for sale	\$ 7,881	\$ 71	\$ 133	\$ 7,819

INVESTMENT SECURITIES				
States and political subdivisions	\$ 17			\$ 17
Other securities	20			20
Total investment securities	\$ 37			\$ 37

<i>in millions</i>	December 31, 2006			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 94			\$ 94
States and political subdivisions	14	\$ 1		15
Collateralized mortgage obligations	7,098	13	\$ 110	7,001
Other mortgage-backed securities	336	2	4	334
Retained interests in securitizations	151	57		208
Other securities	165	10		175
Total securities available for sale	\$ 7,858	\$ 83	\$ 114	\$ 7,827

INVESTMENT SECURITIES				
States and political subdivisions	\$ 20	\$ 1		\$ 21
Other securities	21			21
Total investment securities	\$ 41	\$ 1		\$ 42

<i>in millions</i>	June 30, 2006			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
SECURITIES AVAILABLE FOR SALE				
U.S. Treasury, agencies and corporations	\$ 24			\$ 24
States and political subdivisions	17			17
Collateralized mortgage obligations	6,772	\$ 3	\$ 217	6,558
Other mortgage-backed securities	202	2	6	198
Retained interests in securitizations	122	45		167
Other securities	170	6		176
Total securities available for sale	\$ 7,307	\$ 56	\$ 223	\$ 7,140
INVESTMENT SECURITIES				
States and political subdivisions	\$ 29	\$ 1		\$ 30
Other securities	15			15
Total investment securities	\$ 44	\$ 1		\$ 45

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

Key's loans by category are summarized as follows:

<i>in millions</i>	June 30, 2007	December 31, 2006	June 30, 2006
Commercial, financial and agricultural	\$ 21,814	\$ 21,412	\$ 21,598
Commercial real estate:			
Commercial mortgage	8,629	8,426	7,994
Construction	8,214	8,209	7,767
Total commercial real estate loans	16,843	16,635	15,761
Commercial lease financing	10,138	10,259	9,909
Total commercial loans	48,795	48,306	47,268
Real estate residential mortgage	1,572	1,442	1,418
Home equity ^a	10,879	10,826	13,509
Consumer direct	1,366	1,536	1,670
Consumer indirect:			
Marine	3,444	3,077	2,920
Other	636	639	623
Total consumer indirect loans	4,080	3,716	3,543
Total consumer loans	17,897	17,520	20,140
Total loans	\$ 66,692	\$ 65,826	\$ 67,408

Key uses interest rate swaps to manage interest rate risk; these swaps modify the repricing characteristics of certain loans. For more information about such swaps, see Note 19 (Derivatives and Hedging Activities), which begins on page 100 of Key's 2006 Annual Report to Shareholders.

(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 the anticipated November 29, 2006, sale of the Champion Mortgage finance business.

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

<i>in millions</i>	June 30, 2007	December 31, 2006	June 30, 2006
Commercial, financial and agricultural	\$ 76	\$ 47	\$ 45
Real estate commercial mortgage	1,613	946	1,133
Real estate construction	172	36	36
Commercial lease financing	22	3	
Real estate residential mortgage	39	21	27
Home equity		180	1
Education	2,616	2,390	2,929
Automobile	8	14	18

Total loans held for sale	\$ 4,546	\$ 3,637	\$ 4,189
---------------------------	-----------------	----------	----------

Table of Contents

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

<i>in millions</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Balance at beginning of period	\$ 944	\$ 966	\$ 944	\$ 966
Charge-offs	(72)	(59)	(136)	(124)
Recoveries	19	25	39	51
Net loans charged off	(53)	(34)	(97)	(73)
Provision for loan losses from continuing operations	53	23	97	62
Provision for loan losses from discontinued operations		1		1
Foreign currency translation adjustment	1		1	
Balance at end of period	\$ 945	\$ 956	\$ 945	\$ 956

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

<i>in millions</i>	Three months ended June		Six months ended June	
	30,		30,	
	2007	2006	2007	2006
Balance at beginning of period	\$ 45	\$ 59	\$ 53	\$ 59
Provision (credit) for losses on lending-related commitments	6		(2)	
Charge-offs	(1)		(1)	
Balance at end of period ^a	\$ 50	\$ 59	\$ 50	\$ 59

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

7. Mortgage Servicing Assets

Key originates and periodically sells commercial mortgage loans which it continues to service for the buyers. Key may also purchase the right to service commercial mortgage loans for other lenders. Changes in the carrying amount of mortgage servicing assets are summarized as follows:

<i>in millions</i>	Six months ended	
	June 30,	
	2007	2006
Balance at beginning of period	\$ 247	\$ 248
Servicing retained from loan sales	10	6

Purchases	55	8
Amortization	(40)	(31)
Balance at end of period	\$ 272	\$ 231
Fair value at beginning of period	\$ 332	\$ 301
Fair value at end of period	371	308

The fair value of mortgage servicing assets is estimated by calculating the present value of future cash flows associated with servicing the loans. This calculation uses a number of assumptions that are based on current market conditions. Primary economic assumptions used to measure the fair value of Key's mortgage servicing assets at June 30, 2007 and 2006, are as follows:

- prepayment speed generally at an annual rate of 0.00% to 25.00%;
- expected credit losses at a static rate of 2.00%; and
- residual cash flows discount rate of 8.50% to 15.00%.

Changes in these assumptions could cause the fair value of mortgage servicing assets to change in the future. The volume of loans serviced and expected credit losses are critical to the valuation of servicing assets. A 1.00% increase in the assumed default rate of commercial mortgage loans at June 30, 2007, would cause an \$8 million decrease in the fair value of Key's mortgage servicing assets.

Contractual fee income from servicing commercial mortgage loans totaled \$34 million and \$35 million for the six-month periods ended June 30, 2007 and 2006, respectively. The amortization of servicing assets for the respective six-month periods, as shown in the table above, is recorded as a reduction to fee income. Both the contractual fee income and the amortization are recorded in other income on the income statement.

Table of Contents

Additional information pertaining to the accounting for mortgage and other servicing assets is included in Note 1 (Basis of Presentation) under the heading Servicing Assets on page 7.

8. 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 a VIE to be consolidated by the party that is exposed to a 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
June 30, 2007			
Commercial paper conduit	\$ 159	N/A	N/A
Low-income housing tax credit (LIHTC) funds	299	\$ 186	
LIHTC investments	N/A	782	\$ 242

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 interests as minority interests and adjusts the financial statements each period for the investors' share of the funds' profits and losses. At June 30, 2007, the settlement value of these noncontrolling interests was estimated to be between \$315 million and \$372 million, while the recorded value, including reserves, totaled \$298 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) 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 equity and mezzanine investments, which remain unconsolidated. As discussed in Note 1 (Basis of Presentation) under the heading Accounting Pronouncements Pending Adoption on page 9, in May 2007, the FASB issued Staff Position FIN 46(R)-7, which provides an exception to the scope of Revised Interpretation No. 46 for investment companies within the scope of SOP No. 07-1. Staff Position FIN 46(R)-7 will be effective for fiscal years beginning on or after December 15, 2007 (effective January 1, 2008, for Key). Management is evaluating the potential effect this guidance may have on Key's financial condition or results of operations.

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 2006 Annual Report to Shareholders under the heading Variable Interest Entities on page 84.

Table of Contents**9. Nonperforming Assets and Past Due Loans**

Impaired loans totaled \$137 million at June 30, 2007, compared to \$95 million at December 31, 2006, and \$120 million at June 30, 2006. Impaired loans averaged \$124 million for the second quarter of 2007 and \$121 million for the second quarter of 2006.

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

<i>in millions</i>	June 30, 2007	December 31, 2006	June 30, 2006
Impaired loans	\$ 137	\$ 95	\$ 120
Other nonaccrual loans ^a	139	120	159
Total nonperforming loans	276	215	279
Nonperforming loans held for sale	4	3	1
Other real estate owned (OREO)	27	57	26
Allowance for OREO losses	(2)	(3)	(1)
OREO, net of allowance	25	54	25
Other nonperforming assets	73 ^b	1	3
Total nonperforming assets	\$ 378	\$ 273	\$ 308
Impaired loans with a specifically allocated allowance	\$ 53	\$ 34	\$ 26
Specifically allocated allowance for impaired loans	23	14	8
Accruing loans past due 90 days or more	\$ 181	\$ 120	\$ 119
Accruing loans past due 30 through 89 days	623	644	600

(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 the anticipated November 29, 2006, sale of the Champion

Mortgage
finance
business.

- (b) Primarily two
investments
totaling
approximately
\$68 million held
by the Private
Equity unit
within Key's
Real Estate
Capital line of
business.

At June 30, 2007, Key did not have any significant commitments to lend additional funds to borrowers with loans on nonperforming status.

Management evaluates the collectibility of Key's loans as described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan Losses on page 69 of Key's 2006 Annual Report to Shareholders.

Table of Contents**10. Capital Securities Issued by Unconsolidated Subsidiaries**

KeyCorp owns the outstanding common securities of business trusts that issued corporation-obligated mandatorily redeemable preferred capital securities. The trusts used the proceeds from the issuance of their capital securities and common securities 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; 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 continue to treat capital securities as Tier 1 capital, but imposed stricter quantitative limits that take effect after a five-year transition period ending March 31, 2009. Management believes the new rule will not have any material effect on Key's financial condition.

KeyCorp unconditionally guarantees the following payments or distributions on behalf of the trusts:

- required distributions on the capital securities;
- the redemption price when a capital security is redeemed; and
- amounts due if a trust is liquidated or terminated.

During the first six months of 2007, the business trusts did not repurchase any capital securities or related debentures. The capital securities, common securities and related debentures are summarized as follows:

<i>dollars in millions</i>	Capital		Principal	Interest	Maturity
	Securities, Net of Discount ^a	Common Securities	Amount of Debentures, Net of Discount ^b	Rate of Capital Securities and Debentures ^c	of Capital Securities and Debentures
June 30, 2007					
KeyCorp Capital I	\$ 197	\$ 8	\$ 205	6.089%	2028
KeyCorp Capital II	162	8	165	6.875	2029
KeyCorp Capital III	207	8	197	7.750	2029
KeyCorp Capital V	155	5	180	5.875	2033
KeyCorp Capital VI	70	2	77	6.125	2033
KeyCorp Capital VII	212	8	258	5.700	2035
KeyCorp Capital VIII	243		250	7.000	2066
KeyCorp Capital IX	472		500	6.750	2066
Total	\$ 1,718	\$ 39	\$ 1,832	6.608%	
December 31, 2006	\$ 1,804	\$ 39	\$ 1,832	6.613%	
June 30, 2006	\$ 1,772	\$ 54	\$ 1,847	6.928%	

(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 June 30, 2007, December 31, 2006, and June 30, 2006, are basis adjustments of (\$75) million, \$11 million and (\$21) million, respectively, related to fair value hedges. See Note 19 (Derivatives and Hedging Activities), which begins on page 100 of Key s 2006 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 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), June 15, 2010 (for debentures owned by Capital VII), June 15, 2011 (for debentures owned by Capital VIII) and December 15, 2011 (for debentures owned by Capital IX); 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 I, Capital V, Capital VI, Capital VII, Capital VIII or Capital IX 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 II,
Capital III,
Capital V, Capital
VI, Capital VII,
Capital VIII and
Capital IX 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
June 30, 2007,
December 31,
2006, and
June 30, 2006, are
weighted-average
rates.

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		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Service cost of benefits earned	\$ 12	\$ 12	\$ 26	\$ 24
Interest cost on projected benefit obligation	14	14	29	28
Expected return on plan assets	(22)	(22)	(44)	(44)
Amortization of losses	6	8	14	15
Net pension cost	10	12	25	23
Curtailment gain			(3)	
Total pension cost	\$ 10	\$ 12	\$ 22	\$ 23

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. Retirees' contributions are adjusted annually to reflect certain cost-sharing provisions and benefit limitations. 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 all funded and unfunded plans includes the following components:

<i>in millions</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Service cost of benefits earned	\$ 3	\$ 2	\$ 4	\$ 3
Interest cost on accumulated postretirement benefit obligation	2	2	3	4
Expected return on plan assets	(1)	(1)	(2)	(2)
Amortization of unrecognized transition obligation	2	1	2	2
Amortization of losses				1
Net postretirement benefit cost	\$ 6	\$ 4	\$ 7	\$ 8

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 three types of lease financing transactions with both foreign and domestic customers (primarily municipal authorities) for terms ranging from ten to fifty years. Lease in, Lease out (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. Qualified Technological Equipment Leases (QTEs) 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. LILO and Service Contract Lease 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. 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 Lease transactions generate rental income, as well as deductions from the depreciation of the property, interest expense on nonrecourse debt incurred to fund the transaction, and transaction costs.

Table of Contents

Prior to 2004, 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. 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 net deductions taken in those tax years that relate to LILOs, QTEs and Service Contract Leases. Key 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, discussions with the Appeals Division were discontinued without a resolution. In April 2006, Key received a final assessment from the IRS, consisting of taxes, interest and penalties, disallowing all LILO deductions taken in those tax years. 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 the LILO, QTE and Service Contract Lease deductions taken in the 1998 through 2000 tax years. 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.

Management continues to believe that Key's treatment of these LILO, QTE and Service Contract Lease transactions is appropriate and in compliance with applicable tax law and regulations. Key intends to vigorously pursue the IRS appeals process and litigation alternatives. In addition, in connection with one Service Contract Lease transaction entered into by AWG Leasing Trust (AWG Leasing), in which Key is a partner, the IRS completed its audit for the 1998 through 2003 tax years, disallowed all deductions related to the transaction for those years and assessed penalties. In March 2007, Key filed a lawsuit in the United States District Court for the Northern District of Ohio (captioned *AWG Leasing Trust, KSP Investments, Inc., as Tax Matters Partner v. United States of America*, and referred to herein as the AWG Leasing Litigation) claiming that the disallowance of the deductions and assessment of penalties were erroneous. A trial date has been set for January 21, 2008.

Management believes Key's tax position is correct and well-supported by applicable statutes, regulations and judicial authority, but tax litigation is inherently uncertain. Consequently, management cannot predict the outcome of the AWG Leasing Litigation or its other disputes with the IRS related to its LILO, QTE or Service Contract Lease transactions. If Key were not to prevail in these efforts, in addition to accrued taxes of approximately \$1.7 billion reflected on Key's balance sheet as deferred taxes as of June 30, 2007, Key would owe interest on any taxes and possibly penalties. In the event of an unfavorable resolution of this issue, management estimates that as of June 30, 2007, the after-tax interest cost on any taxes due could be up to approximately \$350 million. This amount would vary based upon the then applicable interest rates as well as the length of time any tax assessments remain outstanding. No reserves have been established for any such interest or penalties. An adverse outcome in these disputes could have a material adverse effect on Key's results of operations and a potentially substantial impact on its capital as discussed in the following section.

Tax-Related Accounting Pronouncements Adopted in 2007

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 affects when earnings from leveraged lease transactions (such as LILOs, QTEs and Service Contract Leases) will be recognized, and requires a lessor to recalculate its recognition of lease income when there are changes or projected changes in the timing of cash flows, including changes due to final or expected settlements of tax matters. Previously, leveraged lease transactions were required to be recalculated only when a change in the total projected net income from the lease occurred. Key adopted this guidance on January 1, 2007, and recorded a cumulative after-tax charge of \$52 million to retained earnings related to the LILO transactions. Future earnings are expected to increase over the remaining term of the affected leases by a similar amount.

Table of Contents

An adverse outcome in the AWG Leasing Litigation, certain settlement scenarios or other factors could change management's current assumptions pertaining to the expected timing of the cash flows related to income taxes for some or all of the leveraged lease transactions previously described. In the event of such a change in management's assumptions, in accordance with Staff Position No. 13-2, Key would be required to recalculate its lease income from the inception of the affected leases and recognize a reduction in its net investment with a corresponding charge to earnings in the period in which the recalculation occurs. Management is currently unable to make a determination regarding the ultimate financial impact, if any, of these events because of the uncertainty of the outcome of the AWG Leasing Litigation, the range of possible settlement opportunities that might be available to Key and other factors. Management believes that under certain outcomes, the recalculation would result in a charge that could have a material adverse effect on Key's results of operations and a potentially substantial impact on its capital. However, future earnings would be expected to increase over the remaining term of the affected leases by an amount equal to a substantial portion of the charge.

Accounting for uncertain tax positions. 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 for the associated tax benefit to be recognized in a company's financial statements. In accordance with this guidance, a company may recognize a 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 measured as the largest amount of such benefit that is greater than 50% likely to be realized upon ultimate settlement. This interpretation also provides guidance on measurement and derecognition of tax benefits, and requires expanded disclosures.

Key adopted FASB Interpretation No. 48 on January 1, 2007, which resulted in an immaterial increase in Key's liability for unrecognized tax benefits and was accounted for as a reduction to retained earnings. The total amount of unrecognized tax benefits as of January 1, 2007, was \$27 million which, if recognized, would impact the effective tax rate. There were no material changes to this amount during the first half of 2007. The amount of unrecognized tax benefits could materially increase or decrease over the next twelve months as a result of developments in the AWG Leasing Litigation or any possible settlement of tax matters related to the leveraged lease transactions. However, management cannot currently estimate the range of possible change.

As permitted under FASB Interpretation No. 48, Key continues to recognize interest and penalties related to unrecognized tax benefits in income tax expense. During the six-month period ended June 30, 2007, Key recognized \$2 million of interest. At June 30, 2007, Key had an \$18 million liability for accrued interest payable on the balance sheet.

Key files income tax returns in the United States federal jurisdiction, as well as various state and foreign jurisdictions. With the exception of the California and New York jurisdictions, Key is not subject to U.S. federal, state and local, and foreign income tax examinations by tax authorities for years prior to 2001. Income tax returns filed in California and New York are subject to examination beginning with the years 1995 and 2000, respectively. As previously discussed, the audits of the 1998 through 2000 federal income tax returns are currently on appeal to the Appeals Division of the IRS. In addition, the IRS is currently conducting audits of Key's income tax returns for the 2001 through 2003 tax years. These audits are expected to be completed by the end of 2007. The outcomes of these open examinations could impact the recognition of benefits related to Key's tax positions.

Table of Contents**13. Contingent Liabilities and Guarantees****Legal Proceedings**

Residual value insurance litigation. Key has previously reported on its on-going litigation with Swiss Reinsurance America Corporation (Swiss Re) in the United States Federal District Court in Ohio relating to insurance coverage of the residual value of certain automobile leases through Key Bank USA (the Residual Value Litigation).

As previously reported, on February 13, 2007, Key and Swiss Re entered into an agreement to settle the Residual Value Litigation, subject to certain conditions. On February 16, 2007, the conditions to settlement were satisfied. Under the settlement agreement, Swiss Re agreed to pay Key \$279 million in two installments: \$50 million, which was paid on March 15, 2007, and \$229 million, which was paid on June 29, 2007. As a result of the settlement, during the first quarter of 2007, Key recorded a one-time gain of \$26 million (\$17 million after tax, or \$.04 per diluted common share), representing the difference between the proceeds received and the receivable recorded on Key s balance sheet.

Tax disputes. 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 audits of Key s income tax returns for the 1995 through 2000 tax years and has disallowed all deductions taken in those tax years that relate to certain lease financing transactions. Further information 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 25.

Honsador litigation. On May 23, 2007, in the case of Honsador Holdings LLC v. Key Principal Partners, LLC (KPP), pending in the Circuit Court of the First Circuit, a Hawaii state court, the jury returned a verdict in favor of the plaintiffs in a lawsuit relating to KPP s investment in a Hawaiian business, and on June 13, 2007, the state court entered a final judgment in favor of the plaintiffs in the amount of \$38.25 million. During the three months ended June 30, 2007, Key established a \$42 million reserve for this case for the verdict, legal costs and other expenses associated with the lawsuit. The trial court has scheduled a hearing on various post-trial motions filed by the parties for August 15, 2007, and Key will, based on the outcome of that hearing, determine whether to appeal the verdict.

Other litigation. In the ordinary course of business, Key is subject to other legal actions that involve claims for substantial monetary relief. Based on information presently known to management, management believes there are no such legal actions to which KeyCorp or any of its subsidiaries is a party, or involving any of their properties, that, individually or in the aggregate, could reasonably be expected to have a material adverse effect on Key s financial condition.

Guarantees

Key is a guarantor in various agreements with third parties. The following table shows the types of guarantees that Key had outstanding at June 30, 2007. 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 71 of Key s 2006 Annual Report to Shareholders.

Table of Contents

<i>in millions</i>	Maximum Potential Undiscounted Future Payments	Liability Recorded
Financial guarantees:		
Standby letters of credit	\$ 12,855	\$ 33
Credit enhancement for asset-backed commercial paper conduit	28	
Recourse agreement with FNMA	600	7
Return guarantee agreement with LIHTC investors	372	42
Default guarantees	9	1
Written interest rate caps ^a	113	6
Total	\$ 13,977	\$ 89

(a) At June 30, 2007, the weighted-average interest rate on written interest rate caps was 5.2%, and the weighted-average strike rate was 5.6%. 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. Many of Key's lines of business issue standby letters of credit 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 June 30, 2007, Key's standby letters of credit had a remaining weighted-average life of approximately 2.2 years, with remaining actual lives ranging from less than one year to as many as eleven 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 June 30, 2007, Key's maximum potential funding requirement under the credit enhancement facility totaled \$28 million, but there were no drawdowns under the facility during the quarter. 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 KBNA sells to FNMA. Accordingly, KBNA maintains a reserve for such potential losses in an amount estimated by management to approximate the fair value of KBNA's liability. At June 30, 2007, the outstanding commercial mortgage loans in this program had a remaining weighted-average term of 7.9 years, and the unpaid principal balance outstanding of loans sold by KBNA as a participant in this program was approximately \$1.9 billion. The maximum potential amount of undiscounted future payments that may be required under this program is generally equal to approximately one-third of the principal balance of loans outstanding at June 30, 2007. 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

Table of Contents

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 to provide the guaranteed return, Key is obligated to make any necessary payments to investors. In October 2003, management elected to discontinue new partnerships under this program.

No recourse or collateral is available to offset Key's 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 by distributing tax credits and deductions associated with the specific properties.

As shown in the table on page 29, KAHC maintained a reserve in the amount of \$42 million at June 30, 2007, which management believes will be sufficient to cover estimated future obligations under the guarantees. The maximum exposure to loss reflected in the table represents undiscounted future payments due to investors for the return on and of their investments. In accordance with FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, 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 fifteen 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 June 30, 2007, these caps had a weighted-average life of approximately 2.1 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 facilities to various asset-backed commercial paper conduits. These facilities obligate Key to provide funding in the event of a disruption in credit markets or other factors that preclude the issuance of commercial paper by the conduits. Key's commitments to provide liquidity are periodically evaluated by management. One of these liquidity facilities obligates Key through May 23, 2008, to provide funding of up to \$166 million to a commercial paper conduit that is consolidated in accordance with Key's consolidation policy described in Note 1 (*Basis of Presentation*), which begins on page 7. The amount available to be drawn, which is based on the amount of current commitments to borrowers, was \$166 million at June 30, 2007, but there were no drawdowns under this committed facility at that date. Additional information pertaining to this conduit is included in this note under the heading *Guarantees* on page 28 and in Note 8 (*Loan Securitizations, Servicing and Variable Interest Entities*) of Key's 2006 Annual Report to Shareholders under the heading *Consolidated VIEs* on page 84.

Table of Contents

Key also provides liquidity facilities to several third-party commercial paper conduits. These liquidity facilities, which expire at various dates through December 31, 2009, obligate Key to provide funding of up to \$593 million in total, with individual facilities ranging from \$6 million to \$100 million. The amounts available to be drawn, which are based on the amount of current commitments to borrowers, totaled \$590 million at June 30, 2007, but there were no drawdowns under these committed facilities at that date.

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. Amounts paid, if any, with respect to these indemnifications did not have 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.

Table of Contents**14. Derivatives and Hedging Activities**

Key, mainly through its subsidiary bank, KBNA, is party to various derivative instruments that 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. Generally, these instruments help Key manage exposure to market risk, mitigate the credit risk inherent in the loan portfolio and meet client 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 June 30, 2007, Key had \$258 million of derivative assets and \$275 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 \$902 million and \$844 million, respectively. Derivative assets and liabilities are recorded at fair value on the balance sheet.

Counterparty Credit Risk

The following table summarizes the fair value of Key's derivative assets by type. These assets represent Key's exposure to potential loss, as described below, before taking into account the effects of master netting arrangements and other means used to mitigate risk.

<i>in millions</i>	June 30, 2007	December 31, 2006	June 30, 2006
Interest rate	\$ 565	\$ 697	\$ 730
Credit	40	43	45
Foreign exchange	450	321	195
Equity	53	45	45
Energy	52	29	1
Total	\$ 1,160	\$ 1,135	\$ 1,016

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, fails to meet its contractual obligations. This risk is measured as the expected positive replacement value of contracts. To mitigate credit risk when managing 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 derivative 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 contract 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 June 30, 2007, Key was party to derivative contracts with 52 different counterparties. These derivatives include interest rate swaps and caps, credit derivatives, foreign exchange contracts, equity derivatives and energy derivatives. Among these were contracts entered into to offset the risk of client exposure. Key had aggregate exposure of \$247 million on these instruments to 24 of the 52 counterparties. However, at June 30, 2007, Key held approximately \$136 million in pooled collateral to mitigate that exposure, resulting in net exposure of \$111 million. The largest exposure to an individual counterparty was approximately \$116 million, which Key secured with approximately \$91 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 100 of Key's 2006 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, 2006	2007 Hedging Activity	Reclassification of Gains to Net Income	June 30, 2007
Accumulated other comprehensive loss resulting from cash flow hedges	\$ (19)	\$ 11	\$ (1)	\$ (9)

Key reclassifies gains and losses from accumulated other comprehensive loss to earnings when a hedged item causes Key to pay variable-rate interest on debt, receive variable-rate interest on commercial loans, or sell or securitize commercial real estate loans. Key expects to reclassify an estimated \$.7 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 $\frac{3}{4}$ primarily credit default swaps $\frac{3}{4}$ to mitigate credit risk by transferring a portion of the risk associated with the underlying extension of credit to a third party. These instruments are also used to manage portfolio concentration and correlation risks. At June 30, 2007, the notional amount of credit default swaps purchased by Key was \$1.1 billion. Key also provides credit protection to other lenders through the sale of credit default swaps. These transactions may generate fee income and can diversify overall exposure to credit loss. At June 30, 2007, the notional amount of credit default swaps sold by Key was \$50 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 credit protection, are included in investment banking and capital markets income on the income statement. 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 derivative assets or derivative 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 \$12 million at June 30, 2007, 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 2006 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 June 30, 2007 and 2006, and the related condensed consolidated statements of income, for the three-month and six-month periods then ended, and the condensed consolidated statements of changes in shareholders equity and cash flows for the six-month periods ended June 30, 2007 and 2006. 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, 2006, and the related consolidated statements of income, changes in shareholders equity, and cash flows for the year then ended not presented herein, and in our report dated February 23, 2007, 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, 2006, 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
August 7, 2007

Table of Contents**Item 2. Management's Discussion & Analysis of Financial Condition & 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 June 30, 2007 and 2006. Some tables may include additional periods to comply with disclosure requirements or to illustrate trends in greater depth. When reading this discussion, 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 18 of Key's 2006 Annual Report to Shareholders. This description does not reflect the reorganization within some of Key's lines of business that took effect January 1, 2007. For a current description of Key's lines of business, see Note 4 ("Line of Business Results"), which begins on page 13.

Terminology

This report contains some shortened names and industry-specific terms. We want to explain some of these terms at the outset to provide a better understanding of the discussion that follows.

- .. **KeyCorp** refers solely to the parent holding company.
- .. **KBNA** refers to KeyCorp's subsidiary bank, KeyBank National Association.
- .. **Key** refers to the consolidated entity consisting of KeyCorp and its subsidiaries.
- .. In November 2006, Key sold the nonprime mortgage loan portfolio held by the Champion Mortgage finance business, and announced a separate agreement to sell Champion's loan origination platform. As a result of these actions, Key has accounted for this business as a **discontinued operation**. We use the phrase **continuing operations** in this document to mean all of Key's business other than Champion. Key completed the sale of Champion's origination platform in February 2007.
- .. Key engages in **capital markets activities**. These activities encompass a variety of products and services. Among other things, Key trades securities as a dealer, enters into derivative contracts (both to accommodate clients' financing needs and for proprietary trading purposes), and conducts 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. A more detailed explanation of total and Tier 1 capital and how they are calculated is presented in the section entitled "Capital," which begins on page 58.

Long-term goals

Key's long-term financial 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%. The strategy for achieving these goals is described under the heading "Corporate Strategy" on page 20 of Key's 2006 Annual Report to Shareholders.

Table of Contents

Key from time-to-time uses capital that exceeds internal guidelines and minimum regulatory requirements to repurchase common shares in the open market or through privately-negotiated transactions. As a result of such repurchases, Key's weighted-average fully-diluted common shares decreased to 400.2 million shares for the first six months of 2007 from 411.8 million shares for the first half of 2006. Reducing the share count can foster both earnings per share growth and improved returns on average equity, but Key's share repurchase activity was not significant enough to cause 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 other 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 management expects, which may have an adverse effect on Key's financial results.
- .. Trade, monetary and fiscal policies of various governmental bodies may affect the economic environment in which Key operates, as well as its financial condition and results of operations.
- .. Adversity in general economic conditions, or in the condition of the local economies or industries in which Key has significant operations or assets, could, among other things, materially impact credit quality trends and Key's ability to generate loans.
- .. Increased competitive pressure among financial services companies may adversely affect Key's ability to market its products and services.
- .. It could take Key longer than anticipated to implement strategic initiatives designed to grow revenue or manage expenses; Key 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 Key in ways that management has not anticipated.
- .. Key may experience operational or risk management failures due to technological or other factors.
- .. Key may continue to become subject to heightened regulatory practices, requirements or expectations.
- .. Key may become subject to new legal obligations or liabilities, or the unfavorable resolution of pending litigation may have an adverse effect on its financial results or its capital.
- .. Changes in the stock markets, public debt markets and other capital markets could adversely affect Key's ability to raise capital or other funding for liquidity and business purposes, as well as its 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 Key's financial results or condition and that of its borrowers.
- .. Key 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 67 of Key's 2006 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 exercise judgment, and 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 judgment, assumptions and estimates in a number of important areas, including accounting for the allowance for loan losses; loan securitizations; contingent liabilities, guarantees and income taxes; derivatives and related hedging activities; principal investments; goodwill; and pension and other postretirement obligations. A brief discussion of each of these areas appears on pages 20 through 22 of Key's 2006 Annual Report to Shareholders.

During the first six months of 2007, 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. Additionally, no new critical accounting policies were adopted.

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

Key's second quarter income from continuing operations was \$337 million, or \$.85 per diluted common share. This compares to income from continuing operations of \$303 million, or \$.74 per share, for the second quarter of 2006, and \$358 million, or \$.89 per share, for the first quarter of 2007. Key's income from continuing operations for the first six months of 2007 was \$695 million, or \$1.74 per diluted common share. This compares to income from continuing operations before the cumulative effect of an accounting change of \$577 million, or \$1.40 per share, for the first half of 2006.

Net income totaled \$334 million, or \$.84 per diluted common share, for the second quarter of 2007, compared to net income of \$308 million, or \$.75 per share, for the second quarter of 2006 and \$350 million, or \$.87 per share, for the first quarter of 2007. Key's net income for the first half of 2007 was \$684 million, or \$1.71 per diluted common share, compared to \$597 million, or \$1.45 per share, for the same period last year.

Figure 1 shows Key's continuing and discontinued operating results and related performance ratios for comparative quarters and for the six-month periods ended June 30, 2007 and 2006. Key's financial performance for each of the past five quarters and the six-month periods ended June 30, 2007 and 2006, is summarized in Figure 3 on page 40.

Table of Contents**Figure 1. Results of Operations**

<i>in millions, except per share amounts</i>	Three months ended			Six months ended	
	6-30-07	3-31-07	6-30-06	6-30-07	6-30-06
SUMMARY OF OPERATIONS					
Income from continuing operations before cumulative effect of accounting change	\$ 337	\$ 358	\$ 303	\$ 695	\$ 577
(Loss) income from discontinued operations, net of taxes	(3)	(8)	5	(11)	15
Cumulative effect of accounting change, net of taxes					5
Net income	\$ 334	\$ 350	\$ 308	\$ 684	\$ 597
PER COMMON SHARE ASSUMING DILUTION					
Income from continuing operations before cumulative effect of accounting change	\$.85	\$.89	\$.74	\$ 1.74	\$ 1.40
(Loss) income from discontinued operations	(.01)	(.02)	.01	(.03)	.04
Cumulative effect of accounting change					.01
Net income	\$.84	\$.87	\$.75	\$ 1.71	\$ 1.45
PERFORMANCE RATIOS					
From continuing operations:					
Return on average total assets	1.45%	1.58%	1.33%	1.51%	1.29%
Return on average equity	17.66	19.06	15.85	18.35	15.40
From consolidated operations:					
Return on average total assets	1.43%	1.54%	1.32%	1.49%	1.29%
Return on average equity	17.50	18.63	16.11	18.06	15.80

As shown in Figure 2, the comparability of Key's income from continuing operations for comparative quarters is affected by several significant items, certain of which were the result of strategic actions described below that were taken to improve Key's business mix and to reposition the balance sheet.

Figure 2. Significant Items Affecting the Comparability of Earnings

<i>in millions, except per share amounts</i>	Second Quarter 2007		First Quarter 2007		Second Quarter 2006	
	Pre-tax Amount	After-tax Amount	Pre-tax Amount	After-tax Amount	Pre-tax Amount	After-tax Amount
INCOME FROM CONTINUING OPERATIONS GAAP BASIS	\$ 467	\$ 337	\$ 505	\$ 358	\$ 428	\$ 303
Significant items:						
McDonald Investments branch network ^a	7	4	(159)	(99)	8	5

Gains related to MasterCard Incorporated shares	(40)	(25)			(9)	(6)
Litigation reserve	42	26				
Gain from settlement of automobile residual value insurance litigation			(26)	(17)		
Loss from repositioning of securities portfolio			49	31		

INCOME FROM CONTINUING OPERATIONS **ADJUSTED BASIS** \$ 476 \$ 342 \$ 369 \$ 273 \$ 427 \$ 302

**PER COMMON SHARE
ASSUMING DILUTION**

Income from continuing operations GAAP basis	N/M	\$.85	N/M	\$.89	N/M	\$.74
Income from continuing operations adjusted basis	N/M	.86	N/M	.68	N/M	.74

(a) Represents the financial effect of the McDonald Investments branch network, including a gain of \$171 million (\$107 million after tax) from the February 9, 2007, sale of that network.

N/M = Not Meaningful

GAAP = U.S. generally accepted accounting principles

During the first quarter of 2007, Key completed the previously announced sales of the McDonald Investments branch network and the Champion Mortgage loan origination platform. Both transactions are consistent with Key's strategy of focusing on core relationship businesses and exiting those areas in which it does not have either the scale or opportunity to build profitable client relationships.

During the same period, Key repositioned the securities portfolio in response to changing market conditions.

Management expects this change to enhance Key's future financial performance, particularly in the event of a decline in interest rates. For more detailed information regarding the repositioning and composition of the securities portfolio, see the section entitled "Securities," which begins on page 56.

Key's top four priorities for 2007 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 second quarter:

• Key's noninterest income rose by \$104 million from the second quarter of 2006. Significant increases in net gains from both principal investing, and loan securitizations and sales, along with higher revenue from several other fee-based businesses drove the improvement. In addition, results for the current quarter

Table of Contents

include a \$40 million gain related to the sale of MasterCard Incorporated shares, compared to a \$9 million gain recorded in the second quarter of 2006. Net interest income decreased by \$20 million from the year-ago quarter as tighter interest rate spreads on both loans and deposits more than offset the positive effect of a 3% increase in average earning assets.

- .. The Comptroller of the Currency and the Federal Reserve Bank of Cleveland removed the regulatory agreements with Key. Additional information pertaining to this positive development is included in the section entitled Operational risk management on page 71.
- .. Asset quality remained solid. The level of nonperforming loans was essentially unchanged from one year ago. Although net loan charge-offs were up, performance in this area is still good compared to historical measures.
- .. Key continued to manage expenses effectively. Excluding the \$42 million charge for litigation in the second quarter of 2007, Key's total noninterest expense decreased by 3% from the second quarter of 2006, largely as a result of the sale of the McDonald Investments branch network.
- .. Further, Key continues to effectively manage its equity capital through dividends paid to shareholders, share repurchases, and investing in its businesses. During the second quarter, Key repurchased 6.0 million of its common shares. At June 30, 2007, Key's tangible equity to tangible assets ratio was 6.89%.

The primary reasons that Key's revenue and expense components changed from those reported for the three- and six-month periods ended June 30, 2006, are reviewed in greater detail throughout the remainder of the Management's Discussion & Analysis section.

Financial outlook

Since Key's July 17, 2007, release of its second quarter 2007 results, the financial markets have shown extraordinary volatility, particularly in the fixed income markets. Key participates in these markets primarily through business conducted by its National Banking group and through its principal investing activities. In light of uncertainty with regard to the period of time over which the market volatility will continue and whether the level of volatility will increase or decrease, management is unable to estimate the full impact of these financial market conditions on Key's results for the remainder of the year. Based on these current market conditions and the potential impact to Key's financial results, earnings per common share for the last six months of 2007 could be at or below the lower end of the \$1.50 to \$1.60 range provided in Key's July 17, 2007, Current Report on Form 8-K. Key's expectations for the second half of 2007 with regard to certain other financial performance measures include:

- .. a net interest margin in the mid 3.40% range;
- .. low- to mid-single digit percentage increases in loans and core deposits;
- .. net loan charge-offs in the range of .30% to .40% of average loans; and
- .. an effective tax rate of approximately 32% on a taxable-equivalent basis.

Strategic developments

Key has taken a number of specific actions during 2007 and 2006 to support its corporate strategy.

- .. On July 27, 2007, Key entered into an agreement to acquire U.S.B. Holding Co., Inc. (U.S.B.), the holding company for Union State Bank, a state-chartered commercial bank headquartered in Orangeburg, New York, with 31 branches. U.S.B. has assets of approximately \$3 billion and deposits of approximately \$2 billion. This acquisition will expand Key's presence in markets both within and contiguous to its current operations in the Hudson Valley. See Note 3 (Acquisitions and Divestitures), which begins on page 11, for more information pertaining to this pending acquisition.
- .. On February 9, 2007, McDonald Investments Inc., a wholly-owned subsidiary of KeyCorp, sold its branch network, which included approximately 570 financial advisors and field support staff, and certain fixed assets. Key has retained the corporate and institutional businesses, including Institutional Equities and Equity Research, Debt Capital Markets and Investment Banking. In addition, KBNA continues to operate the Wealth Management, Trust and Private Banking businesses. On April 16, 2007, Key renamed its registered broker/dealer through which its corporate and institutional investment banking and securities businesses operate. The new name is KeyBanc Capital Markets Inc.

Table of Contents

- .. On November 29, 2006, Key sold the nonprime mortgage loan portfolio held by the Champion Mortgage finance business. Key completed the sale of the Champion loan origination platform on February 28, 2007.
- .. On April 1, 2006, Key broadened its 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. Austin specializes in selecting and managing hedge fund investments for its principally institutional customer base.

Figure 3. Selected Financial Data

<i>Dollars in millions, except per share amounts</i>	2007		2006			Six months ended June 30,	
	Second	First	Fourth	Third	Second	2007	2006
FOR THE PERIOD							
Interest income	\$ 1,395	\$ 1,368	\$ 1,413	\$ 1,389	\$ 1,327	\$ 2,763	\$ 2,578
Interest expense	709	689	701	684	623	1,398	1,180
Net interest income	686	679	712	705	704	1,365	1,398
Provision for loan losses	53	44	53	35	23	97	62
Noninterest income	649	654	558	543	545	1,303	1,026
Noninterest expense	815	784	809	790	798	1,599	1,550
Income from continuing operations before income taxes and cumulative effect of accounting change	467	505	408	423	428	972	812
Income from continuing operations before cumulative effect of accounting change	337	358	311	305	303	695	577
(Loss) income from discontinued operations, net of taxes	(3)	(8)	(165)	7	5	(11)	15
Income before cumulative effect of accounting change	334	350	146	312	308	684	592
Net income	334	350	146	312	308	684	597
PER COMMON SHARE							
Income from continuing operations before cumulative effect of accounting change	\$.86	\$.90	\$.77	\$.76	\$.75	\$ 1.76	\$ 1.42
(Loss) income from discontinued operations	(.01)	(.02)	(.41)	.02	.01	(.03)	.04
Income before cumulative effect of accounting change	.85	.88	.36	.77	.76	1.73	1.46
Net income	.85	.88	.36	.77	.76	1.73	1.47
Income from continuing operations before cumulative effect of accounting change assuming dilution	.85	.89	.76	.74	.74	1.74	1.40
(Loss) income from discontinued operations assuming dilution	(.01)	(.02)	(.40)	.02	.01	(.03)	.04
Income before cumulative effect of accounting change assuming dilution	.84	.87	.36	.76	.75	1.71	1.44
Net income assuming dilution	.84	.87	.36	.76	.75	1.71	1.45
Cash dividends declared	.365	.365	.345	.345	.345	.73	.69
Book value at period end	19.78	19.57	19.30	19.73	19.21	19.78	19.21
Market price:							

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

High	38.96	39.90	38.63	38.15	38.31	39.90	38.31
Low	34.15	35.94	35.73	34.48	34.24	34.15	32.68
Close	34.33	37.47	38.03	37.44	35.68	34.33	35.68
Weighted-average common shares outstanding (000)	392,045	397,875	402,329	403,780	404,528	394,944	405,949
Weighted-average common shares and potential common shares outstanding (000)	396,918	403,478	407,828	409,428	410,559	400,180	411,842
PERIOD END							
Loans	\$ 66,692	\$ 65,711	\$ 65,826	\$ 65,551	\$ 67,408	\$ 66,692	\$ 67,408
Earning assets	82,328	81,263	80,090	83,132	81,737	82,328	81,737
Total assets	94,076	93,219	92,337	96,155	94,794	94,076	94,794
Deposits	60,599	59,773	59,116	61,429	60,838	60,599	60,838
Long-term debt	12,581	13,061	14,533	13,654	14,050	12,581	14,050
Shareholders' equity	7,701	7,719	7,703	7,947	7,737	7,701	7,737
PERFORMANCE RATIOS							
From continuing operations:							
Return on average total assets	1.45%	1.58%	1.33%	1.31%	1.33%	1.51%	1.29%
Return on average equity	17.66	19.06	15.63	15.52	15.85	18.35	15.40
Net interest margin (taxable equivalent)	3.46	3.50	3.66	3.61	3.68	3.48	3.70
From consolidated operations:							
Return of average total assets	1.43%	1.54%	.61%	1.30%	1.32%	1.49%	1.29%
Return of average equity	17.50	18.63	7.34	15.88	16.11	18.06	15.80
Net interest margin (taxable equivalent)	3.46	3.51	3.69	3.63	3.69	3.49	3.73
CAPITAL RATIOS AT PERIOD END							
Equity to assets	8.19%	8.28%	8.34%	8.26%	8.16%	8.19%	8.16%
Tangible equity to tangible assets	6.89	6.97	7.01	6.81	6.68	6.89	6.68
Tier 1 risk-based capital	8.14	8.15	8.24	8.02	7.90	8.14	7.90
Total risk-based capital	12.15	12.20	12.43	12.13	12.08	12.15	12.08
Leverage	9.11	9.17	8.98	8.89	8.82	9.11	8.82
TRUST AND BROKERAGE ASSETS							
Assets under management	\$ 85,592	\$ 82,388	\$ 84,699	\$ 84,060	\$ 80,349	\$ 85,592	\$ 80,349
Nonmanaged and brokerage assets	33,485	32,838	56,292	55,221	57,682	33,485	57,682
OTHER DATA							
Average full-time equivalent employees	18,888	19,801	20,100	20,264	19,931	19,342	19,813
Branches	954	950	950	949	946	954	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 13. Note 4 describes the products and services offered by each of these business groups, provides more detailed financial information pertaining to the groups and their respective lines of business, and explains Other Segments and Reconciling Items.

Figure 4 summarizes the contribution made by each major business group to Key's taxable-equivalent revenue and income from continuing operations for the three- and six-month periods ended June 30, 2007 and 2006. Key's line of business results for each of these periods reflect a new organizational structure that took effect January 1, 2007.

Figure 4. Major Business Groups Taxable-Equivalent Revenue and Income from Continuing Operations

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30, 2007	2006	Change Amount	Change Percent	June 30, 2007	2006	Change Amount	Change Percent
REVENUE FROM CONTINUING OPERATIONS (TE)								
^a								
Community Banking	\$ 624	\$ 672	\$ (48)	(7.1)%	\$ 1,424	\$ 1,321	\$ 103	7.8%
National Banking	630	596	34	5.7	1,235	1,179	56	4.7
Other Segments	92	21	71	338.1	72	14	58	414.3
Total Segments	1,346	1,289	57	4.4	2,731	2,514	217	8.6
Reconciling Items	9	(18)	27	N/M	(22)	(40)	18	45.0
Total	\$ 1,355	\$ 1,271	\$ 84	6.6%	\$ 2,709	\$ 2,474	\$ 235	9.5%
INCOME FROM CONTINUING OPERATIONS ^a								
Community Banking	\$ 97	\$ 100	\$ (3)	(3.0)%	\$ 294	\$ 203	\$ 91	44.8%
National Banking	169	176	(7)	(4.0)	331	348	(17)	(4.9)
Other Segments	49	19	30	157.9	41	19	22	115.8
Total Segments	315	295	20	6.8	666	570	96	16.8
Reconciling Items	22	8	14	175.0	29	7	22	314.3
Total	\$ 337	\$ 303	\$ 34	11.2%	\$ 695	\$ 577	\$ 118	20.5%

(a) Community Banking results for the first quarter of 2007 include a

\$171 million
(\$107 million
after tax) gain
from the
February 9 sale
of the
McDonald
Investments
branch network.
See Note 3
(Acquisitions
and
Divestitures),
which begins on
page 11, for
more
information
pertaining to
this transaction.

National
Banking results
for the first
quarter of 2007
include a
\$26 million
(\$17 million
after tax) gain
from the
settlement of the
residual value
insurance
litigation.

Other Segments
results for the
second quarter
of 2007 include
a \$26 million
(\$16 million
after tax) charge
for litigation.
This charge and
the litigation
charge referred
to in the
comment related
to Reconciling
Items below
comprise the
\$42 million

charge recorded in connection with the Honsador litigation disclosed in Note 13 (Contingent Liabilities and Guarantees), which begins on page 28. Results for the first quarter of 2007 include a \$49 million (\$31 million after tax) loss from the repositioning of the securities portfolio.

Reconciling Items for the second quarter of 2007 and 2006 include gains of \$40 million (\$25 million after tax) and \$9 million (\$6 million after tax), respectively, related to MasterCard Incorporated shares. Results for the second quarter of 2007 also include a \$16 million (\$10 million after tax) charge for litigation.

TE = Taxable
Equivalent, N/M =
Not Meaningful

Community Banking summary of operations

As shown in Figure 5, net income for Community Banking was \$97 million for the second quarter of 2007, compared to \$100 million for the year-ago quarter. Decreases in both net interest income and noninterest income were offset in part by a decline in noninterest expense. The provision for loan losses was essentially unchanged.

Table of Contents

Taxable-equivalent net interest income decreased by \$16 million, or 4%, from the second quarter of 2006. The decrease was attributable to a reduction in, and a tighter interest rate spread on, average earning assets, along with a shift from NOW and money market deposit accounts to higher-cost certificates of deposit. Also, as part of the February 2007 sale of the McDonald Investments branch network, Key transferred approximately \$1.3 billion of NOW and money market deposit accounts to the buyer. McDonald Investments NOW and money market deposit accounts averaged \$1.5 billion for the second quarter of 2006.

Noninterest income decreased by \$32 million, or 14%, from the year-ago quarter, due primarily to a reduction in brokerage income caused by the McDonald Investments sale. This reduction was partially offset by an increase in service charges on deposit accounts.

Noninterest expense declined by \$43 million, or 9%. Lower personnel costs and decreases in certain other costs associated with the McDonald Investments branch network accounted for most of the improvement.

Figure 5. Community Banking

<i>dollars in millions</i>	Three months ended				Six months ended				
	June 30, 2007	2006	Change Amount	Change Percent	June 30, 2007	2006	Change Amount	Change Percent	
SUMMARY OF OPERATIONS									
Net interest income (TE)	\$ 420	\$ 436	\$ (16)	(3.7)%	\$ 838	\$ 865	\$ (27)	(3.1)%	
Noninterest income	204	236	(32)	(13.6)	586 ^a	456	130	28.5	
Total revenue (TE)	624	672	(48)	(7.1)	1,424	1,321	103	7.8	
Provision for loan losses	21	21			36	49	(13)	(26.5)	
Noninterest expense	448	491	(43)	(8.8)	917	947	(30)	(3.2)	
Income before income taxes (TE)	155	160	(5)	(3.1)	471	325	146	44.9	
Allocated income taxes and TE adjustments	58	60	(2)	(3.3)	177	122	55	45.1	
Net income	\$ 97	\$ 100	\$ (3)	(3.0)%	\$ 294	\$ 203	\$ 91	44.8%	
Percent of consolidated income from continuing operations	29%	33%	N/A	N/A	42%	35%	N/A	N/A	
AVERAGE BALANCES									
Loans and leases	\$ 26,551	\$ 26,830	\$ (279)	(1.0)%	\$ 26,489	\$ 26,798	\$ (309)	(1.2)%	
Total assets	29,291	29,918	(627)	(2.1)	29,266	29,868	(602)	(2.0)	
Deposits	46,171	46,675	(504)	(1.1)	46,375	46,255	120	.3	

(a) Community Banking results for the first quarter of 2007 include a \$171 million (\$107 million after tax) gain

from the
February 9 sale
of the
McDonald
Investments
branch network.
See Note 3
(Acquisitions
and
Divestitures),
which begins on
page 11, for
more
information
pertaining to
this transaction.

TE = Taxable
Equivalent, N/A =
Not Applicable

ADDITIONAL COMMUNITY BANKING DATA

<i>Amounts in millions</i>	Three months ended				Six months ended			
	June 30,		Change		June 30,		Change	
	2007	2006	Amount	Percent	2007	2006	Amount	Percent
AVERAGE DEPOSITS OUTSTANDING								
NOW and money market deposit accounts	\$ 18,996	\$ 20,786	\$ (1,790)	(8.6)%	\$ 19,317	\$ 20,515	\$ (1,198)	(5.8)%
Savings deposits	1,619	1,737	(118)	(6.8)	1,618	1,737	(119)	(6.9)
Certificates of deposits (\$100,000 or more)	4,709	4,010	699	17.4	4,643	3,983	660	16.6
Other time deposits	12,038	11,437	601	5.3	12,044	11,358	686	6.0
Deposits in foreign office	1,046	634	412	65.0	1,003	578	425	73.5
Noninterest-bearing deposits	7,763	8,071	(308)	(3.8)	7,750	8,084	(334)	(4.1)
Total deposits	\$ 46,171	\$ 46,675	\$ (504)	(1.1)%	\$ 46,375	\$ 46,255	\$ 120	.3%
LOAN DATA								
LOAN TO VALUE RATIO								
Average balance	\$ 9,660	\$ 10,107						
Weighted-average loan-to-value ratio	70%	70%						
Percent first lien positions	58	60						
OTHER DATA								
Per-line households/household penetration	711,254 / 54%	639,444 / 52%						
Branches	954	946						
Automated teller machines	1,450	2,120						

Table of Contents**National Banking summary of continuing operations**

As shown in Figure 6, income from continuing operations for National Banking was \$169 million for the second quarter of 2007, compared to \$176 million for the same period last year. Increases in the provision for loan losses and noninterest expense accounted for the reduction, and more than offset an increase in noninterest income. Net interest income was essentially unchanged from the year-ago quarter.

Taxable-equivalent net interest income decreased by less than \$1 million from the second quarter of 2006. The adverse effect of a tighter interest rate spread on average earning assets was offset by the growth in average loans and deposits.

The provision for loan losses rose by \$30 million, reflecting a higher level of net loan charge-offs.

Noninterest income was up \$35 million, or 14%. The growth was attributable to a significant increase in net gains from loan securitizations and sales, along with higher income from operating leases, and trust and investment services. Noninterest expense grew by \$15 million, or 5%, due primarily to higher costs associated with operating leases.

Figure 6. National Banking

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30,		Change		June 30,		Change	
	2007	2006	Amount	Percent	2007	2006	Amount	Percent
SUMMARY OF OPERATIONS								
Net interest income (TE)	\$ 348	\$ 349	\$ (1)	(.3)%	\$ 688	\$ 695	\$ (7)	(1.0)%
Noninterest income	282	247	35	14.2	547 ^a	484	63	13.0
Total revenue (TE)	630	596	34	5.7	1,235	1,179	56	4.7
Provision for loan losses	32	2	30	N/M	61	13	48	369.2
Noninterest expense	328	313	15	4.8	644	612	32	5.2
Income from continuing operations before income taxes (TE)	270	281	(11)	(3.9)	530	554	(24)	(4.3)
Allocated income taxes and TE adjustments	101	105	(4)	(3.8)	199	206	(7)	(3.4)
Income from continuing operations (Loss) income from discontinued operations, net of taxes	169	176	(7)	(4.0)	331	348	(17)	(4.9)
	(3)	5	(8)	N/M	(11)	15	(26)	N/M
Net income	\$ 166	\$ 181	\$ (15)	(8.3)%	\$ 320	\$ 363	\$ (43)	(11.8)%
Percent of consolidated income from continuing operations	50%	58%	N/A	N/A	48%	60%	N/A	N/A

**AVERAGE
BALANCES FROM
CONTINUING
OPERATIONS**

Loans and leases	\$ 39,348	\$ 37,730	\$ 1,618	4.3%	\$ 39,110	\$ 37,390	\$ 1,720	4.6%
Loans held for sale	4,377	3,821	556	14.6	4,148	3,752	396	10.6
Total assets	49,639	47,682	1,957	4.1	49,063	47,237	1,826	3.9
Deposits	12,036	10,633	1,403	13.2	11,636	10,294	1,342	13.0

(a) National Banking results for the first quarter of 2007 include a \$26 million (\$17 million after tax) gain from the settlement of the residual value insurance litigation.

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

Other Segments

Other segments consist of Corporate Treasury and Key s Principal Investing unit. These segments generated net income of \$49 million for the second quarter of 2007, up from \$19 million for the same period last year.

Table of Contents**Results of Operations****Net interest income**

One of Key's principal sources of revenue 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 and value of net free funds, such as noninterest-bearing deposits and equity 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 taxable, some 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 7, which spans pages 46 and 47, 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 was \$706 million for the second quarter of 2007, compared to \$726 million for the year-ago quarter. 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. Key's net interest margin declined by 22 basis points from the second quarter of 2006 to 3.46% for the second quarter of 2007. A basis point is equal to one one-hundredth of a percentage point, meaning 22 basis points equal .22%.

The reductions in net interest income and the net interest margin were due primarily to tighter interest rate spreads on both loans and deposits, reflecting the continuation of competitive pricing, and a shift from NOW and money market deposit accounts to higher-cost certificates of deposit. Additionally, as part of the February 2007 sale of the McDonald Investments branch network, Key transferred approximately \$1.3 billion of NOW and money market deposit accounts to the buyer. McDonald Investments' NOW and money market deposit accounts averaged \$1.5 billion for the second quarter of 2006. The decrease in the net interest margin was moderated by the impact of a 7% rise in the volume of noninterest-bearing funds. The growth in these funds added approximately 12 basis points to the net interest margin. Average earning assets for the second quarter of 2007 totaled \$81.6 billion, which was \$2.6 billion, or 3%, higher than the second quarter 2006 level. Increases in commercial loans, commercial mortgage loans held for sale and securities available for sale drove the growth.

Since December 31, 2005, the growth and composition of Key's earning assets have been affected by the following loan sales, most of which came from the held-for-sale portfolio:

- Key sold commercial mortgage loans of \$1.8 billion (\$238 million through a securitization) during the first six months of 2007 and \$2.6 billion during all of 2006. 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 agreements), 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 29.

Table of Contents

- “ Key sold education loans of \$179 million during the first six months of 2007 and \$1.4 billion (\$1.1 billion through a securitization) during all of 2006. Key uses the securitization market for education loans to diversify funding sources.
- “ Key sold other loans totaling \$695 million during the first half of 2007 and \$3.2 billion during all of 2006. This included the fourth quarter 2006 sale of the \$2.5 billion nonprime mortgage loan portfolio held by the Champion Mortgage finance business. The Champion business no longer fit strategically with Key’s longer-term business goals and continued focus on Community Banking and relationship-oriented businesses.

Table of Contents**Figure 7. Average Balance Sheets, Net Interest Income and Yields/Rates
From Continuing Operations**

<i>dollars in millions</i>	Second Quarter 2007			First Quarter 2007		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS						
Loans ^{a,b}						
Commercial, financial and agricultural	\$ 21,856	\$ 401	7.36%	\$ 21,562	\$ 392	7.38%
Real estate commercial mortgage	8,565	165	7.75	8,426	163	7.83
Real estate construction	8,243	167	8.09	8,227	166	8.20
Commercial lease financing	10,096	142	5.62	10,094	146	5.78
Total commercial loans	48,760	875	7.19	48,309	867	7.26
Real estate residential	1,472	24	6.57	1,444	24	6.60
Home equity	10,752	193	7.22	10,706	191	7.22
Consumer direct	1,370	37	10.64	1,450	36	10.15
Consumer indirect	3,961	67	6.76	3,760	64	6.79
Total consumer loans	17,555	321	7.33	17,360	315	7.32
Total loans	66,315	1,196	7.23	65,669	1,182	7.28
Loans held for sale	4,415	82	7.50	3,940	75	7.70
Investment securities ^a	39		6.72	39	1	7.21
Securities available for sale ^c	7,793	106	5.45	7,548	100	5.27
Short-term investments	1,484	16	4.19	1,607	18	4.55
Other investments ^c	1,541	15	3.68	1,400	13	3.65
Total earning assets	81,587	1,415	6.95	80,203	1,389	6.99
Allowance for loan losses	(942)			(942)		
Accrued income and other assets	12,767			12,835		
Total assets	\$ 93,412			\$ 92,096		
LIABILITIES AND SHAREHOLDERS EQUITY						
NOW and money market deposit accounts	\$ 22,953	179	3.14	\$ 23,424	177	3.06
Savings deposits	1,633	1	.19	1,629	1	.19
Certificates of deposit (\$100,000 or more) ^d	6,237	79	5.03	6,151	76	5.03
Other time deposits	12,047	141	4.70	12,063	138	4.64

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

Deposits in foreign office ^e	3,600	47	5.20	3,258	41	5.12
Total interest-bearing deposits	46,470	447	3.85	46,525	433	3.77
Federal funds purchased and securities sold under repurchase agreements ^e	4,748	59	5.04	3,903	49	5.04
Bank notes and other short-term borrowings	1,771	18	4.14	1,113	11	3.98
Long-term debt ^{d, e}	12,909	185	5.83	13,617	196	5.90
Total interest-bearing liabilities	65,898	709	4.33	65,158	689	4.29
Noninterest-bearing deposits	13,927			13,237		
Accrued expense and other liabilities	5,933			6,083		
Shareholders' equity	7,654			7,618		
Total liabilities and shareholders' equity	\$ 93,412			\$ 92,096		
Interest rate spread (TE)			2.62%			2.70%
Net interest income (TE) and net interest margin (TE)		706	3.46%		700	3.50%
TE adjustment ^a		20			21	
Net interest income, GAAP basis		\$ 686			\$ 679	

(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) Yield is calculated on the basis of amortized cost.
- (d) Rate calculation excludes basis adjustments related to fair value hedges.
- (e) Results from continuing operations exclude the dollar amount of liabilities assumed necessary to support interest-earning assets held by the discontinued Champion Mortgage finance business. The interest expense related to these liabilities, which also is excluded from continuing operations, was calculated using a matched funds transfer pricing methodology.

TE = Taxable
Equivalent

GAAP = U.S. generally
accepted accounting
principles

Table of Contents**Figure 7. Average Balance Sheets, Net Interest Income and Yields/Rates
From Continuing Operations (Continued)**

Fourth Quarter 2006			Third Quarter 2006			Second Quarter 2006		
Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
\$ 21,384	\$ 400	7.42%	\$ 21,648	\$ 400	7.34%	\$ 21,970	\$ 390	7.12%
8,399	167	7.86	8,106	164	8.04	8,071	153	7.59
8,347	174	8.25	7,965	171	8.51	7,570	152	8.07
9,891	160	6.47	9,850	144	5.83	9,764	148	6.05
48,021	901	7.44	47,569	879	7.34	47,375	843	7.13
1,428	24	6.59	1,415	23	6.49	1,430	24	6.54
10,896	197	7.22	11,017	200	7.19	11,003	193	7.02
1,557	34	8.63	1,585	36	9.07	1,685	41	9.64
3,671	62	6.85	3,594	61	6.83	3,503	57	6.66
17,552	317	7.21	17,611	320	7.23	17,621	315	7.16
65,573	1,218	7.38	65,180	1,199	7.31	64,996	1,158	7.14
4,547	90	7.86	4,578	94	8.17	3,844	73	7.64
38	1	7.68	42	1	8.12	46	1	8.01
7,765	96	4.88	7,216	84	4.61	7,075	84	4.71
1,584	16	4.04	1,588	16	3.78	1,678	16	3.89
1,351	24	6.76	1,363	16	4.67	1,398	17	4.60
80,858	1,445	7.09	79,967	1,410	7.00	79,037	1,349	6.83
(941)			(951)			(958)		
13,129			13,247			13,137		
\$ 93,046			\$ 92,263			\$ 91,216		
\$ 25,136	198	3.13	\$ 25,230	194	3.05	\$ 25,347	173	2.75
1,651	1	.19	1,700	1	.19	1,752	1	.20
6,013	75	4.93	5,517	67	4.82	5,382	61	4.54
11,921	136	4.50	11,700	127	4.29	11,456	115	4.02
2,245	30	5.55	2,820	39	5.55	2,116	28	5.22

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

46,966	440	3.72	46,967	428	3.61	46,053	378	3.29
2,816	37	5.21	2,315	30	5.05	1,692	20	4.76
1,814	19	4.17	2,285	24	4.29	2,497	27	4.17
14,092	205	5.80	13,763	202	5.83	14,088	198	5.59
65,688	701	4.24	65,330	684	4.15	64,330	623	3.87
13,424			13,073			13,014		
6,041			6,063			6,205		
7,893			7,797			7,667		
\$ 93,046			\$ 92,263			\$ 91,216		
		2.85%			2.85%			2.96%
	744	3.66%		726	3.61%		726	3.68%
	32			21			22	
\$ 712			\$ 705			\$ 704		

Table of Contents

Figure 8 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 8. Components of Net Interest Income Changes

<i>in millions</i>	From three months ended June 30, 2006 to three months ended June 30, 2007			From six months ended June 30, 2006 to six months ended June 30, 2007		
	Average Volume	Yield/ Rate	Net Change	Average Volume	Yield/ Rate	Net Change
INTEREST INCOME						
Loans	\$ 24	\$ 14	\$ 38	\$ 49	\$ 84	\$ 133
Loans held for sale	11	(2)	9	15	1	16
Investment securities		(1)	(1)	(1)	1	
Securities available for sale	9	13	22	14	25	39
Short-term investments	(2)	2		(3)	6	3
Other investments	2	(4)	(2)	3	(17)	(14)
Total interest income (TE)	44	22	66	77	100	177
INTEREST EXPENSE						
NOW and money market deposit accounts	(17)	23	6	(23)	61	38
Certificates of deposit (\$100,000 or more)	10	8	18	19	17	36
Other time deposits	6	20	26	14	46	60
Deposits in foreign office	19		19	35	3	38
Total interest-bearing deposits	18	51	69	45	127	172
Federal funds purchased and securities sold under repurchase agreements	38	1	39	61	7	68
Bank notes and other short-term borrowings	(7)	(2)	(9)	(22)		(22)
Long-term debt	(17)	4	(13)	(22)	22	
Total interest expense	32	54	86	62	156	218
Net interest income (TE)	\$ 12	\$ (32)	\$ (20)	\$ 15	\$ (56)	\$ (41)

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.

TE = Taxable Equivalent

Noninterest income

Noninterest income for the second quarter of 2007 was \$649 million, up from \$545 million for the same period last year. For the first six months of the year, noninterest income was \$1.3 billion, representing an increase of \$277 million, or 27%, from the first six months of 2006.

As shown in Figure 9, the growth in noninterest income from the year-ago quarter reflected increases of \$67 million in net gains from principal investing, \$23 million in net gains from loan securitizations and sales, and higher revenue

from several other fee-based businesses. In addition, results for the current quarter include a \$40 million gain related to the sale of MasterCard Incorporated shares, compared to a \$9 million gain recorded in the year-ago quarter that resulted from the share redemption by MasterCard Incorporated as part of its initial public offering. Trust and investment services income decreased due to lower brokerage income resulting from the sale of the McDonald Investments branch network.

For the year-to-date period, the growth in noninterest income from the same period last year reflected several significant items. During first quarter of 2007, Key recorded a \$171 million gain associated with the February 9, 2007, sale of the McDonald Investments branch network, a \$49 million loss recorded in connection with the repositioning of the securities portfolio and a \$26 million gain from the settlement of the automobile residual value insurance litigation. Excluding these items, Key's noninterest income was \$1.2 billion for the first half of 2007, representing a \$129 million, or 13%, increase from the first six months of 2006. As shown in Figure 9, a \$99 million improvement in net gains from principal investing, along with higher income from operating leases, an increase in net gains from loan securitizations and sales, and the gain related to the sale of MasterCard Incorporated shares drove the growth. These positive results were moderated by decreases in income from trust and investment services, and investment banking and capital markets activities.

Table of Contents**Figure 9. Noninterest Income**

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30, 2007	June 30, 2006	Change Amount	Change Percent	June 30, 2007	June 30, 2006	Change Amount	Change Percent
Trust and investment services income	\$ 115	\$ 139	\$ (24)	(17.3)%	\$ 240	\$ 274	\$ (34)	(12.4)%
Service charges on deposit accounts	84	77	7	9.1	159	149	10	6.7
Investment banking and capital markets income	52	57	(5)	(8.8)	96	117	(21)	(17.9)
Operating lease income	66	56	10	17.9	130	108	22	20.4
Letter of credit and loan fees	45	45			83	85	(2)	(2.4)
Corporate-owned life insurance income	32	26	6	23.1	57	51	6	11.8
Electronic banking fees	25	27	(2)	(7.4)	49	51	(2)	(3.9)
Net gains from loan securitizations and sales	33	10	23	230.0	42	20	22	110.0
Net securities gains (losses)	2	4	(2)	(50.0)	(45)	5	(50)	N/M
Gain on sale of McDonald Investments branch network					171		171	N/M
Other income:								
Insurance income	15	17	(2)	(11.8)	29	31	(2)	(6.5)
Loan securitization servicing fees	6	5	1	20.0	11	10	1	10.0
Credit card fees	3	3			6	6		
Net gains from principal investing	90	23	67	291.3	119	20	99	495.0
Gains related to Mastercard Incorporated shares	40	9	31	344.4	40	9	31	344.4
Litigation settlement automobile residual value insurance					26		26	N/M
Miscellaneous income	41	47	(6)	(12.8)	90	90		
Total other income	195	104	91	87.5	321	166	155	93.4
	\$ 649	\$ 545	\$ 104	19.1%	\$ 1,303	\$ 1,026	\$ 277	27.0%

Total noninterest
income

N/M = Not Meaningful

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

Trust and investment services income. Trust and investment services generally is Key's largest source of noninterest income. The primary components of revenue generated by these services are shown in Figure 10. The decreases compared to 2006 results were attributable to lower brokerage income resulting from the sale of the McDonald Investments branch network. Excluding the impact of the sale, brokerage commissions and fee income was up \$3 million from the second quarter of last year and \$1 million from the first six months of 2006. As shown in Figure 10, growth was also experienced in both personal and institutional asset management and custody fees.

Figure 10. Trust and Investment Services Income

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30, 2007	2006	Amount	Change Percent	June 30, 2007	2006	Amount	Change Percent
Brokerage commissions and fee income	\$ 28	\$ 59	\$ (31)	(52.5)%	\$ 68	\$ 121	\$ (53)	(43.8)%
Personal asset management and custody fees	41	38	3	7.9	81	77	4	5.2
Institutional asset management and custody fees	46	42	4	9.5	91	76	15	19.7
Total trust and investment services income	\$ 115	\$ 139	\$ (24)	(17.3)%	\$ 240	\$ 274	\$ (34)	(12.4)%

A significant portion of Key's trust and investment services income depends on the value and mix of assets under management. At June 30, 2007, Key's bank, trust and registered investment advisory subsidiaries had assets under management of \$85.6 billion, compared to \$80.3 billion at June 30, 2006. As shown in Figure 11, the increase was due primarily to Key's equity portfolio, reflecting improvement in the equity markets in general. Key's fixed income portfolio and the higher-yielding hedge funds obtained in the acquisition of Austin Capital Management, Ltd. on April 1, 2006, also contributed to the increase. The decrease in assets under management during the first quarter of 2007 was attributable to assets transferred in connection with the sale of the McDonald Investments branch network.

Table of Contents

The growth in total assets under management was moderated by declines in the money market portfolio and Key's securities lending business. 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 shared with the lending client. This business, although profitable, generates a significantly lower rate of return (commensurate with the lower level of risk) than other types of assets under management.

Figure 11. Assets Under Management

<i>in millions</i>	2007			2006	
	Second	First	Fourth	Third	Second
Assets under management by investment type:					
Equity	\$ 42,462	\$ 40,065	\$ 41,877	\$ 39,831	\$ 37,290
Securities lending	22,595	21,608	21,146	22,699	22,827
Fixed income	11,187	11,420	11,242	11,311	10,742
Money market	8,069	8,260	9,402	9,298	8,590
Hedge funds	1,279	1,035	1,032	921	900
Total	\$ 85,592	\$ 82,388	\$ 84,699	\$ 84,060	\$ 80,349
Proprietary mutual funds included in assets under management:					
Money market	\$ 6,280	\$ 6,459	\$ 7,579	\$ 7,520	\$ 7,014
Equity	6,392	5,788	5,713	5,250	5,039
Fixed income	615	621	629	639	653
Total	\$ 13,287	\$ 12,868	\$ 13,921	\$ 13,409	\$ 12,706

Service charges on deposit accounts. Service charges on deposit accounts were up from the prior year, due primarily to an increase in overdraft fees resulting from higher transaction volume and a rate increase instituted during the second quarter of 2007.

Investment banking and capital markets income. As shown in Figure 12, the decreases in investment banking and capital markets income were due to reductions in both investment banking income and income from other investments. Included in income from other investments for the first six months of 2006 is a \$25 million gain from the initial public offering completed by the New York Stock Exchange during the first quarter of last year.

Figure 12. Investment Banking and Capital Markets Income

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30, 2007	June 30, 2006	Change Amount	Change Percent	June 30, 2007	June 30, 2006	Change Amount	Change Percent
Investment banking income	\$ 22	\$ 26	\$ (4)	(15.4)%	\$ 43	\$ 48	\$ (5)	(10.4)%
Dealer trading and derivatives income	12	9	3	33.3	20	16	4	25.0
Income from other investments	6	11	(5)	(45.5)	11	32	(21)	(65.6)

Foreign exchange income	12	11	1	9.1	22	21	1	4.8
Total investment banking and capital markets income	\$ 52	\$ 57	\$ (5)	(8.8)%	\$ 96	\$ 117	\$ (21)	(17.9)%

Operating lease income. The increase in operating lease income compared to the second quarter and first half of 2006 reflected a higher volume of activity in the Equipment Finance line of business. Depreciation expense related to the leased equipment is presented in Figure 13 as operating lease expense.

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. The higher level of net gains in the current year is largely attributable to gains of \$15 million recorded in the second quarter of 2007 as a result of the sales of certain leveraged lease financing receivables. The types of loans sold during 2007 and 2006 are presented in Figure 17 on page 55.

Table of Contents

Net gains from principal investing. Principal investments consist of direct and indirect investments in predominantly privately-held companies. 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. These investments are carried on the balance sheet at fair value (\$975 million at June 30, 2007, \$830 million at December 31, 2006, and \$846 million at June 30, 2006). The net gains presented in Figure 9 stem from changes in estimated fair values as well as actual gains on sales of principal investments.

Noninterest expense

Noninterest expense for the second quarter of 2007 was \$815 million, compared to \$798 million for the second quarter of 2006. For the first six months of the year, noninterest expense was \$1.6 billion, representing an increase of \$49 million, or 3%, from the first six months of 2006.

As shown in Figure 13, personnel expense decreased by \$16 million due to lower incentive compensation accruals stemming from the sale of the McDonald Investments branch network. Excluding a \$42 million charge to litigation (included in miscellaneous expense) recorded in the second quarter of 2007, nonpersonnel expense was down \$9 million, due primarily to reductions in professional fees and certain costs associated with the McDonald Investments branch network. See Note 13 (Contingent Liabilities and Guarantees), which begins on page 28, for more information pertaining to the Honsador litigation charge.

For the year-to-date period, personnel expense grew by \$12 million. Nonpersonnel expense was down \$5 million, after adjusting for the litigation charge. Substantially higher operating lease expense was offset by a significant reduction in professional fees.

Figure 13. Noninterest Expense

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30,		Change		June 30,		Change	
	2007	2006	Amount	Percent	2007	2006	Amount	Percent
Personnel	\$ 411	\$ 427	\$ (16)	(3.7)%	\$ 839	\$ 827	\$ 12	1.5%
Net occupancy	59	59			122	120	2	1.7
Computer processing	49	49			100	105	(5)	(4.8)
Operating lease expense	55	45	10	22.2	107	86	21	24.4
Professional fees	26	40	(14)	(35.0)	52	73	(21)	(28.8)
Equipment	24	26	(2)	(7.7)	49	52	(3)	(5.8)
Marketing	20	23	(3)	(13.0)	39	38	1	2.6
Other expense:								
Postage and delivery	11	12	(1)	(8.3)	23	25	(2)	(8.0)
Franchise and business taxes	8	10	(2)	(20.0)	17	20	(3)	(15.0)
Telecommunications	7	7			14	14		
Provision (credit) for losses on lending-related commitments	6		6	N/M	(2)		(2)	N/M
Miscellaneous expense	139	100	39	39.0	239	190	49	25.8
Total other expense	171	129	42	32.6	291	249	42	16.9
Total noninterest expense	\$ 815	\$ 798	\$ 17	2.1%	\$ 1,599	\$ 1,550	\$ 49	3.2%

Average full-time equivalent employees ^a	18,888	19,931	(1,043)	(5.2)%	19,342	19,813	(471)	(2.4)%
---	---------------	--------	---------	--------	---------------	--------	-------	--------

(a) The number of average full-time equivalent employees has not been adjusted for discontinued operations.

N/M = Not Meaningful

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

Personnel. As shown in Figure 14, personnel expense, the largest category of Key's noninterest expense, rose by \$12 million, or 1%, from the first six months of 2006. The increase, which was moderated by the sale of the McDonald Investments branch network, was attributable to normal salary adjustments and higher stock-based compensation. The McDonald Investments branch network accounted for \$17 million of Key's personnel expense in the current year, compared to \$58 million for the first half of 2006. For the second quarter of 2007, the average number of full-time equivalent employees was 18,888, compared to 19,801 for the first quarter of 2007 and 19,931 for the second quarter of 2006.

Table of Contents**Figure 14. Personnel Expense**

<i>dollars in millions</i>	Three months ended				Six months ended			
	June 30, 2007	2006	Amount	Change Percent	June 30, 2007	2006	Amount	Change Percent
Salaries	\$ 236	\$ 234	\$ 2	.9%	\$ 481	\$ 463	\$ 18	3.9%
Incentive compensation	82	98	(16)	(16.3)	157	175	(18)	(10.3)
Employee benefits	73	75	(2)	(2.7)	155	155		
Stock-based compensation ^a	16	18	(2)	(11.1)	40	32	8	25.0
Severance	4	2	2	100.0	6	2	4	200.0
Total personnel expense	\$ 411	\$ 427	\$ (16)	(3.7)%	\$ 839	\$ 827	\$ 12	1.5%

(a) Excludes directors stock-based compensation of \$.5 million and \$.3 million for the three-month periods ended June 30, 2007 and 2006, respectively, and \$1.3 million and \$.6 million for the six-month periods ended June 30, 2007 and 2006, respectively. Directors stock-based compensation is included in the miscellaneous expense component shown in Figure 13.

Operating lease expense. The increase in operating lease expense compared to the second quarter and first half of 2006 reflected a higher volume of activity in the Equipment Finance line of business. Income related to the rental of

leased equipment is presented in Figure 9 as operating lease income.

Professional fees. The decrease in professional fees for both the quarterly and year-to-date periods was due in part to a reduction in costs associated with Key's efforts to strengthen compliance controls, for which substantial investment has already been made.

Income taxes

The provision for income taxes from continuing operations was \$130 million for the second quarter of 2007, compared to \$125 million for the comparable period in 2006. The effective tax rate, which is the provision for income taxes from continuing operations as a percentage of income from continuing operations before income taxes and the cumulative effect of an accounting change, was 27.8% for the second quarter of 2007, compared to 29.2% for the year-ago quarter. For the first six months of 2007, the provision for income taxes was \$277 million, compared to \$235 million for the first six months of 2006. The effective tax rates for these periods were 28.5% and 28.9%, 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%, primarily because Key generates income from investments in tax-advantaged assets such as corporate-owned life insurance, earns credits associated with investments in low-income housing projects and records 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 Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes.

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

At June 30, 2007, total loans outstanding were \$66.7 billion, compared to \$65.8 billion at December 31, 2006, and \$67.4 billion at June 30, 2006. 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 20. Key's commercial loan portfolio grew over the past twelve months, but that growth was more than offset by a third quarter 2006 transfer of home equity loans to loans held for sale in connection with the anticipated November 29, 2006, sale of the Champion Mortgage finance business.

Commercial loan portfolio. Commercial loans outstanding increased by \$1.5 billion, or 3%, 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 June 30, 2007, Key's commercial real estate portfolio included mortgage loans of \$8.6 billion and construction loans of \$8.2 billion. The average mortgage loan originated during the first half of 2007 was \$2 million, and the largest mortgage loan at June 30, 2007, had a balance of \$47 million. At June 30, 2007, the average construction loan commitment was \$6 million. The largest construction loan commitment was \$125 million, of which \$121 million was outstanding.

Key's commercial real estate lending business is conducted 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 at least 50% of the debt service is provided by rental income from nonaffiliated third parties) and accounted for approximately 62% of Key's total average commercial real estate loans during the second quarter of 2007. Key's commercial real estate business generally focuses on larger real estate developers and, as shown in Figure 15, is diversified by both industry type and geographic location of the underlying collateral.

Figure 15. Commercial Real Estate Loans

June 30, 2007 <i>dollars in millions</i>	Geographic Region						Total	Percent of Total
	Northeast	Southeast	Southwest	Midwest	Central	West		
Nonowner-occupied:								
Residential properties	\$ 265	\$ 1,127	\$ 260	\$ 185	\$ 445	\$ 1,573	\$ 3,855	22.9%
Multi-family properties	352	312	208	252	434	433	1,991	11.8
Retail properties	119	544	135	426	308	284	1,816	10.8
Land and development	56	240	191	97	252	232	1,068	6.3
Office buildings	138	205	111	139	116	242	951	5.7
Warehouses	73	140	18	81	69	165	546	3.2
Health facilities	147	107	14	160	46	96	570	3.4
Manufacturing facilities	8		17	22	4	18	69	.4
Hotels/Motels	2	23		1	20	2	48	.3
Other	175	21	2	314	103	210	825	4.9
	1,335	2,719	956	1,677	1,797	3,255	11,739	69.7
Owner-occupied	1,002	184	81	1,750	446	1,641	5,104	30.3
Total	\$ 2,337	\$ 2,903	\$ 1,037	\$ 3,427	\$ 2,243	\$ 4,896	\$ 16,843	100.0%
Nonowner-occupied:								
Nonperforming loans	\$ 3			\$ 13		\$ 12	\$ 28	N/M

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

Accruing loans past due 90 days or more			2	\$	1	47	50	N/M	
Accruing loans past due 30 through 89 days	5	\$	20			15	69	109	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

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. These financing arrangements are conducted through the Equipment Finance line of business. Commercial lease financing receivables increased by \$229 million, or 2%, over the past twelve months.

Consumer loan portfolio. Consumer loans outstanding decreased by \$2.2 billion, or 11%, 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 the November 2006 sale of the Champion Mortgage finance business discussed below. The portfolio also was affected by a general slowdown in the level of home equity loan originations over the past year. Excluding loan sales, acquisitions and the transfer to loans held for sale, consumer loans would have increased by \$304 million, or 2%, during the past twelve months.

The home equity portfolio is by far the largest segment of Key's consumer loan portfolio. This portfolio is derived primarily from the Regional Banking line of business (responsible for 89% of home equity loans at June 30, 2007); the remainder originated from the Home Equity Services unit within our Consumer Finance line of business, which works with home improvement contractors to provide home equity and home improvement financing solutions. Prior to November 2006, Champion Mortgage, a home equity finance business, also contributed to Key's home equity portfolio. In November 2006, Key sold the nonprime mortgage loan portfolio held by the Champion Mortgage finance business and announced a separate agreement to sell Champion's origination platform. The platform sale closed on February 28, 2007.

Figure 16 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 16. Home Equity Loans

<i>dollars in millions</i>	2007			2006	
	Second	First	Fourth	Third	Second
SOURCES OF LOANS					
OUTSTANDING					
Regional Banking	\$ 9,736	\$ 9,623	\$ 9,805	\$ 9,990	\$ 10,122
Champion Mortgage ^a					2,458
Home Equity Services unit	1,143	1,046	1,021	998	929
Total	\$ 10,879	\$ 10,669	\$ 10,826	\$ 10,988	\$ 13,509
Nonperforming loans at period end ^a	\$ 55	\$ 52	\$ 50	\$ 46	\$ 90
Net loan charge-offs for the period	6	7	6	4	7
Yield for the period ^b	7.22%	7.22%	7.22%	7.19%	7.02%

(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
the anticipated
November 29,
2006, sale of the
Champion
Mortgage
finance
business.

(b) From continuing
operations.

Loans held for sale. As shown in Note 6, Key's loans held for sale rose to \$4.5 billion at June 30, 2007, from \$3.6 billion at December 31, 2006, and \$4.2 billion at June 30, 2006, due primarily to originations in the commercial mortgage portfolio.

Sales and securitizations. Key continues to use alternative funding sources like loan sales and securitizations to support its loan origination capabilities. In addition, several acquisitions completed over the past several years have improved Key's 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 \$3.5 billion of commercial mortgage loans (\$238 million through a securitization), \$2.7 billion of home equity loans, \$1.3 billion of education loans (\$963 million through a securitization), \$427 million of residential real estate loans, \$300 million of commercial loans and leases, and \$90 million of consumer direct loans. Most of these sales came from the held-for-sale portfolio.

Table of Contents

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

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

Figure 17 summarizes Key's loan sales (including securitizations) for the first half of 2007 and all of 2006.

Figure 17. Loans Sold (Including Loans Held for Sale)

<i>in millions</i>	Commercial	Commercial Real Estate	Commercial Lease Financing	Residential Real Estate	Home Consumer Equity	Direct Education	Total
2007							
Second quarter	\$ 36	\$ 1,079	\$ 98	\$ 118		\$ 118	\$ 1,449
First quarter	15	688	5	100	\$ 233	\$ 90	1,192
Total	\$ 51	\$ 1,767	\$ 103	\$ 218	\$ 233	\$ 90	\$ 2,641
2006							
Fourth quarter	\$ 80	\$ 1,070	\$ 13	\$ 100	\$ 2,474	\$ 983	\$ 4,720
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	\$ 221	\$ 2,638	\$ 134	\$ 360	\$ 2,476	\$ 1,408	\$ 7,237

Figure 18 shows loans that are either administered or serviced by Key, but not recorded on the balance sheet. Included are loans that have been both securitized and sold, or simply sold outright.

Figure 18. Loans Administered or Serviced

<i>in millions</i>	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006	June 30, 2006
Commercial real estate loans ^a	\$ 121,384	\$ 108,303	\$ 93,611	\$ 81,873	\$ 78,348
Education loans	5,118	5,251	5,475	4,640	4,806
Home equity loans ^b			2,360	4	4
Commercial lease financing	529	458	479	479	479
Commercial loans	242	243	268	252	255

Total	\$ 127,273	\$ 114,255	\$ 102,193	\$ 87,248	\$ 83,892
-------	------------	------------	------------	-----------	-----------

(a) Key acquired the servicing for three commercial mortgage loan portfolios with an aggregate principal balance of \$6.4 billion, \$12.7 billion and \$9.0 billion for the second quarter 2007, first quarter 2007 and fourth quarter 2006, respectively.

(b) In November 2006, Key sold the \$2.5 billion nonprime mortgage loan portfolio held by the Champion Mortgage finance business but continued to provide servicing through various dates in March 2007.

In the event of default by a borrower, Key is subject to recourse with respect to approximately \$600 million of the \$127.3 billion of loans administered or serviced at June 30, 2007. 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 29.

Table of Contents

Key derives income from several sources when loans are securitized or sold, but Key retains the right to administer or service them. Key earns noninterest income (recorded as other income) from fees for servicing or administering loans. In addition, Key earns interest income from securitized assets retained and from lending 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 June 30, 2007, the securities portfolio totaled \$10.5 billion and included \$7.8 billion of securities available for sale, \$37 million of investment securities, \$994 million of trading account securities included in short-term investments on the balance sheet and \$1.6 billion of other investments (primarily principal investments). In comparison, the total portfolio at December 31, 2006, was \$10.1 billion, including \$7.8 billion of securities available for sale, \$41 million of investment securities, \$912 million of trading account securities and \$1.4 billion of other investments. At June 30, 2006, the securities portfolio totaled \$9.4 billion and included \$7.1 billion of securities available for sale, \$44 million of investment securities, \$803 million of trading account securities and \$1.4 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 June 30, 2007, Key had \$7.4 billion invested in CMOs and other mortgage-backed securities, compared to \$7.3 billion at December 31, 2006, and \$6.8 billion at June 30, 2006. Substantially all of Key's mortgage-backed securities are issued or backed by federal agencies.

Management periodically evaluates Key's securities available-for-sale portfolio in light of established asset/liability management objectives, and changing market conditions which could affect the profitability of the portfolio, as well as the level of interest rate risk to which Key is exposed. As a result of these evaluations, management may take steps to improve Key's overall balance sheet positioning.

In March 2007, management completed a comprehensive evaluation of the securities available-for-sale portfolio and determined that a repositioning of the portfolio was appropriate to enhance future financial performance, particularly in the event of a decline in interest rates. As a result, Key sold \$2.4 billion of shorter-maturity, agency-issued CMOs and reinvested the proceeds in agency-issued securities with higher yields and longer expected average maturities. The weighted-average yield of Key's available-for-sale portfolio increased from 4.78% at December 31, 2006, to 5.24% at June 30, 2007, and the weighted-average maturity of the portfolio increased from 2.6 years at December 31, 2006, to 3.3 years at June 30, 2007. The repositioning also served to reduce Key's exposure to prepayment risk in a declining interest rate scenario. This was accomplished by replacing the CMOs sold with those that have underlying mortgage loans with shorter maturities and lower coupon rates. Key continues to maintain a relatively neutral exposure to near-term changes in interest rates. Neither funding nor capital levels were affected materially by this portfolio repositioning.

As a result of the sale, Key recorded a loss of \$49 million (\$31 million after tax, \$0.08 per diluted common share) during the first quarter of 2007. This loss was previously recorded in net unrealized losses on securities available for sale in the accumulated other comprehensive loss component of shareholders' equity.

In addition to changing market conditions, the size and composition of Key's securities available-for-sale portfolio could vary with Key's needs for liquidity, and the extent to which Key is required (or elects) 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 risk profiles.

Table of Contents

Figure 19 shows the composition, yields and remaining maturities of Key's securities available for sale. For more information about Key's securities, including gross unrealized gains and losses by type of security, see Note 5 (Securities), which begins on page 18.

Figure 19. Securities Available for Sale

	U.S. Treasury, Agencies and Corporations	States and Political Subdivisions	Other Collateralized Mortgage Obligations ^a	Mortgage- Backed Securities	Retained Interests in Securitizations ^a	Other Securities ^b	Total	Weighted- Average Yield ^c
JUNE 30, 2007								
Remaining maturity:								
One year or less	\$ 4		\$ 3	\$ 4	\$ 3	\$ 71	\$ 85	5.53%
After one through five years	9	\$ 4	6,310	976	100	87	7,486	5.15
After five through ten years	4	4		122	90	3	223	8.28
After ten years	1	5		11		8	25	6.35
Fair value	\$ 18	\$ 13	\$ 6,313	\$ 1,113	\$ 193	\$ 169	\$ 7,819	
Amortized cost	18	13	6,421	1,133	146	150	7,881	5.24%
Weighted-average yield ^c	5.41%	8.20%	4.87%	5.16%	21.85%	5.62% ^d	5.24% ^d	
Weighted-average maturity	4.8 years	9.2 years	3.0 years	4.7 years	5.6 years	5.2 years	3.3 years	
DECEMBER 31, 2006								
Fair value	\$ 94	\$ 15	\$ 7,001	\$ 334	\$ 208	\$ 175	\$ 7,827	
Amortized cost	94	14	7,098	336	151	165	7,858	4.78%
JUNE 30, 2006								
Fair value	\$ 24	\$ 17	\$ 6,558	\$ 198	\$ 167	\$ 176	\$ 7,140	
Amortized cost	24	17	6,772	202	122	170	7,307	4.62%

(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 \$155 million at June 30, 2007, that have no stated yield.

Investment securities. Foreign bonds and securities issued by states and political subdivisions constitute most of Key's investment securities. Figure 20 shows the composition, yields and remaining maturities of these securities.

Figure 20. Investment Securities

<i>dollars in millions</i>	States and Political Subdivisions	Other Securities	Total	Weighted- Average Yield ^a
JUNE 30, 2007				
Remaining maturity:				
One year or less	\$ 8	\$ 5	\$ 13	6.89%
After one through five years	9	15	24	7.32
Amortized cost	\$ 17	\$ 20	\$ 37	7.15%
Fair value	17	20	37	
Weighted-average yield	8.40%	5.53% ^b	7.15% ^b	
Weighted-average maturity	1.5 years	2.1 years	1.8 years	
DECEMBER 31, 2006				
Amortized cost	\$ 20	\$ 21	\$ 41	7.05%
Fair value	21	21	42	
JUNE 30, 2006				
Amortized cost	\$ 29	\$ 15	\$ 44	7.23%
Fair value	30	15	45	

- (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%.

- (b) Excludes securities
of \$8 million at
June 30, 2007, that
have no stated
yield.

Table of Contents

For additional information pertaining to Key's trading account securities and other investments, see Note 5.

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 second quarter of 2007, core deposits averaged \$50.6 billion, and represented 62% of the funds Key used to support loans and other earning assets, compared to \$51.6 billion and 65% during the same quarter in 2006. The composition of Key's deposits is shown in Figure 7, which spans pages 46 and 47.

The decrease in the level of Key's average core deposits from the second quarter of 2006 was attributable in part to a shift from NOW and money market deposit accounts to higher-cost time deposits. This change reflects client preferences for higher-yielding investments in a changing interest rate environment. Additionally, as part of the February 2007 sale of the McDonald Investments branch network, Key transferred approximately \$1.3 billion of NOW and money market deposit accounts to the buyer. McDonald Investments' NOW and money market deposit accounts averaged \$1.5 billion for the second quarter of last year.

Average noninterest-bearing deposits increased from the year-ago quarter as a result of continued emphasis on cross-selling products, focused sales and marketing efforts related to Key's free checking products, and additional escrow deposits obtained in connection with the servicing of commercial real estate loans. Adjusting for the McDonald Investments sale, average core deposits were up approximately \$500 million from the second quarter of 2006.

Purchased funds, comprising large certificates of deposit, deposits in the foreign branch and short-term borrowings, averaged \$16.4 billion in the second quarter of 2007, compared to \$11.7 billion during the year-ago quarter. The increase was attributable to growth in large certificates of deposit, foreign branch deposits, and federal funds purchased and securities sold under repurchase agreements, offset in part by a decrease in bank notes and other short-term borrowings. During the first half of 2007, purchased funds were relied upon more heavily as a funding source in light of the core deposits transferred in connection with the McDonald Investments sale, and a temporary need for additional short-term funding to facilitate the repositioning of the securities portfolio. In addition, these funds were used to pay down long-term debt.

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

Capital

Shareholders' equity. Total shareholders' equity at June 30, 2007, was \$7.7 billion, down \$2 million from December 31, 2006.

Effective January 1, 2007, Key adopted FASB 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 affects when earnings from leveraged lease transactions will be recognized, and requires a lessor to recalculate its recognition of lease income when there are changes or projected changes in the timing of cash flows. As a result of adopting this guidance, Key recorded a cumulative after-tax charge of \$52 million to retained earnings during the first quarter. Future earnings are expected to increase over the remaining term of the affected leases by a similar amount. Additional information related to this new accounting guidance is included in Note 1 (*Basis of Presentation*) under the heading *Accounting Pronouncements Adopted in 2007* on page 8. See Note 12 (*Income Taxes*) under the heading *Tax-Related Accounting Pronouncements Adopted in 2007* on page 26 for a discussion of the potential impact of Staff Position No. 13-2 on Key in the event of an adverse outcome in the AWG leasing litigation, certain settlement scenarios and other factors.

Table of Contents

Other factors contributing to the change in shareholders' equity during the first half of 2007 are shown in the Consolidated Statements of Changes in Shareholders' Equity presented on page 5.

Changes in common shares outstanding. Figure 21 shows activities that caused the change in Key's outstanding common shares over the past five quarters.

Figure 21. Changes in Common Shares Outstanding

<i>in thousands</i>	2007			2006	
	Second	First	Fourth	Third	Second
Shares outstanding at beginning of period	394,483	399,153	402,748	402,672	405,273
Issuance of shares under employee benefit plans	879	3,330	1,405	2,576	1,399
Repurchase of common shares	(6,000)	(8,000)	(5,000)	(2,500)	(4,000)
Shares outstanding at end of period	389,362	394,483	399,153	402,748	402,672

Key repurchases its common shares periodically under a repurchase program authorized by the Board of Directors. Key's repurchase activity for each of the three months ended June 30, 2007, is summarized in Figure 22.

Figure 22. 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
April 1-30, 2007	2,800	\$ 36.38	2,800	19,200
May 1-31, 2007	3,200	36.31	3,200	16,000
June 1-30, 2007				16,000
Total	6,000	\$ 36.35	6,000	

(a) In January 2007, the Board of Directors authorized the repurchase of 25.0 million common shares, in addition to the shares remaining from a repurchase

program authorized in July 2004. This action brought the total repurchase authorization to 30.0 million shares. These shares may be repurchased in the open market or through privately-negotiated transactions. The program does not have an expiration date.

At June 30, 2007, Key had 102.5 million treasury shares. Management expects to reissue those shares as needed in connection with stock-based compensation awards and other corporate purposes. During the first half of 2007, Key reissued 4.2 million 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 8.19% at June 30, 2007, compared to 8.34% at December 31, 2006, and 8.16% at June 30, 2006. Key's ratio of tangible equity to tangible assets was 6.89% at June 30, 2007, above Key's targeted range of 6.25% to 6.75%. Management believes 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 88 of Key's 2006 Annual Report to Shareholders, explains the implications of failing to meet these specific capital requirements.

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 June 30, 2007, Key's Tier 1 capital ratio was 8.14%, and its total capital ratio was 12.15%.

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 June 30, 2007, Key had a leverage ratio of 9.11%.

Table of Contents

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 June 30, 2007, 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 also would qualify as well capitalized at June 30, 2007. 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 23 presents the details of Key's regulatory capital position at June 30, 2007, December 31, 2006, and June 30, 2006.

Figure 23. Capital Components and Risk-Weighted Assets

<i>dollars in millions</i>	June 30, 2007	December 31, 2006	June 30, 2006
TIER 1 CAPITAL			
Common shareholders' equity ^a	\$ 7,923	\$ 7,924	\$ 7,862
Qualifying capital securities	1,792	1,792	1,792
Less: Goodwill	1,202	1,202	1,372
Other assets ^b	177	176	182
Total Tier 1 capital	8,336	8,338	8,100
TIER 2 CAPITAL			
Allowance for losses on loans and liability for losses on lending-related commitments	995	997	1,015
Net unrealized gains on equity securities available for sale	8	5	3
Qualifying long-term debt	3,107	3,227	3,276
Total Tier 2 capital	4,110	4,229	4,294
Total risk-based capital	\$ 12,446	\$ 12,567	\$ 12,394
RISK-WEIGHTED ASSETS			
Risk-weighted assets on balance sheet	\$ 78,971	\$ 77,490	\$ 78,928
Risk-weighted off-balance sheet exposure	24,455	24,968	24,895
Less: Goodwill	1,202	1,202	1,372
Other assets ^b	755	819	761
Plus: Market risk-equivalent assets	962	698	899
Total risk-weighted assets	\$ 102,431	\$ 101,135	\$ 102,589
AVERAGE QUARTERLY TOTAL ASSETS	\$ 93,413	\$ 94,896	\$ 93,861
CAPITAL RATIOS			
Tier 1 risk-based capital ratio	8.14%	8.24%	7.90%
Total risk-based capital ratio	12.15	12.43	12.08

Leverage ratio ^c	9.11	8.98	8.82
(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), net gains or losses on cash flow hedges, or the amount resulting from the adoption and application of SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.			
(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:
- (i) goodwill,
 - (ii) the nonqualifying intangible assets described in footnote (b),
 - (iii) deductible portions of nonfinancial equity investments, and
 - (iv) net unrealized gains or losses on securities available for sale; plus assets derecognized as an offset to accumulated other comprehensive income resulting from the adoption and application of SFAS No. 158.

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

Like other financial services companies, Key engages in business activities with inherent risks. 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 facing Key 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 Risk Management committees whose appointed members help the Board meet its risk oversight responsibilities. The responsibilities of these two committees are summarized on page 47 of Key's 2006 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. Financial instruments also are susceptible to 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

Interest rate risk, which is inherent in the banking business, is measured by the potential for fluctuations in net interest income and the economic value of equity. Such fluctuations may result from changes in interest rates and differences in the repricing and maturity characteristics of interest-earning assets and interest-bearing liabilities. To minimize the volatility of net interest income and the economic value of equity, Key manages exposure to interest rate risk in accordance with guidelines established by the Asset/Liability Management Committee (ALCO). This committee, which consists of senior finance and business executives, meets monthly, and periodically reports Key's interest rate risk positions to the Risk Management Committee of the Board of Directors.

Interest rate risk positions can be influenced by a number of factors other than changes in market interest rates, including economic conditions, the competitive environment within Key's markets, consumer preferences for specific loan and deposit products, and the level of interest rate exposure arising from basis risk, gap risk, yield curve risk and option risk. Each of these types of risk is defined in the discussion of market risk management, which begins on page 47 of Key's 2006 Annual Report to Shareholders.

Net interest income simulation analysis. The primary tool used by management to measure Key's interest rate risk is a simulation analysis. For purposes of this analysis, management estimates Key's net interest income based on the composition of its balance sheet and the current interest rate environment. The simulation assumes that growth in the balance sheet will reflect recent product trends, as well as consensus economic forecasts.

The amount of net interest income at risk is measured by simulating the change in the level of net interest income that would occur if the Fed Funds Target rate were to gradually increase or decrease by 200 basis points over the next twelve months, and term rates were to move in a similar fashion, but not as dramatically. The amount of net interest income at risk is compared to the base case of an unchanged interest rate environment. The analysis also considers sensitivity to changes in a number of other variables, including product pricing assumptions and deposit mix. In addition, management assesses the potential

Table of Contents

effect of different shapes of the yield curve, including a sustained flat yield curve, an inverted slope yield curve and yield curve twists. (The yield curve depicts the relationship between the yield on a particular type of security and its term to maturity.) Management also performs stress tests to measure the effect on net interest income of an immediate change in market interest rates.

Simulation analysis produces only a sophisticated estimate of interest rate exposure based on assumptions and judgments related to balance sheet growth, customer behavior, new products, new business volume, pricing and anticipated hedging activities. Management tailors the assumptions used in simulation analysis to the specific interest rate environment and yield curve shape being modeled, and validates those assumptions on a periodic basis.

Consistent with current practice, simulations are performed with the assumption that interest rate risk positions will be actively managed through the use of on- and off-balance sheet financial instruments to achieve the desired risk profile. Actual results may differ from those derived in simulation analysis due to the timing, magnitude and frequency of interest rate changes, actual hedging strategies employed and changes in balance sheet composition. Figure 28 (Net Interest Income Volatility) on page 48 of Key's 2006 Annual Report to Shareholders illustrates the variability of simulation results that can arise from changing certain major assumptions.

Figure 24 presents the results of the simulation analysis at June 30, 2007 and 2006. At June 30, 2007, Key's simulated exposure to a rising interest rate environment was relatively neutral and exposure to a falling interest rate environment decreased from June 30, 2006. ALCO policy guidelines for risk management call for preventive measures if simulation modeling demonstrates that a gradual 200 basis point increase or decrease in short-term rates over the next twelve months would adversely affect net interest income over the same period by more than 2%. As shown in Figure 24, Key is operating within these guidelines.

Figure 24. Simulated Change in Net Interest Income

Basis point change assumption (short-term rates)	-200	+200
ALCO policy guidelines	-2.00%	-2.00%

INTEREST RATE RISK ASSESSMENT

June 30, 2007	+1.45%	-.32%
June 30, 2006	+.59	-.02

During the first half of 2006, Key's simulated exposure to a rising interest rate environment changed from modestly asset-sensitive to relatively neutral. Since July 2006, the Federal Reserve has held short-term interest rates constant, and there is uncertainty with regard to the future direction of these rates. Accordingly, management has taken action to maintain a relatively neutral position. Key's long term bias is to be modestly liability-sensitive, which will help protect net interest income in a declining interest rate environment.

Management also conducts simulations that measure the effect of changes in market interest rates in the second year of a two-year horizon. These simulations are conducted in a manner similar to those based on a twelve-month horizon. To capture longer-term exposures, management simulates changes to the economic value of equity as discussed below.

Economic value of equity modeling. Economic value of equity (EVE) measures the extent to which the economic values of assets, liabilities and off-balance sheet instruments may change in response to changes in interest rates. EVE is calculated by subjecting the balance sheet to an immediate 200 basis point increase or decrease in interest rates, and measuring the resulting change in the values of assets and liabilities. This analysis is highly dependent upon assumptions applied to assets and liabilities with noncontractual maturities. Those assumptions are based on historical behaviors, as well as management's expectations. EVE complements net interest income simulation analysis since it provides estimates of risk exposure beyond twelve and twenty-four month horizons. Management takes preventative measures to ensure that Key's EVE will not decrease by more than 15% in response to an immediate 200 basis point increase or decrease in interest rates. Key is operating within these guidelines.

Table of Contents

Management of interest rate exposure. Management uses the results of its various simulation analyses to formulate strategies to achieve the desired risk profile within the parameters of Key's capital and liquidity guidelines. Interest rate risk positions are actively managed through the purchase of investment securities, the issuance of term debt with floating or fixed interest rates, and the use of derivatives—predominantly in the form of interest rate swaps. These swaps modify the interest rate characteristics of certain assets and liabilities by converting them from a fixed rate to a floating rate, from a floating rate to a fixed rate, or from one floating index to another. Figure 25 shows the maturity structure for all swap positions held for asset/liability management (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 converted to a 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 25. Portfolio Swaps by Interest Rate Risk Management Strategy

<i>dollars in millions</i>	June 30, 2007				June 30, 2006		
	Notional Amount	Fair Value	Maturity (Years)	Weighted-Average Rate Receive	Pay	Notional Amount	Fair Value
Receive fixed/pay variable conventional A/LM ^a	\$ 7,638	\$ (26)	1.4	5.2%	5.3%	\$ 5,900	\$ (40)
Receive fixed/pay variable conventional debt	5,163	(172)	16.0	5.4	5.5	6,333	(160)
Receive fixed/pay variable forward starting	3,800	(35)	2.7	5.0	5.1		
Pay fixed/receive variable conventional debt	920	3	4.6	5.3	4.5	955	5
Foreign currency conventional debt	3,073	215	3.1	4.5	5.5	2,730	5
Basis swaps ^b						500	
Total portfolio swaps	\$ 20,594	\$ (15)	5.7	5.1%	5.3%	\$ 16,418	\$ (190)

(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.

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 maximum 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 Key's trading units. At June 30, 2007, 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 six months of 2007, Key's aggregate daily average, minimum and maximum VAR amounts were \$1.1 million, \$.7 million and \$1.8 million, respectively. During the same period last year, Key's aggregate daily average, minimum and maximum VAR amounts were \$1.4 million, \$.7 million and \$2.6 million, respectively.

Table of Contents**Credit risk management**

Credit risk is the risk of loss arising from an obligor's inability or failure to meet contractual payment or performance terms. Like other financial service institutions, Key makes loans, extends credit, purchases securities and enters into financial derivative contracts, all of which expose Key to credit risk.

Credit policy, approval and evaluation. Key manages credit risk exposure through a multi-faceted program. Independent committees approve both retail and commercial credit policies. These policies are communicated throughout Key to foster a consistent 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," on page 50 of Key's 2006 Annual Report to Shareholders.

Key actively manages the overall loan portfolio in a manner consistent with asset quality objectives. This process entails the use of credit derivatives ³/₄ primarily credit default swaps ³/₄ to mitigate Key's credit risk. Credit default swaps enable Key to transfer a portion of the credit risk associated with the underlying extension of credit to a third party, and to manage portfolio concentration and correlation risks. At June 30, 2007, credit default swaps with a notional amount of \$1.1 billion were used to manage the credit risk associated with specific commercial lending obligations. Key also provides credit protection to other lenders through the sale of credit default swaps. These transactions may generate fee income and can diversify overall exposure to credit loss. At June 30, 2007, the notional amount of credit default swaps sold by Key was \$50 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 six-month period ended June 30, 2007.

Other actions used to manage the loan portfolio include loan securitizations, portfolio swaps, or bulk purchases and sales. The overarching goal is to continually manage the loan portfolio within a desirable range of asset quality.

Watch and criticized assets. *Watch assets* are troubled commercial 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 underlying contract. *Criticized assets* are troubled loans and other assets that show additional signs of weakness that may lead, or have led, to an interruption in scheduled repayments from primary sources, potentially requiring Key to rely on repayment from secondary sources, such as collateral liquidation.

At June 30, 2007, the level of both watch assets and criticized commitments was higher than that experienced a year earlier. These increases were attributable to a number of client segments across a range of loan portfolios; most notably Real Estate Capital and Commercial Floor Plan. The increase in criticized commitments was offset in part by the favorable settlement of the automobile residual value insurance litigation, in which the related receivable was eliminated during the first quarter of 2007. Management continues to closely monitor fluctuations in Key's watch assets and criticized commitments.

Allowance for loan losses. The allowance for loan losses at June 30, 2007, was \$945 million, or 1.42% of loans, compared to \$944 million, or 1.43%, at December 31, 2006, and \$956 million, or 1.42%, at June 30, 2006. The allowance includes \$23 million that was specifically allocated for impaired loans of \$53 million at June 30, 2007, compared to \$14 million that was allocated for impaired loans of \$34 million at December 31, 2006, and \$8 million that was allocated for impaired loans of \$26 million one year ago. For more information about impaired loans, see Note 9 ("Nonperforming Assets and Past Due Loans") on page 23. At June 30, 2007, the allowance for loan losses was 342.39% of nonperforming loans, compared to 342.65% at June 30, 2006.

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 69 of Key's 2006 Annual Report to Shareholders. Briefly, management estimates the appropriate level of Key's allowance for loan losses 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, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. For an impaired loan, special treatment exists if the outstanding balance is greater than \$2.5 million and the resulting allocation is deemed insufficient to cover the extent of the impairment. In such cases, a specific allowance is assigned to the loan. A specific allowance may be assigned even when sources of repayment appear sufficient if management remains uncertain about whether the loan will be repaid in full. The aggregate balance of the allowance for loan losses at June 30, 2007, represents management's best estimate of the losses inherent in the loan portfolio at that date.

As shown in Figure 26, Key's allowance for loan losses decreased by \$11 million, or 1%, during the past twelve months. This reduction was attributable to a decrease in the allowance allocated to the consumer loan portfolio, due largely to 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 the anticipated November 29, 2006, sale of the Champion Mortgage finance business. The reduction in the allowance allocated to the consumer portfolio was offset in part by increases in the level of allowance allocated to the commercial mortgage and construction components of the commercial loan portfolio.

Figure 26. Allocation of the Allowance for Loan Losses

	June 30, 2007			December 31, 2006			June 30, 2006		
	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	Percent of Allowance to Total Amount	Percent of Loan Type to Total Loans	
Commercial, financial and agricultural	\$ 357	37.8%	32.7%	\$ 341	36.1%	32.5%	\$ 363	38.0%	32.0%
Real estate commercial mortgage	169	17.9	13.0	170	18.0	12.8	158	16.5	11.9
Real estate construction	135	14.3	12.3	132	14.0	12.5	104	10.9	11.5
Commercial lease financing	127	13.4	15.2	139	14.7	15.6	145	15.1	14.7
Total commercial loans	788	83.4	73.2	782	82.8	73.4	770	80.5	70.1
Real estate residential mortgage	12	1.3	2.4	12	1.3	2.2	13	1.4	2.1
Home equity	75	7.9	16.3	74	7.8	16.4	99	10.4	20.0
Consumer direct	31	3.3	2.0	29	3.1	2.3	28	2.9	2.5
Consumer indirect	39	4.1	6.1	47	5.0	5.7	46	4.8	5.3
	157	16.6	26.8	162	17.2	26.6	186	19.5	29.9

Total consumer
loans

Total	\$ 945	100.0%	100.0%	\$ 944	100.0%	100.0%	\$ 956	100.0%	100.0%
-------	--------	--------	--------	--------	--------	--------	--------	--------	--------

Net loan charge-offs. Net loan charge-offs for the second quarter of 2007 were \$53 million, or .32% of average loans from continuing operations. These results compare to net charge-offs of \$34 million, or .22%, for the same period last year. The composition of Key's loan charge-offs and recoveries by loan type is shown in Figure 27. The largest increases in net charge-offs occurred in the commercial and commercial lease financing portfolios.

Table of Contents**Figure 27. Summary of Loan Loss Experience**

<i>dollars in millions</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Average loans outstanding from continuing operations	\$ 66,315	\$ 64,996	\$ 65,994	\$ 64,610
Allowance for loan losses at beginning of period	\$ 944	\$ 966	\$ 944	\$ 966
Loans charged off:				
Commercial, financial and agricultural	30	20	47	44
Real estate commercial mortgage	5	3	11	6
Real estate construction	2		3	2
Total commercial real estate loans ^a	7	3	14	8
Commercial lease financing	9	8	22	14
Total commercial loans	46	31	83	66
Real estate residential mortgage	1	2	2	3
Home equity	8	8	16	16
Consumer direct	8	9	15	19
Consumer indirect	9	9	20	20
Total consumer loans	26	28	53	58
	72	59	136	124
Recoveries:				
Commercial, financial and agricultural	6	7	13	19
Real estate commercial mortgage ^b	1		4	1
Commercial lease financing	4	9	7	14
Total commercial loans	11	16	24	34
Real estate residential mortgage	1	1	1	1
Home equity	2	1	3	3
Consumer direct	1	2	3	4
Consumer indirect	4	5	8	9
Total consumer loans	8	9	15	17
	19	25	39	51
Net loan charge-offs	(53)	(34)	(97)	(73)
Provision for loan losses from continuing operations	53	23	97	62
Provision for loan losses from discontinued operations		1		1

Foreign currency translation adjustment	1		1	
Allowance for loan losses at end of period	\$ 945	\$ 956	\$ 945	\$ 956
Net loan charge-offs to average loans from continuing operations	.32%	.22%	.30%	.23%
Allowance for loan losses to period-end loans	1.42	1.42	1.42	1.42
Allowance for loan losses to nonperforming loans	342.39	342.65	342.39	342.65

(a) See Figure 15 and the accompanying discussion on page 53 for more information related to Key's commercial real estate portfolio.

Nonperforming assets. Figure 28 shows the composition of Key's nonperforming assets. These assets totaled \$378 million at June 30, 2007, and represented .57% of loans, other real estate owned (known as OREO) and other nonperforming assets, compared to \$273 million, or .41%, at December 31, 2006, and \$308 million, or .46%, at June 30, 2006.

As shown in Figure 28, the growth in nonperforming assets over the past twelve months was attributable to an increase in other nonperforming assets. The increase in other nonperforming assets was due primarily to two investments held by the Private Equity unit within Key's Real Estate Capital line of business. The level of Key's nonperforming loans was essentially unchanged from the prior year as the increase in commercial loans on nonperforming status was offset by a reduction in the level of nonperforming loans within the home equity portfolio. The decrease in nonperforming home equity loans was attributable to the November 2006 sale of the nonprime mortgage loan portfolio held by the Champion Mortgage finance business.

Table of Contents

At June 30, 2007, Key s 20 largest nonperforming loans totaled \$108 million, representing 39% of total loans on nonperforming status.

Figure 28. Summary of Nonperforming Assets and Past Due Loans

<i>dollars in millions</i>	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006	June 30, 2006
Commercial, financial and agricultural	\$ 83	\$ 70	\$ 38	\$ 42	\$ 76
Real estate commercial mortgage	41	44	48	36	35
Real estate construction	23	10	10	37	4
Total commercial real estate loans ^a	64	54	58	73	39
Commercial lease financing	34	31	22	20	29
Total commercial loans	181	155	118	135	144
Real estate residential mortgage	27	32	34	34	36
Home equity ^b	55	52	50	46	90
Consumer direct	2	2	2	2	3
Consumer indirect	11	13	11	6	6
Total consumer loans	95	99	97	88	135
Total nonperforming loans	276	254	215	223	279
Nonperforming loans held for sale ^b	4	3	3	56	1
OREO	27	42	57	52	26
Allowance for OREO losses	(2)	(2)	(3)	(3)	(1)
OREO, net of allowance	25	40	54	49	25
Other nonperforming assets	73 ^c	56 ^d	1	1	3
Total nonperforming assets	\$ 378	\$ 353	\$ 273	\$ 329	\$ 308
Accruing loans past due 90 days or more	\$ 181	\$ 146	\$ 120	\$ 125	\$ 119
Accruing loans past due 30 through 89 days	623	626	644	715	600
Nonperforming loans to period-end portfolio loans	.41%	.39%	.33%	.34%	.41%
Nonperforming assets to period-end portfolio loans plus OREO and other nonperforming assets	.57	.54	.41	.50	.46

- (a) See Figure 15 and the accompanying discussion on page 53 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 the anticipated November 29, 2006, sale of the Champion Mortgage finance business.
- (c) Primarily investments, including two investments totaling approximately \$68 million, held by the Private Equity unit within Key's Real Estate Capital line of business.
- (d) Primarily investments, including one investment of

approximately
\$51 million,
held by the
Private Equity
unit within Key s
Real Estate
Capital line of
business.

Credit exposure by industry classification in the largest sector of Key s loan portfolio, commercial, financial and agricultural loans, is presented in Figure 29. The types of activity that caused the change in Key s nonperforming loans during each of the last five quarters are summarized in Figure 30.

67

Table of Contents**Figure 29. Commercial, Financial and Agricultural Loans**

June 30, 2007	Total Commitments^a	Loans Outstanding	Amount Outstanding	Nonperforming Loans % of Loans
<i>dollars in millions</i>				
Industry classification:				
Manufacturing	\$ 10,451	\$ 3,672	\$ 33	.9%
Services	9,653	2,878	7	.2
Retail trade	6,291	3,452	4	.1
Public utilities	3,750	596	1	.2
Financial services	3,672	1,263	1	.1
Wholesale trade	3,330	1,510	1	.1
Property management	2,985	1,344		
Insurance	2,524	145		
Building contractors	2,351	1,030	8	.8
Transportation	2,148	1,554	19	1.2
Mining	911	406		
Agriculture/forestry/fishing	905	525	2	.4
Public administration	821	322		
Communications	774	274		
Individuals	25	15		
Other	3,382	2,828	7	.2
Total	\$ 53,973	\$ 21,814	\$ 83	.4%

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

Figure 30. Summary of Changes in Nonperforming Loans

<i>in millions</i>	2007			2006	
	Second	First	Fourth	Third	Second
Balance at beginning of period	\$ 254	\$ 215	\$ 223	\$ 279	\$ 295
Loans placed on nonaccrual status	130	129	115	134	98
Charge-offs	(72)	(61)	(74)	(70)	(59)
Loans sold	(7)		(5)	(22)	(6)
Payments	(21)	(7)	(23)	(43)	(45)
Transfer to held-for-sale portfolio ^a				(55)	
Transfers to OREO		(9)	(12)		(4)
Loans returned to accrual status	(8)	(13)	(9)		
Balance at end of period	\$ 276	\$ 254	\$ 215	\$ 223	\$ 279

- (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 the 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 liquidity. As part of the management process, Key's management has 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, management assesses Key's needs for future reliance on wholesale borrowings

Table of Contents

and then develops 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 retains 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.

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 31 on page 71, have a direct impact on Key's cost of funds and ability to raise funds under normal as well as adverse conditions. The results of the 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 to Key's 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 fluctuations on the balance sheet would be managed. Key actively manages several alternatives for enhancing liquidity, including generating client deposits, securitizing or selling loans, extending the maturity of wholesale borrowings, purchasing deposits from other banks, and developing relationships with fixed income investors. Management also measures Key's capacity to borrow using various debt instruments and funding markets.

Key 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 June 30, 2007.

Key monitors its funding sources and measures its capacity to obtain funds in a variety of wholesale funding markets in an effort to maintain an appropriate mix of funds, considering both cost and availability. Key uses several tools as described on page 55 of the 2006 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, 2005, prepayments and maturities of securities available for sale have been the primary sources of cash from investing activities. Securities sold in connection with the repositioning of the securities portfolio also provided significant cash inflow during the first quarter of 2007.

Investing activities that have required the greatest use of cash include lending and purchases of new securities. Key utilizes financing activities to meet the cash flow needs generated by operating and investing activities that cannot be met by deposit growth. These cash needs may be addressed by increasing short- and/or long-term borrowings. Conversely, excess cash generated by operating, investing and deposit-gathering activities may be used to repay outstanding debt.

Table of Contents

In 2006, cash generated by the sale of discontinued operations was used to pay down short-term borrowings. During the first half of 2007, short-term borrowings were used to pay down long-term debt.

The Consolidated Statements of Cash Flows on page 6 summarize Key's sources and uses of cash by type of activity for the six-month periods ended June 30, 2007 and 2006.

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.

Management's primary tool for assessing parent company liquidity is the 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. Key generally relies 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 six months of 2007, KBNA paid the parent a total of \$500 million in dividends, and nonbank subsidiaries paid the parent a total of \$218 million in dividends. As of the close of business on June 30, 2007, KBNA had an additional \$128 million available to pay dividends to the parent without prior regulatory approval and without affecting its status as well-capitalized under 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 June 30, 2007, the parent company held \$2.1 billion in short-term investments, which management projected to be sufficient to meet debt repayment obligations over a period of approximately 26 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 six months of 2007, there were no notes issued under this program. At June 30, 2007, \$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 or foreign currencies. During the first six months of 2007, there were no notes issued under this program. At June 30, 2007, \$6.9 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 six months of 2007, there were no notes issued under this program. At June 30, 2007, unused capacity under this shelf 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 June 30, 2007, 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 June 30, 2007, borrowings outstanding under this commercial paper program totaled C\$395 million in Canadian currency and \$126 million in U.S. currency (equivalent to C\$134 million in Canadian currency).

Key's debt ratings are shown in Figure 31 below. 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 31. Debt Ratings

June 30, 2007	Short-Term Borrowings	Senior Long-Term Debt	Subordinated Long-Term Debt	Capital Securities	Enhanced Trust Preferred Securities
KeyCorp (the parent company)					
Standard & Poor's	A-2	A-	BBB+	BBB	BBB
Moody's	P-1	A2	A3	A3	A3
Fitch	F1	A	A-	A-	A-
KBNA					
Standard & Poor's	A-1	A	A-	N/A	N/A
Moody's	P-1	A1	A2	N/A	N/A
Fitch	F1	A	A-	N/A	N/A
Key Nova Scotia Funding Company (KNSF)					
Dominion Bond Rating Service ^a	R-1 (middle)	N/A	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 is 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, 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 page 57 of Key's 2006 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. These actions did not 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 agreed to continue

to strengthen its anti-money laundering and other compliance controls. As such, management has taken actions to provide enhanced training for employees, upgrade client due diligence procedures and employ advanced technologies. As a result of progress made in this regard, during the second quarter of 2007, both the FRBC and the OCC removed the regulatory agreements with Key.

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, and in the Lease Financing Transactions section of Note 12 (Income Taxes), which begins on page 25 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 22 on page 59 of the Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 4. Submission of Matters to a Vote of Security Holders

At the 2007 Annual Meeting of Shareholders of KeyCorp held on May 10, 2007, the shareholders elected four directors to serve for three-year terms expiring in 2010, amended the Code of Regulations to reduce the size of the Board of Directors to no fewer than twelve and no more than sixteen directors, proposed the annual election of all directors and ratified the appointment by the Audit Committee of the Board of Directors of Ernst & Young LLP as independent auditors of KeyCorp for the year ending December 31, 2007. Director nominees for terms expiring in 2010 were: Alexander M. Cutler, Eduardo R. Menascé, Henry L. Meyer III and Peter G. Ten Eyck, II. Directors whose terms in office as directors continued after the Annual Meeting of Shareholders were: Ralph Alvarez, William G. Bares, Edward P. Campbell, Carol A. Cartwright, H. James Dallas, Charles R. Hogan, Lauralee E. Martin, Bill R. Sanford and Thomas C. Stevens.

Table of Contents

The vote on each issue was as follows:

	For	Against	Abstain
Election of Directors			
Alexander M. Cutler	329,545,239	*	13,661,550
Eduardo R. Menascé	330,886,862	*	12,319,926
Henry L. Meyer III	328,626,659	*	14,600,433
Peter G. Ten Eyck, II	326,690,241	*	16,536,851
Amendment to the Code of Regulations to reduce the size of the Board of Directors to no fewer than twelve and no more than sixteen directors	336,243,460	3,199,994	3,783,158
Shareholder proposal regarding annual election of all Directors	180,399,356	99,328,763	5,517,209**
Ratification of the appointment of Ernst & Young LLP as Independent Auditors of KeyCorp	333,114,607	7,447,211	2,664,773

* Proxies provide that shareholders may either cast a vote for, or abstain from voting for, directors.

** In addition, there were 57,961,584 broker nonvotes on this matter.

Item 6. Exhibits

3.1 Amended and Restated Code of Regulations.

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: August 7, 2007

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

74