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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington D.C. 20549**

**Form 10-Q**

b

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended June 30, 2008

or

o

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period From \_\_\_\_\_ To \_\_\_\_\_

Commission File Number 1-11302



(Exact name of registrant as specified in its charter)

**Ohio**

(State or other jurisdiction of  
incorporation or organization)

**34-6542451**

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

**127 Public Square, Cleveland, Ohio**

(Address of principal executive offices)

**44114-1306**

(Zip Code)

**(216) 689-6300**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 ☒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 ☒

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

(Title of class)

494,657,020 Shares

(Outstanding at July 31, 2008)

**KEYCORP**

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[Table of Contents](#)**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Consolidated Balance Sheets**

| <i>dollars in millions</i>  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 | June 30,<br>2007<br>(Unaudited) |
|---|---------------------------------|----------------------|---------------------------------|
| <b>ASSETS</b>   |                                 |                      |                                 |
| Cash and due from banks   | \$ 1,912                        | \$ 1,814             | \$ 1,818                        |
| Short-term investments  | 826                             | 516                  | 471                             |
| Trading account assets  | 1,483                           | 1,056                | 994                             |
| Securities available for sale   | 8,312                           | 7,860                | 7,819                           |
| Held-to-maturity securities (fair value: \$25, \$28 and \$37)           | 25                              | 28                   | 37                              |
| Other investments   | 1,559                           | 1,538                | 1,602                           |
| Loans, net of unearned income of \$2,532 \$2,202 and \$2,146            | 75,855                          | 70,823               | 66,692                          |
| Less: Allowance for loan losses   | 1,421                           | 1,200                | 945                             |
| Net loans   | 74,434                          | 69,623               | 65,747                          |
| Loans held for sale   | 1,833                           | 4,736                | 4,546                           |
| Premises and equipment  | 748                             | 681                  | 600                             |
| Operating lease assets  | 1,089                           | 1,128                | 1,110                           |
| Goodwill  | 1,598                           | 1,252                | 1,202                           |
| Other intangible assets   | 146                             | 123                  | 110                             |
| Corporate-owned life insurance  | 2,917                           | 2,872                | 2,822                           |
| Derivative assets   | 1,693                           | 879                  | 374                             |
| Accrued income and other assets   | 2,969                           | 4,122                | 3,715                           |
| Total assets  | <u>\$ 101,544</u>               | <u>\$ 98,228</u>     | <u>\$ 92,967</u>                |
| <b>LIABILITIES</b>  |                                 |                      |                                 |
| Deposits in domestic offices:   |                                 |                      |                                 |
| NOW and money market deposit accounts                                   | \$ 27,278                       | \$ 27,635            | \$ 23,315                       |
| Savings deposits  | 1,809                           | 1,513                | 1,613                           |
| Certificates of deposit (\$100,000 or more)                             | 8,699                           | 6,982                | 6,197                           |
| Other time deposits   | 12,541                          | 11,615               | 11,832                          |
| Total interest-bearing  | 50,327                          | 47,745               | 42,957                          |
| Noninterest-bearing   | 10,561                          | 11,028               | 14,199                          |
| Deposits in foreign office <sup>3</sup> / <sub>4</sub> interest-bearing | 3,508                           | 4,326                | 3,443                           |
| Total deposits  | 64,396                          | 63,099               | 60,599                          |
| Federal funds purchased and securities sold under repurchase agreements | 2,088                           | 3,927                | 4,362                           |
| Bank notes and other short-term borrowings                              | 5,985                           | 5,861                | 2,476                           |
| Derivative liabilities  | 637                             | 252                  | 248                             |

|   |                   |                  |                  |
|---|-------------------|------------------|------------------|
| Accrued expense and other liabilities   | 4,626             | 5,386            | 5,000            |
| Long-term debt  | 15,106            | 11,957           | 12,581           |
| Total liabilities   | 92,838            | 90,482           | 85,266           |
| <b>SHAREHOLDERS' EQUITY</b>   |                   |                  |                  |
| Preferred stock, \$1 par value; authorized 25,000,000 shares, none issued   | —                 | —                | —                |
| 7.750% Noncumulative Perpetual Convertible Preferred Stock, Series A, \$1 par value, \$100 liquidation preference; authorized 7,475,000 shares, issued 6,500,000 shares | 650               | —                | —                |
| Common shares, \$1 par value; authorized 1,400,000,000 shares; issued 576,995,163, 491,888,780 and 491,888,780 shares   | 577               | 492              | 492              |
| Capital surplus   | 2,544             | 1,623            | 1,652            |
| Retained earnings   | 7,461             | 8,522            | 8,720            |
| Treasury stock, at cost (91,333,157, 103,095,907 and 102,527,008 shares)  | (2,675)           | (3,021)          | (2,994)          |
| Accumulated other comprehensive income (loss)   | 149               | 130              | (169)            |
| Total shareholders' equity  | 8,706             | 7,746            | 7,701            |
| Total liabilities and shareholders' equity  | <u>\$ 101,544</u> | <u>\$ 98,228</u> | <u>\$ 92,967</u> |

See Notes to Consolidated Financial Statements (Unaudited).

[Table of Contents](#)**Consolidated Statements of Income (Unaudited)**

|   | Three months ended<br>June 30, |          | Six months ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|
|   | 2008                           | 2007     | 2008                         | 2007     |
| <i>dollars in millions, except per share amounts</i>                    |                                |          |                              |          |
| <b>INTEREST INCOME</b>  |                                |          |                              |          |
| Loans   | \$ 717                         | \$ 1,176 | \$ 1,840                     | \$ 2,337 |
| Loans held for sale   | 20                             | 82       | 107                          | 157      |
| Securities available for sale   | 111                            | 106      | 220                          | 206      |
| Held-to-maturity securities   | —                              | —        | 1                            | 1        |
| Trading account assets  | 10                             | 7        | 23                           | 14       |
| Short-term investments  | 8                              | 9        | 17                           | 20       |
| Other investments   | 14                             | 15       | 26                           | 28       |
| Total interest income   | 880                            | 1,395    | 2,234                        | 2,763    |
| <b>INTEREST EXPENSE</b>   |                                |          |                              |          |
| Deposits  | 347                            | 447      | 775                          | 880      |
| Federal funds purchased and securities sold under repurchase agreements | 15                             | 59       | 43                           | 108      |
| Bank notes and other short-term borrowings                              | 27                             | 18       | 66                           | 29       |
| Long-term debt  | 133                            | 185      | 279                          | 381      |
| Total interest expense  | 522                            | 709      | 1,163                        | 1,398    |
| <b>NET INTEREST INCOME</b>  | 358                            | 686      | 1,071                        | 1,365    |
| Provision for loan losses   | 647                            | 53       | 834                          | 97       |
| Net interest (loss) income after provision for loan losses              | (289)                          | 633      | 237                          | 1,268    |
| <b>NONINTEREST INCOME</b>   |                                |          |                              |          |
| Trust and investment services income                                    | 138                            | 115      | 267                          | 240      |
| Service charges on deposit accounts                                     | 93                             | 84       | 181                          | 159      |
| Investment banking and capital markets income                           | 80                             | 52       | 88                           | 96       |
| Operating lease income  | 68                             | 66       | 137                          | 130      |
| Letter of credit and loan fees  | 51                             | 45       | 88                           | 83       |
| Corporate-owned life insurance income                                   | 28                             | 32       | 56                           | 57       |
| Electronic banking fees   | 27                             | 25       | 51                           | 49       |
| Net gains (losses) from loan securitizations and sales                  | 33                             | 33       | (68)                         | 42       |
| Net securities (losses) gains   | (1)                            | 2        | 2                            | (45)     |
| Net (losses) gains from principal investing                             | (14)                           | 90       | (5)                          | 119      |
| Gain from redemption of Visa Inc. shares                                | —                              | —        | 165                          | —        |
| Gain from sale of McDonald Investments branch network                   | —                              | —        | —                            | 171      |
| Other income  | 52                             | 105      | 121                          | 202      |
| Total noninterest income  | 555                            | 649      | 1,083                        | 1,303    |



**NONINTEREST EXPENSE**

|                           |     |     |       |       |
|---------------------------|-----|-----|-------|-------|
| Personnel                 | 404 | 411 | 813   | 839   |
| Net occupancy             | 62  | 59  | 128   | 122   |
| Computer processing       | 43  | 49  | 90    | 100   |
| Operating lease expense   | 55  | 55  | 113   | 107   |
| Professional fees         | 33  | 26  | 56    | 52    |
| Equipment                 | 23  | 24  | 47    | 49    |
| Marketing                 | 21  | 20  | 35    | 39    |
| Other expense             | 140 | 171 | 231   | 291   |
| Total noninterest expense | 781 | 815 | 1,513 | 1,599 |

**(LOSS) INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES**

|              |     |     |     |     |
|--------------|-----|-----|-----|-----|
| Income taxes | 611 | 130 | 715 | 277 |
|--------------|-----|-----|-----|-----|

**(LOSS) INCOME FROM CONTINUING OPERATIONS**

|   |   |     |   |      |
|---|---|-----|---|------|
| Loss from discontinued operations, net of taxes of \$2 and \$7, respectively (see Note 3) | — | (3) | — | (11) |
|---|---|-----|---|------|

|                          |                   |               |                 |               |
|--------------------------|-------------------|---------------|-----------------|---------------|
| <b>NET (LOSS) INCOME</b> | <b>\$ (1,126)</b> | <b>\$ 334</b> | <b>\$ (908)</b> | <b>\$ 684</b> |
|--------------------------|-------------------|---------------|-----------------|---------------|

|   |            |        |          |        |
|---|------------|--------|----------|--------|
| Net (loss) income applicable to common shares | \$ (1,126) | \$ 334 | \$ (908) | \$ 684 |
|---|------------|--------|----------|--------|

## Per common share:

|  |           |        |           |         |
|--|-----------|--------|-----------|---------|
| (Loss) income from continuing operations | \$ (2.70) | \$ .86 | \$ (2.23) | \$ 1.76 |
|--|-----------|--------|-----------|---------|

|                   |        |     |        |      |
|-------------------|--------|-----|--------|------|
| Net (loss) income | (2.70) | .85 | (2.23) | 1.73 |
|-------------------|--------|-----|--------|------|

## Per common share — assuming dilution:

|  |           |        |           |         |
|--|-----------|--------|-----------|---------|
| (Loss) income from continuing operations | \$ (2.70) | \$ .85 | \$ (2.23) | \$ 1.74 |
|--|-----------|--------|-----------|---------|

|                   |        |     |        |      |
|-------------------|--------|-----|--------|------|
| Net (loss) income | (2.70) | .84 | (2.23) | 1.71 |
|-------------------|--------|-----|--------|------|

|  |         |         |         |        |
|--|---------|---------|---------|--------|
| Cash dividends declared per common share | \$ .375 | \$ .365 | \$ .375 | \$ .73 |
|--|---------|---------|---------|--------|

|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Weighted-average common shares outstanding (000) | 416,629 | 392,045 | 407,875 | 394,944 |
|--|---------|---------|---------|---------|

|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Weighted-average common shares and potential common shares outstanding (000) | 416,629 | 396,918 | 407,875 | 400,180 |
|--|---------|---------|---------|---------|

See Notes to Consolidated Financial Statements (Unaudited).

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## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

| <i>dollars in millions, except per share amounts</i>   | Preferred Stock<br>Outstanding (000) | Common Shares<br>Outstanding (000) | Preferred<br>Stock | Common<br>Shares | Capital<br>Surplus | Retained<br>Earnings | Treasury<br>Stock,<br>at Cost | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Comprehensive<br>Income (Loss) |
|--|--------------------------------------|------------------------------------|--------------------|------------------|--------------------|----------------------|-------------------------------|--|--------------------------------|
| <b>BALANCE AT DECEMBER 31, 2006</b>  | —                                    | 399,153                            | —                  | \$ 492           | \$ 1,602           | \$ 8,377             | \$ (2,584)                    | \$ (184)   |                                |
| Cumulative effect of adopting FSP<br>13-2, net of income taxes of (\$2)                                  |                                      |                                    |                    |                  |                    | (52)                 |                               |  |                                |
| Cumulative effect of adopting FIN 48,<br>net of income taxes of (\$1)                                    |                                      |                                    |                    |                  |                    | (1)                  |                               |  |                                |
| <b>BALANCE AT JANUARY 1, 2007</b>  |                                      |                                    |                    |                  |                    | 8,324                |                               |  |                                |
| Net income   |                                      |                                    |                    |                  |                    | 684                  |                               |  | \$ 684                         |
| Other comprehensive income:  |                                      |                                    |                    |                  |                    |                      |                               |  |                                |
| Net unrealized losses on securities<br>available for sale, net of income<br>taxes of (\$12) <sup>a</sup> |                                      |                                    |                    |                  |                    |                      |                               | (19)   | (19)                           |
| Net unrealized gains on derivative<br>financial instruments, net of<br>income taxes of \$6               |                                      |                                    |                    |                  |                    |                      |                               | 10   | 10                             |
| Foreign currency translation<br>adjustments  |                                      |                                    |                    |                  |                    |                      |                               | 14   | 14                             |
| Net pension and postretirement<br>benefit costs, net of income taxes                                     |                                      |                                    |                    |                  |                    |                      |                               | 10   | 10                             |
| Total comprehensive income   |                                      |                                    |                    |                  |                    |                      |                               |  | <u>\$ 699</u>                  |
| Deferred compensation  |                                      |                                    |                    |                  | 27                 | (2)                  |                               |  |                                |
| Cash dividends declared on common<br>shares (\$.73 per share)  |                                      |                                    |                    |                  |                    | (286)                |                               |  |                                |
| Common shares reissued for stock<br>options and other employee<br>benefit plans                          |                                      | 4,209                              |                    |                  | 23                 |                      | 117                           |  |                                |
| Common shares repurchased  |                                      | (14,000)                           |                    |                  |                    |                      | (527)                         |  |                                |
| <b>BALANCE AT JUNE 30, 2007</b>  | <u>—</u>                             | <u>389,362</u>                     | <u>—</u>           | <u>\$ 492</u>    | <u>\$ 1,652</u>    | <u>\$ 8,720</u>      | <u>\$ (2,994)</u>             | <u>\$ (169)</u>  |                                |
| <b>BALANCE AT DECEMBER 31, 2007</b>  | —                                    | 388,793                            | —                  | \$ 492           | \$ 1,623           | \$ 8,522             | \$ (3,021)                    | \$ 130   |                                |
| Net loss   |                                      |                                    |                    |                  |                    | (908)                |                               |  | \$ (908)                       |
| Other comprehensive loss:  |                                      |                                    |                    |                  |                    |                      |                               |  |                                |
| Net unrealized gains on securities<br>available for sale, net of income<br>taxes of \$10 <sup>a</sup>    |                                      |                                    |                    |                  |                    |                      |                               | 15   | 15                             |
| Net unrealized gains on derivative<br>financial instruments, net of<br>income taxes of \$1               |                                      |                                    |                    |                  |                    |                      |                               | 1  | 1                              |
| Foreign currency translation<br>adjustments  |                                      |                                    |                    |                  |                    |                      |                               | (1)  | (1)                            |
| Net pension and postretirement<br>benefit costs, net of income taxes                                     |                                      |                                    |                    |                  |                    |                      |                               | 4  | 4                              |
| Total comprehensive loss   |                                      |                                    |                    |                  |                    |                      |                               |  | <u>\$ (889)</u>                |

|  |              |                |               |               |                 |                 |                   |               |
|--|--------------|----------------|---------------|---------------|-----------------|-----------------|-------------------|---------------|
| Deferred compensation  |              |                |               |               | 3               | (3)             |                   |               |
| Cash dividends declared on common<br>shares (\$.375 per share) |              |                |               |               |                 | (150)           |                   |               |
| Preferred stock issued   | 6,500        |                | \$ 650        |               | (20)            |                 |                   |               |
| Common shares issued   |              | 85,106         |               | 85            | 893             |                 |                   |               |
| Common shares reissued:  |              |                |               |               |                 |                 |                   |               |
| Acquisition of U.S.B. Holding Co.,<br>Inc.                     |              | 9,895          |               |               | 58              |                 | 290               |               |
| Stock options and other employee<br>benefit plans              |              | 1,868          |               |               | (13)            |                 | 56                |               |
| <b>BALANCE AT JUNE 30, 2008</b>                                | <b>6,500</b> | <b>485,662</b> | <b>\$ 650</b> | <b>\$ 577</b> | <b>\$ 2,544</b> | <b>\$ 7,461</b> | <b>\$ (2,675)</b> | <b>\$ 149</b> |

(a) Net of reclassification adjustments.

See Notes to Consolidated Financial Statements (Unaudited).

[Table of Contents](#)**Consolidated Statements of Cash Flows (Unaudited)**

| <i>in millions</i>   | Six months ended<br>June 30, |              |
|--|------------------------------|--------------|
|  | 2008                         | 2007         |
| <b>OPERATING ACTIVITIES</b>  |                              |              |
| Net (loss) income  | \$ (908)                     | \$ 684       |
| Adjustments to reconcile net (loss) income to net cash used in operating activities: |                              |              |
| Provision for loan losses  | 834                          | 97           |
| Depreciation and amortization expense  | 217                          | 209          |
| Litigation reserve   | —                            | 42           |
| Net securities losses (gains)  | (2)                          | 45           |
| Liability to Visa  | (64)                         | —            |
| Gain from redemption of Visa Inc. shares   | (165)                        | —            |
| Gain from sale of McDonald Investments branch network                                | —                            | (171)        |
| Gain related to MasterCard Incorporated shares                                       | —                            | (40)         |
| Gain from settlement of automobile residual value insurance litigation               | —                            | (26)         |
| Net losses (gains) from principal investing  | 5                            | (119)        |
| Net losses (gains) from loan securitizations and sales                               | 68                           | (42)         |
| Loss from sale of discontinued operations  | —                            | 2            |
| Proceeds from settlement of automobile residual value insurance litigation           | —                            | 279          |
| Deferred income taxes  | (151)                        | (56)         |
| Net decrease (increase) in loans held for sale from continuing operations            | 48                           | (909)        |
| Net increase in trading account assets   | (427)                        | (82)         |
| Other operating activities, net  | 371                          | (343)        |
| <b>NET CASH USED IN OPERATING ACTIVITIES</b>   | <b>(174)</b>                 | <b>(430)</b> |
| <b>INVESTING ACTIVITIES</b>  |                              |              |
| Proceeds from redemption of Visa Inc. shares   | 165                          | —            |
| Proceeds from sale of McDonald Investments branch network, net of retention payments | —                            | 199          |
| Proceeds from sale of MasterCard Incorporated shares                                 | —                            | 40           |
| Cash used in acquisitions, net of cash acquired                                      | (184)                        | —            |
| Net increase in short-term investments   | (244)                        | (143)        |
| Purchases of securities available for sale   | (793)                        | (3,955)      |
| Proceeds from sales of securities available for sale                                 | 836                          | 2,449        |
| Proceeds from prepayments and maturities of securities available for sale            | 760                          | 1,443        |
| Purchases of held-to-maturity securities   | (2)                          | —            |
| Proceeds from prepayments and maturities of held-to-maturity securities              | 4                            | 4            |
| Purchases of other investments   | (306)                        | (363)        |
| Proceeds from sales of other investments   | 111                          | 213          |
| Proceeds from prepayments and maturities of other investments                        | 71                           | 64           |
| Net increase in loans, excluding acquisitions, sales and transfers                   | (1,560)                      | (1,309)      |
| Purchases of loans   | (18)                         | (56)         |

|   |                        |                        |
|---|------------------------|------------------------|
| Proceeds from loan securitizations and sales                                  | 221                    | 287                    |
| Purchases of premises and equipment   | (87)                   | (58)                   |
| Proceeds from sales of premises and equipment                                 | 1                      | 1                      |
| Proceeds from sales of other real estate owned                                | 13                     | 45                     |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                  | <b>(1,012)</b>         | <b>(1,139)</b>         |
| <b>FINANCING ACTIVITIES</b>   |                        |                        |
| Net (decrease) increase in deposits   | (509)                  | 1,480                  |
| Net (decrease) increase in short-term borrowings                              | (2,505)                | 2,158                  |
| Net proceeds from issuance of long-term debt                                  | 3,900                  | 39                     |
| Payments on long-term debt  | (910)                  | (1,845)                |
| Purchases of treasury shares  | —                      | (527)                  |
| Net proceeds from issuance of common shares and preferred stock               | 1,601                  | —                      |
| Net proceeds from reissuance of common shares                                 | 6                      | 93                     |
| Tax benefits (under) over recognized compensation cost for stock-based awards | (1)                    | 11                     |
| Cash dividends paid   | (298)                  | (286)                  |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>                              | <b>1,284</b>           | <b>1,123</b>           |
| <b>NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS</b>                     | <b>98</b>              | <b>(446)</b>           |
| <b>CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD</b>                         | <b>1,814</b>           | <b>2,264</b>           |
| <b>CASH AND DUE FROM BANKS AT END OF PERIOD</b>                               | <b><u>\$ 1,912</u></b> | <b><u>\$ 1,818</u></b> |
| Additional disclosures relative to cash flows:                                |                        |                        |
| Interest paid   | \$ 1,144               | \$ 1,416               |
| Income taxes paid   | 322                    | 135                    |
| Noncash items:  |                        |                        |
| Assets acquired   | \$ 2,810               | —                      |
| Liabilities assumed   | 2,648                  | —                      |
| Loans transferred to portfolio from held for sale                             | 3,284                  | —                      |
| Loans transferred to held for sale from portfolio                             | 429                    | —                      |
| Loans transferred to other real estate owned                                  | 23                     | \$ 20                  |

See Notes to Consolidated Financial Statements (Unaudited)

[Table of Contents](#)**Notes to Consolidated Financial Statements (Unaudited)****1. Basis of Presentation**

The unaudited condensed consolidated interim financial statements include the accounts of KeyCorp and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

As used in these notes:

- .. **KeyCorp** refers solely to the parent holding company.
- .. **KeyBank** refers to KeyCorp's subsidiary bank, KeyBank National Association.
- .. **Key** refers to the consolidated entity consisting of KeyCorp and its subsidiaries.

The consolidated financial statements include any voting rights entity in which Key has a controlling financial interest. In accordance with Financial Accounting Standards Board ("FASB") Revised Interpretation No. 46, "Consolidation of Variable Interest Entities," a variable interest entity ("VIE") is consolidated if Key has a variable interest in the entity and is exposed to the majority of its expected losses and/or residual returns (i.e., Key is considered to be the primary beneficiary). Variable interests can include equity interests, subordinated debt, derivative contracts, leases, service agreements, guarantees, standby letters of credit, loan commitments, and other contracts, agreements and financial instruments. See Note 8 ("Variable Interest Entities") on page 23 for information on Key's involvement with VIEs.

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

Qualifying special purpose entities, including securitization trusts, established by Key under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," are not consolidated. Information on SFAS No. 140 is included in Note 1 ("Summary of Significant Accounting Policies") of Key's 2007 Annual Report to Shareholders under the heading "Loan Securitizations" on page 67.

Management believes that the unaudited condensed consolidated interim financial statements reflect all adjustments of a normal recurring nature and disclosures that are necessary for a fair presentation of the results for the interim periods presented. Some previously reported results have been reclassified to conform to current reporting practices.

The results of operations for the interim period are not necessarily indicative of the results of operations to be expected for the full year. The interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in Key's 2007 Annual Report to Shareholders.

**Goodwill and Other Intangible Assets**

Under SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill and certain intangible assets are subject to impairment testing, which must be conducted at least annually. Key typically performs this required testing in the fourth quarter of each year, or more frequently if events or circumstances indicate possible impairment. Key's reporting units for purposes of this testing are its major business segments: Community Banking and National Banking.

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The first step in impairment testing is to determine the fair value of each reporting unit. If the carrying amount of a reporting unit exceeds its fair value, goodwill impairment may be indicated. In such a case, Key would estimate a purchase price for the reporting unit (representing the unit's fair value) and then compare that hypothetical purchase price to the fair value of the unit's net assets (excluding goodwill). Any excess of the estimated purchase price over the fair value of the reporting unit's net assets represents the implied fair value of goodwill. An impairment loss would be recognized as a charge to earnings to the extent the carrying amount of the reporting unit's goodwill exceeds the implied fair value of goodwill.

Key's results for the second quarter of 2008 were adversely affected by after-tax charges of \$1.011 billion, resulting from a previously announced adverse federal court decision on the tax treatment of a Service Contract Lease transaction, and a substantial increase to the provision for loan losses. As a result of these charges, management tested Key's goodwill for impairment as of June 30, 2008, and determined that no impairment existed at that date.

Two primary assumptions are used in determining the fair value of Key's reporting units: Key's revenue growth rate and the future weighted-average cost of capital. Assuming that these assumptions remain unchanged, an incremental after-tax charge exceeding approximately \$700 million within the National Banking reporting unit would likely require additional impairment testing steps since the carrying amount of this unit would then exceed its fair value.

## **Derivatives**

Effective January 1, 2008, Key adopted the accounting guidance in FASB Staff Position FIN 39-1, "Amendment of FASB Interpretation 39," and as a result, also adopted the provisions of Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts." As a result of adopting this guidance, Key changed its accounting policy pertaining to the recognition of derivative assets and liabilities to take into account the impact of master netting agreements that allow Key to settle all derivative contracts held with a single counterparty on a net basis and to offset the net derivative position with the related cash collateral. Additional information regarding Key's adoption of this accounting guidance is provided in Note 14 ("Derivatives and Hedging Activities"), which begins on page 31, and under the heading "Accounting Pronouncements Adopted in 2008" on page 9 of this note.

## **Fair Value Measurements**

Effective January 1, 2008, Key adopted SFAS No. 157, "Fair Value Measurements," for all applicable financial and nonfinancial assets and liabilities. This accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances.

As defined in SFAS No. 157, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants. It represents an exit price at the measurement date. Market participants are buyers and sellers, who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset or liability being measured. Current market conditions, including imbalances between supply and demand, are considered in determining fair value.

Key values its assets and liabilities in the principal market where it sells the particular asset or transfers the liability with the greatest volume and level of activity. In the absence of a principal market, the valuation is based on the most advantageous market for the asset or liability (i.e., the market where the asset could be sold or the liability transferred at a price that maximizes the amount to be received for the asset or minimizes the amount to be paid to transfer the liability).

In measuring the fair value of an asset, Key assumes the highest and best use of the asset by a market participant to maximize the value of the asset, and does not consider the intended use of the asset.

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When measuring the fair value of a liability, Key assumes that the nonperformance risk associated with the liability is the same before and after the transfer. Nonperformance risk is the risk that an obligation will not be satisfied and encompasses not only Key's own credit risk (i.e., the risk that Key will fail to meet its obligation), but also other risks such as settlement risk. Key considers the effect of its own credit risk on the fair value for any period in which fair value is measured.

There are three acceptable valuation techniques that can be used to measure fair value: the market approach, the income approach and the cost approach. Selection of the appropriate technique for valuing a particular asset or liability takes into consideration the exit market, the nature of the asset or liability being valued, and how a market participant would value the same asset or liability. Ultimately, determination of the appropriate valuation method requires significant judgment, and sufficient knowledge and expertise are required to apply the valuation techniques.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of Key.

Unobservable inputs are assumptions based on Key's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. Key considers an input to be significant if it drives 10% or more of the total fair value of a particular asset or liability.

Assets and liabilities are considered to be fair valued on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly or quarterly). Recurring valuation occurs at a minimum on the measurement date.

Assets and liabilities are considered to be fair valued on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheet. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements which require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value.

The fair value of assets or liabilities transferred in or out of Level 3 is measured on the transfer date, with any additional changes in fair value subsequent to the transfer considered to be realized or unrealized gains or losses.

Additional information regarding fair value measurements and Key's adoption of SFAS No. 157 is provided in Note 15 ("Fair Value Measurements"), which begins on page 34, and under the heading "Accounting Pronouncements Adopted in 2008" below.

### **Accounting Pronouncements Adopted in 2008**

***Fair value measurements.*** In September 2006, the FASB issued SFAS No. 157, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This guidance applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 (January 1, 2008, for Key). In February 2008, the FASB



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issued Staff Position FAS 157-2, which delayed the effective date of SFAS No. 157 for all nonfinancial assets and liabilities, except those recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), to fiscal years beginning after November 15, 2008. However, early adoption of SFAS No. 157 for nonfinancial assets and liabilities within the scope of the new guidance is permitted. Key's January 1, 2008, adoption of SFAS No. 157 for all financial and nonfinancial assets and liabilities did not have a material effect on Key's financial condition or results of operations. Additional information regarding fair value measurements and Key's adoption of this accounting guidance is provided in Note 15 and under the heading "Fair Value Measurements" on page 8 of this note.

***Fair value option for financial assets and financial liabilities.*** In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This guidance provides an option to selectively report financial assets and liabilities at fair value, and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 (January 1, 2008, for Key). Key has elected to not apply this fair value option to any of its existing assets or liabilities. However, Key may apply this guidance to assets or liabilities in the future as permitted under SFAS No. 159.

***Offsetting of amounts related to certain contracts.*** In April 2007, the FASB issued Staff Position FIN 39-1, which supplements Interpretation No. 39 by allowing reporting entities to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash (a payable) arising from derivative instruments with the same counterparty. Interpretation No. 39 allowed reporting entities to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. Key did not previously adopt the provisions of Interpretation No. 39 that were permitted but not required. The accounting guidance in Staff Position FIN 39-1 is effective for fiscal years beginning after November 15, 2007 (January 1, 2008, for Key). Key has elected to adopt the accounting guidance in Staff Position FIN 39-1, and as a result, also adopted the provisions of Interpretation No. 39. The adoption of this accounting guidance did not have a material effect on Key's financial condition or results of operations. Additional information regarding Key's adoption of this accounting guidance is provided in Note 14 and under the heading "Derivatives" on page 8 of this note.

### **Accounting Pronouncements Pending Adoption at June 30, 2008**

***Employers' accounting for defined benefit pension and other postretirement plans.*** In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." Except for the measurement requirement, Key adopted this accounting guidance as of December 31, 2006. Additional information regarding the adoption of SFAS No. 158 is included in Note 1 ("Summary of Significant Accounting Policies") under the heading "Accounting Pronouncements Pending Adoption at December 31, 2007" on page 71 of Key's 2007 Annual Report to Shareholders. The requirement to measure plan assets and benefit obligations as of the end of an employer's fiscal year is effective for years ending after December 15, 2008 (December 31, 2008, for Key). Adoption of this guidance is not expected to have a material effect on Key's financial condition or results of operations.

***Business combinations.*** In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations." The new pronouncement requires the acquiring entity in a business combination to recognize only the assets acquired and liabilities assumed in a transaction (e.g., acquisition costs must be expensed when incurred), establishes the fair value at the date of acquisition as the initial measurement for all assets acquired and liabilities assumed, and requires expanded disclosures. SFAS No. 141(R) will be effective for fiscal years beginning after December 15, 2008 (January 1, 2009, for Key). Early adoption is prohibited.

***Noncontrolling interests.*** In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51." The new pronouncement requires all entities to report noncontrolling (minority) interests in subsidiaries as a component of shareholders' equity. SFAS No. 160 will be effective for fiscal years beginning after December 15, 2008 (January 1, 2009, for Key). Early adoption is prohibited. Management is evaluating the potential effect this guidance may have on Key's financial condition and results of operations.

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***Accounting for transfers of financial assets and repurchase financing transactions.*** In February 2008, the FASB issued Staff Position FAS 140-3, “Accounting for Transfers of Financial Assets and Repurchase Financing Transactions.” This Staff Position provides guidance on accounting for a transfer of a financial asset and a repurchase financing, and presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (linked transaction) under SFAS No. 140. However, if certain criteria are met, the initial transfer and repurchase financing shall be evaluated separately under SFAS No. 140. Staff Position FAS 140-3 will be effective for fiscal years beginning after November 15, 2008 (January 1, 2009, for Key), and for interim periods within those fiscal years. Early adoption is prohibited. Management is evaluating the potential effect this guidance may have on Key’s financial condition and results of operations.

***Disclosures about derivative instruments and hedging activities.*** In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities,” which amends and expands the disclosure requirements of SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities.” This accounting guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 will be effective for fiscal years beginning after November 15, 2008 (January 1, 2009, for Key).

***Determination of the useful life of intangible assets.*** In April 2008, the FASB issued Staff Position FAS 142-3, “Determination of the Useful Life of Intangible Assets.” This accounting guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, “Goodwill and Other Intangible Assets.” This Staff Position will be effective for fiscal years beginning after December 15, 2008 (January 1, 2009, for Key), and for interim periods within those fiscal years. Early adoption is prohibited. Adoption of this accounting guidance is not expected to have a material effect on Key’s financial condition or results of operations.

***Hierarchy of generally accepted accounting principles.*** In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” This guidance identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. generally accepted accounting principles. SFAS No. 162 will be effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.” Adoption of this accounting guidance is not expected to have a material effect on Key’s financial condition or results of operations.

***Accounting for convertible debt instruments.*** In May 2008, the FASB issued Staff Position APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (including Partial Cash Settlement).” This guidance requires the issuer of certain convertible debt instruments that may be settled in cash (or other assets) on conversion to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects the issuer’s nonconvertible debt borrowing rate. This Staff Position is effective for fiscal years beginning after December 15, 2008 (January 1, 2009, for Key), and for interim periods within those fiscal years. Early adoption is prohibited. Key has not issued and does not have any convertible debt instruments outstanding that are subject to the accounting guidance in this Staff Position. Therefore, adoption of this accounting guidance is not expected to have a material effect on Key’s financial condition or results of operations.

[Table of Contents](#)**2. Earnings Per Common Share**

Key's basic and diluted earnings per common share are calculated as follows:

|   | Three months ended<br>June 30, |                | Six months ended<br>June 30, |                |
|---|--------------------------------|----------------|------------------------------|----------------|
|   | 2008                           | 2007           | 2008                         | 2007           |
| <i>dollars in millions, except per share amounts</i>  |                                |                |                              |                |
| <b>EARNINGS</b>   |                                |                |                              |                |
| (Loss) income from continuing operations  | \$ (1,126)                     | \$ 337         | \$ (908)                     | \$ 695         |
| Loss from discontinued operations, net of taxes   | —                              | (3)            | —                            | (11)           |
| Net (loss) income   | <u>\$ (1,126)</u>              | <u>\$ 334</u>  | <u>\$ (908)</u>              | <u>\$ 684</u>  |
| Net (loss) income applicable to common shares   | <u>\$ (1,126)</u>              | <u>\$ 334</u>  | <u>\$ (908)</u>              | <u>\$ 684</u>  |
| <b>WEIGHTED-AVERAGE COMMON SHARES</b>   |                                |                |                              |                |
| Weighted-average common shares outstanding (000)  | 416,629                        | 392,045        | 407,875                      | 394,944        |
| Effect of dilutive convertible preferred stock, common stock options and other stock awards (000) | —                              | 4,873          | —                            | 5,236          |
| Weighted-average common shares and potential common shares outstanding (000)                      | <u>416,629</u>                 | <u>396,918</u> | <u>407,875</u>               | <u>400,180</u> |
| <b>EARNINGS PER COMMON SHARE</b>  |                                |                |                              |                |
| (Loss) income from continuing operations  | \$ (2.70)                      | \$ .86         | \$ (2.23)                    | \$ 1.76        |
| Loss from discontinued operations   | —                              | (.01)          | —                            | (.03)          |
| Net (loss) income   | (2.70)                         | .85            | (2.23)                       | 1.73           |
| (Loss) income from continuing operations — assuming dilution                                      | \$ (2.70)                      | \$ .85         | \$ (2.23)                    | \$ 1.74        |
| Loss from discontinued operations — assuming dilution   | —                              | (.01)          | —                            | (.03)          |
| Net (loss) income — assuming dilution   | (2.70)                         | .84            | (2.23)                       | 1.71           |

**3. Acquisitions and Divestitures**

Acquisitions and divestitures completed by Key during 2007 and the first six months of 2008 are summarized below.

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

On January 1, 2008, Key acquired U.S.B. Holding Co., Inc., the holding company for Union State Bank, a 31-branch state-chartered commercial bank headquartered in Orangeburg, New York. U.S.B. Holding Co. had assets of \$2.8 billion and deposits of \$1.8 billion at the date of acquisition. Under the terms of the agreement, 9,895,000 KeyCorp common shares, with a value of \$348 million, and \$194 million in cash were exchanged for all of the outstanding shares of U.S.B. Holding Co. In connection with the acquisition, Key recorded goodwill of approximately \$350 million. The acquisition expanded Key's presence in markets both within and contiguous to its current operations in the Hudson Valley.

**Tuition Management Systems, Inc.**

On October 1, 2007, Key acquired Tuition Management Systems, Inc., one of the nation's largest providers of outsourced tuition planning, billing, counseling and payment services. Headquartered in Warwick, Rhode Island, Tuition Management Systems serves more than 700 colleges, universities, elementary and secondary educational institutions. The terms

of the transaction were not material.

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**Divestitures**
**Champion Mortgage**

On February 28, 2007, Key sold the Champion Mortgage loan origination platform to an affiliate of Fortress Investment Group LLC, a global alternative investment and asset management firm, for cash proceeds of \$.5 million.

On November 29, 2006, Key sold the subprime mortgage loan portfolio held by the Champion Mortgage finance business to a wholly owned subsidiary of HSBC Finance Corporation for cash proceeds of \$2.5 billion. The loan portfolio totaled \$2.5 billion at the date of sale.

Key has applied discontinued operations accounting to the Champion Mortgage finance business. The results of this discontinued business are presented on one line as “loss from discontinued operations, net of taxes” in the Consolidated Statements of Income on page 4. The components of loss from discontinued operations are as follows:

| <i>in millions</i>  | <b>Three months<br/>ended June 30,<br/>2007</b> | <b>Six months<br/>ended June 30,<br/>2007</b> |
|---|---|---|
| Loss, net of taxes of (\$1) and (\$3), respectively a                     | \$ (2)  | \$ (6)  |
| Loss on disposal, net of taxes of (\$1)                                   | —   | (1)   |
| Disposal transaction costs, net of taxes of (\$1) and (\$3), respectively | (1)   | (4)   |
| Loss from discontinued operations   | <u>\$ (3)</u>                                   | <u>\$ (11)</u>                                |

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

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

| <i>in millions</i>                    | <b>December 31,<br/>2007</b> | <b>June 30,<br/>2007</b> |
|---------------------------------------|------------------------------|--------------------------|
| Loans                                 | \$ 8                         | \$ 9                     |
| Accrued income and other assets       | —                            | 2                        |
| Total assets                          | <u>\$ 8</u>                  | <u>\$ 11</u>             |
| Accrued expense and other liabilities | \$ 10                        | \$ 14                    |
| Total liabilities                     | <u>\$ 10</u>                 | <u>\$ 14</u>             |

**McDonald Investments branch network**

On February 9, 2007, McDonald Investments Inc., a wholly owned subsidiary of KeyCorp, sold its branch network, which included approximately 570 financial advisors and field support staff, and certain fixed assets to UBS Financial Services Inc., a subsidiary of UBS AG. Key received cash proceeds of \$219 million and recorded a gain of \$171 million (\$107 million after tax, \$.26 per diluted common share) in connection with the sale. Key retained McDonald Investments’ corporate and institutional businesses, including Institutional Equities and Equity Research, Debt Capital Markets and Investment Banking. In addition, KeyBank continues to operate the Wealth Management, Trust and Private Banking businesses. On April 16, 2007, Key renamed the registered broker/dealer through which its corporate and institutional investment banking and securities businesses operate to KeyBanc Capital Markets Inc.

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#### 4. Line of Business Results

##### Community Banking

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

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

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

##### National Banking

**Real Estate Capital and Corporate Banking Services** consists of two business units. Real Estate Capital is a national business that provides construction and interim lending, permanent debt placements and servicing, equity and investment banking, and other commercial banking products and services to developers, brokers and owner-investors. This unit deals primarily with nonowner-occupied properties (i.e., generally properties in which at least 50% of the debt service is provided by rental income from nonaffiliated third parties). Particular emphasis has been placed on providing clients with finance solutions through access to the capital markets.

Corporate Banking Services provides cash management, interest rate derivatives, and foreign exchange products and services to clients throughout the Community Banking and National Banking groups. Through its Public Sector and Financial Institutions businesses, Corporate Banking Services provides a full array of commercial banking products and services to government and not-for-profit entities, and to community banks.

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

**Institutional and Capital Markets**, through its KeyBanc Capital Markets unit, provides commercial lending, treasury management, investment banking, derivatives and foreign exchange, equity and debt underwriting and trading, and syndicated finance products and services to large corporations and middle-market companies.

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

**Consumer Finance** offers loans to consumers on a direct basis and an indirect basis through dealers. It also provides federal and private education loans to students and their parents, and processes tuition payments for private schools. Through its Commercial Floor Plan Lending unit, Consumer Finance finances inventory for automobile, recreation and marine dealers.

##### Other Segments

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

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### **Reconciling Items**

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

The table that spans pages 16 and 17 shows selected financial data for each major business group for the three- and six-month periods ended June 30, 2008 and 2007. This table is accompanied by supplementary information for each of the lines of business that make up these groups. The information was derived from the internal financial reporting system that management uses to monitor and manage Key’s financial performance. U.S. generally accepted accounting principles (“GAAP”) guide financial accounting, but there is no authoritative guidance for “management accounting”—the way management uses its judgment and experience to make reporting decisions. Consequently, the line of business results Key reports may not be comparable with line of business results presented by other companies.

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

- “ Net interest income is determined by assigning a standard cost for funds used or a standard credit for funds provided based on their assumed maturity, prepayment and/or repricing characteristics. The net effect of this funds transfer pricing is charged to the lines of business based on the total loan and deposit balances of each line.
- “ Indirect expenses, such as computer servicing costs and corporate overhead, are allocated based on assumptions regarding the extent to which each line actually uses the services.
- “ Key’s consolidated provision for loan losses is allocated among the lines of business primarily based on their actual net charge-offs, adjusted periodically for loan growth and changes in risk profile. The amount of the consolidated provision is based on the methodology that management uses to estimate Key’s consolidated allowance for loan losses. This methodology is described in Note 1 (“Summary of Significant Accounting Policies”) under the heading “Allowance for Loan Losses” on page 67 of Key’s 2007 Annual Report to Shareholders.
- “ Income taxes are allocated based on the statutory federal income tax rate of 35% (adjusted for tax-exempt interest income, income from corporate-owned life insurance, and tax credits associated with investments in low-income housing projects) and a blended state income tax rate (net of the federal income tax benefit) of 2.5%.
- “ Capital is assigned based on management’s assessment of economic risk factors (primarily credit, operating and market risk) directly attributable to each line.

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

Effective January 1, 2008, Key moved the Public Sector, Bank Capital Markets and Global Treasury Management units from the Institutional and Capital Markets line of business to the Real Estate Capital and Corporate Banking Services (previously known as Real Estate Capital) line of business within the National Banking group.

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**Three months ended June 30,**  
dollars in millions

|   | Community Banking |               | National Banking      |               |
|---|-------------------|---------------|-----------------------|---------------|
|   | 2008              | 2007          | 2008                  | 2007          |
| <b>SUMMARY OF OPERATIONS</b>                                      |                   |               |                       |               |
| Net interest income (loss) (TE)                                   | \$ 437            | \$ 417        | \$ (472) <sup>d</sup> | \$ 339        |
| Noninterest income  | 222               | 214           | 346                   | 273           |
| Total revenue (TE) a  | 659               | 631           | (126)                 | 612           |
| Provision for loan losses   | 44                | 21            | 609                   | 32            |
| Depreciation and amortization expense                             | 34                | 33            | 73                    | 71            |
| Other noninterest expense   | 415               | 413           | 264                   | 259           |
| Income (loss) from continuing operations before income taxes (TE) | 166               | 164           | (1,072)               | 250           |
| Allocated income taxes and TE adjustments                         | 62                | 62            | (402)                 | 93            |
| Income (loss) from continuing operations                          | 104               | 102           | (670)                 | 157           |
| Loss from discontinued operations, net of taxes                   | —                 | —             | —                     | (3)           |
| Net income (loss)   | <u>\$ 104</u>     | <u>\$ 102</u> | <u>\$ (670)</u>       | <u>\$ 154</u> |
| Percent of consolidated income from continuing operations         | N/M               | 30%           | N/M                   | 47%           |
| Percent of total segments income from continuing operations       | N/M               | 32            | N/M                   | 50            |
| <b>AVERAGE BALANCES <sup>b</sup></b>                              |                   |               |                       |               |
| Loans and leases  | \$ 28,478         | \$ 26,574     | \$ 47,876             | \$ 39,325     |
| Total assets a  | 31,385            | 29,346        | 56,242                | 49,585        |
| Deposits  | 49,948            | 46,126        | 12,289                | 12,082        |
| <b>OTHER FINANCIAL DATA</b>                                       |                   |               |                       |               |
| Net loan charge-offs  | \$ 38             | \$ 26         | \$ 486                | \$ 27         |
| Return on average allocated equity b                              | 13.68%            | 16.57%        | (51.60)%              | 15.12%        |
| Return on average allocated equity                                | 13.68             | 16.57         | (51.60)               | 14.83         |
| Average full-time equivalent employees                            | 8,785             | 9,026         | 3,603                 | 3,856         |

**Six months ended June 30,**  
dollars in millions

|   | Community Banking |                  | National Banking      |                  |
|---|-------------------|------------------|-----------------------|------------------|
|   | 2008              | 2007             | 2008                  | 2007             |
| <b>SUMMARY OF OPERATIONS</b>                                      |                   |                  |                       |                  |
| Net interest income (loss) (TE)                                   | \$ 860            | \$ 836           | \$ (133) <sup>d</sup> | \$ 675           |
| Noninterest income  | 428               | 602 <sup>c</sup> | 447                   | 532 <sup>d</sup> |
| Total revenue (TE) a  | 1,288             | 1,438            | 314                   | 1,207            |
| Provision for loan losses   | 62                | 35               | 778                   | 62               |
| Depreciation and amortization expense                             | 69                | 69               | 148                   | 140              |
| Other noninterest expense   | 807               | 843              | 498                   | 506              |
| Income (loss) from continuing operations before income taxes (TE) | 350               | 491              | (1,110)               | 499              |
| Allocated income taxes and TE adjustments                         | 131               | 184              | (416)                 | 187              |
| Income (loss) from continuing operations                          | 219               | 307              | (694)                 | 312              |



|   |               |               |                 |               |
|---|---------------|---------------|-----------------|---------------|
| Loss from discontinued operations, net of taxes             | —             | —             | —               | (11)          |
| Net income (loss)   | <u>\$ 219</u> | <u>\$ 307</u> | <u>\$ (694)</u> | <u>\$ 301</u> |
| Percent of consolidated income from continuing operations   | N/M           | 44%           | N/M             | 45%           |
| Percent of total segments income from continuing operations | N/M           | 46            | N/M             | 47            |
| <b>AVERAGE BALANCES <sup>b</sup></b>                        |               |               |                 |               |
| Loans and leases  | \$ 28,303     | \$ 26,514     | \$ 46,013       | \$ 39,085     |
| Total assets <sup>a</sup>                                   | 31,227        | 29,317        | 56,230          | 49,003        |
| Deposits  | 49,857        | 46,322        | 12,088          | 11,691        |
| <b>OTHER FINANCIAL DATA</b>                                 |               |               |                 |               |
| Net loan charge-offs  | \$ 68         | \$ 45         | \$ 577          | \$ 52         |
| Return on average allocated equity <sup>b</sup>             | 14.57%        | 25.08%        | (27.53)%        | 15.30%        |
| Return on average allocated equity                          | 14.57         | 25.08         | (27.53)         | 14.76         |
| Average full-time equivalent employees                      | 8,750         | 9,242         | 3,680           | 4,070         |

- (a) Substantially all revenue generated by Key's major business groups is derived from clients with residency in the United States. Substantially all long-lived assets, including premises and equipment, capitalized software and goodwill held by Key's major business groups are located in the United States.
- (b) From continuing operations.
- (c) Community Banking's results for the first quarter of 2007 include a \$171 million (\$107 million after tax) gain from the February 9, 2007, sale of the McDonald Investments branch network. See Note 3 ("Acquisitions and Divestitures"), which begins on page 12, for more information pertaining to this transaction.
- (d) During the second quarter of 2008, National Banking's taxable-equivalent net interest income and net income were reduced by \$838 million and \$536 million, respectively, as a result of an adverse federal court decision on the tax treatment of a Service Contract Lease transaction. During the prior quarter, National Banking increased its tax reserves for certain lease in, lease out transactions and recalculated its lease income in accordance with prescribed accounting standards. These actions reduced National Banking's taxable-equivalent revenue by \$34 million and its net income by \$21 million in the first quarter. National Banking's results for the first quarter of 2007 include a \$26 million (\$17 million after tax) gain from the settlement of the residual value insurance litigation.
- (e) Other Segments' results for the second quarter of 2007 include a \$26 million (\$16 million after tax) charge for litigation. This charge and the litigation referred to in note (f) below comprise the \$42 million charge recorded in connection with the Honsador litigation disclosed in Note 13 ("Contingent Liabilities and Guarantees"), which begins on page 29. Results for the first quarter of 2007 include a \$49 million (\$31 million after tax) loss from the repositioning of the securities portfolio.

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| Other Segments |                  | Total Segments  |               | Reconciling Items |                  | Key               |               |
|----------------|------------------|-----------------|---------------|-------------------|------------------|-------------------|---------------|
| 2008           | 2007             | 2008            | 2007          | 2008              | 2007             | 2008              | 2007          |
| \$ (31)        | \$ (20)          | \$ (66)         | \$ 736        | \$ (34)           | \$ (30)          | \$ (100)          | \$ 706        |
| —              | 121              | 568             | 608           | (13)              | 41 <sup>f</sup>  | 555               | 649           |
| (31)           | 101              | 502             | 1,344         | (47)              | 11               | 455               | 1,355         |
| —              | —                | 653             | 53            | (6)               | —                | 647               | 53            |
| —              | —                | 107             | 104           | —                 | —                | 107               | 104           |
| 8              | 33 <sup>e</sup>  | 687             | 705           | (13)              | 6 <sup>f</sup>   | 674               | 711           |
| (39)           | 68               | (945)           | 482           | (28)              | 5                | (973)             | 487           |
| (26)           | 13               | (366)           | 168           | 519 <sup>f</sup>  | (18)             | 153               | 150           |
| (13)           | 55               | (579)           | 314           | (547)             | 23               | (1,126)           | 337           |
| —              | —                | —               | (3)           | —                 | —                | —                 | (3)           |
| <u>\$ (13)</u> | <u>\$ 55</u>     | <u>\$ (579)</u> | <u>\$ 311</u> | <u>\$ (547)</u>   | <u>\$ 23</u>     | <u>\$ (1,126)</u> | <u>\$ 334</u> |
| N/M            | 16%              | N/M             | 93%           | N/M               | 7%               | N/M               | 100%          |
| N/M            | 18               | N/M             | 100           | N/A               | N/A              | N/A               | N/A           |
| \$ 177         | \$ 266           | \$ 76,531       | \$ 66,165     | \$ 121            | \$ 150           | \$ 76,652         | \$ 66,315     |
| 14,098         | 12,387           | 101,725         | 91,318        | 1,565             | 2,094            | 103,290           | 93,412        |
| 3,092          | 2,361            | 65,329          | 60,569        | (197)             | (172)            | 65,132            | 60,397        |
| —              | —                | \$ 524          | \$ 53         | —                 | —                | \$ 524            | \$ 53         |
| N/M            | N/M              | (26.45)%        | 17.71%        | N/M               | N/M              | (52.56)%          | 17.66%        |
| N/M            | N/M              | (26.45)         | 17.54         | N/M               | N/M              | (52.56)           | 17.50         |
| 43             | 43               | 12,431          | 12,925        | 5,733             | 5,963            | 18,164            | 18,888        |
| Other Segments |                  | Total Segments  |               | Reconciling Items |                  | Key               |               |
| 2008           | 2007             | 2008            | 2007          | 2008              | 2007             | 2008              | 2007          |
| \$ (58)        | \$ (46)          | \$ 669          | \$ 1,465      | \$ (65)           | \$ (59)          | \$ 604            | \$ 1,406      |
| 53             | 128 <sup>e</sup> | 928             | 1,262         | 155 <sup>f</sup>  | 41 <sup>f</sup>  | 1,083             | 1,303         |
| (5)            | 82               | 1,597           | 2,727         | 90                | (18)             | 1,687             | 2,709         |
| —              | —                | 840             | 97            | (6)               | —                | 834               | 97            |
| —              | —                | 217             | 209           | —                 | —                | 217               | 209           |
| 17             | 43 <sup>e</sup>  | 1,322           | 1,392         | (26)              | (2) <sup>f</sup> | 1,296             | 1,390         |
| (22)           | 39               | (782)           | 1,029         | 122               | (16)             | (660)             | 1,013         |
| (30)           | (8)              | (315)           | 363           | 563 <sup>f</sup>  | (45)             | 248               | 318           |
| 8              | 47               | (467)           | 666           | (441)             | 29               | (908)             | 695           |

|             |              |                 | (11)          |                 |              |                 | (11)          |
|-------------|--------------|-----------------|---------------|-----------------|--------------|-----------------|---------------|
| <u>\$ 8</u> | <u>\$ 47</u> | <u>\$ (467)</u> | <u>\$ 655</u> | <u>\$ (441)</u> | <u>\$ 29</u> | <u>\$ (908)</u> | <u>\$ 684</u> |
| N/M         | 7%           | N/M             | 96%           | N/M             | 4%           | N/M             | 100%          |
| N/M         | 7            | N/M             | 100           | N/A             | N/A          | N/A             | N/A           |
| \$ 207      | \$ 273       | \$ 74,523       | \$ 65,872     | \$ 147          | \$ 122       | \$ 74,670       | \$ 65,994     |
| 14,260      | 12,339       | 101,717         | 90,659        | 1,606           | 2,099        | 103,323         | 92,758        |
| —           | —            | 61,945          | 58,013        | 3,764           | 2,068        | 65,709          | 60,081        |
| —           | —            | \$ 645          | \$ 97         | —               | —            | \$ 645          | \$ 97         |
| N/M         | N/M          | (10.90)%        | 19.06%        | N/M             | N/M          | (21.40)%        | 18.35%        |
| N/M         | N/M          | (10.90)         | 18.75         | N/M             | N/M          | (21.40)         | 18.06         |
| 43          | 43           | 12,473          | 13,355        | 5,822           | 5,987        | 18,295          | 19,342        |

- (f) Reconciling Items for the second quarter of 2008 include a \$475 million charge to income taxes for the interest cost associated with the leveraged lease tax litigation. Reconciling Items for the prior quarter include a \$165 million (\$103 million after tax) gain from the partial redemption of Key's equity interest in Visa Inc. and a \$17 million charge to income taxes for the interest cost associated with the increase to Key's tax reserves for certain lease in, lease out transactions. Reconciling Items for the second quarter of 2007 include a \$40 million (\$25 million after tax) gain related to MasterCard Incorporated shares, and a \$16 million (\$10 million after tax) charge for litigation.

TE = Taxable Equivalent

N/A = Not Applicable

N/M = Not Meaningful

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## Supplementary information (Community Banking lines of business)

| Three months ended June 30,<br>dollars in millions | Regional Banking |        | Commercial Banking |        |
|--|------------------|--------|--------------------|--------|
|  | 2008             | 2007   | 2008               | 2007   |
| Total revenue (TE)                                 | \$ 557           | \$ 537 | \$ 102             | \$ 94  |
| Provision for loan losses                          | 25               | 20     | 19                 | 1      |
| Noninterest expense                                | 401              | 396    | 48                 | 50     |
| Net income   | 82               | 75     | 22                 | 27     |
| Average loans and leases                           | 19,608           | 18,471 | 8,870              | 8,103  |
| Average deposits                                   | 46,246           | 42,725 | 3,702              | 3,401  |
| Net loan charge-offs                               | 33               | 20     | 5                  | 6      |
| Net loan charge-offs to average loans              | .68%             | .43%   | .23%               | .30%   |
| Nonperforming assets at period end                 | \$ 157           | \$ 114 | \$ 61              | \$ 34  |
| Return on average allocated equity                 | 15.06%           | 17.38% | 10.21%             | 14.67% |
| Average full-time equivalent employees             | 8,439            | 8,655  | 346                | 371    |

| Six months ended June 30,<br>dollars in millions | Regional Banking |          | Commercial Banking |        |
|--|------------------|----------|--------------------|--------|
|  | 2008             | 2007     | 2008               | 2007   |
| Total revenue (TE)                               | \$ 1,087         | \$ 1,253 | \$ 201             | \$ 185 |
| Provision for loan losses                        | 39               | 38       | 23                 | (3)    |
| Noninterest expense                              | 785              | 814      | 91                 | 98     |
| Net income                                       | 165              | 251      | 54                 | 56     |
| Average loans and leases                         | 19,540           | 18,485   | 8,763              | 8,029  |
| Average deposits                                 | 46,211           | 42,890   | 3,646              | 3,432  |
| Net loan charge-offs                             | 62               | 38       | 6                  | 7      |
| Net loan charge-offs to average loans            | .64%             | .41%     | .14%               | .18%   |
| Nonperforming assets at period end               | \$ 157           | \$ 114   | \$ 61              | \$ 34  |
| Return on average allocated equity               | 15.21%           | 29.11%   | 12.90%             | 15.49% |
| Average full-time equivalent employees           | 8,402            | 8,870    | 348                | 372    |

## Supplementary information (National Banking lines of business)

| Three months ended June 30,<br>dollars in millions | Real Estate Capital and<br>Corporate Banking Services |        | Equipment Finance |        | Institutional and<br>Capital Markets |        | Consumer Finance |       |
|--|---|--------|-------------------|--------|--------------------------------------|--------|------------------|-------|
|  | 2008  | 2007   | 2008              | 2007   | 2008                                 | 2007   | 2008             | 2007  |
| Total revenue (TE)                                 | \$ 233  | \$ 214 | \$ (694)          | \$ 150 | \$ 231                               | \$ 159 | \$ 104           | \$ 89 |
| Provision for loan losses                          | 366   | 8      | 36                | 16     | 36                                   | —      | 171              | 8     |
| Noninterest expense                                | 68  | 92     | 89                | 94     | 128                                  | 99     | 52               | 45    |
| (Loss) income from continuing operations           | (126)   | 71     | (512)             | 25     | 42                                   | 38     | (74)             | 23    |
| Net (loss) income                                  | (126)   | 71     | (512)             | 25     | 42                                   | 38     | (74)             | 20    |
| Average loans and leases a                         | 17,086  | 13,713 | 10,326            | 10,609 | 7,897                                | 6,566  | 12,567           | 8,437 |
| Average loans held for sale a                      | 616   | 1,246  | 51                | 10     | 494                                  | 463    | 121              | 2,658 |

|   |                 |        |                  |        |               |        |                 |        |
|---|-----------------|--------|------------------|--------|---------------|--------|-----------------|--------|
| Average deposits a                      | <b>10,460</b>   | 9,447  | <b>21</b>        | 16     | <b>1,384</b>  | 2,072  | <b>424</b>      | 547    |
| Net loan charge-offs                    | <b>376</b>      | 3      | <b>28</b>        | 16     | <b>5</b>      | —      | <b>77</b>       | 8      |
| Net loan charge-offs to average loans a | <b>8.85%</b>    | .09%   | <b>1.09%</b>     | .60%   | <b>.25%</b>   | —      | <b>2.46%</b>    | .38%   |
| Nonperforming assets at period end      | <b>\$ 779</b>   | \$ 110 | <b>\$ 105</b>    | \$ 60  | <b>\$ 26</b>  | \$ 22  | <b>\$ 82</b>    | \$ 38  |
| Return on average allocated equity a    | <b>(23.69)%</b> | 20.43% | <b>(225.30)%</b> | 11.43% | <b>13.61%</b> | 13.92% | <b>(32.07)%</b> | 11.56% |
| Return on average allocated equity      | <b>(23.69)</b>  | 20.43  | <b>(225.30)</b>  | 11.43  | <b>13.61</b>  | 13.92  | <b>(32.07)</b>  | 10.05  |
| Average full-time equivalent employees  | <b>1,228</b>    | 1,293  | <b>837</b>       | 895    | <b>931</b>    | 992    | <b>607</b>      | 676    |

| Six months ended June 30,<br>dollars in millions | Real Estate Capital and<br>Corporate Banking Services |        | Equipment Finance |        | Institutional and<br>Capital Markets |        | Consumer Finance |        |
|--|---|--------|-------------------|--------|--------------------------------------|--------|------------------|--------|
|  | 2008  | 2007   | 2008              | 2007   | 2008                                 | 2007   | 2008             | 2007   |
| Total revenue (TE)                               | <b>\$ 310</b>   | \$ 403 | <b>\$ (593)</b>   | \$ 282 | <b>\$ 389</b>                        | \$ 316 | <b>\$ 208</b>    | \$ 206 |
| Provision for loan losses                        | <b>410</b>  | 9      | <b>60</b>         | 29     | <b>53</b>                            | —      | <b>255</b>       | 24     |
| Noninterest expense                              | <b>129</b>  | 176    | <b>186</b>        | 181    | <b>229</b>                           | 200    | <b>102</b>       | 89     |
| (Loss) income from continuing operations         | <b>(143)</b>  | 136    | <b>(525)</b>      | 45     | <b>67</b>                            | 73     | <b>(93)</b>      | 58     |
| Net (loss) income                                | <b>(143)</b>  | 136    | <b>(525)</b>      | 45     | <b>67</b>                            | 73     | <b>(93)</b>      | 47     |
| Average loans and leases a                       | <b>16,785</b>   | 13,675 | <b>10,461</b>     | 10,544 | <b>7,765</b>                         | 6,559  | <b>11,002</b>    | 8,307  |
| Average loans held for sale a                    | <b>803</b>  | 1,196  | <b>41</b>         | 7      | <b>525</b>                           | 302    | <b>1,738</b>     | 2,643  |
| Average deposits a                               | <b>10,124</b>   | 8,996  | <b>17</b>         | 14     | <b>1,421</b>                         | 2,122  | <b>526</b>       | 559    |
| Net loan charge-offs                             | <b>413</b>  | 4      | <b>52</b>         | 29     | <b>7</b>                             | 1      | <b>105</b>       | 18     |
| Net loan charge-offs to average loans a          | <b>4.95%</b>  | .06%   | <b>1.00%</b>      | .55%   | <b>.18%</b>                          | .03%   | <b>1.92%</b>     | .44%   |
| Nonperforming assets at period end               | <b>\$ 779</b>   | \$ 110 | <b>\$ 105</b>     | \$ 60  | <b>\$ 26</b>                         | \$ 22  | <b>\$ 82</b>     | \$ 38  |
| Return on average allocated equity a             | <b>(14.31)%</b>                                       | 20.18% | <b>(115.01)%</b>  | 10.41% | <b>11.05%</b>                        | 13.49% | <b>(20.24)%</b>  | 14.81% |
| Return on average allocated equity               | <b>(14.31)</b>  | 20.18  | <b>(115.01)</b>   | 10.41  | <b>11.05</b>                         | 13.49  | <b>(20.24)</b>   | 12.00  |
| Average full-time equivalent employees           | <b>1,230</b>  | 1,285  | <b>848</b>        | 890    | <b>934</b>                           | 1,024  | <b>668</b>       | 871    |

(a) From continuing operations.

TE = Taxable Equivalent

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## 5. Securities

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

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

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

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

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

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|  | June 30, 2008     |                              |                               |                 |
|--|-------------------|------------------------------|-------------------------------|-----------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value   |
| <i>in millions</i>                       |                   |                              |                               |                 |
| <b>SECURITIES AVAILABLE FOR SALE</b>     |                   |                              |                               |                 |
| U.S. Treasury, agencies and corporations | \$ 18             | —                            | —                             | \$ 18           |
| States and political subdivisions        | 92                | —                            | \$ 1                          | 91              |
| Collateralized mortgage obligations      | 6,309             | \$ 69                        | 28                            | 6,350           |
| Other mortgage-backed securities         | 1,583             | 10                           | 9                             | 1,584           |
| Retained interests in securitizations    | 153               | 34                           | —                             | 187             |
| Other securities                         | 82                | 6                            | 6                             | 82              |
| Total securities available for sale      | <u>\$ 8,237</u>   | <u>\$ 119</u>                | <u>\$ 44</u>                  | <u>\$ 8,312</u> |
| <b>HELD-TO-MATURITY SECURITIES</b>       |                   |                              |                               |                 |
| States and political subdivisions        | \$ 8              | —                            | —                             | \$ 8            |
| Other securities                         | 17                | —                            | —                             | 17              |
| Total held-to-maturity securities        | <u>\$ 25</u>      | <u>—</u>                     | <u>—</u>                      | <u>\$ 25</u>    |

|  | December 31, 2007 |                              |                               |                 |
|--|-------------------|------------------------------|-------------------------------|-----------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value   |
| <i>in millions</i>                       |                   |                              |                               |                 |
| <b>SECURITIES AVAILABLE FOR SALE</b>     |                   |                              |                               |                 |
| U.S. Treasury, agencies and corporations | \$ 19             | —                            | —                             | \$ 19           |
| States and political subdivisions        | 10                | —                            | —                             | 10              |
| Collateralized mortgage obligations      | 6,167             | \$ 33                        | \$ 33                         | 6,167           |
| Other mortgage-backed securities         | 1,393             | 13                           | 3                             | 1,403           |
| Retained interests in securitizations    | 149               | 36                           | —                             | 185             |
| Other securities                         | 72                | 8                            | 4                             | 76              |
| Total securities available for sale      | <u>\$ 7,810</u>   | <u>\$ 90</u>                 | <u>\$ 40</u>                  | <u>\$ 7,860</u> |
| <b>HELD-TO-MATURITY SECURITIES</b>       |                   |                              |                               |                 |
| States and political subdivisions        | \$ 9              | —                            | —                             | \$ 9            |
| Other securities                         | 19                | —                            | —                             | 19              |
| Total held-to-maturity securities        | <u>\$ 28</u>      | <u>—</u>                     | <u>—</u>                      | <u>\$ 28</u>    |

|                                      | June 30, 2007     |                              |                               |               |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| <i>in millions</i>                   |                   |                              |                               |               |
| <b>SECURITIES AVAILABLE FOR SALE</b> |                   |                              |                               |               |

|  |    |              |    |           |    |              |
|--|----|--------------|----|-----------|----|--------------|
| U.S. Treasury, agencies and corporations | \$ | 18           | —  | —         | \$ | 18           |
| States and political subdivisions        |    | 13           | —  | —         |    | 13           |
| Collateralized mortgage obligations      |    | 6,421        | \$ | 3         | \$ | 111          |
| Other mortgage-backed securities         |    | 1,133        |    | 2         |    | 22           |
| Retained interests in securitizations    |    | 146          |    | 47        |    | —            |
| Other securities                         |    | 150          |    | 19        |    | —            |
| Total securities available for sale      | \$ | <u>7,881</u> | \$ | <u>71</u> | \$ | <u>133</u>   |
|  |    |              |    |           | \$ | <u>7,819</u> |
| <b>HELD-TO-MATURITY SECURITIES</b>       |    |              |    |           |    |              |
| States and political subdivisions        | \$ | 17           | —  | —         | \$ | 17           |
| Other securities                         |    | 20           |    | —         |    | 20           |
| Total held-to-maturity securities        | \$ | <u>37</u>    |    | <u>—</u>  |    | <u>37</u>    |



[Table of Contents](#)**6. Loans and Loans Held for Sale**

Key's loans by category are summarized as follows:

| <i>in millions</i>                      | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|---|------------------|----------------------|------------------|
| Commercial, financial and agricultural  | \$ 25,929        | \$ 24,797            | \$ 21,814        |
| Commercial real estate:                 |                  |                      |                  |
| Commercial mortgage                     | 10,737           | 9,630                | 8,629            |
| Construction                            | 7,849            | 8,102                | 8,214            |
| Total commercial real estate loans      | 18,586 a         | 17,732               | 16,843           |
| Commercial lease financing              | 9,610            | 10,176               | 10,138           |
| Total commercial loans                  | 54,125           | 52,705               | 48,795           |
| Real estate — residential mortgage      | 1,928            | 1,594                | 1,572            |
| Home equity:                            |                  |                      |                  |
| Community Banking                       | 9,851            | 9,655                | 9,736            |
| National Banking                        | 1,153            | 1,262                | 1,143            |
| Total home equity loans                 | 11,004           | 10,917               | 10,879           |
| Consumer other — Community Banking      | 1,261            | 1,298                | 1,366            |
| Consumer other — National Banking:      |                  |                      |                  |
| Marine                                  | 3,634            | 3,637                | 3,444            |
| Education                               | 3,584 b          | 331                  | 327              |
| Other                                   | 319              | 341                  | 309              |
| Total consumer other — National Banking | 7,537            | 4,309                | 4,080            |
| Total consumer loans                    | 21,730           | 18,118               | 17,897           |
| Total loans                             | \$ 75,855        | \$ 70,823            | \$ 66,692        |

(a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.

(b) On March 31, 2008, Key transferred \$3.3 billion of education loans from loans held for sale to the loan portfolio.

Key uses interest rate swaps to manage interest rate risk; these swaps modify the repricing characteristics of certain loans. For more information about such swaps, see Note 19 ("Derivatives and Hedging Activities"), which begins on page 100 of Key's 2007 Annual Report to Shareholders.

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

| <i>in millions</i>                     | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|--|------------------|----------------------|------------------|
| Commercial, financial and agricultural | \$ 212           | \$ 250               | \$ 76            |
| Real estate — commercial mortgage      | 994              | 1,219                | 1,613            |
| Real estate — construction             | 398 a            | 35                   | 172              |
| Commercial lease financing             | 42               | 1                    | 22               |
| Real estate — residential mortgage     | 79               | 47                   | 39               |

|                           |                        |                        |                        |
|---------------------------|------------------------|------------------------|------------------------|
| Home equity               | —                      | 1                      | —                      |
| Education                 | <b>103 b</b>           | 3,176                  | 2,616                  |
| Automobile                | <b>5</b>               | 7                      | 8                      |
| Total loans held for sale | <u><b>\$ 1,833</b></u> | <u><b>\$ 4,736</b></u> | <u><b>\$ 4,546</b></u> |

- (a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.
- (b) On March 31, 2008, Key transferred \$3.3 billion of education loans from loans held for sale to the loan portfolio.

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

| <i>in millions</i>                                   | Three months ended<br>June 30, |               | Six months ended<br>June 30, |               |
|--|--------------------------------|---------------|------------------------------|---------------|
|  | 2008                           | 2007          | 2008                         | 2007          |
| Balance at beginning of period                       | \$ 1,298                       | \$ 944        | \$ 1,200                     | \$ 944        |
| Charge-offs  | (554)                          | (72)          | (702)                        | (136)         |
| Recoveries   | 30                             | 19            | 57                           | 39            |
| Net loans charged off                                | (524)                          | (53)          | (645)                        | (97)          |
| Provision for loan losses from continuing operations | 647                            | 53            | 834                          | 97            |
| Allowance related to loans acquired, net             | —                              | —             | 32                           | —             |
| Foreign currency translation adjustment              | —                              | 1             | —                            | 1             |
| Balance at end of period                             | <u>\$ 1,421</u>                | <u>\$ 945</u> | <u>\$ 1,421</u>              | <u>\$ 945</u> |

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

| <i>in millions</i>   | Three months ended<br>June 30, |              | Six months ended<br>June 30, |              |
|--|--------------------------------|--------------|------------------------------|--------------|
|  | 2008                           | 2007         | 2008                         | 2007         |
| Balance at beginning of period                               | \$ 53                          | \$ 45        | \$ 80                        | \$ 53        |
| (Credit) provision for losses on lending-related commitments | (2)                            | 6            | (29)                         | (2)          |
| Charge-offs  | —                              | (1)          | —                            | (1)          |
| Balance at end of period <sup>a</sup>                        | <u>\$ 51</u>                   | <u>\$ 50</u> | <u>\$ 51</u>                 | <u>\$ 50</u> |

(a) Included in “accrued expenses and other liabilities” on the consolidated balance sheet.

## 7. Mortgage Servicing Assets

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

| <i>in millions</i>                 | Six months ended<br>June 30, |               |
|------------------------------------|------------------------------|---------------|
|                                    | 2008                         | 2007          |
| Balance at beginning of period     | \$ 313                       | \$ 247        |
| Servicing retained from loan sales | 9                            | 10            |
| Purchases                          | 3                            | 55            |
| Amortization                       | (53)                         | (40)          |
| Balance at end of period           | <u>\$ 272</u>                | <u>\$ 272</u> |
| Fair value at end of period        | <u>\$ 426</u>                | <u>\$ 371</u> |

The fair value of mortgage servicing assets is determined by calculating the present value of future cash flows associated with servicing the loans. This calculation uses a number of assumptions that are based on current market conditions. Primary economic assumptions used to measure the fair value of Key’s mortgage servicing assets at June 30, 2008, and

2007, are as follows:

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

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Changes in these assumptions could cause the fair value of mortgage servicing assets to change in the future. The volume of loans serviced and expected credit losses are critical to the valuation of servicing assets. A 1.00% increase in the assumed default rate of commercial mortgage loans at June 30, 2008, would cause a \$9 million decrease in the fair value of Key's mortgage servicing assets.

Contractual fee income from servicing commercial mortgage loans totaled \$32 million and \$34 million for the six-month periods ended June 30, 2008 and 2007, respectively. The amortization of servicing assets for each year, as shown in the preceding table, is recorded as a reduction to fee income. Both the contractual fee income and the amortization are recorded in "other income" on the income statement.

### 8. Variable Interest Entities

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

Key's VIEs, including those consolidated and those in which Key holds a significant interest, are summarized below. Key defines a "significant interest" in a VIE as a subordinated interest that exposes Key to a significant portion, but not the majority, of the VIE's expected losses or residual returns.

| <i>in millions</i>                            | Consolidated VIEs | Unconsolidated VIEs |                          |
|---|-------------------|---------------------|--------------------------|
|   | Total Assets      | Total Assets        | Maximum Exposure to Loss |
| June 30, 2008                                 |                   |                     |                          |
| Low-income housing tax credit ("LIHTC") funds | \$ 261            | \$ 158              | —                        |
| LIHTC investments                             | N/A               | 720                 | \$ 287                   |

N/A = Not Applicable

The noncontrolling interests associated with the consolidated LIHTC guaranteed funds are considered mandatorily redeemable instruments and are recorded in "accrued expense and other liabilities" on the balance sheet. The FASB has indefinitely deferred the measurement and recognition provisions of SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," for mandatorily redeemable noncontrolling interests associated with finite-lived subsidiaries, such as Key's LIHTC guaranteed funds. Key currently accounts for these interests as minority interests and adjusts the financial statements each period for the investors' share of the funds' profits and losses. At June 30, 2008, the settlement value of these noncontrolling interests was estimated to be between \$233 million and \$272 million, while the recorded value, including reserves, totaled \$274 million.

Key's Principal Investing unit and the Real Estate Capital and Corporate Banking Services line of business make equity and mezzanine investments in entities, some of which are VIEs. These investments are held by nonregistered investment companies subject to the provisions of the American Institute of Certified Public Accountants ("AICPA") Audit and Accounting Guide, "Audits of Investment Companies." The FASB deferred the effective date of Revised Interpretation No. 46 for such nonregistered investment companies until the AICPA clarifies the scope of the Audit Guide. As a result, Key is not currently applying the accounting or disclosure provisions of Revised Interpretation No. 46 to its principal and real estate equity and mezzanine investments, which remain unconsolidated.

Additional information pertaining to Revised Interpretation No. 46 and the activities of the specific VIEs with which Key is involved is provided in Note 8 ("Loan Securitizations, Servicing and Variable Interest Entities") of Key's 2007 Annual Report to Shareholders under the heading "Variable Interest Entities" on page 82.

[Table of Contents](#)**9. Nonperforming Assets and Past Due Loans**

Impaired loans totaled \$628 million at June 30, 2008, compared to \$519 million at December 31, 2007, and \$137 million at June 30, 2007. Impaired loans had an average balance of \$733 million for the second quarter of 2008 and \$124 million for the second quarter of 2007.

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

| <i>in millions</i>                                     | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|--|------------------|----------------------|------------------|
| Impaired loans   | \$ 628           | \$ 519               | \$ 137           |
| Other nonaccrual loans                                 | 186              | 168                  | 139              |
| Total nonperforming loans                              | 814 a            | 687                  | 276              |
| Nonperforming loans held for sale                      | 342 a            | 25                   | 4                |
| Other real estate owned ("OREO")                       | 26               | 21                   | 27               |
| Allowance for OREO losses                              | (2)              | (2)                  | (2)              |
| OREO, net of allowance                                 | 24               | 19                   | 25               |
| Other nonperforming assets b                           | 30               | 33                   | 73               |
| Total nonperforming assets                             | <u>\$ 1,210</u>  | <u>\$ 764</u>        | <u>\$ 378</u>    |
| Impaired loans with a specifically allocated allowance | \$ 564           | \$ 426               | \$ 53            |
| Specifically allocated allowance for impaired loans    | 166              | 126                  | 23               |
| Accruing loans past due 90 days or more                | \$ 367           | \$ 231               | \$ 181           |
| Accruing loans past due 30 through 89 days             | 852              | 843                  | 623              |

(a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.

(b) Primarily investments held by the Private Equity unit within Key's Real Estate Capital and Corporate Banking Services line of business.

At June 30, 2008, Key did not have any significant commitments to lend additional funds to borrowers with loans on nonperforming status.

Management evaluates the collectibility of Key's loans as described in Note 1 ("Summary of Significant Accounting Policies") under the heading "Allowance for Loan Losses" on page 67 of Key's 2007 Annual Report to Shareholders.

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### 10. Capital Securities Issued by Unconsolidated Subsidiaries

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

The capital securities provide an attractive source of funds: they constitute Tier 1 capital for regulatory reporting purposes, but have the same tax advantages as debt for federal income tax purposes. During the first quarter of 2005, the Federal Reserve Board adopted a rule that allows bank holding companies to continue to treat capital securities as Tier 1 capital, but imposed stricter quantitative limits that take effect after a five-year transition period ending March 31, 2009. Management believes the new rule will not have any material effect on Key's financial condition.

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

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

During the first six months of 2008, the KeyCorp Capital X trust issued \$740 million of securities. Also included in the table below are the capital securities held by the Union State Capital I, Union State Statutory II and Union State Statutory IV business trusts. The outstanding common stock of these trusts was owned by U.S.B. Holding Co., Inc., which Key acquired on January 1, 2008.

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

| <i>dollars in millions</i> | Capital<br>Securities,<br>Net of Discount a | Common<br>Stock | Principal<br>Amount of<br>Debentures,<br>Net of Discount b | Interest Rate<br>of Capital<br>Securities and<br>Debentures c | Maturity<br>of Capital<br>Securities and<br>Debentures |
|----------------------------|---|-----------------|--|---|--|
| June 30, 2008              |   |                 |  |   |  |
| KeyCorp Capital I          | \$ 197                                      | \$ 8            | \$ 201   | 3.438%  | 2028   |
| KeyCorp Capital II         | 181   | 8               | 178  | 6.875   | 2029   |
| KeyCorp Capital III        | 230   | 8               | 208  | 7.750   | 2029   |
| KeyCorp Capital V          | 167   | 5               | 189  | 5.875   | 2033   |
| KeyCorp Capital VI         | 74  | 2               | 80   | 6.125   | 2033   |
| KeyCorp Capital VII        | 239   | 8               | 265  | 5.700   | 2035   |
| KeyCorp Capital VIII       | 258   | —               | 273  | 7.000   | 2066   |
| KeyCorp Capital IX         | 500   | —               | 501  | 6.750   | 2066   |
| KeyCorp Capital X          | 726   | —               | 729  | 8.000   | 2068   |
| Union State Capital I      | 20  | 1               | 21   | 9.580   | 2027   |
| Union State Statutory II   | 20  | —               | 20   | 6.479   | 2031   |
| Union State Statutory IV   | 10  | —               | 10   | 5.513   | 2034   |
| Total                      | <u>\$ 2,622</u>                             | <u>\$ 40</u>    | <u>\$ 2,675</u>  | 6.814%  | —  |
| December 31, 2007          | <u>\$ 1,848</u>                             | <u>\$ 39</u>    | <u>\$ 1,896</u>  | 6.599%  | —  |

|               |  |              |                 |        |   |
|---------------|--|--------------|-----------------|--------|---|
| June 30, 2007 | \$ <u>1,718</u>  | \$ <u>39</u> | \$ <u>1,838</u> | 6.608% | — |
| <hr/>         |  |              |                 |        |   |
| (a)           | The capital securities must be redeemed when the related debentures mature, or earlier if provided in the governing indenture. Each issue of capital securities carries an interest rate identical to that of the related debenture. Included in certain capital securities at June 30, 2008, December 31, 2007, and June 30, 2007, are basis adjustments of \$39 million, \$55 million and (\$75) million, respectively, related to fair value hedges. See Note 19 (“Derivatives and Hedging Activities”), which begins on page 100 of Key’s 2007 Annual Report to Shareholders, for an explanation of fair value hedges. |              |                 |        |   |
| (b)           | KeyCorp has the right to redeem its debentures: (i) in whole or in part, on or after July 1, 2008 (for debentures owned by Capital I); March 18, 1999 (for debentures owned by Capital II); July 16, 1999 (for debentures owned by Capital III); July 31, 2006 (for debentures owned by Union State Statutory II); February 1, 2007 (for debentures owned by Union State Capital I); July 21, 2008   |              |                 |        |   |



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(for debentures owned by Capital V); December 15, 2008 (for debentures owned by Capital VI); April 7, 2009 (for debentures owned by Union State Statutory IV); June 15, 2010 (for debentures owned by Capital VII); June 15, 2011 (for debentures owned by Capital VIII); December 15, 2011 (for debentures owned by Capital IX); and March 15, 2013 (for debentures owned by Capital X); and (ii) in whole at any time within 90 days after and during the continuation of a “tax event,” an “investment company event” or a “capital treatment event” (as defined in the applicable indenture). If the debentures purchased by Union State Statutory IV, Capital I, Capital V, Capital VI, Capital VII, Capital VIII, Capital IX or Capital X are redeemed before they mature, the redemption price will be the principal amount, plus any accrued but unpaid interest. If the debentures purchased by Union State Capital I are redeemed before they mature, the redemption price will be 104.31% of the principal amount, plus any accrued but unpaid interest. If the debentures purchased by Union State Statutory II are redeemed before they mature, the redemption price will be 106.00% of the principal amount, plus any accrued but unpaid interest. If the debentures purchased by Capital II or Capital III are redeemed before they mature, the redemption price will be the greater of: (a) the principal amount, plus any accrued but unpaid interest or (b) the sum of the present values of principal and interest payments discounted at the Treasury Rate (as defined in the applicable indenture), plus 20 basis points (25 basis points for Capital III), plus any accrued but unpaid interest. When debentures are redeemed in response to tax or capital treatment events, the redemption price generally is slightly more favorable to KeyCorp. Included in the principal amount of debentures at June 30, 2008, December 31, 2007, and June 30, 2007, are adjustments relating to hedging with financial instruments totaling \$52 million, \$64 million and \$6 million, respectively.

- (c) The interest rates for Capital II, Capital III, Capital V, Capital VI, Capital VII, Capital VIII, Capital IX, Capital X and Union State Capital I are fixed. Capital I has a floating interest rate equal to three-month LIBOR plus 74 basis points that reprices quarterly. Union State Statutory II has a floating interest rate equal to three-month LIBOR plus 358 basis points that reprices quarterly. Union State Statutory IV has a floating interest rate equal to three-month LIBOR plus 280 basis points that reprices quarterly. The rates shown as the totals at June 30, 2008, December 31, 2007, and June 30, 2007, are weighted-average rates.

## 11. Employee Benefits

### Pension Plans

The components of net pension cost and the amount recognized in comprehensive income (loss) for all funded and unfunded plans are as follows:

| <i>in millions</i>                            | Three months ended<br>June 30, |              | Six months ended<br>June 30, |              |
|---|--------------------------------|--------------|------------------------------|--------------|
|   | 2008                           | 2007         | 2008                         | 2007         |
| Service cost of benefits earned               | \$ 13                          | \$ 12        | \$ 26                        | \$ 26        |
| Interest cost on projected benefit obligation | 16                             | 14           | 32                           | 29           |
| Expected return on plan assets                | (24)                           | (22)         | (47)                         | (44)         |
| Amortization of prior service cost            | 1                              | —            | 1                            | —            |
| Amortization of losses                        | 3                              | 6            | 6                            | 14           |
| Curtailment gain                              | —                              | —            | —                            | (3)          |
| Net pension cost                              | <u>\$ 9</u>                    | <u>\$ 10</u> | <u>\$ 18</u>                 | <u>\$ 22</u> |

### Other Postretirement Benefit Plans

Key sponsors a contributory postretirement healthcare plan that covers substantially all active and retired employees hired before 2001 who meet certain eligibility criteria. Retirees' contributions are adjusted annually to reflect certain cost-sharing provisions and benefit limitations. Key also sponsors life insurance plans covering certain grandfathered employees. These plans are principally noncontributory. Separate Voluntary Employee Beneficiary Association trusts are used to fund the healthcare plan and one of the life insurance plans.

The components of net postretirement benefit (income) cost and the amount recognized in comprehensive income (loss) for all funded and unfunded plans are as follows:

### Other Postretirement Benefits

| <i>in millions</i>   | Three months ended<br>June 30, |             | Six months ended<br>June 30, |             |
|--|--------------------------------|-------------|------------------------------|-------------|
|  | 2008                           | 2007        | 2008                         | 2007        |
| Service cost of benefits earned                                | \$ 1                           | \$ 3        | \$ 1                         | \$ 4        |
| Interest cost on accumulated postretirement benefit obligation | 1                              | 2           | 2                            | 3           |
| Expected return on plan assets                                 | (1)                            | (1)         | (2)                          | (2)         |
| Amortization of unrecognized:                                  |                                |             |                              |             |
| Transition obligation  | —                              | 2           | —                            | 2           |
| Prior service benefit  | (1)                            | —           | (1)                          | —           |
| Cumulative net gain  | (1)                            | —           | (1)                          | —           |
| Net postretirement benefit (income) cost                       | <u>\$ (1)</u>                  | <u>\$ 6</u> | <u>\$ (1)</u>                | <u>\$ 7</u> |

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## 12. Income Taxes

### Lease Financing Transactions

In the ordinary course of business, Key's equipment finance business unit ("KEF") enters into various types of lease financing transactions. Between 1996 and 2004, KEF entered into three types of lease financing transactions with both foreign and domestic customers (primarily municipal authorities) for terms ranging from ten to fifty years. Lease in, lease out ("LILO") transactions are leveraged leasing transactions in which KEF leases property from an unrelated third party and then leases the property back to that party. The transaction is similar to a sale-leaseback, except that KEF leases the property rather than purchasing it. Qualified Technological Equipment Leases ("QTEs") and Service Contract Leases are even more like sale-leaseback transactions, as KEF is considered to be the purchaser of the equipment for tax purposes. LILO and Service Contract Lease transactions involve commuter rail equipment, public utility facilities and commercial aircraft. QTE transactions involve sophisticated high technology hardware and related software, such as telecommunications equipment.

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

Prior to 2004, LILO, QTE and Service Contract Leases were prevalent in the financial services industry and in certain other industries. The tax treatment that Key applied was based on applicable statutes, regulations and judicial authority. However, in subsequent years, the Internal Revenue Service ("IRS") has challenged the tax treatment of these transactions by a number of bank holding companies and other corporations.

Currently, the IRS is auditing Key's income tax returns for the 2004 through 2006 tax years. The IRS has completed audits of Key's income tax returns for the 1995 through 2003 tax years and has disallowed all net deductions that relate to LILOs, QTEs and Service Contract Leases. Key appealed the examination results for the tax years 1995 through 1997, which pertained to LILOs only, to the Appeals Division of the IRS. During the fourth quarter of 2005, discussions with the Appeals Division were discontinued without a resolution. In April 2006, Key received a final assessment from the IRS, consisting of taxes, interest and penalties, disallowing all LILO deductions taken in the 1995-1997 tax years. Key paid the final assessment and filed a refund claim for the total amount. Key also has filed appeals with the Appeals Division of the IRS with regard to the proposed disallowance of the LILO, QTE and Service Contract Lease deductions taken in the 1998 through 2003 tax years. Key and the Appeals Division of the IRS have ongoing discussions regarding these transactions, as well as the LILOs entered into for the tax years 1995 through 1997. Key intends to vigorously pursue the IRS appeals process and litigation alternatives.

In addition, in connection with one Service Contract Lease transaction entered into by AWG Leasing Trust ("AWG Leasing"), in which Key is a partner, the IRS completed its audit for the 1998 through 2003 tax years, disallowed all deductions related to the transaction for those years and assessed penalties. In March 2007, Key filed a lawsuit in the United States District Court for the Northern District of Ohio (captioned *AWG Leasing Trust, KSP Investments, Inc., as Tax Matters Partner v. United States of America*, and referred to herein as the "AWG Leasing Litigation"), claiming that the disallowance of the deductions and assessment of penalties were erroneous. The case proceeded to a bench trial, which commenced on January 21, 2008. On May 28, 2008, the Court rendered a decision that was adverse to Key. Management disagreed with the decision and, on July 23, 2008, Key filed a notice of appeal to the United States Court of Appeals for the Sixth Circuit.

Although the Court decision applies only to the AWG Leasing Litigation, under applicable accounting guidance, the decision has implications for the timing of the recognition of tax benefits on Key's entire portfolio of LILO, QTE and Service Contract Leases. Therefore, management has updated its assessment of Key's tax position in accordance with FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." As a result, during the second quarter of 2008, Key increased the amount of its unrecognized tax benefits associated with all of the leases under challenge by the IRS by \$2.15 billion.

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This amount has not been reduced by existing tax deposits of \$200 million. Key also recorded a related \$475 million charge to the provision for income taxes for the interest cost associated with the contested leases. Key has not recognized any charge for penalties or interest on penalties that the IRS has asserted or may assert in the future.

The increase in unrecognized tax benefits associated with the contested leases necessitated a recalculation of Key's lease income under FASB Staff Position No. 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction." This resulted in a \$536 million reduction of Key's second quarter 2008 after-tax earnings, including a \$359 million reduction to lease income and a \$177 million increase to the provision for income taxes. Of this amount, approximately \$365 million will be taken back into earnings over the remaining lives of the affected leases. The remaining \$171 million represents the reversal of the tax benefits previously recorded as a result of applying a lower tax rate to a portion of these transactions that are managed by a foreign subsidiary in a lower tax jurisdiction. These tax benefits will be recorded only if they are ultimately realized in the future in the course of Key's ongoing challenge of the tax treatment.

During the first quarter of 2008, Key increased the amount of its unrecognized tax benefits associated with its LILO transactions by \$46 million. This adjustment resulted from an updated assessment of Key's tax position performed by management in accordance with the provisions of FASB Interpretation No. 48. The increase in unrecognized tax benefits associated with Key's LILO transactions also necessitated a recalculation of Key's lease income under FASB Staff Position No. 13-2 and an increase to Key's tax reserves. These actions reduced Key's first quarter 2008 after-tax earnings by \$38 million, including a \$3 million reduction to lease income, an \$18 million increase to the provision for income taxes and a \$17 million charge to the tax provision for the associated interest charges.

While Key has recognized the effects of the adverse Court decision for financial statement purposes, management continues to believe that the tax treatment Key applied to its leveraged lease transactions complied with all tax laws, regulations and judicial authorities in effect at the time, and Key has appealed the adverse trial court decision.

As permitted under FASB Interpretation No. 48, it is Key's policy to recognize interest and penalties related to unrecognized tax benefits in income tax expense. During the six months ended June 30, 2008, Key recognized \$762 million of pre-tax interest, of which \$760 million (\$475 million, after tax) was attributable to the increase in unrecognized tax benefits associated with its LILO, QTE and Service Contract Lease transactions. Key's liability for accrued interest payable was \$804 million at June 30, 2008.

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

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### 13. Contingent Liabilities and Guarantees

#### Legal Proceedings

**Tax disputes.** In the ordinary course of business, Key enters into transactions that have tax consequences. On occasion, the IRS may challenge a particular tax position taken by Key. The IRS has completed audits of Key's income tax returns for the 1995 through 2003 tax years and has disallowed all deductions taken in those tax years that relate to certain lease financing transactions. Further information on these matters is included in Note 12 ("Income Taxes"), which begins on page 27.

**Honsador litigation.** In November 2004, Key Principal Partners, LLC ("KPP"), a Key affiliate, was sued in Hawaii state court in connection with KPP's investment in a Hawaiian business. On May 23, 2007, in the case of *Honsador Holdings LLC v. KPP*, the jury returned a verdict in favor of the plaintiffs. On June 13, 2007, the state court entered a final judgment in favor of the plaintiffs in the amount of \$38.25 million. During the three months ended June 30, 2007, Key established a \$42 million reserve for the verdict, legal costs and other expenses associated with this lawsuit. As previously reported, Key has filed a notice of appeal with the Intermediate Court of Appeals for the State of Hawaii (the "ICA"), and the appeal is currently pending before the ICA.

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

#### Guarantees

Key is a guarantor in various agreements with third parties. The following table shows the types of guarantees that Key had outstanding at June 30, 2008. Information pertaining to the basis for determining the liabilities recorded in connection with these guarantees is included in Note 1 ("Summary of Significant Accounting Policies") under the heading "Guarantees" on page 69 of Key's 2007 Annual Report to Shareholders.

| <i>in millions</i>                              | Maximum Potential<br>Undiscounted<br>Future Payments | Liability<br>Recorded |
|---|--|-----------------------|
| Financial guarantees:                           |  |                       |
| Standby letters of credit                       | \$ 14,911  | \$ 40                 |
| Recourse agreement with FNMA                    | 632  | 5                     |
| Return guarantee agreement with LIHTC investors | 272  | 54                    |
| Written interest rate caps a                    | 159  | 21                    |
| Default guarantees                              | 23   | 1                     |
| Total   | <u>\$ 15,997</u>                                     | <u>\$ 121</u>         |

- (a) As of June 30, 2008, the weighted-average interest rate of written interest rate caps was 2.7%, and the weighted-average strike rate was 5.1%. Maximum potential undiscounted future payments were calculated assuming a 10% interest rate.

**Standby letters of credit.** Many of Key's lines of business issue standby letters of credit to address clients' financing needs. These instruments obligate Key to pay a specified third party when a client fails to repay an outstanding loan or debt instrument, or fails to perform some contractual nonfinancial obligation. Any amounts drawn under standby letters of credit are treated as loans: they bear interest (generally at variable rates) and pose the same credit risk to Key as a loan. At June 30, 2008, Key's standby letters of credit had a remaining weighted-average life of approximately 2.2 years, with remaining actual lives ranging from less than one year to as many as ten years.

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**Recourse agreement with Federal National Mortgage Association.** KeyBank participates as a lender in the Federal National Mortgage Association (“FNMA”) Delegated Underwriting and Servicing program. As a condition to FNMA’s delegation of responsibility for originating, underwriting and servicing mortgages, KeyBank has agreed to assume a limited portion of the risk of loss during the remaining term on each commercial mortgage loan KeyBank sells to FNMA. Accordingly, KeyBank maintains a reserve for such potential losses in an amount estimated by management to approximate the fair value of KeyBank’s liability. At June 30, 2008, the outstanding commercial mortgage loans in this program had a weighted-average remaining term of 7.5 years, and the unpaid principal balance outstanding of loans sold by KeyBank as a participant in this program was approximately \$2.0 billion. The maximum potential amount of undiscounted future payments that KeyBank may be required to make under this program is equal to approximately one-third of the principal balance of loans outstanding at June 30, 2008. If KeyBank is required to make a payment it would have an interest in the collateral underlying the commercial mortgage loan on which the loss occurred.

**Return guarantee agreement with LIHTC investors.** Key Affordable Housing Corporation (“KAHC”), a subsidiary of KeyBank, offered limited partnership interests to qualified investors. Partnerships formed by KAHC invested in low-income residential rental properties that qualify for federal LIHTCs under Section 42 of the Internal Revenue Code. In certain partnerships, investors pay a fee to KAHC for a guaranteed return that is based on the financial performance of the property and the property’s confirmed LIHTC status throughout a fifteen-year compliance period. If KAHC defaults on its obligation to provide the guaranteed return, Key is obligated to make any necessary payments to investors. In October 2003, management elected to discontinue new partnerships under this program. Additional information regarding these partnerships is included in Note 8 (“Variable Interest Entities”) on page 23.

No recourse or collateral is available to offset Key’s guarantee obligation other than the underlying income stream from the properties. These guarantees have expiration dates that extend through 2018. Key meets its obligations pertaining to the guaranteed returns generally by distributing tax credits and deductions associated with the specific properties.

As shown in the table on page 29, KAHC maintained a reserve in the amount of \$54 million at June 30, 2008, which management believes will be sufficient to cover estimated future obligations under the guarantees. The maximum exposure to loss reflected in the table represents undiscounted future payments due to investors for the return on and of their investments. In accordance with FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,” the amount of all fees received in consideration for any return guarantee agreements entered into or modified with LIHTC investors on or after January 1, 2003, has been recognized as a component of the recorded liability.

**Written interest rate caps.** In the ordinary course of business, Key “writes” interest rate caps for commercial loan clients that have variable rate loans with Key and wish to limit their exposure to interest rate increases. At June 30, 2008, these caps had a weighted-average life of approximately 2.1 years.

Key is obligated to pay the client if the applicable benchmark interest rate exceeds a specified level (known as the “strike rate”). These instruments are accounted for as derivatives. Key mitigates its potential future payments by entering into offsetting positions with third parties.

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

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### **Other Off-Balance Sheet Risk**

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

***Liquidity facilities that support asset-backed commercial paper conduits.*** Key provides liquidity facilities to several unconsolidated third-party commercial paper conduits. These facilities obligate Key to provide funding if there is a disruption in credit markets or other factors exist that preclude the issuance of commercial paper by the conduits. The liquidity facilities, all of which expire by November 10, 2010, obligate Key to provide aggregate funding of up to \$1.1 billion, with individual facilities ranging from \$10 million to \$127 million. The aggregate amount available to be drawn is based on the amount of current commitments to borrowers and totaled \$837 million at June 30, 2008. Key's commitments to provide liquidity are periodically evaluated by management.

***Indemnifications provided in the ordinary course of business.*** Key provides certain indemnifications primarily through representations and warranties in contracts that are entered into in the ordinary course of business in connection with loan sales and other ongoing activities, as well as in connection with purchases and sales of businesses. Key maintains reserves, when appropriate, with respect to liability it reasonably expects to incur in connection with these indemnities.

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

### **14. Derivatives and Hedging Activities**

Key, mainly through its subsidiary bank, KeyBank, is party to various derivative instruments that are used for asset and liability management, credit risk management and trading purposes. Derivative instruments are contracts between two or more parties. They have a notional amount and underlying variable, require no net investment and allow for the net settlement of positions. The notional amount serves as the basis for the payment provision of the contract and takes the form of units, such as shares or dollars. The underlying variable represents a specified interest rate, index or other component. The interaction between the notional amount and the underlying variable determines the number of units to be exchanged between the parties and drives the market value of the derivative contract.

The primary derivatives that Key uses are interest rate swaps, caps and futures, credit derivatives and foreign exchange forward contracts. Generally, these instruments help Key manage exposure to market risk, mitigate the credit risk inherent in the loan portfolio and meet client financing needs. Market risk represents the possibility that economic value or net interest income will be adversely affected by changes in interest rates or other economic factors.

Derivative assets and liabilities are recorded at fair value on the balance sheet, after taking into account the effects of master netting agreements. These agreements allow Key to settle all derivative contracts held with a single counterparty on a net basis, and to offset net derivative positions with the related cash collateral. As a result, Key could have derivative contracts with negative fair values included in derivative assets on the balance sheet and contracts with positive fair values included in derivative liabilities.

At June 30, 2008, Key had \$309 million of derivative assets and a \$142 million debit balance in derivative liabilities that relate to contracts entered into for hedging purposes. As of the same date, Key had trading derivative assets of \$1.4 billion and trading derivative liabilities of \$779 million.

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### Counterparty Credit Risk

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

| <i>in millions</i>                       | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|--|------------------|----------------------|------------------|
| Interest rate                            | \$ 693           | \$ 850               | \$ 156           |
| Foreign exchange                         | 245              | 492                  | 278              |
| Energy                                   | 889              | 52                   | 8                |
| Credit                                   | 37               | 13                   | 3                |
| Equity                                   | 25               | 34                   | 52               |
| Derivative assets before cash collateral | 1,889            | 1,441                | 497              |
| Less: Related cash collateral            | 196              | 562                  | 123              |
| Total derivative assets                  | <u>\$ 1,693</u>  | <u>\$ 879</u>        | <u>\$ 374</u>    |

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

Key uses two additional means to manage exposure to credit risk on derivative contracts. First, Key generally enters into bilateral collateral and master netting agreements. These agreements provide for the net settlement of all contracts with a single counterparty in the event of default. Second, Key's Credit Administration department monitors credit risk exposure to the counterparty on each contract to determine appropriate limits on Key's total credit exposure and decide whether to demand collateral. If Key determines that collateral is required, it is generally collected immediately. Key generally holds collateral in the form of cash and highly rated securities issued by the U.S. Treasury, government sponsored enterprises or the Government National Mortgage Association. The cash collateral netted against derivative assets on the balance sheet was \$196 million at June 30, 2008, \$562 million at December 31, 2007, and \$123 million at June 30, 2007. The cash collateral netted against derivative liabilities was \$531 million at June 30, 2008, \$254 million at December 31, 2007, and \$134 million at June 30, 2007.

At June 30, 2008, Key was party to derivative contracts with 58 different counterparties. These derivatives include interest rate swaps and caps, credit derivatives, foreign exchange contracts, equity derivatives and energy derivatives. Among these were contracts entered into to offset the risk of loss associated with contracts entered into to accommodate clients. Key had aggregate exposure of \$456 million on these instruments to 34 of the 58 counterparties. However, at June 30, 2008, Key held approximately \$290 million in pooled collateral to mitigate that exposure, resulting in net exposure of \$166 million. The largest exposure to an individual counterparty was approximately \$209 million, which is secured with approximately \$186 million in collateral.

### Asset and Liability Management

Key uses fair value and cash flow hedging strategies to manage its exposure to interest rate risk. These strategies reduce the potential adverse impact of interest rate movements on future net interest income. For more information about these asset and liability management strategies, see Note 19 ("Derivatives and Hedging Activities"), which begins on page 100 of Key's 2007 Annual Report to Shareholders.



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The change in “accumulated other comprehensive income (loss)” resulting from cash flow hedges is as follows:

| <i>in millions</i>  | December 31,<br>2007 | 2008<br>Hedging Activity | Reclassification<br>of Gains to<br>Net Income | June 30,<br>2008 |
|---|----------------------|--------------------------|---|------------------|
| Accumulated other comprehensive income (loss) resulting from cash flow hedges | \$ 103               | \$ 55                    | \$ (54)                                       | \$ 104           |

Key reclassifies gains and losses from “accumulated other comprehensive income (loss)” to earnings when a hedged item causes Key to pay variable-rate interest on debt, receive variable-rate interest on commercial loans, or sell or securitize commercial real estate loans. If interest rates, yield curves and notional amounts remain at current levels, management expects to reclassify an estimated \$54 million of net gains on derivative instruments from “accumulated other comprehensive income (loss)” to earnings during the next twelve months. The maximum length of time over which forecasted transactions are hedged is twenty years.

### Credit Risk Management

Key uses credit derivatives  $\frac{3}{4}$  primarily credit default swaps  $\frac{3}{4}$  to mitigate credit risk by transferring a portion of the risk associated with the underlying extension of credit to a third party. These instruments are also used to manage portfolio concentration and correlation risks. At June 30, 2008, the notional amount of credit default swaps purchased by Key was \$1.3 billion. Key also provides credit protection to other lenders through the sale of credit default swaps. These transactions may generate fee income and can diversify overall exposure to credit loss. At June 30, 2008, the notional amount of credit default swaps sold by Key was \$203 million.

These derivatives are recorded on the balance sheet at fair value, which is based on the creditworthiness of the borrowers. Related gains or losses, as well as the premium paid or received for credit protection, are included in “investment banking and capital markets income” on the income statement. Key does not apply hedge accounting to credit derivatives.

### Trading Portfolio

Key’s trading portfolio includes:

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

The fair values of these trading portfolio items are included in “derivative assets” or “derivative liabilities” on the balance sheet. Adjustments to the fair values are included in “investment banking and capital markets income” on the income statement. Key has established a reserve in the amount of \$19 million at June 30, 2008, which management believes will be sufficient to cover estimated future losses on the trading portfolio in the event of client default. Additional information pertaining to Key’s trading portfolio is summarized in Note 19 of Key’s 2007 Annual Report to Shareholders.

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## 15. Fair Value Measurements

Effective January 1, 2008, Key adopted SFAS No. 157, "Fair Value Measurements," for all applicable financial and nonfinancial assets and liabilities. This accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances. Additional information pertaining to Key's accounting policy for fair value measurements is summarized in Note 1 ("Basis of Presentation") under the heading "Fair Value Measurements" on page 8.

### Fair Value Determination

As defined in SFAS No. 157, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants in Key's principal market. Key has established and documented its process for determining the fair values of its 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, management determines the fair value of Key's assets and liabilities using valuation models or third-party pricing services, both of which 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 management's judgment, assumptions and estimates related to credit quality, liquidity, interest rates and other relevant inputs.

Valuation adjustments, such as those pertaining to counterparty and Key's 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 is not indicative of the counterparty's credit quality. Most classes of derivative contracts are valued using internally-developed models based on market-standard derivative pricing conventions, which rely primarily on observable market inputs, such as interest rate yield curves and volatilities. Market convention implies a credit rating of double-A equivalent in the pricing of derivative contracts, which assumes all counterparties have the same creditworthiness. In determining the fair value of derivatives, management applies cash collateral and/or a default reserve to reflect the credit quality of the counterparty.

Liquidity valuation adjustments are made when management is unable to observe recent market transactions for identical or similar instruments. Management adjusts the fair value to reflect the uncertainty in the pricing and trading of the instrument. 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.

Key has various controls in place to ensure that fair value measurements are accurate and appropriate. These controls include:

- .. an independent review and approval of valuation models;
- .. a detailed review of profit and loss conducted on a regular basis; and
- .. validation of valuation model components against benchmark data and similar products, where possible.

Any changes to valuation methodologies are reviewed by management to ensure they are relevant and justified. Valuation methodologies are refined as more market-based data becomes available.

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### **Fair Value Hierarchy**

SFAS No. 157 establishes a three-level valuation hierarchy for determining fair value that is based on the transparency of the inputs used in the valuation process. The inputs used in determining fair value in each of the three levels of the hierarchy are as follows:

- “ **Level 1.** Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- “ **Level 2.** Either: (i) quoted market prices for similar assets or liabilities; (ii) observable inputs, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data.
- “ **Level 3.** Unobservable inputs.

The hierarchy gives the highest ranking to Level 1 inputs and the lowest ranking to Level 3 inputs. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the overall fair value measurement.

### **Qualitative Disclosures of Valuation Techniques**

**Loans.** Loans recorded as trading account assets are valued based on market spreads for identical or similar assets. Generally, these loans are classified as Level 2 since the fair value recorded is based on observable market data. Key corroborates these inputs periodically through a pricing service, which obtains data about actual transactions in the marketplace for identical or similar assets.

**Securities (trading and available for sale).** Where quoted prices are available in an active market, securities are classified as Level 1. Level 1 instruments include highly liquid government bonds, securities issued by the U.S. Treasury and exchange-traded equity securities. If quoted prices are not available, management determines fair value using pricing models, quoted prices of similar securities or discounted cash flows. These instruments include assets such as municipal bonds and certain agency collateralized mortgage obligations and are classified as Level 2. In certain cases where there is limited activity in the market for a particular instrument, assumptions must be made to determine their fair value. Such instruments include certain mortgage-backed securities, certain commercial paper and restricted stock, and are classified as Level 3.

**Private equity and mezzanine investments.** Valuations of private equity and mezzanine investments, held primarily within Key's Real Estate Capital and Corporate Banking Services line of business, are based primarily on management's judgment due to the lack of readily determinable fair values, inherent illiquidity and the long-term nature of these assets. These investments are initially valued based upon the transaction price. The carrying amount is then adjusted upward or downward based upon the estimated future cash flows associated with the investments. Factors used in determining future cash flows include, but are not limited to, the cost of build-out, future selling prices, current market outlook and operating performance of the particular investment. The valuation of private equity and mezzanine investments is classified as Level 3.

**Principal investments.** Valuations of principal investments, made by KPP, are based on the underlying investments of the fund. In the case of equity securities where readily available market quotes exist, those market quotes are utilized, and the related investments are classified as Level 1. Most of KPP's investments are in private companies without readily available market data. For these investments, the inputs are classified as Level 3 and are used in valuation methodologies such as discounted cash flows, price/earnings ratios, and multiples of earnings before interest, tax, depreciation and amortization.

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**Derivatives.** Exchange-traded derivatives are valued using quoted prices and, therefore, are classified as Level 1. Only a few types of derivatives are exchange-traded; thus, the majority of Key's derivative positions are valued using internally-developed models that use observable market inputs. These derivative contracts are classified as Level 2 and include interest rate swaps, options and credit default swaps. Market convention implies a credit rating of double-A equivalent in the pricing of derivative contracts, which assumes all counterparties have the same creditworthiness. In order to reflect the actual exposure on Key's derivative contracts related to both counterparty and Key's own creditworthiness, management records a fair value adjustment in the form of a reserve. The credit component is valued on a counterparty-by-counterparty basis and considers master netting agreements and collateral.

### Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities are considered to be fair valued on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly or quarterly). The following table shows Key's assets and liabilities measured at fair value on a recurring basis.

June 30, 2008

| <i>in millions</i>                                   | Level 1       | Level 2          | Level 3         | Netting<br>Adjustments <sup>a</sup> | Total            |
|--|---------------|------------------|-----------------|-------------------------------------|------------------|
| <b>ASSETS MEASURED ON A RECURRING BASIS</b>          |               |                  |                 |                                     |                  |
| Trading account assets                               | \$ 6          | \$ 753           | \$ 724          | —                                   | \$ 1,483         |
| Securities available for sale                        | 66            | 8,055            | 3               | —                                   | 8,124            |
| Other investments                                    | 33            | —                | 1,191           | —                                   | 1,224            |
| Derivative assets                                    | 265           | 2,881            | 9               | \$ (1,462)                          | 1,693            |
| Accrued income and other assets                      | 5             | 125              | —               | —                                   | 130              |
| Total assets on a recurring basis at fair value      | <u>\$ 375</u> | <u>\$ 11,814</u> | <u>\$ 1,927</u> | <u>\$ (1,462)</u>                   | <u>\$ 12,654</u> |
| <b>LIABILITIES MEASURED ON A RECURRING BASIS</b>     |               |                  |                 |                                     |                  |
| Bank notes and other short-term borrowings           | \$ 16         | \$ 336           | —               | —                                   | \$ 352           |
| Derivative liabilities                               | 269           | 2,164            | \$ 1            | \$ (1,797)                          | 637              |
| Accrued expense and other liabilities                | 1             | 48               | —               | —                                   | 49               |
| Total liabilities on a recurring basis at fair value | <u>\$ 286</u> | <u>\$ 2,548</u>  | <u>\$ 1</u>     | <u>\$ (1,797)</u>                   | <u>\$ 1,038</u>  |

- (a) Netting adjustments represent the amounts recorded to convert Key's derivative assets and liabilities from a gross basis to a net basis in conjunction with Key's January 1, 2008, adoption of FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," and FASB Staff Position FIN 39-1, "Amendment of FASB Interpretation 39." The net basis takes into account the impact of master netting agreements which allow Key to settle all derivative contracts with a single counterparty on a net basis and to offset the net derivative position with the related cash collateral.

### Changes in Level 3 Fair Value Measurements

The following table shows the change in the fair values of Key's Level 3 financial instruments for the six months ended June 30, 2008. Classification in Level 3 is based on the significance of unobservable inputs relative to the overall fair value measurement of the instrument. In addition to unobservable inputs, Level 3 instruments also may have inputs that are observable within the market. Management mitigates the credit risk, interest rate risk and risk of loss related to many of these Level 3 instruments through the use of securities and derivative positions classified as Level 1 or Level 2. Level 1 or Level 2 instruments are not included in the following table; therefore, the gains or losses shown do not include the impact of Key's risk management activities related to these Level 3 instruments.

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|  | Six months ended June 30, 2008 |                                     |                      |                             |
|--|--------------------------------|-------------------------------------|----------------------|-----------------------------|
|  | Trading<br>Account<br>Assets   | Securities<br>Available<br>for Sale | Other<br>Investments | Derivative<br>Instruments a |
| <i>in millions</i>                             |                                |                                     |                      |                             |
| Balance at beginning of period                 | \$ 338                         | \$ 4                                | \$ 1,161             | \$ 6                        |
| (Losses) gains:                                |                                |                                     |                      |                             |
| Included in earnings                           | (38) b                         | 1 c                                 | 1 d                  | 2 b                         |
| Included in other comprehensive income         | —                              | (1)                                 | —                    | —                           |
| Purchases, sales, issuances and settlements    | 424                            | (1)                                 | 29                   | —                           |
| Balance at end of period                       | <u>\$ 724</u>                  | <u>\$ 3</u>                         | <u>\$ 1,191</u>      | <u>\$ 8</u>                 |
| Unrealized (losses) gains included in earnings | \$ (29) b                      | \$ (1) c                            | \$ (43) d            | \$ 2 b                      |

- (a) Amount represents Level 3 derivative assets less Level 3 derivative liabilities.
- (b) Realized and unrealized gains and losses on trading account assets and derivative instruments are reported in “investment banking and capital markets income” on the income statement.
- (c) Unrealized gains and losses on securities available for sale are reported in “net securities (losses) gains” on the income statement.
- (d) Other investments consist of principal investments, and private equity and mezzanine investments. Realized and unrealized gains and losses on principal investments are reported in “net (losses) gains from principal investments” on the income statement. Realized and unrealized gains and losses on private equity and mezzanine investments are reported in “investment banking and capital markets income” on the income statement.

**Assets Measured at Fair Value on a Nonrecurring Basis**

Assets and liabilities are considered to be fair valued on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheet. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements which require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value. The following table presents Key’s assets measured at fair value on a nonrecurring basis.

**June 30, 2008**

| <i>in millions</i>                                 | Level 1  | Level 2     | Level 3       | Total         |
|--|----------|-------------|---------------|---------------|
| <b>ASSETS MEASURED ON A NONRECURRING BASIS</b>     |          |             |               |               |
| Securities available for sale                      | —        | —           | \$ 4          | \$ 4          |
| Other investments                                  | —        | \$ 1        | —             | 1             |
| Loans held for sale                                | —        | —           | 752           | 752           |
| Accrued income and other assets                    | —        | 3           | 27            | 30            |
| Total assets on a nonrecurring basis at fair value | <u>—</u> | <u>\$ 4</u> | <u>\$ 783</u> | <u>\$ 787</u> |

Through Key’s quarterly analysis of its commercial loan portfolio, management determined that certain adjustments were necessary to record the portfolio at the lower of cost or fair value in accordance with GAAP. While some loans were impaired as a result of current market conditions, other loans recovered some of the value that was previously written down. After adjustments, these loans totaled \$368 million at June 30, 2008. Valuation of these loans is performed using an internal model which relies on market data from sales of similar assets, including credit spreads, interest rate curves and risk profiles, as well as Key’s own assumptions about the exit market for the loans. The valuation methodology employed is based on Level 3 inputs. Key’s loans held for sale, which are measured at fair value on a nonrecurring basis, also include the \$384 million of commercial real estate loans transferred from the loan portfolio to held-for-sale status in June 2008. The fair value of these loans was measured using nonbinding broker quotes obtained through a third party.



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Other real estate owned and other repossessed properties are valued based on appraisals and third-party price opinions, less estimated selling costs. Assets that are acquired through, or in lieu of, loan foreclosures are recorded as held for sale initially at the lower of the loan balance or fair value upon the date of foreclosure. Subsequent to foreclosure, valuations are updated periodically, and the assets may be marked down further, reflecting a new cost basis. These assets, which totaled \$18 million at June 30, 2008, are considered to be nonrecurring items in the fair value hierarchy.

Current market conditions, including lower prepayments, interest rates and expected recovery rates have impacted Key's modeling assumptions pertaining to education lending-related servicing rights and residual interests, and consequently resulted in write-downs of these instruments. These instruments are included in "accrued income and other assets" and "securities available for sale" respectively, in the preceding table.

[Table of Contents](#)**Report of Independent Registered Public Accounting Firm****Shareholders and Board of Directors****KeyCorp**

We have reviewed the condensed consolidated balance sheets of KeyCorp and subsidiaries (“Key”) as of June 30, 2008 and 2007, and the related condensed consolidated statements of income, for the three- and six-month periods then ended, and the condensed consolidated statement of changes in shareholders’ equity and cash flows for the six-month periods ended June 30, 2008 and 2007. These financial statements are the responsibility of Key’s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Key as of December 31, 2007, and the related consolidated statements of income, changes in shareholders’ equity, and cash flows for the year then ended not presented herein, and in our report dated February 22, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Cleveland, Ohio  
August 7, 2008



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### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

#### Introduction

This section generally reviews the financial condition and results of operations of KeyCorp and its subsidiaries for the quarterly and year-to-date periods ended June 30, 2008 and 2007. Some tables may include additional periods to comply with disclosure requirements or to illustrate trends in greater depth. When you read this discussion, you should also refer to the consolidated financial statements and related notes that appear on pages 3 through 38. A description of Key's business is included under the heading "Description of Business" on page 14 of Key's 2007 Annual Report to Shareholders. This description does not reflect the reorganization within some of Key's lines of business that took effect on January 1, 2008. For a current description of Key's lines of business, see Note 4 ("Line of Business Results"), which begins on page 14.

#### Terminology

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

- **KeyCorp** refers solely to the parent holding company.
- **KeyBank** refers to KeyCorp's subsidiary bank, KeyBank National Association.
- **Key** refers to the consolidated entity consisting of KeyCorp and its subsidiaries.
- In November 2006, Key sold the subprime mortgage loan portfolio held by the Champion Mortgage finance business and announced a separate agreement to sell Champion's origination platform. As a result of these actions, Key has accounted for this business as a **discontinued operation**. We use the phrase **continuing operations** in this document to mean all of Key's business other than Champion. Key completed the sale of Champion's origination platform in February 2007.
- Key engages in **capital markets activities** primarily through business conducted by the National Banking group. These activities encompass a variety of products and services. Among other things, Key trades securities as a dealer, enters into derivative contracts (both to accommodate clients' financing needs and for proprietary trading purposes), and conducts transactions in foreign currencies (both to accommodate clients' needs and to benefit from fluctuations in exchange rates).
- All earnings per share data included in this discussion are presented on a **diluted** basis, which takes into account all common shares outstanding as well as potential common shares that could result from the conversion of preferred stock to common shares, the exercise of outstanding stock options and other stock awards. Some of the financial information tables also include **basic** earnings per share, which takes into account only common shares outstanding.
- For regulatory purposes, capital is divided into two classes. Federal regulations prescribe that at least one-half of a bank or bank holding company's **total risk-based capital** must qualify as **Tier 1**. Both total and Tier 1 capital serve as bases for several measures of capital adequacy, which is an important indicator of financial stability and condition. You will find a more detailed explanation of total and Tier 1 capital and how they are calculated in the section entitled "Capital," which begins on page 72.

#### Forward-looking statements

This report may contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, including statements about Key's long-term goals, financial condition, results of operations, earnings, levels of net loan charge-offs and nonperforming assets, interest rate exposure and profitability. These statements usually can be identified by the use of forward-looking



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language such as “our goal,” “our objective,” “our plan,” “will likely result,” “expects,” “plans,” “anticipates,” “intends,” “projects,” “believes,” “estimates” or other similar words, expressions or conditional verbs such as “will,” “would,” “could” and “should.”

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

- “ Interest rates could change more quickly or more significantly than management expects, which may have an adverse effect on Key’s financial results.
- “ Trade, monetary and fiscal policies of various governmental bodies may affect the economic environment in which Key operates, as well as its financial condition and results of operations.
- “ Changes in the stock markets, public debt markets and other capital markets, including continued disruption in the fixed income markets, could adversely affect Key’s ability to raise capital or other funding for liquidity and business purposes, as well as its revenues from client-based underwriting, investment banking and other capital markets-driven businesses.
- “ Recent problems in the housing markets, including issues related to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, and related conditions in the financial markets, or other issues, such as the high price of oil or other commodities, could cause further deterioration in general economic conditions, or in the condition of the local economies or industries in which Key has significant operations or assets, and, among other things, materially impact credit quality in existing portfolios and/or Key’s ability to generate loans in the future.
- “ Increasing interest rates or further weakening economic conditions could constrain borrowers’ ability to repay outstanding loans or diminish the value of the collateral securing those loans. Additionally, the allowance for loan losses may be insufficient if the estimates and judgments management used to establish that allowance prove to be inaccurate.
- “ Increased competitive pressure among financial services companies may adversely affect Key’s ability to market its products and services.
- “ It could take Key longer than anticipated to implement strategic initiatives, including those designed to grow revenue or manage expenses; Key may be unable to implement certain initiatives; or the initiatives may be unsuccessful.
- “ Acquisitions and dispositions of assets, business units or affiliates could adversely affect Key in ways that management has not anticipated.
- “ Key may experience operational or risk management failures due to technological or other factors.
- “ Changes in accounting principles or in tax laws, rules and regulations could have an adverse effect on Key’s financial results or its capital.
- “ Key may become subject to new legal obligations or liabilities, or the unfavorable resolution of pending litigation may have an adverse effect on its financial results or its capital.
- “ Key may become subject to new or heightened regulatory practices, requirements or expectations which may impede its profitability.
- “ Terrorist activities or military actions could disrupt the economy and the general business climate, which may have an adverse effect on Key’s financial results or condition and that of its borrowers.



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### Long-term goals

Key's long-term financial goals are to grow its earnings per common share and achieve a return on average equity, each at or above the respective median of its peer group. The strategy for achieving these goals is described under the heading "Corporate Strategy" on page 16 of Key's 2007 Annual Report to Shareholders.

### Economic overview

During the second quarter of 2008, the U.S. consumer faced inflationary pressures and a weakening labor market. Consumer prices in June 2008 rose 5.0% from June 2007, up from a 4.0% annual increase in March 2008. Energy costs increased by 24.7% from the same month one year ago, as the price of oil rose from \$102 per barrel at March 31, 2008, to \$140 per barrel at June 30, 2008. Employment also softened during the second quarter as the economy lost 191,000 jobs, which brought the number of jobs lost since December 2007 to 438,000. The average unemployment rate for the quarter rose to 5.3%, compared to the first quarter average of 4.9% and the 2007 average of 4.6%. Although consumer confidence dropped to a 28-year low, the consumer did show signs of resiliency, due in part to tax rebate checks that the government began to disburse in early May. Consumer spending during the second quarter rose at an average monthly rate of .6%, compared to an average monthly rate of .3% in the first quarter and .5% in 2007.

The downward trend in real estate values and home sales continued into the second quarter of 2008. June new home sales were down 33% and existing home sales were down 15% from the respective sales levels reported for the same month last year, while the median price of existing homes fell by more than 6%. The number of homes available for sale was further elevated by home foreclosures, which rose by 53% from the number of foreclosures experienced in June 2007. As of June 30, an estimated one out of every 501 homes was in some stage of foreclosure. Decreasing home sales and a rising inventory of homes for sale slowed the pace of new home construction, as housing starts and building permits were down more than 20% from June 2007.

Write-downs caused by distressed real estate values and increasing loan losses further strained already diminished capital levels at financial institutions, forcing many to raise additional capital, often at substantially higher costs than experienced in recent years. For regional banking institutions such as Key, access to the capital markets for unsecured term debt continues to be severely restricted, with investors requiring historically wide spreads over risk-free U.S. Treasury obligations to make new investments.

In response to the continued disruptions in the credit markets, softening labor markets, further housing declines and weak economic growth, during the second quarter of 2008 the Federal Reserve lowered the federal funds target rate to 2.00% from 2.25%. However, increases occurred in most national money market interest rates as the market anticipated that the Federal Reserve may eventually have to increase interest rates to address the increasing risk of inflation. The benchmark two-year Treasury yield increased to 2.62% at June 30, 2008, from 1.59% at March 31, 2008. The ten-year Treasury yield began the quarter at 3.41% and closed the second quarter at 3.97%.

**Demographics.** The extent to which Key's business has been affected by continued volatility and weakness in the housing market is directly related to the state of the economy in the regions in which its two major business groups, Community Banking and National Banking, operate.

Key's Community Banking group serves consumers and small to mid-sized businesses by offering a variety of deposit, investment, lending and wealth management products and services. These products and services are provided through a 14-state branch network organized into four geographic regions as defined by management: Northwest, Rocky Mountains, Great Lakes and Northeast. Figure 1 shows the geographic diversity of the Community Banking group's average core deposits, commercial loans and home equity loans.

[Table of Contents](#)**Figure 1. Community Banking Geographic Diversity**

| Three months ended June 30, 2008<br><i>dollars in millions</i> | Geographic Region |                 |             |           |             | Total     |
|--|-------------------|-----------------|-------------|-----------|-------------|-----------|
|  | Northwest         | Rocky Mountains | Great Lakes | Northeast | Nonregion a |           |
| Average core deposits  | \$ 9,662          | \$ 3,523        | \$ 14,112   | \$ 13,069 | \$ 1,615    | \$ 41,981 |
| Percent of total   | 23.0%             | 8.4%            | 33.6%       | 31.1%     | 3.9%        | 100.0%    |
| Average commercial loans                                       | \$ 4,264          | \$ 2,095        | \$ 4,860    | \$ 3,175  | \$ 1,362    | \$ 15,756 |
| Percent of total   | 27.1%             | 13.3%           | 30.8%       | 20.2%     | 8.6%        | 100.0%    |
| Average home equity loans                                      | \$ 2,777          | \$ 1,312        | \$ 2,917    | \$ 2,632  | \$ 128      | \$ 9,766  |
| Percent of total   | 28.4%             | 13.4%           | 29.9%       | 27.0%     | 1.3%        | 100.0%    |

(a) Represents core deposit, commercial loan and home equity loan products centrally managed outside of the four Community Banking regions.

Key's National Banking group includes those corporate and consumer business units that operate nationally, within and beyond the 14-state branch network, as well as internationally. The specific products and services offered by the National Banking group are described in Note 4 ("Line of Business Results"), which begins on page 14.

The diversity of Key's commercial real estate lending business based on industry type and location is shown in Figure 19 on page 65. The homebuilder loan portfolio within the National Banking group has been adversely affected by the downturn in the U.S. housing market. As a result of deteriorating market conditions in the residential properties segment of Key's commercial real estate construction portfolio, principally in Florida and southern California, Key has experienced a significant increase in the level of its nonperforming assets since mid-2007. As previously reported, during the second quarter of 2008, Key initiated a process to reduce its exposure in this segment of its loan portfolio through the planned sale of certain loans. Although Key's actions in this regard resulted in additional net charge-offs and a higher provision for loan losses for the second quarter, the sale of these loans, once closed, is expected to reduce the level of Key's total nonperforming assets. Management anticipates that the majority of the loan sales will close in the third quarter. Additional information pertaining to the planned loan sales is included in the "Credit risk management" section, which begins on page 81.

In recent quarters, results for the National Banking group have also been affected adversely by volatility in the capital markets, leading to declines in the market values at which certain assets (primarily commercial real estate loans and securities held for sale or trading) are recorded. During the first quarter of 2008, management placed hedges on Key's remaining previously unhedged commercial real estate mortgage loans held for sale to protect against further declines in market values that may result from changes in credit spreads and other market-driven factors. These actions, along with improved execution and market conditions, contributed to a more favorable performance from Key's capital markets-driven businesses in the second quarter of 2008.

During the second quarter of 2008, the banking industry, including Key, continued to experience commercial and industrial loan growth, due in part to increased reliance by borrowers on commercial lines of credit in response to the challenging economic environment.

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### **Critical accounting policies and estimates**

Key's business is dynamic and complex. Consequently, management must exercise judgment in choosing and applying accounting policies and methodologies in many areas. These choices are critical; not only are they necessary to comply with U.S. generally accepted accounting principles ("GAAP"); they also reflect management's view of the appropriate way to record and report Key's overall financial performance. All accounting policies are important, and all policies described in Note 1 ("Summary of Significant Accounting Policies"), which begins on page 65 of Key's 2007 Annual Report to Shareholders, should be reviewed for a greater understanding of how Key's financial performance is recorded and reported.

In management's opinion, some accounting policies are more likely than others to have a significant effect on Key's financial results and to expose those results to potentially greater volatility. These policies apply to areas of relatively greater business importance, or require management to exercise judgment and to make assumptions and estimates that affect amounts reported in the financial statements. Because these assumptions and estimates are based on current circumstances, they may change over time or prove to be inaccurate.

Management relies heavily on the use of judgment, assumptions and estimates to make a number of core decisions, including accounting for the allowance for loan losses; loan securitizations; contingent liabilities, guarantees and income taxes; derivatives and related hedging activities; and assets and liabilities that involve valuation methodologies. A brief discussion of each of these areas appears on pages 17 through 19 of Key's 2007 Annual Report to Shareholders. Information related to the results of Key's goodwill impairment testing conducted as of June 30, 2008, is included in Note 1 ("Basis of Presentation") under the heading "Goodwill and Other Intangible Assets" on page 7.

Effective January 1, 2008, Key adopted Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. In the absence of quoted market prices, management determines the fair value of Key's assets and liabilities using internally-developed models which are based on management's judgment, assumptions and estimates regarding credit quality, liquidity, interest rates and other relevant inputs. Key's adoption of this accounting guidance and the process used in determining fair values is more fully described in Note 1 ("Basis of Presentation") under the heading "Fair Value Measurements" on page 8, and Note 15 ("Fair Value Measurements"), which begins on page 34.

At June 30, 2008, \$12.7 billion, or 12%, of Key's total assets were measured at fair value on a recurring basis. Approximately 96% of these assets were classified as Level 1 or Level 2 within the fair value hierarchy. At June 30, 2008, \$1.0 billion, or 1%, of Key's total liabilities were measured at fair value on a recurring basis. Substantially all of these liabilities were classified as Level 1 or Level 2.

At June 30, 2008, \$787 million, or 1%, of Key's total assets were measured at fair value on a nonrecurring basis. Less than 1% of these assets were classified as Level 1 or Level 2. At June 30, 2008, there were no liabilities measured at fair value on a nonrecurring basis.

### **Highlights of Key's Performance**

#### **Financial performance**

For the second quarter of 2008, Key recorded a loss of \$1.126 billion from continuing operations, or \$2.70 per common share. These results compare to income from continuing operations of \$337 million, or \$.85 per diluted common share, for the second quarter of 2007, and \$218 million, or \$.54 per diluted common share, for the first quarter of 2008.

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Key's results for both the second and first quarters of 2008 include additional charges associated with certain leveraged lease financing transactions being challenged by the Internal Revenue Service ("IRS"). Second quarter results include after-tax charges of \$1.011 billion, or \$2.43 per common share, resulting from a previously announced adverse federal court decision on the tax treatment of a Service Contract Lease transaction – a decision that the company has appealed.

During the first quarter of 2008, Key increased its tax reserves for certain lease in, lease out ("LILO") transactions and recalculated its lease income in accordance with prescribed accounting standards, resulting in after-tax charges of \$38 million, or \$.10 per common share.

Excluding the lease financing charges recorded in the first and second quarters, Key had a loss from continuing operations of \$115 million, or \$.28 per common share, for the second quarter of 2008, compared to income from continuing operations of \$337 million, or \$.85 per diluted common share, for the second quarter of 2007, and \$256 million, or \$.64 per diluted common share, for the first quarter of 2008.

For the first six months of 2008, Key reported a loss from continuing operations of \$908 million, or \$2.23 per common share. Adjusting for the lease financing charges, Key had income from continuing operations of \$141 million, or \$.34 per diluted common share, compared to \$695 million, or \$1.74 per diluted common share, for the first half of 2007.

Key reported a net loss of \$1.126 billion, or \$2.70 per common share, for the second quarter of 2008, compared to net income of \$334 million, or \$.84 per diluted common share, for the second quarter of 2007, and \$218 million, or \$.54 per diluted common share, for the first quarter of 2008. For the first half of 2008, Key reported a net loss of \$908 million, or \$2.23 per common share, compared to net income of \$684 million, or \$1.71 per diluted common share, for the same period last year.

Figure 2 shows Key's continuing and discontinued operating results and related performance ratios for comparative quarters and the six-month periods ended June 30, 2008 and 2007.

**Figure 2. Results of Operations**

| <i>dollars in millions, except per share amounts</i>         | Three months ended |               |               | Six months ended |                |
|--|--------------------|---------------|---------------|------------------|----------------|
|  | 6-30-08            | 3-31-08       | 6-30-07       | 6-30-08          | 6-30-07        |
| <b>SUMMARY OF OPERATIONS</b>                                 |                    |               |               |                  |                |
| (Loss) income from continuing operations                     | \$ (1,126)         | \$ 218        | \$ 337        | \$ (908)         | \$ 695         |
| Loss from discontinued operations, net of taxes <sup>a</sup> | —                  | —             | (3)           | —                | (11)           |
| Net (loss) income  | <u>\$ (1,126)</u>  | <u>\$ 218</u> | <u>\$ 334</u> | <u>\$ (908)</u>  | <u>\$ 684</u>  |
| Net (loss) income applicable to common shares                | \$ (1,126)         | \$ 218        | \$ 334        | \$ (908)         | \$ 684         |
| <b>PER COMMON SHARE — ASSUMING DILUTION</b>                  |                    |               |               |                  |                |
| (Loss) income from continuing operations                     | \$ (2.70)          | \$ .54        | \$ .85        | \$ (2.23)        | \$ 1.74        |
| Loss from discontinued operations <sup>a</sup>               | —                  | —             | (.01)         | —                | (.03)          |
| Net (loss) income  | <u>\$ (2.70)</u>   | <u>\$ .54</u> | <u>\$ .84</u> | <u>\$ (2.23)</u> | <u>\$ 1.71</u> |
| <b>PERFORMANCE RATIOS</b>                                    |                    |               |               |                  |                |
| <b>From continuing operations:</b>                           |                    |               |               |                  |                |
| Return on average total assets                               | (4.38)%            | .85%          | 1.45%         | (1.77)%          | 1.51%          |
| Return on average common equity                              | (53.35)            | 10.38         | 17.66         | (21.57)          | 18.35          |
| Return on average total equity                               | (52.56)            | 10.38         | 17.66         | (21.40)          | 18.35          |
| <b>From consolidated operations:</b>                         |                    |               |               |                  |                |
| Return on average total assets                               | (4.38)%            | .85%          | 1.43%         | (1.77)%          | 1.49%          |
| Return on average common equity                              | (53.35)            | 10.38         | 17.50         | (21.57)          | 18.06          |
| Return on average total equity                               | (52.56)            | 10.38         | 17.50         | (21.40)          | 18.06          |

- (a) Key sold the subprime mortgage loan portfolio held by the Champion Mortgage finance business in November 2006, and completed the sale of Champion's origination platform in February 2007. As a result of these actions, Key has accounted for this business as a discontinued operation.

In addition to the lease financing charges, Key's results for the second quarter of 2008 were adversely affected by a higher provision for loan losses. The increased provision resulted from the company's previously reported efforts to reduce its exposure to the residential properties segment of its commercial real estate construction loan portfolio through the planned sale of assets, and actions taken to bolster the

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allowance for loan losses. Key's provision for loan losses for the second quarter of 2008 was \$647 million, compared to \$53 million for the same period one year ago. The current quarter's provision exceeded net loan charge-offs by \$123 million and increased Key's reserve for loan losses to \$1.421 billion, or 1.87% of period-end loans. Additional information pertaining to the planned sale of assets is presented in the section entitled "Credit risk management," which begins on page 81.

Key took aggressive steps in the second quarter to further strengthen its capital position, due in large part to the impact of the lease accounting charges. Including shares issued in July under an over allotment option, the company raised \$1.74 billion of additional capital through the issuance of preferred stock and common shares. Further, Key's Board of Directors announced its intention to reduce the dividend on Key's common shares by 50% to an annualized dividend of \$.75 per share commencing with the dividend payable in the third quarter of 2008. Management believes these actions will position the company to respond to future business opportunities and are prudent steps in light of the challenging economic environment.

During the second quarter of 2008, Key experienced positive trends in several of its fee-based businesses, most notably trust and investment services, and the investment banking, syndications and capital markets businesses. Expenses continued to be well-controlled and the company benefited from the actions taken in the first quarter to reduce exposure to future market volatility. Key also continued to gain traction in its Community Banking model. While working through this difficult credit cycle, management intends to continue to focus on Key's relationship business model, carefully manage expenses and upgrade delivery platforms to maintain Key's readiness to respond to business opportunities as they emerge.

As shown in Figure 3, the comparability of Key's earnings for the current, prior and year-ago quarters is affected by several significant items.

**Figure 3. Significant Items Affecting the Comparability of Earnings**

|  | Three months ended<br>June 30, 2008 |                     |                  | Three months ended<br>March 31, 2008 |                     |                  | Three months ended<br>June 30, 2007 |                     |                  |
|--|-------------------------------------|---------------------|------------------|--------------------------------------|---------------------|------------------|-------------------------------------|---------------------|------------------|
|  | Pre-tax<br>Amount                   | After-tax<br>Amount | Impact<br>on EPS | Pre-tax<br>Amount                    | After-tax<br>Amount | Impact<br>on EPS | Pre-tax<br>Amount                   | After-tax<br>Amount | Impact<br>on EPS |
| <i>in millions, except per share amounts</i>   |                                     |                     |                  |                                      |                     |                  |                                     |                     |                  |
| Charge related to leveraged lease<br>tax litigation  | \$ (359)                            | \$ (1,011)          | \$ (2.43)        | \$ (3)                               | \$ (38)             | \$ (.10)         | —                                   | —                   | —                |
| Gain from redemption of Visa<br>Inc. shares  | —                                   | —                   | —                | 165                                  | 103                 | .26              | —                                   | —                   | —                |
| Realized and unrealized gains<br>(losses) on loan and securities<br>portfolios held for sale or<br>trading | 62                                  | 39                  | .09              | (128)                                | (80)                | (.20)            | \$ 51                               | \$ 32               | \$ .08           |
| Litigation reserve   | —                                   | —                   | —                | —                                    | —                   | —                | (42)                                | (26)                | (.07)            |
| Gains related to MasterCard<br>Incorporated shares   | —                                   | —                   | —                | —                                    | —                   | —                | 40                                  | 25                  | .06              |

EPS = Earnings per diluted common share

Events leading to the recognition of the items presented in Figure 3, as well as other factors that contributed to the changes in Key's revenue and expense components from those reported for the second quarter of 2007, are reviewed in detail throughout the remainder of the Management's Discussion and Analysis section.

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Key's financial performance for each of the past five quarters is summarized in Figure 4.

**Figure 4. Selected Financial Data**

| <i>dollars in millions, except per share amounts</i>           | 2008      |          | 2007     |          |          | Six months ended June 30, |          |
|--|-----------|----------|----------|----------|----------|---------------------------|----------|
|  | Second    | First    | Fourth   | Third    | Second   | 2008                      | 2007     |
| <b>FOR THE PERIOD</b>  |           |          |          |          |          |                           |          |
| Interest income  | \$ 880    | \$ 1,354 | \$ 1,447 | \$ 1,434 | \$ 1,395 | \$ 2,234                  | \$ 2,763 |
| Interest expense   | 522       | 641      | 737      | 740      | 709      | 1,163                     | 1,398    |
| Net interest income  | 358 a     | 713 a    | 710      | 694      | 686      | 1,071 a                   | 1,365    |
| Provision for loan losses                                      | 647       | 187      | 363      | 69       | 53       | 834                       | 97       |
| Noninterest income   | 555       | 528      | 488      | 438      | 649      | 1,083                     | 1,303    |
| Noninterest expense  | 781       | 732      | 896      | 753      | 815      | 1,513                     | 1,599    |
| (Loss) income from continuing operations before income taxes   | (515)     | 322      | (61)     | 310      | 467      | (193)                     | 972      |
| (Loss) income from continuing operations                       | (1,126)   | 218      | 22       | 224      | 337      | (908)                     | 695      |
| Income (loss) from discontinued operations, net of taxes       | —         | —        | 3        | (14)     | (3)      | —                         | (11)     |
| Net (loss) income  | (1,126) a | 218 a    | 25       | 210      | 334      | (908) a                   | 684      |
| Net (loss) income applicable to common shares                  | (1,126)   | 218      | 25       | 210      | 334      | (908)                     | 684      |
| <b>PER COMMON SHARE</b>  |           |          |          |          |          |                           |          |
| (Loss) income from continuing operations                       | \$ (2.70) | \$ .55   | \$ .06   | \$ .58   | \$ .86   | \$ (2.23)                 | \$ 1.76  |
| (Loss) income from discontinued operations                     | —         | —        | .01      | (.03)    | (.01)    | —                         | (.03)    |
| Net (loss) income  | (2.70)    | .55      | .06      | .54      | .85      | (2.23)                    | 1.73     |
| (Loss) income from continuing operations — assuming dilution   | (2.70)    | .54      | .06      | .57      | .85      | (2.23)                    | 1.74     |
| Income (loss) from discontinued operations — assuming dilution | —         | —        | .01      | (.03)    | (.01)    | —                         | (.03)    |
| Net (loss) income — assuming dilution                          | (2.70) a  | .54 a    | .06      | .54      | .84      | (2.23) a                  | 1.71     |
| Cash dividends paid  | .375      | .375     | .365     | .365     | .365     | .75                       | .73      |
| Book value at period end                                       | 16.59     | 21.48    | 19.92    | 20.12    | 19.78    | 16.59                     | 19.78    |
| Tangible book value at period end                              | 13.00     | 17.07    | 16.39    | 16.76    | 16.41    | 13.00                     | 16.41    |
| Market price:  |           |          |          |          |          |                           |          |
| High   | 26.12     | 27.23    | 34.05    | 37.09    | 38.96    | 27.23                     | 39.90    |
| Low  | 10.00     | 19.00    | 21.04    | 31.38    | 34.15    | 10.00                     | 34.15    |
| Close  | 10.98     | 21.95    | 23.45    | 32.33    | 34.33    | 10.98                     | 34.33    |

|  |                   |                  |           |           |           |                   |           |
|--|-------------------|------------------|-----------|-----------|-----------|-------------------|-----------|
| Weighted-average common shares outstanding (000)                             | <b>416,629</b>    | <b>399,121</b>   | 388,940   | 389,319   | 392,045   | <b>407,875</b>    | 394,944   |
| Weighted-average common shares and potential common shares outstanding (000) | <b>416,629</b>    | <b>399,769</b>   | 389,911   | 393,164   | 396,918   | <b>407,875</b>    | 400,180   |
| <b>AT PERIOD END</b>   |                   |                  |           |           |           |                   |           |
| Loans  | <b>\$ 75,855</b>  | <b>\$ 76,444</b> | \$ 70,823 | \$ 68,999 | \$ 66,692 | <b>\$ 75,855</b>  | \$ 66,692 |
| Earning assets   | <b>89,893</b>     | <b>89,719</b>    | 86,557    | 84,838    | 82,161    | <b>89,893</b>     | 82,161    |
| Total assets   | <b>101,544</b>    | <b>101,492</b>   | 98,228    | 96,137    | 92,967    | <b>101,544</b>    | 92,967    |
| Deposits   | <b>64,396</b>     | <b>64,702</b>    | 63,099    | 63,714    | 60,599    | <b>64,396</b>     | 60,599    |
| Long-term debt   | <b>15,106</b>     | <b>14,337</b>    | 11,957    | 11,549    | 12,581    | <b>15,106</b>     | 12,581    |
| Common shareholders' equity  | <b>8,056</b>      | <b>8,592</b>     | 7,746     | 7,820     | 7,701     | <b>8,056</b>      | 7,701     |
| Total shareholders' equity   | <b>8,706</b>      | <b>8,592</b>     | 7,746     | 7,820     | 7,701     | <b>8,706</b>      | 7,701     |
| <b>PERFORMANCE RATIOS</b>  |                   |                  |           |           |           |                   |           |
| <b>From continuing operations:</b>   |                   |                  |           |           |           |                   |           |
| Return on average total assets   | <b>(4.38)%</b>    | <b>.85%</b>      | .09%      | .93%      | 1.45%     | <b>(1.77)%</b>    | 1.51%     |
| Return on average common equity  | <b>(53.35)</b>    | <b>10.38</b>     | 1.11      | 11.50     | 17.66     | <b>(21.57)</b>    | 18.35     |
| Return on average total equity   | <b>(52.56)</b>    | <b>10.38</b>     | 1.11      | 11.50     | 17.66     | <b>(21.40)</b>    | 18.35     |
| Net interest margin (taxable equivalent)                                     | <b>(.44)</b>      | <b>3.14</b>      | 3.48      | 3.40      | 3.46      | <b>1.35</b>       | 3.48      |
| <b>From consolidated operations:</b>   |                   |                  |           |           |           |                   |           |
| Return on average total assets   | <b>(4.38) % a</b> | <b>.85% a</b>    | .10%      | .88%      | 1.43%     | <b>(1.77) % a</b> | 1.49%     |
| Return on average common equity  | <b>(53.35) a</b>  | <b>10.38 a</b>   | 1.26      | 10.79     | 17.50     | <b>(21.57) a</b>  | 18.06     |
| Return on average total equity   | <b>(52.56) a</b>  | <b>10.38 a</b>   | 1.26      | 10.79     | 17.50     | <b>(21.40) a</b>  | 18.06     |
| Net interest margin (taxable equivalent)                                     | <b>(.44) a</b>    | <b>3.14 a</b>    | 3.48      | 3.40      | 3.46      | <b>1.35 a</b>     | 3.49      |
| <b>CAPITAL RATIOS AT PERIOD END</b>  |                   |                  |           |           |           |                   |           |
| Equity to assets   | <b>8.57%</b>      | <b>8.47%</b>     | 7.89%     | 8.13%     | 8.28%     | <b>8.57%</b>      | 8.28%     |
| Tangible equity to tangible assets   | <b>6.98</b>       | <b>6.85</b>      | 6.58      | 6.87      | 6.97      | <b>6.98</b>       | 6.97      |
| Tier 1 risk-based capital  | <b>8.53</b>       | <b>8.33</b>      | 7.44      | 7.94      | 8.14      | <b>8.53</b>       | 8.14      |
| Total risk-based capital   | <b>12.41</b>      | <b>12.34</b>     | 11.38     | 11.76     | 12.15     | <b>12.41</b>      | 12.15     |
| Leverage   | <b>9.34</b>       | <b>9.15</b>      | 8.39      | 8.96      | 9.11      | <b>9.34</b>       | 9.11      |
| <b>TRUST AND BROKERAGE ASSETS</b>  |                   |                  |           |           |           |                   |           |
| Assets under management  | <b>\$ 80,998</b>  | <b>\$ 80,453</b> | \$ 85,442 | \$ 88,100 | \$ 85,592 | <b>\$ 80,998</b>  | \$ 85,592 |
| Nonmanaged and brokerage assets  | <b>29,905</b>     | <b>30,532</b>    | 33,918    | 33,273    | 33,485    | <b>29,905</b>     | 33,485    |
| <b>OTHER DATA</b>  |                   |                  |           |           |           |                   |           |
| Average full-time equivalent employees                                       | <b>18,164</b>     | <b>18,426</b>    | 18,500    | 18,567    | 18,888    | <b>18,295</b>     | 19,342    |
| Branches   | <b>985</b>        | <b>985</b>       | 955       | 954       | 954       | <b>985</b>        | 954       |

Acquisitions and divestitures completed by Key during the periods shown in this table may have had a significant effect on Key's results, making it difficult to compare results from one period to the next. Note 3 ("Acquisitions and Divestitures"), which begins on page 12, contains specific information about the acquisitions and divestitures that Key completed during 2007 and the first six months of 2008 to help in understanding how those transactions may have impacted Key's financial condition and results of operations.

- (a) See Figure 5 for computations of certain earnings data and performance ratios, excluding charges related to the tax treatment of certain leveraged lease financing transactions disallowed by the IRS. Figure 5 reconciles certain GAAP performance measures to the corresponding non-GAAP measures and provides a basis for period-to-period comparisons.

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As a result of an adverse federal court decision on Key's tax treatment of a Service Contract Lease transaction entered into by AWG Leasing Trust, in which Key is a partner, Key recorded after-tax charges of \$1.011 billion, or \$2.43 per common share, during the second quarter of 2008. Additionally, during the first quarter of 2008, Key increased its tax reserves for certain LIFO transactions and recalculated its lease income in accordance with prescribed accounting standards, resulting in after-tax charges of \$38 million, or \$.10 per common share. Figure 5 below presents computations of certain earnings data and performance ratios, excluding these charges (non-GAAP), reconciles the GAAP performance measures to the corresponding non-GAAP measures and provides a basis for period-to-period comparisons. Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied and are not audited. Non-GAAP financial measures should not be considered in isolation, or as a substitute for analyses of results as reported under GAAP.

**Figure 5. GAAP to Non-GAAP Reconciliations**

|   |     | Three months ended |               | Six months ended |
|---|-----|--------------------|---------------|------------------|
|   |     | 6-30-08            | 3-31-08       | 6-30-08          |
| <i>dollars in millions, except per share amounts</i>  |     |                    |               |                  |
| <b>NET INCOME</b>   |     |                    |               |                  |
| Net (loss) income (GAAP)  | A   | \$ (1,126)         | \$ 218        | \$ (908)         |
| Charges related to leveraged lease tax litigation, after tax  |     | 1,011              | 38            | 1,049            |
| Net (loss) income, excluding charges related to leveraged lease tax litigation (non-GAAP)                     | B   | <u>\$ (115)</u>    | <u>\$ 256</u> | <u>\$ 141</u>    |
| Weighted-average common shares and potential common shares outstanding (000)                                  | C   | 416,629            | 399,769       | 407,875          |
| <b>PER COMMON SHARE</b>   |     |                    |               |                  |
| Net (loss) income — assuming dilution (GAAP)  | A/C | \$ (2.70)          | \$ .54        | \$ (2.23)        |
| Net (loss) income, excluding charges related to leveraged lease tax litigation — assuming dilution (non-GAAP) | B/C | (.28)              | .64           | .34              |
| <b>PERFORMANCE RATIOS</b>   |     |                    |               |                  |
| <b>Return on average total assets: a</b>  |     |                    |               |                  |
| Average total assets  | D   | \$ 103,290         | \$ 103,356    | \$ 103,323       |
| Return on average total assets (GAAP)   | A/D | (4.38)%            | .85%          | (1.77)%          |
| Return on average total assets, excluding charges related to leveraged lease tax litigation (non-GAAP)        | B/D | (.45)              | 1.00          | .27              |
| <b>Return on average common equity: a</b>   |     |                    |               |                  |
| Average common equity   | E   | \$ 8,489           | \$ 8,445      | \$ 8,467         |
| Return on average common equity (GAAP)  | A/E | (53.35)%           | 10.38%        | (21.57)%         |
| Return on average common equity, excluding charges related to leveraged lease tax litigation (non-GAAP)       | B/E | (5.45)             | 12.19         | 3.35             |
| <b>Return on average total equity: a</b>  |     |                    |               |                  |
| Average total equity  | F   | \$ 8,617           | \$ 8,445      | \$ 8,531         |

|  |     |          |        |          |
|--|-----|----------|--------|----------|
| Return on average total equity (GAAP)  | A/F | (52.56)% | 10.38% | (21.40)% |
| Return on average total equity, excluding charges related to leveraged lease tax litigation (non-GAAP) | B/F | (5.37)   | 12.19  | 3.32     |

**NET INTEREST INCOME AND MARGIN****Net interest income:**

|   |    |            |    |            |    |              |
|---|----|------------|----|------------|----|--------------|
| Net interest income (GAAP)  | \$ | 358        | \$ | 713        | \$ | 1,071        |
| Charges related to leveraged lease tax litigation, pre-tax                                  |    | 359        |    | 3          |    | 362          |
| Net interest income, excluding charges related to leveraged lease tax litigation (non-GAAP) | \$ | <u>717</u> | \$ | <u>716</u> | \$ | <u>1,433</u> |

**Net interest income/margin (TE):**

|   |    |              |    |              |    |              |
|---|----|--------------|----|--------------|----|--------------|
| Net interest (loss) income (TE) (as reported)   | \$ | (100)        | \$ | 704          | \$ | 604          |
| Charges related to leveraged lease tax litigation, pre-tax (TE)   |    | 838          |    | 34           |    | 872          |
| Net interest income, excluding charges related to leveraged lease tax litigation (TE) (adjusted basis)              | \$ | <u>738</u>   | \$ | <u>738</u>   | \$ | <u>1,476</u> |
| Net interest margin (TE) (as reported) <sup>a</sup>   |    | (.44)%       |    | 3.14%        |    | 1.35%        |
| Impact of charges related to leveraged lease tax litigation, pre-tax (TE) <sup>a</sup>                              |    | 3.76         |    | .15          |    | 1.95         |
| Net interest margin, excluding charges related to leveraged lease tax litigation (TE) (adjusted basis) <sup>a</sup> |    | <u>3.32%</u> |    | <u>3.29%</u> |    | <u>3.30%</u> |

(a) Income statement amount has been annualized in calculation of percentage.

TE = Taxable Equivalent

GAAP = U.S. generally accepted accounting principles



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### **Financial outlook**

Although difficult to project in this turbulent economy, considering current and anticipated conditions in the financial markets, the impact of the lease accounting adjustment and the continuation of competitive pricing for deposits, management expects that in the second half of 2008 Key will experience:

- .. a taxable-equivalent net interest margin in the range of 3.15% to 3.20%;
- .. stable to reduced loan balances;
- .. a low single digit percentage increase in core deposits;
- .. net loan charge-offs in the range of 1.20% to 1.60% of average loans;
- .. a low single digit percentage increase in expenses; and
- .. an effective tax rate of approximately 34% to 36% on a taxable-equivalent basis. This estimate includes an interest accrual of approximately \$32 million to \$34 million per quarter related to disputed taxes on the leveraged lease financing portfolio.

### **Strategic developments**

Management initiated a number of specific actions during 2008 and 2007 to support Key's corporate strategy.

- .. On January 1, 2008, Key acquired U.S.B. Holding Co., Inc., the holding company for Union State Bank, a 31-branch state-chartered commercial bank headquartered in Orangeburg, New York. The acquisition doubles Key's branch penetration in the attractive Lower Hudson Valley area. Assets and deposits acquired in this transaction were assigned to both the Community Banking and National Banking groups.
- .. On December 20, 2007, Key announced its decision to exit dealer-originated home improvement lending activities, which involve prime loans but are largely out-of-footprint. Key also announced that it will cease offering Payroll Online services, which are not of sufficient size to provide economies of scale to compete profitably. Additionally, Key has moved to cease conducting business with nonrelationship homebuilders outside of its 14-state Community Banking footprint.
- .. On October 1, 2007, Key acquired Tuition Management Systems, Inc., one of the nation's largest providers of outsourced tuition planning, billing, counseling and payment services. Headquartered in Warwick, Rhode Island, Tuition Management Systems serves more than 700 colleges, universities, elementary and secondary educational institutions. The combination of the payment plan systems and technology in place at Tuition Management Systems and the array of payment plan products offered by Key's Consumer Finance line of business created one of the largest payment plan providers in the nation.
- .. On February 9, 2007, McDonald Investments Inc., a wholly owned subsidiary of KeyCorp, sold its branch network, which included approximately 570 financial advisors and field support staff, and certain fixed assets. Key retained the corporate and institutional businesses, including Institutional Equities and Equity Research, Debt Capital Markets and Investment Banking. In addition, KeyBank continues to operate the Wealth Management, Trust and Private Banking businesses. On April 16, 2007, Key renamed the registered broker/dealer through which its corporate and institutional investment banking and securities businesses operate to KeyBanc Capital Markets Inc.

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**Line of Business Results**

This section summarizes the financial performance and related strategic developments of Key's two major business groups: Community Banking and National Banking. To better understand this discussion, see Note 4 ("Line of Business Results"), which begins on page 14. Note 4 describes the products and services offered by each of these business groups, provides more detailed financial information pertaining to the groups and their respective lines of business, and explains "Other Segments" and "Reconciling Items."

Figure 6 summarizes the contribution made by each major business group to Key's taxable-equivalent revenue and (loss) income from continuing operations for the three- and six-month periods ended June 30, 2008 and 2007. Key's line of business results for each of these periods reflect a new organizational structure that took effect January 1, 2008.

**Figure 6. Major Business Groups — Taxable-Equivalent Revenue and (Loss) Income  
from Continuing Operations**

|   | Three months ended<br>June 30, |                 | Change            |         | Six months ended<br>June 30, |                 | Change            |         |
|---|--------------------------------|-----------------|-------------------|---------|------------------------------|-----------------|-------------------|---------|
|   | 2008                           | 2007            | Amount            | Percent | 2008                         | 2007            | Amount            | Percent |
| <i>dollars in millions</i>                      |                                |                 |                   |         |                              |                 |                   |         |
| <b>REVENUE FROM CONTINUING OPERATIONS (TE)</b>  |                                |                 |                   |         |                              |                 |                   |         |
| Community Banking <sup>a</sup>                  | \$ 659                         | \$ 631          | \$ 28             | 4.4%    | \$ 1,288                     | \$ 1,438        | \$ (150)          | (10.4)% |
| National Banking <sup>b</sup>                   | (126)                          | 612             | (738)             | N/M     | 314                          | 1,207           | (893)             | (74.0)  |
| Other Segments <sup>c</sup>                     | (31)                           | 101             | (132)             | N/M     | (5)                          | 82              | (87)              | N/M     |
| Total Segments                                  | 502                            | 1,344           | (842)             | (62.6)  | 1,597                        | 2,727           | (1,130)           | (41.4)  |
| Reconciling Items <sup>d</sup>                  | (47)                           | 11              | (58)              | N/M     | 90                           | (18)            | 108               | N/M     |
| Total   | <u>\$ 455</u>                  | <u>\$ 1,355</u> | <u>\$ (900)</u>   | (66.4)% | <u>\$ 1,687</u>              | <u>\$ 2,709</u> | <u>\$ (1,022)</u> | (37.7)% |
| <b>(LOSS) INCOME FROM CONTINUING OPERATIONS</b> |                                |                 |                   |         |                              |                 |                   |         |
| Community Banking <sup>a</sup>                  | \$ 104                         | \$ 102          | \$ 2              | 2.0%    | \$ 219                       | \$ 307          | \$ (88)           | (28.7)% |
| National Banking <sup>b</sup>                   | (670)                          | 157             | (827)             | N/M     | (694)                        | 312             | (1,006)           | N/M     |
| Other Segments <sup>c</sup>                     | (13)                           | 55              | (68)              | N/M     | 8                            | 47              | (39)              | (83.0)  |
| Total Segments                                  | (579)                          | 314             | (893)             | N/M     | (467)                        | 666             | (1,133)           | N/M     |
| Reconciling Items <sup>d</sup>                  | (547)                          | 23              | (570)             | N/M     | (441)                        | 29              | (470)             | N/M     |
| Total   | <u>\$ (1,126)</u>              | <u>\$ 337</u>   | <u>\$ (1,463)</u> | N/M     | <u>\$ (908)</u>              | <u>\$ 695</u>   | <u>\$ (1,603)</u> | N/M     |

- (a) Community Banking's results for the first quarter of 2007 include a \$171 million (\$107 million after tax) gain from the February 9, 2007, sale of the McDonald Investments branch network. See Note 3 ("Acquisitions and Divestitures"), which begins on page 12, for more information pertaining to this transaction.
- (b) During the second quarter of 2008, National Banking's taxable-equivalent net interest income and net income were reduced by \$838 million and \$536 million, respectively, as a result of an adverse federal court decision on the tax treatment of a Service Contract Lease transaction. During the prior quarter, National Banking increased its tax reserves for certain LIFO transactions and recalculated its lease income in accordance with prescribed accounting standards. These actions reduced National Banking's taxable-equivalent revenue by \$34 million and its net income by \$21 million in the first quarter. National Banking's results for the first quarter of 2007 include a \$26 million (\$17 million after tax) gain from the settlement of the residual value insurance litigation.

- (c) Other Segments' results for the second quarter of 2007 include a \$26 million (\$16 million after tax) charge for litigation. This charge and the litigation charge referred to in note (d) below comprise the \$42 million charge recorded in connection with the Honsador litigation. Other Segments' results for the first quarter of 2007 include a \$49 million (\$31 million after tax) loss from the repositioning of the securities portfolio.
- (d) Reconciling Items for the second quarter of 2008 include a \$475 million charge to income taxes for the interest cost associated with the leveraged lease tax litigation. Reconciling Items for the prior quarter include a \$165 million (\$103 million after tax) gain from the partial redemption of Key's equity interest in Visa Inc. and a \$17 million charge to income taxes for the interest cost associated with the increase to Key's tax reserves for certain LIFO transactions. Reconciling Items for the second quarter of 2007 include a \$40 million (\$25 million after tax) gain related to MasterCard Incorporated shares, and a \$16 million (\$10 million after tax) charge for litigation.

TE = Taxable Equivalent

N/M = Not Meaningful

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**Community Banking summary of operations**

As shown in Figure 7, Community Banking recorded net income of \$104 million for the second quarter of 2008, compared to \$102 million for the year-ago quarter. Increases in both net interest income and noninterest income accounted for the improvement, but were substantially offset by a higher provision for loan losses.

Taxable-equivalent net interest income rose by \$20 million, or 5%, from the second quarter of 2007. The increase was attributable to a \$1.9 billion, or 7%, rise in average earning assets, due largely to growth in the commercial loan portfolio, and a \$3.8 billion, or 8%, increase in average deposits. Both loans and deposits experienced organic growth and benefited from the January 1 acquisition of U.S.B. Holding Co., Inc. described below. The positive effect of this growth was offset in part by the impact of tighter loan and deposit spreads.

Noninterest income increased by \$8 million, or 4%, from the same period one year ago, reflecting strong growth in bank channel investment product sales income and deposit service charge income.

The provision for loan losses rose by \$23 million, or 110%, compared to the second quarter of 2007, reflecting a \$12 million increase in net loan charge-offs and the remainder a provision for general weakness in the economy.

On January 1, 2008, Key acquired U.S.B. Holding Co., Inc., the holding company for Union State Bank, a 31-branch state-chartered commercial bank headquartered in Orangeburg, New York. The acquisition doubles Key's branch penetration in the attractive Lower Hudson Valley area. Assets and deposits acquired in this transaction were assigned to both the Community Banking and National Banking groups.

On February 9, 2007, McDonald Investments Inc., a wholly owned subsidiary of KeyCorp, sold its branch network, which included approximately 570 financial advisors and field support staff, and certain fixed assets. Key retained the corporate and institutional businesses, including Institutional Equities and Equity Research, Debt Capital Markets and Investment Banking. In addition, KeyBank continues to operate the Wealth Management, Trust and Private Banking businesses. On April 16, 2007, Key renamed its registered broker/dealer through which its corporate and institutional investment banking and securities businesses operate. The new name is KeyBanc Capital Markets Inc.

**Figure 7. Community Banking**

| <i>dollars in millions</i>                                   | Three months ended<br>June 30, |               | Change      |         | Six months ended<br>June 30, |                  | Change         |         |
|--|--------------------------------|---------------|-------------|---------|------------------------------|------------------|----------------|---------|
|  | 2008                           | 2007          | Amount      | Percent | 2008                         | 2007             | Amount         | Percent |
| <b>SUMMARY OF OPERATIONS</b>                                 |                                |               |             |         |                              |                  |                |         |
| Net interest income (TE)                                     | \$ 437                         | \$ 417        | \$ 20       | 4.8%    | \$ 860                       | \$ 836           | \$ 24          | 2.9%    |
| Noninterest income   | 222                            | 214           | 8           | 3.7     | 428                          | 602 <sup>a</sup> | (174)          | (28.9)  |
| Total revenue (TE)   | 659                            | 631           | 28          | 4.4     | 1,288                        | 1,438            | (150)          | (10.4)  |
| Provision for loan losses                                    | 44                             | 21            | 23          | 109.5   | 62                           | 35               | 27             | 77.1    |
| Noninterest expense  | 449                            | 446           | 3           | .7      | 876                          | 912              | (36)           | (3.9)   |
| Income before income taxes (TE)                              | 166                            | 164           | 2           | 1.2     | 350                          | 491              | (141)          | (28.7)  |
| Allocated income taxes and TE<br>adjustments                 | 62                             | 62            | —           | —       | 131                          | 184              | (53)           | (28.8)  |
| Net income   | <u>\$ 104</u>                  | <u>\$ 102</u> | <u>\$ 2</u> | 2.0%    | <u>\$ 219</u>                | <u>\$ 307</u>    | <u>\$ (88)</u> | (28.7)% |
| Percent of consolidated income<br>from continuing operations | N/M                            | 30%           | N/A         | N/A     | N/M                          | 44%              | N/A            | N/A     |

**AVERAGE BALANCES**

|                                       |           |           |            |        |           |           |            |        |
|---------------------------------------|-----------|-----------|------------|--------|-----------|-----------|------------|--------|
| Loans and leases                      | \$ 28,478 | \$ 26,574 | \$ 1,904   | 7.2%   | \$ 28,303 | \$ 26,514 | \$ 1,789   | 6.7%   |
| Total assets                          | 31,385    | 29,346    | 2,039      | 6.9    | 31,227    | 29,317    | 1,910      | 6.5    |
| Deposits                              | 49,948    | 46,126    | 3,822      | 8.3    | 49,857    | 46,322    | 3,535      | 7.6    |
| Assets under management at period end | \$ 19,366 | \$ 21,061 | \$ (1,695) | (8.0)% | \$ 19,366 | \$ 21,061 | \$ (1,695) | (8.0)% |

(a) Community Banking's results for the first quarter of 2007 include a \$171 million (\$107 million after tax) gain from the February 9, 2007, sale of the McDonald Investments branch network. See Note 3 ("Acquisitions and Divestitures"), which begins on page 12, for more information pertaining to this transaction.

TE = Taxable Equivalent

N/M = Not Meaningful

N/A = Not Applicable

[Table of Contents](#)**ADDITIONAL COMMUNITY BANKING DATA**

| <i>dollars in millions</i>                   | Three months ended<br>June 30, |                  | Change          |         | Six months ended<br>June 30, |                  | Change          |         |
|--|--------------------------------|------------------|-----------------|---------|------------------------------|------------------|-----------------|---------|
|  | 2008                           | 2007             | Amount          | Percent | 2008                         | 2007             | Amount          | Percent |
| <b>AVERAGE DEPOSITS</b>                      |                                |                  |                 |         |                              |                  |                 |         |
| <b>OUTSTANDING</b>                           |                                |                  |                 |         |                              |                  |                 |         |
| NOW and money market deposit accounts        | \$ 19,656                      | \$ 18,970        | \$ 686          | 3.6%    | \$ 19,761                    | \$ 19,292        | \$ 469          | 2.4%    |
| Savings deposits                             | 1,804                          | 1,619            | 185             | 11.4    | 1,779                        | 1,619            | 160             | 9.9     |
| Certificates of deposits (\$100,000 or more) | 6,661                          | 4,709            | 1,952           | 41.5    | 6,548                        | 4,630            | 1,918           | 41.4    |
| Other time deposits                          | 12,735                         | 12,038           | 697             | 5.8     | 12,756                       | 12,044           | 712             | 5.9     |
| Deposits in foreign office                   | 1,306                          | 1,046            | 260             | 24.9    | 1,281                        | 1,002            | 279             | 27.8    |
| Noninterest-bearing deposits                 | 7,786                          | 7,744            | 42              | .5      | 7,732                        | 7,735            | (3)             | —       |
| Total deposits                               | <u>\$ 49,948</u>               | <u>\$ 46,126</u> | <u>\$ 3,822</u> | 8.3%    | <u>\$ 49,857</u>             | <u>\$ 46,322</u> | <u>\$ 3,535</u> | 7.6%    |
| <b>HOME EQUITY LOANS</b>                     |                                |                  |                 |         |                              |                  |                 |         |
| Average balance                              | \$ 9,766                       | \$ 9,660         |                 |         |                              |                  |                 |         |
| Weighted-average loan-to-value ratio         | 70%                            | 70%              |                 |         |                              |                  |                 |         |
| Percent first lien positions                 | 55                             | 58               |                 |         |                              |                  |                 |         |
| <b>OTHER DATA</b>                            |                                |                  |                 |         |                              |                  |                 |         |
| On-line households/household penetration     | 759,003 / 45%                  | 723,955 / 44%    |                 |         |                              |                  |                 |         |
| Branches                                     | 985                            | 954              |                 |         |                              |                  |                 |         |
| Automated teller machines                    | 1,479                          | 1,450            |                 |         |                              |                  |                 |         |

**National Banking summary of continuing operations**

As shown in Figure 8, National Banking recorded a loss of \$670 million from continuing operations for the second quarter of 2008, compared to income of \$157 million from continuing operations for the same period last year. During the second quarter of 2008, National Banking's net interest income was adversely affected by a federal court ruling on the tax treatment of a segment of Key's leveraged lease financing portfolio as further described below. Also contributing to the less favorable results compared to the year-ago quarter were a substantially higher provision for loan losses and an increase in noninterest expense, offset in part by significant growth in noninterest income.

National Banking's taxable-equivalent net interest income for the second quarter of 2008 was reduced significantly as a result of an adverse federal court ruling on the company's tax treatment of a Service Contract Lease transaction entered into by AWG Leasing Trust, in which Key is a partner. As a result of this ruling, under Financial Accounting Standards Board ("FASB") Staff Position No. 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," National Banking recalculated its lease income from inception for this particular transaction, as well as any other lease financing transactions being contested by the IRS. Excluding the additional charges associated with these actions, taxable-equivalent net interest income grew by \$27 million, or 8%, from the second quarter of 2007 as a result of increases in average earning assets and deposits, offset in part by tighter loan and deposit spreads and a higher level of nonperforming assets. Average loans and leases grew by \$8.6 billion, or 22%, while average deposits rose by \$207 million, or 2%, from the year-ago quarter.

Noninterest income increased by \$73 million, or 27%, reflecting higher income from several fee-based businesses. Income from investment banking and capital markets activities rose by \$35 million, while trust and investment services income was up \$23 million. Increases in income from tuition payment plan processing, as well as syndication and other

loan-related fees also contributed to the improvement.

The provision for loan losses rose by \$577 million, due primarily to a higher level of net loan charge-offs recorded in the commercial real estate portfolio. National Banking's provision for loan losses for the second quarter of 2008 exceeded its net loan charge-offs by \$123 million, as the company continued to build reserves.

[Table of Contents](#)**Figure 8. National Banking**

| <i>dollars in millions</i>  | Three months ended<br>June 30, |               | Change          |         | Six months ended<br>June 30, |               | Change          |         |
|---|--------------------------------|---------------|-----------------|---------|------------------------------|---------------|-----------------|---------|
|   | 2008                           | 2007          | Amount          | Percent | 2008                         | 2007          | Amount          | Percent |
| <b>SUMMARY OF OPERATIONS</b>                                      |                                |               |                 |         |                              |               |                 |         |
| Net interest (loss) income (TE)                                   | \$ (472) a                     | \$ 339        | \$ (811)        | N/M     | \$ (133) a                   | \$ 675        | \$ (808)        | N/M     |
| Noninterest income  | 346                            | 273           | 73              | 26.7%   | 447                          | 532 a         | (85)            | (16.0)% |
| Total revenue (TE)  | (126)                          | 612           | (738)           | N/M     | 314                          | 1,207         | (893)           | (74.0)  |
| Provision for loan losses   | 609                            | 32            | 577             | N/M     | 778                          | 62            | 716             | N/M     |
| Noninterest expense   | 337                            | 330           | 7               | 2.1     | 646                          | 646           | —               | —       |
| (Loss) income from continuing operations before income taxes (TE) | (1,072)                        | 250           | (1,322)         | N/M     | (1,110)                      | 499           | (1,609)         | N/M     |
| Allocated income taxes and TE adjustments                         | (402)                          | 93            | (495)           | N/M     | (416)                        | 187           | (603)           | N/M     |
| (Loss) income from continuing operations                          | (670)                          | 157           | (827)           | N/M     | (694)                        | 312           | (1,006)         | N/M     |
| Loss from discontinued operations, net of taxes                   | —                              | (3)           | 3               | 100.0%  | —                            | (11)          | 11              | 100.0%  |
| Net (loss) income   | <u>\$ (670)</u>                | <u>\$ 154</u> | <u>\$ (824)</u> | N/M     | <u>\$ (694)</u>              | <u>\$ 301</u> | <u>\$ (995)</u> | N/M     |
| Percent of consolidated income from continuing operations         | N/M                            | 47%           | N/A             | N/A     | N/M                          | 45%           | N/A             | N/A     |
| <b>AVERAGE BALANCES FROM CONTINUING OPERATIONS</b>                |                                |               |                 |         |                              |               |                 |         |
| Loans and leases  | \$ 47,876                      | \$ 39,325     | \$ 8,551        | 21.7%   | \$ 46,013                    | \$ 39,085     | \$ 6,928        | 17.7%   |
| Loans held for sale   | 1,282                          | 4,377         | (3,095)         | (70.7)  | 3,107                        | 4,148         | (1,041)         | (25.1)  |
| Total assets  | 56,242                         | 49,585        | 6,657           | 13.4    | 56,230                       | 49,003        | 7,227           | 14.7    |
| Deposits  | 12,289                         | 12,082        | 207             | 1.7     | 12,088                       | 11,691        | 397             | 3.4     |
| Assets under management at period end                             | \$ 61,632                      | \$ 64,531     | \$ (2,899)      | (4.5)%  | \$ 61,632                    | \$ 64,531     | \$ (2,899)      | (4.5)%  |

- (a) During the second quarter of 2008, National Banking's taxable-equivalent net interest income and net income were reduced by \$838 million and \$536 million, respectively, as a result of an adverse federal court decision on the tax treatment of a Service Contract Lease transaction. During the prior quarter, National Banking increased its tax reserves for certain LILO transactions and recalculated its lease income in accordance with prescribed accounting standards. These actions reduced National Banking's taxable-equivalent revenue by \$34 million and its net income by \$21 million in the first quarter. National Banking's results for the first quarter of 2007 include a \$26 million (\$17 million after tax) gain from the settlement of the residual value insurance litigation.

TE = Taxable Equivalent



N/M = Not Meaningful

N/A = Not Applicable

**Other Segments**

Other segments consist of Corporate Treasury and Key's Principal Investing unit. These segments generated a net loss of \$13 million for the second quarter of 2008, compared to net income of \$55 million for the same period last year. These results reflect net losses of \$14 million from principal investing in the second quarter of 2008, compared to net gains of \$90 million for the year-ago quarter.

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### Results of Operations

#### **Net interest income**

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

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

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

Figure 10, which spans pages 57 and 58, shows the various components of Key's balance sheet that affect interest income and expense, and their respective yields or rates over the past five quarters. The net interest margin, which is an indicator of the profitability of the earning assets portfolio, is calculated by dividing net interest income by average earning assets. This figure also presents a reconciliation of taxable-equivalent net interest income for each of the past five quarters to net interest income reported in accordance with GAAP.

Key's taxable-equivalent net interest income for the second quarter of 2008 was reduced significantly as a result of an adverse federal court decision on the company's tax treatment of a Service Contract Lease transaction entered into by AWG Leasing Trust, in which Key is a partner. The Court decision, which Key has appealed, applies only to the single AWG Leasing transaction. Notwithstanding the appeal, management believes that the applicable accounting guidance requires Key to recalculate lease income recognized on all leveraged leases being contested by the IRS, not just the single leveraged lease subject to the Court decision. Under FASB Staff Position No. 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," Key has recalculated the lease income recognized from inception for all of the contested leases. Key's second quarter results also reflect a \$475 million charge to income taxes for the interest cost associated with the contested tax liabilities. These actions reduced Key's taxable-equivalent net interest income and net interest margin for the second quarter of 2008 by \$838 million and 376 basis points, respectively, and reduced Key's earnings by \$1.011 billion, or \$2.43 per common share. A basis point is equal to one one-hundredth of a percentage point, meaning 376 basis points equal 3.76%.

As previously reported, Service Contract Leases, LILo transactions discussed on the following page and Qualified Technological Equipment Leases represent a portion of Key's overall leveraged lease financing portfolio, and the tax deductions for some of these transactions are being challenged by the IRS. Additional information related to these lease financing transactions and the status of Key's response to the IRS disallowance and federal tax court decision is included in Note 12 ("Income Taxes"), which begins on page 27.

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The impact of the leveraged lease accounting charges on the components of Key's interest income and related yields for the second quarter of 2008 are shown in Figure 9.

**Figure 9. Second Quarter 2008 Adjusted Interest and Yields  
From Continuing Operations**

| <i>dollars in millions</i>                                   | As Reported        |               |               | Adjusted Basis     |               |              |
|--|--------------------|---------------|---------------|--------------------|---------------|--------------|
|  | Average<br>Balance | Interest      | Yield/Rate    | Average<br>Balance | Interest      | Yield/Rate   |
| Total commercial loans                                       | \$ 54,932          | \$ (83)       | (.58)%        | \$ 54,932          | \$ 755        | 5.52%        |
| Total earning assets   | 89,742             | 422           | 1.89          | 89,742             | 1,260         | 5.63         |
| Total interest-bearing liabilities                           | 77,172             | 522           | 2.75          | 77,172             | 522           | 2.75         |
| Interest rate spread (TE)                                    |                    |               | <u>(.86)%</u> |                    |               | <u>2.88%</u> |
| Net interest (loss) income (TE) and net interest margin (TE) |                    | (100)         | <u>(.44)%</u> |                    | 738           | <u>3.32%</u> |
| TE adjustment  |                    | (458)         |               |                    | 21            |              |
| Net interest income  |                    | <u>\$ 358</u> |               |                    | <u>\$ 717</u> |              |

TE = Taxable Equivalent

Excluding the charges associated with the leveraged lease tax litigation, Key's taxable-equivalent net interest income was \$738 million for the second quarter of 2008, compared to \$706 million for the year-ago quarter. Average earning assets rose by \$8.2 billion, or 10%, due primarily to growth in commercial loans and the January 1 acquisition of U.S.B. Holding Co., Inc., which added approximately \$1.5 billion to Key's loan portfolio. The growth in commercial loans was due in part to the higher demand for credit caused by the volatile capital markets environment. The adjusted net interest margin for the current quarter declined to 3.32% from 3.46% for the second quarter of 2007. The reduction was attributable largely to tighter loan and deposit spreads caused by competitive pricing, and a higher level of nonperforming assets.

Compared to the first quarter of 2008, Key's taxable-equivalent net interest income and net interest margin were essentially unchanged, after excluding the effects of charges recorded in connection with leveraged lease transactions in both periods. During the first quarter of 2008, Key increased its tax reserves for certain LILLO transactions and recalculated its income under FASB Staff Position No. 13-2. These actions reduced Key's taxable-equivalent net interest income and net interest margin for the first quarter of 2008 by \$34 million and 15 basis points, respectively, and reduced Key's earnings by \$38 million, or \$.10 per diluted common share. On an adjusted basis, Key had taxable-equivalent net interest income of \$738 million and a net interest margin of 3.29% for the first quarter of 2008.

Over the remainder of the year, management expects Key's net interest margin to be in the range of 3.15% to 3.20%. Management believes the effects of the lease financing accounting adjustment recorded in the second quarter and the continuation of competitive pressure on deposit pricing will offset the impact of more favorable yields on new assets.

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Since January 1, 2007, the growth and composition of Key's earning assets have been affected by the following actions:

- .. During the first quarter of 2008, Key increased its loan portfolio (primarily commercial real estate and consumer loans) through the acquisition of U.S.B. Holding Co., Inc., the holding company for Union State Bank, a 31-branch state-chartered commercial bank headquartered in Orangeburg, New York.
- .. Key sold commercial real estate loans of \$965 million during the first six months of 2008 and \$3.8 billion (\$238 million through a securitization) during all of 2007. Since some of these loans have been sold with limited recourse (i.e., there is a risk that Key will be held accountable for certain events or representations made in the sales agreements), Key established and has maintained a loss reserve in an amount estimated by management to be appropriate. More information about the related recourse agreement is provided in Note 13 ("Contingent Liabilities and Guarantees") under the heading "Recourse agreement with Federal National Mortgage Association" on page 30.
- .. Key sold education loans of \$110 million during the first half of 2008 and \$247 million during all of 2007. In March 2008, Key transferred \$3.3 billion of education loans from held-for-sale status to the held-to-maturity loan portfolio. The secondary markets for these loans have been adversely affected by market liquidity issues, prompting the company's decision to move them to a held-to-maturity classification.
- .. Key sold other loans (primarily residential mortgage loans) totaling \$483 million during the six months of 2008 and \$1.2 billion during all of 2007.

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**Figure 10. Average Balance Sheets, Net Interest Income and Yields/Rates  
From Continuing Operations**

| <i>dollars in millions</i>                 | Second Quarter 2008 |          |                | First Quarter 2008 |          |                |
|--|---------------------|----------|----------------|--------------------|----------|----------------|
|  | Average<br>Balance  | Interest | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate |
| <b>ASSETS</b>                              |                     |          |                |                    |          |                |
| Loans: a,b                                 |                     |          |                |                    |          |                |
| Commercial, financial and agricultural     | \$ 26,057           | \$ 352   | 5.42%          | \$ 25,411          | \$ 392   | 6.21%          |
| Real estate — commercial mortgage          | 10,593              | 156      | 5.91           | 10,283             | 175      | 6.84           |
| Real estate — construction                 | 8,484               | 118      | 5.61           | 8,468              | 134      | 6.36           |
| Commercial lease financing                 | 9,798               | (709)    | (28.94) c      | 10,004             | 98       | 3.91 c         |
| Total commercial loans                     | 54,932              | (83)     | (.58)          | 54,166             | 799      | 5.93           |
| Real estate — residential                  | 1,918               | 30       | 6.12           | 1,916              | 30       | 6.29           |
| Home equity:                               |                     |          |                |                    |          |                |
| Community Banking                          | 9,765               | 140      | 5.78           | 9,693              | 154      | 6.38           |
| National Banking                           | 1,200               | 23       | 7.68           | 1,260              | 24       | 7.74           |
| Total home equity loans                    | 10,965              | 163      | 5.99           | 10,953             | 178      | 6.54           |
| Consumer other — Community Banking         | 1,271               | 33       | 10.34          | 1,305              | 34       | 10.59          |
| Consumer other — National Banking:         |                     |          |                |                    |          |                |
| Marine                                     | 3,646               | 56       | 6.26           | 3,646              | 58       | 6.31           |
| Education                                  | 3,595               | 53       | 5.88           | 363                | 7        | 8.04           |
| Other                                      | 325                 | 7        | 8.21           | 339                | 7        | 8.32           |
| Total consumer other — National<br>Banking | 7,566               | 116      | 6.16           | 4,348              | 72       | 6.61           |
| Total consumer loans                       | 21,720              | 342      | 6.32           | 18,522             | 314      | 6.81           |
| Total loans                                | 76,652              | 259      | 1.37           | 72,688             | 1,113    | 6.15           |
| Loans held for sale                        | 1,356               | 20       | 5.94           | 4,984              | 87       | 7.01           |
| Securities available for sale a,d          | 8,315               | 111      | 5.40           | 8,419              | 110      | 5.28           |
| Held-to-maturity securities a              | 25                  | —        | 11.47          | 29                 | 1        | 11.02          |
| Trading account assets                     | 1,041               | 10       | 3.88           | 1,075              | 13       | 4.84           |
| Short-term investments                     | 773                 | 8        | 3.83           | 1,165              | 9        | 3.18           |
| Other investments d                        | 1,580               | 14       | 3.09           | 1,552              | 12       | 3.05           |
| Total earning assets                       | 89,742              | 422      | 1.89           | 89,912             | 1,345    | 6.01           |
| Allowance for loan losses                  | (1,338)             |          |                | (1,236)            |          |                |
| Accrued income and other assets            | 14,886              |          |                | 14,680             |          |                |
| <b>Total assets</b>                        | <b>\$ 103,290</b>   |          |                | <b>\$ 103,356</b>  |          |                |
| <b>LIABILITIES AND SHAREHOLDERS'</b>       |                     |          |                |                    |          |                |
| <b>EQUITY</b>                              |                     |          |                |                    |          |                |
| NOW and money market deposit accounts      | \$ 27,158           | 102      | 1.51           | \$ 26,996          | 139      | 2.07           |

|   |                   |     |      |                   |     |      |
|---|-------------------|-----|------|-------------------|-----|------|
| Savings deposits  | 1,815             | 1   | .27  | 1,865             | 3   | .62  |
| Certificates of deposit (\$100,000 or more) e                           | 8,670             | 88  | 4.09 | 8,072             | 95  | 4.72 |
| Other time deposits   | 12,751            | 135 | 4.27 | 12,759            | 146 | 4.59 |
| Deposits in foreign office  | 4,121             | 21  | 1.95 | 5,853             | 45  | 3.13 |
| Total interest-bearing deposits   | 54,515            | 347 | 2.56 | 55,545            | 428 | 3.10 |
| Federal funds purchased and securities sold under repurchase agreements | 3,267             | 15  | 1.86 | 3,863             | 28  | 2.91 |
| Bank notes and other short-term borrowings                              | 4,770             | 27  | 2.26 | 4,934             | 39  | 3.22 |
| Long-term debt e, f   | 14,620            | 133 | 3.87 | 13,238            | 146 | 4.71 |
| Total interest-bearing liabilities                                      | 77,172            | 522 | 2.75 | 77,580            | 641 | 3.36 |
| Noninterest-bearing deposits  | 10,617            |     |      | 10,741            |     |      |
| Accrued expense and other liabilities                                   | 6,884             |     |      | 6,590             |     |      |
| Preferred stock   | 128               |     |      | —                 |     |      |
| Common shareholders' equity   | 8,489             |     |      | 8,445             |     |      |
| Total shareholders' equity  | 8,617             |     |      | 8,445             |     |      |
| <b>Total liabilities and shareholders' equity</b>                       | <b>\$ 103,290</b> |     |      | <b>\$ 103,356</b> |     |      |

|  |               |                 |               |                |
|--|---------------|-----------------|---------------|----------------|
| Interest rate spread (TE)                                    |               | (.86)%          |               | 2.65%          |
| Net interest (loss) income (TE) and net interest margin (TE) | (100) c       | <u>(.44)% c</u> | 704 c         | <u>3.14% c</u> |
| TE adjustment a  | (458)         |                 | (9)           |                |
| Net interest income, GAAP basis                              | <u>\$ 358</u> |                 | <u>\$ 713</u> |                |

Average balances have not been restated to reflect Key's January 1, 2008, adoption of FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," and FASB Staff Position FIN 39-1, "Amendment of FASB Interpretation 39." Key's adoption of this accounting guidance is described in Note 1 ("Basis of Presentation") under the heading "Accounting Pronouncements Adopted in 2008" on page 9.

- (a) Interest income on tax-exempt securities and loans has been adjusted to a taxable-equivalent basis using the statutory federal income tax rate of 35%.
- (b) For purposes of these computations, nonaccrual loans are included in average loan balances.
- (c) During the second quarter of 2008, Key's taxable-equivalent net interest income and net income were reduced by \$838 million and \$1.011 billion, respectively, as a result of an adverse federal court decision on Key's tax treatment of a Service Contract Lease transaction. Excluding this reduction, the taxable-equivalent yield on Key's commercial lease financing portfolio would have been 5.25% for the second quarter of 2008, and Key's taxable-equivalent net interest margin would have been 3.32%. During the prior quarter, Key increased its tax reserves for certain LILO transactions and recalculated its lease income in accordance with prescribed accounting standards. These actions reduced Key's first quarter 2008 taxable-equivalent net interest income and net income by \$34 million and \$38 million, respectively. Excluding this reduction, the taxable-equivalent yield on Key's commercial lease financing portfolio would have been 5.27% for the first quarter of 2008, and Key's taxable-equivalent net interest margin would have been 3.29%.

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**Figure 10. Average Balance Sheets, Net Interest Income and Yields/Rates  
From Continuing Operations (Continued)**

| Fourth Quarter 2007 |          |                | Third Quarter 2007 |          |                | Second Quarter 2007 |          |                |
|---------------------|----------|----------------|--------------------|----------|----------------|---------------------|----------|----------------|
| Average<br>Balance  | Interest | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate | Average<br>Balance  | Interest | Yield/<br>Rate |
| \$ 23,825           | \$ 419   | 6.98%          | \$ 22,393          | \$ 410   | 7.25%          | \$ 21,856           | \$ 401   | 7.36%          |
| 9,351               | 175      | 7.42           | 8,855              | 172      | 7.69           | 8,565               | 165      | 7.75           |
| 8,192               | 153      | 7.42           | 8,285              | 167      | 8.01           | 8,243               | 167      | 8.09           |
| 10,252              | 171      | 6.65           | 10,172             | 147      | 5.80           | 10,096              | 142      | 5.62           |
| 51,620              | 918      | 7.06           | 49,705             | 896      | 7.16           | 48,760              | 875      | 7.19           |
| 1,596               | 27       | 6.72           | 1,586              | 26       | 6.68           | 1,472               | 24       | 6.57           |
| 9,658               | 168      | 6.92           | 9,690              | 175      | 7.14           | 9,660               | 172      | 7.15           |
| 1,259               | 24       | 7.77           | 1,193              | 24       | 7.85           | 1,092               | 21       | 7.86           |
| 10,917              | 192      | 7.02           | 10,883             | 199      | 7.22           | 10,752              | 193      | 7.22           |
| 1,308               | 35       | 10.73          | 1,342              | 36       | 10.66          | 1,370               | 37       | 10.64          |
| 3,608               | 58       | 6.34           | 3,506              | 55       | 6.32           | 3,323               | 52       | 6.26           |
| 329                 | 8        | 9.47           | 332                | 8        | 9.65           | 329                 | 8        | 9.56           |
| 339                 | 7        | 8.66           | 326                | 7        | 8.92           | 309                 | 7        | 9.18           |
| 4,276               | 73       | 6.76           | 4,164              | 70       | 6.79           | 3,961               | 67       | 6.76           |
| 18,097              | 327      | 7.20           | 17,975             | 331      | 7.33           | 17,555              | 321      | 7.33           |
| 69,717              | 1,245    | 7.10           | 67,680             | 1,227    | 7.20           | 66,315              | 1,196    | 7.23           |
| 4,748               | 89       | 7.53           | 4,731              | 91       | 7.59           | 4,415               | 82       | 7.50           |
| 7,858               | 115      | 5.89           | 7,825              | 106      | 5.45           | 7,793               | 106      | 5.45           |
| 30                  | 1        | 6.24           | 36                 | —        | 6.43           | 39                  | —        | 6.72           |
| 1,042               | 12       | 4.40           | 1,055              | 11       | 4.39           | 813                 | 7        | 3.58           |
| 1,226               | 13       | 3.94           | 633                | 5        | 3.32           | 671                 | 9        | 4.93           |
| 1,589               | 12       | 3.02           | 1,563              | 12       | 2.99           | 1,541               | 15       | 3.68           |
| 86,210              | 1,487    | 6.86           | 83,523             | 1,452    | 6.92           | 81,587              | 1,415    | 6.95           |
| (966)               |          |                | (942)              |          |                | (942)               |          |                |
| 13,547              |          |                | 12,581             |          |                | 12,767              |          |                |
| <u>\$ 98,791</u>    |          |                | <u>\$ 95,162</u>   |          |                | <u>\$ 93,412</u>    |          |                |
| \$ 25,687           | 197      | 3.05           | \$ 24,190          | 209      | 3.41           | \$ 22,953           | 179      | 3.14           |
| 1,523               | 1        | .19            | 1,581              | —        | .19            | 1,633               | 1        | .19            |

|                  |       |      |                  |       |      |                  |       |      |
|------------------|-------|------|------------------|-------|------|------------------|-------|------|
| 6,887            | 86    | 4.98 | 6,274            | 80    | 5.06 | 6,237            | 79    | 5.03 |
| 11,455           | 135   | 4.68 | 11,512           | 136   | 4.68 | 12,047           | 141   | 4.70 |
| 5,720            | 64    | 4.42 | 4,540            | 57    | 5.00 | 3,600            | 47    | 5.20 |
| 51,272           | 483   | 3.74 | 48,097           | 482   | 3.98 | 46,470           | 447   | 3.85 |
| 4,194            | 45    | 4.23 | 4,470            | 55    | 4.85 | 4,748            | 59    | 5.04 |
| 4,233            | 45    | 4.15 | 2,539            | 30    | 4.70 | 1,771            | 18    | 4.14 |
| 11,851           | 164   | 5.72 | 11,801           | 173   | 5.89 | 12,909           | 185   | 5.83 |
| 71,550           | 737   | 4.11 | 66,907           | 740   | 4.40 | 65,898           | 709   | 4.33 |
| 12,948           |       |      | 14,424           |       |      | 13,927           |       |      |
| 6,405            |       |      | 6,106            |       |      | 5,933            |       |      |
| —                |       |      | —                |       |      | —                |       |      |
| 7,888            |       |      | 7,725            |       |      | 7,654            |       |      |
| 7,888            |       |      | 7,725            |       |      | 7,654            |       |      |
| <u>\$ 98,791</u> |       |      | <u>\$ 95,162</u> |       |      | <u>\$ 93,412</u> |       |      |
| 2.75%            |       |      | 2.52%            |       |      | 2.62%            |       |      |
| 750              | 3.48% |      | 712              | 3.40% |      | 706              | 3.46% |      |
| 40               |       |      | 18               |       |      | 20               |       |      |
| <u>\$ 710</u>    |       |      | <u>\$ 694</u>    |       |      | <u>\$ 686</u>    |       |      |

(d) Yield is calculated on the basis of amortized cost.

(e) Rate calculation excludes basis adjustments related to fair value hedges.

(f) Results from continuing operations exclude the dollar amount of liabilities assumed necessary to support interest-earning assets held by the discontinued Champion Mortgage finance business. The interest expense related to these liabilities, which also is excluded from continuing operations, was calculated using a matched funds transfer pricing methodology.

TE = Taxable Equivalent

GAAP = U.S. generally accepted accounting principles



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Figure 11 shows how the changes in yields or rates, and average balances from the prior year affected net interest income. The section entitled “Financial Condition,” which begins on page 65, contains more discussion about changes in earning assets and funding sources.

**Figure 11. Components of Net Interest (Loss) Income Changes**

| <i>in millions</i>  | From three months ended June 30, 2007<br>to three months ended June 30, 2008 |                 |                 | From six months ended June 30, 2007<br>to six months ended June 30, 2008 |                 |                 |
|---|--|-----------------|-----------------|--|-----------------|-----------------|
|   | Average<br>Volume  | Yield/<br>Rate  | Net<br>Change   | Average<br>Volume  | Yield/<br>Rate  | Net<br>Change   |
| <b>INTEREST INCOME</b>  |  |                 |                 |  |                 |                 |
| Loans   | \$ 162   | \$ (1,099)      | \$ (937)        | \$ 280   | \$ (1,286)      | \$ (1,006)      |
| Loans held for sale   | (48)   | (14)            | (62)            | (35)   | (15)            | (50)            |
| Securities available for sale   | 7  | (2)             | 5               | 18   | (3)             | 15              |
| Trading account assets  | 2  | 1               | 3               | 6  | 3               | 9               |
| Short-term investments  | 1  | (2)             | (1)             | 5  | (8)             | (3)             |
| Other investments   | —  | (1)             | (1)             | 2  | (4)             | (2)             |
| Total interest income (TE)  | 124  | (1,117)         | (993)           | 276  | (1,313)         | (1,037)         |
| <b>INTEREST EXPENSE</b>   |  |                 |                 |  |                 |                 |
| NOW and money market deposit accounts                                   | 28   | (105)           | (77)            | 53   | (168)           | (115)           |
| Savings deposits  | —  | —               | —               | —  | 2               | 2               |
| Certificates of deposit (\$100,000 or more)                             | 27   | (18)            | 9               | 49   | (21)            | 28              |
| Other time deposits   | 8  | (14)            | (6)             | 16   | (14)            | 2               |
| Deposits in foreign office  | 6  | (32)            | (26)            | 31   | (53)            | (22)            |
| Total interest-bearing deposits   | 69   | (169)           | (100)           | 149  | (254)           | (105)           |
| Federal funds purchased and securities sold under repurchase agreements | (15)   | (29)            | (44)            | (17)   | (48)            | (65)            |
| Bank notes and other short-term borrowings                              | 20   | (11)            | 9               | 49   | (12)            | 37              |
| Long-term debt  | 22   | (74)            | (52)            | 18   | (120)           | (102)           |
| Total interest expense  | 96   | (283)           | (187)           | 199  | (434)           | (235)           |
| Net interest (loss) income (TE)   | <u>\$ 28</u>   | <u>\$ (834)</u> | <u>\$ (806)</u> | <u>\$ 77</u>   | <u>\$ (879)</u> | <u>\$ (802)</u> |

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

TE = Taxable Equivalent

**Noninterest income**

Key’s noninterest income was \$555 million for the second quarter of 2008, compared to \$649 million for the year-ago quarter. For the first six months of the year, noninterest income was \$1.1 billion, representing a decrease of \$220 million, or 17%, from the first six months of 2007.

As shown in Figure 13, the decrease from the year-ago quarter was attributable largely to net losses of \$14 million from principal investing in the second quarter of 2008, compared to net gains of \$90 million for the same period last year. Additionally, results for the second quarter of 2007 benefited from a \$40 million gain related to the sale of MasterCard Incorporated shares. These factors were offset in part by higher income from several fee-based businesses. Income from investment banking and capital markets activities rose by \$28 million, trust and investment services income was up \$23 million, and income from deposit service charges grew by \$9 million.



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The trend in the major components of Key's fee-based income over the past five quarters is shown in Figure 12.

**Figure 12. Fee-Based Income – Major Components**

| <i>in millions</i>                            | 2008   |        | 2007   |        |        |
|---|--------|--------|--------|--------|--------|
|   | Second | First  | Fourth | Third  | Second |
| Trust and investment services income          | \$ 138 | \$ 129 | \$ 131 | \$ 119 | \$ 115 |
| Service charges on deposit accounts           | 93     | 88     | 90     | 88     | 84     |
| Investment banking and capital markets income | 80     | 8      | 12     | 9      | 52     |
| Operating lease income                        | 68     | 69     | 72     | 70     | 66     |
| Letter of credit and loan fees                | 51     | 37     | 58     | 51     | 45     |
| Corporate-owned life insurance income         | 28     | 28     | 37     | 27     | 32     |
| Electronic banking fees                       | 27     | 24     | 25     | 25     | 25     |

For the year-to-date period, the decrease in noninterest income reflected several significant items. During the first quarter of 2008, Key recorded a \$165 million gain from the partial redemption of Visa Inc. shares. Results for the first half of 2007 included the \$40 million gain related to the sale of MasterCard Incorporated shares, a \$171 million gain associated with the sale of the McDonald Investments branch network, a \$26 million gain from the settlement of the automobile residual value insurance litigation and a \$49 million loss recorded in connection with the repositioning of the securities portfolio.

Excluding the significant items discussed above, Key's noninterest income was \$918 million for the first six months of 2008, representing a \$197 million, or 18%, decrease from the same period last year. As shown in Figure 13, Key recorded net losses of \$5 million from principal investing in the first six months of 2008, compared to net gains of \$119 million for the first half of 2007. Additionally, Key had net losses from loan sales and write-downs of \$68 million in the current year, compared to net gains of \$42 million through the first six months of 2007. The reduction in noninterest income attributable to these factors was substantially offset by increases of \$22 million in income from deposit service charges and \$27 million in income from trust and investment services. Last year's results included \$16 million of trust and investment services income generated by the McDonald Investments branch network. Adjusting for this revenue, trust and investment services income rose by \$43 million, or 19%, driven by growth in institutional asset management income, and income from brokerage commissions and fees.

**Figure 13. Noninterest Income**

| <i>dollars in millions</i>                    | Three months ended<br>June 30, |        | Change |         | Six months ended<br>June 30, |        | Change |         |
|---|--------------------------------|--------|--------|---------|------------------------------|--------|--------|---------|
|   | 2008                           | 2007   | Amount | Percent | 2008                         | 2007   | Amount | Percent |
| Trust and investment services income          | \$ 138                         | \$ 115 | \$ 23  | 20.0%   | \$ 267                       | \$ 240 | \$ 27  | 11.3%   |
| Service charges on deposit accounts           | 93                             | 84     | 9      | 10.7    | 181                          | 159    | 22     | 13.8    |
| Investment banking and capital markets income | 80                             | 52     | 28     | 53.8    | 88                           | 96     | (8)    | (8.3)   |
| Operating lease income                        | 68                             | 66     | 2      | 3.0     | 137                          | 130    | 7      | 5.4     |
| Letter of credit and loan fees                | 51                             | 45     | 6      | 13.3    | 88                           | 83     | 5      | 6.0     |
| Corporate-owned life insurance income         | 28                             | 32     | (4)    | (12.5)  | 56                           | 57     | (1)    | (1.8)   |
| Electronic banking fees                       | 27                             | 25     | 2      | 8.0     | 51                           | 49     | 2      | 4.1     |

|   |                             |                             |                              |         |                               |                               |                               |         |
|---|-----------------------------|-----------------------------|------------------------------|---------|-------------------------------|-------------------------------|-------------------------------|---------|
| Net gains (losses) from loan securitizations and sales      | <b>33</b>                   | 33                          | —                            | —       | <b>(68)</b>                   | 42                            | (110)                         | N/M     |
| Net securities (losses) gains                               | <b>(1)</b>                  | 2                           | (3)                          | N/M     | <b>2</b>                      | (45)                          | 47                            | N/M     |
| Net (losses) gains from principal investing                 | <b>(14)</b>                 | 90                          | (104)                        | N/M     | <b>(5)</b>                    | 119                           | (124)                         | N/M     |
| Gain from redemption of Visa Inc. shares                    | —                           | —                           | —                            | —       | <b>165</b>                    | —                             | 165                           | N/M     |
| Gain from sale of McDonald Investments branch network       | —                           | —                           | —                            | —       | —                             | 171                           | (171)                         | (100.0) |
| Other income:   |                             |                             |                              |         |                               |                               |                               |         |
| Insurance income  | <b>20</b>                   | 15                          | 5                            | 33.3    | <b>35</b>                     | 29                            | 6                             | 20.7    |
| Loan securitization servicing fees                          | <b>5</b>                    | 6                           | (1)                          | (16.7)  | <b>9</b>                      | 11                            | (2)                           | (18.2)  |
| Credit card fees  | <b>3</b>                    | 3                           | —                            | —       | <b>7</b>                      | 6                             | 1                             | 16.7    |
| Gains related to MasterCard Incorporated shares             | —                           | 40                          | (40)                         | (100.0) | —                             | 40                            | (40)                          | (100.0) |
| Litigation settlement — automobile residual value insurance | —                           | —                           | —                            | —       | —                             | 26                            | (26)                          | (100.0) |
| Miscellaneous income  | <b>24</b>                   | 41                          | (17)                         | (41.5)  | <b>70</b>                     | 90                            | (20)                          | (22.2)  |
| Total other income  | <b>52</b>                   | 105                         | (53)                         | (50.5)  | <b>121</b>                    | 202                           | (81)                          | (40.1)  |
| Total noninterest income                                    | <u><u><b>\$ 555</b></u></u> | <u><u><b>\$ 649</b></u></u> | <u><u><b>\$ (94)</b></u></u> | (14.5)% | <u><u><b>\$ 1,083</b></u></u> | <u><u><b>\$ 1,303</b></u></u> | <u><u><b>\$ (220)</b></u></u> | (16.9)% |

N/M = Not Meaningful

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

**Trust and investment services income.** Trust and investment services generally are Key's largest source of noninterest income. The primary components of revenue generated by these services are shown in Figure 14. The increases from 2007 results were attributable to strong growth in institutional asset management income and higher income from brokerage commissions and fees. Excluding the results of the McDonald Investments branch network, income from brokerage commissions and fees was up \$22 million from the first six months of 2007.

**Figure 14. Trust and Investment Services Income**

| <i>dollars in millions</i>                      | Three months ended<br>June 30, |               | Change       |         | Six months ended<br>June 30, |               | Change       |         |
|---|--------------------------------|---------------|--------------|---------|------------------------------|---------------|--------------|---------|
|   | 2008                           | 2007          | Amount       | Percent | 2008                         | 2007          | Amount       | Percent |
| Brokerage commissions and fee income            | \$ 41                          | \$ 28         | \$ 13        | 46.4%   | \$ 74                        | \$ 68         | \$ 6         | 8.8%    |
| Personal asset management and custody fees      | 40                             | 41            | (1)          | (2.4)   | 81                           | 81            | —            | —       |
| Institutional asset management and custody fees | 57                             | 46            | 11           | 23.9    | 112                          | 91            | 21           | 23.1    |
| Total trust and investment services income      | <u>\$ 138</u>                  | <u>\$ 115</u> | <u>\$ 23</u> | 20.0%   | <u>\$ 267</u>                | <u>\$ 240</u> | <u>\$ 27</u> | 11.3%   |

A significant portion of Key's trust and investment services income depends on the value and mix of assets under management. At June 30, 2008, Key's bank, trust and registered investment advisory subsidiaries had assets under management of \$81.0 billion, compared to \$85.6 billion at June 30, 2007. As shown in Figure 15, most of the decrease was attributable to the securities lending portfolio, due in part to increased volatility in the fixed income markets and actions taken by management to maintain sufficient liquidity within the portfolio. When clients' securities are lent to a borrower, the borrower must provide Key with cash collateral, which is invested during the term of the loan. The difference between the revenue generated from the investment and the cost of the collateral is shared with the lending client. This business, although profitable, generates a significantly lower rate of return (commensurate with the lower level of risk) than other types of assets under management.

**Figure 15. Assets Under Management**

| <i>in millions</i>  | 2008             |                  | 2007             |                  |                  |
|---|------------------|------------------|------------------|------------------|------------------|
|   | Second           | First            | Fourth           | Third            | Second           |
| Assets under management by investment type:                   |                  |                  |                  |                  |                  |
| Equity  | \$ 40,446        | \$ 39,800        | \$ 42,868        | \$ 44,465        | \$ 42,462        |
| Securities lending  | 17,756           | 18,476           | 20,228           | 22,056           | 22,595           |
| Fixed income  | 10,823           | 10,598           | 11,357           | 11,372           | 11,187           |
| Money market  | 9,604            | 9,746            | 9,440            | 8,861            | 8,069            |
| Hedge funds   | 2,369            | 1,833            | 1,549            | 1,346            | 1,279            |
| Total   | <u>\$ 80,998</u> | <u>\$ 80,453</u> | <u>\$ 85,442</u> | <u>\$ 88,100</u> | <u>\$ 85,592</u> |
| Proprietary mutual funds included in assets under management: |                  |                  |                  |                  |                  |
| Money market  | \$ 7,178         | \$ 7,131         | \$ 7,298         | \$ 6,888         | \$ 6,280         |
| Equity  | 7,202            | 6,556            | 6,957            | 6,748            | 6,392            |

|              |                  |                  |                  |                  |                  |
|--------------|------------------|------------------|------------------|------------------|------------------|
| Fixed income | 617              | 631              | 631              | 629              | 615              |
| Total        | <u>\$ 14,997</u> | <u>\$ 14,318</u> | <u>\$ 14,886</u> | <u>\$ 14,265</u> | <u>\$ 13,287</u> |

**Service charges on deposit accounts.** Service charges on deposit accounts were up from the prior year, due primarily to an increase in fee income from cash management services. Other factors contributing to the improvement include growth in the number of transaction accounts within Key's Community Banking Group, an increase in overdraft fee income resulting from higher transaction volume and a rate increase instituted during the second quarter of 2007.

**Investment banking and capital markets income.** As shown in Figure 16, investment banking and capital markets income increased from the year-ago quarter as a result of strong growth in income from the investment banking business, and from dealer trading and derivatives. On a year-to-date basis, the decline from the prior year was attributable to losses recorded during the first quarter of 2008 from dealer trading and derivatives, and from certain real estate-related investments, both of which reflected extraordinary volatility in the fixed income markets. During the second quarter of 2008, results from dealer trading and derivatives showed substantial improvement, due in part to actions taken by management in the prior quarter to mitigate the effects of future market volatility on Key's held-for-sale and trading portfolios.

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Figure 16. Investment Banking and Capital Markets Income

| <i>dollars in millions</i>                          | Three months ended<br>June 30, |              | Change       |         | Six months ended<br>June 30, |              | Change        |         |
|---|--------------------------------|--------------|--------------|---------|------------------------------|--------------|---------------|---------|
|   | 2008                           | 2007         | Amount       | Percent | 2008                         | 2007         | Amount        | Percent |
| Investment banking income                           | \$ 36                          | \$ 22        | \$ 14        | 63.6%   | \$ 58                        | \$ 43        | \$ 15         | 34.9%   |
| Income (loss) from other investments                | 1                              | 6            | (5)          | (83.3)  | (5)                          | 11           | (16)          | N/M     |
| Dealer trading and derivatives income               | 28                             | 12           | 16           | 133.3   | 7                            | 20           | (13)          | (65.0)  |
| Foreign exchange income                             | 15                             | 12           | 3            | 25.0    | 28                           | 22           | 6             | 27.3    |
| Total investment banking and capital markets income | <u>\$ 80</u>                   | <u>\$ 52</u> | <u>\$ 28</u> | 53.8%   | <u>\$ 88</u>                 | <u>\$ 96</u> | <u>\$ (8)</u> | (8.3)%  |

N/M = Not Meaningful

**Net gains (losses) from loan securitizations and sales.** Key sells or securitizes loans to achieve desired interest rate and credit risk profiles, to improve the profitability of the overall loan portfolio or to diversify funding sources. During the first six months of 2008, Key recorded \$68 million of net losses from loan sales and write-downs, compared to net gains of \$42 million for the first six months of 2007. Results for the current year reflect \$101 million of net losses from loan sales and write-downs recorded during the first quarter, due primarily to volatility in the fixed income markets and the related housing correction. Approximately \$84 million of these losses pertained to commercial real estate loans held for sale. The types of loans sold during 2008 and 2007 are presented in Figure 21 on page 68. In March 2008, Key transferred \$3.3 billion of education loans from held-for-sale status to the loan portfolio. The secondary markets for these loans have been adversely affected by market liquidity issues, precluding any recent securitizations and prompting the company's decision to move them to a held-to-maturity classification.

**Net (losses) gains from principal investing.** Principal investments consist of direct and indirect investments in predominantly privately held companies. Key's principal investing income is susceptible to volatility since most of it is derived from mezzanine debt and equity investments in small to medium-sized businesses. These investments are carried on the balance sheet at fair value (\$1.0 billion at June 30, 2008, \$993 million at December 31, 2007, and \$975 million at June 30, 2007). The net (losses) gains presented in Figure 13 derive from changes in fair values as well as the sales of principal investments.

### Noninterest expense

Noninterest expense for the second quarter of 2008 was \$781 million, compared to \$815 million for the second quarter of 2007. For the first six months of the year, noninterest expense was \$1.5 billion, representing a decrease of \$86 million, or 5%, from the first six months of 2007.

As shown in Figure 17, personnel expense decreased by \$7 million from the second quarter of 2007, due primarily to a reduction in costs associated with employee benefits. Nonpersonnel expense decreased by \$27 million, due to a \$42 million litigation charge (included in "miscellaneous expense") recorded during the second quarter of 2007, offset in part by a \$7 million increase in professional fees. See Note 13 ("Contingent Liabilities and Guarantees"), which begins on page 29, for more information pertaining to the Honsador litigation charge.

For the year-to-date period, personnel expense decreased by \$26 million. Approximately \$13 million of the reduction was attributable to the sale of the McDonald Investments branch network. Nonpersonnel expense was down \$60 million, due primarily to the litigation charge recorded during the second quarter of 2007. Additionally, nonpersonnel expense included a \$29 million credit for losses on lending-related commitments in the current year, compared to a \$2 million credit in the prior year. The sale of the McDonald Investments branch network reduced Key's total nonpersonnel expense by approximately \$17 million.

The decline in total noninterest expense was moderated by additional expenses recorded during the first half of 2008 as a result of the January 1, 2008, acquisition of U.S.B. Holding Co., Inc. and the October 1, 2007, acquisition of Tuition Management Systems, Inc.





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Figure 17. Noninterest Expense

| <i>dollars in millions</i>                                      | Three months ended<br>June 30, |          | Change  |         | Six months ended<br>June 30, |          | Change  |         |
|---|--------------------------------|----------|---------|---------|------------------------------|----------|---------|---------|
|   | 2008                           | 2007     | Amount  | Percent | 2008                         | 2007     | Amount  | Percent |
| Personnel   | \$ 404                         | \$ 411   | \$ (7)  | (1.7)%  | \$ 813                       | \$ 839   | \$ (26) | (3.1)%  |
| Net occupancy   | 62                             | 59       | 3       | 5.1     | 128                          | 122      | 6       | 4.9     |
| Computer processing   | 43                             | 49       | (6)     | (12.2)  | 90                           | 100      | (10)    | (10.0)  |
| Operating lease expense   | 55                             | 55       | —       | —       | 113                          | 107      | 6       | 5.6     |
| Professional fees   | 33                             | 26       | 7       | 26.9    | 56                           | 52       | 4       | 7.7     |
| Equipment   | 23                             | 24       | (1)     | (4.2)   | 47                           | 49       | (2)     | (4.1)   |
| Marketing   | 21                             | 20       | 1       | 5.0     | 35                           | 39       | (4)     | (10.3)  |
| Other expense:  |                                |          |         |         |                              |          |         |         |
| Postage and delivery  | 12                             | 11       | 1       | 9.1     | 23                           | 23       | —       | —       |
| Franchise and business taxes                                    | 8                              | 8        | —       | —       | 16                           | 17       | (1)     | (5.9)   |
| Telecommunications  | 7                              | 7        | —       | —       | 15                           | 14       | 1       | 7.1     |
| (Credit) provision for losses on<br>lending-related commitments | (2)                            | 6        | (8)     | N/M     | (29)                         | (2)      | (27)    | N/M     |
| Miscellaneous expense   | 115                            | 139      | (24)    | (17.3)  | 206                          | 239      | (33)    | (13.8)  |
| Total other expense   | 140                            | 171      | (31)    | (18.1)  | 231                          | 291      | (60)    | (20.6)  |
| Total noninterest expense                                       | \$ 781                         | \$ 815   | \$ (34) | (4.2)%  | \$ 1,513                     | \$ 1,599 | \$ (86) | (5.4)%  |
| Average full-time equivalent<br>employees                       | 18,164                         | 18,888 a | (724)   | (3.8)%  | 18,295                       | 19,342 a | (1,047) | (5.4)%  |

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

N/M = Not meaningful

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

**Personnel.** As shown in Figure 18, personnel expense, the largest category of Key's noninterest expense, decreased by \$26 million, or 3%, from the first six months of 2007. This improvement was largely attributable to lower stock-based compensation, as well as decreases in costs associated with salaries and employee benefits stemming from a 5% reduction in the average number of full-time equivalent employees. The McDonald Investments branch network accounted for \$4 million of Key's personnel expense in the first half of 2008, compared to \$17 million for the same period last year. More than half of the reduction resulting from the sale of the McDonald Investments branch network relates to incentive compensation.

Figure 18. Personnel Expense

| <i>dollars in millions</i> | Three months ended<br>June 30, |        | Change |         | Six months ended<br>June 30, |        | Change |         |
|----------------------------|--------------------------------|--------|--------|---------|------------------------------|--------|--------|---------|
|                            | 2008                           | 2007   | Amount | Percent | 2008                         | 2007   | Amount | Percent |
| Salaries                   | \$ 235                         | \$ 236 | \$ (1) | (.4)%   | \$ 474                       | \$ 481 | \$ (7) | (1.5)%  |
| Incentive compensation     | 79                             | 82     | (3)    | (3.7)   | 153                          | 157    | (4)    | (2.5)   |
| Employee benefits          | 65                             | 73     | (8)    | (11.0)  | 141                          | 155    | (14)   | (9.0)   |

|                          |                      |                      |                      |        |                      |                      |                       |        |
|--------------------------|----------------------|----------------------|----------------------|--------|----------------------|----------------------|-----------------------|--------|
| Stock-based compensation | <b>17</b>            | 16                   | 1                    | 6.3    | <b>31</b>            | 40                   | (9)                   | (22.5) |
| Severance                | <b>8</b>             | 4                    | 4                    | 100.0  | <b>14</b>            | 6                    | 8                     | 133.3  |
| Total personnel expense  | <u><u>\$ 404</u></u> | <u><u>\$ 411</u></u> | <u><u>\$ (7)</u></u> | (1.7)% | <u><u>\$ 813</u></u> | <u><u>\$ 839</u></u> | <u><u>\$ (26)</u></u> | (3.1)% |

**Computer processing.** The decrease in computer processing costs for both the quarterly and year-to-date periods reflected a reduction in expenses attributable to the use of outside services.

**Professional fees.** The increase in professional fees for both the quarterly and year-to-date periods was due in part to additional costs recorded in connection with increased collection efforts on loans and product pricing.

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### **Income taxes**

The provision for income taxes from continuing operations was \$611 million for the second quarter of 2008, compared to \$130 million for the comparable period in 2007. For the first six months of 2008, the provision for income taxes was \$715 million, compared to \$277 million for the first six months of 2007. The significant increase in the tax provision reflects several developments related to Key's tax treatment of certain leveraged lease financing transactions.

During the second quarter of 2008, Key received an adverse federal court decision on the company's tax treatment of a Service Contract Lease transaction entered into by AWG Leasing Trust, in which Key is a partner. Although the Court decision applies only to the previously disclosed AWG Leasing Litigation, in accordance with FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," Key was required to increase the amount of unrecognized tax benefits associated with all of the leases under challenge by the IRS by \$2.15 billion. This amount has not been reduced by existing tax deposits of \$200 million. The increase in unrecognized tax benefits associated with the contested leases necessitated a recalculation of Key's lease income under FASB Staff Position No. 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," as well as an increase to Key's tax reserves. These actions reduced Key's second quarter 2008 after-tax earnings by \$1.011 billion, or \$2.43 per common share, including a \$359 million reduction to lease income, a \$177 million increase to the provision for income taxes and a \$475 million charge to the tax provision for the interest cost associated with the contested tax liabilities.

During the first quarter of 2008, Key increased the amount of its unrecognized tax benefits associated with its LILO transactions by \$46 million. This adjustment resulted from an updated assessment of Key's tax position performed by management in accordance with the provisions of FASB Interpretation No. 48. The increase in unrecognized tax benefits associated with Key's LILO transactions also necessitated a recalculation of Key's lease income under FASB Staff Position No. 13-2 and an increase to Key's tax reserves. These actions reduced Key's first quarter 2008 after-tax earnings by \$38 million, or \$.10 per diluted common share, including a \$3 million reduction to lease income, an \$18 million increase to the provision for income taxes and a \$17 million charge to the tax provision for the associated interest charges.

The effective tax rate represents the provision for income taxes from continuing operations as a percentage of income from continuing operations before income taxes. Excluding the lease financing charges recorded in the current year, the effective tax rate was 17.4% for the second quarter of 2008, compared to 27.8% for the second quarter of 2007. On an adjusted basis, the effective tax rates for the first six months of 2008 and 2007 were 33.9% and 28.5%, respectively.

On an adjusted basis, the effective tax rates for both the current and prior year are substantially below Key's combined federal and state tax rate of 37.5%, primarily because Key generates income from investments in tax-advantaged assets such as corporate-owned life insurance, earns credits associated with investments in low-income housing projects and records tax deductions associated with dividends paid on Key common shares held in the 401(k) savings plan.

In the ordinary course of business, Key enters into certain types of lease financing transactions, including those discussed above, that result in tax deductions. The IRS has completed audits of Key's income tax returns for a number of prior years and has disallowed the tax deductions taken in connection with these transactions. Key is contesting the IRS' position and challenging the federal court decision in the AWG Leasing Litigation. Additional information related to the specific types of lease financing transactions involved, and the status of Key's response to the IRS disallowance and federal court decision is included in Note 12 ("Income Taxes"), which begins on page 27.

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**Financial Condition**
**Loans and loans held for sale**

At June 30, 2008, total loans outstanding were \$75.9 billion, compared to \$70.8 billion at December 31, 2007, and \$66.7 billion at June 30, 2007. The increase in Key's loan portfolio over the past twelve months was primarily attributable to growth in the commercial portfolio and the March 2008 transfer of \$3.3 billion of education loans from held-for-sale status to the loan portfolio.

Commercial loan portfolio

Commercial loans outstanding increased by \$5.3 billion, or 11%, from the year ago quarter, due largely to a higher volume of originations in the commercial mortgage portfolio, and the commercial, financial and agricultural portfolio. This growth reflected increased reliance by borrowers on commercial lines of credit in response to the challenging economic environment, as well as the January 1, 2008, acquisition of U.S.B. Holding Co., Inc., which added approximately \$900 million to Key's commercial loan portfolio. The overall growth in the commercial loan portfolio was geographically broad-based and spread among a number of industry sectors.

**Commercial real estate loans.** Commercial real estate loans for both owner- and nonowner-occupied properties constitute one of the largest segments of Key's commercial loan portfolio. At June 30, 2008, Key's commercial real estate portfolio included mortgage loans of \$10.7 billion and construction loans of \$7.8 billion. The average mortgage loan originated during the first half of 2008 was \$2 million, and the largest mortgage loan at June 30, 2008, had a balance of \$66 million. At June 30, 2008, the average construction loan commitment was \$6 million. The largest construction loan commitment was \$77 million, of which the entire amount was outstanding and on nonperforming status.

Key's commercial real estate lending business is conducted through two primary sources: a 14-state banking franchise, and Real Estate Capital and Corporate Banking Services, a national line of business that cultivates relationships both within and beyond the branch system. This line of business deals exclusively with nonowner-occupied properties (generally properties for which at least 50% of the debt service is provided by rental income from nonaffiliated third parties) and accounted for approximately 64% of Key's average commercial real estate loans during the second quarter of 2008. Key's commercial real estate business generally focuses on larger real estate developers and, as shown in Figure 19, is diversified by both industry type and geographic location of the underlying collateral.

**Figure 19. Commercial Real Estate Loans**

| June 30, 2008<br><i>dollars in millions</i> | Geographic Region |                 |                 |                 |                 |                 | Total            | Percent of<br>Total |
|---|-------------------|-----------------|-----------------|-----------------|-----------------|-----------------|------------------|---------------------|
|   | Northeast         | Southeast       | Southwest       | Midwest         | Central         | West            |                  |                     |
| Nonowner-occupied:                          |                   |                 |                 |                 |                 |                 |                  |                     |
| Residential properties                      | \$ 432            | \$ 850          | \$ 100          | \$ 139          | \$ 290          | \$ 904          | \$ 2,715         | 14.6%               |
| Retail properties                           | 164               | 849             | 270             | 538             | 355             | 408             | 2,584            | 13.9                |
| Multifamily properties                      | 276               | 533             | 386             | 300             | 446             | 464             | 2,405            | 13.0                |
| Office buildings                            | 278               | 165             | 66              | 150             | 186             | 436             | 1,281            | 6.9                 |
| Land and development                        | 148               | 193             | 220             | 36              | 149             | 131             | 877              | 4.7                 |
| Health facilities                           | 193               | 124             | 30              | 176             | 114             | 243             | 880              | 4.7                 |
| Warehouses                                  | 94                | 195             | 13              | 155             | 61              | 207             | 725              | 3.9                 |
| Hotels/Motels                               | 60                | 83              | —               | 22              | 29              | 60              | 254              | 1.4                 |
| Manufacturing facilities                    | 8                 | 35              | 23              | 12              | 1               | 18              | 97               | .5                  |
| Other                                       | 168               | 44              | 4               | 154             | 245             | 221             | 836              | 4.5                 |
|   | 1,821             | 3,071           | 1,112           | 1,682           | 1,876           | 3,092           | 12,654           | 68.1                |
| Owner-occupied                              | 1,237             | 187             | 94              | 2,049           | 517             | 1,848           | 5,932            | 31.9                |
| Total                                       | <u>\$ 3,058</u>   | <u>\$ 3,258</u> | <u>\$ 1,206</u> | <u>\$ 3,731</u> | <u>\$ 2,393</u> | <u>\$ 4,940</u> | <u>\$ 18,586</u> | <u>100.0%</u>       |
| Nonowner-occupied:                          |                   |                 |                 |                 |                 |                 |                  |                     |

|                            |    |    |    |     |    |    |    |   |    |    |    |    |    |     |     |
|----------------------------|----|----|----|-----|----|----|----|---|----|----|----|----|----|-----|-----|
| Nonperforming loans        | \$ | 35 | \$ | 190 | \$ | 2  | \$ | 8 | \$ | 14 | \$ | 74 | \$ | 323 | N/M |
| Accruing loans past due    |    |    |    |     |    |    |    |   |    |    |    |    |    |     |     |
| 90 days or more            |    | 9  |    | 53  |    | 17 |    | 5 |    | 4  |    | 78 |    | 166 | N/M |
| Accruing loans past due 30 |    |    |    |     |    |    |    |   |    |    |    |    |    |     |     |
| through 89 days            |    | 55 |    | 43  |    | 1  |    | 5 |    | 10 |    | 43 |    | 157 | N/M |

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

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

Southwest – Arizona, Nevada and New Mexico

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

Central – Arkansas, Colorado, Oklahoma, Texas and Utah

West – Alaska, California, Hawaii, Idaho, Montana, Oregon, Washington and Wyoming

N/M = Not Meaningful

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During the past twelve months, nonperforming loans related to Key's nonowner-occupied properties rose by \$295 million, due primarily to deteriorating market conditions in the residential properties segment of Key's commercial real estate construction portfolio. The majority of the increase in this segment came from loans outstanding in Florida and southern California. As previously reported, Key has undertaken a process to reduce its exposure in the residential properties segment of its construction loan portfolio through the planned sale of certain loans. In conjunction with these efforts, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status in June 2008. As of June 30, 2008, sales had closed on \$44 million of these loans. With respect to the balance, Key is working with bidders to finalize sales terms and documentation, and management anticipates that sales of the majority of the remaining \$340 million of loans, which are on nonperforming status, will close during the third quarter.

**Commercial lease financing.** Management believes Key has both the scale and array of products to compete in the specialty of equipment lease financing. Key conducts these financing arrangements through the Equipment Finance line of business. Commercial lease financing receivables represented 18% of commercial loans at June 30, 2008, compared to 21% at June 30, 2007.

### Consumer loan portfolio

Consumer loans outstanding increased by \$3.8 billion, or 21%, from one year ago. As stated previously, in March 2008, Key transferred \$3.3 billion of education loans from held-for-sale status to the loan portfolio. The secondary markets for these loans have been adversely affected by market liquidity issues, prompting the company's decision to move them to a held-to-maturity classification. Adjusting for this transfer, consumer loans were up \$549 million, or 3%, from the year-ago quarter, due primarily to the January 1, 2008, acquisition of U.S.B. Holding Co., Inc.

The home equity portfolio is by far the largest segment of Key's consumer loan portfolio. A significant amount of this portfolio (90% at June 30, 2008) is derived primarily from the Regional Banking line of business within the Community Banking group; the remainder originated from the Consumer Finance line of business within the National Banking group. Management expects the level of the home equity portfolio to decrease in the future as a result of Key's December 2007 decision to exit dealer-originated home improvement lending activities, which are largely out-of-footprint.

Figure 20 summarizes Key's home equity loan portfolio by source at the end of each of the last five quarters, as well as certain asset quality statistics and yields on the portfolio as a whole.

**Figure 20. Home Equity Loans**

| <i>dollars in millions</i>          | <b>2008</b>      |                  | <b>2007</b>      |                  |                  |
|-------------------------------------|------------------|------------------|------------------|------------------|------------------|
|                                     | <b>Second</b>    | <b>First</b>     | <b>Fourth</b>    | <b>Third</b>     | <b>Second</b>    |
| <b>SOURCES OF PERIOD-END LOANS</b>  |                  |                  |                  |                  |                  |
| Community Banking                   | \$ 9,851         | \$ 9,678         | \$ 9,655         | \$ 9,674         | \$ 9,736         |
| National Banking                    | 1,153            | 1,220            | 1,262            | 1,230            | 1,143            |
| Total                               | <u>\$ 11,004</u> | <u>\$ 10,898</u> | <u>\$ 10,917</u> | <u>\$ 10,904</u> | <u>\$ 10,879</u> |
| Nonperforming loans at period end   | \$ 75            | \$ 74            | \$ 66            | \$ 61            | \$ 55            |
| Net loan charge-offs for the period | 19               | 15               | 12               | 8                | 6                |
| Yield for the period <sup>a</sup>   | 5.99%            | 6.54%            | 7.02%            | 7.22%            | 7.22%            |

(a) From continuing operations.

### Loans held for sale

As shown in Note 6 ("Loans and Loans Held for Sale"), which begins on page 21, Key's loans held for sale were \$1.8 billion at June 30, 2008, compared to \$4.7 billion at December 31, 2007, and \$4.5 billion at June 30, 2007. The decrease was attributable to the transfer of the education loans from held-for-sale status to the loan portfolio and the

sales of commercial real estate loans. Adjusting for the transfer, loans held for sale were up \$571 million, or 13%, from the year-ago quarter due in part to the June 2008 transfer of commercial real estate loans from the loan portfolio to held-for-sale status.

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At June 30, 2008, Key's loans held for sale included \$994 million of commercial mortgage loans. In the absence of quoted market prices, management uses valuation models to measure the fair value of these loans and adjusts the amount recorded on the balance sheet if fair value falls below recorded cost. The models are based on assumptions related to prepayment speeds, default rates, funding cost and discount rates. In light of the volatility in the financial markets, management has reviewed Key's assumptions and determined they reflect current market conditions. As a result, no significant adjustments to the assumptions were required during the first half of 2008.

During the first six months of 2008, Key recorded net unrealized losses of \$79 million and net realized gains of \$3 million on its loans held for sale portfolio. Key records these transactions in "net gains (losses) from loan securitizations and sales" on the income statement. Key has not been significantly impacted by market volatility in the subprime mortgage lending industry because it sold the \$2.5 billion subprime mortgage loan portfolio held by the Champion Mortgage finance business in November 2006.

### Sales and securitizations

Key continues to utilize alternative funding sources like loan sales and securitizations to support its loan origination capabilities. In addition, certain acquisitions completed over the past several years have improved Key's ability under favorable market conditions to originate and sell new loans, and to securitize and service loans generated by others, especially in the area of commercial real estate.

During the past twelve months, Key sold \$3.0 billion of commercial real estate loans, \$628 million of residential real estate loans, \$320 million of commercial loans and leases, and \$178 million of education loans. Most of these sales came from the held-for-sale portfolio. Due to unfavorable market conditions, Key did not proceed with an education loan securitization during 2007 and does not anticipate entering into any securitizations of this type during 2008.

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

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



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Figure 21 summarizes Key's loan sales (including securitizations) for the first six months of 2008 and all of 2007.

**Figure 21. Loans Sold (Including Loans Held for Sale)**

| <i>in millions</i> | Commercial    | Commercial<br>Real Estate | Commercial<br>Lease Financing | Residential<br>Real Estate | Home<br>Equity | Consumer<br>Other —<br>National<br>Banking | Education     | Total           |
|--------------------|---------------|---------------------------|-------------------------------|----------------------------|----------------|--|---------------|-----------------|
| <b>2008</b>        |               |                           |                               |                            |                |  |               |                 |
| Second quarter     | \$ 19         | \$ 761                    | \$ 38                         | \$ 213                     | —              | —  | \$ 38         | \$ 1,069        |
| First quarter      | 14            | 204                       | 29                            | 170                        | —              | —  | 72            | 489             |
| Total              | <u>\$ 33</u>  | <u>\$ 965</u>             | <u>\$ 67</u>                  | <u>\$ 383</u>              | —              | —  | <u>\$ 110</u> | <u>\$ 1,558</u> |
| <b>2007</b>        |               |                           |                               |                            |                |  |               |                 |
| Fourth quarter     | \$ 38         | \$ 965                    | \$ 130                        | \$ 118                     | —              | —  | \$ 24         | \$ 1,275        |
| Third quarter      | 17            | 1,059                     | 35                            | 127                        | —              | —  | 44            | 1,282           |
| Second quarter     | 36            | 1,079                     | 98                            | 118                        | —              | —  | 118           | 1,449           |
| First quarter      | 15            | 688                       | 5                             | 100                        | \$ 233         | \$ 90                                      | 61            | 1,192           |
| Total              | <u>\$ 106</u> | <u>\$ 3,791</u>           | <u>\$ 268</u>                 | <u>\$ 463</u>              | <u>\$ 233</u>  | <u>\$ 90</u>                               | <u>\$ 247</u> | <u>\$ 5,198</u> |

Figure 22 shows loans that are either administered or serviced by Key, but not recorded on the balance sheet. The table includes loans that have been both securitized and sold, or simply sold outright.

**Figure 22. Loans Administered or Serviced**

| <i>in millions</i>             | June 30,<br>2008  | March 31,<br>2008 | December 31,<br>2007 | September 30,<br>2007 | June 30,<br>2007  |
|--------------------------------|-------------------|-------------------|----------------------|-----------------------|-------------------|
| Commercial real estate loans a | \$ 128,010        | \$ 130,645        | \$ 134,982           | \$ 134,510            | \$ 121,384        |
| Education loans                | 4,474             | 4,592             | 4,722                | 4,984                 | 5,118             |
| Commercial lease financing     | 782               | 762               | 790                  | 657                   | 529               |
| Commercial loans               | 225               | 227               | 229                  | 228                   | 242               |
| Total                          | <u>\$ 133,491</u> | <u>\$ 136,226</u> | <u>\$ 140,723</u>    | <u>\$ 140,379</u>     | <u>\$ 127,273</u> |

- (a) Key acquired the servicing for commercial mortgage loan portfolios with an aggregate principal balance of \$738 million for the second quarter 2008, \$345 million for the first quarter 2008, \$5.3 billion for the fourth quarter 2007, \$21.1 billion for the third quarter 2007 and \$6.4 billion for the second quarter 2007.

In the event of default by a borrower, Key is subject to recourse with respect to approximately \$632 million of the \$133.5 billion of loans administered or serviced at June 30, 2008. Additional information about this recourse arrangement is included in Note 13 ("Contingent Liabilities and Guarantees") under the heading "Recourse agreement with Federal National Mortgage Association" on page 30.

Key derives income from several sources when retaining the right to administer or service loans that are securitized or sold. Key earns noninterest income (recorded as "other income") from fees for servicing or administering loans. This fee income is reduced by the amortization of related servicing assets. In addition, Key earns interest income from securitized assets retained and from investing funds generated by escrow deposits collected in connection with the servicing of commercial real estate loans.

**Securities**

At June 30, 2008, the securities portfolio totaled \$8.3 billion, compared to \$7.9 billion at December 31, 2007, and June 30, 2007. At each of these dates, almost the entire securities portfolio was securities available for sale, with the remainder consisting of held-to-maturity securities of less than \$40 million.

***Securities available for sale.*** The majority of Key's securities available-for-sale portfolio consists of collateralized mortgage obligations ("CMOs"). A CMO is a debt security that is secured by a pool of

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mortgages or mortgage-backed securities. Key's CMOs generate interest income and serve as collateral to support certain pledging agreements. At June 30, 2008, Key had \$7.9 billion invested in CMOs and other mortgage-backed securities in the available-for-sale portfolio, compared to \$7.6 billion at December 31, 2007, and \$7.4 billion at June 30, 2007.

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

In March 2007, management completed a comprehensive evaluation of the securities available-for-sale portfolio and determined that a repositioning of the portfolio was appropriate to enhance future financial performance, particularly in the event of a decline in interest rates. As a result, Key sold \$2.4 billion of shorter-maturity CMOs and reinvested the proceeds in mortgage-backed securities with higher yields and longer expected average maturities. The repositioning also reduced Key's exposure to prepayment risk if interest rates decline by replacing the CMOs sold with CMOs whose underlying mortgage loans have shorter maturities and lower coupon rates. Key maintains a modest liability-sensitive exposure to near-term changes in interest rates. Neither funding nor capital levels were affected materially by this portfolio repositioning.

As a result of the sale of CMOs, Key recorded a net realized loss of \$49 million (\$31 million after tax, or \$.08 per diluted common share) during the first quarter of 2007. This net loss was previously recorded in "net unrealized losses on securities available for sale" in the "accumulated other comprehensive income (loss) component" of shareholders' equity.

In addition to changing market conditions, the size and composition of Key's securities available-for-sale portfolio could vary with Key's needs for liquidity and the extent to which Key is required (or elects) to hold these assets as collateral to secure public funds and trust deposits. Although Key generally uses debt securities for this purpose, other assets, such as securities purchased under resale agreements, are occasionally used when they provide more favorable yields or risk profiles.

As shown in Figure 23, all of Key's mortgage-backed securities are issued by government sponsored enterprises or the Government National Mortgage Association, and are traded in highly liquid secondary markets. For more than 99% of these securities, management employs an outside bond pricing service to determine the fair value at which they should be recorded on the balance sheet. In performing the valuations, the pricing service relies on models that consider security-specific details as well as relevant industry and economic factors. The most significant of these inputs are quoted market prices, interest rate spreads on relevant benchmark securities and certain prepayment assumptions. Management uses a purchased pricing model, along with inputs similar to those described above, to value a small portion (less than \$5 million) of Key's mortgage-backed securities. Management must make additional assumptions beyond those relied upon by the pricing service for these aged securities. The valuations derived from the models are reviewed by management for reasonableness to ensure they are consistent with the values placed on similar securities traded in the secondary markets.

**Figure 23. Mortgage-Backed Securities by Issuer**

| <i>in millions</i>                       | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|--|------------------|----------------------|------------------|
| Federal Home Loan Mortgage Corporation   | \$ 4,675         | \$ 4,566             | \$ 4,553         |
| Federal National Mortgage Association    | 2,875            | 2,748                | 2,605            |
| Government National Mortgage Association | 384              | 256                  | 268              |
| Total                                    | <u>\$ 7,934</u>  | <u>\$ 7,570</u>      | <u>\$ 7,426</u>  |

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For the first half of 2008, net gains from Key's mortgage-backed securities totaled \$33 million. These net gains include net unrealized gains of \$32 million, caused by the decline in benchmark Treasury yields, offset in part by the widening of interest rate spreads on these securities. Key records the net unrealized gains in the "accumulated other comprehensive income (loss)" component of shareholders' equity and records the net realized gains in "net securities (losses) gains" on the income statement.

Figure 24 shows the composition, yields and remaining maturities of Key's securities available for sale. For more information about securities, including gross unrealized gains and losses by type of security, see Note 5 ("Securities"), which begins on page 19.

**Figure 24. Securities Available for Sale**

| <i>dollars in millions</i>   | U.S. Treasury,<br>Agencies and<br>Corporations | States and<br>Political<br>Subdivisions | Collateralized<br>Mortgage<br>Obligations a | Other<br>Mortgage-<br>Backed<br>Securities a | Retained<br>Interests in<br>Securitizations a | Other<br>Securities b | Total              | Weighted -<br>Average<br>Yield c |
|------------------------------|--|---|---|--|---|-----------------------|--------------------|----------------------------------|
| <b>JUNE 30, 2008</b>         |  |   |   |  |   |                       |                    |                                  |
| Remaining maturity:          |  |   |   |  |   |                       |                    |                                  |
| One year or less             | \$ 5   | —                                       | \$ 4  | \$ 6   | —   | \$ 12                 | \$ 27              | 3.96%                            |
| After one through five years | 6  | \$ 7                                    | 6,179                                       | 1,445  | \$ 77   | 66                    | 7,780              | 5.07                             |
| After five through ten years | 6  | 57                                      | 167   | 110  | 110   | 1                     | 451                | 7.15                             |
| After ten years              | 1  | 27                                      | —   | 23   | —   | 3                     | 54                 | 5.84                             |
| Fair value                   | \$ 18  | \$ 91                                   | \$ 6,350                                    | \$ 1,584                                     | \$ 187  | \$ 82                 | \$ 8,312           | —                                |
| Amortized cost               | 18   | 92                                      | 6,309                                       | 1,583  | 153   | 82                    | 8,237              | 5.19%                            |
| Weighted-average yield c     | 3.86%  | 5.79%                                   | 4.89%                                       | 5.08%  | 18.17%  | 5.11% <sup>d</sup>    | 5.19% <sup>d</sup> | —                                |
| Weighted-average maturity    | 5.2 years                                      | 8.6 years                               | 3.2 years                                   | 4.5 years                                    | 4.9 years                                     | 4.2 years             | 3.5 years          | —                                |
| <b>DECEMBER 31, 2007</b>     |  |   |   |  |   |                       |                    |                                  |
| Fair value                   | \$ 19  | \$ 10                                   | \$ 6,167                                    | \$ 1,403                                     | \$ 185  | \$ 76                 | \$ 7,860           | —                                |
| Amortized cost               | 19   | 10                                      | 6,167                                       | 1,393  | 149   | 72                    | 7,810              | 5.22%                            |
| <b>JUNE 30, 2007</b>         |  |   |   |  |   |                       |                    |                                  |
| Fair value                   | \$ 18  | \$ 13                                   | \$ 6,313                                    | \$ 1,113                                     | \$ 193  | \$ 169                | \$ 7,819           | —                                |
| Amortized cost               | 18   | 13                                      | 6,421                                       | 1,133  | 146   | 150                   | 7,881              | 5.24%                            |

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

(b) Includes primarily marketable equity securities.

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

(d) Excludes securities of \$78 million at June 30, 2008, that have no stated yield.

**Held-to-maturity securities.** Foreign bonds, preferred equity securities and securities issued by states and political subdivisions comprise Key's held-to-maturity portfolio.

Figure 25 shows the composition, yields and remaining maturities of these securities.

[Table of Contents](#)**Figure 25. Held-to-Maturity Securities**

| <i>dollars in millions</i>          | States and<br>Political<br>Subdivisions | Other<br>Securities | Total              | Weighted -<br>Average<br>Yield <sup>a</sup> |
|-------------------------------------|---|---------------------|--------------------|---|
| <b>JUNE 30, 2008</b>                |   |                     |                    |   |
| Remaining maturity:                 |   |                     |                    |   |
| One year or less                    | \$ 5                                    | \$ 8                | \$ 13              | 6.82%                                       |
| After one through five years        | 3                                       | 9                   | 12                 | 6.11  |
| Amortized cost                      | \$ 8                                    | \$ 17               | \$ 25              | 6.51%                                       |
| Fair value                          | 8                                       | 17                  | 25                 | —   |
| Weighted-average yield <sup>a</sup> | 8.39%                                   | 4.93% <sup>b</sup>  | 6.51% <sup>b</sup> | —   |
| Weighted-average maturity           | 1.4 years                               | 1.6 years           | 1.5 years          | —   |
| <b>DECEMBER 31, 2007</b>            |   |                     |                    |   |
| Amortized cost                      | \$ 9                                    | \$ 19               | \$ 28              | 6.84%                                       |
| Fair value                          | 9                                       | 19                  | 28                 | —   |
| <b>JUNE 30, 2007</b>                |   |                     |                    |   |
| Amortized cost                      | \$ 17                                   | \$ 20               | \$ 37              | 7.15%                                       |
| Fair value                          | 17                                      | 20                  | 37                 | —   |

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

(b) Excludes securities of \$8 million at June 30, 2008, that have no stated yield.

**Other investments**

Principal investments <sup>3</sup>/<sub>4</sub> investments in equity and mezzanine instruments made by Key's Principal Investing unit <sup>3</sup>/<sub>4</sub> represent 66% of other investments at June 30, 2008. They include direct investments (investments made in a particular company), as well as indirect investments (investments made through funds that include other investors). Principal investments are predominantly made in privately held companies and are carried at fair value (\$1.0 billion at June 30, 2008, \$993 million at December 31, 2007, and \$975 million at June 30, 2007).

In addition to principal investments, "other investments" include other equity and mezzanine instruments, such as certain real estate-related investments that are carried at fair value, as well as other types of investments that generally are carried at cost.

Most of Key's other investments are not traded on a ready market. Management determines the fair value at which these investments should be recorded based on the nature of the specific investment, and all available information and relevant facts about the issuer's performance. Management's review may encompass such factors as the issuer's past financial performance and future potential, the values of public companies in comparable businesses, the risks associated with the particular business or investment type, current market conditions, the nature and duration of resale restrictions, the issuer's payment history, management's knowledge of the industry and other relevant factors. For the first six months of 2008, net losses from Key's principal investing activities totaled \$5 million, which included \$76 million of net unrealized losses. Key records these net losses as "net (losses) gains from principal investing" on the income statement.

**Deposits and other sources of funds**

"Core deposits" — domestic deposits other than certificates of deposit of \$100,000 or more — are Key's primary source of funding. These deposits generally are stable, have a relatively low cost and typically react more slowly to changes in interest rates than market-based deposits. During the second quarter of 2008, core deposits averaged

\$52.3 billion, and represented 58% of the funds Key used to support loans and other earning assets, compared to \$50.6 billion and 62% during the same quarter in 2007. The composition of Key's deposits is shown in Figure 10, which spans pages 57 and 58.

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The increase in average core deposits compared to the second quarter of 2007 was attributable to growth in Negotiable Order of Withdrawal (“NOW”) and money market deposits accounts, savings deposits and certificates of deposit, offset in part by a decline in noninterest-bearing deposits. The growth in and change in composition of core deposits were attributable to several factors.

- “ The January 1, 2008, acquisition of U.S.B. Holding Co., Inc. added approximately \$1.7 billion to Key’s average core deposits for the current quarter. Adjusting for the acquisition of U.S.B. Holding Co., Inc., the level of average core deposits was essentially unchanged from the second quarter of 2007.
- “ The increase in NOW and money market deposits accounts and the decrease in noninterest-bearing deposits reflect actions taken by Key in November 2007 to reduce its deposit reserve requirement by converting approximately \$3.4 billion of noninterest-bearing deposits to NOW and money market deposit accounts.
- “ Competition for deposits in the markets in which Key operates remains strong, and consumer preferences shifted more to certificates of deposit as a result of the declining interest rate environment.

Purchased funds, comprising large certificates of deposit, deposits in the foreign office and short-term borrowings, averaged \$20.8 billion in the second quarter of 2008, compared to \$16.4 billion during the year-ago quarter. The significant increase was attributable to growth in large certificate of deposits, foreign office deposits, and bank notes and other short-term borrowings. During the current year, Key has used purchased funds more heavily to accommodate borrowers’ increased reliance on commercial lines of credit in the volatile capital markets environment.

## **Capital**

**Shareholders’ equity.** Total shareholders’ equity at June 30, 2008, was \$8.7 billion, up \$960 million from December 31, 2007. Factors contributing to the change in shareholders’ equity during the first six months of 2008 are shown in the Consolidated Statements of Changes in Shareholders’ Equity presented on page 5.

During the second quarter of 2008, Key took several actions to further strengthen its capital position in light of charges recorded in connection with the adverse federal court decision in the AWG Leasing Litigation. KeyCorp issued \$650 million, or 6.5 million shares, of noncumulative perpetual convertible preferred stock with a liquidation value of \$100 per share, and \$1.0 billion, or 85.1 million shares, of additional common stock. Further, Key’s Board of Directors announced its intention to reduce the dividend on Key’s common shares by 50% to an annualized dividend of \$.75 per share, commencing with the dividend payable in the third quarter of 2008.

As part of the over allotment granted by KeyCorp to the underwriters in conjunction with the issuance of preferred stock and common shares, Key issued 7 million additional common shares and 75,000 additional shares of noncumulative perpetual convertible preferred stock on July 11, 2008. The proceeds received as a result of these issuances totaled approximately \$90 million, and represented approximately 9 basis points of additional Tier 1 and total risk-based capital.

**Common shares outstanding.** Figure 26 shows activities that caused the change in Key’s outstanding common shares over the past five quarters.

[Table of Contents](#)**Figure 26. Changes in Common Shares Outstanding**

| <i>in thousands</i>                                 | 2008           |                | 2007    |         |         |
|---|----------------|----------------|---------|---------|---------|
|   | Second         | First          | Fourth  | Third   | Second  |
| <b>Shares outstanding at beginning of period</b>    | <b>400,071</b> | <b>388,793</b> | 388,708 | 389,362 | 394,483 |
| Common shares issued                                | <b>85,106</b>  | —              | —       | —       | —       |
| Shares reissued to acquire U.S.B. Holding Co., Inc. | —              | <b>9,895</b>   | —       | —       | —       |
| Shares reissued under employee benefit plans        | <b>485</b>     | <b>1,383</b>   | 85      | 1,346   | 879     |
| Common shares repurchased                           | —              | —              | —       | (2,000) | (6,000) |
| <b>Shares outstanding at end of period</b>          | <b>485,662</b> | <b>400,071</b> | 388,793 | 388,708 | 389,362 |

Key repurchases its common shares periodically in the open market or through privately negotiated transactions under a repurchase program authorized by the Board of Directors. The program does not have an expiration date. Key did not repurchase any shares during the first half of 2008 and management does not expect to initiate any corporate share repurchases during the remainder of the year. At June 30, 2008, 14.0 million shares were remaining for repurchase under Board authority.

At June 30, 2008, Key had 91.3 million treasury shares. Management expects to reissue those shares as needed in connection with stock-based compensation awards and for other corporate purposes. On January 1, 2008, Key reissued 9.9 million of its common shares in connection with the acquisition of U.S.B. Holding Co., Inc. Additionally, during the first half of 2008, Key reissued 1.9 million shares under employee benefit plans.

**Capital availability.** As a result of the recent market disruptions, the availability of capital (principally to financial services companies) has become significantly restricted. While some companies, such as Key, have been successful in raising additional capital, the cost of that capital has been substantially higher than the prevailing market rate prior to the volatility. Management cannot predict when or if the markets will return to more favorable conditions.

As discussed on page 72, during the second quarter of 2008 and subsequent month of July, Key raised additional capital of \$1.74 billion through the issuance of both noncumulative perpetual convertible preferred stock and common shares. In addition, Key's Board of Directors announced its intention to reduce the dividend on Key's common shares commencing with the dividend payable in the third quarter of 2008. These actions were taken to further strengthen Key's capital position in light of the adverse federal court decision in the AWG Leasing Litigation, and to position Key to respond to future business opportunities as they emerge.

**Capital adequacy.** Capital adequacy is an important indicator of financial stability and performance. Key's ratio of total shareholders' equity to total assets was 8.57% at June 30, 2008, compared to 7.89% at December 31, 2007, and 8.28% at June 30, 2007. Key's ratio of tangible equity to tangible assets was 6.98% at June 30, 2008. Management believes Key's capital position provides sufficient flexibility to take advantage of investment opportunities and to pay dividends.

Banking industry regulators prescribe minimum capital ratios for bank holding companies and their banking subsidiaries. Note 14 ("Shareholders' Equity"), which begins on page 87 of Key's 2007 Annual Report to Shareholders, explains the implications of failing to meet these specific capital requirements.

Risk-based capital guidelines require a minimum level of capital as a percent of "risk-weighted assets." Risk-weighted assets consist of total assets plus certain off-balance sheet items, subject to adjustment for predefined credit risk factors. Currently, banks and bank holding companies must maintain, at a minimum, Tier 1 capital as a percent of risk-weighted assets of 4.00%, and total capital as a percent of risk-weighted assets of 8.00%. As of June 30, 2008, Key's Tier 1 capital ratio was 8.53%, and its total capital ratio was 12.41%.

Another indicator of capital adequacy, the leverage ratio, is defined as Tier 1 capital as a percentage of average quarterly tangible assets. Leverage ratio requirements vary with the condition of the financial institution. Bank holding companies that either have the highest supervisory rating or have implemented



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the Federal Reserve's risk-adjusted measure for market risk — as KeyCorp has — must maintain a minimum leverage ratio of 3.00%. All other bank holding companies must maintain a minimum ratio of 4.00%. As of June 30, 2008, Key had a leverage ratio of 9.34%.

Federal bank regulators group FDIC-insured depository institutions into five categories, ranging from “critically undercapitalized” to “well capitalized.” Key's affiliate bank, KeyBank, qualified as “well capitalized” at June 30, 2008, since it exceeded the prescribed thresholds of 10.00% for total capital, 6.00% for Tier 1 capital and 5.00% for the leverage ratio. If these provisions applied to bank holding companies, Key also would qualify as “well capitalized” at June 30, 2008. The FDIC-defined capital categories serve a limited supervisory function. Investors should not treat them as a representation of the overall financial condition or prospects of KeyCorp or KeyBank.

Figure 27 presents the details of Key's regulatory capital position at June 30, 2008, December 31, 2007, and June 30, 2007.

**Figure 27. Capital Components and Risk-Weighted Assets**

| <i>dollars in millions</i>  | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> | <b>June 30,<br/>2007</b> |
|---|--------------------------|------------------------------|--------------------------|
| <b>TIER 1 CAPITAL</b>   |                          |                              |                          |
| Common shareholders' equity a   | \$ 8,627                 | \$ 7,687                     | \$ 7,923                 |
| Qualifying capital securities   | 2,582                    | 1,857                        | 1,792                    |
| Less: Goodwill  | 1,598                    | 1,252                        | 1,202                    |
| Other assets b  | 221                      | 197                          | 177                      |
| Total Tier 1 capital  | 9,390                    | 8,095                        | 8,336                    |
| <b>TIER 2 CAPITAL</b>   |                          |                              |                          |
| Allowance for losses on loans and liability for losses on lending-related commitments c | 1,385                    | 1,280                        | 995                      |
| Net unrealized gains on equity securities available for sale                            | —                        | 2                            | 8                        |
| Qualifying long-term debt   | 2,879                    | 3,003                        | 3,107                    |
| Total Tier 2 capital  | 4,264                    | 4,285                        | 4,110                    |
| Total risk-based capital  | <u>\$ 13,654</u>         | <u>\$ 12,380</u>             | <u>\$ 12,446</u>         |
| <b>RISK-WEIGHTED ASSETS</b>   |                          |                              |                          |
| Risk-weighted assets on balance sheet   | \$ 85,600                | \$ 83,758                    | \$ 78,971                |
| Risk-weighted off-balance sheet exposure  | 25,510                   | 25,676                       | 24,455                   |
| Less: Goodwill  | 1,598                    | 1,252                        | 1,202                    |
| Other assets b  | 1,004                    | 962                          | 755                      |
| Plus: Market risk-equivalent assets   | 1,606                    | 1,525                        | 962                      |
| Gross risk-weighted assets  | 110,114                  | 108,745                      | 102,431                  |
| Less: Excess allowance for loan losses c  | 87                       | —                            | —                        |
| Net risk-weighted assets  | <u>\$ 110,027</u>        | <u>\$ 108,745</u>            | <u>\$ 102,431</u>        |
| <b>AVERAGE QUARTERLY TOTAL ASSETS</b>   | <u>\$ 103,128</u>        | <u>\$ 98,728</u>             | <u>\$ 93,413</u>         |
| <b>CAPITAL RATIOS</b>   |                          |                              |                          |
| Tier 1 risk-based capital ratio   | 8.53%                    | 7.44%                        | 8.14%                    |
| Total risk-based capital ratio  | 12.41                    | 11.38                        | 12.15                    |
| Leverage ratio d  | 9.34                     | 8.39                         | 9.11                     |

- 
- (a) Common shareholders' equity does not include net unrealized gains or losses on securities available for sale (except for net unrealized losses on marketable equity securities), net gains or losses on cash flow hedges, or the amount resulting from the adoption of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans."
  - (b) Other assets deducted from Tier 1 capital and risk-weighted assets consist of intangible assets (excluding goodwill) recorded after February 19, 1992, and deductible portions of nonfinancial equity investments.
  - (c) The allowance for loan losses included in Tier 2 capital is limited by regulation to 1.25% of the sum of gross risk-weighted assets plus low level exposures and residual interests calculated under the direct reduction method, as defined by the Federal Reserve.
  - (d) This ratio is Tier 1 capital divided by average quarterly total assets less: (i) goodwill, (ii) the nonqualifying intangible assets described in footnote (b), (iii) deductible portions of nonfinancial equity investments, and (iv) net unrealized gains or losses on securities available for sale; plus assets derecognized as an offset to accumulated other comprehensive income resulting from the adoption and application of SFAS No. 158.

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### **Risk Management**

#### **Overview**

Like other financial services companies, Key engages in business activities with inherent risks. The ability to properly and effectively identify, measure, monitor and report such risks is essential to maintaining safety and soundness and to maximizing profitability. Management believes that the most significant risks facing Key are market risk, liquidity risk, credit risk and operational risk, and that these risks must be managed across the entire enterprise. Key continues to enhance its Enterprise Risk Management practices and program, and uses a risk adjusted capital framework to manage these risks. This framework is approved and managed by the Risk Capital Committee, which consists of senior finance, risk management and business executives. Each type of risk is defined and discussed in greater detail in the remainder of this section.

Key's Board of Directors has established and follows a corporate governance program that serves as the foundation for managing and mitigating risk. In accordance with this program, the Board focuses on the interests of shareholders, encourages strong internal controls, demands management accountability, mandates adherence to Key's code of ethics and administers an annual self-assessment process. The Audit and Risk Management committees help the Board meet these risk oversight responsibilities. The responsibilities of these two committees are summarized on page 46 of Key's 2007 Annual Report to Shareholders.

#### **Market risk management**

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

#### Interest rate risk management

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

Interest rate risk positions can be influenced by a number of factors other than changes in market interest rates, including economic conditions, the competitive environment within Key's markets, consumer preferences for specific loan and deposit products, and the level of interest rate exposure arising from basis risk, gap risk, yield curve risk and option risk. Each of these types of risk is defined in the discussion of market risk management, which begins on page 46 of Key's 2007 Annual Report to Shareholders.

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

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The amount of net interest income at risk is measured by simulating the change in the level of net interest income that would occur if the Federal Funds Target rate were to gradually increase or decrease by 200 basis points over the next twelve months, and term rates were to move in a similar fashion, but not as dramatically. Short-term interest rates were relatively low at June 30, 2008, and as a result management modified the standard rate scenario of a gradual decrease of 200 basis points over twelve months to a gradual decrease of 150 basis points over nine months and no change over the following three months. Management then compares the amount of net interest income at risk to the base case of an unchanged interest rate environment. The analysis also considers sensitivity to changes in a number of other variables, including other market interest rates and deposit mix. In addition, management assesses the potential effect of different shapes in the yield curve, including a sustained flat yield curve and an inverted slope yield curve. (The yield curve depicts the relationship between the yield on a particular type of security and its term to maturity.) Management also performs stress tests to measure the effect on net interest income of an immediate change in market interest rates, as well as changes in assumptions related to the pricing of deposits without contractual maturities, prepayments on loans and securities, and loan and deposit growth.

Simulation analysis produces only a sophisticated estimate of interest rate exposure based on assumptions and judgments related to balance sheet growth, customer behavior, new products, new business volume, pricing and anticipated hedging activities. Management tailors the assumptions to the specific interest rate environment and yield curve shape being modeled, and validates those assumptions on a periodic basis. Consistent with current practice, simulations are performed with the assumption that interest rate risk positions will be actively managed through the use of on- and off-balance sheet financial instruments to achieve the desired risk profile. Actual results may differ from those derived in simulation analysis due to the timing, magnitude and frequency of interest rate changes, actual hedging strategies employed, changes in balance sheet composition, and the possible effects of unanticipated or unknown events.

Figure 28 presents the results of the simulation analysis at June 30, 2008 and 2007. At June 30, 2008, Key's simulated exposure to a change in short-term rates was modestly liability-sensitive and slightly higher than the comparable risk measure at June 30, 2007. ALCO policy guidelines for risk management call for corrective measures if simulation modeling demonstrates that a gradual increase or decrease in short-term rates over the next twelve months would adversely affect net interest income over the same period by more than 2%. As shown in Figure 28, Key is operating within these guidelines.

**Figure 28. Simulated Change in Net Interest Income**

June 30, 2008

|  |               |              |
|--|---------------|--------------|
| Basis point change assumption (short-term rates) | -150          | +200         |
| ALCO policy guidelines                           | -2.00%        | -2.00%       |
| <b>Interest rate risk assessment</b>             | <b>+1.30%</b> | <b>-.96%</b> |

June 30, 2007

|  |               |              |
|--|---------------|--------------|
| Basis point change assumption (short-term rates) | -200          | +200         |
| ALCO policy guidelines                           | -2.00%        | -2.00%       |
| <b>Interest rate risk assessment</b>             | <b>+1.45%</b> | <b>-.32%</b> |

Throughout 2007, Key's interest rate risk exposure gradually changed from relatively neutral to modestly liability-sensitive, with the potential to fluctuate between higher or lower levels of risk, depending on the assumed change in short-term interest rates and the accuracy of management's assumptions related to product pricing and customer behavior. From September 2007 through April 2008, the Federal Reserve reduced the federal funds target rate by 325 basis points. Although the timing and magnitude of further interest rate reductions is uncertain, Key's current positioning is consistent with its long-term bias to be modestly liability-sensitive, which will help protect net interest income in a declining interest rate environment. Key proactively evaluates the need to revise its interest rate risk profile as changes occur in business flows and the outlook for the economy.

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



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

**Management of interest rate exposure.** Management uses the results of its various simulation analyses to formulate strategies to achieve the desired risk profile within the parameters of Key’s capital and liquidity guidelines. Specifically, management actively manages interest rate risk positions by purchasing securities, issuing term debt with floating or fixed interest rates, and using derivatives — predominantly in the form of interest rate swaps, which modify the interest rate characteristics of certain assets and liabilities.

Figure 29 shows all swap positions held by Key for asset/liability management (“A/LM”) purposes. These positions are used to convert the contractual interest rate index of agreed-upon amounts of assets and liabilities (i.e., notional amounts) to another interest rate index. For example, fixed-rate debt is converted to a floating rate through a “receive fixed, pay variable” interest rate swap. The volume, maturity and mix of portfolio swaps changes frequently with changes in balance sheet positions selected to be hedged, and with changes to broader asset/liability management objectives. For more information about how Key uses interest rate swaps to manage its balance sheet, see Note 14 (“Derivatives and Hedging Activities”), which begins on page 31.

**Figure 29. Portfolio Swaps by Interest Rate Risk Management Strategy**

| <i>dollars in millions</i>                                  | June 30, 2008    |               |                  |                       |             | June 30, 2007    |                |
|---|------------------|---------------|------------------|-----------------------|-------------|------------------|----------------|
|   | Notional Amount  | Fair Value    | Maturity (Years) | Weighted-Average Rate |             | Notional Amount  | Fair Value     |
|   |                  |               |                  | Receive               | Pay         |                  |                |
| Receive fixed/pay variable — conventional A/LM <sup>a</sup> | \$ 12,488        | \$ 162        | 1.6              | 4.3%                  | 2.5%        | \$ 7,638         | \$ (26)        |
| Receive fixed/pay variable — conventional debt              | 6,119            | 125           | 20.0             | 5.6                   | 3.1         | 5,163            | (172)          |
| Receive fixed/pay variable — forward starting               | 300              | 10            | 1.8              | 5.4                   | 2.5         | 3,800            | (35)           |
| Pay fixed/receive variable — conventional debt              | 1,026            | (18)          | 3.8              | 4.2                   | 4.7         | 920              | 3              |
| Foreign currency — conventional debt                        | 2,659            | 135           | 2.5              | 5.2                   | 2.9         | 3,073            | 215            |
| Total portfolio swaps                                       | <u>\$ 22,592</u> | <u>\$ 414</u> | <u>6.8</u>       | <u>4.8%</u>           | <u>2.8%</u> | <u>\$ 20,594</u> | <u>\$ (15)</u> |

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

#### Trading portfolio risk management

Key’s trading derivatives portfolio is described in Note 14. Management uses a value at risk (“VAR”) simulation model to measure the potential adverse effect of changes in interest rates, foreign exchange rates, equity prices and credit spreads on the fair value of Key’s trading portfolio. Using two years of historical information, the model estimates the maximum potential one-day loss with a 95% confidence level. Statistically, this means that losses will exceed VAR, on average, five out of 100 trading days, or three to four times each quarter.

Key manages exposure to market risk in accordance with VAR limits for trading activity that have been approved by the Risk Capital Committee. At June 30, 2008, the aggregate one-day trading limit set by the committee was \$6.4 million. Key is operating within these constraints. During the first six months of 2008, Key’s aggregate daily average, minimum and maximum VAR amounts were \$2.5 million, \$1.7 million and \$3.8 million, respectively. During the same period one year ago, Key’s aggregate daily average, minimum and

maximum VAR amounts were \$1.1 million, \$.7 million and \$1.8 million, respectively.

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In addition to comparing VAR exposure against limits on a daily basis, management monitors loss limits, uses sensitivity measures and conducts stress tests. Risk Management reports Key's market risk exposure to Key's Risk Capital Committee and the Risk Management Committee of the Board of Directors.

### **Liquidity risk management**

Key defines "liquidity" as the ongoing ability to accommodate liability maturities and deposit withdrawals, meet contractual obligations, and fund asset growth and new business transactions at a reasonable cost, in a timely manner and without adverse consequences. Liquidity management involves maintaining sufficient and diverse sources of funding to accommodate planned as well as unanticipated changes in assets and liabilities under both normal and adverse conditions. In addition, Key occasionally guarantees a subsidiary's obligations in transactions with third parties. Management closely monitors the extension of such guarantees to ensure that Key retains ample liquidity to satisfy these obligations.

Key manages liquidity for all of its affiliates on an integrated basis. This approach considers the unique funding sources available to each entity, as well as each entity's capacity to manage through adverse conditions. It also recognizes that adverse market conditions or other events that could negatively affect the availability or cost of liquidity will affect the access of all affiliates to money market funding.

Under ordinary circumstances, management monitors Key's funding sources and measures its capacity to obtain funds in a variety of situations in an effort to maintain an appropriate mix of available and affordable cash. Management has established guidelines or target ranges for various types of wholesale borrowings, such as money market funding and term debt, at various maturities. In addition, management assesses whether Key will need to rely on wholesale borrowings in the future and develops strategies to address those needs.

Key uses several tools as described on page 49 of the 2007 Annual Report to Shareholders to actively manage and maintain liquidity on an ongoing basis.

Key generates cash flows from operations and from investing and financing activities. Since December 31, 2006, prepayments and maturities of securities available for sale have been the primary sources of cash from investing activities. Securities sold in connection with the repositioning of the securities portfolio also provided significant cash inflow during the first quarter of 2007. Investing activities such as lending and purchases of new securities have required the greatest use of cash.

Key relies on financing activities, such as increasing short-term or long-term borrowings, to provide the cash flow needed to support operating and investing activities if that need is not satisfied by deposit growth. Conversely, excess cash generated by operating, investing and deposit-gathering activities may be used to repay outstanding debt or repurchase shares. For example, during 2007, Key used short-term borrowings to pay down long-term debt, while the net increase in deposits funded the growth in portfolio loans and loans held for sale.

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

Management performs stress tests to determine the effect that a potential downgrade in Key's debt ratings or other market disruptions could have on liquidity over various time periods. These debt ratings, which are presented in Figure 30 on page 81, have a direct impact on Key's cost of funds and ability to raise



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funds under normal as well as adverse conditions. The results of the stress tests indicate that, following the occurrence of an adverse event, Key could continue to meet its financial obligations and to fund its operations for at least one year. The stress test scenarios include major disruptions to Key's access to funding markets and consider the potential adverse effect on cash flows. To compensate for the effect of these assumed liquidity pressures, management considers alternative sources of liquidity over different time periods to project how fluctuations on the balance sheet would be managed. Key actively manages several alternatives for enhancing liquidity, including generating client deposits, securitizing or selling loans, extending the level or maturity of wholesale borrowings, purchasing deposits from other banks, and developing relationships with fixed income investors in a variety of markets. Management also measures Key's capacity to borrow using various debt instruments and funding markets.

Certain credit markets that Key participates in and relies upon as sources of funding have been significantly disrupted and highly volatile since July 2007. As a means of maintaining adequate liquidity, Key, like many other financial institutions, has relied more heavily on the liquidity and stability present in the short-term and secured credit markets since access to unsecured term debt has been restricted. Short-term funding has been available and cost effective. However, if further market disruption were to also reduce the cost effectiveness and availability of these funds for a prolonged period of time, management may need to secure other funding alternatives.

Key maintains a liquidity contingency plan that outlines the process for addressing a liquidity crisis. The plan provides for an evaluation of funding sources under various market conditions. It also assigns specific roles and responsibilities for effectively managing liquidity through a problem period. Key has access to various sources of money market funding (such as federal funds purchased, securities sold under repurchase agreements, eurodollars and commercial paper), and also has secured borrowing facilities established at the Federal Home Loan Bank of Cincinnati, the U.S. Treasury Department and the Federal Reserve Bank of Cleveland to facilitate short-term liquidity requirements.

The Consolidated Statements of Cash Flows on page 6 summarize Key's sources and uses of cash by type of activity for the six-month periods ended June 30, 2008 and 2007.

### Liquidity for KeyCorp (the "parent company" or "parent")

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

Management's primary tool for assessing parent company liquidity is the net short-term cash position, which measures the ability to fund debt maturing in twelve months or less with existing liquid assets. Another key measure of parent company liquidity is the "liquidity gap," which represents the difference between projected liquid assets and anticipated financial obligations over specified time horizons. Key generally relies upon the issuance of term debt to manage the liquidity gap within targeted ranges assigned to various time periods.

The parent company has met its liquidity requirements principally through receiving regular dividends from KeyBank. Federal banking law limits the amount of capital distributions that a bank can make to its holding company without prior regulatory approval. A national bank's dividend-paying capacity is affected by several factors, including net profits (as defined by statute) for the two previous calendar years and for the current year up to the date of dividend declaration. During the first six months of 2008, KeyBank did not pay any dividends to the parent, and nonbank subsidiaries paid the parent a total of \$3 million in dividends. As of the close of business on June 30, 2008, KeyBank would not have been permitted to pay dividends to the parent without prior regulatory approval since the bank had a year-to-date net loss of \$838 million. During the second quarter of 2008, the parent made a \$500 million capital infusion to KeyBank in the form of cash.

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The parent company generally maintains excess funds in interest-bearing deposits in an amount sufficient to meet projected debt maturities over the next twelve months. At June 30, 2008, the parent company held \$2.7 billion in short-term investments, which management projected to be sufficient to meet debt repayment obligations over a period of approximately 63 months.

During the first quarter of 2008, the KeyCorp Capital X trust issued \$740 million of capital securities. In addition to increasing Key's Tier I capital, this transaction created additional liquidity for the parent company.

During the second quarter of 2008, the parent company issued \$650 million of noncumulative perpetual convertible preferred stock and \$1.0 billion of additional common stock in light of the charges recorded in connection with an adverse federal court decision in the AWG Leasing Litigation. In addition to strengthening the company's capital position, this transaction provided additional liquidity for the parent company.

### Additional sources of liquidity

Management has implemented several programs, as described below, that enable the parent company and KeyBank to raise funding in the public and private markets when the capital markets are functioning normally. The proceeds from most of these programs can be used for general corporate purposes, including acquisitions. Each of the programs is replaced or renewed as needed. There are no restrictive financial covenants in any of these programs. In addition, certain KeyCorp subsidiaries maintain credit facilities with the parent company or third parties, which provide alternative sources of funding in light of current market conditions. KeyCorp is the guarantor of some of the third-party facilities.

**Bank note program.** KeyBank's bank note program provides for the issuance of up to \$20.0 billion of notes. These notes may have original maturities from thirty days up to thirty years. KeyBank issued \$555 million of notes under this program during the first six months of 2008. At June 30, 2008, \$17.5 billion was available for future issuance.

**Euro medium-term note program.** Under Key's euro medium-term note program, the parent company and KeyBank may issue both long- and short-term debt of up to \$10.0 billion in the aggregate (\$9.0 billion by KeyBank and \$1.0 billion by the parent company). The notes are offered exclusively to non-U.S. investors and can be denominated in U.S. dollars or foreign currencies. Key issued \$26 million of notes under this program during the first six months of 2008. At June 30, 2008, \$7.3 billion was available for future issuance.

**KeyCorp shelf registration, including medium-term note program.** In June 2008, the parent company filed an updated shelf registration statement with the Securities and Exchange Commission under revised rules that allow for the registration of various types of debt and equity securities without limitations on the aggregate amounts available for issuance. Following the closing of the capital raising transactions in June 2008 and the over allotment option in July 2008, KeyCorp's Board had authority to issue up to \$2.8 billion of additional debt and/or equity securities. On June 20, 2008, the parent company filed an updated prospectus, renewing its medium-term note program under which the company may issue notes with original maturities of nine months or more. The parent company issued \$750 million of notes under this program during the first six months of 2008 prior to the June filings.

**Commercial paper.** The parent company has a commercial paper program that provides funding availability of up to \$500 million. As of June 30, 2008, there were no borrowings outstanding under this program.

KeyBank has a separate commercial paper program at a Canadian subsidiary that provides funding availability of up to C\$1.0 billion in Canadian currency. The borrowings under this program can be denominated in Canadian or U.S. dollars. As of June 30, 2008, borrowings outstanding under this commercial paper program totaled C\$420 million in Canadian currency and \$121 million in U.S. currency (equivalent to C\$124 million in Canadian currency).

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Key's debt ratings are shown in Figure 30. Management believes that these debt ratings, under normal conditions in the capital markets, will enable the parent company or KeyBank to effect future offerings of securities that would be marketable to investors at a competitive cost. Current conditions in the capital markets are not normal and for regional banking institutions, such as Key, access to the capital markets for unsecured term debt continues to be severely restricted, with investors requiring historically wide spreads over "benchmark" U.S. Treasury obligations.

**Figure 30. Debt Ratings**

|   | Short-Term<br>Borrowings | Senior<br>Long-Term<br>Debt | Subordinated<br>Long-Term<br>Debt | Capital<br>Securities | Enhanced<br>Trust<br>Preferred<br>Securities |
|---|--------------------------|-----------------------------|-----------------------------------|-----------------------|--|
| <b>June 30, 2008</b>                            |                          |                             |                                   |                       |  |
| <b>KEYCORP (THE PARENT COMPANY)</b>             |                          |                             |                                   |                       |  |
| Standard & Poor's                               | A-2                      | A-                          | BBB+                              | BBB                   | BBB  |
| Moody's   | P-1                      | A2                          | A3                                | A3                    | A3   |
| Fitch   | F1                       | A                           | A-                                | A-                    | A-   |
| DBRS  | R-1 (low)                | A                           | A (low)                           | N/A                   | A (low)                                      |
| <b>KEYBANK</b>                                  |                          |                             |                                   |                       |  |
| Standard & Poor's                               | A-1                      | A                           | A-                                | N/A                   | N/A  |
| Moody's   | P-1                      | A1                          | A2                                | N/A                   | N/A  |
| Fitch   | F1                       | A                           | A-                                | N/A                   | N/A  |
| DBRS  | R-1 (middle)             | A (high)                    | A                                 | N/A                   | N/A  |
| <b>KEY NOVA SCOTIA FUNDING COMPANY ("KNSF")</b> |                          |                             |                                   |                       |  |
| DBRS <sup>a</sup>                               | R-1 (middle)             | A (high)                    | N/A                               | N/A                   | N/A  |

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

N/A = Not Applicable

### Credit risk management

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

**Credit policy, approval and evaluation.** Key manages credit risk exposure through a multifaceted program. Independent committees approve both retail and commercial credit policies. These policies are communicated throughout Key to foster a consistent approach to granting credit. For more information about Key's credit policies, as well as related approval and evaluation processes, see the section entitled "Credit policy, approval and evaluation" on page 51 of Key's 2007 Annual Report to Shareholders.

Key actively manages the overall loan portfolio in a manner consistent with asset quality objectives. This process entails the use of credit derivatives  $\frac{3}{4}$  primarily credit default swaps  $\frac{3}{4}$  to mitigate Key's credit risk. Credit default swaps enable Key to transfer a portion of the credit risk associated with a particular extension of credit to a third party, and to manage portfolio concentration and correlation risks. At June 30, 2008, Key used credit default swaps with a notional amount of \$1.3 billion to manage the credit risk associated with specific commercial lending obligations. Occasionally, Key will provide credit protection to other lenders through the sale of credit default swaps. These transactions may generate fee income and can diversify overall exposure to credit loss. At June 30, 2008, the notional amount of credit default swaps sold by Key was \$203 million.

Credit default swaps are recorded on the balance sheet at fair value. Related gains or losses, as well as the premium paid or received for credit protection, are included in the

trading income component of noninterest income. These swaps added \$6 million to Key's operating results for the six-month period ended June 30, 2008.

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

Selected asset quality statistics for Key for each of the past five quarters are presented in Figure 31. The factors that drive these statistics are discussed in the remainder of this section.

**Figure 31. Selected Asset Quality Statistics**

| <i>dollars in millions</i>  | 2008     |          | 2007     |        |        |
|---|----------|----------|----------|--------|--------|
|   | Second   | First    | Fourth   | Third  | Second |
| Net loan charge-offs  | \$ 524   | \$ 121   | \$ 119   | \$ 59  | \$ 53  |
| Net loan charge-offs to average loans from continuing operations                            | 2.75%    | .67%     | .67%     | .35%   | .32%   |
| Nonperforming loans at period end   | \$ 814   | \$ 1,054 | \$ 687   | \$ 498 | \$ 276 |
| Nonperforming loans to period-end portfolio loans   | 1.07%    | 1.38%    | .97%     | .72%   | .41%   |
| Nonperforming assets at period end  | \$ 1,210 | \$ 1,115 | \$ 764   | \$ 570 | \$ 378 |
| Nonperforming assets to period-end portfolio loans plus OREO and other nonperforming assets | 1.59%    | 1.46%    | 1.08%    | .83%   | .57%   |
| Allowance for loan losses   | \$ 1,421 | \$ 1,298 | \$ 1,200 | \$ 955 | \$ 945 |
| Allowance for loan losses to period-end loans   | 1.87%    | 1.70%    | 1.69%    | 1.38%  | 1.42%  |
| Allowance for loan losses to nonperforming loans  | 174.57   | 123.15   | 174.67   | 191.77 | 342.39 |

**Watch and criticized assets.** *Watch assets* are troubled commercial loans with the potential to deteriorate in quality due to the client's current financial condition and possible inability to perform in accordance with the terms of the underlying contract. *Criticized assets* are troubled loans and other assets that show additional signs of weakness that may lead, or have led, to an interruption in scheduled repayments from primary sources, potentially requiring Key to rely on repayment from secondary sources, such as collateral liquidation.

At June 30, 2008, the levels of watch assets and criticized assets were higher than they were a year earlier. Both watch and criticized levels increased in most of the commercial lines of business. The most significant increase occurred in the Real Estate Capital and Corporate Banking Services line of business, due principally to deteriorating market conditions in the residential properties segment of Key's commercial real estate construction portfolio.

**Allowance for loan losses.** The allowance for loan losses at June 30, 2008, was \$1.421 billion, or 1.87% of loans, and included the impact of \$32 million of allowance added in the January 1, 2008, acquisition of U.S.B. Holding Co., Inc. and an additional provision for loan losses recorded in connection with the March 2008 transfer of \$3.3 billion of education loans from held-for-sale status to the loan portfolio. This compares to an allowance of \$945 million, or 1.42%, at June 30, 2007. The allowance includes \$166 million that was specifically allocated for impaired loans of \$564 million at June 30, 2008, compared to \$23 million that was allocated for impaired loans of \$53 million one year ago. For more information about impaired loans, see Note 9 ("Nonperforming Assets and Past Due Loans") on page 24. At June 30, 2008, the allowance for loan losses was 174.57% of nonperforming loans, compared to 342.39% at June 30, 2007.

Management estimates the appropriate level of the allowance for loan losses on at least a quarterly basis. The methodology used is described in Note 1 ("Summary of Significant Accounting Policies") under the heading "Allowance for Loan Losses" on page 67 of Key's 2007 Annual Report to Shareholders. Briefly, management estimates the appropriate level of Key's allowance for loan losses by applying historical loss rates to existing loans with similar risk characteristics and by exercising judgment to assess the impact of factors, such as changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. If an impaired loan has an outstanding balance greater than \$2.5 million, management conducts further analysis to determine the

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probable loss content, and assigns a specific allowance to the loan if deemed appropriate, considering the results of the analysis and other relevant factors. A specific allowance also may be assigned — even when sources of repayment appear sufficient — if management remains uncertain about whether the loan will be repaid in full. The allowance for loan losses at June 30, 2008, represents management's best estimate of the losses inherent in the loan portfolio at that date.

As shown in Figure 32, Key's allowance for loan losses increased by \$476 million, or 50%, during the past twelve months. This increase was attributable primarily to deteriorating conditions in the commercial real estate portfolio, and in the commercial and financial portfolio within the Real Estate Capital and Corporate Banking Services line of business. Also contributing to the increase was the impact of the U.S.B. Holding Co., Inc. acquisition and the March 2008 transfer of education loans from held-for-sale status to the loan portfolio. During the second quarter of 2008, Key experienced further deterioration in the credit quality of those education loans associated with trade schools or non-Title IV institutions. Management expects losses related to these loans to remain elevated over the remainder of this year, but below the level of losses experienced in the second quarter.

**Figure 32. Allocation of the Allowance for Loan Losses**

| <i>dollars in millions</i>              | June 30, 2008 |   |   | December 31, 2007 |   |   | June 30, 2007 |   |   |
|---|---------------|---|---|-------------------|---|---|---------------|---|---|
|   | Amount        | Percent of<br>Allowance to<br>Total Allowance | Percent of<br>Loan Type to<br>Total Loans | Amount            | Percent of<br>Allowance to<br>Total Allowance | Percent of<br>Loan Type to<br>Total Loans | Amount        | Percent of<br>Allowance to<br>Total Allowance | Percent of<br>Loan Type to<br>Total Loans |
| Commercial, financial and agricultural  | \$ 504        | 35.5%   | 34.2%                                     | \$ 392            | 32.6%   | 35.0%                                     | \$ 357        | 37.8%   | 32.7%                                     |
| Real estate — commercial mortgage       | 244           | 17.2  | 14.2                                      | 206               | 17.2  | 13.6                                      | 169           | 17.9  | 13.0                                      |
| Real estate — construction a            | 264           | 18.6  | 10.3                                      | 326               | 27.2  | 11.4                                      | 135           | 14.3  | 12.3                                      |
| Commercial lease financing              | 137           | 9.6   | 12.7                                      | 125               | 10.4  | 14.4                                      | 127           | 13.4  | 15.2                                      |
| Total commercial loans                  | 1,149         | 80.9  | 71.4                                      | 1,049             | 87.4  | 74.4                                      | 788           | 83.4  | 73.2                                      |
| Real estate — residential mortgage      | 5             | .3  | 2.5                                       | 7                 | .6  | 2.3                                       | 12            | 1.3   | 2.4                                       |
| Home equity:                            |               |   |   |                   |   |   |               |   |   |
| Community Banking                       | 40            | 2.8   | 13.0                                      | 53                | 4.4   | 13.6                                      | 58            | 6.1   | 14.6                                      |
| National Banking                        | 25            | 1.8   | 1.5                                       | 19                | 1.6   | 1.8                                       | 17            | 1.8   | 1.7                                       |
| Total home equity loans                 | 65            | 4.6   | 14.5                                      | 72                | 6.0   | 15.4                                      | 75            | 7.9   | 16.3                                      |
| Consumer other — Community Banking      | 32            | 2.2   | 1.7                                       | 31                | 2.6   | 1.8                                       | 31            | 3.3   | 2.0                                       |
| Consumer other — National Banking:      |               |   |   |                   |   |   |               |   |   |
| Marine                                  | 35            | 2.5   | 4.8                                       | 28                | 2.3   | 5.1                                       | 26            | 2.7   | 5.2                                       |
| Education b                             | 133           | 9.4   | 4.7                                       | 5                 | .4  | .5  | 4             | .4  | .5  |
| Other                                   | 2             | .1  | .4  | 8                 | .7  | .5  | 9             | 1.0   | .4  |
| Total consumer other — National Banking | 170           | 12.0  | 9.9                                       | 41                | 3.4   | 6.1                                       | 39            | 4.1   | 6.1                                       |
| Total consumer loans                    | 272           | 19.1  | 28.6                                      | 151               | 12.6  | 25.6                                      | 157           | 16.6  | 26.8                                      |
| Total                                   | \$ 1,421      | 100.0%  | 100.0%                                    | \$ 1,200          | 100.0%  | 100.0%                                    | \$ 945        | 100.0%  | 100.0%                                    |

- (a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.
- (b) On March 31, 2008, Key transferred \$3.3 billion of education loans from loans held for sale to the loan portfolio.

Key's provision for loan losses from continuing operations was \$647 million for the second quarter of 2008, compared to \$53 million for the year-ago quarter. The increase in the provision was due primarily to a higher level of net loan charge-offs recorded in the commercial real estate portfolio. As previously reported, Key has undertaken a process to reduce its exposure in the residential properties segment of its construction loan portfolio through the planned sale of certain loans. In conjunction with these efforts, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status in June. As of June 30, 2008, sales had closed on \$44 million of these loans. With respect to the balance, Key is working with bidders to finalize sales terms and documentation, and management anticipates that sales of the majority of the remaining \$340 million of loans, which are on nonperforming status, will close during the third quarter. Key's provision for loan losses for the second quarter of 2008 exceeded its net loan charge-offs by \$123 million, as the company continued to build reserves.

**Net loan charge-offs.** Net loan charge-offs for the second quarter of 2008 were \$524 million, or 2.75% of average loans from continuing operations. These results compare to net charge-offs of \$53 million, or .32%, for the same period last year. Figure 33 shows the composition of Key's loan charge-offs and recoveries by type of loan, while the trend in Key's net loan charge-offs by loan type is presented in Figure 34.

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As shown in Figure 34, the largest increases in net charge-offs compared to the second quarter of 2007 occurred in the commercial, financial and agricultural portfolio; the residential properties segment of the real estate construction portfolio and the consumer portfolio. The higher level of net charge-offs in the real estate construction portfolio reflects the actions taken to sell certain loans. More than half of the increase in net charge-offs in the consumer portfolio derived from approximately \$780 million of education loans, predominantly loans associated with non-Title IV schools, which the company stopped underwriting in mid-2006.

**Figure 33. Summary of Loan Loss Experience**

| <i>dollars in millions</i>                           | Three months ended<br>June 30, |                  | Six months ended<br>June 30, |                  |
|--|--------------------------------|------------------|------------------------------|------------------|
|  | 2008                           | 2007             | 2008                         | 2007             |
| Average loans outstanding from continuing operations | <u>\$ 76,652</u>               | <u>\$ 66,315</u> | <u>\$ 74,670</u>             | <u>\$ 65,994</u> |
| Allowance for loan losses at beginning of period     | \$ 1,298                       | \$ 944           | \$ 1,200                     | \$ 944           |
| Loans charged off:                                   |                                |                  |                              |                  |
| Commercial, financial and agricultural               | 75                             | 30               | 125                          | 47               |
| Real estate — commercial mortgage                    | 15                             | 5                | 19                           | 11               |
| Real estate — construction                           | 340                            | 2                | 365                          | 3                |
| Total commercial real estate loans a,b               | 355                            | 7                | 384                          | 14               |
| Commercial lease financing                           | 18                             | 9                | 33                           | 22               |
| Total commercial loans                               | 448                            | 46               | 542                          | 83               |
| Real estate — residential mortgage                   | 2                              | 1                | 6                            | 2                |
| Home equity:   |                                |                  |                              |                  |
| Community Banking                                    | 9                              | 5                | 18                           | 10               |
| National Banking                                     | 11                             | 3                | 18                           | 6                |
| Total home equity loans                              | 20                             | 8                | 36                           | 16               |
| Consumer other — Community Banking                   | 11                             | 8                | 20                           | 15               |
| Consumer other — National Banking:                   |                                |                  |                              |                  |
| Marine   | 16                             | 6                | 35                           | 14               |
| Education  | 55                             | 1                | 57                           | 2                |
| Other  | 2                              | 2                | 6                            | 4                |
| Total consumer other — National Banking              | 73                             | 9                | 98                           | 20               |
| Total consumer loans                                 | 106                            | 26               | 160                          | 53               |
| Total loans  | 554                            | 72               | 702                          | 136              |
| Recoveries:  |                                |                  |                              |                  |
| Commercial, financial and agricultural               | 14                             | 6                | 28                           | 13               |
| Real estate — commercial mortgage                    | —                              | 1                | —                            | 4                |
| Real estate — construction                           | 1                              | —                | 1                            | —                |
| Total commercial real estate loans b                 | 1                              | 1                | 1                            | 4                |
| Commercial lease financing                           | 4                              | 4                | 10                           | 7                |



|  |                        |               |                        |               |
|--|------------------------|---------------|------------------------|---------------|
| Total commercial loans   | <b>19</b>              | 11            | <b>39</b>              | 24            |
| Real estate — residential mortgage                               | <b>1</b>               | 1             | <b>1</b>               | 1             |
| Home equity:   |                        |               |                        |               |
| Community Banking  | —                      | 1             | <b>1</b>               | 2             |
| National Banking   | <b>1</b>               | 1             | <b>1</b>               | 1             |
| Total home equity loans  | <b>1</b>               | 2             | <b>2</b>               | 3             |
| Consumer other — Community Banking                               | <b>1</b>               | 1             | <b>3</b>               | 3             |
| Consumer other — National Banking:                               |                        |               |                        |               |
| Marine   | <b>6</b>               | 3             | <b>9</b>               | 6             |
| Education  | <b>1</b>               | 1             | <b>1</b>               | 1             |
| Other  | <b>1</b>               | —             | <b>2</b>               | 1             |
| Total consumer other — National Banking                          | <b>8</b>               | 4             | <b>12</b>              | 8             |
| Total consumer loans   | <b>11</b>              | 8             | <b>18</b>              | 15            |
| Total loans  | <b>30</b>              | 19            | <b>57</b>              | 39            |
| Net loans charged off  | <b>(524)</b>           | (53)          | <b>(645)</b>           | (97)          |
| Provision for loan losses from continuing operations             | <b>647</b>             | 53            | <b>834</b>             | 97            |
| Allowance related to loans acquired, net                         | —                      | —             | <b>32</b>              | —             |
| Foreign currency translation adjustment                          | —                      | 1             | —                      | 1             |
| Allowance for loan losses at end of period                       | <u><b>\$ 1,421</b></u> | <u>\$ 945</u> | <u><b>\$ 1,421</b></u> | <u>\$ 945</u> |
| Net loan charge-offs to average loans from continuing operations | <b>2.75%</b>           | .32%          | <b>1.74%</b>           | .30%          |
| Allowance for loan losses to period-end loans                    | <b>1.87</b>            | 1.42          | <b>1.87</b>            | 1.42          |
| Allowance for loan losses to nonperforming loans                 | <b>174.57</b>          | 342.39        | <b>174.57</b>          | 342.39        |

- (a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.
- (b) See Figure 19 and the accompanying discussion on pages 65 and 66 for more information related to Key's commercial real estate portfolio.

[Table of Contents](#)**Figure 34. Net Loan Charge-offs**

| <i>dollars in millions</i>                                       | 2008          |               | 2007          |              |              |
|--|---------------|---------------|---------------|--------------|--------------|
|  | Second        | First         | Fourth        | Third        | Second       |
| Commercial, financial and agricultural                           | \$ 61         | \$ 36         | \$ 35         | \$ 22        | \$ 24        |
| Real estate — commercial mortgage                                | 15            | 4             | 1             | 2            | 4            |
| Real estate — construction                                       | 339 a         | 25            | 44            | 6            | 2            |
| Commercial lease financing                                       | 14            | 9             | 6             | 8            | 5            |
| Total consumer loans   | 95            | 47            | 33            | 21           | 18           |
| Total net loan charge-offs                                       | <u>\$ 524</u> | <u>\$ 121</u> | <u>\$ 119</u> | <u>\$ 59</u> | <u>\$ 53</u> |
| Net loan charge-offs to average loans from continuing operations | 2.75%         | .67%          | .67%          | .35%         | .32%         |

(a) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.

Management expects Key's quarterly net loan charge-offs to be below the second quarter level during the remainder of the year; however, net loan charge-offs are expected to remain at elevated levels. Additionally, management expects net loan charge-offs to be in the range of 1.20% to 1.60% of average loans for the second half of 2008.

**Nonperforming assets.** Figure 35 shows the composition of Key's nonperforming assets. These assets totaled \$1.210 billion at June 30, 2008, and represented 1.59% of portfolio loans, other real estate owned and other nonperforming assets, compared to \$764 million, or 1.08%, at December 31, 2007, and \$378 million, or .57%, at June 30, 2007.

As shown in Figure 35, the growth in nonperforming assets over the past twelve months was attributable to a higher level of nonperforming loans caused largely by deteriorating market conditions in the residential properties segment of Key's commercial real estate construction portfolio. The majority of the increase in this segment relates to loans outstanding in Florida and southern California. Also contributing to the rise in nonperforming assets was an increase in the level of commercial loans (principally to businesses tied to residential construction) on nonaccrual status.

The decrease in nonperforming loans and the increase in nonperforming assets during the second quarter of 2008 were due primarily to the transfer of commercial real estate construction loans to held-for-sale status.

At June 30, 2008, Key's 20 largest nonperforming loans totaled \$372 million, representing 46% of total loans on nonperforming status. The level of Key's delinquent loans rose over the past twelve months, reflecting the deterioration in the housing market.

[Table of Contents](#)**Figure 35. Summary of Nonperforming Assets and Past Due Loans**

| <i>dollars in millions</i>  | June 30,<br>2008 | March 31,<br>2008 | December 31,<br>2007 | September 30,<br>2007 | June 30,<br>2007 |
|---|------------------|-------------------|----------------------|-----------------------|------------------|
| Commercial, financial and agricultural  | \$ 259           | \$ 147            | \$ 84                | \$ 94                 | \$ 83            |
| Real estate — commercial mortgage   | 107              | 113               | 41                   | 41                    | 41               |
| Real estate — construction  | 256              | 610               | 415                  | 228                   | 23               |
| Total commercial real estate loans a  | 363 b            | 723               | 456                  | 269                   | 64               |
| Commercial lease financing  | 57               | 38                | 28                   | 30                    | 34               |
| Total commercial loans  | 679              | 908               | 568                  | 393                   | 181              |
| Real estate — residential mortgage  | 32               | 34                | 28                   | 29                    | 27               |
| Home equity:  |                  |                   |                      |                       |                  |
| Community Banking   | 61               | 60                | 54                   | 50                    | 46               |
| National Banking  | 14               | 14                | 12                   | 11                    | 9                |
| Total home equity loans   | 75               | 74                | 66                   | 61                    | 55               |
| Consumer other — Community Banking  | 2                | 2                 | 2                    | 2                     | 2                |
| Consumer other — National Banking:  |                  |                   |                      |                       |                  |
| Marine  | 20               | 20                | 20                   | 12                    | 10               |
| Education   | 4                | 15                | 2                    | —                     | —                |
| Other   | 2                | 1                 | 1                    | 1                     | 1                |
| Total consumer other — National Banking   | 26               | 36                | 23                   | 13                    | 11               |
| Total consumer loans  | 135              | 146               | 119                  | 105                   | 95               |
| Total nonperforming loans   | 814              | 1,054             | 687                  | 498                   | 276              |
| Nonperforming loans held for sale   | 342 b            | 9                 | 25                   | 6                     | 4                |
| OREO  | 26               | 29                | 21                   | 21                    | 27               |
| Allowance for OREO losses   | (2)              | (2)               | (2)                  | (1)                   | (2)              |
| OREO, net of allowance  | 24               | 27                | 19                   | 20                    | 25               |
| Other nonperforming assets c  | 30               | 25                | 33                   | 46                    | 73               |
| Total nonperforming assets  | \$ 1,210         | \$ 1,115          | \$ 764               | \$ 570                | \$ 378           |
| Accruing loans past due 90 days or more   | \$ 367           | \$ 283            | \$ 231               | \$ 190                | \$ 181           |
| Accruing loans past due 30 through 89 days  | 852              | 1,169             | 843                  | 717                   | 623              |
| Nonperforming loans to period-end portfolio loans   | 1.07%            | 1.38%             | .97%                 | .72%                  | .41%             |
| Nonperforming assets to period-end portfolio loans plus OREO and other nonperforming assets | 1.59             | 1.46              | 1.08                 | .83                   | .57              |

(a) See Figure 19 and the accompanying discussion on pages 65 and 66 for more information related to Key's commercial real estate portfolio.

- (b) During the second quarter of 2008, Key transferred \$384 million of commercial real estate loans (\$719 million of primarily construction loans, net of \$335 million in net charge-offs) from the loan portfolio to held-for-sale status.
- (c) Primarily investments held by the Private Equity unit within Key's Real Estate Capital and Corporate Banking Services line of business.

Figure 36 shows credit exposure by industry classification in the largest sector of Key's loan portfolio, "commercial, financial and agricultural loans." The types of activity that caused the change in Key's nonperforming loans during each of the last five quarters are summarized in Figure 37.

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Figure 36. Commercial, Financial and Agricultural Loans

| June 30, 2008<br><i>dollars in millions</i> | Total<br>Commitments <sup>a</sup> | Loans<br>Outstanding | Nonperforming Loans |                           |
|---|-----------------------------------|----------------------|---------------------|---------------------------|
|   |                                   |                      | Amount              | % of Loans<br>Outstanding |
| Industry classification:                    |                                   |                      |                     |                           |
| Services                                    | \$ 11,404                         | \$ 4,032             | \$ 9                | .2%                       |
| Manufacturing                               | 10,210                            | 4,099                | 45                  | 1.1                       |
| Retail trade                                | 6,891                             | 3,896                | 4                   | .1                        |
| Public utilities                            | 4,791                             | 1,068                | 1                   | .1                        |
| Financial services                          | 4,497                             | 1,428                | 1                   | .1                        |
| Wholesale trade                             | 3,811                             | 1,793                | 7                   | .4                        |
| Property management                         | 3,256                             | 1,731                | 59                  | 3.4                       |
| Insurance                                   | 2,465                             | 353                  | —                   | —                         |
| Building contractors                        | 2,235                             | 1,011                | 57                  | 5.6                       |
| Transportation                              | 1,971                             | 1,473                | 34                  | 2.3                       |
| Public administration                       | 1,066                             | 439                  | —                   | —                         |
| Mining                                      | 1,034                             | 474                  | —                   | —                         |
| Agriculture/forestry/fishing                | 883                               | 527                  | 1                   | .2                        |
| Communications                              | 826                               | 352                  | 7                   | 2.0                       |
| Individuals                                 | 30                                | 12                   | —                   | —                         |
| Other                                       | 3,769                             | 3,241                | 34                  | 1.0                       |
| Total                                       | <u>\$ 59,139</u>                  | <u>\$ 25,929</u>     | <u>\$ 259</u>       | 1.0%                      |

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

Figure 37. Summary of Changes in Nonperforming Loans

| <i>in millions</i>                            | 2008          |                 | 2007          |               |               |
|---|---------------|-----------------|---------------|---------------|---------------|
|   | Second        | First           | Fourth        | Third         | Second        |
| Balance at beginning of period                | \$ 1,054      | \$ 687          | \$ 498        | \$ 276        | \$ 254        |
| Loans placed on nonaccrual status             | 789           | 566             | 378           | 337           | 130           |
| Charge-offs                                   | (547)         | (144)           | (147)         | (81)          | (72)          |
| Loans sold                                    | (48)          | —               | (13)          | (6)           | (7)           |
| Payments                                      | (86)          | (32)            | (17)          | (13)          | (21)          |
| Transfers to OREO                             | —             | (10)            | (5)           | (12)          | —             |
| Transfer to nonperforming loans held-for-sale | (342)         | (8)             | —             | —             | —             |
| Loans returned to accrual status              | (6)           | (5)             | (7)           | (3)           | (8)           |
| Balance at end of period                      | <u>\$ 814</u> | <u>\$ 1,054</u> | <u>\$ 687</u> | <u>\$ 498</u> | <u>\$ 276</u> |

### Operational risk management

Key, like all businesses, is subject to operational risk, which is the risk of loss resulting from human error, inadequate or failed internal processes and systems, and external events. Operational risk also encompasses compliance (legal) risk, which is the risk of loss from violations of, or noncompliance with, laws, rules, regulations, prescribed practices or

ethical standards. Resulting losses could take the form of explicit charges, increased operational costs, harm to Key's reputation or forgone opportunities. Key seeks to mitigate operational risk through a system of internal controls.

Management continuously strives to strengthen Key's system of internal controls to ensure compliance with laws, rules and regulations, and to improve the oversight of Key's operational risk. For example, a loss-event database is used to track the amounts and sources of operational losses. This tracking mechanism helps to identify weaknesses and to highlight the need to take corrective action. Management also relies upon sophisticated software programs designed to assist in monitoring Key's control processes. This technology has enhanced the reporting of the effectiveness of Key's controls to senior management and the Board of Directors.

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Primary responsibility for managing and monitoring internal control mechanisms lies with the managers of Key's various lines of business. Key's Risk Review function periodically assesses the overall effectiveness of Key's system of internal controls. Risk Review reports the results of reviews on internal controls and systems to senior management and the Audit Committee, and independently supports the Audit Committee's oversight of these controls. A senior management committee, known as the Operational Risk Committee, oversees Key's level of operational risk, and directs and supports Key's operational infrastructure and related activities.

### **Item 3. Quantitative and Qualitative Disclosure about Market Risk**

The information presented in the Market Risk Management section, which begins on page 75 of the Management's Discussion and Analysis of Financial Condition and Results of Operations, is incorporated herein by reference.

### **Item 4. Controls and Procedures**

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

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The information presented in the Legal Proceedings section of Note 13 ("Contingent Liabilities and Guarantees"), which begins on page 29 of the Notes to Consolidated Financial Statements, and in the Lease Financing Transactions section of Note 12 ("Income Taxes"), which begins on page 27 of the Notes to Consolidated Financial Statements, is incorporated herein by reference.

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

The discussion related to Key's common share repurchase activities in the section entitled "Capital," which begins on page 72 of the Management's Discussion and Analysis of Financial Condition and Results of Operations, is incorporated herein by reference.

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

At the 2008 Annual Meeting of Shareholders of KeyCorp held on May 15, 2008, the shareholders elected four directors to serve for three-year terms expiring in 2011, amended the Code of Regulations to require the annual election of all directors, and ratified the appointment by the Audit Committee of the Board of Directors of Ernst & Young LLP as independent auditors of KeyCorp for the year ending December 31, 2008. Director nominees for terms expiring in 2011 were: Edward P. Campbell, H. James Dallas, Lauralee E. Martin and Bill R. Sanford. Directors whose terms in office as directors continued after the Annual Meeting of Shareholders were: Ralph Alvarez, William G. Bares, Carol A. Cartwright, Alexander M. Cutler, Eduardo R. Menascé, Henry L. Meyer III, Thomas C. Stevens and Peter G. Ten Eyck, II.

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The vote on each issue was as follows:

|   | For         | Against   | Abstain    |
|---|-------------|-----------|------------|
| Election of Directors   |             |           |            |
| Edward P. Campbell  | 335,623,289 | *         | 13,398,584 |
| H. James Dallas   | 336,143,129 | *         | 12,878,744 |
| Lauralee E. Martin  | 336,064,327 | *         | 12,957,546 |
| Bill R. Sanford   | 336,023,886 | *         | 12,997,987 |
| Amendment to the Code of Regulations to require the annual election of all Directors                          | 338,542,761 | 4,258,055 | 6,221,057  |
| Ratification of the Appointment of Ernst & Young LLP as Independent Auditors of KeyCorp for Fiscal Year 2008. | 340,860,515 | 3,714,800 | 4,446,558  |

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

**Item 5. Other Information****Thomas W. Bunn's Retirement**

As KeyCorp previously reported on Form 8-K filed on July 10, 2008, Thomas W. Bunn, Vice Chair for KeyCorp's National Banking group and Senior Executive Vice President of KeyBank National Association, has announced his intention to retire from KeyCorp (the "Company"). Pursuant to a letter agreement executed on August 6, 2008 (the "Letter Agreement"), Mr. Bunn has agreed to continue to serve in his present capacity through November 30, 2008, at his current base salary. For his continued services, the Company has agreed to provide a retention bonus of \$1,450,000 to Mr. Bunn payable on December 15, 2008. Mr. Bunn has also agreed to provide transition services to the Company through February 28, 2009. During this period, Mr. Bunn will be paid one-half of his normal salary for such services, as well as a single lump sum cash bonus of \$767,400 payable at the conclusion of this period.

In addition, Mr. Bunn has agreed to not engage in any Competitive Activity (as defined in the Letter Agreement), to solicit any KeyCorp customer, or hire any KeyCorp employee on his own behalf or on behalf of anyone else following his retirement and for an agreed-upon period. Under the Letter Agreement, restricted stock and cash performance awards given to Mr. Bunn will continue to vest or forfeit according to the terms of the plans under which they were issued. Mr. Bunn will also retain the ability to exercise vested stock options for three years from his retirement date in conformity with plan provisions. As of February 28, 2009, Mr. Bunn will forfeit all right, title and interest in his Change of Control Agreement dated December 17, 2007.

The Letter Agreement is attached as Exhibit 10 to this Form 10-Q and incorporated herein by reference.



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### **Housing and Economic Recovery Act of 2008**

On July 30, 2008, the President signed into law the “Housing and Economic Recovery Act of 2008.” This Act is intended to respond to the mortgage crisis that has impaired the U.S. economy over the past year by mandating a number of reforms. Among its many provisions, the Act:

- “ provides mortgage refinancing assistance and expands Federal Housing Administration’s guarantees of mortgages and funding for financial counseling for borrowers;
- “ strengthens the regulation of the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (the “GSEs”) by establishing a new regulator with enhanced authority;
- “ raises the GSE loan limits for mortgages on single family homes;
- “ creates an affordable housing trust fund financed by the GSEs to fund the construction, maintenance and preservation of affordable rental housing for low-income individuals and families;
- “ requires the Federal Reserve and Treasury to consult with the new GSE regulator on issues concerning the safety and soundness of the GSEs;
- “ provides \$4 billion in emergency assistance to communities hardest hit by the foreclosure and subprime crisis to purchase or rehabilitate homes in order to stabilize neighborhoods;
- “ establishes a nationwide loan originator licensing and registration system to set minimum licensing standards to improve the oversight of mortgage brokers and bank loan officers, and requires enhanced loan disclosure documents;
- “ increases lending opportunities in high-cost housing areas for veterans and those with disabilities;
- “ provides tax credits and other benefits to spur home buying and improve access to low-income housing; and
- “ increases the U.S. debt limit by \$800 billion to \$10.6 trillion.

### **Item 6. Exhibits**

- 3.1 Amended and Restated Articles of Incorporation of KeyCorp.
- 3.2 Amended and Restated Code of Regulations of KeyCorp.
- 10 Letter Agreement for Mr. Thomas W. Bunn.
- 15 Acknowledgment of Independent Registered Public Accounting Firm.
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

**Information Available on Website**

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

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

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KEYCORP

(Registrant)

Date: August 8, 2008

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/s/ Robert L. MorrisBy: Robert L. Morris  
Chief Accounting Officer