KEYCORP /NEW/
Form 10-Q
November 01, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

Form 10-Q

[ü] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2012

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

KeyCorp

(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) 689-3000

(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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No ¨

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

Large accelerated filer þ	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No þ

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	933,646,295 Shares
(Title of class)	(Outstanding at October 31, 2012)

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KEYCORP

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets

in millions, except per share data	September 30, 2012 (Unaudited)	December 31, 2011	September 30, 2011 (Unaudited)
ASSETS			
Cash and due from banks	**$ 974**	$ 694	$ 828
Short-term investments	**2,208**	3,519	4,766
Trading account assets	**663**	623	729
Securities available for sale	**11,962**	16,012	17,612
Held-to-maturity securities (fair value: $4,212, $2,133 and $1,186)	**4,153**	2,109	1,176
Other investments	**1,106**	1,163	1,210
Loans, net of unearned income of $980, $1,388 and $1,413	**51,419**	49,575	48,195
Less: Allowance for loan and lease losses	**888**	1,004	1,131
Net loans	**50,531**	48,571	47,064
Loans held for sale	**628**	728	479
Premises and equipment	**942**	944	924
Operating lease assets	**290**	350	393
Goodwill	**979**	917	917
Other intangible assets	**182**	17	18
Corporate-owned life insurance	**3,309**	3,256	3,227
Derivative assets	**771**	945	940
Accrued income and other assets (including $59 of consolidated LIHTC guaranteed funds VIEs, see Note 9)[a]	**2,871**	3,077	2,946
Discontinued assets (including $2,542 of consolidated education loan securitization trust VIEs (see Note 9) and $71 of loans in portfolio at fair value)[a]	**5,381**	5,860	6,033
Total assets	**$ 86,950**	$ 88,785	$ 89,262
LIABILITIES			
Deposits in domestic offices:			
NOW and money market deposit accounts	**$ 30,573**	$ 27,954	$ 27,548
Savings deposits	**2,393**	1,962	1,968
Certificates of deposit ($100,000 or more)	**3,226**	4,111	4,457
Other time deposits	**4,941**	6,243	6,695
Total interest-bearing	**41,133**	40,270	40,668
Noninterest-bearing	**22,486**	21,098	19,803
Deposits in foreign office interest-bearing	**569**	588	561
Total deposits	**64,188**	61,956	61,032
Federal funds purchased and securities sold under repurchase agreements	**1,746**	1,711	1,728
Bank notes and other short-term borrowings	**388**	337	519
Derivative liabilities	**657**	1,026	1,141
Accrued expense and other liabilities	**1,238**	1,763	1,556
Long-term debt	**6,119**	9,520	10,717
Discontinued liabilities (including $2,335 of consolidated education loan securitization trust VIEs at fair value, see Note 9)[a]	**2,335**	2,550	2,651
Total liabilities	**76,671**	78,863	79,344

EQUITY			
Preferred stock, $1 par value, authorized 25,000,000 shares:			
7.75% Noncumulative Perpetual Convertible Preferred Stock, Series A, $100 liquidation preference; authorized 7,475,000 shares; issued 2,904,839, 2,904,839 and 2,904,839 shares	**291**	291	291
Common shares, $1 par value; authorized 1,400,000,000 shares; issued 1,016,969,905, 1,016,969,905 and 1,016,969,905 shares	**1,017**	1,017	1,017
Capital surplus	**4,118**	4,194	4,191
Retained earnings	**6,762**	6,246	6,079
Treasury stock, at cost (80,775,030, 63,962,113 and 64,161,618)	**(1,868)**	(1,815)	(1,820)
Accumulated other comprehensive income (loss)	**(69)**	(28)	143
Key shareholders equity	**10,251**	9,905	9,901
Noncontrolling interests	**28**	17	17
Total equity	**10,279**	9,922	9,918
Total liabilities and equity	**$ 86,950**	$ 88,785	$ 89,262

(a) The assets of the VIEs can only be used by the particular VIE and there is no recourse to Key with respect to the liabilities of the consolidated LIHTC or education loan securitization trust VIEs.

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Income (Unaudited)

dollars in millions, except per share amounts	Three months ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
INTEREST INCOME				
Loans	**$ 538**	$ 543	**$ 1,592**	$ 1,664
Loans held for sale	**5**	3	**15**	10
Securities available for sale	**93**	140	**314**	455
Held-to-maturity securities	**21**	2	**50**	3
Trading account assets	**4**	5	**15**	21
Short-term investments	**1**	3	**4**	5
Other investments	**9**	9	**27**	33
Total interest income	**671**	705	**2,017**	2,191
INTEREST EXPENSE				
Deposits	**60**	95	**208**	305
Federal funds purchased and securities sold under repurchase agreements	**1**	1	**3**	4
Bank notes and other short-term borrowings	**1**	3	**5**	9
Long-term debt	**37**	57	**138**	163
Total interest expense	**99**	156	**354**	481
NET INTEREST INCOME	**572**	549	**1,663**	1,710
Provision (credit) for loan and lease losses	**109**	10	**172**	(38)
Net interest income (expense) after provision for loan and lease losses	**463**	539	**1,491**	1,748
NONINTEREST INCOME				
Trust and investment services income	**106**	107	**317**	330
Service charges on deposit accounts	**74**	74	**212**	211
Operating lease income	**17**	30	**59**	97
Letter of credit and loan fees	**52**	55	**162**	157
Corporate-owned life insurance income	**26**	31	**86**	86
Net securities gains (losses)[a]				1
Electronic banking fees	**18**	33	**54**	96
Gains on leased equipment	**46**	7	**109**	16
Insurance income	**13**	13	**36**	42
Net gains (losses) from loan sales	**39**	18	**93**	48
Net gains (losses) from principal investing	**11**	34	**70**	86
Investment banking and capital markets income (loss)	**38**	25	**118**	110
Other income	**104**	56	**185**	114
Total noninterest income	**544**	483	**1,501**	1,394
NONINTEREST EXPENSE				
Personnel	**411**	382	**1,185**	1,133
Net occupancy	**65**	65	**191**	192
Operating lease expense	**13**	23	**45**	76
Computer processing	**43**	40	**127**	124
Business services and professional fees	**49**	47	**138**	129
FDIC assessment	**7**	7	**23**	45
OREO expense, net	**1**	1	**14**	8
Equipment	**27**	26	**80**	78
Marketing	**18**	16	**48**	36
Provision (credit) for losses on lending-related commitments	**(8)**	(1)	**(2)**	(17)
Intangible asset amortization on credit cards	**6**		**6**	
Other intangible asset amortization	**3**	1	**5**	3
Other expense	**99**	85	**291**	266

Total noninterest expense		**734**		692		**2,151**		2,073
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES		**273**		330		**841**		1,069
Income taxes		**52**		95		**184**		300
INCOME (LOSS) FROM CONTINUING OPERATIONS		**221**		235		**657**		769
Income (loss) from discontinued operations, net of taxes of $-, ($11), $3 and ($23) (see Note 11)				(17)		**5**		(37)
NET INCOME (LOSS)		**221**		218		**662**		732
Less: Net income (loss) attributable to noncontrolling interests		**2**		1		**7**		12
NET INCOME (LOSS) ATTRIBUTABLE TO KEY	**$**	**219**	$	217	**$**	**655**	$	720
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**214**	$	229	**$**	**634**	$	656
Net income (loss) attributable to Key common shareholders		**214**		212		**639**		619
Per common share:								
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**.23**	$	.24	**$**	**.67**	$	.71
Income (loss) from discontinued operations, net of taxes				(.02)		**.01**		(.04)
Net income (loss) attributable to Key common shareholders [b]		**.23**		.22		**.68**		.67
Per common share assuming dilution:								
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**.23**	$	.24	**$**	**.67**	$	.71
Income (loss) from discontinued operations, net of taxes				(.02)		**.01**		(.04)
Net income (loss) attributable to Key common shareholders [b]		**.23**		.22		**.67**		.67
Cash dividends declared per common share	**$**	**.05**	$	.03	**$**	**.13**	$	.07
Weighted-average common shares outstanding (000) [c]		**936,223**		948,702		**943,378**		926,298
Weighted-average common shares and potential common shares outstanding (000)		**940,764**		950,686		**947,582**		930,449

(a) For the three months ended September 30, 2012 and 2011, we did not have any impairment losses related to securities.

(b) Earnings per share may not foot due to rounding.

(c) Assumes conversion of stock options and/or Preferred Series A, as applicable.
See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Comprehensive Income (Unaudited)

in millions	Three months ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
Net income (loss)	**$ 221**	$ 218	**$ 662**	$ 732
Other comprehensive income (loss):				
Net unrealized gains (losses) on securities available for sale, net of income taxes of ($17), $32, ($48), and $93	**(28)**	54	**(81)**	157
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of $12, ($7), $17, and ($3)	**20**	(13)	**28**	(6)
Foreign currency translation adjustments	**9**	(8)	**5**	5
Net pension and postretirement benefit costs, net of income taxes	**2**	1	**7**	4
Other comprehensive income (loss), net of tax:	**224**	252	**621**	892
Net contribution from (distribution to) noncontrolling interests	**5**	(13)	**4**	(252)
Total comprehensive income (loss) attributable to Key	**$ 229**	$ 239	**$ 625**	$ 640

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Changes in Equity (Unaudited)

					Key Shareholders Equity					
dollars in millions, except per share amounts	**Preferred Shares Outstanding (000)**	**Common Shares Outstanding (000)**	**Preferred Stock**	**Common Shares**	**Common Stock Warrant**	**Capital Surplus**	**Retained Earnings**	**Treasury Stock, at Cost**	**Accumulated Other Comprehensive Income (Loss)**	**Noncontrolling Interests**
BALANCE AT DECEMBER 31, 2010	2,930	880,608	$ 2,737	$ 946	$ 87	$ 3,711	$ 5,557	$ (1,904)	$ (17)	$ 257
Correction of an error in cumulative effective adjustment							(30) [a]			
Net income (loss)							720			12
Other comprehensive income (loss):										
Net unrealized gains (losses) on securities available for sale, net of income taxes of $93									157	
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of $(3)									(6)	
Net distribution to noncontrolling interests										(252)
Foreign currency translation adjustments									5	
Net pension and postretirement benefit costs, net of income taxes									4	
Deferred compensation						(2)				
Cash dividends declared on common shares ($.07 per share)							(67)			
Cash dividends declared on Noncumulative Series A Preferred Stock ($5.8125 per share)							(17)			
Cash dividends accrued on Cumulative Series B Preferred Stock (5% per annum)							(31)			
Series B Preferred Stock - TARP redemption	(25)		(2,451)				(49)			
Repurchase of common stock warrant					(87)	17				
Amortization of discount on Series B Preferred Stock			4				(4)			
Common shares issuance		70,621		71		533				
Common shares reissued for stock options and other employee benefit plans		1,579				(68)		84		
Other			1							
BALANCE AT SEPTEMBER 30, 2011	2,905	952,808	$ 291	$ 1,017		$ 4,191	$ 6,079	$ (1,820)	$ 143	$ 17
BALANCE AT DECEMBER 31, 2011	2,905	953,008	$ 291	$ 1,017		$ 4,194	$ 6,246	$ (1,815)	$ (28)	$ 17
Net income (loss)							655			7

Other comprehensive income (loss):									
Net unrealized gains (losses) on securities available for sale, net of income taxes of $(48)								(81)	
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of $17								28	
Net contribution from noncontrolling interests									4
Foreign currency translation adjustments								5	
Net pension and postretirement benefit costs, net of income taxes								7	
Deferred compensation					10				
Cash dividends declared on common shares ($.13 per share)						(123)			
Cash dividends declared on Noncumulative Series A Preferred Stock ($5.8125 per share)						(16)			
Common shares repurchased		(20,107)					(163)		
Common shares reissued (returned) for stock options and other employee benefit plans		3,294			(86)		110		
BALANCE AT SEPTEMBER 30, 2012	2,905	936,195	$ 291	$ 1,017	$ 4,118	$ 6,762	$ (1,868)	$ (69)	$ 28

(a) Corrected the cumulative effective adjustment made to beginning retained earnings on January 1, 2010 related to the consolidation of the student loan securitization trusts in discontinued operations. See Note 11 (Acquisitions and Discontinued Operations) for more information.

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Cash Flows (Unaudited)

in millions	Nine months ended September 30, 2012	2011
OPERATING ACTIVITIES		
Net income (loss)	**$ 662**	$ 732
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Provision (credit) for loan and lease losses	**172**	(38)
Depreciation, amortization, and accretion, net	**178**	208
FDIC (payments) net of FDIC expense	**19**	41
Deferred income taxes (benefit)	**36**	(261)
Net losses (gains) and writedown on OREO	**12**	6
Provision (credit) for customer derivative losses	**5**	(12)
Net losses (gains) from loan sales	**(93)**	(48)
Net losses (gains) from principal investing	**(70)**	(86)
Provision (credit) for losses on lending-related commitments	**2**	(17)
(Gains) losses on leased equipment	**(109)**	(16)
Net securities losses (gains)		(1)
Net decrease (increase) in loans held for sale excluding loan transfers from continuing operations	**23**	66
Net decrease (increase) in trading account assets	**(40)**	256
Other operating activities, net	**(141)**	1,045
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	**656**	1,875
INVESTING ACTIVITIES		
Cash received (used) in acquisitions, net of cash acquired	**866**	
Net decrease (increase) in short-term investments	**1,311**	(3,422)
Purchases of securities available for sale	**(232)**	(624)
Proceeds from sales of securities available for sale	**1**	1,662
Proceeds from prepayments and maturities of securities available for sale	**4,159**	3,532
Proceeds from prepayments and maturities of held-to-maturity securities	**437**	11
Purchases of held-to-maturity securities	**(2,481)**	(1,170)
Purchases of other investments	**(48)**	(125)
Proceeds from sales of other investments	**17**	57
Proceeds from prepayments and maturities of other investments	**134**	63
Net decrease (increase) in loans, excluding acquisitions, sales and transfers	**(1,226)**	1,257
Proceeds from loan sales	**114**	111
Purchases of premises and equipment	**(93)**	(102)
Proceeds from sales of premises and equipment	**1**	1
Proceeds from sales of other real estate owned	**55**	112
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	**3,015**	1,363
FINANCING ACTIVITIES		
Net increase (decrease) in deposits, excluding acquisitions	**184**	422
Net increase (decrease) in short-term borrowings	**86**	(949)
Net proceeds from issuance of long-term debt	**20**	1,021
Payments on long-term debt	**(3,381)**	(1,086)
Repurchase of Treasury Shares	**(163)**	
Net proceeds from issuance of common shares		604
Net proceeds from reissuance of common shares	**2**	
Series B Preferred Stock - TARP redemption		(2,500)
Repurchase of common stock warrant		(70)
Cash dividends paid	**(139)**	(130)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	**(3,391)**	(2,688)
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	**280**	550
CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD	**694**	278
CASH AND DUE FROM BANKS AT END OF PERIOD	**$ 974**	$ 828

Additional disclosures relative to cash flows:				
Interest paid	**$**	**302**	$	445
Income taxes paid (refunded)		**39**		(314)
Noncash items:				
Assets acquired	**$**	**1,194**		
Liabilities assumed		**2,059**		
Loans transferred to portfolio from held for sale	**$**	**93**		
Loans transferred to held for sale from portfolio		**16**	$	78
Loans transferred to other real estate owned		**32**		34

See Notes to Consolidated Financial Statements (Unaudited).

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Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

As used in these Notes, references to Key, we, our, us and similar terms refer to the consolidated entity consisting of KeyCorp and its subsidiaries. KeyCorp refers solely to the parent holding company, and KeyBank refers to KeyCorp s subsidiary, KeyBank National Association.

The acronyms and abbreviations identified below are used in the Notes to Consolidated Financial Statements (Unaudited) as well as in the Management s Discussion & Analysis of Financial Condition & Results of Operations. You may find it helpful to refer back to this page as you read this report.

References to our 2011 Annual Report on Form 10-K refer to our Annual Report on Form 10-K for the year ended December 31, 2011, that has been filed with the U.S. Securities and Exchange Commission and is available on its website (www.sec.gov) or on our website (www.key.com/ir).

ABO: Accumulated benefit obligation.
AICPA: American Institute of Certified Public Accountants.
ALCO: Asset/Liability Management Committee.
ALLL: Allowance for loan and lease losses.
A/LM: Asset/liability management.
AOCI: Accumulated other comprehensive income (loss).
APBO: Accumulated postretirement benefit obligation.
Austin: Austin Capital Management, Ltd.
BHCs: Bank holding companies.
CCAR: Comprehensive Capital Analysis and Review.
CMO: Collateralized mortgage obligation.
Common Shares: Common Shares, $1 par value.
CPP: Capital Purchase Program of the U.S. Treasury.
DIF: Deposit Insurance Fund.
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
ERISA: Employee Retirement Income Security Act of 1974.
ERM: Enterprise risk management.
EVE: Economic value of equity.
FASB: Financial Accounting Standards Board.
FDIC: Federal Deposit Insurance Corporation.
Federal Reserve: Board of Governors of the Federal Reserve System.
FHLMC: Federal Home Loan Mortgage Corporation.
FNMA: Federal National Mortgage Association.
FVA: Fair value of pension plan assets.
GAAP: U.S. generally accepted accounting principles.
GNMA: Government National Mortgage Association.
IRS: Internal Revenue Service.
ISDA: International Swaps and Derivatives Association.
KAHC: Key Affordable Housing Corporation.
LIBOR: London Interbank Offered Rate.
LIHTC: Low-income housing tax credit.
LILO: Lease in, lease out transaction.
Moody s: Moody s Investor Services, Inc.
N/A: Not applicable.
NASDAQ: The NASDAQ Stock Market LLC.
N/M: Not meaningful.
NOW: Negotiable Order of Withdrawal.
NPR: Notice of proposed rulemaking.
NYSE: New York Stock Exchange.
OCC: Office of the Comptroller of the Currency.
OCI: Other comprehensive income (loss).
OREO: Other real estate owned.
OTTI: Other-than-temporary impairment.
QSPE: Qualifying special purpose entity.
PCI: Purchased credit impaired.
PBO: Projected benefit obligation.
S&P: Standard and Poor s Ratings Services, a Division of The McGraw-Hill Companies, Inc.
SCAP: Supervisory Capital Assessment Program administered by the Federal Reserve.
SEC: U.S. Securities & Exchange Commission.
Series A Preferred Stock: KeyCorp s 7.750% Noncumulative Perpetual Convertible Preferred Stock, Series A.
Series B Preferred Stock: KeyCorp s Fixed-Rate Cumulative Perpetual Preferred Stock, Series B issued to the U.S. Treasury under the CPP.
SILO: Sale in, lease out transaction.
SPE: Special purpose entity.
TAG: Transaction Account Guarantee program of the FDIC.
TARP: Troubled Asset Relief Program.
TDR: Troubled debt restructuring.
TE: Taxable equivalent.
TLGP: Temporary Liquidity Guarantee Program of the FDIC.
U.S. Treasury: United States Department of the Treasury.
VAR: Value at risk.
VEBA: Voluntary Employee Beneficiary Association.
VIE: Variable interest entity.
XBRL: eXtensible Business Reporting Language.

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The consolidated financial statements include the accounts of KeyCorp and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Some previously reported amounts have been reclassified to conform to current reporting practices.

The consolidated financial statements include any voting rights entities in which we have a controlling financial interest. In accordance with the applicable accounting guidance for consolidations, we consolidate a VIE if we have: (i) a variable interest in the entity; (ii) the power to direct activities of the VIE that most significantly impact the entity s economic performance; and (iii) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE (i.e., we are 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 9 (Variable Interest Entities) for information on our involvement with VIEs.

We use the equity method to account for unconsolidated investments in voting rights entities or VIEs if we have significant influence over the entity s operating and financing decisions (usually defined as a voting or economic interest of 20% to 50%, but not controlling). Unconsolidated investments in voting rights entities or VIEs in which we have a voting or economic interest of less than 20% generally are carried at cost. Investments held by our registered broker-dealer and investment company subsidiaries (primarily principal investments) are carried at fair value.

We believe that the unaudited 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. 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 our 2011 Annual Report on Form 10-K. See Note 11 (Acquisitions and Discontinued Operations) for further information regarding an error correction that was made during the third quarter of 2011.

In preparing these financial statements, subsequent events were evaluated through the time the financial statements were issued. Financial statements are considered issued when they are widely distributed to all shareholders and other financial statement users, or filed with the SEC.

Acquisitions

On July 13, 2012, we acquired 37 branches in Western New York and recorded approximately $2 billion of assets acquired and deposits assumed at their estimated fair values as of the acquisition date. Fair value adjustments to assets acquired and liabilities assumed will be amortized in accordance with the applicable accounting guidance over periods consistent with the average life, useful life and/or contractual term of the related assets and liabilities. The core deposit intangible will be amortized over a seven-year period using an accelerated amortization method reflective of the manner in which the related benefit attributable to the deposits will be recognized. In a second closing of this acquisition on September 14, 2012, we acquired approximately $69 million of credit card assets and assumed a related reward liability of $1 million. The fair values of these assets and the liability including the purchased credit card relationship intangible asset are still being determined.

On August 1, 2012, we acquired approximately $718 million (based on estimated fair value at acquisition date) in Key-branded credit card assets from Elan Financial Services, Inc. These assets and the related purchased credit card relationship intangible asset were recorded at acquisition date fair value. The intangible asset related to this acquisition will be amortized over an eight-year period using an accelerated amortization method reflective of the manner in which the related benefit attributable to the credit card assets will be recognized.

Additional information regarding these acquisitions is provided in Note 11.

Purchased Loans

We evaluate purchased loans for impairment in accordance with the applicable accounting guidance. Purchased loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that all contractually required payments will not be collected are deemed PCI and initially recorded at fair value without recording an allowance for loan losses. Fair value of these loans is determined using market participant assumptions in estimating the amount and timing of both principal and interest cash flows expected to be collected, as adjusted for an estimate of future credit losses and prepayments, and then a market-based discount rate is applied to those cash flows. PCI loans are generally accounted for on a pool basis, with pools formed based on the common characteristics of the loans, such as loan collateral type or loan product type. Each pool is accounted for as a single asset with one composite interest rate and an aggregate expectation of cash flows.

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Under the accounting model for PCI loans, the excess of cash flows expected to be collected over the carrying amount of the loans, referred to as the accretable amount, is accreted into interest income over the life of the loans in each pool using the effective yield method. Accordingly, PCI loans are not subject to classification as nonaccrual (and nonperforming) in the same manner as originated loans. Rather, acquired PCI loans are considered to be accruing loans because their interest income relates to the accretable yield recognized at the pool level and not to contractual interest payments at the loan level. The difference between contractually required principal and interest payments and the cash flows expected to be collected, referred to as the nonaccretable amount, includes estimates of both the impact of prepayments and future credit losses expected to be incurred over the life of the loans in each pool.

Subsequent to acquisition of loans determined to be PCI loans, actual cash collections are monitored relative to management s expectations, and revised cash flow expectations are prepared, as necessary. These revised expectations involve updates, as necessary, of the key assumptions used in the initial estimate of fair value. A decrease in expected cash flows in subsequent periods may indicate that the loan pool is impaired thus requiring the establishment of an allowance for loan losses by a charge to the provision for loan losses. An increase in expected cash flows in subsequent periods initially reduces any previously established allowance for loan losses by the increase in the present value of cash flows expected to be collected, and results in a recalculation of the amount of accretable yield for the loan pool. The adjustment of accretable yield due to an increase in expected cash flows is accounted for as a change in estimate. The additional cash flows expected to be collected are reclassified from the nonaccretable difference to the accretable yield, and the amount of periodic accretion is adjusted accordingly over the remaining life of the loans in the pool.

A purchased loan may be resolved either through receipt of payment (in full or in part) from the borrower, the sale of the loan to a third party or foreclosure of the collateral. In the event of a sale of the loan, a gain or loss on sale is recognized and reported within noninterest income based on the difference between the sales proceeds and the carrying amount of the loan. In the case of a foreclosure an individual loan is removed from the pool based on comparing the amount received from its resolution (fair value of the underlying collateral less costs to sell). Any difference between this amount and the loan carrying value is absorbed by the nonaccretable difference established for the entire pool. For loans resolved by payment in full, there is no adjustment of the nonaccretable difference since there is no difference between the amount received at resolution and the outstanding balance of the loan. In these cases, the remaining accretable amount balance is unaffected and any material change in remaining effective yield caused by the removal of the loan from the pool is addressed in connection with the subsequent cash flow re-assessment for the pool. PCI loans subject to modification are not removed from the pool even if those loans would otherwise be deemed TDRs as the pool, and not the individual loan, represents the unit of account.

Offsetting Derivative Positions

In accordance with the applicable accounting guidance, we take into account the impact of bilateral collateral and master netting agreements that allow us to settle all derivative contracts held with a single counterparty on a net basis, and to offset the net derivative position with the related collateral when recognizing derivative assets and liabilities. Additional information regarding derivative offsetting is provided in Note 7 (Derivatives and Hedging Activities).

Accounting Guidance Adopted in 2012

Fair value measurement. In May 2011, the FASB issued accounting guidance that changed the wording used to describe many of the current accounting requirements for measuring fair value and disclosing information about fair value measurements. This accounting guidance clarified the FASB s intent about the application of existing fair value measurement requirements. It was effective for the interim and annual periods beginning on or after December 15, 2011 (effective January 1, 2012, for us). The adoption of this accounting guidance did not have a material effect on our financial condition or results of operations. As required by this accounting guidance, additional information regarding the classification is provided in Note 5 (Fair Value Measurements).

Presentation of comprehensive income. In June 2011, the FASB issued new accounting guidance that required all nonowner changes in shareholders equity to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This new accounting guidance did not change any of the components currently recognized in net income or comprehensive income. It was effective for public entities for interim and annual periods beginning after December 15, 2011 (effective January 1, 2012, for us) as well as interim and annual periods thereafter. As required by this accounting guidance, Consolidated Statements of Comprehensive Income (Unaudited) are now included as part of our financial statements.

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Testing goodwill for impairment. In September 2011, the FASB issued new accounting guidance that simplified how an entity tests goodwill for impairment. It permits an entity to first assess qualitative factors to determine whether additional goodwill impairment testing is required. This accounting guidance was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 (effective January 1, 2012, for us). The adoption of this accounting guidance did not have a material effect on our financial condition or results of operations.

Repurchase agreements. In April 2011, the FASB issued accounting guidance that changed the accounting for repurchase agreements and other similar arrangements by eliminating the collateral maintenance requirement when assessing effective control in these transactions. This change could result in more of these transactions being accounted for as secured borrowings instead of sales. This accounting guidance was effective for new transactions and transactions modified on or after the first interim or annual period beginning after December 15, 2011 (effective January 1, 2012, for us). The adoption of this accounting guidance did not have a material effect on our financial condition or results of operations since we do not account for these types of arrangements as sales.

Accounting Guidance Pending Adoption at September 30, 2012

Testing indefinite-lived intangible assets for impairment. In July 2012, the FASB issued new accounting guidance that simplifies how an entity tests indefinite-lived intangible assets other than goodwill for impairment. It permits an entity to first assess qualitative factors to determine whether further testing for impairment of indefinite-lived intangible assets other than goodwill is required. This accounting guidance will be effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 (January 1, 2013, for us). Early adoption is permitted. The adoption of this accounting guidance is not expected to have a material effect on our financial condition or results of operations.

Offsetting disclosures. In December 2011, the FASB issued new accounting guidance that requires an entity to disclose information about offsetting and related arrangements to enable financial statement users to understand the effect of those arrangements on the entity s financial position. This new accounting guidance will be effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods (effective January 1, 2013, for us).

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2. Earnings Per Common Share

Our basic and diluted earnings per Common Share are calculated as follows:

dollars in millions, except per share amounts	Three months ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
EARNINGS				
Income (loss) from continuing operations	**$ 221**	$ 235	**$ 657**	$ 769
Less: Net income (loss) attributable to noncontrolling interests	**2**	1	**7**	12
Income (loss) from continuing operations attributable to Key	**219**	234	**650**	757
Less: Dividends on Series A Preferred Stock	**5**	5	**16**	17
Cash dividends on Series B Preferred Stock				31
Amortization of discount on Series B Preferred Stock[b]				53
Income (loss) from continuing operations attributable to Key common shareholders	**214**	229	**634**	656
Income (loss) from discontinued operations, net of taxes[a]		(17)	**5**	(37)
Net income (loss) attributable to Key common shareholders	**$ 214**	$ 212	**$ 639**	$ 619
WEIGHTED-AVERAGE COMMON SHARES				
Weighted-average common shares outstanding (000)	**936,223**	948,702	**943,378**	926,298
Effect of dilutive convertible preferred stock, common share options and other stock awards (000)	**4,541**	1,984	**4,204**	4,151
Weighted-average common shares and potential common shares outstanding (000)	**940,764**	950,686	**947,582**	930,449
EARNINGS PER COMMON SHARE				
Income (loss) from continuing operations attributable to Key common shareholders	**$ .23**	$ .24	**$ .67**	$ .71
Income (loss) from discontinued operations, net of taxes [a]		(.02)	**.01**	(.04)
Net income (loss) attributable to Key common shareholders[c]	**.23**	.22	**.68**	.67
Income (loss) from continuing operations attributable to Key common shareholders assuming dilution	**$ .23**	$ .24	**$ .67**	$ .71
Income (loss) from discontinued operations, net of taxes [a]		(.02)	**.01**	(.04)
Net income (loss) attributable to Key common shareholders assuming dilution[c]	**.23**	.22	**.67**	.67

(a) In April 2009, we decided to wind down the operations of Austin, a subsidiary that specialized in managing hedge fund investments for institutional customers. In September 2009, we decided to discontinue the education lending business conducted through Key Education Resources, the education payment and financing unit of KeyBank. As a result of these decisions, we have accounted for these businesses as discontinued operations. The income from discontinued operations for the nine months ended September 30, 2012, was primarily attributable to fair value adjustments related to the education lending securitization trusts.

(b) Includes a $49 million deemed dividend recorded in the first quarter of 2011 related to the repurchase of the $2.5 billion Series B Preferred Stock.

(c) EPS may not foot due to rounding.

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3. Loans and Loans Held for Sale

Our loans by category are summarized as follows:

in millions	September 30, 2012	December 31, 2011	September 30, 2011
Commercial, financial and agricultural[(a)]	**$ 21,979**	$ 19,759	$ 17,848
Commercial real estate:			
Commercial mortgage	**7,529**	8,037	7,958
Construction	**1,067**	1,312	1,456
Total commercial real estate loans	**8,596**	9,349	9,414
Commercial lease financing	**4,960**	5,674	5,957
Total commercial loans	**35,535**	34,782	33,219
Residential prime loans:			
Real estate residential mortgage	**2,138**	1,946	1,875
Home equity:			
Key Community Bank	**9,768**	9,229	9,347
Other	**409**	535	565
Total home equity loans	**10,177**	9,764	9,912
Total residential prime loans	**12,315**	11,710	11,787
Consumer other Key Community Bank	**1,313**	1,192	1,187
Credit cards	**710**		
Consumer other:			
Marine	**1,448**	1,766	1,871
Other	**98**	125	131
Total consumer other	**1,546**	1,891	2,002
Total consumer loans	**15,884**	14,793	14,976
Total loans [(b) (c)]	**$ 51,419**	$ 49,575	$ 48,195

(a) September 30, 2012 loan balance includes $88 million of commercial credit card balances.

(b) Excluded at September 30, 2012, December 31, 2011, and September 30, 2011, are loans in the amount of $5.3 billion, $5.8 billion and $6.0 billion, respectively, related to the discontinued operations of the education lending business.

(c) September 30, 2012 includes purchased loans of $231 million of which $25 million were PCI loans.

Our loans held for sale are summarized as follows:

in millions	September 30, 2012	December 31, 2011	September 30, 2011

Commercial, financial and agricultural	**$ 13**	$ 19	$ 29
Real estate commercial mortgage	**484**	567	325
Real estate construction	**10**	35	20
Commercial lease financing	**4**	12	26
Real estate residential mortgage	**117**	95	79
Total loans held for sale	**$ 628**	$ 728	$ 479

Our quarterly summary of changes in loans held for sale as follows:

in millions	**September 30, 2012**	**December 31, 2011**	**September 30, 2011**
Balance at beginning of the period	**$ 656**	$ 479	$ 381
New originations	**1,280**	1,235	853
Transfers from held to maturity, net	**13**	19	23
Loan sales	**(1,311)**	(932)	(759)
Loan draws (payments), net	**(9)**	(72)	1
Transfers to OREO / valuation adjustments	**(1)**	(1)	(20)
Balance at end of period	**$ 628**	$ 728	$ 479

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4. Asset Quality

We manage our exposure to credit risk by closely monitoring loan performance trends and general economic conditions. A key indicator of the potential for future credit losses is the level of nonperforming assets and past due loans.

Our nonperforming assets and past due loans were as follows:

in millions	September 30, 2012	December 31, 2011	September 30, 2011
Total nonperforming loans [a][b]	**$ 653**	$ 727	$ 788
Nonperforming loans held for sale	**19**	46	42
OREO	**29**	65	63
Other nonperforming assets	**17**	21	21
Total nonperforming assets	**$ 718**	$ 859	$ 914
Nonperforming assets from discontinued operation - education lending [f]	**$ 22**	$ 23	$ 22
Restructured loans included in nonperforming loans [a][c]	**$ 217**	$ 191	$ 178
Restructured loans with an allocated specific allowance [d]	**78**	50	27
Specifically allocated allowance for restructured loans [e]	**31**	10	5
Accruing loans past due 90 days or more	**$ 89**	$ 164	$ 118
Accruing loans past due 30 through 89 days	**354**	441	478

(a) September 30, 2012 includes $38 million of performing secured loans that were discharged through Chapter 7 bankruptcy and not formally re-affirmed as addressed in recently updated regulatory guidance. Such loans have been designated as nonperforming and TDRs.

(b) September 30, 2012 excludes $25 million of PCI loans acquired in July 2012.

(c) A loan is restructured (i.e., TDRs) when the borrower is experiencing financial difficulty and we grant a concession that we would not otherwise consider to improve the collectability of the loan. Typical concessions include: reducing the interest rate, extending the maturity date, or reducing the principal balance.

(d) Included in individually impaired loans allocated a specific allowance.

(e) Included in allowance for individually evaluated impaired loans.

(f) Includes approximately $3 million of restructured loans at September 30, 2012. See Note 11 for further discussion.

We evaluate purchased loans for impairment in accordance with the applicable accounting guidance. Purchased loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that all contractually required payments will not be collected are deemed PCI and initially recorded at fair value without recording an allowance for loan losses. At the date of acquisition, the estimated gross contractual amount receivable of PCI loans totaled $41 million. The estimated cash flows not expected to be collected (i,e, nonaccretable amount) was $11 million and the accretable amount was approximately $5 million. The difference between the fair value and the cash flows expected to be collected from the purchased loans is accreted to interest income over the remaining term of the loans. Accordingly, these loans are not subject to classification as non-accrual (and nonperforming) in the same manner as originated loans. Rather, purchased loans are considered to be accruing loans because their interest income relates to the accretable yield recognized at the pool level and not to the contractual interest payments at the loan level.

At September 30, 2012, the approximate carrying amount of our commercial nonperforming loans outstanding represented 59% of their original contractual amount, total nonperforming loans outstanding represented 70% of their original contractual amount owed, and nonperforming assets in total were carried at 67% of their original contractual amount.

At September 30, 2012, our twenty largest nonperforming loans totaled $202 million, representing 31% of total loans on nonperforming status from continuing operations. At September 30, 2011, the twenty largest nonperforming loans totaled $265 million, representing 34% of total loans on nonperforming status.

The amount by which nonperforming loans and loans held for sale reduced expected interest income was $18 million for the nine months ended September 30, 2012, and $31 million for the year ended December 31, 2011.

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The following tables set forth a further breakdown of individually impaired loans as of September 30, 2012, December 31, 2011 and September 30, 2011:

September 30, 2012 *in millions*	**Recorded Investment** (a)	**Unpaid Principal Balance** (b)	**Specific Allowance**	**Average Recorded Investment**
With no related allowance recorded:				
Commercial, financial and agricultural	$ 57	$ 118		$ 58
Commercial real estate:				
Commercial mortgage	106	182		109
Construction	42	203		47
Total commercial real estate loans	148	385		156
Total commercial loans with no related allowance recorded	205	503		214
Real estate residential mortgage				1
Home equity:				
Key Community Bank	45	45		23
Other	2	2		1
Total home equity loans	47	47		24
Consumer other Key Community Bank	1	1		1
Consumer other:				
Marine	4	4		2
Total consumer other	4	4		2
Total consumer loans	52	52		28
Total loans with no related allowance recorded	257	555		242
With an allowance recorded:				
Commercial, financial and agricultural	35	45	$ 12	39
Commercial real estate:				
Commercial mortgage	31	32	7	44
Construction				2
Total commercial real estate loans	31	32	7	46
Total commercial loans with an allowance recorded	66	77	19	85
Real estate residential mortgage	18	18	1	17
Home equity:				
Key Community Bank	20	20	10	16
Other	8	8	1	7
Total home equity loans	28	28	11	23
Consumer other Key Community Bank	2	2	1	2
Consumer other:				

Marine		56		56		7		53
Other		1		1				1
Total consumer other		57		57		7		54
Total consumer loans		105		105		20		96
Total loans with an allowance recorded		171		182		39		181
Total	$	428	$	737	$	39	$	423

(a) The Recorded Investment in impaired loans represents the face amount of the loan increased or decreased by applicable accrued interest, net deferred loan fees and costs, unamortized premium or discount, and reflects direct charge-offs. This amount is a component of total loans on our consolidated balance sheet.

(b) The Unpaid Principal Balance represents the customer s legal obligation to us.

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December 31, 2011 *in millions*	Recorded Investment (a)	Unpaid Principal Balance (b)	Specific Allowance	Average Recorded Investment
With no related allowance recorded:				
Commercial, financial and agricultural	$ 88	$ 195		$ 75
Commercial real estate:				
Commercial mortgage	100	240		131
Construction	30	113		98
Total commercial real estate loans	130	353		229
Total loans with no related allowance recorded	218	548		304
With an allowance recorded:				
Commercial, financial and agricultural	62	70	$ 26	75
Commercial real estate:				
Commercial mortgage	96	115	21	91
Construction	12	18	4	29
Total commercial real estate loans	108	133	25	120
Commercial lease financing				6
Total loans with an allowance recorded	170	203	51	201
Total	$ 388	$ 751	$ 51	$ 505

(a) The Recorded Investment in impaired loans represents the face amount of the loan increased or decreased by applicable accrued interest, net deferred loan fees and costs, unamortized premium or discount, and reflects direct charge-offs. This amount is a component of total loans on our consolidated balance sheet.

(b) The Unpaid Principal Balance represents the customer s legal obligation to us.

September 30, 2011 *in millions*	Recorded Investment (a)	Unpaid Principal Balance (b)	Specific Allowance	Average Recorded Investment
With no related allowance recorded:				
Commercial, financial and agricultural	$ 91	$ 202		$ 104
Commercial real estate:				
Commercial mortgage	139	292		131
Construction	58	203		71
Total commercial real estate loans	197	495		202
Total commercial loans with an allowance recorded	288	697		306
Home equity Key Community Bank	2	2		1
Total loans with no related allowance recorded	290	699		307

With an allowance recorded:				
Commercial, financial and agricultural	53	61	$ 20	48
Commercial real estate:				
Commercial mortgage	78	90	14	84
Construction	20	20	10	27
Total commercial real estate loans	98	110	24	111
Total loans with an allowance recorded	151	171	44	159
Total	$ 441	$ 870	$ 44	$ 466

(a) The Recorded Investment in impaired loans represents the face amount of the loan increased or decreased by applicable accrued interest, net deferred loan fees and costs, unamortized premium or discount, and reflects direct charge-offs. This amount is a component of total loans on our consolidated balance sheet.

(b) The Unpaid Principal Balance represents the customer s legal obligation to us.

For the nine months ended September 30, 2012 and 2011, interest income recognized on the outstanding balances of accruing impaired loans totaled $4 million for each period presented.

At September 30, 2012, aggregate restructured loans (accrual, nonaccrual and held-for-sale loans) totaled $323 million, compared to $276 million at December 31, 2011, and $277 million at September 30, 2011. We added $192 million in restructured loans during the nine months ended of 2012, which were partially offset by $144 million in payments and charge-offs.

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A further breakdown of restructured loans (TDRs) included in nonperforming loans by loan category as of September 30, 2012, follows:

September 30, 2012 *dollars in millions*	**Number of loans**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
LOAN TYPE			
Nonperforming:			
Commercial, financial and agricultural	91	$ 107	$ 54
Commercial real estate:			
Real estate commercial mortgage	18	47	29
Real estate construction	8	53	30
Total commercial real estate loans	26	100	59
Total commercial loans	117	207	113
Real estate residential mortgage	70	7	7
Home equity:			
Key Community Bank	1,804	89	58
Other	486	11	7
Total home equity loans	2,290	100	65
Consumer other Key Community Bank	125	2	2
Consumer other:			
Marine	491	33	28
Other	91	2	2
Total consumer other	582	35	30
Total consumer loans	3,067	144	104
Total nonperforming TDRs	3,184	351	217
Prior-year accruing [(a)]			
Commercial, financial and agricultural	152	15	7
Commercial real estate:			
Real estate commercial mortgage	7	71	45
Real estate construction	1	15	
Total commercial real estate loans	8	86	45
Total commercial loans	160	101	52
Real estate residential mortgage	108	11	11
Home equity:			
Key Community Bank	86	6	6
Other	95	3	3
Total home equity loans	181	9	9
Consumer other Key Community Bank	20		
Consumer other:			
Marine	126	32	32
Other	51	2	2

Total consumer other	177		34		34
Total consumer loans	486		54		54
Total prior-year accruing TDRs	646		155		106
Total TDRs	3,830	$	506	$	323

(a) All TDRs that were restructured prior to January 1, 2012 and are fully accruing.

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A further breakdown of restructured loans (TDRs) included in nonperforming loans by loan category as of September 30, 2011, follows:

September 30, 2011 *dollars in millions*	**Number of loans**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
LOAN TYPE			
Nonperforming:			
Commercial, financial and agricultural	11	$ 84	$ 46
Commercial real estate:			
Real estate commercial mortgage	12	74	69
Real estate construction	6	50	18
Total commercial real estate loans	18	124	87
Commercial lease financing	182	24	11
Total commercial loans	211	232	144
Real estate residential mortgage	73	7	7
Home equity:			
Key Community Bank	30	2	1
Other	29	1	1
Total home equity loans	59	3	2
Consumer other Key Community Bank	7		
Consumer other:			
Marine	43	26	25
Other	18		
Total consumer other	61	26	25
Total consumer loans	200	36	34
Total nonperforming TDRs	411	268	178
Prior-year accruing [(a)]			
Commercial, financial and agricultural	1	8	5
Commercial real estate:			
Real estate commercial mortgage	4	57	32
Real estate construction	3	39	19
Total commercial real estate loans	7	96	51
Commercial lease financing	167	17	13
Total commercial loans	175	121	69
Real estate residential mortgage	56	9	9
Home equity:			
Key Community Bank	64	6	6
Other	71	3	2
Total home equity loans	135	9	8
Consumer other Key Community Bank	14		
Consumer other:			
Marine	109	13	11
Other	34	2	2

Total consumer other	143		15		13
Total consumer loans	348		33		30
Total prior-year accruing TDRs	523		154		99
Total TDRs	934	$	422	$	277

(a) All TDRs that were restructured prior to January 1, 2011 and are fully accruing.

We classify loan modifications as TDRs when a borrower is experiencing financial difficulties and we have granted a concession to the borrower without commensurate financial, structural, or legal consideration. All commercial and consumer loan TDRs, regardless of size, are evaluated for impairment individually to determine the probable loss content and are assigned a specific loan allowance if deemed appropriate. The financial effects of TDRs are reflected in the components that comprise the allowance for loan and lease losses in either the amount of charge-offs or loan loss provision and appropriately impact the ultimate allowance level. Additional information regarding TDRs for discontinued operations is provided in Note 11 (Acquisitions and Discontinued Operations).

Commercial and consumer loan TDRs are considered subsequently defaulted at 90 days past due and when they are greater than 60 days past due, respectively, for principal and interest payments. There were no significant commercial or consumer loans that were designated as TDRs during calendar year 2011, for which there was a payment default during the first nine months of 2012.

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Our loan modifications are handled on a case by case basis and are negotiated to achieve mutually agreeable terms that maximize loan collectability and meet our client s financial needs. A majority of our concessions granted to borrowers are in the form of interest rate reductions. Other concession types include forgiveness of principal and other modifications of loan terms. Consumer loan concessions include Home Affordable Modification Program (HAMP) loans of approximately $3 million as of September 30, 2012. These loan concessions have successfully completed the required trial period under HAMP and as a result have been permanently modified and are included in consumer TDRs.

As of September 30, 2012, $38 million of performing secured loans discharged through Chapter 7 bankruptcy and not reaffirmed by the borrower were reclassified as TDRs. Regardless of delinquency status, these loans were transferred at the collateral s fair market value less selling costs, classified as nonaccrual, and are included in nonperforming loans.

The following table shows the concession types for our commercial accruing and nonaccruing TDRs and other selected financial data.

dollars in millions	**September 30, 2012**	December 31, 2011	September 30, 2011
Interest rate reduction	**$ 145**	$ 177	$ 195
Forgiveness of principal	**7**	23	12
Other modification of loan terms	**14**	8	6
Total	**$ 166**	$ 208	$ 213
Total commercial and consumer TDRs (a)	**$ 323**	$ 276	$ 277
Total commercial TDRs to total commercial loans	**.47 %**	.60 %	.64 %
Total commercial TDRs to total loans	**.32**	.42	.44
Total commercial loans	**$ 35,535**	$ 34,782	$ 33,219
Total loans	**51,419**	49,575	48,195

(a) Commitments outstanding to lend additional funds to borrowers whose terms have been modified in TDRs are $47 million, $25 million, and $39 million at September 30, 2012, December 31, 2011, and September 30, 2011, respectively.

Our policies for determining past due loans, placing loans on nonaccrual, applying payments on nonaccrual loans and resuming accrual of interest for our commercial and consumer loan portfolios are disclosed in Note 1 (Summary of Significant Accounting Policies) under the heading Nonperforming Loans on page 117 of our 2011 Annual Report on Form 10-K. Pursuant to regulatory guidance issued in January 2012, the above-mentioned policy for nonperforming loans was revised effective for the second quarter of 2012. As of June 30, 2012, any second lien home equity loan with an associated first lien that is: 120 days or more past due; in foreclosure; or when the first mortgage delinquency timeframe is unknown, is reported as a nonperforming loan. This policy was implemented prospectively, and, therefore, prior periods were not presented. Credit card loans on which payments are past due for 90 days are placed on nonaccrual status.

At September 30, 2012, approximately $50.3 billion, or 98%, of our total loans are current. At September 30, 2012, total past due loans and nonperforming loans of $1.1 billion represent approximately 2% of total loans.

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The following aging analysis as of September 30, 2012 and 2011, of past due and current loans provides further information regarding Key s credit exposure.

September 30, 2012 *in millions*	**Current**	**30-59 Days Past Due**	**60-89 Days Past Due**	**90 and Greater Days Past Due**	**Nonperforming Loans (a)**	**Total Past Due and Nonperforming Loans**	**Purchased Credit Impaired**	**Total Loans**
LOAN TYPE								
Commercial, financial and agricultural	$ 21,766	$ 46	$ 19	$ 15	$ 132	$ 212	$ 1	$ 21,979
Commercial real estate:								
Commercial mortgage	7,344	19	3	26	134	182	3	7,529
Construction	993	5	3	13	53	74		1,067
Total commercial real estate loans	8,337	24	6	39	187	256	3	8,596
Commercial lease financing	4,881	48	11	2	18	79		4,960
Total commercial loans	$ 34,984	$ 118	$ 36	$ 56	$ 337	$ 547	$ 4	$ 35,535
Real estate residential mortgage	$ 1,997	$ 22	$ 13	$ 6	$ 83	$ 124	$ 17	$ 2,138
Home equity:								
Key Community Bank	9,492	57	30	15	171	273	3	9,768
Other	374	9	5	3	18	35		409
Total home equity loans	9,866	66	35	18	189	308	3	10,177
Consumer other Key Community Bank	1,290	9	4	6	3	22	1	1,313
Credit cards	692	6	4		8	18		710
Consumer other:								
Marine	1,377	29	9	2	31	71		1,448
Other	92	2	1	1	2	6		98
Total consumer other	1,469	31	10	3	33	77		1,546
Total consumer loans	$ 15,314	$ 134	$ 66	$ 33	$ 316	$ 549	$ 21	$ 15,884
Total loans	$ 50,298	$ 252	$ 102	$ 89	$ 653	$ 1,096	$ 25	$ 51,419

(a) Includes $38 million of performing secured loans that were discharged through Chapter 7 bankruptcy and not formally re-affirmed as addressed in recently updated regulatory guidance. Such loans have been designated as nonperforming and TDRs.

September 30, 2011 *in millions*	**Current**	**30-59 Days Past Due**	**60-89 Days Past Due**	**90 and Greater Days Past Due**	**Nonperforming Loans**	**Total Past Due and Nonperforming Loans**	**Total Loans**
LOAN TYPE							
Commercial, financial and agricultural	$ 17,576	$ 40	$ 20	$ 24	$ 188	$ 272	$ 17,848

Commercial real estate:							
Commercial mortgage	7,612	101	3	5	237	346	7,958
Construction	1,345	5	5	8	93	111	1,456
Total commercial real estate loans	8,957	106	8	13	330	457	9,414
Commercial lease financing	5,812	57	23	34	31	145	5,957
Total commercial loans	$ 32,345	$ 203	$ 51	$ 71	$ 549	$ 874	$ 33,219
Real estate residential mortgage	$ 1,747	$ 20	$ 11	$ 9	$ 88	$ 128	$ 1,875
Home equity:							
Key Community Bank	9,125	63	35	22	102	222	9,347
Other	529	13	7	4	12	36	565
Total home equity loans	9,654	76	42	26	114	258	9,912
Consumer other Key Community Bank	1,159	11	5	8	4	28	1,187
Consumer other:							
Marine	1,781	36	19	3	32	90	1,871
Other	125	3	1	1	1	6	131
Total consumer other	1,906	39	20	4	33	96	2,002
Total consumer loans	$ 14,466	$ 146	$ 78	$ 47	$ 239	$ 510	$ 14,976
Total loans	$ 46,811	$ 349	$ 129	$ 118	$ 788	$ 1,384	$ 48,195

The risk characteristic prevalent to both commercial and consumer loans is the risk of loss arising from an obligor s inability or failure to meet contractual payment or performance terms. Evaluation of this risk is stratified and monitored by the assigned loan risk rating grades for the commercial loan portfolios and the regulatory risk ratings assigned for the consumer loan portfolios. This risk rating stratification assists in the determination of the ALLL. Loan grades are assigned at the time of origination, verified by credit risk management, and periodically reevaluated thereafter.

Most extensions of credit are subject to loan grading or scoring. This risk rating methodology blends our judgment with quantitative modeling. Commercial loans generally are assigned two internal risk ratings. The first rating reflects the

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probability that the borrower will default on an obligation; the second rating reflects expected recovery rates on the credit facility. Default probability is determined based on, among other factors, the financial strength of the borrower, an assessment of the borrower s management, the borrower s competitive position within its industry sector, and our view of industry risk within the context of the general economic outlook. Types of exposure, transaction structure, and collateral, including credit risk mitigants, affect the expected recovery assessment.

Credit quality indicators for loans are updated on an ongoing basis. Bond rating classifications are indicative of the credit quality of our commercial loan portfolios and are determined by converting our internally assigned risk rating grades to bond rating categories. Payment activity and the regulatory classifications of pass and substandard are indicators of the credit quality of our consumer loan portfolios.

Credit quality indicators for our commercial and consumer loan portfolios excluding $25 million of purchased credit impaired loans, based on bond rating, regulatory classification and payment activity as of September 30, 2012 and September 30, 2011 are as follows:

Commercial Credit Exposure

Credit Risk Profile by Creditworthiness Category [(a)]

September 30,
in millions

	Commercial, financial and agricultural		RE Commercial		RE Construction		Commercial Lease		Total	
RATING [(b)] [(c)]	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**
AAA AA	**$ 166**	$ 109	**$ 1**	$ 2	**$ 1**	$ 3	**$ 465**	$ 639	**$ 633**	$ 753
A	**755**	655	**63**	62	**1**	1	**1,107**	1,272	**1,926**	1,990
BBB BB	**19,229**	14,928	**6,137**	5,747	**759**	762	**3,087**	3,509	**29,212**	24,946
B	**940**	807	**585**	726	**38**	132	**188**	306	**1,751**	1,971
CCC C	**888**	1,349	**740**	1,421	**268**	558	**113**	231	**2,009**	3,559
Total	**$ 21,978**	$ 17,848	**$ 7,526**	$ 7,958	**$ 1,067**	$ 1,456	**$ 4,960**	$ 5,957	**$ 35,531**	$ 33,219

(a) Credit quality indicators are updated on an ongoing basis and reflect credit quality information as of the dates indicated.

(b) Our bond rating to internal loan grade conversion system is as follows: AAA - AA = 1, A = 2, BBB - BB = 3 - 13, B = 14 - 16, and CCC - C = 17 - 20.

(c) Our internal loan grade to regulatory-defined classification is as follows: Pass = 1-16, Special Mention = 17, Substandard = 18, Doubtful = 19, and Loss = 20.

Consumer Credit Exposure

Credit Risk Profile by Regulatory Classifications [(a)] [(b)]

September 30,

in millions

	Residential Prime	
GRADE	**2012**	**2011**

Pass	**$ 11,999**	$ 11,550
Substandard	**296**	237
Total	**$ 12,295**	$ 11,787

Credit Risk Profile Based on Payment Activity [a] [b]

September 30, *in millions*	Consumer Key Community Bank 2012	Consumer Key Community Bank 2011	Credit cards 2012	Credit cards 2011	Consumer Marine 2012	Consumer Marine 2011	Consumer Other 2012	Consumer Other 2011	Total 2012	Total 2011
Performing	**$ 1,309**	$ 1,183	**$ 702**		**$ 1,417**	$ 1,839	**$ 96**	$ 130	**$ 3,524**	$ 3,152
Nonperforming	**3**	4	**8**		**31**	32	**2**	1	**44**	37
Total	**$ 1,312**	$ 1,187	**$ 710**		**$ 1,448**	$ 1,871	**$ 98**	$ 131	**$ 3,568**	$ 3,189

(a) Credit quality indicators are updated on an ongoing basis and reflect credit quality information as of the dates indicated.

(b) Our past due payment activity to regulatory classification conversion is as follows: pass = less than 90 days; and substandard = 90 days and greater plus nonperforming loans. As of September 30, 2012, any second lien home equity loan with an associated first lien: that is 120 days or more past due; in foreclosure; or when the first mortgage delinquency timeframe is unknown, is reported as a nonperforming loan in accordance with regulatory guidance issued in January 2012.

We determine the appropriate level of the ALLL on at least a quarterly basis. The methodology is described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan and Lease Losses beginning on page 117 of our 2011 Annual Report on Form 10-K. We apply expected loss rates to existing loans with similar risk characteristics as noted in the credit quality indicator table above and exercise 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.

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For all commercial and consumer loan TDRs, regardless of size, as well as impaired commercial loans with an outstanding balance greater than $2.5 million, we conduct further analysis to determine the probable loss content and assign a specific allowance to the loan if deemed appropriate. We estimate the extent of impairment by comparing the recorded investment of the loan with the estimated present value of its future cash flows, the fair value of its underlying collateral, or the loan s observable market price. A specific allowance also may be assigned even when sources of repayment appear sufficient if we remain uncertain about whether the loan will be repaid in full. On at least a quarterly basis, we evaluate the appropriateness of our loss estimation methods to reduce differences between estimated incurred losses and actual losses. The ALLL at September 30, 2012 represents our best estimate of the probable credit losses inherent in the loan portfolio at that date.

While quantitative modeling factors such as default probability and expected recovery rates are constantly changing as the financial strength of the borrower and overall economic conditions change, there have been no changes to the accounting policies or methodology we used to estimate the ALLL.

Commercial loans generally are charged off in full or charged down to the fair value of the underlying collateral when the borrower s payment is 180 days past due. Home equity and residential mortgage loans generally are charged down to the fair value of the underlying collateral when payment is 180 days past due. Credit card loans are charged off when payments are 180 days past due. All other consumer loans are charged off when payments are 120 days past due.

At September 30, 2012, the ALLL was $888 million, or 1.73% of loans, compared to $1.1 billion, or 2.35% of loans, at September 30, 2011. At September 30, 2012, the ALLL was 135.99% of nonperforming loans compared to 143.53% at September 30, 2011.

A summary of the allowance for loan and lease losses for the periods indicated is presented in the table below:

	Three months ended September 30,		**Nine months ended September 30,**	
in millions	**2012**	**2011**	**2012**	**2011**
Balance at beginning of period continuing operations	**$ 888**	$ 1,230	**$ 1,004**	$ 1,604
Charge-offs	**(141)**	(157)	**(404)**	(566)
Recoveries	**32**	48	**117**	130
Net loans charged off	**(109)**	(109)	**(287)**	(436)
Provision for loan and lease losses from continuing operations	**109**	10	**172**	(38)
Foreign currency translation adjustment			**(1)**	1
Balance at end of period continuing operations	**$ 888**	$ 1,131	**$ 888**	$ 1,131

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The changes in the ALLL by loan category for the periods indicated are as follows:

in millions	December 31, 2011	Provision	Charge-offs	Recoveries	September 30, 2012
Commercial, financial and agricultural	$ 334	**$ 9**	**$ (65)**	**$ 40**	**$ 318**
Real estate commercial mortgage	272		**(69)**	**18**	**221**
Real estate construction	63		**(19)**	**3**	**47**
Commercial lease financing	78	**(10)**	**(20)**	**18**	**66**
Total commercial loans	747	**(1)**	**(173)**	**79**	**652**
Real estate residential mortgage	37	**5**	**(19)**	**2**	**25**
Home equity:					
Key Community Bank	103	**92**	**(113)**	**7**	**89**
Other	29	**14**	**(23)**	**4**	**24**
Total home equity loans	132	**106**	**(136)**	**11**	**113**
Consumer other Key Community Bank	41	**15**	**(29)**	**5**	**32**
Credit cards		**27**	**(2)**		**25**
Consumer other:					
Marine	46	**14**	**(41)**	**18**	**37**
Other	1	**5**	**(4)**	**2**	**4**
Total consumer other:	47	**19**	**(45)**	**20**	**41**
Total consumer loans	257	**172**	**(231)**	**38**	**236**
Total ALLL continuing operations	1,004	**171** (a)	**(404)**	**117**	**888**
Discontinued operations	104	**4**	**(56)**	**13**	**65**
Total ALLL including discontinued operations	$ 1,108	**$ 175**	**$ (460)**	**$ 130**	**$ 953**

(a) Includes $1 million of foreign currency translation adjustment.

in millions	December 31, 2010	Provision	Charge-offs	Recoveries	September 30, 2011
Commercial, financial and agricultural	$ 485	$ (24)	$ 124	$ 33	$ 370
Real estate commercial mortgage	416	(31)	89	9	305
Real estate construction	145	4	81	19	87
Commercial lease financing	175	(62)	36	19	96
Total commercial loans	1,221	(113)	330	80	858
Real estate residential mortgage	49	4	22	3	34
Home equity:					
Key Community Bank	120	59	78	9	110
Other	57	10	35	3	35
Total home equity loans	177	69	113	12	145
Consumer other Key Community Bank	57	12	34	6	41
Consumer other:					
Marine	89	(4)	60	26	51

Other	11	(5)	7	3	2
Total consumer other:	100	(9)	67	29	53
Total consumer loans	383	76	236	50	273
Total ALLL continuing operations	1,604	(37) [(a)]	566	130	1,131
Discontinued operations	114	99	107	9	115
Total ALLL including discontinued operations	$ 1,718	$ 62	$ 673	$ 139	$ 1,246

(a) Includes $1 million of foreign currency translation adjustment.

Our ALLL decreased by $243 million, or 21%, since the third quarter of 2011. This contraction was associated with the improvement in credit quality of our loan portfolios, which has trended more favorably over the past seven quarters. Our asset quality metrics have showed continued improvement and, therefore, resulted in favorable risk rating migration and a reduction in our general allowance. Our general allowance encompasses the application of expected loss rates to our existing loans with similar risk characteristics and an assessment of factors such as changes in economic conditions and changes in credit policies or underwriting standards. Our delinquency trends showed continued improvement during 2011 and the first nine months of 2012. We attribute this improvement to a more moderate level of lending activity, more favorable conditions in the capital markets, improvement in client income statements, and continued run off in our exit loan portfolio.

For continuing operations, the loans outstanding individually evaluated for impairment totaled $428 million, with a corresponding allowance of $39 million at September 30, 2012. Loans outstanding collectively evaluated for impairment totaled $51.0 billion, with a corresponding allowance of $849 million at September 30, 2012. PCI loans evaluated for impairment totaled $25 million, with no corresponding allowance at September 30, 2012.

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A breakdown of the individual and collective ALLL and the corresponding loan balances as of September 30, 2012 follows:

September 30, 2012 *in millions*	**Allowance** Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Purchased Credit Impaired	**Loans**	**Outstanding** Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Purchased Credit Impaired
Commercial, financial and agricultural	$ 12	$ 306		$ 21,979	$ 92	$ 21,886	$ 1
Commercial real estate:							
Commercial mortgage	7	214		7,529	138	7,388	3
Construction		47		1,067	42	1,025	
Total commercial real estate loans	7	261		8,596	180	8,413	3
Commercial lease financing		66		4,960		4,960	
Total commercial loans	19	633		35,535	272	35,259	4
Real estate residential mortgage	1	24		2,138	18	2,103	17
Home equity:							
Key Community Bank	10	79		9,768	65	9,700	3
Other	1	23		409	10	399	
Total home equity loans	11	102		10,177	75	10,099	3
Consumer other Key Community Bank	1	31		1,313	2	1,310	1
Credit cards		25		710		710	
Consumer other:							
Marine	7	30		1,448	60	1,388	
Other		4		98	1	97	
Total consumer other	7	34		1,546	61	1,485	
Total consumer loans	20	216		15,884	156	15,707	21
Total ALLL continuing operations	39	849		51,419	428	50,966	25
Discontinued operations		65		5,328 (a)	3	5,325	
Total ALLL including discontinued operations	$ 39	$ 914		$ 56,747	$ 431	$ 56,291	$ 25

(a) Amount includes $2.6 billion of loans carried at fair value that are excluded from ALLL consideration.

A breakdown of the individual and collective ALLL and the corresponding loan balances as of September 30, 2011 follows:

September 30, 2011 *in millions*	**Allowance(a)** Individually Evaluated for Impairment	Collectively Evaluated for Impairment	**Loans**	**Outstanding(a)** Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Commercial, financial and agricultural	$ 20	$ 349	$ 17,848	$ 144	$ 17,704
Commercial real estate:					
Commercial mortgage	14	291	7,958	217	7,741
Construction	10	78	1,456	78	1,378

Total commercial real estate loans	24	369	9,414	295	9,119
Commercial lease financing		96	5,957		5,957
Total commercial loans	44	814	33,219	439	32,780
Real estate residential mortgage		34	1,875		1,875
Home equity:					
Key Community Bank		110	9,347	2	9,345
Other		35	565		565
Total home equity loans		145	9,912	2	9,910
Consumer other Key Community Bank		41	1,187		1,187
Consumer other:					
Marine		51	1,871		1,871
Other		2	131		131
Total consumer other		53	2,002		2,002
Total consumer loans		273	14,976	2	14,974
Total ALLL continuing operations	44	1,087	48,195	441	47,754
Discontinued operations		115	5,984		5,984
Total ALLL including discontinued operations	$ 44	$ 1,202	$ 54,179	$ 441	$ 53,738

(a) There were no loans acquired with deteriorated credit quality at September 30, 2011.

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The liability for credit losses inherent in lending-related commitments, such as letters of credit and unfunded loan commitments, is included in "accrued expense and other liabilities" on the balance sheet. We establish the amount of this reserve by considering both historical trends and current market conditions quarterly, or more often if deemed necessary. Our liability for credit losses on lending-related commitments has decreased by $13 million since the third quarter of 2011 to $43 million at September 30, 2012. When combined with our ALLL, our total allowance for credit losses represented 1.81% of loans at September 30, 2012, compared to 2.46% at September 30, 2011.

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

in millions	**Three months ended September 30, 2012**	**2011**	**Nine months ended September 30, 2012**	**2011**
Balance at beginning of period	**$ 51**	$ 57	**$ 45**	$ 73
Provision (credit) for losses on lending-related commitments	**(8)**	(1)	**(2)**	(17)
Balance at end of period	**$ 43**	$ 56	**$ 43**	$ 56

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5. Fair Value Measurements

Fair Value Determination

As defined in the applicable accounting guidance, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants in our principal market. We have established and documented our process for determining the fair values of our assets and liabilities, where applicable. Fair value is based on quoted market prices, when available, for identical or similar assets or liabilities. In the absence of quoted market prices, we determine the fair value of our assets and liabilities using valuation models or third-party pricing services. Both of these approaches rely on market-based parameters, when available, such as interest rate yield curves, option volatilities, and credit spreads, or unobservable inputs. Unobservable inputs may be based on our judgment, assumptions, and estimates related to credit quality, liquidity, interest rates, and other relevant inputs.

Valuation adjustments, such as those pertaining to counterparty and our own credit quality and liquidity, may be necessary to ensure that assets and liabilities are recorded at fair value. Credit valuation adjustments are made when market pricing does not accurately reflect the counterparty s credit quality. We make liquidity valuation adjustments to the fair value of certain assets to reflect the uncertainty in the pricing and trading of the instruments when we are unable to observe recent market transactions for identical or similar instruments. Liquidity valuation adjustments are based on the following factors:

¿ the amount of time since the last relevant valuation;

¿ whether there is an actual trade or relevant external quote available at the measurement date; and

¿ volatility associated with the primary pricing components.

We ensure that our fair value measurements are accurate and appropriate by relying upon various controls, including:

¿ an independent review and approval of valuation models and assumptions;

¿ recurring detailed reviews of profit and loss; and

¿ a validation of valuation model components against benchmark data and similar products, where possible.

We recognize transfers between levels of the fair value hierarchy at the end of the reporting period. Quarterly, we review any changes to our valuation methodologies to ensure they are appropriate and justified, and refine our valuation methodologies if more market-based data becomes available. The Fair Value Committee, which is governed by ALCO, oversees the valuation process for all lines of business and support areas, as applicable. Various Working Groups that report to the Fair Value Committee analyze and approve the valuation methodologies used to fair value assets and liabilities managed within specific areas. The Working Groups are discussed in more detail in the qualitative disclosures within this footnote and in Note 11 (Acquisitions and Discontinued Operations). Formal documentation in the form of fair value valuation methodologies are prepared by the lines of business and support areas as appropriate detailing the asset or liability class and related general ledger accounts, valuation techniques, fair value hierarchy level, market participants, accounting methods, valuation methodology, group responsible for valuations, and valuation inputs.

Additional information regarding our accounting policies for determining fair value is provided in Note 1 (Summary of Significant Accounting Policies) under the heading Fair Value Measurements on page 122 of our 2011 Annual Report on Form 10-K.

Qualitative Disclosures of Valuation Techniques

Loans. Most loans recorded as trading account assets are valued based on market spreads for identical assets since they are actively traded. Therefore, these loans are classified as Level 2 because the fair value recorded is based on observable market data for similar assets.

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Securities (trading and available for sale). We own several types of securities, requiring a range of valuation methods:

¿ Securities are classified as Level 1 when quoted market prices are available in an active market for the identical securities. Level 1 instruments include exchange-traded equity securities.

¿ Securities are classified as Level 2 if quoted prices for identical securities are not available, and fair value is determined using pricing models (either by a third-party pricing service or internally) or quoted prices of similar securities. These instruments include municipal bonds; bonds backed by the U.S. government; corporate bonds; certain mortgage-backed securities; securities issued by the U.S. Treasury; money markets; and certain agency and corporate CMOs. Inputs to the pricing models include actual trade data (i.e., spreads, credit ratings, and interest rates) for comparable assets, spread tables, matrices, high-grade scales, option-adjusted spreads, and standard inputs, such as yields, benchmark securities, bids, and offers.

¿ Securities are classified as Level 3 when there is limited activity in the market for a particular instrument. In such cases, we use internal models based on certain assumptions to determine fair value. Level 3 instruments consist of certain commercial mortgage-backed securities. Our Real Estate Capital line of business is responsible for the valuation process for these commercial mortgage-backed securities, which is conducted on a quarterly basis. The methodology incorporates a loan-by-loan credit review in combination with discounting the risk-adjusted bond cash flows. A detailed credit review of the underlying loans involves a screening process using a multitude of filters to identify the highest risk loans associated with these commercial mortgage-backed securities. Each of the highest risk loans identified is re-underwritten and loan specific defaults and recoveries are assigned. A matrix approach is used to assign an expected default and recovery percentage for the loans which are not individually re-underwritten. Bond classes will then be run through a discounted cash flow analysis, taking into account the expected default and recovery percentages as well as discount rates developed by our Finance area. Inputs for the Level 3 internal models include expected cash flows from the underlying loans, which take into account expected default and recovery percentages, market research, and discount rates commensurate with current market conditions. Changes in the credit quality of the underlying loans or market discount rate would impact the value of the bonds. An increase in the underlying loan credit quality or decrease in the market discount rate would positively impact the bond value. A decrease in the underlying loan credit quality or increase in the market discount rate would negatively impact the bond value.

The fair values of our Level 2 securities available for sale are determined by a third-party pricing service. The valuations provided by the third-party pricing service are based on observable market inputs, which include benchmark yields, reported trades, issuer spreads, benchmark securities, bids, offers, and reference data obtained from market research publications. Inputs used by the third-party pricing service in valuing CMOs and other mortgage-backed securities also include new issue data, monthly payment information, whole loan collateral performance, and To Be Announced prices. In valuations of state and political subdivisions securities, inputs used by the third-party pricing service also include material event notices.

On a quarterly basis, we validate the pricing methodologies utilized by our third-party pricing service to ensure the fair value determination is consistent with the applicable accounting guidance and that our assets are properly classified in the fair value hierarchy. To perform this validation, we:

¿ review documentation received from our third-party pricing service regarding the inputs used in their valuations and determine a level assessment for each category of securities;

¿ substantiate actual inputs used for a sample of securities by comparing the actual inputs used by our third-party pricing service to comparable inputs for similar securities; and

¿ substantiate the fair values determined for a sample of securities by comparing the fair values provided by our third-party pricing service to prices from other independent sources for the same and similar securities. We analyze variances and conduct additional research with our third-party pricing service and take appropriate steps based on our findings.

Private equity and mezzanine investments. Private equity and mezzanine investments consist of investments in debt and equity securities through our Real Estate Capital line of business. They include direct investments made in specific properties, as well as indirect investments made in funds that pool assets of many investors to invest in properties. There is no active market for these investments, so we employ other valuation methods.

Private equity and mezzanine investments are classified as Level 3 assets since our judgment significantly influences the determination of fair value. Our Fund Management, Asset Management, and Accounting groups are responsible for

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reviewing the valuation models and determining the fair value of these investments on a quarterly basis. Direct investments in properties are initially valued based upon the transaction price. This amount is then adjusted to fair value based on current market conditions using the discounted cash flow method based on the expected investment exit date. The fair values of the assets are reviewed and adjusted quarterly. Periodically, a third-party appraisal is obtained for the investment to validate the specific inputs for determining fair value.

Inputs used in calculating future cash flows include the cost of build-out, future selling prices, current market outlook, and operating performance of the investment. Investment income and expense assumptions are based on market inputs, such as rental/leasing rates and vacancy rates for the geographic- and property type-specific markets. For investments under construction, investment income and expense assumptions are determined using expected future build-out costs and anticipated future rental prices based on current market conditions, discount rates, holding period, the terminal cap rate and sales commissions paid in the terminal cap year. For investments that are in lease-up or are fully leased, income and expense assumptions are based on the current geographic market lease rates, underwritten expenses, market lease terms, and historical vacancy rates. Asset Management validates these inputs on a quarterly basis through the use of industry publications, third-party broker opinions, and comparable property sales, where applicable. Changes in the significant inputs (rental/leasing rates, vacancy rates, valuation capitalization rate, discount rate, and terminal cap rate) would significantly affect the fair value measurement. Increases in rental/leasing rates would increase fair value while increases in the vacancy rates, the valuation capitalization rate, the discount rate, and the terminal cap rate would decrease fair value.

Indirect investments are valued using a methodology that is consistent with accounting guidance that allows us to use statements from the investment manager to calculate net asset value per share. A primary input used in estimating fair value is the most recent value of the capital accounts as reported by the general partners of the funds in which we invest. The calculation to determine the investment s fair value is based on our percentage ownership in the fund multiplied by the net asset value of the fund, as provided by the fund manager.

Investments in real estate private equity funds are included within private equity and mezzanine investments. The main purpose of these funds is to acquire a portfolio of real estate investments that provides attractive risk-adjusted returns and current income for investors. Certain of these investments do not have readily determinable fair values and represent our ownership interest in an entity that follows measurement principles under investment company accounting. The following table presents the fair value of our indirect investments and related unfunded commitments at September 30, 2012:

September 30, 2012

in millions	Fair Value	Unfunded Commitments
INVESTMENT TYPE		
Passive funds [(a)]	$ 18	$ 3
Co-managed funds [(b)]	24	3
Total	$ 42	$ 6

(a) We invest in passive funds, which are multi-investor private equity funds. These investments can never be redeemed. Instead, distributions are received through the liquidation of the underlying investments in the funds. Some funds have no restrictions on sale, while others require investors to remain in the fund until maturity. The funds will be liquidated over a period of one to seven years.

(b) We are a manager or co-manager of these funds. These investments can never be redeemed. Instead, distributions are received through the liquidation of the underlying investments in the funds. In addition, we receive management fees. We can sell or transfer our interest in any of these funds with the written consent of a majority of the fund s investors. In one instance, the other co-manager of the fund must consent to the sale or transfer of our interest in the fund. The funds will mature over a period of two to five years.

Principal investments. Principal investments consist of investments in equity and debt instruments made by our principal investing entities. They include direct investments (investments made in a particular company), as well as indirect investments (investments made through funds that include other investors). During the first half of 2011, employees who managed our various principal investments formed two independent entities that serve as investment managers of these investments going forward. Under this new arrangement, which was mutually agreeable to both parties, these individuals are no longer employees of Key.

Each investment is adjusted to fair value with any net realized or unrealized gain/loss recorded in the current period s earnings. This process is a coordinated and documented effort by the Principal Investing Entities Deal Team (comprised of individuals from one of the independent investment managers noted above), the Key Principal Partners (KPP) Controller and certain members of the KPP Controller s staff, a member of Key s senior management team, and the Investment Committee (members comprised of individuals from Key and one of the independent investment managers). This process involves an in-depth review of the condition of each investment depending on the type of investment.

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Our direct investments include investments in debt and equity instruments of both private and public companies. When quoted prices are available in an active market for the identical direct investment, we use the quoted prices in the valuation process, and the related investments are classified as Level 1 assets. However, in most cases, quoted market prices are not available for our direct investments, and we must perform valuations using other methods. These direct investment valuations are an in-depth analysis of the condition of each investment and are based on the unique facts and circumstances related to each individual investment. There is a certain amount of subjectivity surrounding the valuation of these investments due to the combination of quantitative and qualitative factors that are used in the valuation models. Therefore, these direct investments are classified as Level 3 assets. The specific inputs used in the valuations of each type of direct investment are described below.

Interest-bearing securities (i.e., loans) are valued on a quarterly basis. Valuation adjustments are determined by the Principal Investing Entities Deal Team and are subject to approval by the Investment Committee. Valuations of debt instruments are based on the Principal Investing Entities Deal Team s knowledge of the current financial status of the subject company, which is regularly monitored throughout the term of the investment. Significant unobservable inputs used in the valuations of these investments include the company s payment history, adequacy of cash flows from operations, and current operating results, including market multiples, and historical and forecast earnings before interest, taxation, depreciation, and amortization. Inputs can also include the seniority of the debt, the nature of any pledged collateral, the extent to which the security interest is perfected and the net liquidation value of collateral.

Valuations of equity instruments of private companies, which are prepared on a quarterly basis, are based on current market conditions and the current financial status of each company. A valuation analysis is performed to value each investment that is reviewed by the Principal Investing Entities Deal Team Member as well as reviewed and approved by the Chief Administrative Officer of one of the independent investment managers. Significant unobservable inputs used in these valuations include adequacy of the company s cash flows from operations, any significant change in the company s performance since the prior valuation and any significant equity issuances by the company. Equity instruments of public companies are valued using quoted prices in an active market for the identical security. If the instrument is restricted, the fair value is determined considering the number of shares traded daily, the number of the company s total restricted shares, and price volatility.

Our indirect investments are classified as Level 3 assets since our significant inputs are not observable in the marketplace. Indirect investments include primary and secondary investments in private equity funds engaged mainly in venture- and growth-oriented investing. These investments do not have readily determinable fair values. Indirect investments are valued using a methodology that is consistent with accounting guidance that allows us to estimate fair value based upon net asset value per share (or its equivalent, such as member units or an ownership interest in partners capital to which a proportionate share of net assets is attributed). The significant unobservable input used in estimating fair value is primarily the most recent value of the capital accounts as reported by the general partners of the funds in which we invest.

For indirect investments, management makes adjustments as deemed appropriate to the net asset value and only if it is determined that the net asset value does not properly reflect fair value. In determining the need for an adjustment to net asset value, management performs an analysis of the private equity funds based on the independent fund manager s valuations as well as management s own judgment. Significant unobservable inputs used in these analyses include current fund financial information provided by the fund manager, an estimate of future proceeds expected to be received on the investment, and market multiples. Management also considers whether the independent fund manager adequately marks down an impaired investment, maintains financial statements in accordance with GAAP, or follows a practice of holding all investments at cost.

The fair value of our indirect investments and related unfunded commitments at September 30, 2012 was $455 million and $103 million, respectively. Our indirect investments consist of buyout, venture capital, and fund of funds. These investments can never be redeemed. Instead, distributions are received through the liquidation of the underlying investments of the fund. An investment in any one of these funds can be sold only with the approval of the fund s general partners. We estimate that the underlying investments of the funds will be liquidated over a period of one to ten years.

Derivatives. Exchange-traded derivatives are valued using quoted prices and, therefore, are classified as Level 1 instruments. However, only a few types of derivatives are exchange-traded. The majority of our derivative positions are valued using internally developed models based on market convention that use observable market inputs, such as interest rate curves, yield curves, LIBOR discount rates and curves, index pricing curves, foreign currency curves, and volatility surfaces (a three-dimensional graph of implied volatility against strike price and maturity). These derivative contracts, which are classified as Level 2 instruments, include interest rate swaps, certain options, cross currency swaps, and credit default swaps.

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In addition, we have several customized derivative instruments and risk participations that are classified as Level 3 instruments. These derivative positions are valued using internally developed models, with inputs consisting of available market data, such as bond spreads and asset values, as well as unobservable internally-derived assumptions, such as loss probabilities and internal risk ratings of customers. These derivatives are priced monthly by our Market Risk Management group using a credit valuation adjustment methodology. Swap details with the customer and our related participation percentage, if applicable, are obtained from our derivatives accounting system, which is the system of record. Applicable customer rating information is obtained from the particular loan system and represents an unobservable input to this valuation process. Using these various inputs, a valuation of these Level 3 derivatives is performed using a model that was acquired from a third party. In summary, the fair value represents an estimate of the amount that the risk participation counterparty would need to pay/receive as of the measurement date based on the probability of customer default on the swap transaction and the fair value of the underlying customer swap. Therefore, a higher loss probability and a lower credit rating would negatively affect the fair value of the risk participations and a lower loss probability and higher credit rating would positively affect the fair value of the risk participations.