STATE STREET CORP
Form 10-Q
August 03, 2007

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 June 30, 2007

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

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 State Street s common stock outstanding on July 31, 2007 was 389,515,571.

STATE STREET CORPORATION

Quarterly Report on Form 10-Q for the Quarterly Period Ended June 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 & 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 June 30, 2007, we had consolidated total assets of $112.27 billion, total deposits of $73.04 billion, total shareholders equity of $7.75 billion and employed 22,350.

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 $13.04 trillion of assets under custody and $1.93 trillion of assets under management at June 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 Report on Form 10-Q for the quarter ended March 31, 2007. We previously filed both of 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 six months of 2007.

RECENT 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 as of June 30, 2007. We exchanged approximately 60.8 million shares of our common stock, with an aggregate value of approximately

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

$4.2 billion, for all of the outstanding common stock of Investors Financial. Financial results of Investors Financial will be included in our consolidated financial statements beginning on July 2, 2007. Additional information about this acquisition is included in note 2 to the consolidated financial statements in this Form 10-Q.

During the second quarter of 2007, we issued an aggregate of $1.5 billion of debt, composed of $700 million of senior debt and $800 million of capital securities, and used the net proceeds from these issuances to fund, in substantial part, the accelerated share repurchase and redemptions of debt described below. Additional information with respect to these issuances is included in the Liquidity section of this Management s Discussion and Analysis.

On July 20, 2007, we entered into an accelerated share repurchase, under which we committed to repurchase $1 billion of our common stock. The total number of shares repurchased will depend, in part, on the weighted average price per share of our common stock paid by our dealer over the repurchase period, which is not expected to exceed six months. The total number of shares to be repurchased is also subject to other conditions and adjustments. Additional information about this repurchase is included in the Capital section of this Management s Discussion and Analysis.

On July 23, 2007, 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. This redemption premium will be included in the merger and integration charge which we will record during the third quarter of 2007 in connection with the Investors Financial acquisition. Additional information about this redemption is included in the Liquidity section of this Management s Discussion and Analysis.

In addition, in July 2007, in connection with an overall evaluation of our requirements for office space as a result of the acquisition, we terminated the operating lease related to one of our office buildings in Boston. The termination resulted in a non-cash charge of approximately $94 million, which will be included in the merger and integration charge which we will record during the third quarter of 2007.

FORWARD-LOOKING STATEMENTS

This Form 10-Q, particularly this Management s Discussion and Analysis, 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 s 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.

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

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

- 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;

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

- 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;

- 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;

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

- 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, particularly Item 1A, Risk Factors. You should read and consider the risk factors discussed in our 2006 Form 10-K in conjunction with the information 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.

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

OVERVIEW OF FINANCIAL RESULTS

	Quarters Ended June 30,			**Six Months Ended June 30,**		
(Dollars in millions, except per share amounts)	**2007**	**2006**	**% Change**	**2007**	**2006**	**% Change**
Total fee revenue	**$ 1,537**	$ 1,375	12 %	**$ 2,907**	$ 2,635	10 %
Net interest revenue	**385**	262	47	**710**	528	34
(Losses) Gains on sales of available-for-sale investment securities, net	**(1)**	14			11	
Total revenue	**1,921**	1,651	16	**3,617**	3,174	14
Total operating expenses	**1,358**	1,176	15	**2,571**	2,272	13
Income from continuing operations before income tax expense	**563**	475	19	**1,046**	902	16
Income tax expense from continuing operations	**197**	248		**366**	393	
Income from continuing operations	**366**	227	61	**680**	509	34
Income from discontinued operations					10	
Net income	**$ 366**	$ 227		**$ 680**	$ 519	
Earnings Per Share From Continuing Operations:						
Basic	**$ 1.09**	$ .69	58	**$ 2.03**	$ 1.54	32
Diluted	**1.07**	.68	57	**2.00**	1.52	32
Earnings Per Share:						
Basic	**1.09**	.69		**2.03**	1.57	
Diluted	**1.07**	.68		**2.00**	1.55	
Cash dividends declared	**.22**	.20		**.43**	.39	
Return on shareholders equity from continuing operations	**19.2 %**	14.0 %		**18.4 %**	15.8 %	
Return on shareholders equity	**19.2**	14.0		**18.4**	16.1	

Summary

Our financial results for the second quarter and first six months of 2007 continued to reflect growth in revenue along with our ability to balance expense growth with revenue growth. Other highlights for the second quarter and first six months of 2007 relative to the 2006 periods are as follows:

- Compared to the second quarter of 2006, servicing fees grew 12%, management fees grew 22% and securities finance revenue grew 27%, contributing to aggregate growth of 12% in total fee revenue.

- In the year-to-date comparison, servicing fees grew 11%, management fees grew 21% and securities finance revenue grew 24%, contributing to aggregate growth of 10% in total fee revenue.

- Net interest revenue grew 47% and net interest margin grew 44 basis points compared to last year s second quarter. In the year-to-date comparison, net interest revenue grew 34% and net interest margin grew 33 basis points.

- We achieved positive operating leverage, which we define as the difference between the growth rate of total revenue and the growth rate of total operating expenses, for both the second quarter and first six months of 2007 compared to the corresponding prior-year periods.

- State Street Global Advisors, which we refer to as SSgA, generated $32 billion of net new business in assets under management during the second quarter and $108 billion for the first six months of

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

2007. Approximately 75% of SSgA s new business was in active management products, including enhanced indexing, hedge fund strategies and active quantitative management.

- We ended the second quarter of 2007 with State Street record levels of assets under custody and assets under management.

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

Financial Highlights

Second quarter 2007 net income of $366 million increased 61%, and diluted earnings per share of $1.07 increased 57%, from net income of $227 million and diluted earnings per share of $.68 for the second quarter of 2006. Net income was $680 million and diluted earnings per share was $2.00 for the first six months of 2007, compared to income from continuing operations of $509 million and diluted earnings per share from continuing operations of $1.52 for the first six months of 2006. Net income of $519 million for the first six 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 second quarter of 2007 to the second quarter of 2006, our total revenue grew 16%. Total fee revenue was up 12%, with increases in all income statement revenue line items except processing fees and other, which was down 12%. The growth in fee revenue was particularly notable in servicing fees, up 12%, management fees, up 22%, and securities finance revenue, up 27%. Both servicing fees and management fees benefited from increases in net new business and favorable equity market performance. The increase in securities finance revenue was driven by higher securities lending volumes, from both existing and new customers.

Net interest revenue increased 47% compared to the prior year second quarter, with a related increase in net interest margin of 44 basis points. The increase resulted primarily from a higher level of customer deposits, the continued favorable non-U.S. interest rate environment and stable U.S. interest rates. Overall, we continue to benefit from increases in both non-U.S. transaction deposits and non-U.S. interest rates.

Total operating expenses increased 15%, primarily the result of increased incentive compensation due to improved performance and increased headcount to support new business. With growth in total revenue exceeding the growth in total operating expenses for the second quarter of 2006, we achieved positive operating leverage of approximately 90 basis points.

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

SSgA continued to generate increased revenue, principally from increased customer demand for its active investment management products, such as enhanced indexing and active quantitative management, which earn a higher level of fees than other products. SSgA revenue comprised approximately 20% of our consolidated total revenue for the second quarter and first six months of 2007, compared to 19% for the second quarter and first six months of 2006. SSgA achieved a pre-tax operating margin of 38% and 34% for the second quarters of 2007 and 2006, and 36% and 35% for the first six months of 2007 and 2006, respectively. SSgA generated net new business of $32 billion in assets under management in the second quarter of 2007, compared to net lost business of $5 billion in last year s second quarter. On a year-to-date basis, SSgA generated net new business of $108 billion for 2007 compared to $29 billion for 2006. Net new business is measured as the aggregate value of new asset management business added less asset management business lost during the period.

At June 30, 2007, we had aggregate assets under custody of $13.04 trillion, which grew 10% from $11.85 trillion at December 31, 2006, and 20% from $10.86 trillion at June 30, 2006. At the same date, we had aggregate assets under management of $1.93 trillion, which grew 10% from $1.75 trillion at December 31, 2006 and 26% from $1.53 trillion at June 30, 2006.

Our effective tax rate for the second quarter of 2007 was 35%, compared to 52.1% from continuing operations for the second quarter of 2006, and 38.1% for full-year 2006. The effective rate for the second quarter of 2006 reflected increased income tax expense that resulted from tax-related adjustments recorded in the 2006 period 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, we adjusted these financial goals for 2007 in anticipation of our then-planned acquisition of Investors Financial, which we completed in July 2007. These adjusted financial goals for 2007 were:

- Growth in operating-basis revenue of between 16% and 18%;
- Growth in operating-basis earnings per share from continuing operations of between 8% and 10%; and
- Operating-basis return on shareholders equity from continuing operations of between 12% and 15%.

Operating-basis results, as defined by management, include fully taxable-equivalent net interest revenue, reflecting increases related to tax-equivalent adjustments of $12 million and $13 million for the second quarters of 2007 and 2006, respectively, and $24 million for each of the six-month periods, with a corresponding charge to income tax expense. In addition, operating-basis results for the six months ended June 30, 2006 exclude the previously mentioned tax-related adjustments recorded in the second quarter of 2006 associated with tax legislation and leveraged leases. Operating-basis results for 2007 will exclude merger and integration costs associated with the Investors Financial acquisition.

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 tax-related adjustments and merger-related costs are not part of our normal ongoing business operations, and

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

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 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 second quarter of 2007 compared to the second quarter of 2006, we continued to make progress toward achieving our financial goals for 2007. We increased our operating-basis earnings per share from continuing operations by 15%, from $.93 to $1.07 (excluding tax-related adjustments of $.25 per share included in earnings per share from continuing operations of $.68 for the second quarter of 2006). Our operating-basis revenue increased 16% from $1.664 billion to $1.933 billion (including taxable-equivalent adjustments of $13 million for 2006 and $12 million for 2007, excluded from $1.651 billion and $1.921 billion on a GAAP basis); and we achieved operating-basis return on shareholders equity of 18.4%, equivalent to 18.4% prepared in accordance with GAAP.

Outlook

As a result of our second quarter 2007 results and those of Investors Financial for the same period, the latter of which are not included in our accompanying consolidated results for the second quarter and first six months of 2007, in July we revised 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 revenue will include fully taxable-equivalent net interest revenue, as described earlier. In addition, operating-basis results for 2007 will exclude merger and integration costs related to the acquisition, and for 2006 will exclude the previously disclosed tax-related adjustments. As discussed earlier in this section, 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, as well as the tax-related adjustments, are not part of 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.

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%;
- Growth in revenue generated from active quantitative asset management products;
- Relatively stable domestic interest rates;
- Expected flattening of the U.S. dollar yield curve;
- 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;

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

- 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 six months of 2007 has differed from our assumptions in many respects. In particular, during the first six 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 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. 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.

CONSOLIDATED RESULTS OF OPERATIONS

This section discusses our consolidated results of operations for the second quarter and first six 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

	Quarters Ended June 30,			**Six Months Ended June 30,**		
(Dollars in millions)	**2007**	**2006**	**% Change**	**2007**	**2006**	**% Change**
Fee Revenue:						
Servicing fees	**$ 766**	$ 683	12 %	**$ 1,484**	$ 1,340	11 %
Management fees	**284**	232	22	**545**	452	21
Trading services	**260**	258	1	**480**	488	(2)
Securities finance	**162**	128	27	**260**	209	24
Processing fees and other	**65**	74	(12)	**138**	146	(5)
Total fee revenue	**1,537**	1,375	12	**2,907**	2,635	10
Net Interest Revenue:						
Interest revenue	**1,203**	1,034	16	**2,375**	1,995	19
Interest expense	**818**	772	6	**1,665**	1,467	13
Net interest revenue	**385**	262	47	**710**	528	34
(Losses) Gains on sales of available-for-sale investment securities, net	**(1)**	14			11	
Total revenue	**$ 1,921**	$ 1,651	16	**$ 3,617**	$ 3,174	14

Fee Revenue

Servicing fees and management fees collectively comprised approximately 68% and 70% of total fee revenue for the second quarter and first six months of 2007, compared to approximately 67% and 68% for the comparable prior-year periods. 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,

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

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 six months of 2007, performance fees comprised about 6% of management fee revenue. 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.

FEE REVENUE

	Quarters Ended June 30,			**Six Months Ended June 30,**		
(Dollars in millions)	**2007**	**2006**	**% Change**	**2007**	**2006**	**% Change**
Servicing fees	**$ 766**	$ 683	12 %	**$ 1,484**	$ 1,340	11 %
Management fees	**284**	232	22	**545**	452	21
Trading services	**260**	258	1	**480**	488	(2)
Securities finance	**162**	128	27	**260**	209	24
Processing fees and other	**65**	74	(12)	**138**	146	(5)
Total fee revenue	**$ 1,537**	$ 1,375	12	**$ 2,907**	$ 2,635	10

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

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 six months ended June 30, 2007 compared to the comparable 2006 periods, the increase in servicing fees was driven primarily by net new business from existing and new customers, as well as higher daily average equity market valuations. The daily average values for the S&P 500 Index were up 17%, and for the MSCI® EAFE Index were up 22%, compared with the second quarter of 2006. For the year, daily average values for the S&P 500 Index and MSCI® EAFE Index were up 14% and 20%, respectively.

ASSETS UNDER CUSTODY (In billions)	June 30, 2007	December 31, 2006	June 30, 2006
Mutual funds	**$ 4,194**	$ 3,738	$ 3,395
Collective funds	**1,828**	1,665	1,479
Pension products	**3,949**	3,713	3,486
Insurance and other products	**3,069**	2,738	2,504
Total	**$ 13,040**	$ 11,854	$ 10,864
Financial Instrument Mix:			
Equities	**$ 6,820**	$ 5,821	$ 5,396
Fixed income	**3,960**	4,035	3,891
Short-term and other investments	**2,260**	1,998	1,577
Total	**$ 13,040**	$ 11,854	$ 10,864

Management fees

The increase in management fees primarily reflected increases in net new business, particularly in the area of quantitative active management, as well as higher month-end equity market valuations. Performance fees were $18 million and $34 million for the second quarter and first six months of 2007, up from $15 million and $28 million for the second quarter and first six months of 2006. The averages of month-end values for the S&P 500 Index were up 17%, and for the MSCI® EAFE Index were up 22%, compared with the second quarter of 2006.

ASSETS UNDER MANAGEMENT (In billions)	June 30, 2007	December 31, 2006	June 30, 2006
Equities:			
Passive	**$ 747**	$ 691	$ 623
Active and other	**204**	181	156
Company stock/ESOP	**88**	85	78
Total equities	**1,039**	957	857
Fixed income	**222**	201	174
Cash and money market	**673**	591	503
Total fixed income and cash	**895**	792	677
Total	**$ 1,934**	$ 1,749	$ 1,534

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 June 30, 2007.

ASSETS UNDER MANAGEMENT (In billions)	
June 30, 2006	$ 1,534
Net new business	57
Market appreciation	158
December 31, 2006	**1,749**
Net new business	**108**
Market appreciation	**77**
June 30, 2007	**$ 1,934**

Trading services

Trading services revenue, which includes foreign exchange trading revenue and brokerage and other trading fees, was up 1% for the second quarter of 2007 compared to the second quarter of 2006 and down 2% in the six-month comparison. Foreign exchange trading revenue for the second quarter and first six months of 2007 totaled $174 million and $326 million, respectively, both down 9% from $192 million and $357 million in the prior-year periods. The quarterly decrease reflected a 40% decline in currency volatility partly offset by a 13% increase in customer volumes, mostly in foreign exchange for our custody customers. The six-month decrease resulted from a 29% decrease in currency volatility partly offset by an 18% increase in customer volume.

Brokerage and other trading fees totaled $86 million for the second quarter of 2007, up 30% from $66 million in the second quarter of 2006, primarily the result of fees from the operations of Currenex, which we acquired in March 2007. Brokerage and other trading fees in the six-month comparison totaled $154 million for 2007 and $131 million for 2006.

Securities finance

Securities finance revenue for the second quarter of 2007 increased 27% compared to the second quarter of 2006, and 24% in the six-month comparison, with both increases driven by a 32% increase in the average volume of securities loaned on both a quarterly and a year-to-date basis. The growth in volume resulted from increased demand from existing customers and demand from new customers. Consolidated spread was up slightly from the prior-year quarter and flat on a year-to-date basis compared to 2006.

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 unit, primarily associated with the impact of the consolidation of our tax-exempt investment program onto our balance sheet on September 30, 2006, partly offset by improved results from joint venture investments. As a result of the above-described consolidation, revenue from the tax-exempt investment program, previously recorded in processing fees and other, is currently recorded in net interest revenue.

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

NET INTEREST REVENUE

(Dollars in millions)	Quarters Ended June 30, 2007	2006	% Change	Six Months Ended June 30, 2007	2006	% Change
Interest revenue(1)	**$ 1,203**	$ 1,034	16 %	**$ 2,375**	$ 1,995	19 %
Interest expense(1)	**818**	772	6	**1,665**	1,467	13
Net interest revenue	**385**	262	47	**710**	528	34
Provision for loan losses						
Net interest revenue after provision for loan losses	**$ 385**	$ 262	47	**$ 710**	$ 528	34
Net interest revenue (fully taxable-equivalent basis)(2)	**$ 397**	$ 275	44	**$ 734**	$ 552	33

(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 $12 million and $13 million for the second quarters of 2007 and 2006, respectively, and $24 million for each of the first six months of 2007 and 2006.

NET INTEREST MARGIN

(Dollars in millions)	Quarters Ended June 30, 2007 Average Balance	Rate(1)	2006 Average Balance	Rate(1)	Six Months Ended June 30, 2007 Average Balance	Rate(1)	2006 Average Balance	Rate(1)
Interest-earning assets	**$ 96,927**	**5.03 %**	$ 91,764	4.57 %	**$ 95,636**	**5.06 %**	$ 91,452	4.45 %
Interest-bearing liabilities	**87,363**	**3.76**	83,953	3.68	**86,061**	**3.90**	83,114	3.56
Excess of rate earned over rate paid		**1.27 %**		.89 %		**1.16 %**		.89 %
Net interest margin		**1.64 %**		1.20 %		**1.55 %**		1.22 %

(1) Fully taxable-equivalent basis

Net interest revenue increased 47% and 34%, and net interest margin increased 44 basis points and 33 basis points for the quarter and six months ended June 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 a higher level of low-cost funds; 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; and the continued impact of favorable non-U.S. interest rates and stable U.S. interest rates.

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; tighter interest-rate spreads on the reinvestment of proceeds from

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.

At June 30, 2007, our investment securities portfolio included a consistent percentage of floating-rate, asset-backed securities (36% of our average investment portfolio for the second quarter of 2007 compared to 37% a year earlier), a higher percentage of collateralized mortgage obligations (19% compared to 11%), and a lower percentage of direct obligations from U.S. Treasury and federal agencies (9% compared to 16%). We continue to invest conservatively in AAA and AA rated securities. AAA and AA rated securities comprised approximately 94% of our investment securities portfolio at June 30, 2007, with approximately 87% AAA rated.

OPERATING EXPENSES

(Dollars in millions)	Quarters Ended June 30, 2007	2006	% Change	Six Months Ended June 30, 2007	2006	% Change
Salaries and employee benefits	**$ 808**	$ 684	18 %	**$ 1,547**	$ 1,319	17 %
Information systems and communications	**128**	129	(1)	**253**	261	(3)
Transaction processing services	**141**	134	5	**270**	254	6
Occupancy	**98**	95	3	**192**	188	2
Other	**183**	134	37	**309**	250	24
Total operating expenses	**$ 1,358**	$ 1,176	15	**$ 2,571**	$ 2,272	13
Number of employees at quarter end	**22,350**	21,675				

Salaries and employee benefits expense increases were mainly the result of higher incentive compensation due to improved performance 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.

The slight increases in occupancy costs partly resulted from additional space and facilities needs associated with growth in business in Europe. The decrease in information systems and communications expense for the year-to-date period was primarily the result of lower infrastructure costs, partly offset by technology spending both in Europe and related to the Currenex acquisition.

Transaction processing expense increased in both comparisons primarily as a result of higher external contract services caused by increased volumes in asset servicing, partially offset by lower brokerage expenses. Other expenses increased in both comparisons, primarily the result of our recent acquisitions as well as new business initiatives, and an increase in sales promotion expenses.

Income Taxes

We recorded income tax expense of $197 million for the second quarter of 2007, compared to $248 million for the second quarter of 2006, with the decrease due primarily to the absence of the tax-related adjustments recorded in the 2006 quarter associated with tax legislation and leveraged leases, partly offset by higher pre-tax earnings. For the first six months of 2007, income tax expense was $366 million, compared to $393 million from continuing operations for the 2006 period. The effective tax rate for the second quarter of 2007 was 35% compared to 52.1% for the second quarter of 2006, the latter rate reflective of the above-described tax-related adjustments.

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

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.

	For the Quarters Ended June 30,					
	Investment Servicing		Investment Management		Total	
(Dollars in millions, except where otherwise noted)	2007	2006	2007	2006	2007	2006
Fee Revenue:						
Servicing fees	**$ 766**	$ 683			**$ 766**	$ 683
Management fees			**$ 284**	$ 232	**284**	232
Trading services						