STATE STREET CORP
Form 10-Q
November 03, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from to

Commission File No. 001-07511

STATE STREET CORPORATION

(Exact name of registrant as specified in its charter)

MASSACHUSETTS (State or other jurisdiction of incorporation)	**04-2456637** (I.R.S. Employer Identification No.)
One Lincoln Street **Boston, Massachusetts** (Address of principal executive office)	**02111** (Zip Code)

617-786-3000

(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 x No o

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

The number of shares of the Registrant s Common Stock outstanding on October 31, 2006 was 332,075,130.

STATE STREET CORPORATION

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PART I. FINANCIAL INFORMATION

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

State Street Corporation is a financial holding company headquartered in Boston, Massachusetts and through its subsidiaries, provides a full range of products and services for institutional investors worldwide. Unless otherwise indicated or unless the context requires otherwise, all references in this Discussion and Analysis to State Street, we, us, our or similar terms mean State Street Corporation and its subsidiaries on a consolidated basis. As of September 30, 2006, we had consolidated total assets of $112.31 billion, total deposits of $63.45 billion, total shareholders equity of $7.02 billion and employed 21,500.

This Discussion and Analysis is part of our Quarterly Report on Form 10-Q to the Securities and Exchange Commission, or SEC, and updates our Annual Report on Form 10-K for the year ended December 31, 2005, and our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2006 and June 30, 2006, all of which we previously filed with the SEC. You should read this Discussion and Analysis in conjunction with the financial information contained in those filings. Certain previously reported amounts presented in this Discussion and Analysis have been reclassified to conform to current period classifications.

We report two lines of business. Investment Servicing provides services for institutional customers worldwide, including mutual funds and collective investment funds, corporate and public retirement plans, insurance companies, foundations, endowments, and other investment pools. Investment Management offers a broad array of services for managing financial assets, including investment management and investment research services, primarily for institutional investors worldwide. Information about products and services provided by these lines of business is included in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 23 to the Consolidated Financial Statements in our 2005 10-K. Financial information about these business lines is provided in the Line of Business Information section of this Discussion and Analysis.

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States, or GAAP. The preparation of financial statements requires management to make judgments in the application of certain of its accounting policies that involve significant estimates and assumptions about the effect of matters that are inherently uncertain. Accounting policies considered relatively more significant in this respect are accounting for lease financing, goodwill, income taxes and pension costs. Additional information about these accounting policies is included in the Significant Accounting Estimates section of Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2005 10-K. There were no significant changes to these accounting policies during the first nine months of 2006.

This Form 10-Q, particularly this Discussion and Analysis, contains forward-looking statements as defined by United States securities laws, including statements about the financial outlook and business environment. These statements are based on current expectations and involve a number of risks and uncertainties.

These risks and uncertainties include those related to changes in market interest rates, the values of global and regional securities markets, the extent of volatility in foreign currency exchange rates, the maintenance of adequate capital in accordance with regulatory requirements, the rate of individual savings, the pace of cross-border investment activity, the pace of customer outsourcing and our performance under outsourcing contracts, our success at integrating and converting acquisitions into our

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

business, the impact of changes in tax legislation, the pace of pension reform, our compliance with governmental regulation, the impact of regulatory limits on our investment in non-U.S. activities, the impact of investigations into the financial services industry, the adequacy of our business continuity and disaster recovery plans, our ability to anticipate and keep pace with rapid changes in technology, our success in protecting our proprietary rights, our access to capital markets, and the impact of worldwide economic conditions or failures of significant counterparties.

Additional information about important factors that could cause our actual financial results to differ materially from those indicated by any forward-looking statements is provided in our 2005 10-K, particularly in Item 1A, Risk Factors. We undertake no obligation to revise the forward-looking statements contained in this Form 10-Q to reflect events after its filing date.

SUMMARY FINANCIAL INFORMATION

	Three Months Ended September 30,			**Nine Months Ended September 30,**		
(Dollars in millions, except per share data)	**2006**	**2005**	**% Change**	**2006**	**2005**	**% Change**
Revenue:						
Fee revenue	**$ 1,246**	$ 1,135	10	**$ 3,881**	$ 3,375	15
Net interest revenue after provision for loan losses	**266**	236	13	**794**	665	19
Gains on sales of available-for-sale investment securities, net	**3**	1		**14**	1	
Gain on sale of Private Asset Management business		16			16	
Total revenue	**1,515**	1,388	9	**4,689**	4,057	16
Total operating expenses	**1,090**	1,008	8	**3,362**	3,002	12
Income from continuing operations before income tax expense	**425**	380	12	**1,327**	1,055	26
Income tax expense from continuing operations	**147**	130		**540**	359	
Income from continuing operations	**278**	250	11	**787**	696	13
(Loss) Income from discontinued operations, net of taxes		(107)		**10**	(107)	
Net income	**$ 278**	$ 143		**$ 797**	$ 589	
Per Common Share:						
Income from continuing operations:						
Basic	**$ .84**	$ .76	11	**$ 2.38**	$ 2.11	13
Diluted	**.83**	.75	11	**2.35**	2.08	13
Net income:						
Basic	**.84**	.43		**2.41**	1.78	
Diluted	**.83**	.43		**2.38**	1.76	
Cash dividends declared	**.20**	.18		**.59**	.53	
Ratios:						
From continuing operations:						
Return on shareholders equity	**16.4 %**	15.9 %		**16.0 %**	15.1 %	
Return on average assets	**1.07**	.98		**1.01**	.93	
From net income:						
Return on shareholders equity	**16.4**	9.1		**16.2**	12.8	
Return on average assets	**1.07**	.56		**1.02**	.79	

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

(Dollars in millions, unless otherwise indicated)	As of September 30, 2006	December 31, 2005
At Quarter End:		
Investment securities available for sale and held to maturity	**$ 65,949**	$ 59,870
Loans and leases, net of allowance	**9,206**	6,464
Total assets	**112,310**	97,968
Total deposits	**63,452**	59,646
Long-term debt	**2,620**	2,659
Total shareholders equity	**7,015**	6,367
Closing price of common stock	**$ 62.40**	$ 55.44
Assets under custody (in billions)	**$ 11,266**	$ 10,121
Assets under management (in billions)	**1,632**	1,441
Number of employees	**21,500**	20,965
Ratios:		
Year-to-date average shareholders equity to average assets	**6.3 %**	6.2 %
Tier 1 risk-based capital	**12.2**	11.7
Total risk-based capital	**14.3**	14.0
Tier 1 leverage	**6.0**	5.6
Tangible common equity to tangible total assets	**4.7**	4.8

OVERVIEW

Comparing the third quarter of 2006 to the third quarter of 2005, our total revenue grew 9%, with fee revenue up 10% and net interest revenue up 13%, and total operating expenses increased 8%. The year-over-year growth in revenue was particularly notable in servicing and management fees and securities finance revenue. We experienced seasonal weakness in trading services and securities finance revenue during the third quarter of 2006 compared to this year s second quarter; however, compared to the very strong third quarter of 2005, securities finance revenue increased 18%. While operating expenses increased 8% in the 2006 to 2005 quarterly comparison, they were down 7% from this year s second quarter, partly offsetting seasonal revenue declines, as we continued to actively manage our expenses. Our effective tax rate for the third quarter of 2006 was 34.6%, compared to 34.0% for the third quarter of 2005.

Third quarter 2006 diluted earnings per share of $.83 increased 11% from $.75 per share from continuing operations for the third quarter of 2005. This year s third quarter earnings included $.03 per share related to a cumulative gain recorded in trading services revenue resulting from the consolidation into our balance sheet of certain trusts that we use in connection with our tax-exempt investment programs. Additional information about this cumulative gain is included in the Results of Operations Fee Revenue section of this Discussion and Analysis. Earnings for the third quarter of 2005 included $.03 per share related to the final settlement of the 2003 sale of our Private Asset Management business. We reported this gain in our 2005 10-K.

In the same comparison, earnings per share from net income was $.83 and $.43, respectively. The 2005 earnings included a loss from discontinued operations of $.32 per share related to our plan to divest our ownership interest in Bel Air Investment Advisors LLC (Bel Air), which we completed early in the third

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

quarter of 2006. We reported this loss in our 2005 10-K. Additional information concerning the Bel Air divestiture is included in Note 2 to the Consolidated Financial Statements in this Form 10-Q.

For the first nine months of 2006, total revenue grew 16%, with particularly strong growth in management fee and trading services revenues, up 28% and 29%, respectively, and net interest revenue, up 19%. In the same comparison, servicing fee revenue grew 10% and securities finance revenue grew 15%. Growth in operating expenses of 12% resulted in positive operating leverage of 4%, which we define as the excess of the growth rate of total revenue over the growth rate of total operating expenses.

Diluted earnings per share from continuing operations for the first nine months of 2006 was $2.35, up 13% from $2.08 for the 2005 period. Earnings for the 2006 period included tax-related charges of $.25 per share, which consisted of $.18 per share primarily related to the impact on income tax expense of the Tax Increase Prevention and Reconciliation Act, or TIPRA, and $.07 per share related to an increased tax provision for the potential resolution of issues with the Internal Revenue Service, or IRS, with respect to our treatment of certain leveraged leases. These charges were reported in our second quarter 10-Q. Excluding the $.25 per share of tax-related charges, diluted earnings per share from continuing operations was $2.60 for the first nine months of 2006, a 25% increase from $2.08 per share for the first nine months of 2005.

Diluted earnings per share from net income for the same periods was $2.38 and $1.76, respectively. The nine-month 2006 period included income from discontinued operations of $.03 related to the Bel Air divestiture, which we reported in our first quarter 2006 10-Q. The 2005 period included the previously mentioned loss from discontinued operations of $.32 per share related to the Bel Air divestiture.

In our 2005 10-K, management reaffirmed our financial goals for 2006. These financial goals are: (1) annual growth in operating-basis earnings per share from continuing operations of 10% to 15%; (2) annual growth in operating-basis revenue of 8% to 12%; and (3) annual operating-basis return on shareholders equity from continuing operations of 14% to 17%. Operating-basis results, as defined by management, include taxable-equivalent net interest revenue with a corresponding charge to income tax expense, and exclude the previously described tax-related charges.

Management measures our financial goals and related results on an operating basis to provide financial information that is comparable from period to period, and to present comparable financial trends with respect to our ongoing business operations. The use of taxable-equivalent net interest revenue facilitates the comparison of revenues from both taxable and non-taxable sources. The previously described tax-related charges are not part of our normal ongoing business operations, and as a result prevent a meaningful comparison of earnings per share and return on shareholders equity with that of other periods. Management believes that operating-basis financial information facilitates an investor s understanding and analysis of State Street s underlying performance and trends in addition to financial information prepared in accordance with GAAP.

Through the first nine months of 2006, our operating-basis financial performance, as defined above, places us above the high end of our ranges for all three of the above-described financial goals. For full-year 2006, we expect that we will moderately exceed the high end of these ranges. Our full-year 2006 financial results will continue to be affected by the current short-term domestic and non-U.S. interest-rate environment, as well as the pace of capital markets activities. We intend to keep the credit quality of our investment portfolio high, and will continue to manage our operating expense growth to support growth in revenue.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Information about risks and uncertainties that could cause our actual financial results to differ materially from our financial goals is included in Item 1A of our 2005 10-K.

RESULTS OF OPERATIONS

Revenue

Comparing the third quarter of 2006 to that of 2005, total revenue increased $127 million, or 9%. Fee revenue growth was $111 million, or 10%, with notable increases in servicing and management fees and securities finance revenue. In addition, net interest revenue increased $30 million, or 13% ($30 million, or 12%, on a fully taxable-equivalent basis). For the nine months ended September 30, 2006, we achieved 16% growth in total revenue compared with the comparable period in 2005. Fee revenue was up $506 million, or 15%. Net interest revenue was up $129 million, or 19% ($131 million, or 19%, on a fully taxable-equivalent basis), and gains on sales of available-for-sale securities increased $13 million.

Fee Revenue

Servicing and management fees are a function of several factors, including the mix and volume of assets under custody and assets under management, securities positions held and the volume of portfolio transactions, as well as the types of products and services used by customers, and are affected by changes in worldwide equity and fixed income valuations. In general, servicing fees are impacted, in part, by changes in daily average valuations of assets under custody, while management fees are impacted by changes in month-end valuations of assets under management. However, additional factors, such as transaction volumes, balance credits, customer minimum balances and other factors, may have a significant impact on servicing fee revenue.

Generally, management fee revenue is more sensitive to changes in market valuations than servicing fee revenue. In addition, performance fees have become a larger component of our management fee revenue over the past two years. Performance fees, which are generated when the performance of managed funds exceeds benchmarks specified in the management agreements, are less sensitive to market valuation than to manager performance against the respective benchmarks.

As a result of the above, we estimate, assuming all other factors remain constant, that a 10% increase or decrease in worldwide equity values would result in a corresponding change in our total revenue of approximately 2%. If fixed income security values were to increase or decrease by 10%, we would anticipate a corresponding change of approximately 1% in our total revenue.

Total fee revenue consisted of the following for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,			Nine Months Ended September 30,		
(Dollars in millions)	**2006**	**2005**	**% Change**	**2006**	**2005**	**% Change**
Servicing fees	**$ 685**	$ 620	10	**$ 2,025**	$ 1,837	10
Management fees	**238**	188	27	**690**	538	28
Trading services	**171**	176	(3)	**659**	512	29
Securities finance	**87**	74	18	**296**	257	15
Processing fees and other	**65**	77	(16)	**211**	231	(9)
Total fee revenue	**$ 1,246**	$ 1,135	10	**$ 3,881**	$ 3,375	15

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Servicing fees are derived from custody, product- and participant-level accounting, daily pricing and administration; recordkeeping; investment manager and hedge fund manager operations outsourcing; master trust and master custody; and performance, risk and compliance analytics. The increases in servicing fees in the quarterly and nine-month comparisons were driven by new business, consisting mostly of successful cross-selling to existing customers, higher average equity market valuations, and increased customer transaction volumes.

Total assets under custody were $11.27 trillion at September 30, 2006, up 11% from $10.12 trillion at December 31, 2005, and up 15% compared with $9.80 trillion at September 30, 2005. The daily average values for the S&P 500 Index were up 5%, and for the MSCI® EAFE Index were up 19%, for the third quarter of 2006 compared with the prior-year quarter.

ASSETS UNDER CUSTODY **(Dollars in billions)**	**September 30, 2006**	**December 31, 2005**
Customers in the U.S.:		
Mutual funds	**$ 4,326**	$ 3,891
Pensions, insurance and other investment pools	**4,451**	4,136
Customers outside the U.S.	**2,489**	2,094
Total	**$ 11,266**	$ 10,121
Financial instrument mix:		
Equities	**$ 5,595**	$ 4,814
Fixed income	**3,928**	3,797
Short-term and other investments	**1,743**	1,510
Total	**$ 11,266**	$ 10,121

The increases in management fees for the three- and nine-month comparisons reflected new business, the impact of increased performance fees and increases in month-end equity market valuations. New business resulted partly from the introduction of more quantitative active strategies over the past year by State Street Global Advisors. Performance fees totaled $28 million and $9 million for the third quarters of 2006 and 2005, respectively, and $56 million and $19 million for the respective nine-month periods. Total assets under management were $1.63 trillion at September 30, 2006, up 13% from $1.44 trillion at December 31, 2005 and up 16% from $1.41 trillion at September 30, 2005.

ASSETS UNDER MANAGEMENT **(Dollars in billions)**	**September 30, 2006**	**December 31, 2005**
Equities:		
Passive	**$ 606**	$ 602
Active	**190**	172
Employer securities	**80**	76
Fixed income	**184**	155
Money market	**572**	436
Total	**$ 1,632**	$ 1,441

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table presents a roll-forward of assets under management for the twelve months ended September 30, 2006.

ASSETS UNDER MANAGEMENT
(Dollars in billions)

September 30, 2005	$ 1,410
Net new business	9
Market appreciation	22
December 31, 2005	**1,441**
Net new business	**62**
Market appreciation	**129**
September 30, 2006	**$ 1,632**

Trading services revenue, which includes foreign exchange trading and brokerage and other trading fees, was down 3% for the third quarter and up 29% for the first nine months of 2006, compared to the same periods in 2005. The quarterly comparison reflected an unusually strong quarter in 2005, while the nine-month comparison reflected the benefit from strong capital markets, particularly in the first half of 2006. Foreign exchange trading revenue totaled $113 million, down 7% compared to $121 million in the prior-year quarter, reflecting weaker currency volatilities partly offset by increased customer transaction volumes. Foreign exchange trading revenue totaled $470 million, compared to $348 million, up 35% in the nine-month comparison, reflecting higher volumes and a favorable transaction mix, partly offset by a decline in volatilities.

Brokerage and other trading fees totaled $58 million for the third quarter of 2006, up 5% from $55 million in the quarterly comparison, and $189 million compared to $164 million, up 15% in the nine-month comparison. Brokerage and other trading fees for the third quarter of 2006 included a $15 million cumulative gain related to the impact of consolidating into our September 30, 2006 balance sheet certain trusts that we use in our tax-exempt investment programs. Additional information about the consolidation of these trusts is included in Note 6 to the Consolidated Financial Statements in this Form 10-Q.

Excluding the $15 million cumulative gain, brokerage and other trading fees were $43 million, down 22% for the third quarter of 2006 compared to the 2005 quarter, and $174 million, up 6% in the nine-month comparison. The quarterly decrease reflected reduced activity in transition management during the current quarter, while the year-to-date increase reflected an overall increase in U.S. transition management, particularly in the first half of the current year.

Securities finance revenue for the third quarter of 2006 increased 18% compared to the third quarter of 2005 and 15% compared to the first nine months of 2005, driven by 22% and 20% increases, respectively, in the average volume of securities lent, driven principally by strong customer demand, increased asset allocations from existing customers and new business, somewhat offset by declines in interest-rate spreads.

Processing fees and other revenue decreased 16% in the quarterly comparison, reflecting lower levels of fees from structured financing products, and decreased 9% in the nine-month comparison, mostly due to declines in fees from Deutsche Bank, as GSS client deposits were converted to our systems.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Net Interest Revenue

	Three Months Ended September 30,			Nine Months Ended September 30,		
(Dollars in millions)	**2006**	**2005**	**% Change**	**2006**	**2005**	**% Change**
Interest revenue	**$ 1,103**	$ 773	43	**$ 3,098**	$ 2,069	50
Interest expense	**837**	537	56	**2,304**	1,404	64
Net interest revenue	**266**	236	13	**794**	665	19
Provision for loan losses						
Net interest revenue after provision for loan losses	**$ 266**	$ 236	13	**$ 794**	$ 665	19
Net interest revenue, taxable-equivalent basis(1)	**$ 275**	$ 245		**$ 827**	$ 696	

(1) Taxable-equivalent adjustment was computed using a federal income tax rate of 35%, adjusted for applicable state income taxes, net of the related federal tax benefit. Taxable-equivalent adjustments included in taxable-equivalent basis net interest revenue in the preceding table, and in the rates earned on interest-earning assets in the table below, were $9 million for the third quarters of 2006 and 2005, and $33 million and $31 million for the first nine months of 2006 and 2005, respectively.

The $30 million, or 13%, increase in net interest revenue for the third quarter of 2006, and the $129 million, or 19%, increase for the first nine months, were principally due to an increase in average interest-earning assets, the impact of our previous investment securities portfolio repositioning, which resulted in investments in higher yielding securities, and a more favorable mix of deposits, particularly non-U.S. deposits.

At September 30, 2006, our investment securities portfolio included a higher percentage of floating-rate, asset-backed securities and collateralized mortgage obligations compared to a year earlier, and a lower percentage of U.S. Treasuries and direct obligations of federal agencies. The shift in the portfolio was designed to better position State Street in a rising short-term interest-rate environment without significantly increasing credit risk, as we continued to invest conservatively in AAA and AA rated securities. AAA and AA rated securities comprised approximately 95% of our investment securities portfolio at September 30, 2006, with 89% AAA rated.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2006		**2005**		**2006**		**2005**	
(Dollars in millions)	**Average Balance**	**Rate(1)**	**Average Balance**	**Rate(1)**	**Average Balance**	**Rate(1)**	**Average Balance**	**Rate(1)**
Interest-earning assets	**$ 89,880**	**4.91 %**	$ 88,523	3.51 %	**$ 90,922**	**4.60 %**	$ 87,588	3.20 %
Interest-bearing liabilities	**81,739**	**4.06**	79,806	2.67	**82,650**	**3.72**	78,828	2.38
Excess of rate earned over rate paid		**.85 %**		.84 %		**.88 %**		.82 %
Net interest margin		**1.22 %**		1.10 %		**1.22 %**		1.06 %

(1) Taxable-equivalent basis

Several factors could continue to affect our net interest revenue and margin for 2006, including ongoing actions by the Federal Reserve to manage short-term interest rates; the slope of the yield curve; changes in non-U.S. interest rates; tighter interest-rate spreads on the reinvestment of proceeds from

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MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

maturities of investment securities; and our maintenance of the high credit quality of our investment securities portfolio.

Operating Expenses

	Three Months Ended September 30,			Nine Months Ended September 30,		
(Dollars in millions)	**2006**	**2005**	**% Change**	**2006**	**2005**	**% Change**
Salaries and employee benefits	**$ 639**	$ 566	13	**$ 1,958**	$ 1,642	19
Information systems and communications	**121**	117	3	**382**	364	5
Transaction processing services	**121**	111	9	**375**	331	13
Occupancy	**91**	96	(5)	**279**	302	(8)
Other	**118**	118		**368**	363	1
Total operating expenses	**$ 1,090**	$ 1,008	8	**$ 3,362**	$ 3,002	12
Number of employees at quarter end	**21,500**	20,375				

Salaries and employee benefits expense increased 13% for the third quarter of 2006, and 19% for the nine months, compared to the same periods in 2005, primarily as a result of increased staffing levels to service new business, higher incentive compensation driven by improved performance, and the impact of increases in benefits costs.

The increases in information systems and communications expense for the third quarter and first nine months of 2006 of 3% and 5%, respectively, reflected increased investments in our global infrastructure. Transaction processing expense increased 9% and 13% in the quarter and year-to-date comparison, respectively, due to higher volumes in our Investment Servicing business, particularly in Europe. Occupancy expense decreased 5% in the quarterly comparison, primarily due to a decrease in costs associated with our headquarters building, while the 8% drop in the nine-month comparison reflected the absence of the $26 million charge recorded in the second quarter of 2005 related to a sub-lease agreement for 160,000 square feet in our headquarters building.

Income Taxes

We recorded income tax expense of $147 million for the third quarter of 2006, up from $130 million from continuing operations for the third quarter of 2005, primarily as a result of higher pre-tax earnings. For the first nine months of 2006, income tax expense from continuing operations was $540 million compared to $359 million for the 2005 period. The effective tax rate for the third quarter of 2006 was 34.6%, and for the first nine months of 2006 was 40.7%, compared to 34.0% for both the third quarter and first nine months of 2005. The increase in the effective rate in the nine-month comparison resulted from the aggregate $83 million of additional income tax provisions recorded during the second quarter of 2006, which are discussed below.

During the second quarter of 2006, TIPRA repealed the federal income tax exclusion, effective January 1, 2007, which was previously allowed for a portion of the income generated from certain leveraged leases of aircraft. As a result of this legislation, and in accordance with existing lease accounting standards, we recalculated the allocation of the components of leasing-related income over the terms of the affected leases and cumulatively adjusted the income tax expense we had previously accrued. A non-

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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cash charge to income tax expense of approximately $59 million, or $.18 per share, was recorded in the second quarter of 2006 primarily related to the impact of this legislation.

In addition, during the second quarter of 2006, we recorded an additional provision of approximately $24 million, or $.07 per share, to accrue for the potential resolution of issues with the IRS regarding the treatment of lease-in-lease-out, or LILO, and sale-in-lease-out, or SILO, transactions. At September 30, 2006, management believes we are sufficiently reserved for this exposure.

Our overall effective tax rate reflects reductions expected to result from tax credits related to investments in alternative energy projects. Some of these credits phase out as the price of oil increases. If the price of oil for the fourth quarter of 2006 were to average approximately $92 per barrel or higher, we expect that we would lose all credits that are subject to phase-out, which would increase our effective tax rate for the full year by approximately .5% and reduce our earnings per share by approximately $.01.

Line of Business Information

We report two lines of business: Investment Servicing and Investment Management. Given State Street s services and management organization, the results of operations for these lines of business are not necessarily comparable with those of other companies, including companies in the financial services industry. Additional information about our lines of business is included in Note 23 to the Consolidated Financial Statements in our 2005 10-K.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following is a summary of line of business results from continuing operations. These results exclude the income (loss) from discontinued operations related to our divestiture of Bel Air described in the Overview section of this Discussion and Analysis.

(Dollars in millions, except where otherwise noted)	For the Three Months Ended September 30, Investment Servicing 2006	Investment Servicing 2005	Investment Management 2006	Investment Management 2005	Other/ One-Time 2006	Other/ One-Time 2005	Total 2006	Total 2005
Fee Revenue:								
Servicing fees	**$ 685**	$ 620					**$ 685**	$ 620
Management fees			**$ 238**	$ 188			**238**	$ 188
Trading services	**171**	176					**171**	176
Securities finance	**66**	60	**21**	14			**87**	74
Processing fees and other	**51**	56	**14**	21			**65**	77
Total fee revenue	**973**	912	**273**	223			**1,246**	1,135
Net interest revenue after provision for loan losses	**235**	216	**31**	20			**266**	236
Gains on sales of available-for-sale investment securities, net	**3**	1					**3**	1
Gain on sale of Private Asset Management business					**$**	$ 16		16
Total revenue	**1,211**	1,129	**304**	243		16	**1,515**	1,388
Operating expenses	**903**	834	**187**	174			**1,090**	1,008
Income from continuing operations before income tax expense	**$ 308**	$ 295	**$ 117**	$ 69	**$**	$ 16	**$ 425**	$ 380
Pre-tax margin	**25 %**	26 %	**39 %**	28 %			**28 %**	27 %
Average assets (in billions)	**$ 99.9**	$ 98.1	**$ 2.9**	$ 2.9			**$ 102.8**	$ 101.0

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

	For the Nine Months Ended September 30,							
	Investment Servicing		Investment Management		Other/ One-Time		Total	
(Dollars in millions, except where otherwise noted)	2006	2005	2006	2005	2006	2005	2006	2005
Fee Revenue:								
Servicing fees	**$ 2,025**	$ 1,837					**$ 2,025**	$ 1,837
Management fees			**$ 690**	$ 538			**690**	538
Trading services	**659**	512					**659**	512
Securities finance	**224**	202	**72**	55			**296**	257
Processing fees and other	**163**	172	**48**	59			**211**	231
Total fee revenue	**3,071**	2,723	**810**	652			**3,881**	3,375
Net interest revenue after provision for loan losses	**705**	609	**89**	56			**794**	665
Gains on sales of available-for-sale investment securities, net	**14**	1					**14**	1
Gain on sale of Private Asset Management business					**$**	$ 16		16
Total revenue	**3,790**	3,333	**899**	708		16	**4,689**	4,057
Operating expenses	**2,786**	2,510	**576**	492			**3,362**	3,002
Income from continuing operations before income tax expense	**$ 1,004**	$ 823	**$ 323**	$ 216	**$**	$ 16	**$ 1,327**	$ 1,055
Pre-tax margin	**26 %**	25 %	**36 %**	31 %			**28 %**	26 %
Average assets (in billions)	**$ 101.6**	$ 96.7	**$ 2.9**	$ 3.0			**$ 104.5**	$ 99.7

Investment Servicing

Total revenue for the three and nine months ended September 30, 2006 increased $82 million, or 7%, and $457 million, or 14%, respectively, compared to the same periods in 2005. Total fee revenue for the three months ended September 30, 2006 increased $61 million, or 7%, compared to the 2005 period, with the increases primarily attributable to growth in servicing fees and securities finance revenue, partly offset by declines in processing fees and other revenue and trading services revenue. In the nine-month comparison, total fee revenue increased $348 million, or 13%, with increases in all revenue types except processing fees and other. Servicing fees and trading services revenue for Investment Servicing comprise the consolidated amounts for State Street, and securities finance and processing fees and other revenue comprise just over 76% of these types of revenue reflected in our consolidated results. Refer to the Results of Operations Fee Revenue section of this Discussion and Analysis for additional information about the growth in these types of fee revenue.

Net interest revenue for the three and nine months ended September 30, 2006 increased $19 million, or 9%, and $96 million, or 16%, respectively, compared to the 2005 periods. The increases were principally due to growth in average balance sheet volumes, the impact of the previous investment securities portfolio repositioning, and a more favorable mix of deposits, particularly with respect to non-U.S. deposits.

Operating expenses for the third quarter and first nine months of 2006 increased $69 million, or 8%, and $276 million, or 11%, respectively, compared to the 2005 periods. The increases were primarily attributable to higher salaries, reflecting an increase in headcount to service new business, increased incentive compensation related to improved performance, and increases in benefits costs. In addition, higher volumes for this line of business, particularly in Europe, resulted in higher transaction processing expense.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Investment Management

Total revenue for the three and nine months ended September 30, 2006 increased $61 million, or 25%, and $191 million, or 27%, from the comparable periods in 2005, with the increases driven by growth in both management fees and securities finance revenue. In the three- and nine-month comparison, processing fees and other revenue declined from 2005. Fees from investment management, delivered through State Street Global Advisors, increased $50 million, or 27%, and $152 million, or 28%, compared to the 2005 periods. These fees comprise the consolidated amounts for State Street. Refer to the Results of Operations Fee Revenue section of this Discussion and Analysis for additional information. Securities finance revenue was up 50% for the third quarter and up 31% for the nine months ended September 30, 2006, compared to the same periods in 2005, due to a higher volume of securities lent.

Operating expenses for the three and nine months ended September 30, 2006 increased $13 million, or 7%, and $84 million, or 17%, from the comparable periods in 2005, primarily attributable to higher salaries which resulted from increased incentive compensation related to improved performance.

FINANCIAL CONDITION

Capital

Regulatory and economic capital management both use key metrics evaluated by management to ensure that our actual level of capital is commensurate with our risk profile, is in compliance with all regulatory requirements, and is sufficient to provide us with the financial flexibility to undertake future strategic business initiatives.

Regulatory Capital

Our objective with respect to regulatory capital management is to maintain a strong capital base in order to provide financial flexibility for our business needs, including funding corporate growth and supporting customers cash management needs, and to provide protection against loss to depositors and creditors. We strive to maintain an optimal level of capital, commensurate with our risk profile, on which an attractive return to shareholders will be realized over both the short and long term, while protecting our obligations to depositors and creditors and satisfying regulatory requirements. You can obtain additional information about our capital management process in the Financial Condition section of Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2005 10-K.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

At September 30, 2006, State Street and State Street Bank and Trust Company, or State Street Bank, met all capital adequacy requirements to which they were subject. The regulatory capital amounts and ratios were as follows at September 30, 2006, and December 31, 2005:

	Regulatory Guidelines(1)		State Street		State Street Bank	
(Dollars in millions)	**Minimum**	**Well Capitalized**	**2006**	**2005**	**2006**	**2005**
Tier 1 risk-based capital ratio	4 %	6 %	**12.2 %**	11.7 %	**10.8 %**	10.3 %
Total risk-based capital ratio	8	10	**14.3**	14.0	**12.8**	12.5
Tier 1 leverage ratio	4	5	**6.0**	5.6	**5.8**	5.4
Tier 1 risk-based capital			**$ 6,077**	$ 5,511	**$ 5,185**	$ 4,738
Total risk-based capital			**7,123**	6,617	**6,159**	5,720
Adjusted risk-weighted assets and market-risk equivalents:						
Balance sheet risk-weighted assets			**$ 33,808**	$ 27,288	**$ 32,065**	$ 25,965
Off-balance sheet equivalent risk-weighted assets			**15,579**	19,586	**15,581**	19,602
Market-risk equivalents			**352**	361	**325**	351
Total			**$ 49,739**	$ 47,235	**$ 47,971**	$ 45,918
Quarterly average adjusted assets			**$ 101,703**	$ 98,970	**$ 89,078**	$ 87,667

(1) State Street Bank must meet regulatory guidelines for well capitalized in order to maintain State Street s status as a financial holding company, which require a minimum tier 1 risk-based capital ratio of 6%, a minimum total risk-based capital ratio of 10% and a tier 1 leverage ratio of 5%. In addition, State Street must meet Federal Reserve guidelines for well capitalized for a bank holding company to be eligible for a streamlined review process for acquisition proposals. These guidelines require a minimum tier 1 risk-based capital ratio of 6% and a minimum total risk-based capital ratio of 10%.

At September 30, 2006, State Street s and State Street Bank s tier 1 and total risk-based capital ratios increased compared to year-end 2005. The impact of growth in capital, primarily from earnings, exceeded the impact of growth in total risk-weighted assets. Growth in balance sheet risk-weighted assets, primarily investment securities available for sale and loans, was partly offset by a decrease in off-balance sheet equivalent risk-weighted assets. The decrease in off-balance sheet equivalent assets resulted from allowable changes in the calculation of exposure related to our securities finance activities. Both ratios for State Street and State Street Bank exceeded the regulatory minimum and well-capitalized thresholds.

In June 2004, the Basel Committee on Banking Supervision released the final version of its capital adequacy framework, known as Basel II. U.S. banking regulatory agencies must now apply international risk-based capital guidance to rules to be implemented in the U.S. In September 2006, the Federal Reserve released proposed new rules which are subject to a 120-day comment period. We, along with other large internationally active U.S. institutions, will be subject to the new rules. To foster readiness for the implementation of Basel II, we established and are executing a comprehensive implementation program to achieve Basel II compliance. At this time, we cannot predict the final form of the rules in the U.S., nor their impact on State Street s or State Street Bank s risk-based capital.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

On March 16, 2006, the Board of Directors, or Board, authorized a new program for the purchase of up to 15 million shares of common stock for general corporate purposes, including mitigating the dilutive impact of shares issued under employee benefit programs, and canceled its authorization for purchases of common stock remaining under a previous program authorized in 2005. During the second quarter of 2006, we purchased approximately 2.8 million shares of our common stock under the new program. In the third quarter of 2006 no shares were purchased. As of September 30, 2006, 12.2 million shares remained available for future purchase under the new program. During the first quarter of 2006, we purchased approximately 3.0 million shares of our common stock under the previously authorized program. We employ third-party broker-dealers to acquire shares on the open market in connection with our stock purchase program.

Economic Capital

We define economic capital as the common equity required to protect debt holders against unexpected economic losses over a one-year period at a level consistent with the solvency of a firm with our target debt rating. The framework and methodologies used to quantify economic capital for each of the risk types described below have been developed by our Enterprise Risk Management, Global Treasury and Corporate Finance groups and are designed to be generally consistent with our risk management principles. This framework has been approved by senior management and has been reviewed by the Executive Committee of the Board. Our Capital Committee, consisting of senior management, oversees the management of State Street s economic capital, along with other matters related to State Street s capital structure. Due to the evolving nature of quantification techniques, we expect to periodically refine the methodologies, assumptions and data used to estimate our economic capital requirements, which could result in a different amount of capital needed to support our risk profile.

We quantify capital requirements for the risks inherent in our business activities and group them into one of the following broadly defined categories:

- Market risk: the risk of adverse financial impact due to fluctuations in market prices, primarily as they relate to our trading activities

- Interest-rate risk: the risk of loss in non-trading asset and liability management positions, primarily the impact of adverse movements in interest rates on the repricing mismatches that exist between balance sheet assets and liabilities

- Credit risk: the risk of loss that may result from the default or downgrade of a borrower or counterparty

- Operational risk: the risk of loss from inadequate or failed internal processes, people and systems, or from external events, which is consistent with the Basel II definition

- Business risk: the risk of adverse changes in our earnings from business factors, including changes in the competitive environment, changes in the operational economics of business activities, and the effect of strategic and reputation risks

Economic capital for each of these five categories is estimated on a stand-alone basis using statistical modeling techniques applied to internally generated and external data. These individual results are then aggregated at the State Street consolidated level. A capital reduction or diversification benefit is then

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

applied to reflect the unlikely event of experiencing an extremely large loss in each risk type at the same time.

Liquidity

The objective of liquidity management is to ensure that we have the ability to meet our financial obligations in a timely and cost-effective manner, and that we maintain sufficient flexibility to fund strategic corporate initiatives as they arise. Effective management of liquidity involves assessing the potential mismatch between the future cash needs of our customers and our available sources of cash under normal and adverse economic and business conditions. Uses of liquidity consist primarily of meeting deposit withdrawals and funding outstanding commitments to extend credit as they are drawn upon. Liquidity is provided by the maintenance of broad access to the global capital markets and by our balance sheet asset structure. You can obtain additional information about our liquidity management process in the Financial Condition section of Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2005 10-K.

Material risks to the sou