KEYCORP /NEW/
Form 10-Q
August 02, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

Form 10-Q

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

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2012

or

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

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period From ____ To ____

Commission File Number 1-11302

KeyCorp

(Exact name of registrant as specified in its charter)

Ohio	**34-6542451**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
127 Public Square, Cleveland, Ohio	**44114-1306**
(Address of principal executive offices)	(Zip Code)

(216) 689-3000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No ¨

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

Yes þ No ¨

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

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

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

Yes ¨ No þ

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

Common Shares with a par value of $1 each	943,463,119 Shares
(Title of class)	(Outstanding at July 31, 2012)

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KEYCORP

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PART I. FINANCIAL INFORMATION

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Throughout the Notes to Consolidated Financial Statements (Unaudited) and Management s Discussion & Analysis of Financial Condition & Results of Operations, we use certain acronyms and abbreviations as defined in Note 1 (Basis of Presentation), that begins on page 10.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets

in millions, except per share data	**June 30, 2012 (Unaudited)**	**December 31, 2011**	**June 30, 2011 (Unaudited)**
ASSETS			
Cash and due from banks	**$ 717**	$ 694	$ 853
Short-term investments	**2,216**	3,519	4,563
Trading account assets	**679**	623	769
Securities available for sale	**13,205**	16,012	18,680
Held-to-maturity securities (fair value: $4,396, $2,133 and $19)	**4,352**	2,109	19
Other investments	**1,186**	1,163	1,195
Loans, net of unearned income of $1,155, $1,388 and $1,460	**49,605**	49,575	47,840
Less: Allowance for loan and lease losses	**888**	1,004	1,230
Net loans	**48,717**	48,571	46,610
Loans held for sale	**656**	728	381
Premises and equipment	**931**	944	919
Operating lease assets	**318**	350	453
Goodwill	**917**	917	917
Other intangible assets	**15**	17	19
Corporate-owned life insurance	**3,285**	3,256	3,208
Derivative assets	**818**	945	900
Accrued income and other assets (including $91 of consolidated LIHTC guaranteed funds VIEs, see Note 9)[(a)]	**2,978**	3,077	2,968
Discontinued assets (including $2,611 of consolidated education loan securitization trust VIEs (see Note 9) and $73 of loans in portfolio at fair value)[(a)]	**5,533**	5,860	6,328
Total assets	**$ 86,523**	$ 88,785	$ 88,782
LIABILITIES			
Deposits in domestic offices:			
NOW and money market deposit accounts	**$ 28,957**	$ 27,954	$ 26,277
Savings deposits	**2,103**	1,962	1,973
Certificates of deposit ($100,000 or more)	**3,669**	4,111	4,939
Other time deposits	**5,385**	6,243	7,167
Total interest-bearing	**40,114**	40,270	40,356
Noninterest-bearing	**21,435**	21,098	19,318
Deposits in foreign office interest-bearing	**618**	588	736
Total deposits	**62,167**	61,956	60,410
Federal funds purchased and securities sold under repurchase agreements	**1,716**	1,711	1,668
Bank notes and other short-term borrowings	**362**	337	511
Derivative liabilities	**763**	1,026	991
Accrued expense and other liabilities	**1,417**	1,763	1,518
Long-term debt	**7,521**	9,520	10,997
Discontinued liabilities (including $2,401 of consolidated education loan securitization trust VIEs at fair value, see Note 9)[(a)]	**2,401**	2,550	2,950
Total liabilities	**76,347**	78,863	79,045

EQUITY			
Preferred stock, $1 par value, authorized 25,000,000 shares:			
7.75% Noncumulative Perpetual Convertible Preferred Stock, Series A, $100 liquidation preference; authorized 7,475,000 shares; issued 2,904,839, 2,904,839 and 2,904,839 shares	**291**	291	291
Common shares, $1 par value; authorized 1,400,000,000 shares; issued 1,016,969,905, 1,016,969,905 and 1,016,969,905 shares	**1,017**	1,017	1,017
Capital surplus	**4,120**	4,194	4,191
Retained earnings	**6,595**	6,246	5,926
Treasury stock, at cost (71,496,550, 63,962,113 and 63,147,538)	**(1,796)**	(1,815)	(1,815)
Accumulated other comprehensive income (loss)	**(72)**	(28)	109
Key shareholders equity	**10,155**	9,905	9,719
Noncontrolling interests	**21**	17	18
Total equity	**10,176**	9,922	9,737
Total liabilities and equity	**$ 86,523**	$ 88,785	$ 88,782

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

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Income (Unaudited)

dollars in millions, except per share amounts	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
INTEREST INCOME				
Loans	**$ 518**	$ 551	**$ 1,054**	$ 1,121
Loans held for sale	**5**	3	**10**	7
Securities available for sale	**105**	149	**221**	315
Held-to-maturity securities	**17**	1	**29**	1
Trading account assets	**5**	9	**11**	16
Short-term investments	**2**	1	**3**	2
Other investments	**10**	12	**18**	24
Total interest income	**662**	726	**1,346**	1,486
INTEREST EXPENSE				
Deposits	**71**	100	**148**	210
Federal funds purchased and securities sold under repurchase agreements	**1**	2	**2**	3
Bank notes and other short-term borrowings	**2**	3	**4**	6
Long-term debt	**50**	57	**101**	106
Total interest expense	**124**	162	**255**	325
NET INTEREST INCOME	**538**	564	**1,091**	1,161
Provision (credit) for loan and lease losses	**21**	(8)	**63**	(48)
Net interest income (expense) after provision for loan and lease losses	**517**	572	**1,028**	1,209
NONINTEREST INCOME				
Trust and investment services income	**102**	113	**211**	223
Service charges on deposit accounts	**70**	69	**138**	137
Operating lease income	**20**	32	**42**	67
Letter of credit and loan fees	**56**	47	**110**	102
Corporate-owned life insurance income	**30**	28	**60**	55
Net securities gains (losses)[a]		2		1
Electronic banking fees	**19**	33	**36**	63
Gains on leased equipment	**36**	5	**63**	9
Insurance income	**11**	14	**23**	29
Net gains (losses) from loan sales	**32**	11	**54**	30
Net gains (losses) from principal investing	**24**	17	**59**	52
Investment banking and capital markets income (loss)	**37**	42	**80**	85
Other income	**48**	41	**81**	58
Total noninterest income	**485**	454	**957**	911
NONINTEREST EXPENSE				
Personnel	**389**	380	**774**	751
Net occupancy	**62**	62	**126**	127
Operating lease expense	**15**	25	**32**	53
Computer processing	**43**	42	**84**	84
Business services and professional fees	**51**	44	**89**	82
FDIC assessment	**8**	9	**16**	38
OREO expense, net	**7**	(3)	**13**	7
Equipment	**27**	26	**53**	52
Marketing	**17**	10	**30**	20
Provision (credit) for losses on lending-related commitments	**6**	(12)	**6**	(16)
Other expense	**89**	97	**194**	183
Total noninterest expense	**714**	680	**1,417**	1,381

INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES		**288**		346		**568**		739
Income taxes		**57**		94		**132**		205
INCOME (LOSS) FROM CONTINUING OPERATIONS		**231**		252		**436**		534
Income (loss) from discontinued operations, net of taxes of $6, ($6), $3 and ($12) (see Note 11)		**10**		(9)		**5**		(20)
NET INCOME (LOSS)		**241**		243		**441**		514
Less: Net income (loss) attributable to noncontrolling interests		**5**		3		**5**		11
NET INCOME (LOSS) ATTRIBUTABLE TO KEY	**$**	**236**	$	240	**$**	**436**	$	503
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**221**	$	243	**$**	**420**	$	427
Net income (loss) attributable to Key common shareholders		**231**		234		**425**		407
Per common share:								
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**.23**	$	.26	**$**	**.44**	$	.47
Income (loss) from discontinued operations, net of taxes		**.01**		(.01)		**.01**		(.02)
Net income (loss) attributable to Key common shareholders		**.24**		.25		**.45**		.44
Per common share assuming dilution:								
Income (loss) from continuing operations attributable to Key common shareholders	**$**	**.23**	$	.26	**$**	**.44**	$	.46
Income (loss) from discontinued operations, net of taxes		**.01**		(.01)		**.01**		(.02)
Net income (loss) attributable to Key common shareholders [c]		**.24**		.25		**.45**		.44
Cash dividends declared per common share	**$**	**.05**	$	.03	**$**	**.08**	$	.04
Weighted-average common shares outstanding (000) [b]		**944,648**		947,565		**946,995**		914,911
Weighted-average common shares and potential common shares outstanding (000)		**948,087**		952,133		**951,029**		920,162

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

(b) Assumes conversion of stock options and/or Preferred Series A, as applicable.

(c) EPS may not foot due to rounding.

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Comprehensive Income (Unaudited)

in millions	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Net income (loss)	**$ 241**	$ 243	**$ 441**	$ 514
Other comprehensive income (loss):				
Net unrealized gains (losses) on securities available for sale, net of income taxes of ($25), $73, ($31), and $61	**(42)**	123	**(53)**	103
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of ($2), $9, $5, and $4	**(4)**	15	**8**	7
Foreign currency translation adjustments	**(10)**	4	**(4)**	13
Net pension and postretirement benefit costs, net of income taxes	**3**	2	**5**	3
Other comprehensive income (loss), net of tax:	**188**	387	**397**	640
Net contribution to (distribution from) noncontrolling interests	**4**	(254)	**4**	(239)
Total comprehensive income (loss) attributable to Key	**$ 192**	$ 133	**$ 401**	$ 401

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Changes in Equity (Unaudited)

			Key Shareholders	Equity						
dollars in millions, except per share amounts	**Preferred Shares Outstanding (000)**	**Common Shares Outstanding (000)**	**Preferred Stock**	**Common Shares**	**Common Stock Warrant**	**Capital Surplus**	**Retained Earnings**	**Treasury Stock, at Cost**	**Accumulated Other Comprehensive Income (Loss)**	**Noncontrolling Interests**
BALANCE AT DECEMBER 31, 2010	2,930	880,608	$ 2,737	$ 946	$ 87	$ 3,711	$ 5,557	$ (1,904)	$ (17)	$ 257
Net income (loss)							503			11
Net unrealized gains (losses) on securities available for sale, net of income taxes of $61									103	
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of $4									7	
Net distribution to noncontrolling interests										(250)
Foreign currency translation adjustments									13	
Net pension and postretirement benefit costs, net of income taxes									3	
Deferred compensation						(2)				
Cash dividends declared on common shares ($.04 per share)							(38)			
Cash dividends declared on Noncumulative Series A Preferred Stock ($3.875 per share)							(12)			
Cash dividends accrued on Cumulative Series B Preferred Stock (5% per annum)							(31)			
Series B Preferred Stock - TARP redemption	(25)		(2,451)				(49)			
Repurchase of common stock warrant					(87)	17				
Amortization of discount on Series B Preferred Stock			4				(4)			
Common shares issuance		70,621		71		533				
Common shares reissued for stock options and other employee benefit plans		2,593				(68)		89		
Other			1							
BALANCE AT JUNE 30, 2011	2,905	953,822	$ 291	$ 1,017		$ 4,191	$ 5,926	$ (1,815)	$ 109	$ 18
BALANCE AT DECEMBER 31, 2011	2,905	953,008	$ 291	$ 1,017		$ 4,194	$ 6,246	$ (1,815)	$ (28)	$ 17
Net income (loss)							**436**			**5**
Other comprehensive income (loss):										
Net unrealized gains (losses) on securities available for sale, net of income taxes of ($31)									**(53)**	
Net unrealized gains (losses) on derivative financial instruments, net of income taxes of $5									**8**	
Net distribution from noncontrolling interests										**(1)**
Foreign currency translation adjustments									**(4)**	
Net pension and postretirement benefit costs, net of income taxes									**5**	
Deferred compensation						**8**				
Cash dividends declared on common shares ($.08 per share)							**(76)**			
Cash dividends declared on Noncumulative Series A Preferred Stock ($3.875 per share)							**(11)**			
Common shares repurchased		**(10,468)**						**(82)**		
Common shares reissued (returned) for stock options and other employee benefit plans		**2,933**				**(82)**		**101**		

BALANCE AT JUNE 30, 2012	**2,905**	**945,473**	**$ 291**	**$ 1,017**		**$ 4,120**	**$ 6,595**	**$ (1,796)**	**$ (72)**	**$ 21**

See Notes to Consolidated Financial Statements (Unaudited).

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Consolidated Statements of Cash Flows (Unaudited)

in millions	Six months ended June 30, 2012	2011
OPERATING ACTIVITIES		
Net income (loss)	**$ 441**	$ 514
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Provision (credit) for loan and lease losses	**63**	(48)
Depreciation and amortization expense	**119**	143
FDIC (payments) net of FDIC expense	**13**	35
Deferred income taxes (benefit)	**38**	157
Net losses (gains) and writedown on OREO	**12**	5
Provision (credit) for customer derivative losses	**1**	(12)
Net losses (gains) from loan sales	**(54)**	(30)
Net losses (gains) from principal investing	**(59)**	(52)
Provision (credit) for losses on lending-related commitments	**6**	(16)
(Gains) losses on leased equipment	**(63)**	(9)
Net securities losses (gains)		(1)
Net decrease (increase) in loans held for sale excluding loan transfers from continuing operations	**(5)**	140
Net decrease (increase) in trading account assets	**(57)**	216
Other operating activities, net	**(220)**	412
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	**235**	1,454
INVESTING ACTIVITIES		
Net decrease (increase) in short-term investments	**1,303**	(3,219)
Purchases of securities available for sale	**(10)**	(619)
Proceeds from sales of securities available for sale		1,587
Proceeds from prepayments and maturities of securities available for sale	**2,733**	2,448
Proceeds from prepayments and maturities of held-to-maturity securities	**238**	
Purchases of held-to-maturity securities	**(2,481)**	(2)
Purchases of other investments	**(39)**	(104)
Proceeds from sales of other investments	**3**	43
Proceeds from prepayments and maturities of other investments	**72**	41
Net decrease (increase) in loans, excluding acquisitions, sales and transfers	**(217)**	1,775
Proceeds from loan sales	**135**	94
Purchases of premises and equipment	**(53)**	(74)
Proceeds from sales of premises and equipment	**1**	
Proceeds from sales of other real estate owned	**45**	94
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	**1,730**	2,064
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	**211**	(200)
Net increase (decrease) in short-term borrowings	**30**	(1,017)
Net proceeds from issuance of long-term debt	**4**	1,020
Payments on long-term debt	**(2,019)**	(684)
Repurchase of Treasury Shares	**(82)**	
Net proceeds from issuance of common shares		604
Net proceeds from reissuance of common shares	**1**	
Series B Preferred Stock - TARP redemption		(2,500)
Repurchase of common stock warrant		(70)
Cash dividends paid	**(87)**	(96)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	**(1,942)**	(2,943)
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	**23**	575
CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD	**694**	278
CASH AND DUE FROM BANKS AT END OF PERIOD	**$ 717**	$ 853

Additional disclosures relative to cash flows:		
Interest paid	$ **249**	$ 317
Income taxes paid (refunded)	**26**	(319)
Noncash items:		
Loans transferred to portfolio from held for sale	$ **93**	
Loans transferred to held for sale from portfolio	**16**	$ 54
Loans transferred to other real estate owned	**21**	23

See Notes to Consolidated Financial Statements (Unaudited).

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Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

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

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

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

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

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

The consolidated financial statements include any voting rights entities in which we have a controlling financial interest. In accordance with the applicable accounting guidance for consolidations, we consolidate a VIE if we have: (i) a variable interest in the entity; (ii) the power to direct activities of the VIE that most significantly impact the entity s economic performance; and (iii) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE (i.e., we are considered to be the primary beneficiary). Variable interests can include equity interests, subordinated debt, derivative contracts, leases, service agreements, guarantees, standby letters of credit, loan commitments, and other contracts, agreements and financial instruments. See Note 9 (Variable Interest Entities) for information on our involvement with VIEs.

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

We believe that the unaudited consolidated interim financial statements reflect all adjustments of a normal recurring nature and disclosures that are necessary for a fair presentation of the results for the interim periods presented. The results of operations for the interim period are not necessarily indicative of the results of operations to be expected for the full year. The interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our 2011 Annual Report on Form 10-K. See Note 11 (Acquisition and Discontinued Operations) for further information regarding an error correction that was made during the third quarter of 2011.

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

On August 1, 2012, we announced certain new strategic actions to further strengthen our consumer and commercial payments businesses. We have acquired Key-branded credit card assets from Elan Financial Services and will begin to self-issue credit cards. The acquired credit card portfolio of approximately 400,000 consumer and business accounts is comprised of current and former Key clients and has approximately $725 million in credit card assets. We also announced that we entered into a new third party processing agreement with Elavon, Inc. This new agreement continues the legacy arrangement with Elavon while providing Key the opportunity to more fully integrate merchant processing services into our overall payment solutions for business clients. This new arrangement with Elavon is expected to become effective in the first half of 2013.

Offsetting Derivative Positions

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

Accounting Guidance Adopted in 2012

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

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

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

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

Accounting Guidance Pending Adoption at June 30, 2012

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

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

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2. Earnings Per Common Share

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

dollars in millions, except per share amounts	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
EARNINGS				
Income (loss) from continuing operations	**$ 231**	$ 252	**$ 436**	$ 534
Less: Net income (loss) attributable to noncontrolling interests	**5**	3	**5**	11
Income (loss) from continuing operations attributable to Key	**226**	249	**431**	523
Less: Dividends on Series A Preferred Stock	**5**	6	**11**	12
Cash dividends on Series B Preferred Stock [b]				31
Amortization of discount on Series B Preferred Stock[b]				53
Income (loss) from continuing operations attributable to Key common shareholders	**221**	243	**420**	427
Income (loss) from discontinued operations, net of taxes[a]	**10**	(9)	**5**	(20)
Net income (loss) attributable to Key common shareholders	**$ 231**	$ 234	**$ 425**	$ 407
WEIGHTED-AVERAGE COMMON SHARES				
Weighted-average common shares outstanding (000)	**944,648**	947,565	**946,995**	914,911
Effect of dilutive convertible preferred stock, common share options and other stock awards (000)	**3,439**	4,568	**4,034**	5,251
Weighted-average common shares and potential common shares outstanding (000)	**948,087**	952,133	**951,029**	920,162
EARNINGS PER COMMON SHARE				
Income (loss) from continuing operations attributable to Key common shareholders	**$ .23**	$ .26	**$ .44**	$ .47
Income (loss) from discontinued operations, net of taxes [a]	**.01**	(.01)	**.01**	(.02)
Net income (loss) attributable to Key common shareholders[c]	**.24**	.25	**.45**	.44
Income (loss) from continuing operations attributable to Key common shareholders assuming dilution	**$ .23**	$ .26	**$ .44**	$ .46
Income (loss) from discontinued operations, net of taxes [a]	**.01**	(.01)	**.01**	(.02)
Net income (loss) attributable to Key common shareholders assuming dilution[c]	**.24**	.25	**.45**	.44

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

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

(c) EPS may not foot due to rounding.

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3. Loans and Loans Held for Sale

Our loans by category are summarized as follows:

in millions	June 30, 2012	December 31, 2011	June 30, 2011
Commercial, financial and agricultural	**$ 20,386**	$ 19,378	$ 16,883
Commercial real estate:			
Commercial mortgage	**7,409**	8,037	8,069
Construction	**1,172**	1,312	1,631
Total commercial real estate loans	**8,581**	9,349	9,700
Commercial lease financing	**5,636**	6,055	6,105
Total commercial loans	**34,603**	34,782	32,688
Residential prime loans:			
Real estate residential mortgage	**2,016**	1,946	1,838
Home equity:			
Key Community Bank	**9,601**	9,229	9,431
Other	**479**	535	595
Total home equity loans	**10,080**	9,764	10,026
Total residential prime loans	**12,096**	11,710	11,864
Consumer other Key Community Bank	**1,263**	1,192	1,157
Consumer other:			
Marine	**1,542**	1,766	1,989
Other	**101**	125	142
Total consumer other	**1,643**	1,891	2,131
Total consumer loans	**15,002**	14,793	15,152
Total loans [(a)]	**$ 49,605**	$ 49,575	$ 47,840

(a) Excluded at June 30, 2012, December 31, 2011, and June 30, 2011, are loans in the amount of $5.5 billion, $5.8 billion and $6.3 billion, respectively, related to the discontinued operations of the education lending business.

Our loans held for sale are summarized as follows:

in millions	June 30, 2012	December 31, 2011	June 30, 2011
Commercial, financial and agricultural	**$ 18**	$ 19	$ 80
Real estate commercial mortgage	**523**	567	198
Real estate construction	**12**	35	39
Commercial lease financing	**13**	12	6
Real estate residential mortgage	**90**	95	58
Total loans held for sale	**$ 656**	$ 728	$ 381

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

in millions	June 30, 2012	December 31, 2011	June 30, 2011
Balance at beginning of the period	**$ 511**	$ 479	$ 426
New originations	**1,308**	1,235	914
Transfers from held to maturity, net	**7**	19	16
Loan sales	**(1,165)**	(932)	(1,039)
Loan draws (payments), net	**(4)**	(72)	73
Transfers to OREO / valuation adjustments	**(1)**	(1)	(9)
Balance at end of perod	**$ 656**	$ 728	$ 381

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4. Asset Quality

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

Our nonperforming assets and past due loans were as follows:

in millions	June 30, 2012	December 31, 2011	June 30, 2011
Total nonperforming loans [(a)]	**$ 657**	$ 727	$ 842
Nonperforming loans held for sale	**38**	46	42
OREO	**28**	65	52
Other nonperforming assets	**28**	21	14
Total nonperforming assets	**$ 751**	$ 859	$ 950
Restructured loans included in nonperforming loans [(b)]	**$ 163**	$ 191	$ 144
Restructured loans with an allocated specific allowance [(c)]	**71**	50	19
Specifically allocated allowance for restructured loans [(d)]	**34**	10	5
Accruing loans past due 90 days or more	**$ 131**	$ 164	$ 118
Accruing loans past due 30 through 89 days	**362**	441	465

(a) Includes $36 million of performing home equity second liens at June 30, 2012, that are: subordinate to first liens that are 120 days or more past due; in foreclosure; or when the first mortgage delinquency timeframe is unknown. Such second liens are now being reported as nonperforming loans based upon regulatory guidance issued in January, 2012. This policy related to the classification of second lien home equity loans was implemented prospectively, and therefore prior periods were not presented.

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

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

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

At June 30, 2012, the approximate carrying amount of our commercial nonperforming loans outstanding represented 59% of their original contractual amount, total nonperforming loans outstanding represented 70% of their original contractual amount owed, and nonperforming assets in total were carried at 64% of their original contractual amount.

At June 30, 2012, our twenty largest nonperforming loans totaled $220 million, representing 33% of total loans on nonperforming status from continuing operations. At June 30, 2011, the twenty largest nonperforming loans totaled $276 million, representing 33% of total loans on nonperforming status.

The amount by which nonperforming loans and loans held for sale reduced expected interest income was $12 million for the six months ended June 30, 2012, and $31 million for the year ended December 31, 2011.

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

June 30, 2012 *in millions*	**Recorded Investment** (a)	**Unpaid Principal Balance** (b)	**Specific Allowance**	**Average Recorded Investment**
With no related allowance recorded:				
Commercial, financial and agricultural	$ 59	$ 142		$ 68
Commercial real estate:				
Commercial mortgage	112	199		113
Construction	51	204		49
Total commercial real estate loans	163	403		162
Total commercial loans with no related allowance recorded	222	545		230
Real estate residential mortgage	1	1		1
Total consumer loans	1	1		1
Total loans with no related allowance recorded	223	546		231
With an allowance recorded:				
Commercial, financial and agricultural	43	53	$ 12	46
Commercial real estate:				
Commercial mortgage	56	98	15	63
Construction	4	4	3	4
Total commercial real estate loans	60	102	18	67
Total commercial loans with an allowance recorded	103	155	30	113
Real estate residential mortgage	16	17	2	8
Home equity:				
Key Community Bank	11	11	3	6
Other	6	6	1	3
Total home equity loans	17	17	4	9
Consumer other Key Community Bank	2	2	1	1
Consumer other:				
Marine	50	50	11	25
Other				
Total consumer other	50	50	11	25
Total consumer loans	85	86	18	43
Total loans with an allowance recorded	188	241	48	156
Total	$ 411	$ 787	$ 48	$ 387

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

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

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

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

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

June 30, 2011 *in millions*	**Recorded Investment** (a)	**Unpaid Principal Balance** (b)	**Specific Allowance**	**Average Recorded Investment**
With no related allowance recorded:				
Commercial, financial and agricultural	$ 116	$ 217		$ 89
Commercial real estate:				
Commercial mortgage	123	207		143
Construction	83	226		124
Total commercial real estate loans	206	433		267
Total loans with no related allowance recorded	322	650		356
With an allowance recorded:				
Commercial, financial and agricultural	43	71	$ 14	66
Commercial real estate:				
Commercial mortgage	89	174	21	88
Construction	34	73	11	39
Total commercial real estate loans	123	247	32	127
Commercial lease financing				6

Total loans with an allowance recorded	166	318	46	199
Total	$ 488	$ 968	$ 46	$ 555

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

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

For the six months ended June 30, 2012 and 2011, interest income recognized on the outstanding balances of accruing impaired loans totaled $2 million for each period presented.

At June 30, 2012, aggregate restructured loans (accrual, nonaccrual and held-for-sale loans) totaled $274 million, compared to $276 million at December 31, 2011, and $252 million at June 30, 2011. We added $109 million in restructured loans during the first six months of 2012, which were partially offset by $111 million in payments and charge-offs.

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

June 30, 2012 *dollars in millions*	**Number of loans**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
LOAN TYPE			
Nonperforming:			
Commercial, financial and agricultural	95	$ 108	$ 59
Commercial real estate:			
Real estate commercial mortgage	16	47	31
Real estate construction	11	60	43
Total commercial real estate loans	27	107	74
Total commercial loans	122	215	133
Real estate residential mortgage	56	7	7
Home equity:			
Key Community Bank	50	4	4
Other	74	2	1
Total home equity loans	124	6	5
Consumer other Key Community Bank	11	1	1
Consumer other:			
Marine	139	17	17
Other	11	1	
Total consumer other	150	18	17
Total consumer loans	341	32	30
Total nonperforming TDRs	463	247	163
Prior-year accruing [(a)]			
Commercial, financial and agricultural	115	8	6
Commercial real estate:			
Real estate commercial mortgage	7	71	48
Real estate construction	1	15	1
Total commercial real estate loans	8	86	49
Total commercial loans	123	94	55
Real estate residential mortgage	111	11	11
Home equity:			
Key Community Bank	88	7	7
Other	101	3	3
Total home equity loans	189	10	10
Consumer other Key Community Bank	20	1	
Consumer other:			
Marine	135	34	33
Other	53	2	2
Total consumer other	188	36	35
Total consumer loans	508	58	56

Total prior-year accruing TDRs	631		152		111
Total TDRs	1,094	$	399	$	274

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

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

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

Our loan modifications are handled on a case by case basis and are negotiated to achieve mutually agreeable terms that maximize loan collectability and meet our client s financial needs. A majority of our concessions granted to borrowers are in the form of interest rate reductions. Other concession types include forgiveness of principal and other modifications of loan terms. Consumer loan concessions include Home Affordable Modification Program (HAMP) loans of approximately $4

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million as of June 30, 2012. These loan concessions have successfully completed the required trial period under HAMP and as a result have been permanently modified and are included in consumer TDRs.

The following table shows the concession types for our commercial accruing and nonaccruing TDRs.

dollars in millions	**June 30, 2012**	December 31, 2011	June 30, 2011
Interest rate reduction	**$ 155**	$ 177	$ 175
Forgiveness of principal	**13**	23	10
Other modification of loan terms	**20**	8	6
Total	**$ 188**	$ 208	$ 191
Total commercial and consumer TDRs [a]	**$ 274**	$ 276	$ 252
Total commercial TDRs to total commercial loans	**.54 %**	.60 %	.58 %
Total commercial TDRs to total loans	**.38**	.42	.40
Total commercial loans	**$ 34,603**	$ 34,782	$ 32,688
Total loans	**49,605**	49,575	47,840

(a) Commitments outstanding to lend additional funds to borrowers whose terms have been modified in TDRs are $45 million, $25 million, and $45 million at June 30, 2012, December 31, 2011, and June 30, 2011, respectively.

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

At June 30, 2012, approximately $48.5 billion, or 98%, of our total loans are current. At June 30, 2012, total past due loans and nonperforming loans of $1.2 billion represent approximately 2% of total loans.

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

June 30, 2012 *in millions*	**Current**	**30-59 Days Past Due**	**60-89 Days Past Due**	**90 and Greater Days Past Due**	**Nonperforming Loans [a]**	**Total Past Due and Nonperforming Loans**	**Total Loans**
LOAN TYPE							
Commercial, financial and agricultural	$ 20,148	$ 60	$ 13	$ 24	$ 141	$ 238	$ 20,386
Commercial real estate:							
Commercial mortgage	7,182	15	16	24	172	227	7,409
Construction	1,033	12	24	35	68	139	1,172
Total commercial real estate loans	8,215	27	40	59	240	366	8,581
Commercial lease financing	5,581	22	8	7	18	55	5,636

Total commercial loans	$ 33,944	$ 109	$ 61	$ 90	$ 399	$ 659	$ 34,603
Real estate residential mortgage	$ 1,895	$ 24	$ 10	$ 9	$ 78	$ 121	$ 2,016
Home equity:							
Key Community Bank	9,361	56	26	17	141	240	9,601
Other	445	10	4	3	17	34	479
Total home equity loans	9,806	66	30	20	158	274	10,080
Consumer other Key Community Bank	1,237	13	4	7	2	26	1,263
Consumer other:							
Marine	1,478	31	10	4	19	64	1,542
Other	95	2	2	1	1	6	101
Total consumer other	1,573	33	12	5	20	70	1,643
Total consumer loans	$ 14,511	$ 136	$ 56	$ 41	$ 258	$ 491	$ 15,002
Total loans	$ 48,455	$ 245	$ 117	$ 131	$ 657	$ 1,150	$ 49,605

(a) Includes $36 million of performing home equity second liens at June 30, 2012, that are subordinate to first liens that are 120 days or more past due; in foreclosure; or when the first mortgage delinquency is unknown. Such second liens are now being reported as nonperforming loans based upon regulatory guidance issued in January 2012.

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June 30, 2011 *in millions*	Current	30-59 Days Past Due	60-89 Days Past Due	90 and Greater Days Past Due	Nonperforming Loans	Total Past Due and Nonperforming Loans	Total Loans
LOAN TYPE							
Commercial, financial and agricultural	$ 16,599	$ 35	$ 17	$ 19	$ 213	$ 284	$ 16,883
Commercial real estate:							
Commercial mortgage	7,743	34	51	11	230	326	8,069
Construction	1,437	11	24	28	131	194	1,631
Total commercial real estate loans	9,180	45	75	39	361	520	9,700
Commercial lease financing	5,983	20	40	21	41	122	6,105
Total commercial loans	$ 31,762	$ 100	$ 132	$ 79	$ 615	$ 926	$ 32,688
Real estate residential mortgage	$ 1,713	$ 24	$ 14	$ 8	$ 79	$ 125	$ 1,838
Home equity:							
Key Community Bank	9,216	66	32	16	101	215	9,431
Other	559	13	7	5	11	36	595
Total home equity loans	9,775	79	39	21	112	251	10,026
Consumer other Key Community Bank	1,129	14	4	7	3	28	1,157
Consumer other:							
Marine	1,898	42	14	3	32	91	1,989
Other	138	2	1		1	4	142
Total consumer other	2,036	44	15	3	33	95	2,131
Total consumer loans	$ 14,653	$ 161	$ 72	$ 39	$ 227	$ 499	$ 15,152
Total loans	$ 46,415	$ 261	$ 204	$ 118	$ 842	$ 1,425	$ 47,840

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

Most extensions of credit are subject to loan grading or scoring. This risk rating methodology blends our judgment with quantitative modeling. Commercial loans generally are assigned two internal risk ratings. The first rating reflects the probability that the borrower will default on an obligation; the second rating reflects expected recovery rates on the credit facility. Default probability is determined based on, among other factors, the financial strength of the borrower, an assessment of the borrower s management, the borrower s competitive position within its industry sector, and our view of industry risk within the context of the general economic outlook. Types of exposure, transaction structure, and collateral, including credit risk mitigants, affect the expected recovery assessment.

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

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Credit quality indicators for our commercial and consumer loan portfolios based on bond rating, regulatory classification and payment activity as of June 30, 2012, and June 30, 2011, are as follows:

Commercial Credit Exposure

Credit Risk Profile by Creditworthiness Category [(a)]

June 30,
in millions

	Commercial, financial and agricultural		RE Commercial		RE Construction		Commercial Lease		Total	
RATING [(b)] [(c)]	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**
AAA AA	**$ 165**	$ 100		$ 2	**$ 1**	$ 3	**$ 605**	$ 655	**$ 771**	$ 760
A	**680**	671	**$ 64**	63	**1**	1	**992**	1,245	**1,737**	1,980
BBB BB	**17,652**	13,546	**5,925**	5,553	**791**	747	**3,709**	3,590	**28,077**	23,436
B	**868**	955	**553**	941	**58**	262	**197**	343	**1,676**	2,501
CCC C	**1,021**	1,611	**867**	1,510	**321**	618	**133**	272	**2,342**	4,011
Total	**$ 20,386**	$ 16,883	**$ 7,409**	$ 8,069	**$ 1,172**	$ 1,631	**$ 5,636**	$ 6,105	**$ 34,603**	$ 32,688

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

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

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

Consumer Credit Exposure

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

June 30,
in millions

Residential Prime

GRADE	2012	2011
Pass	**$ 11,831**	$ 11,644
Substandard	**265**	220
Total	**$ 12,096**	$ 11,864

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

June 30,	Consumer Key Community Bank		Consumer Marine		Consumer Other		Total	
in millions	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**
Performing	**$ 1,261**	$ 1,154	**$ 1,523**	$ 1,957	**$ 100**	$ 141	**$ 2,884**	$ 3,252
Nonperforming	**2**	3	**19**	32	**1**	1	**22**	36
Total	**$ 1,263**	$ 1,157	**$ 1,542**	$ 1,989	**$ 101**	$ 142	**$ 2,906**	$ 3,288

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

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

We determine the appropriate level of the ALLL on at least a quarterly basis. The methodology is described in Note 1 (Summary of Significant Accounting Policies) under the heading Allowance for Loan and Lease Losses beginning on page 117 of our 2011 Annual Report on Form 10-K. We apply expected loss rates to existing loans with similar risk characteristics as noted in the credit quality indicator table above and exercise judgment to assess the impact of factors such as changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets.

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

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

Commercial loans generally are charged off in full or charged down to the fair value of the underlying collateral when the borrower s payment is 180 days past due. Our charge-off policy for most consumer loans is similar but takes effect when payments are 120 days past due. Home equity and residential mortgage loans generally are charged down to the fair value of the underlying collateral when payment is 180 days past due.

At June 30, 2012, the ALLL was $888 million, or 1.79% of loans, compared to $1.2 billion, or 2.57% of loans, at June 30, 2011. At June 30, 2012, the ALLL was 135.16% of nonperforming loans compared to 146.08% at June 30, 2011.

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

in millions	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Balance at beginning of period continuing operations	**$ 944**	$ 1,372	**$ 1,004**	$ 1,604
Charge-offs	**(131)**	(177)	**(263)**	(409)
Recoveries	**54**	43	**85**	82
Net loans charged off	**(77)**	(134)	**(178)**	(327)
Provision for loan and lease losses from continuing operations	**21**	(8)	**63**	(48)
Foreign currency translation adjustment			**(1)**	1
Balance at end of period continuing operations	**$ 888**	$ 1,230	**$ 888**	$ 1,230

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

in millions	December 31, 2011	Provision	Charge-offs	Recoveries	June 30, 2012
Commercial, financial and agricultural	$ 334	**$ (12)**	**$ (49)**	**$ 31**	**$ 304**
Real estate commercial mortgage	272	**8**	**(46)**	**16**	**250**
Real estate construction	63	**6**	**(16)**	**2**	**55**
Commercial lease financing	78		**(20)**	**10**	**68**
Total commercial loans	747	**2**	**(131)**	**59**	**677**
Real estate residential mortgage	37		**(13)**	**2**	**26**
Home equity:					
Key Community Bank	103	**21**	**(48)**	**4**	**80**
Other	29	**9**	**(17)**	**3**	**24**
Total home equity loans	132	**30**	**(65)**	**7**	**104**
Consumer other Key Community Bank	41	**10**	**(20)**	**3**	**34**
Consumer other:					
Marine	46	**15**	**(30)**	**13**	**44**
Other	1	**5**	**(4)**	**1**	**3**
Total consumer other:	47	**20**	**(34)**	**14**	**47**

Total consumer loans	257	**60**	**(132)**	**26**	**211**
Total ALLL continuing operations	1,004	**62** [(a)]	**(263)**	**85**	**888**
Discontinued operations	104	**6**	**(39)**	**8**	**79**
Total ALLL including discontinued operations	$ 1,108	**$ 68**	**$ (302)**	**$ 93**	**$ 967**

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

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in millions	December 31, 2010	Provision	Charge-offs	Recoveries	June 30, 2011
Commercial, financial and agricultural	$ 485	$ (22)	$ (93)	$ 25	$ 395
Real estate commercial mortgage	416	(18)	(62)	7	343
Real estate construction	145	15	(62)	8	106
Commercial lease financing	175	(53)	(26)	11	107
Total commercial loans	1,221	(78)	(243)	51	951
Real estate residential mortgage	49	7	(17)	2	41
Home equity:					
Key Community Bank	120	30	(53)	2	99
Other	57	4	(26)	2	37
Total home equity loans	177	34	(79)	4	136
Consumer other Key Community Bank	57	9	(23)	4	47
Consumer other:					
Marine	89	(14)	(42)	19	52
Other	11	(5)	(5)	2	3
Total consumer other:	100	(19)	(47)	21	55
Total consumer loans	383	31	(166)	31	279
Total ALLL continuing operations	1,604	(47) [(a)]	(409)	82	1,230
Discontinued operations	114	62	(73)	6	109
Total ALLL including discontinued operations	$ 1,718	$ 15	$ (482)	$ 88	$ 1,339

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

Our ALLL decreased by $342 million, or 28%, since the second quarter of 2011. This contraction was associated with the improvement in credit quality of our loan portfolios, which has trended more favorably over the past six quarters. Our asset quality metrics have showed continued improvement and, therefore, resulted in favorable risk rating migration and a reduction in our general allowance. Our general allowance encompasses the application of expected loss rates to our existing loans with similar risk characteristics and an assessment of factors such as changes in economic conditions and changes in credit policies or underwriting standards. Our delinquency trends showed continued improvement during 2011 and the first-half of 2012. We attribute this improvement to a more moderate level of lending activity, more favorable conditions in the capital markets, improvement in client income statements, and continued run off in our exit loan portfolio.

For continuing operations, the loans outstanding individually evaluated for impairment totaled $411 million, with a corresponding allowance of $48 million at June 30, 2012. Loans outstanding collectively evaluated for impairment totaled $49.2 billion, with a corresponding allowance of $840 million at June 30, 2012.

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

June 30, 2012 *in millions*	**Allowance (a)** Individually Evaluated for Impairment	Collectively Evaluated for Impairment	**Loans**	**Outstanding** [a] Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Commercial, financial and agricultural	$ 12	$ 292	$ 20,386	$ 102	$ 20,284
Commercial real estate:					
Commercial mortgage	15	235	7,409	168	7,241
Construction	3	52	1,172	55	1,117
Total commercial real estate loans	18	287	8,581	223	8,358
Commercial lease financing		68	5,636		5,636
Total commercial loans	30	647	34,603	325	34,278
Real estate residential mortgage	2	24	2,016	17	1,999
Home equity:					
Key Community Bank	3	77	9,601	11	9,590
Other	1	23	479	6	473
Total home equity loans	4	100	10,080	17	10,063
Consumer other Key Community Bank	1	33	1,263	2	1,261
Consumer other:					
Marine	11	33	1,542	50	1,492
Other		3	101		101
Total consumer other	11	36	1,643	50	1,593
Total consumer loans	18	193	15,002	86	14,916
Total ALLL continuing operations	48	840	49,605	411	49,194
Discontinued operations		79	5,483 [b]		5,483
Total ALLL including discontinued operations	$ 48	$ 919	$ 55,088	$ 411	$ 54,677

(a) There were no loans acquired with deteriorated credit quality at June 30, 2012.

(b) Amount includes $2.8 billion of loans carried at fair value that are excluded from ALLL consideration.

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

June 30, 2011 *in millions*	**Allowance** [a] Individually Evaluated for Impairment	Collectively Evaluated for Impairment	**Loans**	**Outstanding** [a] Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Commercial, financial and agricultural	$ 14	$ 381	$ 16,883	$ 159	$ 16,724
Commercial real estate:					
Commercial mortgage	21	322	8,069	213	7,856

Construction	11	95	1,631	116	1,515
Total commercial real estate loans	32	417	9,700	329	9,371
Commercial lease financing		107	6,105		6,105
Total commercial loans	46	905	32,688	488	32,200
Real estate residential mortgage		41	1,838		1,838
Home equity:					
Key Community Bank		99	9,431		9,431
Other		37	595		595
Total home equity loans		136	10,026		10,026
Consumer other Key Community Bank		47	1,157		1,157
Consumer other:					
Marine		52	1,989		1,989
Other		3	142		142
Total consumer other		55	2,131		2,131
Total consumer loans		279	15,152		15,152
Total ALLL continuing operations	46	1,184	47,840	488	47,352
Discontinued operations		109	6,261		6,261
Total ALLL including discontinued operations	$ 46	$ 1,293	$ 54,101	$ 488	$ 53,613

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

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The liability for credit losses inherent in lending-related commitments, such as letters of credit and unfunded loan commitments, is included in accrued expense and other liabilities on the balance sheet. We establish the amount of this reserve by considering both historical trends and current market conditions quarterly, or more often if deemed necessary. Our liability for credit losses on lending-related commitments has decreased by $6 million since the second quarter of 2011 to $51 million at June 30, 2012. When combined with our ALLL, our total allowance for credit losses represented 1.89% of loans at June 30, 2012, compared to 2.69% at June 30, 2011.

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

	Three months ended June 30,		Six months ended June 30,	
in millions	**2012**	**2011**	**2012**	**2011**
Balance at beginning of period	**$ 45**	$ 69	**$ 45**	$ 73
Provision (credit) for losses on lending-related commitments	**6**	(12)	**6**	(16)
Balance at end of period	**$ 51**	$ 57	**$ 51**	$ 57

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5. Fair Value Measurements

Fair Value Determination

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

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

¿ the amount of time since the last relevant valuation;

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

¿ volatility associated with the primary pricing components.

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

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

¿ recurring detailed reviews of profit and loss; and

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

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

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

Qualitative Disclosures of Valuation Techniques

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

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

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

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

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

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

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

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

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

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

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

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Private equity and mezzanine investments are classified as Level 3 assets since our judgment significantly influences the determination of fair value. Our Fund Management, Asset Management, and Accounting groups are responsible for reviewing the valuation models and determining the fair value of these investments on a quarterly basis. Direct investments in properties are initially valued based upon the transaction price. This amount is then adjusted to fair value based on current market conditions using the discounted cash flow method based on the expected investment exit date. The fair value of the assets are reviewed and adjusted quarterly. Periodically, a third-party appraisal is obtained for the investment to validate the specific inputs for determining fair value.

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

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

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

June 30, 2012 *in millions*	**Fair Value**	**Unfunded Commitments**
INVESTMENT TYPE		
Passive funds [(a)]	$ 18	$ 3
Co-managed funds [(b)]	25	3
Total	$ 43	$ 6

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

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

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

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

Committee (members comprised of individuals from Key and one of the independent investment managers). This process involves an in-depth review of the condition of each investment depending on the type of investment.

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

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

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

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

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

The following table presents the fair value of our indirect investments and related unfunded commitments at June 30, 2012:

June 30, 2012 *in millions*	**Fair Value**	**Unfunded Commitments**
INVESTMENT TYPE		
Private equity funds [(a)]	$ 478	$ 106
Hedge fund[(b)]	4	
Total	$ 482	$ 106

(a) Consists of buyout, venture capital, and fund of funds. These investments can never be redeemed. Instead, distributions are received through the liquidation of the underlying investments of the fund. An investment in any one of these funds can be sold only with the approval of the fund s general partners. We estimate that the underlying investments of the funds will be liquidated over a period of one to ten years.

(b) Consists of a fund invested in long and short positions of stressed and distressed fixed income-oriented securities, with the goal of producing attractive risk-adjusted returns. The investments can be redeemed quarterly with 45 days notice. However, the fund s general partners may impose quarterly redemption limits that may delay receipt of requested redemptions.

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

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

Market convention implies a credit rating of AA equivalent in the pricing of derivative contracts, which assumes all counterparties have the same creditworthiness. To reflect the actual exposure on our derivative contracts related to both counterparty and our own creditworthiness, we record a fair value adjustment in the form of a default reserve. The credit component is determined by individual counterparty based on the probability of default, and considers master netting and collateral agreements. The default reserve is classified as Level 3. Our Market Risk Management group is responsible for the valuation policies and procedure related to this default reserve. A weekly reconciliation process is performed to ensure that all applicable derivative positions are covered in the calculation, which includes transmitting customer exposures and reserve reports to trading management, derivative traders and marketers, derivatives middle office, and corporate accounting personnel. On a quarterly basis, Market Risk Management prepares the reserve calculation. A detailed reserve comparison with the previous quarter, an analysis for change in reserve and a reserve forecast are provided by Market Risk Management to ensure that the default reserve recorded at period end is sufficient.

Other assets and liabilities. The value of our repurchase and reverse repurchase agreements, trade date receivables and payables, and short positions is driven by the valuation of the underlying securities. The underlying securities may include equity securities, which are valued using quoted market prices in an active market for identical securities, resulting in a Level 1 classification. If quoted prices for identical securities are not available, fair value is determined by using pricing models or quoted prices of similar securities, resulting in a Level 2 classification. For the interest rate-driven products, such as government bonds, U.S. Treasury bonds and other products backed by the U.S. government, inputs include spreads, credit ratings and interest rates. For the credit-driven products, such as corporate bonds and mortgage-backed securities, inputs include actual trade data for comparable assets, and bids and offers.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

Certain assets and liabilities are measured at fair value on a recurring basis in accordance with GAAP. The following tables present these assets and liabilities at June 30, 2012 and December 31, 2011.

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June 30, 2012 *in millions*	**Level 1**	**Level 2**	**Level 3**	**Total**
ASSETS MEASURED ON A RECURRING BASIS				
Short-term investments:				
Securities purchased under resale agreements		$ 338		$ 338
Trading account assets:				
U.S. Treasury, agencies and corporations		438		438
States and political subdivisions		27	$ 57	84
Collateralized mortgage obligations		16		16
Other mortgage-backed securities		100	1	101
Other securities	$ 3	37		40
Total trading account securities	3	618	58	679
Commercial loans				
Total trading account assets	3	618	58	679
Securities available for sale:				
States and political subdivisions		$ 56		$ 56
Collateralized mortgage obligations		12,477		12,477
Other mortgage-backed securities		652		652
Other securities	$ 20			20
Total securities available for sale	20	13,185		13,205
Other investments:				
Principal investments:				
Direct	$ 11		$ 231	$ 242
Indirect			482	482
Total principal investments	11		713	724
Equity and mezzanine investments:				
Direct			$ 18	$ 18
Indirect			43	43
Total equity and mezzanine investments			61	61
Total other investments	11		774	785
Derivative assets:				
Interest rate		$ 1,824	$ 35	$ 1,859
Foreign exchange	$ 81	26		107
Energy and commodity		209		209
Credit		19	6	25
Equity				
Derivative assets	81	2,078	41	2,200
Netting adjustments[(a)]				(1,382)
Total derivative assets	81	2,078	41	818
Accrued income and other assets	2	134		136
Total assets on a recurring basis at fair value	$ 117	$ 16,353	$ 873	$ 15,961
LIABILITIES MEASURED ON A RECURRING BASIS				
Federal funds purchased and securities sold under repurchase agreements:				
Securities sold under repurchase agreements		$ 481		$ 481
Bank notes and other short-term borrowings:				

Short positions	$	3		360				363
Derivative liabilities:								
Interest rate				1,310				1,310
Foreign exchange		81		24				105
Energy and commodity				203	$	1		204
Credit				23		1		24
Equity								
Derivative liabilities		81		1,560		2		1,643
Netting adjustments[a]								(880)
Total derivative liabilities		81		1,560		2		763
Accrued expense and other liabilities				4				4
Total liabilities on a recurring basis at fair value	$	84	$	2,405	$	2	$	1,611

(a) Netting adjustments represent the amounts recorded to convert our derivative assets and liabilities from a gross basis to a net basis in accordance with applicable accounting guidance. The net basis takes into account the impact of bilateral collateral and master netting agreements that allow us to settle all derivative contracts with a single counterparty on a net basis and to offset the net derivative position with the related collateral. Total derivative assets and liabilities include these netting adjustments.

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December 31, 2011 *in millions*	Level 1	Level 2	Level 3	Total
ASSETS MEASURED ON A RECURRING BASIS				
Short term investments:				
Securities purchased under resale agreements		$ 236		$ 236
Trading account assets:				
U.S. Treasury, agencies and corporations		353		353
States and political subdivisions		81		81
Collateralized mortgage obligations		19		19
Other mortgage-backed securities		27	$ 35	62
Other securities	$ 79	29		108
Total trading account securities	79	509	35	623
Commercial loans				
Total trading account assets	79	509	35	623
Securities available for sale:				
States and political subdivisions		63		63
Collateralized mortgage obligations		15,162		15,162
Other mortgage-backed securities		778		778
Other securities	9			9
Total securities available for sale	9	16,003		16,012
Other investments:				
Principal investments:				
Direct	11		225	236
Indirect			473	473
Total principal investments	11		698	709
Equity and mezzanine investments:				
Direct			15	15
Indirect			36	36
Total equity and mezzanine investments			51	51
Total other investments	11		749	760
Derivative assets:				
Interest rate		1,915	38	1,953
Foreign exchange	86	65		151
Energy and commodity		253		253
Credit		30	7	37
Equity		3		3
Derivative assets	86	2,266	45	2,397
Netting adjustments [(a)]				(1,452)
Total derivative assets	86	2,266	45	945
Accrued income and other assets	7	105		112
Total assets on a recurring basis at fair value	$ 192	$ 19,119	$ 829	$ 18,688
LIABILITIES MEASURED ON A RECURRING BASIS				
Federal funds purchased and securities sold under repurchase agreements:				
Securities sold under repurchase agreements		$ 292		$ 292
Bank notes and other short-term borrowings:				
Short positions		337		337
Derivative liabilities:				
Interest rate		1,398		1,398

Foreign exchange	$	79		209				288
Energy and commodity				252	$	1		253
Credit				34		28		62
Equity				3				3
Derivative liabilities		79		1,896		29		2,004
Netting adjustments [a]								(978)
Total derivative liabilities		79		1,896		29		1,026
Accrued expense and other liabilities		23		22				45
Total liabilities on a recurring basis at fair value	$	102	$	2,547	$	29	$	1,700

(a) Netting adjustments represent the amounts recorded to convert our derivative assets and liabilities from a gross basis to a net basis in accordance with applicable accounting guidance. The net basis takes into account the impact of bilateral collateral and master netting agreements that allow us to settle all derivative contracts with a single counterparty on a net basis and to offset the net derivative position with the related collateral. Total derivative assets and liabilities include these netting adjustments.

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Changes in Level 3 Fair Value Measurements

The following table shows the change in the fair values of our Level 3 financial instruments for the three and six months ended June 30, 2012 and 2011. We mitigate the credit risk, interest rate risk, and risk of loss related to many of these Level 3 instruments by using securities and derivative positions classified as Level 1 or Level 2. Level 1 and Level 2 instruments are not included in the following table. Therefore, the gains or losses shown do not include the impact of our risk management activities.

	Trading Account Assets		**Other Investments**				**Derivative Instruments** [a]		
	Other		**Principal Investments**		**Equity and Mezzanine Investments**				
in millions	**Mortgage-Backed Securities**	**Other Securities**	**Direct**	**Indirect**	**Direct**	**Indirect**	**Interest Rate**	**Energy and Commodity**	**Credit**
Balance at December 31, 2011	$ 35		$ 225	$ 473	$ 15	$ 36	$ 38	$ (1)	$ (21)
Gains (losses) included in earnings	**2** [b]	**$ (2)** [b]	**8** [c]	**43** [c]	**3** [c]	**6** [c]	**(3)** [b]	[b]	**(7)** [b]
Purchases			**10**	**20**		**4**	**1**		
Sales	**(32)**		**(12)**	**(54)**			**(1)**		
Issuances									
Settlements		**2**				**(3)**			**33**
Transfers into Level 3		**57** [d]					**4** [d]		
Transfers out of Level 3	**(4)** [d]						**(4)** [d]		
Balance at June 30, 2012	**$ 1**	**57**	**$ 231**	**$ 482**	**$ 18**	**$ 43**	**$ 35**	**$ (1)**	**$ 5**
Unrealized gains (losses) included in earnings	[b]	**$ (2)** [b]	**$ 8** [c]	**$ 28** [c]	**$ 10** [c]	**$ 6** [c]	[b]	[b]	[b]
Balance at March 31, 2012	**$ 1**	**$**	**$ 226**	**$ 485**	**$ 15**	**$ 42**	**$ 36**	**(1)**	**$ 5**
Gains (losses) included in earnings	[b]	**(5)** [b]	**7** [c]	**20** [c]	**3** [c]	**5** [c]	**2** [b]	[b]	**(2)** [b]
Purchases			**9**	**10**		**1**			
Sales			**(11)**	**(33)**					
Issuances									
Settlements		**5**				**(2)**			**2**
Transfers into Level 3		**57** [d]				**(3)** [d]			
Transfers out of Level 3							**(3)** [d]		
Balance at June 30, 2012	**$ 1**	**57**	**$ 231**	**$ 482**	**$ 18**	**$ 43**	**$ 35**	**(1)**	**$ 5**
Unrealized gains (losses) included in earnings	[b]	**(5)** [b]	**$ 7** [c]	**$ 9** [c]	**$ 4** [c]	**$ 2** [c]	[b]	[b]	[b]
Balance at December 31, 2010	$ 1	$ 21	$ 372	$ 526	$ 20	$ 30	$ 75	$ 1	$ 11
Gains (losses) included in earnings	[b]	[b]	2 [c]	43 [c]	13 [c]	[c]	14 [b]	(1) [b]	(10) [b]
Purchases		3	30	46		9	11		
Sales			(9)	(36)			(20)		

Issuances									
Settlements		(24)			(19)	(3)			7
Transfers into Level 3							10		
Transfers out of Level 3			(125) [e]	(109) [e]		(3)	(9)		
Balance at June 30, 2011	$ 1	$	$ 270	$ 470	$ 14	$ 33	$ 81	$	$ 8
Unrealized gains (losses) included in earnings	[b]	$ 3 [b]	$ 8 [c]	$ 28 [c]	$ 32 [c]	$ (3) [c]	[b]	[b]	[b]
Balance at March 31, 2011	$ 1		$ 395	$ 548	$ 25	$ 27	$ 81		$ 4
Gains (losses) included in earnings	[b]	$ 3 [b]	[c]	10 [c]	8 [c]	1 [c]	10 [b]	[b]	(9) [b]
Purchases			2	32		7	11		6
Sales			(2)	(11)			(18)		
Issuances									