

STATE STREET CORP
Form 10-Q
November 02, 2007

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

or

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

For the transition period from _____ to _____

Commission File 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 No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares of State Street's common stock outstanding on October 31, 2007 was 386,205,577.

STATE STREET CORPORATION

Quarterly Report on Form 10-Q for the Quarterly Period Ended September 30, 2007

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

OVERVIEW

State Street Corporation is a financial holding company headquartered in Boston, Massachusetts. Through its subsidiaries, including its principal bank subsidiary, State Street Bank and Trust Company, State Street provides a full range of products and services to meet the needs of institutional investors worldwide. Unless otherwise indicated or unless the context requires otherwise, all references in this Management's Discussion and Analysis to "State Street," "we," "us," "our" or similar terms mean State Street Corporation and its subsidiaries on a consolidated basis. At September 30, 2007, we had consolidated total assets of \$139.89 billion, total deposits of \$93.00 billion, total shareholders' equity of \$11.25 billion and employed 26,425.

Our customers include mutual funds and other collective investment funds, corporate and public retirement plans, insurance companies, foundations, endowments and other investment pools, and investment managers. Our two lines of business, Investment Servicing and Investment Management, provide products and services including custody, recordkeeping, daily pricing and administration, shareholder services, foreign exchange, brokerage and other trading services, securities finance, deposit and short-term investment facilities, loan and lease financing, investment manager and hedge fund manager operations outsourcing, performance, risk and compliance analytics, investment research and investment management, including passive and active U.S. and non-U.S. equity and fixed income strategies. We had \$15.15 trillion of assets under custody and \$2 trillion of assets under management at September 30, 2007. Financial information about our business lines is provided later in the "Line of Business Information" section.

This Management's Discussion and Analysis is part of our Quarterly Report on Form 10-Q to the SEC, and updates the Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2006, which we refer to as the 2006 Form 10-K, and in our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2007 and June 30, 2007. We previously filed these reports with the SEC. You should read the financial information in this Form 10-Q in conjunction with the financial information contained in those filings. Certain amounts previously reported have been reclassified to conform to current period classifications.

We prepare our consolidated financial statements in accordance with United States generally accepted accounting principles, which we refer to as GAAP, and which require management to make judgments in the application 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 2006 Form 10-K. Other than our application of the provisions of FASB Staff Position No. FAS 13-2 and Interpretation No. 48, which are discussed in note 1 to the consolidated financial statements in this Form 10-Q, there were no significant changes to these accounting policies during the first nine months of 2007.

THIRD QUARTER DEVELOPMENTS

On July 2, 2007, we completed our acquisition of Investors Financial Services Corp., a bank holding company based in Boston with approximately \$17 billion in total assets and approximately \$1.9 trillion in assets under custody. We acquired Investors Financial in order to enhance our position as a worldwide service provider to institutional investors. We exchanged approximately 60.8 million shares of our common stock, with an aggregate value of approximately \$4.2 billion, for all of the

outstanding common stock of Investors Financial. Results of operations of Investors Financial are included in our consolidated financial statements beginning on July 2, 2007. Accordingly, our financial results for the third quarter of 2007, included in the accompanying consolidated financial statements and discussed in this Management's Discussion and Analysis, include results for the third quarter of 2007 of the acquired Investors Financial business.

In connection with the acquisition, we recorded goodwill of \$2.7 billion and other intangible assets, specifically customer relationship and core deposit intangibles, of \$1.4 billion. In addition, we recorded merger and integration costs of \$141 million in our statement of income during the third quarter of 2007. Additional information about the acquisition, including the goodwill and other intangible assets and the merger and integration costs, is provided in notes 2 and 4 to the consolidated financial statements in this Form 10-Q.

During the third quarter of 2007, we repurchased 13.4 million shares of our common stock in connection with the \$1 billion accelerated share repurchase program announced on July 20, 2007. The total number of shares repurchased will depend, in part, on the weighted-average price per share of our common stock over the repurchase period. This period is not expected to exceed six months from commencement of the program. The total number of shares to be repurchased is also subject to other conditions and adjustments. Additional information with respect to this accelerated share repurchase program is in the "Capital Regulatory Capital" section of this Management's Discussion and Analysis.

FORWARD-LOOKING STATEMENTS

This Form 10-Q, particularly this Management's Discussion and Analysis, and the discussion in Part II Item 1A, "Risk Factors," in this Form 10-Q, contains statements that are considered "forward-looking statements" within the meaning of United States securities laws. In addition, management may make other written or oral communications from time to time that contain forward-looking statements. Forward-looking statements, including statements about industry trends, management's future expectations and other matters that do not relate strictly to historical facts, are based on assumptions by management, and are often identified by such forward-looking terminology as "expect," "look," "believe," "anticipate," "estimate," "seek," "may," "will," "trend," "target" and "goal," or similar statements or variations of such terms.

These statements are subject to various risks and uncertainties, which change over time, and are based on management's expectations and assumptions at the time the statements are made, and are not guarantees of future results. Management's expectations and assumptions, and the continued validity of the forward-looking statements, are subject to change due to a broad range of factors affecting the national and global economies, the equity, debt, currency and other financial markets, as well as factors specific to the parent company and to our principal bank subsidiary, State Street Bank and Trust Company.

Factors that could cause changes in the expectations or assumptions on which forward-looking statements are based include, but are not limited to:

Our ability to integrate and convert acquisitions into our business, including our acquisition of Investors Financial;

The level and volatility of interest rates, particularly in the U.S. and Europe; the performance and volatility of securities, currency and other markets in the U.S. and internationally; and economic conditions and monetary and other governmental actions designed to address those conditions;

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The liquidity of the U.S. and European securities markets, particularly the markets for fixed-income securities, including asset-backed commercial paper, as well as the liquidity requirements of our customers;

Our ability to attract non-interest bearing deposits and other low-cost funds;

The performance of, and demand for, the investment products we offer;

The competitive environment in which we operate, including our ability to cross-sell services to our customers and to maintain service levels, technology and product offerings that are sufficient to attract new customers and retain current customers;

The enactment of legislation, including tax legislation, and changes in regulation and enforcement that impact State Street and its customers, as well as the effects of legal and regulatory proceedings, including litigation;

Our ability to continue to grow revenue, control expenses and attract the capital necessary to achieve our business goals and comply with regulatory requirements;

Our ability to control systemic and operating risks;

Trends in the globalization of investment activity and the growth on a worldwide basis in financial assets;

Trends in governmental and corporate pension plans and savings rates;

Changes in accounting standards and practices, including changes in the interpretation of existing standards, that impact our consolidated financial statements; and

Changes in tax legislation and in the interpretation of existing tax laws by U.S. and non-U.S. tax authorities that impact the amount of taxes due.

Therefore, actual outcomes and results may differ materially from what is expressed in our forward-looking statements, and those statements should not be relied upon as representing our expectations or beliefs as of any date subsequent to the date this Form 10-Q is filed with the SEC. 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 2006 Form 10-K and in this Form 10-Q, particularly in Item 1A, "Risk Factors," in each report. You should read and consider the risk factors discussed in our 2006 Form 10-K and in this Form 10-Q in conjunction with the information provided in this Form 10-Q. We undertake no obligation to revise the forward-looking statements contained in this Form 10-Q to reflect events after its filing date.

OVERVIEW OF FINANCIAL RESULTS

(Dollars in millions, except per share amounts)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2007 ⁽¹⁾	2006	% Change	2007 ⁽¹⁾	2006	% Change
Total fee revenue	\$ 1,782	\$ 1,246	43%	\$ 4,689	\$ 3,881	21%
Net interest revenue	464	266	74	1,174	794	48
(Losses) Gains on sales of available-for-sale investment securities, net	(6)	3		(6)	14	
Total revenue	2,240	1,515	48	5,857	4,689	25
Total operating expenses ⁽²⁾	1,689	1,090	55	4,260	3,362	27
Income from continuing operations before income tax expense	551	425	30	1,597	1,327	20
Income tax expense from continuing operations	193	147	31	559	540	4
Income from continuing operations	358	278	29	1,038	787	32
Income from discontinued operations					10	
Net income	\$ 358	\$ 278		\$ 1,038	\$ 797	
Earnings Per Share From Continuing Operations ⁽³⁾ :						
Basic	\$.92	\$.84	10	\$ 2.95	\$ 2.38	24
Diluted	.91	.83	10	2.91	2.35	24
Earnings Per Share ⁽³⁾ :						
Basic	.92	.84		2.95	2.41	
Diluted	.91	.83		2.91	2.38	
Cash dividends declared	.22	.20		.65	.59	
Return on shareholders' equity from continuing operations	12.6%	16.4%		15.9%	16.0%	
Return on shareholders' equity	12.6	16.4		15.9	16.2	

(1) Financial results for the third quarter and first nine months of 2007 include results of the acquired Investors Financial business for the third quarter of 2007.

(2) Amounts for third quarter and first nine months of 2007 include merger and integration costs of \$141 million, or \$91 million after-tax, recorded in connection with the acquisition of Investors Financial.

(3) Earnings per share for the third quarter and first nine months of 2007 reflect the issuance of 60.8 million shares on July 2, 2007 in connection with the acquisition of Investors Financial.

Summary

Our financial results for the third quarter and first nine months of 2007 continued to reflect growth in revenue along with our ability to balance expense growth with revenue growth. Other

highlights for the third quarter and first nine months of 2007 relative to the 2006 periods are as follows:

Compared to the third quarter of 2006, servicing fees grew 37%, management fees grew 26%, trading service revenue grew 87% and securities finance revenue grew 90%, contributing to aggregate growth of 43% in total fee revenue, of which the acquired Investors Financial business contributed a 16% increase, primarily in servicing fees.

In the year-to-date comparison, servicing fees grew 20%, management fees grew 22%, trading services revenue grew 21% and securities finance revenue grew 44%, contributing to aggregate growth of 21% in total fee revenue.

Net interest revenue grew 74% and net interest margin grew 51 basis points compared to last year's third quarter. In the year-to-date comparison, net interest revenue grew 48% and net interest margin grew 40 basis points.

Total operating expenses grew 55% compared to last year's third quarter, with Investors Financial contributing a 16% increase, and grew 27% in the nine-month comparison. These expenses for 2007 included \$141 million of merger and integration costs recorded in connection with our acquisition of Investors Financial.

State Street Global Advisors, which we refer to as SSgA, generated \$26 billion of net new business in assets under management during the third quarter and \$134 billion for the first nine months of 2007.

We ended the third quarter of 2007 with record levels, for State Street, of assets under custody and assets under management.

Our financial results for the third quarter of 2007 are discussed in the following "Financial Highlights" section, with more detailed information about the third quarter and first nine months of 2007 provided in the "Consolidated Results of Operations" section of this Management's Discussion and Analysis.

Financial Highlights

Third quarter 2007 net income of \$358 million increased 29%, and diluted earnings per share of \$.91 increased 10%, from net income of \$278 million and diluted earnings per share of \$.83 for the third quarter of 2006. Net income was \$1,038 million and diluted earnings per share was \$2.91 for the first nine months of 2007, compared to income from continuing operations of \$787 million and diluted earnings per share from continuing operations of \$2.35 for the first nine months of 2006. Net income of \$797 million for the first nine months of 2006 included income from discontinued operations of \$10 million (gross income of \$16 million reduced by related income tax expense of \$6 million), or \$.03 per share, which resulted from the finalization of legal, selling and other costs recorded in connection with our divestiture of Bel Air Investment Advisors LLC. Additional information about the Bel Air divestiture is included in note 2 to the consolidated financial statements in this Form 10-Q.

Comparing the third quarter of 2007 to the third quarter of 2006, our total revenue grew 48% to \$2.2 billion. Total fee revenue was up 43%, with increases in all income statement revenue line items except processing fees and other, which was down 6%. The growth in fee revenue was composed of growth in servicing fees, up 37%, management fees, up 26%, trading services revenue, up 87% and securities finance revenue, up 90%. The acquired Investors Financial business contributed about one-third of the increase in total fee revenue.

Both servicing fees and management fees benefited from increases in net new business and favorable equity market performance, with servicing fees also reflecting the contribution of the acquired Investors Financial business. Trading services revenue benefited from increases in customer volumes and currency volatility, both of which were driven by the disruption experienced in the global fixed-income securities markets during the third quarter of 2007, as well as the contribution of the acquired Investors Financial business. Trading services revenue also benefited from the contribution of revenue from the Currenex business, which we acquired in March 2007. The increase in securities finance revenue was driven by higher securities lending volumes from both existing and new customers and by wider spreads, which benefited from an increase in volatility attributable to the above-mentioned fixed-income markets disruption. Spreads also benefited from the Federal Reserve's 50-basis-point reduction in the federal funds rate in September 2007. The decline in processing fees and other revenue primarily reflected the impact of the fixed-income markets disruption experienced during the third quarter, as revenue from our Structured Products group's asset-backed commercial paper business decreased.

Net interest revenue increased 74% compared to the prior year third quarter, with a related increase in net interest margin of 51 basis points. The increases were primarily due to a favorable funding mix, including a higher volume of non-U.S. transaction deposits at higher spreads, as well as the addition of interest-earning assets from the acquired Investors Financial business and the ongoing impact of our investment securities portfolio repositioning. Overall, we continue to benefit from higher levels of customer deposits and the continued favorable non-U.S. interest rate environment and stable U.S. interest rates.

Total operating expenses increased 55% to \$1.69 billion, primarily the result of increased incentive compensation due to improved performance, the addition of the operating expenses of the acquired Investors Financial business, which contributed a 16% increase, and increased staffing levels to support new business. Total operating expenses for the third quarter of 2007 included \$141 million of merger and integration costs recorded in connection with the acquisition of Investors Financial. Excluding the merger and integration costs, total operating expenses were \$1.55 billion, which represents 42% growth over the third quarter of 2006. With growth in total revenue of 48% exceeding the growth in total operating expenses of 42%, excluding the merger and integration costs, for the third quarter of 2007, we achieved positive operating leverage of approximately 580 basis points. We define operating leverage as the difference between the growth rate of total revenue and the growth rate of total operating expenses, with total operating expenses adjusted to exclude the impact of non-recurring expenses.

Our Investment Management business continued to generate increased revenue, principally from increased customer demand for active investment management products, such as enhanced indexing and active quantitative management, which earn a higher level of fees than other products. Revenue from the Investment Management business line increased 26% for the third quarter of 2007 compared to the third quarter of 2006. Net new business totaled \$26 billion in assets under management in the third quarter of 2007, compared to net new business of \$33 billion in last year's third quarter. On a year-to-date basis, net new business totaled \$134 billion for 2007 compared to \$62 billion for the 2006 period. Net new business is measured as the aggregate value of new asset management business added less asset management business lost during the period.

At September 30, 2007, we had aggregate assets under custody of \$15.15 trillion, which grew 28% from \$11.85 trillion at December 31, 2006, and 34% from \$11.27 trillion at September 30, 2006. The total assets under custody at September 30, 2007 included assets under custody contributed by the acquired Investors Financial business of \$1.9 trillion. At the same date, we had aggregate assets under management of \$2 trillion, which grew 14% from \$1.75 trillion at December 31, 2006 and 22% from \$1.63 trillion at September 30, 2006.

Our effective tax rate for the third quarter of 2007 was 35%, compared to 34.6% from continuing operations for the third quarter of 2006, and 38.1% for full-year 2006. The effective rate for full-year 2006 reflected increased income tax expense that resulted from tax-related adjustments recorded in the second and fourth quarters of 2006 primarily associated with tax legislation and leveraged leases.

Financial Goals

In our 2006 Form 10-K, we reaffirmed our long-term financial goals for State Street. However, in anticipation of our then-planned acquisition of Investors Financial, and subsequently as a result of our financial results and those of Investors Financial for the second quarter of 2007, we adjusted our financial goals for full-year 2007, as follows:

Growth in operating-basis revenue of between 20% and 22%;

Growth in operating-basis earnings per share from continuing operations of between 10% and 15%; and

Operating-basis return on shareholders' equity from continuing operations of between 14% and 17%.

Operating-basis results, as defined by management, include fully taxable-equivalent net interest revenue, reflecting increases related to tax-equivalent adjustments of \$17 million and \$9 million for the third quarters of 2007 and 2006, respectively, and \$41 million and \$33 million respectively for each of the nine-month periods of 2007 and 2006, with a corresponding charge to income tax expense. Operating-basis results for the quarter and nine months ended September 30, 2007 exclude \$141 million (\$91 million after-tax), equivalent to \$.24 per share, of merger and integration costs recorded in connection with the Investors Financial acquisition. Operating-basis results for the nine months ended September 30, 2006 exclude tax-related adjustments of \$83 million recorded in the second quarter of 2006 primarily associated with tax legislation and leveraged leases.

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 fully taxable-equivalent net interest revenue facilitates the comparison of revenues from both taxable and non-taxable sources. In addition, the merger and integration costs and the tax-related adjustments are not associated with our normal ongoing business operations, and as a result could prevent a meaningful comparison of earnings per share and return on shareholders' equity with those of other periods. Management believes that operating-basis financial information, which includes the impact of revenue from non-taxable sources and excludes the impact of these non-recurring expenses, 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.

For the first nine months of 2007 compared to the first nine months of 2006, we continued to make progress toward achieving our financial goals for 2007. As presented in the table below, we increased our operating-basis earnings per share from continuing operations by 21%, from \$2.60 to \$3.15; our operating-basis revenue increased 25% from \$4.722 billion to \$5.898 billion; and we achieved operating-basis return on shareholders' equity of 17.3%.

RECONCILIATION OF REPORTED RESULTS TO OPERATING-BASIS RESULTS

(Dollars in millions, except per share amounts)	Nine Months Ended September 30, 2007			Nine Months Ended September 30, 2006			2007 vs 2006
	Reported Results	Adjustments	Operating Results	Reported Results	Adjustments	Operating Results	% Change ⁽⁴⁾
Fee revenue	\$ 4,689		\$ 4,689	\$ 3,881		\$ 3,881	21%
Net interest revenue	1,174	\$ 41 ⁽¹⁾	1,215	794	\$ 33 ⁽¹⁾	827	47
(Losses) Gains on sales of available-for-sale investment securities, net	(6)		(6)	14		14	
Total revenue	5,857	41	5,898	4,689	33	4,722	25
Total operating expenses	4,260	(141) ⁽²⁾	4,119	3,362		3,362	23
Income from continuing operations before income tax expense	1,597	182	1,779	1,327	33	1,360	31
Income tax expense	559	50 ⁽²⁾	609	540	(83) ⁽³⁾	457	
Taxable-equivalent adjustment		41 ⁽¹⁾	41		33 ⁽¹⁾	33	
Income from continuing operations	\$ 1,038	\$ 91	\$ 1,129	\$ 787	\$ 83	\$ 870	30
Diluted earnings per share	\$ 2.91	\$.24	\$ 3.15	\$ 2.35	\$.25	\$ 2.60	21
Return on equity from continuing operations	15.9%	1.4%	17.3%	16.0%	1.7%	17.7%	

(1) Taxable-equivalent adjustments are not included in reported results.

(2) Merger and integration costs are direct and incremental costs to integrate the acquired Investors Financial business into our operations, and do not include ongoing costs of the combined organization.

(3) Tax-related adjustments were related to additional income tax expense primarily associated with tax legislation and leveraged leases.

(4) The percent change represents the change in operating-basis results for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006.

Outlook

Some of the factors and assumptions that we considered earlier this year in determining our outlook for 2007 were as follows:

Expected equity market growth, based on S&P 500 and/or MSCI® EAFE indices, of about 7%;

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Growth in revenue generated from active quantitative asset management products;

Relatively stable U.S. interest rates;

Expected flattening of the U.S. dollar yield curve;

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Continuation of beneficial trends in non-U.S. interest rates;

Modest growth in non-U.S. deposits, as well as the maintenance of a favorable mix of customer deposits, including demand deposits;

A stable income tax and regulatory environment;

Achievement of expected cost savings from the Investors Financial acquisition; and

Retention of, and success in cross-selling to, Investors Financial's customer base.

Actual experience during the first nine months of 2007 has differed from our assumptions in many respects. In particular, during the first nine months of 2007, increases in our servicing and management fee revenues, due in part to the performance of the equity markets, as well as increases in, and higher spreads on, our non-U.S. deposits have been more favorable than our assumptions. However, these favorable trends may not continue or may lessen over the remainder of 2007. In addition, changes in U.S. and non-U.S. interest rates could affect our net interest revenue. Additional information about factors that could affect our net interest revenue for 2007 are described in the "Net Interest Revenue" section of this Management's Discussion and Analysis. Information about risks and uncertainties which could cause these and other actual results to differ materially from those expected is included in Item 1A of our 2006 Form 10-K and this Form 10-Q.

CONSOLIDATED RESULTS OF OPERATIONS

This section discusses our consolidated results of operations for the third quarter and first nine months of 2007 compared to the same periods in 2006, and should be read in conjunction with the accompanying consolidated financial statements and related condensed notes.

TOTAL REVENUE

(Dollars in millions)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2007	2006	% Change	2007	2006	% Change
Fee Revenue:						
Servicing fees	\$ 937	\$ 685	37%	\$ 2,421	\$ 2,025	20%
Management fees	299	238	26	844	690	22
Trading services	320	171	87	800	659	21
Securities finance	165	87	90	425	296	44
Processing fees and other	61	65	(6)	199	211	(6)
Total fee revenue	1,782	1,246	43	4,689	3,881	21
Net Interest Revenue:						
Interest revenue	1,383	1,103	25	3,758	3,098	21
Interest expense	919	837	10	2,584	2,304	12
Net interest revenue	464	266	74	1,174	794	48
(Losses) Gains on sales of available-for-sale investment securities, net	(6)	3		(6)	14	
Total revenue	\$ 2,240	\$ 1,515	48	\$ 5,857	\$ 4,689	25

Fee Revenue

Servicing fees and management fees collectively comprised approximately 69% and 70% of total fee revenue for the third quarter and first nine months of 2007. These fee levels 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. These fees are affected by changes in worldwide equity and fixed income valuations. Generally, servicing fees are affected, in part, by changes in daily average valuations of assets under custody, while management fees are affected by changes in month-end valuations of assets under management. However, additional factors, such as the level of transaction volumes, changes in service level, balance credits, customer minimum balances, pricing concessions 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. Performance fees have become a larger component of our management fee revenue over the past two years, and comprised about 9% of our management fee revenue for full-year 2006, compared to about 5% for 2005. For the first nine months of 2007, performance fees comprised about 6% of management fee revenue. Performance fees are generated when the performance of managed funds exceeds benchmarks specified in the management agreements.

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, under the same assumptions, a corresponding change of approximately 1% in our total revenue.

FEE REVENUE

(Dollars in millions)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2007	2006	% Change	2007	2006	% Change
Servicing fees	\$ 937	\$ 685	37%	\$ 2,421	\$ 2,025	20%
Management fees	299	238	26	844	690	22
Trading services	320	171	87	800	659	21
Securities finance	165	87	90	425	296	44
Processing fees and other	61	65	(6)	199	211	(6)
Total fee revenue	\$ 1,782	\$ 1,246	43	\$ 4,689	\$ 3,881	21

Servicing fees

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. For the quarter and nine months ended September 30, 2007, compared to the corresponding 2006 periods, the increase in servicing fees was driven primarily by the contribution of servicing fee revenue from the acquired Investors Financial business, net new business from existing and new customers, and higher daily average equity market valuations. The quarterly comparison also benefited from higher transaction volumes. The daily average values for the S&P 500 Index were up 16%, and for the MSCI®

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EAFE Index were up 20%, compared with the third quarter of 2006. For the year to date, daily average values for the S&P 500 Index increased 15% and for the MSCI® EAFE Index increased 20%.

ASSETS UNDER CUSTODY	September 30, 2007 ⁽¹⁾	December 31, 2006	September 30, 2006
(In billions)			
Mutual funds	\$ 4,771	\$ 3,738	\$ 3,536
Collective funds	3,146	1,665	1,554
Pension products	3,934	3,713	3,546
Insurance and other products	3,297	2,738	2,630
Total	\$ 15,148	\$ 11,854	\$ 11,266
Financial Instrument Mix:			
Equities	\$ 8,210	\$ 5,821	\$ 5,595
Fixed income	4,347	4,035	3,928
Short-term and other investments	2,591	1,998	1,743
Total	\$ 15,148	\$ 11,854	\$ 11,266

(1) Total assets under custody at September 30, 2007 included \$1,889 billion from the acquired Investors Financial business.

Management fees

The increase in management fees primarily reflected increases in net new business, as well as higher month-end equity market valuations. Performance fees were \$18 million and \$51 million for the third quarter and first nine months of 2007, compared to \$28 million and \$56 million for the third quarter and first nine months of 2006. The averages of month-end values for the S&P 500 Index on both a quarter and year-to-date basis were up 14%, and for the MSCI® EAFE Index were up 20%, compared with the third quarter and first nine months of 2006.

ASSETS UNDER MANAGEMENT	September 30, 2007	December 31, 2006	September 30, 2006
(In billions)			
Equities:			
Passive	\$ 781	\$ 691	\$ 638
Active and other	216	181	158
Company stock/ESOP	87	85	80
Total equities	1,084	957	876
Fixed income	244	201	184
Cash and money market	666	591	572
Total fixed income and cash	910	792	756
Assets under management from Investors Financial	4		
Total	\$ 1,998	\$ 1,749	\$ 1,632

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The following table presents a roll-forward of assets under management for the twelve months ended September 30, 2007.

ASSETS UNDER MANAGEMENT

(In billions)

September 30, 2006	\$ 1,632
Net new business	24
Market appreciation	93
December 31, 2006	1,749
Net new business	134
Market appreciation	111
Assets under management from Investors Financial	4
September 30, 2007	\$ 1,998

Trading services

Trading services revenue, which includes foreign exchange trading revenue and brokerage and other trading fees, was up 87% for the third quarter of 2007 compared to the third quarter of 2006 and up 21% in the nine-month comparison. Foreign exchange trading revenue for the third quarter and first nine months of 2007 totaled \$224 million and \$550 million, respectively, up 98% and 17% from \$113 million and \$470 million in the prior-year periods. The quarterly increase reflected a 55% increase in customer volumes, mostly in foreign exchange trading, the contribution of revenue from the acquired Investors Financial business, and a 9% increase in currency volatility. The nine-month increase resulted from a 29% increase in customer volumes and the contribution from the acquired Investors Financial business, partially offset by an 18% decline in currency volatility.

Brokerage and other trading fees totaled \$96 million for the third quarter of 2007, up 66% from \$58 million in the third quarter of 2006, primarily the result of the contribution of fees from the operations of Currenex, which we acquired in March 2007, and increased fees from transition management. Brokerage and other trading fees in the nine-month comparison totaled \$250 million for 2007 and \$189 million for 2006, primarily the result of the contribution of revenue from the acquired Currenex operations and increased transition management fees.

Securities finance

Securities finance revenue for the third quarter of 2007 increased 90% compared to the third quarter of 2006, and 44% on a year-to-date comparison, with both increases driven by an increase in the average volume of securities loaned, up 34% quarter to quarter and up 33% on a year-to-date comparison. The growth in volume resulted from increased demand from existing customers and demand from new customers. Consolidated spread was increased 43% in the quarterly comparison and 13% on a year-to-date comparison. Spreads benefited from the disruption in the global fixed-income securities markets experienced during the third quarter of 2007, as well as from the Federal Reserve Board's 50 basis point reduction in the federal funds rate in September 2007.

Processing Fees and Other

The decreases in processing fees and other in both the quarterly and year-to-date comparisons resulted from a decline in revenue from our Structured Products group, primarily associated with the previously described fixed-income markets disruption, which impacted fees from asset-backed

commercial paper activities, as rates paid on commercial paper increased and spreads between the overall yield on the assets collateralizing the commercial paper and the rates paid on the commercial paper narrowed. The decline also resulted from the impact of the September 30, 2006 consolidation of our tax-exempt investment program onto our balance sheet. As a result of the consolidation, revenue from the program, previously recorded in processing fees and other, is currently recorded in net interest revenue.

NET INTEREST REVENUE

(Dollars in millions)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2007	2006	% Change	2007	2006	% Change
Interest revenue ⁽¹⁾	\$ 1,383	\$ 1,103	25%	\$ 3,758	\$ 3,098	21%
Interest expense ⁽¹⁾	919	837	10	2,584	2,304	12
Net interest revenue	464	266	74	1,174	794	48
Provision for loan losses						
Net interest revenue after provision for loan losses	\$ 464	\$ 266	74	\$ 1,174	\$ 794	48
Net interest revenue (fully taxable-equivalent basis) ⁽²⁾	\$ 481	\$ 275	75	\$ 1,215	\$ 827	47

(1) Additional detail about the components of interest revenue and interest expense is in note 11 to the consolidated financial statements in this Form 10-Q.

(2) Fully taxable-equivalent amounts reflect adjustments computed using a federal income tax rate of 35%, adjusted for applicable state income taxes, net of the related federal tax benefit. Adjustments included in fully taxable-equivalent basis net interest revenue in the preceding table, and in the rates earned on interest-earning assets in the table below, were \$17 million and \$9 million for the third quarters of 2007 and 2006, respectively, and \$41 million and \$33 million for the first nine months of 2007 and 2006.

NET INTEREST MARGIN

(Dollars in millions)	Quarters Ended September 30,				Nine Months Ended September 30,			
	2007		2006		2007		2006	
	Average Balance	Rate ⁽¹⁾	Average Balance	Rate ⁽¹⁾	Average Balance	Rate ⁽¹⁾	Average Balance	Rate ⁽¹⁾
Interest-earning assets	\$ 109,968	5.05%	\$ 89,880	4.91%	\$ 100,465	5.05%	\$ 90,922	4.60%
Interest-bearing liabilities	98,260	3.71	81,739	4.06	90,172	3.83	82,650	3.72
Excess of rate earned over rate paid		1.34%		.85%		1.22%		.88%
Net interest margin		1.73%		1.22%		1.62%		1.22%

(1) Fully taxable-equivalent basis.

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Net interest revenue increased 74% and 48%, and net interest margin increased 51 basis points and 40 basis points, for the quarter and nine months ended September 30, 2007, respectively, compared to the same periods in 2006. The increases were principally due to a favorable funding mix, including a higher volume of non-U.S. transaction deposits at higher spreads, as well as the addition of interest-earning assets from the acquired Investors Financial business and the ongoing impact of our investment securities portfolio repositioning, substantially completed in 2006, which has resulted in the maturity of fixed-rate securities and re-investment in higher yielding securities. The increases were offset by a decline in fees from domestic overdrafts and an increase in higher-cost time deposits.

Several factors could continue to affect our net interest revenue and margin for 2007, including ongoing actions by the Federal Reserve to manage short-term interest rates; the shape of the yield curve; changes in non-U.S. interest rates; interest-rate spreads on the reinvestment of proceeds from maturities of investment securities; and our maintenance of the high credit quality of our investment securities portfolio.

For the third quarter of 2007, our average investment securities portfolio of \$74.6 billion included fixed-and floating-rate asset-backed securities (\$26.4 billion, or 35% of the average investment portfolio for the third quarter of 2007), collateralized mortgage obligations (\$14.6 billion, or 20% of the average portfolio for the third quarter of 2007), and mortgage-backed securities from U.S. Treasury and federal agencies (\$16.3 billion, or 22%). Asset-backed securities that were collateralized by sub-prime mortgages totaled \$6.6 billion at September 30, 2007. Of this total, 73% were AAA rated, and 27% were AA rated. Overall, we continue to invest primarily in AAA and AA rated securities. AAA and AA rated securities comprised approximately 95% of our investment securities portfolio at September 30, 2007, with approximately 89% AAA rated.

OPERATING EXPENSES

(Dollars in millions)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2007	2006	% Change	2007	2006	% Change
Salaries and employee benefits	\$ 916	\$ 639	43%	\$ 2,463	\$ 1,958	26%
Information systems and communications	145	121	20	398	382	4
Transaction processing services	165	121	36	435	375	16
Occupancy	109	91	20	301	279	8
Merger and integration	141			141		
Other	213	118	81	522	368	42
Total operating expenses	\$ 1,689	\$ 1,090	55	\$ 4,260	\$ 3,362	27
Number of employees at quarter end	26,425	21,500				

Salaries and employee benefits expense increases were mainly the result of higher incentive compensation due to improved performance, the addition of the acquired Investors Financial business' salaries and benefits expenses for the third quarter and increased staffing levels. Staffing levels increased to support new business, particularly internationally, and also resulted from the acquisition of Currenex. The year-to-date increase was also affected by higher average salaries attributable to annual merit increases.

The increases in occupancy costs primarily resulted from costs contributed by the acquired Investors Financial business related to leased space, as well as additional costs to support the growth in business in Europe and Asia. The increase in information systems and communications expense for both periods was primarily the result of the contribution of costs from the acquired Investors Financial business and technology spending both in Europe and related to the Currenex acquisition. Transaction processing expense increased in both comparisons primarily as a result of the contribution of expenses from the acquired Investors Financial business and higher volumes in asset servicing.

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Other expenses increased in both comparisons, primarily the result of the impact of the acquired Investors Financial business, which contributed increases in professional services and intangible amortization, and costs to support growth in business. The year-to-date increase also resulted from increased charitable contributions and sales promotion expenses.

During the third quarter of 2007, in connection with the Investors Financial acquisition, we recorded merger and integration costs in our consolidated statement of income. These costs consisted only of direct and incremental costs to integrate the acquired Investors Financial business into our operations. These expenses do not include on-going expenses of the combined organization. The expenses included a non-cash charge of approximately \$91 million resulting from the termination of an operating lease related to one of our office buildings in Boston. This termination was completed in connection with an overall evaluation of our requirements for office space as a result of the acquisition.

We also recorded costs totaling \$20 million associated with retention and other compensation paid to employees of Investors Financial, \$8 million related to the integration of the acquired Investors Financial business's accounting and management systems and customers, and \$2 million of other costs. In addition, subsequent to the completion of the acquisition, we redeemed an aggregate of \$500 million of unsecured junior subordinated debentures issued by the parent company to two of our statutory business trusts, State Street Capital Trusts A and B, composed of \$200 million of 7.94% debentures issued in 1996 and \$300 million of 8.035% debentures issued in 1997. We paid the trusts the outstanding amount on the debentures plus accrued interest and an aggregate redemption premium of approximately \$20 million, which was included in the merger and integration costs.

Income Taxes

We recorded income tax expense of \$193 million for the third quarter of 2007, compared to \$147 million for the third quarter of 2006, with the increase due primarily to higher pre-tax earnings. For the first nine months of 2007, income tax expense was \$559 million, compared to \$540 million from continuing operations for the 2006 period, which included \$83 million of additional income tax expense recorded in the second quarter of 2006 primarily associated with tax legislation and leveraged leases. The effective tax rate for the third quarter of 2007 was 35% compared to 34.6% for the third quarter of 2006, the latter rate reflective of the above-described additional income tax expense.

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 22 to the consolidated financial statements in our 2006 Form 10-K.

The following is a summary of line of business results on a continuing operations basis. The amount presented in the "Other/One-Time" column represents the merger and acquisition costs

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recorded in connection with the acquisition of Investors Financial. These costs were not allocated to State Street's business lines.

For the Quarters Ended September 30,

	Investment Servicing		Investment Management		Other/ One-Time		Total	
	2007	2006	2007	2006	2007	2006	2007	2006
(Dollars in millions, except where otherwise noted)								
Fee Revenue:								
Servicing fees	\$ 937	\$ 685					\$ 937	\$ 685
Management fees			\$ 299	\$ 238			299	238
Trading services	320	171					320	171
Securities finance	128	66	37	21			165	87
Processing fees and other	52	51	9	14			61	65
Total fee revenue	1,437	973	345	273			1,782	1,246
Net interest revenue after provision for loan losses	427	235	37	31			464	266
(Losses) Gains on sales of available-for-sale investment securities, net	(6)	3					(6)	3
Total revenue	1,858	1,211	382	304			2,240	1,515
Operating expenses	1,292	903	256	187	\$ 141		1,689	1,090
Income from continuing operations before income tax expense	\$ 566	\$ 308	\$ 126	\$ 117	\$ (141)		\$ 551	\$ 425
Pre-tax margin	30%	25%	33%	39%			25%	28%
Average assets (in billions)	\$ 128.4	\$ 99.9	\$ 3.6	\$ 2.9			\$ 132.0	\$ 102.8

For the Nine Months Ended September 30,

	Investment Servicing		Investment Management		Other/ One-Time		Total	
	2007	2006	2007	2006	2007	2006	2007	2006
(Dollars in millions, except where otherwise noted)								
Fee Revenue:								
Servicing fees	\$ 2,421	\$ 2,025					\$ 2,421	\$ 2,025
Management fees			\$ 844	\$ 690			844	690
Trading services	800	659					800	659
Securities finance	323	224	102	72			425	296
Processing fees and other	160	163	39	48			199	211
Total fee revenue	3,704	3,071	985	810			4,689	3,881
Net interest revenue after provision for loan losses	1,056	705	118	89			1,174	794
(Losses) Gains on sales of available-for-sale investment securities, net	(6)	14					(6)	14
Total revenue	4,754	3,790	1,103	899			5,857	4,689
Operating expenses	3,405	2,786	714	576	\$ 141		4,260	3,362

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For the Nine Months Ended September 30,

Income from continuing operations before income tax expense	\$ 1,349	\$ 1,004	\$ 389	\$ 323	\$ (141)	\$ 1,597	\$ 1,327
Pre-tax margin	28%	26%	35%	36%		27%	28%
Average assets (in billions)	\$ 114.2	\$ 101.6	3.5	\$ 2.9		\$ 117.7	\$ 104.5

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Investment Servicing

Total revenue for the third quarter of 2007 increased 53% compared to the same period in 2006, and 25% in the nine-month comparison. Total fee revenue in the same comparisons increased 48% and 21%, respectively, with the increases primarily attributable to growth in servicing fees, trading services revenue and securities finance revenue. The growth in servicing fees over the prior year was primarily due to the contribution of the acquired Investors Financial business, increases in net new business, the impact of favorable equity market performance and, in the quarterly comparison, an increase in transaction volumes. Trading services revenue increased mainly as the result of increased volume and higher volatility in our foreign exchange trading business, and the growth in securities finance revenue resulted from an improvement in spreads and an increase in volume attributable to the disruption in the global fixed-income securities markets, as well as increased demand from existing customers and demand from new customers.

Servicing fees and trading services revenue for Investment Servicing comprise the total consolidated amounts for State Street, and securities finance and processing fees and other revenue for Investment Servicing comprise just over 80% of these types of revenue included in our consolidated results. Refer to the "Consolidated Results of Operations Fee Revenue" section of this Management's Discussion and Analysis for additional information about the growth in these types of fee revenue.

Net interest revenue for the third quarter of 2007 increased 82% compared to the third quarter of 2006 and 50% for the first nine months of 2007, compared to the prior-year periods. The increases in both periods were principally due to a more favorable funding mix, including a higher volume of non-U.S. transaction deposits at higher spreads, and the addition of interest-earning assets from the acquired Investors Financial business.

Total operating expenses for the third quarter of 2007 increased 43%, and for the first nine months of 2007 increased 22%, compared to the 2006 periods. The increases were primarily attributable to increased incentive compensation due to improved performance and costs related to the acquired Investors Financial business, in addition to increased headcount to support new business.

Investment Management

Total revenue for the third quarter of 2007 increased 26% compared to the comparable period in 2006, with the increases driven by growth in management fees (up 26%), securities finance revenue (up 76%) and net interest revenue (up 19%). For the first nine months of 2007, total revenue increased 23% compared to the prior year period, with management fees up 22%, securities finance revenue up 42% and net interest revenue up 33%.

Total fee revenue in the quarterly and nine-month comparisons increased 26% and 22%, driven largely by a 26% increase quarter to quarter, and a 22% increase nine months to nine months, in management fees. For the third quarter and first nine months of 2007, these fees, generated by SSgA, increased mainly as a result of an increase in net new business and favorable equity market performance. This increase was slightly offset by a decrease in performance fees for the comparable periods. Management fees for Investment Management comprise the total consolidated management fees for State Street. Refer to the "Consolidated Results of Operations Fee Revenue" section of this Management's Discussion and Analysis for additional information.

For the third quarter and first nine months of 2007, total operating expenses increased 37% and 24%, respectively, from the comparable periods in 2006, primarily attributable to the impact of

increased incentive compensation due to improved performance and merit-based compensation increases, as well as an increase in headcount to support new business.

During the third quarter of 2007, the global markets for fixed-income securities, particularly the markets for financial instruments collateralized by sub-prime mortgages, experienced significant disruption. This disruption affected the liquidity and pricing of securities traded in these markets, as well as the returns of, and levels of redemptions in, investment vehicles investing in those instruments. Additional information about the impact of these market conditions on the asset-backed commercial paper conduits administered by State Street is provided in the "Off Balance Sheet Arrangements" section of this Management's Discussion and Analysis and in Part II Item 1A, "Risk Factors," in this Form 10-Q.

As of June 30, 2007, SSgA had approximately \$222 billion of global fixed-income assets under management, of which approximately \$38 billion was under active management. Approximately \$13.9 billion of the assets under active management described above represented SSgA customer assets which were invested in strategies that were adversely affected by a combination of holdings in financial instruments collateralized by sub-prime mortgages, illiquidity in the fixed-income markets generally, and customer redemptions. SSgA's customers had significant losses in these strategies during the third quarter of 2007. Each of these strategies have different investment objectives and risk profiles. As of June 30, 2007, these strategies included approximately \$7.8 billion of institutional customer investments in non-registered pooled investment funds; approximately \$2.9 billion of unit investments by other SSgA investment funds in the same non-registered pooled investment funds; approximately \$2.6 billion of institutional customer investments in separately-managed customer accounts; and approximately \$0.6 billion of customer investments in mutual funds.

As of September 30, 2007, global fixed-income assets under management totaled approximately \$244 billion, an increase of approximately \$22 billion compared to June 30, 2007, with approximately \$36 billion under active management. This amount included approximately \$8.2 billion of SSgA customer assets which were invested in strategies that were adversely affected by a combination of holdings in financial instruments collateralized by sub-prime mortgages, illiquidity in the fixed-income markets generally, and customer redemptions during the third quarter of 2007. These strategies included approximately \$2.6 billion of institutional customer investments in non-registered pooled investment funds; approximately \$2.1 billion of unit investments by other SSgA investment funds in the same non-registered pooled investment funds; approximately \$3.1 billion of institutional customer investments in separately-managed customer accounts; and approximately \$0.4 billion of customer investments in mutual funds.

In October 2007, three customers filed litigation claims, two of which are putative class actions purportedly on behalf of ERISA plans invested in certain of SSgA's bond funds, against State Street Bank and SSgA related to investment losses in one or more of SSgA's strategies associated with sub-prime investments. We intend to vigorously defend ourselves against these claims. We are currently in discussions with other customers regarding the performance of these strategies, and it is possible that some additional legal proceedings may be commenced. The potential consolidated financial statement impact on State Street of the pending or potential claims cannot currently be estimated.

Information about the liquidity and other risks inherent in our investment management activities is included in Part II Item 1A, "Risk Factors" in this Form 10-Q.

FINANCIAL CONDITION

(In millions)	For the Nine Months Ended September 30,	
	2007 Average Balance	2006 Average Balance
Assets:		
Interest-bearing deposits with non-U.S. banks	\$ 5,895	\$ 10,664
Securities purchased under resale agreements	12,734	11,281
Federal funds sold	1,369	299
Trading account assets	974	1,027
Investment securities	69,345	60,193
Loans	10,148	7,458
Total interest-earning assets	100,465	90,922
Cash and due from banks	3,137	3,150
Other assets	14,089	10,426
Total assets	\$ 117,691	\$ 104,498
Liabilities and Shareholders' Equity:		
Interest-bearing deposits:		
U.S.	4,808	2,553
Non-U.S.	59,486	52,415
Total interest-bearing deposits	64,294	54,968
Securities sold under repurchase agreements	16,706	20,772
Federal funds purchased	2,002	2,510
Other short-term borrowings	3,843	1,779
Long-term debt	3,327	2,621
Total interest-bearing liabilities	90,172	82,650
Noninterest-bearing deposits	9,957	8,165
Other liabilities	8,817	7,108
Shareholders' equity	8,745	6,575
Total liabilities and shareholders' equity	\$ 117,691	\$ 104,498

Overview of Consolidated Statement of Condition

The structure of our consolidated statement of condition, or balance sheet, is primarily driven by the liabilities generated by our core Investment Servicing and Investment Management businesses, while the volume, mix and currency denomination of the balance sheet is determined by both our customers' needs and our operating objectives. As our customers execute their worldwide cash management and investment activities, they use short-term investments and deposits that constitute the majority of our liabilities, generally non-interest-bearing demand deposits; interest-bearing transaction account deposits denominated in a variety of currencies; and repurchase agreements, which generally serve as short-term investment alternatives for our customers.

Deposits and other liabilities generated by customer activities are invested in assets that generally match the liquidity and interest-rate characteristics of the liabilities. As a result, our assets consist primarily of high-quality, marketable securities classified as either available for sale or held to maturity,