

STATE STREET Corp
Form 10-Q
November 06, 2009
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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, 2009

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

04-2456637

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(State or other jurisdiction

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

of incorporation)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of shares of State Street's common stock outstanding on October 30, 2009 was 494,665,224

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STATE STREET CORPORATION

Quarterly Report on Form 10-Q for the Quarterly Period Ended September 30, 2009

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

GENERAL

State Street Corporation is a financial holding company headquartered in Boston, Massachusetts. Through its subsidiaries, including its principal banking subsidiary, State Street Bank and Trust Company, which we refer to as State Street Bank, State Street Corporation 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. All references in this Form 10-Q to the parent company are to State Street Corporation. At September 30, 2009, we had consolidated total assets of \$163.28 billion, consolidated total deposits of \$91.77 billion, consolidated total shareholders' equity of \$13.44 billion and employed 27,130.

Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments 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 \$17.94 trillion of assets under custody and administration (including \$13.26 trillion of assets under custody) and \$1.74 trillion of assets under management at September 30, 2009. Information about these assets, and financial information about our business lines, is provided in the Consolidated Results of Operations, Total Revenue and Line of Business Information sections of this Management's Discussion and Analysis.

This Management's Discussion and Analysis is part of our Quarterly Report on Form 10-Q for the third quarter of 2009 which we filed with the SEC, and updates the Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2008, which we refer to as the 2008 Form 10-K, and in our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2009 and June 30, 2009. We previously filed these reports with the SEC. You should read the financial information in this Management's Discussion and Analysis and elsewhere in this Form 10-Q in conjunction with the financial information contained in those reports. Certain previously reported amounts have been reclassified to conform to current period classifications as presented in this Form 10-Q.

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 by management to be relatively more significant in this respect are accounting for the fair value of financial instruments, special purpose entities, and goodwill and other intangible assets. Additional information about these accounting policies is included in the Significant Accounting Estimates section of Management's Discussion and Analysis in our 2008 Form 10-K. Although no significant changes were made to these accounting policies during the first nine months of 2009, we have provided updated information with respect to our accounting for the fair value of financial instruments in the Fair Value Measurements section of this Management's Discussion and Analysis.

Certain financial information provided in this Management's Discussion and Analysis has been prepared on both a GAAP basis and a non-GAAP basis, the latter of which we refer to as operating basis. Management measures and compares certain financial information on an operating basis, as it believes this presentation supports meaningful comparisons from period to period and the analysis of comparable financial trends with respect to State Street's normal ongoing business operations.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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Management believes that operating-basis financial information, which reports revenue from non-taxable sources on a fully taxable-equivalent basis and excludes the impact of revenue and expenses outside of the normal course of our business, facilitates an investor's understanding and analysis of State Street's underlying financial performance and trends in addition to financial information prepared in accordance with GAAP.

FORWARD-LOOKING STATEMENTS

This Form 10-Q, particularly this Management's Discussion and Analysis, contains statements that are considered forward-looking within the meaning of U.S. securities laws, 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 terms or variations of such terms. Such statements may include, among other things, statements about State Street's confidence in its strategies and its expectations about its financial performance, market growth, acquisitions and divestitures, new technologies, services and opportunities, the outcome of legal proceedings and its earnings.

Forward-looking statements are subject to various risks and uncertainties, which change over time, 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 State Street and its subsidiaries. Factors that could cause changes in the expectations or assumptions on which forward-looking statements are based include, but are not limited to:

financial market disruptions and the economic recession, whether in the U.S. or internationally, and monetary and other governmental actions designed to address such disruptions and recession, including actions taken in the U.S. and internationally to address the financial and economic disruptions that began in 2007;

increases in the potential volatility of, or declines in the levels of, our net interest revenue, changes in the composition of the assets on our consolidated balance sheet and the possibility that we may be required to change the manner in which we fund those assets;

the financial strength and continuing viability of the counterparties with which we or our customers do business and to which we have investment, credit or financial exposure;

the liquidity of the U.S. and international securities markets, particularly the markets for fixed-income securities, and the liquidity requirements of our customers;

the credit quality, credit agency ratings, and fair values of the securities in our investment securities portfolio, a deterioration or downgrade of which could lead to other-than-temporary impairment of the respective securities and the income statement recognition of an impairment loss;

the maintenance of credit agency ratings for our debt and depository obligations as well as the level of credibility of credit agency ratings;

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the possibility of our customers incurring substantial losses in investment pools where we act as agent, and the possibility of further general reductions in the valuation of assets;

our ability to attract deposits and other low-cost, short-term funding;

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

potential changes to the competitive environment, including changes due to the effects of consolidation, extensive and changing government regulation and perceptions of State Street as a suitable service provider or counterparty;

the level and volatility of interest rates and the performance and volatility of securities, credit, currency and other markets in the U.S. and internationally;

our ability to measure the fair value of the investment securities on our consolidated balance sheet;

the results of litigation, government investigations and similar disputes and, in particular, the effect of current or potential proceedings concerning State Street Global Advisors, or SSgAs, active fixed-income strategies and other investment products, including the potential for monetary damages and negative consequences for our business and our reputation arising from the previously reported Wells notice we received from the SEC;

the enactment of legislation and changes in regulation and enforcement that impact us and our customers;

adverse publicity or other reputational harm;

our ability to pursue acquisitions, strategic alliances and divestures, finance future business acquisitions and obtain regulatory approvals and consents for acquisitions;

the performance and demand for the products and services we offer, including the level and timing of withdrawals from our collective investment products;

our ability to grow revenue, attract and retain highly skilled people, control expenses and attract the capital necessary to achieve our business goals and comply with regulatory requirements;

our ability to control operating risks, information technology systems risks and outsourcing risks, the possibility of errors in the quantitative models we use to manage our business and the possibility that our controls will fail or be circumvented;

the potential for new products and services to impose additional costs on us and expose us to increased operational risk, and our ability to protect our intellectual property rights;

changes in government regulation or new legislation, which may increase our costs, expose us to risk related to compliance or impact our customers;

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changes in accounting standards and practices; 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 from our historical financial results due to the factors discussed in this Management's Discussion and Analysis and elsewhere in this Form 10-Q or disclosed in our other SEC filings. Forward-looking statements should not be relied upon as representing our expectations or beliefs as of any time subsequent to the time this Form 10-Q is filed with the SEC. State Street undertakes no obligation to revise the forward-looking statements contained in this Form 10-Q to reflect events after the time it is filed with the SEC. The factors discussed above are not intended to be a complete summary of all risks and uncertainties that may affect our businesses. We cannot anticipate all potential economic, operational and financial developments that may adversely affect our operations and our financial results.

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

Forward-looking statements should not be viewed as predictions, and should not be the primary basis upon which investors evaluate State Street. Any investor in State Street should consider all risks and uncertainties disclosed in our SEC filings, including our filings under the Securities Exchange Act of 1934, in particular our reports on Form 10-K, Form 10-Q and Form 8-K, including the risk factors disclosure provided in our Current Report on Form 8-K filed on May 18, 2009, or registration statements filed under the Securities Act of 1933, all of which are accessible on the SEC's website at www.sec.gov or on our website at www.statestreet.com.

OVERVIEW OF FINANCIAL RESULTS

(Dollars in millions, except per share amounts)	Quarters Ended September 30,			Nine Months Ended September 30,		
	2009	2008	% Change	2009	2008	% Change
Total fee revenue	\$ 1,471	\$ 1,899	(23)%	\$ 4,409	\$ 5,866	(25)%
Net interest revenue	723	525	38	1,867	1,807	3
Gains (Losses) related to investment securities, net	42	(3)		84	(3)	
Gain on sale of CitiStreet, net of exit and other associated costs		350			350	
Total revenue	2,236	2,771	(19)	6,360	8,020	(21)
Provision for loan losses	16			114		
Expenses:						
Expenses from operations	1,472	1,895	(22)	4,111	5,452	(25)
Provision for legal exposure	250			250		
Merger and integration costs	11	30	(63)	40	88	(55)
Total expenses	1,733	1,925	(10)	4,401	5,540	(21)
Income before income tax expense and extraordinary loss	487	846	(42)	1,845	2,480	(26)
Income tax expense	160	369		540	925	
Income before extraordinary loss	327	477	(31)	1,305	1,555	(16)
Extraordinary loss, net of taxes				(3,684)		
Net income (loss)	\$ 327	\$ 477		\$ (2,379)	\$ 1,555	
Adjustments to net income (loss) ⁽¹⁾				(163)		
Net income before extraordinary loss available to common shareholders	\$ 327	\$ 477	(31)	\$ 1,142	\$ 1,555	(27)
Net income (loss) available to common shareholders	\$ 327	\$ 477		\$ (2,542)	\$ 1,555	
Earnings per common share before extraordinary loss:						
Basic	\$.66	\$ 1.11		\$ 2.48	\$ 3.82	
Diluted	.66	1.09		2.45	3.78	
Earnings (loss) per common share:						
Basic	\$.66	\$ 1.11		\$ (5.47)	\$ 3.82	
Diluted	.66	1.09		(5.45)	3.78	

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Average common shares outstanding

(in thousands):

Basic	493,453	430,872	462,900	407,186
Diluted	498,290	435,030	466,234	411,204
Cash dividends declared	.01	.24	.03	.71
Return on common shareholders' equity ⁽²⁾	10.2%	13.6%	12.8%	16.8%

(1) Adjustments are described in note 17 to the consolidated financial statements included in this Form 10-Q.

(2) For the nine months ended September 30, 2009, return on common shareholders' equity was determined by dividing annualized net income before extraordinary loss available to common shareholders by average common shareholders' equity for the period.

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

Recent Developments

In 2007, we established a reserve to address legal exposure associated with certain active fixed-income strategies and customer concerns as to whether the execution of these strategies was consistent with the customers' investment intent. On June 25, 2009, the Staff of the SEC provided State Street Bank with a Wells notice related to the SEC's ongoing investigation into disclosures and management by SSgA of these active fixed-income strategies during 2007 and prior periods. While the Wells notice relates to the same events from 2007, the reserve as initially established did not contemplate any governmental proceedings with respect to such matters. Since the receipt of the Wells notice, we have been in discussions with the SEC and other governmental authorities regarding a potential settlement of this matter, which discussions have accelerated since the end of the third quarter of 2009.

Based on our discussions with the SEC and other regulatory authorities to date, we have determined that it is appropriate to increase, as of September 30, 2009, our previously established reserve by \$250 million to take into account such a potential settlement with these governmental authorities and the other ongoing litigation related to the active fixed-income strategies. Consequently, we have adjusted our reported financial results for the third quarter of 2009, to reflect a provision for legal exposure of \$250 million, or \$0.38 per share, from net income of \$516 million, or \$1.04 per share, to net income of \$327 million, or \$0.66 per share. After adjustment for the provision, the reserve totaled approximately \$443 million at September 30, 2009.

While we have determined that it is appropriate to increase our reserve for the active fixed-income matter, we have not entered into a settlement agreement with the SEC or any other regulator at this time, and there can be no assurance that we will do so in the future. In addition, we recently entered into a settlement of the purported class action with respect to ERISA participants in the active fixed-income strategies. The proposed settlement, which totals \$89.75 million, is subject to court approval, and as such has not been deducted from the aforementioned reserve as of September 30, 2009.

Additional information with respect to the Wells notice and the reserve is provided in note 8 to the consolidated financial statements included in this Form 10-Q.

Financial Highlights

For the third quarter of 2009, we recorded net income of \$327 million, or \$0.66 per diluted common share, compared to \$477 million, or \$1.09 per diluted share, for the third quarter of 2008. Return on common shareholders' equity was 10.2% compared to 13.6% for the third quarter of 2008. The results for the third quarter of 2009 reflected the aforementioned additional provision for legal exposure of \$250 million, or \$0.38 per share.

Total revenue for the third quarter of 2009 decreased 19% compared to the third quarter of 2008, with total fee revenue down 23%. Generally, all fee revenue types were down compared to the prior-year quarter, reflecting the impact of the global financial markets decline. Servicing fee and management fee revenue were down 14% and 16%, respectively, compared to generally similar declines in equity market valuations over the same period as measured by the published indices presented in the INDEX table in this Management's Discussion and Analysis on page 9. Trading services revenue decreased primarily as a result of lower foreign exchange volatility and trading volumes, partly offset by an increase in brokerage fees. Securities finance revenue decreased primarily as a result of compressed rate spreads and lower lending volumes.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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Net interest revenue increased 38% for the third quarter of 2009 compared to the prior-year third quarter, or 37% on a fully taxable-equivalent basis (\$754 million compared to \$550 million, reflecting tax-equivalent adjustments of \$31 million and \$25 million, respectively), with a related increase in net interest margin of 64 basis points. The increase was the result of \$279 million of discount accretion associated with investment securities added in connection with the May 2009 consolidation of the State Street-administered asset-backed commercial paper conduits. This increase was partly offset by decreases in interest-bearing deposit volumes and related interest-rate spreads, reflecting relatively more stable market conditions compared to 2008, as well as the negative impact of lower rates on the yields of floating-rate assets.

We recorded provisions for loan losses of \$16 million and \$114 million during the third quarter and first nine months of 2009, respectively, of which \$98 million related to commercial real estate loans purchased in 2008 pursuant to indemnified repurchase agreements, reflecting management's revised expectation of future principal and interest cash flows with respect to certain of the commercial real estate loans. Management's change in expectation with respect to these loans resulted primarily from its assessment of the impact of deteriorating economic conditions in the commercial real estate markets on certain of these loans during the period.

Total expenses decreased 10% to \$1.73 billion for the third quarter of 2009 compared to the 2008 quarter, primarily the result of a 20% reduction in salaries and benefits expense. The decrease in salaries and benefits expense was attributable to the impact of our previously announced reduction in force, as well as lower accruals of incentive compensation in 2009. The decrease in total expenses also reflected the impact of lower transaction processing expenses, securities processing costs and professional fees. Expenses for the third quarter of 2009 included \$11 million of merger and integration costs associated with the 2007 acquisition of Investors Financial, compared to \$30 million for the third quarter of 2008.

At September 30, 2009, we had aggregate assets under custody and administration of \$17.94 trillion, which increased \$2.03 trillion, or 13%, from \$15.91 trillion at December 31, 2008, and decreased \$512 billion, or 3%, from \$18.45 trillion at September 30, 2008. At September 30, 2009, we had aggregate assets under management of \$1.74 trillion, which increased \$291 billion, or 20%, from \$1.44 trillion at December 31, 2008, and increased \$49 billion, or 3%, from \$1.69 trillion at September 30, 2008. The slight decrease in servicing assets from September 30, 2008 to September 30, 2009 was primarily associated with the global financial markets decline and related declines in asset valuations. The increase in servicing assets from December 31, 2008 reflected additions of new asset servicing business and increases in asset valuations. The increase in assets under management from December 31, 2008 resulted from net new business and increases in asset valuations.

During the first nine months of 2009, we generated approximately \$626 billion of gross new business in assets to be serviced, for which we will provide various services including accounting, fund administration, custody, foreign exchange, transition management, currency management, securities finance, transfer agency, performance analytics, compliance reporting and monitoring, hedge fund servicing and private equity administration, and investment manager operations outsourcing. With respect to this new business, we expect to earn fee revenue in future periods as we begin to service the assets.

During the first nine months of 2009, we generated approximately \$106 billion of net new business in assets to be managed, for which we will provide various asset management services including passive index strategies and exchange-traded funds. With respect to this new business, we expect to earn fee revenue in future periods as we manage the customer assets.

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

Our effective tax rates for the third quarter and first nine months of 2009 were 32.8% and 29.3%, respectively, compared to 43.7% and 37.3% for the same periods in 2008. Refer to note 16 to the consolidated financial statements included in this Form 10-Q for additional information with respect to the change in the effective rates.

CONSOLIDATED RESULTS OF OPERATIONS

This section discusses our consolidated results of operations for the third quarter and first nine months of 2009 compared to the same periods in 2008, and should be read in conjunction with the consolidated financial statements and accompanying condensed notes included elsewhere in this Form 10-Q.

TOTAL REVENUE

(Dollars in millions)	Quarters Ended September 30,		Nine Months Ended September 30,
	2009	2008	