STATE STREET CORP
Form 10-Q
May 04, 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 March 31, 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 April 30, 2007 was 336,375,333.

STATE STREET CORPORATION

Quarterly Report on Form 10-Q for the Quarterly Period Ended March 31, 2007

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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 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 March 31, 2007, we had consolidated total assets of $110.00 billion, total deposits of $66.60 billion, total shareholders equity of $7.47 billion and employed 21,950.

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 $12.33 trillion of assets under custody and $1.85 trillion of assets under management at March 31, 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 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 which we previously filed with the SEC. You should read the financial information in this Form 10-Q in conjunction with the financial information contained in the 2006 Form 10-K. Certain amounts previously reported have been reclassified to conform to current period classifications.

In February 2007, we announced a definitive agreement to acquire Investors Financial Services Corp., a bank holding company based in Boston with $12 billion in total assets at December 31, 2006. Under the terms of the agreement, we will exchange .906 shares of our common stock for each share of Investors Financial common stock. The transaction is subject to the approvals of regulatory agencies and Investors Financial shareholders, and we expect to close the acquisition in the the middle of 2007.

In April 2007, State Street Corporation, which we refer to as the parent company, issued $700 million of senior debt, composed of $250 million of floating-rate notes and $450 million of fixed-rate notes. In addition, State Street Capital Trust IV, a Delaware statutory trust wholly owned by the parent company, issued $800 million of floating-rate capital securities and used the proceeds to purchase floating-rate junior subordinated debentures from the parent company. Additional information about these issuances is included in the Capital section of this Discussion and Analysis and in note 6 to the consolidated financial statements 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 relatively more significant in this respect are accounting for lease financing, goodwill, income taxes and pension costs.

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

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 quarter of 2007.

This Form 10-Q, particularly this 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 simila variations of such terms.

These 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 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:

- 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 the receipt of required regulatory and shareholder approvals in connection with our planned acquisition of Investors Financial;
- Trends in governmental and corporate pension plans and savings rates;

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

- 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.

OVERVIEW OF FINANCIAL RESULTS

(Dollars in millions, except per share amounts)	Quarters Ended March 31, 2007	2006	% Change
Total fee revenue	**$ 1,370**	$ 1,260	9 %
Net interest revenue	**325**	266	22
Gains (Losses) on sales of available-for-sale investment securities, net	**1**	(3)	
Total revenue	**1,696**	1,523	11
Total operating expenses	**1,213**	1,096	11
Income from continuing operations before income tax expense	**483**	427	13
Income tax expense from continuing operations	**169**	145	17
Income from continuing operations	**314**	282	11
Income from discontinued operations		10	
Net income	**$ 314**	$ 292	8
Earnings Per Share From Continuing Operations:			
Basic	**$ .94**	$ .85	11
Diluted	**.93**	.84	11
Earnings Per Share:			
Basic	**.94**	.88	
Diluted	**.93**	.87	
Cash dividends declared	**.21**	.19	
Return on shareholders equity from continuing operations	**17.4 %**	17.6 %	
Return on shareholders equity	**17.4**	18.3	

Summary

Our financial results for the first quarter of 2007 reflected growth in revenue and our ability to balance expense growth with revenue growth. Other highlights for the first quarter of 2007 relative to the first quarter of 2006 are as follows:

- Servicing fees grew 9%, management fees grew 19% and securities finance revenue grew 21%, contributing to aggregate growth of 9% in total fee revenue compared to the prior year s first quarter.

- Net interest revenue grew 22% and and net interest margin grew 22 basis points compared to last year s first quarter.

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

- We achieved positive operating leverage, which we define as the difference between the growth rate of total operating revenue and the growth rate of total operating expenses, compared to the prior-year quarter.

- State Street Global Advisors, which we refer to as SSgA, generated $76 billion of net new business in assets under management during the first quarter. Approximately 70% of new business was in active management products, including enhanced indexing, hedge fund strategies and active quantitative management.

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

Our financial results for the first quarter of 2007 are discussed in the following Financial Highlights section, followed by more detailed information in the Consolidated Results of Operations section of this Discussion and Analysis.

Financial Highlights

First quarter 2007 net income of $314 million and diluted earnings per share of $.93 both increased 11% from income from continuing operations of $282 million and $.84 diluted earnings per share from continuing operations for the first quarter of 2006. Earnings per share from net income were $.93, compared to $.87 for last year s first quarter. Net income of $292 million for the first quarter 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 first quarter of 2007 to the first quarter of 2006, our total revenue grew more than 11%. With increases in all income statement revenue line items except trading services, total fee revenue was up 9%. The growth in fee revenue was particularly notable in servicing fees, up 9%, management fees, up 19%, and securities finance revenue, up 21%. 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, principally the result of new customers and growth from existing customers. For the first quarter of 2007, trading services revenue was down 4% from an unusually strong first quarter of 2006, due to a decrease in currency volatility partly offset by an increase in volumes.

Net interest revenue increased 22% compared to the prior year s first quarter, with a related increase in net interest margin of 22 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 the repositioning of the investment portfolio that we substantially completed during 2006, through portfolio repricing, as well as from continued growth in our non-U.S. business, particularly non-U.S. transaction deposits.

Total operating expenses increased less than 11%, primarily the result of increased performance-based incentive compensation, the impact of merit-based compensation increases, and increased headcount to support new business, particularly internationally. With growth in revenue of 11.4% and growth in operating expenses of 10.7% compared to the first quarter of 2006, we achieved positive operating leverage.

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. SSgA revenue comprised approximately 20% of our consolidated total revenue for the first quarter of 2007, compared to 19% for the first quarter of 2006, and the business achieved a pre-tax operating margin of 35% for the first quarters of 2007 and 2006. SSgA generated net new business of about $76 billion in assets under management in the first quarter of 2007, compared to about $34 billion in last year s first quarter.

At March 31, 2007, we had aggregate assets under custody of $12.33 trillion, which grew 4% from $11.85 trillion at December 31, 2006 and 15% from $10.74 trillion at March 31, 2006. At the same date, we had aggregate assets under management of $1.85 trillion, which grew 6% from $1.75 trillion at December 31, 2006 and 20% from $1.54 trillion at March 31, 2006.

Our effective tax rate for the first quarter of 2007 was 35%, compared to 34% from continuing operations for the first quarter of 2006, and 38.1% for full-year 2006.

Financial Goals

In our 2006 Form 10-K, we reaffirmed our long-term financial goals for State Street. These financial goals, on an annual basis, are:

- Growth in operating-basis revenue of between 8% and 12%;
- 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 $12 million and $11 million for the first quarters of 2007 and 2006, respectively, and a corresponding charge to income tax expense.

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. 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 first quarter of 2007 compared to the first quarter of 2006, we met our financial goals. We increased our earnings per share from continuing operations by 11%, from $.84 to $.93. Our operating-basis revenue increased 11% from $1.534 billion to $1.708 billion (including taxable-equivalent adjustments of $12 million for 2007 and $11 million for 2006); and we achieved return on shareholders equity of 17.4%.

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

Outlook

While these long-term goals remain in place, we revised our financial goals for 2007, relative to 2006, as a result of our planned acquisition of Investors Financial, which we expect to complete in the middle of 2007:

- 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 revenue will reflect fully taxable-equivalent net interest revenue, as described earlier. In addition, operating-basis results for 2007 will exclude merger, integration and restructuring charges 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, integration and restructuring charges, 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 in determining this 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;
- The expected flattening of the U.S. dollar yield curve;
- The 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;
- Shareholder and regulatory approvals of the Investors Financial acquisition;
- Achievement of expected cost savings from the acquisition; and
- Retention of, and success in cross-selling to, Investors Financial s customer base.

Information about other risks and uncertainties which could cause 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 first quarter of 2007 compared to the first quarter of 2006, and should be read in conjunction with the accompanying consolidated financial statements and related condensed notes.

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

TOTAL REVENUE

(Dollars in millions)	Quarters Ended March 31, 2007	2006	% Change
Fee Revenue:			
Servicing fees	**$ 718**	$ 657	9 %
Management fees	**261**	220	19
Trading services	**220**	230	(4)
Securities finance	**98**	81	21
Processing fees and other	**73**	72	1
Total fee revenue	**1,370**	1,260	9
Net Interest Revenue:			
Interest revenue	**1,172**	961	22
Interest expense	**847**	695	22
Net interest revenue	**325**	266	22
Gains (Losses) on sales of available-for-sale investment securities, net	**1**	(3)	
Total revenue	**$ 1,696**	$ 1,523	11

Fee Revenue

Servicing fees and management fees collectively comprised approximately 71% of total fee revenue for the first quarter of 2007 compared to approximately 70% for the prior-year quarter. These fees are a function of several factors, including the mix and volume of assets under custody and assets under management, securities positions held and the volume of portfolio transactions, as well as the types of products and services used by customers. 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. 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.

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

FEE REVENUE

(Dollars in millions)	Quarters Ended March 31, 2007	2006	% Change
Servicing fees	**$ 718**	$ 657	9 %
Management fees	**261**	220	19
Trading services	**220**	230	(4)
Securities finance	**98**	81	21
Processing fees and other	**73**	72	1
Total fee revenue	**$ 1,370**	$ 1,260	9

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. The increase in servicing fees was driven primarily by net new business as well as higher average equity market valuations. The daily average values for the S&P 500 Index were up 11%, and for the MSCI® EAFE Index were up 19%, compared with the first quarter of 2006.

ASSETS UNDER CUSTODY (In billions)	March 31, 2007	December 31, 2006
Mutual funds	**$ 3,952**	$ 3,738
Collective funds	**1,720**	1,665
Pension products	**3,775**	3,713
Insurance and other products	**2,884**	2,738
Total	**$ 12,331**	$ 11,854
Financial Instrument Mix:		
Equities	**$ 6,347**	$ 5,821
Fixed income	**3,730**	4,035
Short-term and other investments	**2,254**	1,998
Total	**$ 12,331**	$ 11,854

Management fees

The increase in management fees primarily reflected net new business and increases in month-end equity market valuations. Net new business resulted partly from engagements in more quantitative active strategies introduced over the past year by SSgA. Performance fees were $15 million, essentially flat with the prior-year quarter. The averages of month-end values for the S&P 500 Index were up 11%, and for the MSCI® EAFE Index were up 18%, compared with the first quarter of 2006.

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

ASSETS UNDER MANAGEMENT (In billions)	March 31, 2007	December 31, 2006
Equities:		
Passive.	**$ 714**	$ 691
Active and other.	**188**	181
Company stock/ESOP	**85**	85
Total equities	**987**	957
Fixed income	**210**	201
Cash and money market	**652**	591
Total fixed income and cash	**862**	792
Total		