FIFTH THIRD BANCORP
Form 10-Q
November 02, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2006

Commission File Number 0-8076

FIFTH THIRD BANCORP

(Exact name of Registrant as specified in its charter)

Ohio	**31-0854434**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**

Fifth Third Center

Cincinnati, Ohio 45263

(Address of principal executive offices)

Registrant s telephone number, including area code: (513) 534-5300

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 ¨

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 ¨ Non-accelerated filer ¨

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

There were 558,066,338 shares of the Registrant s Common Stock, without par value, outstanding as of September 30, 2006.

FIFTH THIRD BANCORP

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This report may contain forward-looking statements about the Registrant and/or the company as combined with acquired entities within the meaning of Sections 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and 21E of the Securities Exchange Act of 1934, as amended, and Rule 3b-6 promulgated thereunder, that involve inherent risks and uncertainties. This report may contain certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Registrant and/or the combined company including statements preceded by, followed by or that include the words or phrases such as believes, expects, anticipates, plans, trend, objective, continue, remain or similar expressions or future or conditional verbs such as should, could, might, can, may or similar expressions. There are a number of important factors that could cause future results to differ mater from historical performance and these forward-looking statements. Factors that might cause such a difference include, but are not limited to: (1) competitive pressures among depository institutions increase significantly; (2) changes in the interest rate environment reduce interest margins; (3) prepayment speeds, loan origination and sale volumes, charge-offs and loan loss provisions; (4) general economic conditions, either national or in the states in which the Registrant, one or more acquired entities and/or the combined company do business, are less favorable than expected; (5) political developments, wars or other hostilities may disrupt or increase volatility in securities markets or other economic conditions; (6) changes and trends in the securities markets; (7) legislative or regulatory changes or actions, or significant litigation, adversely affect the Registrant, one or more acquired entities and/or the combined company or the businesses in which the Registrant, one or more acquired entities and/or the combined company are engaged; (8) difficulties in combining the operations of acquired entities and (9) the impact of reputational risk created by the developments discussed above on such matters as business generation and retention, funding and liquidity. Additional information concerning factors that could cause actual results to differ materially from those expressed or implied in the forward-looking statements is available in the Registrant s Annual Report on Form 10-K for the year ended December 31, 2005, filed with the United States Securities and Exchange Commission (SEC). Copies of this filing are available at no cost on the SEC s Web site at www.sec.gov or on the Registrant s Web site at www.53.com. The Registrant undertakes no obligation to release revisions to these forward-looking statements or reflect events or circumstances after the date of this report.

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Item 2)

The following is management s discussion and analysis of certain significant factors that have affected Fifth Third Bancorp s (the Registrant or Fifth Third) financial condition and results of operations during the periods included in the Condensed Consolidated Financial Statements, which are a part of this filing. Reference to the Registrant incorporates the parent holding company and all consolidated subsidiaries.

TABLE 1: Selected Financial Data

($ in millions, except per share data)	For the three months ended September 30, 2006	2005	Percent Change	For the nine months ended September 30, 2006	2005	Percent Change
Income Statement Data						
Net interest income *(a)*	$ **719**	745	(3)%	$ **2,154**	2,262	(5)%
Noninterest income	**662**	622	6	**1,934**	1,864	4
Total revenue *(a)*	1,381	1,367	1	**4,088**	4,126	(1)
Provision for loan and lease losses	**87**	69	26	**236**	197	20
Noninterest expense	**767**	732	5	**2,257**	2,164	4
Net income	**377**	395	(5)	**1,123**	1,217	(8)
Common Share Data						
Earnings per share, basic	$ **.68**	.71	(4)%	$ **2.02**	2.19	(8)%
Earnings per share, diluted	**.68**	.71	(4)	**2.01**	2.18	(8)
Cash dividends per common share	**.40**	.38	5	**1.18**	1.08	9
Book value per share	**17.96**	16.93	6			
Dividend payout ratio	**58.8%**	53.5	10	**58.7%**	49.5	19
Financial Ratios						
Return on average assets	**1.41%**	1.51	(7)%	**1.42%**	1.59	(11)%
Return on average equity	**15.1**	16.6	(9)	**15.5**	17.6	(12)
Average equity as a percent of average assets	**9.33**	9.11	2	**9.19**	9.04	2
Tangible equity	**7.40**	6.84	8			
Net interest margin *(a)*	**2.99**	3.16	(5)	**3.03**	3.27	(7)
Efficiency *(a)*	**55.5**	53.5	4	**55.2**	52.4	5
Credit Quality						
Net losses charged off	$ **79**	64	23%	$ **219**	183	20%
Net losses charged off as a percent of average loans and leases	**.43%**	.38	13	**.41%**	.37	11
Allowance for loan and lease losses as a percent of loans and leases	**1.04**	1.06	(2)			
Allowance for credit losses as a percent of loans and leases *(b)*	**1.14**	1.16	(2)			
Nonperforming assets as a percent of loans, leases and other assets, including other real estate owned	**.56**	.51	10			
Average Balances						
Loans and leases, including held for sale	$ **73,938**	68,556	8%	$ **72,896**	$ 66,812	9%
Total securities and other short-term investments	**21,582**	24,915	(13)	**22,309**	25,578	(13)
Total assets	**105,868**	103,699	2	**105,452**	102,501	3
Transaction deposits	**48,543**	47,568	2	**48,923**	47,591	3
Core deposits	**59,337**	56,298	5	**59,257**	55,862	6
Wholesale funding	**33,040**	34,615	(5)	**33,022**	34,089	(3)
Shareholders equity	**9,878**	9,451	5	**9,696**	9,262	5
Regulatory Capital Ratios						
Tier I capital	**8.60%**	8.42	2%			
Total risk-based capital	**10.56**	10.54				
Tier I leverage	**8.52**	7.93	7			

(a) Amounts presented on a fully taxable equivalent basis.
(b) The allowance for credit losses is the sum of the allowance for loan and lease losses and the reserve for unfunded commitments.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

OVERVIEW

This overview of management s discussion and analysis highlights selected information in the financial results of the Registrant and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources and critical accounting policies and estimates, you should carefully read this entire document. Each of these items could have an impact on the Registrant s financial condition and results of operations.

The Registrant is a diversified financial services company headquartered in Cincinnati, Ohio. At September 30, 2006, the Registrant had $105.8 billion in assets, operated 19 affiliates with 1,145 full-service Banking Centers including 115 Bank Mart® locations open seven days a week inside select grocery stores and 2,114 Jeanie® ATMs in Ohio, Kentucky, Indiana, Michigan, Illinois, Florida, Tennessee, West Virginia, Pennsylvania and Missouri. The Registrant reports on five business segments: Commercial Banking, Branch Banking, Consumer Lending, Investment Advisors and Fifth Third Processing Solutions (FTPS). During the first quarter of 2006, the Registrant began separating its Retail line of business into the Branch Banking and Consumer Lending business segments. All prior year information has been updated to reflect this presentation.

The Registrant believes that banking is first and foremost a relationship business where the strength of the competition and challenges for growth can vary in every market. Its affiliate operating model provides a competitive advantage by keeping the decisions close to the customer and by emphasizing individual relationships. Through its affiliate operating model, individual managers, from the banking center to the executive level, are given the opportunity to tailor financial solutions for their customers.

The Registrant s revenues are fairly evenly dependent on net interest income and noninterest income. For the three months ended September 30, 2006, net interest income, on a fully taxable equivalent (FTE) basis, and noninterest income provided 52% and 48% of total revenue, respectively. Therefore, changes in interest rates, credit quality, economic trends and the capital markets are primary factors that drive the performance of the Registrant. As discussed later in the Risk Management section, risk identification, measurement, monitoring, control and reporting are important to the management of risk and to the financial performance and capital strength of the Registrant.

Net interest income, which continues to be the Registrant s largest revenue source, is the difference between interest income earned on assets such as loans, leases and securities, and interest expense paid on liabilities such as deposits and borrowings. Net interest income is affected by the general level of interest rates, the relative level of short- and long-term interest rates, changes in interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities. Generally, the rates of interest the Registrant earns on its assets and owes on its liabilities are established for a period of time. The change in market interest rates over time exposes the Registrant to interest rate risk through potential adverse changes to net interest income and financial position. The Registrant manages this risk by continually analyzing and adjusting the composition of its assets and liabilities based on their payment streams and interest rates, the timing of their maturities and their sensitivity to changes in market interest rates. Additionally, in the ordinary course of business, the Registrant enters into certain derivative transactions as part of its overall strategy to manage its interest rate and prepayment risks.

The Registrant is also exposed to the risk of losses on its loan and lease portfolio as a result of changing expected cash flows caused by loan defaults and inadequate collateral, among other factors.

Noninterest income is derived primarily from electronic funds transfer (EFT) and merchant transaction processing fees, card interchange, fiduciary and investment management fees, banking fees and service charges and mortgage banking revenue.

Net interest income, net interest margin, net interest rate spread and the efficiency ratio are presented in Management s Discussion and Analysis of Financial Condition and Results of Operations on an FTE basis. The FTE basis adjusts for the tax-favored status of income from certain loans and securities held by the Registrant that are not taxable for federal income tax purposes. The Registrant believes this presentation to be the preferred industry measurement of net interest income as it provides a relevant comparison between taxable and non-taxable amounts.

The Registrant s net income was $377 million in the third quarter of 2006, a five percent decrease compared to $395 million for the same period last year. Earnings per diluted share were $.68 for the third quarter, a four percent decrease from $.71 for the same period last year. The Registrant s quarterly dividend was $.40 per common share in the third quarter of 2006, a five percent increase over the $.38 dividend in the third quarter of 2005.

Net interest income (FTE) decreased three percent compared to the same period last year. Net interest margin decreased to 2.99% in the third quarter of 2006 from 3.16% in the same period last year and from 3.01% in the second quarter of 2006 largely due to the rise in short-term interest rates, the impact of the primarily fixed-rate securities portfolio and mix shifts within the core deposit base. Noninterest income increased six percent over the same period last year due to continued strong growth in electronic payment processing and corporate banking revenue and an $11 million increase in net securities gain partially offset by a $9 million decline in mortgage banking revenue. Noninterest expense increased five percent over the same quarter last year primarily due to increases in volume-related bankcard expenditures, equipment expenditures and occupancy expense related to the addition of de-novo banking centers and investments in technology, as well as an $11 million debt termination charge.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Credit quality metrics deteriorated slightly in the third quarter of 2006. Net charge-offs as a percent of average loans and leases were .43% in the third quarter of 2006 compared to .37% in the second quarter of 2006 and .38% in the third quarter of 2005. At September 30, 2006, nonperforming assets as a percent of loans and leases increased to .56% from ..49% at June 30, 2006 and .51% at September 30, 2005.

The Registrant s capital ratios exceed the well-capitalized guidelines as defined by the Board of Governors of the Federal Reserve System (FRB). As of September 30, 2006, the Tier I capital ratio was 8.60% and the total risk-based capital ratio was 10.56%.

The Registrant continues to invest in the geographic areas that offer the best growth prospects, as it believes this investment is the most cost efficient method of expansion within its largest affiliate markets. During the first nine months of 2006, the Registrant opened 40 net new banking centers (excluding relocations and consolidations of existing facilities) with plans to add 10 to 12 new banking centers in high-growth markets during the fourth quarter of 2006.

RECENT ACCOUNTING STANDARDS

Note 2 of the Notes to Condensed Consolidated Financial Statements provides a complete discussion of the new accounting standards adopted by the Registrant during 2006 and 2005 and the expected impact of accounting standards issued but not yet required to be adopted.

CRITICAL ACCOUNTING POLICIES

Allowance for Loan and Lease Losses

The Registrant maintains an allowance to absorb probable loan and lease losses inherent in the portfolio. The allowance is maintained at a level the Registrant considers to be adequate and is based on ongoing quarterly assessments and evaluations of the collectibility and historical loss experience of loans and leases. Credit losses are charged and recoveries are credited to the allowance. Provisions for loan and lease losses are based on the Registrant s review of the historical credit loss experience and such factors that, in management s judgment, deserve consideration under existing economic conditions in estimating probable credit losses. In determining the appropriate level of the allowance, the Registrant estimates losses using a range derived from base and conservative estimates. The Registrant s strategy for credit risk management includes a combination of conservative exposure limits significantly below legal lending limits and conservative underwriting, documentation and collections standards. The strategy also emphasizes diversification on a geographic, industry and customer level, regular credit examinations and quarterly management reviews of large credit exposures and loans experiencing deterioration of credit quality.

Larger commercial loans that exhibit probable or observed credit weakness are subject to individual review. Where appropriate, allowances are allocated to individual loans based on management s estimate of the borrower s ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Registrant. The review of individual loans includes those loans that are impaired as provided in SFAS No. 114, Accounting by Creditors for Impairment of a Loan. Any allowances for impaired loans are measured based on the present value of expected future cash flows discounted at the loan s effective interest rate or the fair value of the underlying collateral. The Registrant evaluates the collectibility of both principal and interest when assessing the need for loss accrual. Historical loss rates are applied to other commercial loans not subject to specific allowance allocations. The loss rates are derived from a migration analysis, which tracks the net charge-off experience sustained on loans according to their internal risk grade. The risk grading system currently utilized for allowance analysis purposes encompasses ten categories. The Registrant also maintains a dual risk rating system that provides for thirteen probability of default grade categories and an additional six grade categories for estimating actual losses given an event of default. The probability of default and estimated loss given default evaluations are not separated in the ten-grade risk rating system. The Registrant is in the process of completing significant validation and testing of the dual risk rating system prior to implementation for allowance analysis purposes. The dual risk rating system is expected to be consistent with Basel II requirements and will allow for more precision in the analysis of commercial credit risk.

Homogenous loans and leases, such as consumer installment, residential mortgage and automobile leases are not individually risk graded. Rather, standard credit scoring systems and delinquency monitoring are used to assess credit risks. Allowances are established for each pool of loans based on the expected net charge-offs for one year. Loss rates are based on the average net charge-off history by loan category.

Historical loss rates for commercial and consumer loans may be adjusted for significant factors that, in management s judgment, reflect the impact of any current conditions on loss recognition. Factors that management considers in the analysis include the effects of the national and local economies, trends in the nature and volume of loans (delinquencies, charge-offs and nonaccrual loans), changes in mix, credit score migration comparisons, asset quality trends, risk management and loan administration, changes in the internal lending policies and credit standards, collection practices and examination results from bank regulatory agencies and the Registrant s internal credit examiners.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Regardless of the extent of the evaluation of the previously discussed factors, certain inherent but undetected losses are probable within the loan and lease portfolios. An unallocated component to the allowance is maintained to recognize the imprecision in estimating and measuring loss when evaluating allowances for individual loans or pools of loans. Allowances on individual loans and historical loss rates are reviewed quarterly and adjusted as necessary based on changing borrower and/or collateral conditions and actual collection and charge-off experience.

Loans acquired by the Registrant through a purchase business combination are evaluated for possible credit impairment. Reduction to the carrying value of the acquired loans as a result of credit impairment is recorded as an adjustment to goodwill. The Registrant does not carry over the acquired company s allowance for loan and lease losses nor does the Registrant add to its existing allowance for the acquired loans as part of purchase accounting.

The Registrant s determination of the allowance for commercial loans is sensitive to the risk grade it assigns to these loans. In the event that 10% of commercial loans in each risk category would experience a downgrade of one risk category, the allowance for commercial loans would increase by approximately $72 million at September 30, 2006. The Registrant s determination of the allowance for residential and retail loans is sensitive to changes in estimated loss rates. In the event that estimated loss rates would increase by 10%, the allowance for residential and retail loans would increase by approximately $24 million at September 30, 2006. As several quantitative and qualitative factors are considered in determining the allowance for loan and lease losses, these sensitivity analyses do not necessarily reflect the nature and extent of future changes in the allowance for loan and lease losses. They are intended to provide insights into the impact of adverse changes in risk grades and inherent losses and do not imply any expectation of future deterioration in the risk rating or loss rates. Given current processes employed by the Registrant, management believes the risk grades and inherent loss rates currently assigned are appropriate.

The Registrant s primary market areas for lending are Ohio, Kentucky, Indiana, Michigan, Illinois, Florida, Tennessee, West Virginia, Pennsylvania and Missouri. When evaluating the adequacy of allowances, consideration is given to this regional geographic concentration and the closely associated effect changing economic conditions have on the Registrant s customers.

In the current year, the Registrant has not substantively changed any material aspect of its overall approach to determine its allowance for loan and lease losses. There have been no material changes in assumptions or estimation techniques as compared to prior periods that impacted the determination of the current period allowance for loan and lease losses. Based on the procedures discussed above, the Registrant is of the opinion that the allowance of $761 million was adequate, but not excessive, to absorb estimated credit losses associated with the loan and lease portfolio at September 30, 2006.

Valuation of Securities

Securities are classified as held-to-maturity, available-for-sale or trading on the date of purchase. Only those securities classified as held-to-maturity, and which management has both the intent and ability to hold to maturity, are reported at amortized cost. Available-for-sale and trading securities are reported at fair value with unrealized gains and losses, net of related deferred income taxes, included in accumulated other comprehensive income on the Condensed Consolidated Balance Sheets and noninterest income in the Condensed Consolidated Statements of Income, respectively. The fair value of a security is determined based on quoted market prices. If quoted market prices are not available, fair value is determined based on quoted prices of similar instruments. Realized securities gains or losses are reported within noninterest income in the Condensed Consolidated Statements of Income. The cost of securities sold is based on the specific identification method. Available-for-sale and held-to-maturity securities are reviewed quarterly for possible other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as the severity of loss, the length of time the fair value has been below cost, the expectation for that security s performance, the creditworthiness of the issuer and the Registrant s intent and ability to hold the security. A decline in value that is considered to be other-than-temporary is recorded as a loss within noninterest income in the Condensed Consolidated Statements of Income. At September 30, 2006, 93% of the unrealized losses in the available-for-sale security portfolio were comprised of securities issued by U.S. Treasury and Government agencies, U.S. Government sponsored agencies and states and political subdivisions as well as agency mortgage-backed securities. The Registrant believes the price movements in these securities are dependent upon the movement in market interest rates. The Registrant also maintains its intent and ability to hold these securities.

Reserve for Unfunded Commitments

The reserve for unfunded commitments is maintained at a level believed by management to be sufficient to absorb estimated probable losses related to unfunded credit facilities. The determination of the adequacy of the reserve is based upon an evaluation of the unfunded credit facilities, including an assessment of historical commitment utilization experience, credit risk grading and credit grade migration. Net adjustments to the reserve for unfunded commitments are included in other noninterest expense.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Taxes

The Registrant estimates income tax expense based on amounts expected to be owed to the various tax jurisdictions in which the Registrant conducts business. On a quarterly basis, management assesses the reasonableness of its effective tax rate based upon its current estimate of the amount and components of net income, tax credits and the applicable statutory tax rates expected for the full year. The estimated income tax expense is recorded in the Condensed Consolidated Statements of Income.

Deferred income tax assets and liabilities are determined using the balance sheet method and are reported in accrued taxes, interest and expenses in the Condensed Consolidated Balance Sheets. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax basis of assets and liabilities and recognizes enacted changes in tax rates and laws. Deferred tax assets are recognized subject to management judgment that realization is more likely than not.

Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions and are reported in accrued taxes, interest and expenses in the Condensed Consolidated Balance Sheets. The Registrant evaluates and assesses the relative risks and appropriate tax treatment of transactions and filing positions after considering statutes, regulations, judicial precedent and other information and maintains tax accruals consistent with its evaluation of these relative risks and merits. Changes to the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations being conducted by taxing authorities and changes to statutory, judicial and regulatory guidance that impact the relative risks of tax positions. These changes, when they occur, can affect deferred taxes and accrued taxes as well as the current period s income tax expense and can be significant to the operating results of the Registrant. See Note 2 of the Notes to the Condensed Consolidated Financial Statements for discussion of the recently issued accounting statement, which clarifies the accounting for uncertainty in income taxes. As described in greater detail in Note 9 of the Notes to the Condensed Consolidated Financial Statements, the Internal Revenue Service is currently challenging the Registrant s tax treatment of certain leasing transactions.

Valuation of Servicing Rights

When the Registrant sells loans through either securitizations or individual loan sales in accordance with its investment policies, it often retains servicing rights. Servicing rights resulting from loan sales are amortized in proportion to and over the period of estimated net servicing revenues. Servicing rights are assessed for impairment monthly, based on fair value, with temporary impairment recognized through a valuation allowance and permanent impairment recognized through a write-off of the servicing asset and related valuation allowance. Key economic assumptions used in measuring any potential impairment of the servicing rights include the prepayment speeds of the underlying loans, the weighted-average life, the discount rate, the weighted-average coupon and the weighted-average default rate, as applicable. The primary risk of material changes to the value of the servicing rights resides in the potential volatility in the economic assumptions used, particularly the prepayment speeds.

The Registrant monitors risk and adjusts its valuation allowance as necessary to adequately reserve for any probable impairment in the portfolio. For purposes of measuring impairment, the servicing rights are stratified based on the financial asset type and interest rates. In addition, the Registrant obtains an independent third-party valuation of mortgage servicing rights (MSR) on a quarterly basis. Fees received for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in noninterest income as loan payments are received. Costs of servicing loans are charged to expense as incurred.

The change in the fair value of MSRs at September 30, 2006, due to immediate 10% and 20% adverse changes in the current prepayment assumption would be approximately $23 million and $43 million, respectively, and due to immediate 10% and 20% favorable changes in the current prepayment assumption would be approximately $25 million and $51 million, respectively. The change in the fair value of the MSR portfolio at September 30, 2006, due to immediate 10% and 20% adverse changes in the discount rate assumption would be approximately $18 million and $35 million, respectively, and due to immediate 10% and 20% favorable changes in the discount rate assumption would be approximately $19 million and $40 million, respectively. Sensitivity analysis related to other consumer and commercial servicing rights is not material to the Registrant s Condensed Consolidated Financial Statements. These sensitivities are hypothetical and should be used with caution. As the figures indicate, change in fair value based on a 10% and 20% variation in assumptions typically cannot be extrapolated because the relationship of the change in assumptions to change in fair value may not be linear. Also, the effect of variation in a particular assumption on the fair value of the retained interests is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. Additionally, the effect of the Registrant s non-qualifying hedging strategy, which is maintained to lessen the impact of changes in value of the MSR portfolio, is excluded from the above analysis.

STATEMENTS OF INCOME ANALYSIS

Net Interest Income

The increases in short-term rates during the second quarter of 2006 negatively impacted the Registrant s net interest margin in the third quarter. The net interest margin declined to 2.99% from 3.01% in the second quarter and 3.16% in the third quarter of 2005. Net interest income (FTE) was $719 million for the third quarter of 2006, an increase of $3 million compared to the sequential quarter and a decline of $26 million compared to the prior year quarter. In terms of mix between volume and yield, the impact of

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

changes in interest rates on net interest income (FTE) was a decrease of eight percent from the third quarter of 2005. Given the moderation of short-term rate increases during the third quarter, the Registrant currently expects a stable to slightly improved net interest margin in the fourth quarter with future trends dependent on the timing of any further short-term interest rate changes, the growth and composition of core deposits and loan growth.

Total average earning assets were relatively flat versus the second quarter and increased two percent over the third quarter of 2005. Margin compression was the result of a decrease in net interest spread of 7 basis points (bp) compared to the second quarter of 2006 and 40 bp compared to the third quarter 2005. The decrease in net interest spread was the result of higher short-term funding costs and the yield curve continuing to be flat, the impact of the primarily fixed rate security portfolio and a change in mix within core deposits. The average interest rate spread between the 3-month Treasury bill and the 10-year Treasury note compressed from 78 bp in the third quarter of 2005 to 24 bp in the second quarter of 2006 to negative 15 bp in the third quarter of 2006, illustrating the relative pressure between shorter-term and longer-term funding costs and general security portfolio reinvestment opportunities. The decrease in net interest rate spread was partially offset by an increased benefit from free funding of 73 bp in the third quarter of 2006, up 5 bp from the second quarter of 2006 and 23 bp over the third quarter of 2005. The relatively large increase in the benefit of free funding over the third quarter of 2005 was the result of higher funding costs and an improvement in the net free funding position of the Registrant, calculated as the total of noninterest-bearing liabilities and equity less noninterest-earning assets, which increased two percent to $16.8 billion.

The growth in average loans and leases since the third quarter of 2005 outpaced core deposit growth for the same period by $2.3 billion. The funding shortfall was more than offset by a $3.5 billion reduction in the average available-for-sale securities portfolio, as the Registrant continues to use cash flows from its securities portfolio to reduce its reliance on wholesale funding. In the third quarter of 2006, the Registrant sold approximately $726 million from its securities portfolio, which represented nearly all of its position in Federal Home Loan Mortgage Corporation (FHLMC) callable debt, in order to manage its credit exposure to certain government-sponsored entities. For the third quarter of 2006, wholesale funding represented 42% of interest-bearing liabilities, down from 45% for the same period in the prior year. In the current interest rate environment, the Registrant expects to continue to use cash flows from its securities portfolio during the remainder of 2006 to fund its loan and lease growth that is in excess of its core deposit growth.

During the third quarter of 2006, the Registrant continued its deposit pricing strategy of moving away from promotional rates and towards highly competitive daily rates. As part of this strategy, the Registrant maintains competitive deposit rates in all of its affiliate markets and across all of its deposit products. Additionally, interest checking balances have continued to migrate into money market, savings and time deposit accounts. During the third quarter of 2006, interest-checking balances were 36% of average interest-bearing core deposits and savings and money market combined to represent 41%, compared to 44% and 36%, respectively, in the third quarter of 2005.

The cost of interest-bearing core deposits was 3.32% in the third quarter of 2006, up from 3.12% in the second quarter of 2006 and 2.24% in the third quarter of 2005. Despite the increasing deposit rates, the relative cost advantage of interest-bearing core deposits compared to wholesale funding increased from 127 bp from the third quarter of 2005 and 188 bp in the second quarter of 2006 to 196 bp in the third quarter of 2006.

Interest income (FTE) from loans and leases increased $277 million, or 27%, compared to the third quarter of 2005. The increase resulted from the growth in average loans and leases of eight percent for the third quarter of 2006 over the comparable period in 2005 as well as a 106 bp increase in average rates. The increase in average loans and leases included growth in commercial loans and leases of 10% and growth in average consumer loans and leases of five percent compared to the third quarter of 2005.

Interest income (FTE) from investment securities and short-term investments decreased $28 million to $243 million for the third quarter of 2006 compared to the same period in 2005 due to the previously mentioned reduction of the investment securities portfolio. The average yield on taxable securities increased by only 17 bp as a result of 84% of the debt securities within the available-for-sale portfolio being fixed-rate securities and the relative stability in longer-term interest rates.

The interest on core deposits increased $143 million, or 60%, in the third quarter of 2006 over the comparable period in 2005 due to increases in short-term interest rates and increasing average balances. Average interest-bearing core deposits increased $3.4 billion, or eight percent, compared to the third quarter of 2005. The Registrant continues to focus on growing its core deposit balances in order to improve the funding mix and improve net interest margin trends. The growth in noninterest-bearing funds and other core deposits is a critical component in the growth of net interest income.

The interest on wholesale funding increased by $132 million, or 43%, in the third quarter over the comparable period in 2005 due to increasing short-term interest rates partially offset by a $1.6 billion decrease in average balances. The Registrant continues to reduce its reliance on wholesale funding by funding loan growth with core deposits and cash flows from its securities portfolio. Included within other short-term borrowings are the Registrant s customer repo sweep balances, which were $2.5 billion on an average basis for both the three months ended September 30, 2006 and 2005.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

TABLE 2: Consolidated Average Balance Sheets and Analysis of Net Interest Income (FTE)

For the three months ended	September 30, 2006			September 30, 2005			Attribution of Change in Net Interest Income (a)		
			Average Yield/			Average Yield/		Yield/	
($ in millions)	Average Balance	Revenue/ Cost	Rate	Average Balance	Revenue/ Cost	Rate	Volume	Rate	Total
Assets									
Interest-earning assets:									
Loans and leases *(b)*:									
Commercial loans	$ 20,769	$ 389	7.43%	$ 18,203	$ 276	6.01%	$ 42	71	113
Commercial mortgage	9,833	181	7.31	9,095	144	6.28	12	25	37
Commercial construction	5,913	118	7.90	5,700	91	6.37	4	23	27
Commercial leases	3,740	46	4.85	3,537	46	5.14	3	(3)	
Subtotal commercial	40,255	734	7.23	36,535	557	6.05	61	116	177
Residential mortgage	8,967	135	5.97	8,271	114	5.49	10	11	21
Residential construction	733	11	5.90	624	9	5.56	1	1	2
Other consumer loans	22,729	402	7.04	21,348	320	5.93	21	61	82
Consumer leases	1,254	15	4.63	1,778	20	4.54	(6)	1	(5)
Subtotal consumer	33,683	563	6.64	32,021	463	5.73	26	74	100
Total loans and leases	73,938	1,297	6.96	68,556	1,020	5.90	87	190	277
Securities:									
Taxable	20,836	231	4.39	24,013	255	4.22	(34)	10	(24)
Exempt from income taxes *(b)*	587	10	7.29	787	15	7.42	(4)	(1)	(5)
Other short-term investments	159	2	5.69	115	1	3.49		1	1
Total interest-earning assets	95,520	1,540	6.40	93,471	1,291	5.48	49	200	249
Cash and due from banks	2,355			2,742					
Other assets	8,745			8,207					
Allowance for loan and lease losses	(752)			(721)					
Total assets	$ 105,868			$ 103,699					
Liabilities									
Interest-bearing liabilities:									
Interest checking	$ 16,251	$ 102	2.49%	$ 18,498	$ 86	1.84%	$ (11)	27	16
Savings	12,279	95	3.08	9,939	48	1.90	13	34	47
Money market	6,371	69	4.30	5,154	37	2.82	10	22	32
Other time deposits	10,794	116	4.24	8,730	68	3.14	19	29	48
Certificates - $100,000 and over	6,415	81	5.03	4,156	34	3.28	24	23	47
Foreign office deposits	3,668	47	5.05	3,925	34	3.41	(2)	15	13
Federal funds purchased	4,546	61	5.33	4,001	35	3.50	5	21	26
Other short-term borrowings	4,056	45	4.42	5,619	41	2.92	(13)	17	4
Long-term debt	14,355	205	5.66	16,914	163	3.80	(28)	70	42
Total interest-bearing liabilities	78,735	821	4.14	76,936	546	2.82	17	258	275
Demand deposits	13,642			13,977					
Other liabilities	3,613			3,335					

Total liabilities	**95,990**				94,248					
Shareholders equity	**9,878**				9,451					
Total liabilities and shareholders equity	**$ 105,868**				$ 103,699					
Net interest income margin		**$**	**719**	**2.99%**		$ 745	3.16%	$ 32	(58)	(26)
Net interest rate spread				**2.26**			2.66			
Interest-bearing liabilities to interest-earning assets				**82.43**			82.31			

(a) *Changes in interest not solely due to volume or yield/rate are allocated in proportion to the absolute dollar amount of change in volume and yield/rate.*

(b) *The net taxable equivalent adjustment amounts included in the above table are $6 million and $8 million for the three months ended September 30, 2006 and 2005, respectively.*

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

TABLE 3: Consolidated Average Balance Sheets and Analysis of Net Interest Income (FTE)

For the nine months ended	September 30, 2006			September 30, 2005			Attribution of Change in Net Interest Income (a)		
($ in millions)	Average Balance	Revenue/ Cost	Average Yield/ Rate	Average Balance	Revenue/ Cost	Average Yield/ Rate	Volume	Yield/ Rate	Total
Assets									
Interest-earning assets:									
Loans and leases *(b)*:									
Commercial loans	**$ 20,160**	**$ 1,079**	**7.16%**	$ 18,016	$ 757	5.62%	$ 98	224	322
Commercial mortgage	**9,753**	**516**	**7.08**	8,843	398	6.01	43	75	118
Commercial construction	**5,987**	**340**	**7.58**	5,349	237	5.93	31	72	103
Commercial leases	**3,719**	**139**	**5.00**	3,456	134	5.17	10	(5)	5
Subtotal commercial	**39,619**	**2,074**	**7.00**	35,664	1,526	5.72	182	366	548
Residential mortgage	**8,694**	**384**	**5.90**	8,380	344	5.49	13	27	40
Residential construction	**725**	**32**	**5.93**	557	22	5.40	8	2	10
Other consumer loans	**22,466**	**1,137**	**6.77**	20,342	872	5.73	97	168	265
Consumer leases	**1,392**	**50**	**4.79**	1,869	65	4.62	(17)	2	(15)
Subtotal consumer	**33,277**	**1,603**	**6.44**	31,148	1,303	5.59	101	199	300
Total loans and leases	**72,896**	**3,677**	**6.74**	66,812	2,829	5.66	283	565	848
Securities:									
Taxable	**21,527**	**712**	**4.42**	24,569	789	4.30	(100)	23	(77)
Exempt from income taxes *(b)*	**616**	**34**	**7.41**	819	46	7.35	(12)		(12)
Other short-term investments	**166**	**7**	**5.44**	190	3	2.35		4	4
Total interest-earning assets	**95,205**	**4,430**	**6.22**	92,390	3,667	5.31	171	592	763
Cash and due from banks	**2,528**			2,728					
Other assets	**8,467**			8,101					
Allowance for loan and lease losses	**(748)**			(718)					
Total assets	**$ 105,452**			$ 102,501					
Liabilities									
Interest-bearing liabilities:									
Interest checking	**$ 16,955**	**$ 303**	**2.39%**	$ 19,240	$ 220	1.53%	$ (29)	112	83
Savings	**11,979**	**259**	**2.89**	9,660	109	1.51	31	119	150
Money market	**6,296**	**188**	**3.99**	4,900	90	2.46	31	67	98
Other time deposits	**10,334**	**308**	**4.00**	8,271	182	2.94	51	75	126
Certificates - $100,000 and over	**5,473**	**191**	**4.66**	3,883	89	3.05	45	57	102
Foreign office deposits	**4,032**	**143**	**4.73**	4,056	89	2.94	(1)	55	54
Federal funds purchased	**4,328**	**160**	**4.93**	4,040	89	2.96	7	64	71
Short-term bank notes				332	6	2.60	(3)	(3)	(6)
Other short-term borrowings	**4,540**	**142**	**4.18**	5,250	102	2.60	(15)	55	40
Long-term debt	**14,649**	**582**	**5.31**	16,528	429	3.47	(53)	206	153
Total interest-bearing liabilities	**78,586**	**2,276**	**3.87**	76,160	1,405	2.47	64	807	871
Demand deposits	**13,693**			13,791					

Other liabilities	**3,477**			3,288					
Total liabilities	**95,756**			93,239					
Shareholders equity	**9,696**			9,262					
Total liabilities and shareholders equity	**$ 105,452**			$ 102,501					
Net interest income margin		**$ 2,154**	**3.03%**		$ 2,262	3.27%	$ 107	(215)	(108)
Net interest rate spread			**2.35**			2.84			
Interest-bearing liabilities to interest-earning assets			**82.54**			82.43			

(a) Changes in interest not solely due to volume or yield/rate are allocated in proportion to the absolute dollar amount of change in volume and yield/rate.

(b) The net taxable equivalent adjustment amounts included in the above table are $20 million and $24 million for the nine months ended September 30, 2006 and 2005, respectively.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Provision for Loan and Lease Losses

The Registrant provides as an expense an amount for probable loan and lease losses within the loan portfolio that is based on the factors discussed in the Critical Accounting Policies section. The provision is recorded to bring the allowance for loan and lease losses to a level deemed appropriate by the Registrant. Actual credit losses on loans and leases are charged against the allowance for loan and lease losses. The amount of loans actually removed from the Condensed Consolidated Balance Sheets is referred to as charge-offs. Net charge-offs include current period charge-offs less recoveries in the current period on previously charged off assets.

The provision for loan and lease losses increased to $87 million in the third quarter of 2006 compared to $69 million in the same quarter last year. The increase is due to both the increase in net charge-offs from $64 million in the third quarter of 2005 to $79 million and increased loan growth in the third quarter of 2006. The allowance for loan and lease losses as a percent of loans and leases was 1.04% at September 30, 2006 compared to 1.06% at September 30, 2005. Refer to the Credit Risk Management section for further information on the provision for loan and lease losses, net charge-offs and other factors considered by the Registrant in assessing the credit quality of the loan portfolio and the allowance for loan and lease losses.

Noninterest Income

For the three and nine months ended September 30, 2006, noninterest income increased by six percent and four percent, respectively. The components of noninterest income for these periods are as follows:

TABLE 4: Noninterest Income

	For the three months ended September 30,		Percent	For the nine months ended September 30,		Percent
($ in millions)	**2006**	**2005**	**Change**	**2006**	**2005**	**Change**
Electronic payment processing revenue	$ **218**	190	15%	$ **626**	544	15%
Service charges on deposits	**134**	137	(2)	**395**	390	1
Mortgage banking net revenue	**36**	45	(19)	**125**	132	(6)
Investment advisory revenue	**89**	89	(1)	**276**	271	2
Corporate banking revenue	**79**	71	11	**236**	207	14
Other noninterest income	**87**	82	6	**242**	282	(14)
Securities gains, net	**19**	8	128	**34**	38	(10)
Total noninterest income	$ **662**	622	6%	$ **1,934**	1,864	4%

During the first quarter of 2006, the Registrant refined its presentation of noninterest income in order to provide more granularity around its revenue streams. The primary result of this refinement was the consolidation of the Registrant s interest rate derivative sales, international service fees, institutional sales and loan and lease syndication fees into a new income statement line item named corporate banking revenue. Corporate banking revenue increased to $79 million in the third quarter of 2006, up 11% over the comparable period in 2005. The growth in corporate banking revenue was largely attributable to increases in institutional fees and other commercial fees.

Electronic payment processing revenue increased $28 million in the third quarter of 2006 compared to the same period last year. EFT revenue increased $18 million, or 18%, to $118 million, as a result of continued success in attracting financial institution customers as well as an $8 million increase in issuer interchange. Merchant processing revenue increased 11%, to $100 million, compared to the same period in 2005. Growth in the merchant business is expected to increase as national merchant additions announced throughout 2006 are fully realized. The Registrant continues to see significant opportunities in attracting new financial institutional customers and retailers. The Registrant handles electronic processing for approximately 120,000 merchant locations and over 1,600 financial institutions worldwide, including The Kroger Co., Nordstrom, Inc., the Armed Forces Financial Network and, most recently, Federated Department Stores, Inc. and Gregg Appliances, Inc.

Service charges on deposits decreased two percent in the third quarter of 2006 compared to the same period last year. Commercial deposit revenue decreased four percent while consumer deposit revenue remained stable. Despite growth in the number of relationships and overall activity, commercial service charges were negatively impacted compared to the third quarter last year by a 28% increase in earnings credits on commercial customer demand deposit accounts due to the higher interest rate environment. Net new consumer deposit account production increased by over 52% through the third quarter of 2006 compared to the same period last year. Growth in the number of customer deposit account relationships and deposit generation continues to be a primary focus of the Registrant.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Mortgage banking net revenue decreased to $36 million in the third quarter of 2006 from $45 million in the same period last year. Mortgage originations were $2.3 billion and $2.9 billion in the third quarter of 2006 and 2005, respectively. The components of mortgage banking net revenue for the three and nine months ended September 30, 2006 and 2005 are as follows:

TABLE 5: Components of Mortgage Banking Net Revenue

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Origination fees and gains (losses) on loan sales	**$ 21**	34	**69**	95
Servicing revenue:				
Servicing fees	**30**	28	**90**	80
Servicing rights amortization	**(18)**	(21)	**(49)**	(54)
Net valuation adjustments on servicing rights and free-standing derivatives entered into to economically hedge MSR	**3**	4	**15**	11
Net servicing revenue	**15**	11	**56**	37
Mortgage banking net revenue	**$ 36**	45	**125**	132

Mortgage net servicing revenue increased by $4 million as compared to the same period last year. Net servicing revenue is comprised of gross servicing fees and amortization as well as valuation adjustments on mortgage servicing rights and mark-to-market adjustments on both settled and outstanding free-standing derivative financial instruments. The Registrant s total residential mortgage loans serviced at September 30, 2006 and 2005 were $36.7 billion and $33.1 billion, respectively, with $27.8 billion and $24.5 billion, respectively, of residential mortgage loans serviced for others.

Net valuation adjustments on servicing rights and free-standing derivatives for the three months ended September 30, 2006 and 2005, were $3 million and $4 million, respectively. Temporary impairment on the MSR portfolio was $3 million compared to a reversal of $27 million during the third quarter of 2005. Servicing rights are deemed impaired when a borrower s loan rate is distinctly higher than prevailing rates. Impairment on servicing rights is reversed when the prevailing rates return to a level commensurate with the borrower s loan rate. The Registrant recognized a net gain of $6 million and a net loss of $23 million in the third quarter of 2006 and 2005, respectively, related to changes in fair value and the settlement of free-standing derivatives purchased to economically hedge the MSR portfolio.

The Registrant maintains a non-qualifying hedging strategy to manage a portion of the risk associated with changes in impairment on the MSR portfolio. In the third quarter of 2006, the Registrant primarily used principal only swaps, interest rate swaps and swaptions to hedge the economic risk of the MSR portfolio as they were deemed to be the best available instruments for several reasons. Principal only swaps hedge the mortgage-LIBOR spread because they appreciate in value as a result of tightening spreads. They also provide prepayment protection by increasing in value when prepayment speeds increase, as opposed to MSRs that lose value in a faster prepayment environment. Receive fixed/pay floating interest rate swaps and swaptions increase in value when interest rates do not increase as quickly as expected. As of September 30, 2006 and 2005, the Registrant held a combination of free-standing derivatives, including principal only swaps, swaptions and interest rate swaps with a net positive fair value of $1 million and a net negative fair value of $10 million, respectively, on outstanding notional amounts of $1.9 billion and $3.6 billion, respectively. In addition to the derivative positions used to economically hedge the MSR portfolio, the Registrant began to acquire various securities (primarily principal only strips) during 2005 and 2006 as a component of its non-qualifying hedging strategy. Principal only strips increase in value as prepayment speeds increase, thus providing an economic hedge for the MSR portfolio. As of September 30, 2006, the Registrant s available-for-sale securities portfolio included $251 million of securities related to the non-qualifying hedging strategy.

Investment advisory revenues were stable in the third quarter of 2006 compared to the same period last year and down eight percent from a seasonally strong second quarter that reflected annually assessed trust and tax related fees. During the third quarter of 2006, the Registrant experienced increased private client and trust fees offset by lower mutual fund revenue. Mutual fund fees were down as the Registrant has continued to evolve toward a more open architectural framework to meet the needs of its customers. The Registrant continues to focus its sales efforts on improving execution in retail brokerage and retail mutual funds and on growing the institutional money management business by improving penetration and cross-sell in its large middle-market commercial customer base. The Registrant is one of the largest money managers in the Midwest and as of September 30, 2006 had over $215 billion in assets under care and $32 billion in assets under management.

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The major components of other noninterest income are as follows:

TABLE 6: Components of Other Noninterest Income

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Cardholder fees	**$ 13**	12	**36**	34
Consumer loan and lease fees	**13**	9	**37**	37
Operating lease income	**6**	11	**20**	46
Bank owned life insurance income	**21**	23	**65**	68
Insurance income	**7**	8	**21**	20
Other	**27**	19	**63**	77
Total other noninterest income	**$ 87**	82	**242**	282

Other noninterest income increased by six percent in the third quarter of 2006 compared to the same period last year. The increase reflects net gains totaling $10.5 million from the sale of three branches in rural Indiana and the sale of $23 million of out-of-footprint credit card receivables. The increase was mitigated by the $5 million decrease in operating lease income resulting from the continued runoff in the operating lease portfolio. Operating lease revenues will moderate as automobile leases continue to mature and are offset by originations of commercial operating leases.

Net securities gains totaled $19 million in the third quarter and consisted of a $53 million gain from the sale of the Registrant s remaining MasterCard, Inc. shares and $34 million of losses on other investment securities.

Noninterest Expense

During the third quarter, the Registrant continued to invest in the expansion of the retail distribution network. The efficiency ratio (noninterest expense divided by the sum of net interest income (FTE) and noninterest income) was 55.5% and 53.5% for the third quarter of 2006 and 2005, respectively. The Registrant continues to focus on efficiency initiatives as part of its core emphasis on operating leverage and views its recent investments in information technology and branch expansion as its platform for future growth and increasing expense efficiency.

With the continued focus on expense control, the Registrant expects growth in noninterest expenses to be consistent with recent trends. Cost savings initiatives will continue to be somewhat mitigated by investments in certain high opportunity markets, as evidenced by the 40 net new banking centers added in the first three quarters and the 10 to 12 net new banking centers expected to be added in the fourth quarter of 2006.

The major components of noninterest expense are as follows:

TABLE 7: Noninterest Expense

($ in millions)	For the three months ended September 30, 2006	2005	Percent Change	For the nine months ended September 30, 2006	2005	Percent Change
Salaries, wages and incentives	**$ 288**	285	1%	**$ 875**	846	3%
Employee benefits	**74**	70	6	**230**	218	6
Equipment expense	**34**	26	30	**90**	76	18
Net occupancy expense	**63**	54	16	**180**	162	11

Other noninterest expense		**308**	297	4		**882**	862	2
Total noninterest expense	**$**	**767**	732	5%	**$**	**2,257**	2,164	4%

Total noninterest expense increased five percent in the third quarter of 2006 compared to the same period last year and increased one percent compared to the second quarter of 2006. The current quarter expenses reflected an additional $8 million of pension settlement expense, similar to the level experienced in the third quarter of last year, while second quarter expenses included a $9 million charge related to the April 2006 issuance of stock-based awards to retirement-eligible employees. Increases in noninterest expense over the prior year quarter resulted primarily from bankcard volume-related costs, included in other noninterest expense, and the increase in occupancy and equipment expenses offset by a decrease in operating lease expense. Net occupancy expenses increased 16% in the third quarter of 2006 over the same period last year primarily due to the addition of 61 net new banking centers since September 30, 2005.

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The major components of other noninterest expense are as follows:

TABLE 8: Components of Other Noninterest Expense

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Marketing and communications	$ **29**	36	**95**	98
Postal and courier	**12**	13	**37**	37
Bankcard	**82**	69	**231**	195
Loan and lease	**27**	25	**67**	63
Travel	**13**	13	**39**	40
Information technology and operations	**29**	30	**79**	82
Operating lease	**4**	8	**14**	34
Other	**112**	103	**320**	313
Total other noninterest expense	$ **308**	297	**882**	862

Total other noninterest expense increased by $11 million from the third quarter of 2005 primarily due to an $11 million charge in the third quarter associated with the early extinguishment of debt in the form of a $300 million structured repurchase agreement. Marketing and communications declined primarily due to expenses incurred in the third quarter 2005 associated with increased spending on deposit campaign initiatives. Bankcard expense increased 19% compared to last year due to an increase in the number of merchant and retail customers as well as continued organic growth in debit and credit card usage. The decrease in operating lease expense is attributable to the continued runoff in the operating lease portfolio. The remaining expense captions continue to be well-controlled.

Applicable Income Taxes

The Registrant s income before income taxes, applicable income tax expense and effective tax rate for each of the periods are as follows:

TABLE 9: Applicable Income Taxes

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Income before income taxes and cumulative effect	$ **521**	558	**1,575**	1,741
Applicable income taxes	**144**	163	**456**	524
Effective tax rate	**27.6%**	29.2	**28.9**	30.1

Applicable income tax expense for all periods include the benefit from tax-exempt income, tax-advantaged investments and general business tax credits, partially offset by the effect of nondeductible expenses. Income tax expense for the third quarter of 2006 includes the favorable resolution of certain tax examinations.

Cumulative Effect of Change in Accounting Principle

In the first quarter of 2006, the Registrant recognized a benefit of approximately $4 million, net of $2 million of tax, related to the adoption of SFAS No. 123 (Revised 2004). The benefit recognized relates to the Registrant s estimate of forfeiture experience to be realized for all unvested stock-based awards outstanding.

BUSINESS SEGMENT REVIEW

The Registrant reports on five business segments: Commercial Banking, Branch Banking, Consumer Lending, Investment Advisors and Processing Solutions. During the first quarter of 2006, the Registrant began reporting its Retail line of business as two business segments, Branch Banking and Consumer Lending. All prior year information has been updated to reflect this presentation. Further detailed financial information on each business segment is included in Note 14 of the Notes to the Condensed Consolidated Financial Statements.

Results of the Registrant s business segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Registrant; therefore, the financial results of the Registrant s business segments are not necessarily comparable with similar information for other financial institutions. The Registrant refines its methodologies from time to time as management accounting practices are improved and businesses change. Revisions to the Registrant s methodologies are applied on a retroactive basis.

The Registrant manages interest rate risk centrally at the corporate level by employing a funds transfer pricing (FTP) methodology. This methodology insulates the business segments from interest rate risk, enabling them to focus on servicing customers through loan originations and deposit taking. The FTP system assigns charge and credit rates to classes of assets and liabilities, respectively, based on expected duration. The Registrant has not changed the conceptual application of FTP during 2005 or 2006. The net impact of the FTP methodology is included in Other/Eliminations.

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The financial results of the business segments include allocations for shared services and headquarters expenses. Even with these allocations, the financial results are not necessarily indicative of the business segments financial condition and results of operations as if they were to exist as independent entities. Additionally, the business segments form synergies by taking advantage of cross-sell opportunities and when funding operations by accessing the capital markets as a collective unit. Net income by business segment is summarized as follows:

TABLE 10: Business Segment Results

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Commercial Banking	$ **215**	190	**611**	562
Branch Banking	**254**	204	**718**	597
Consumer Lending	**30**	34	**109**	136
Investment Advisors	**40**	27	**114**	83
Processing Solutions	**69**	27	**149**	94
Other/Eliminations	**(231)**	(87)	**(578)**	(255)
Net income	$ **377**	395	**1,123**	1,217

Commercial Banking

Commercial Banking provides a comprehensive range of financial services and products to large and middle-market businesses, governments and professional customers. In addition to the traditional lending and depository offerings, Commercial Banking products and services include, among others, cash management, foreign exchange and international trade finance, derivatives and capital markets services, asset-based lending, real estate finance, public finance, commercial leasing and syndicated finance. The table below contains selected financial data for the Commercial Banking segment.

TABLE 11: Commercial Banking Selected Financial Data

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Income Statement Data				
Net interest income (FTE)	$ **391**	367	**1,146**	1,063
Provision for loan and lease losses	**29**	26	**96**	79
Noninterest income:				
Corporate banking revenue	**75**	67	**225**	200
Service charges on deposits	**35**	39	**112**	115
Other noninterest income	**18**	13	**43**	42
Noninterest expense:				
Salaries, incentives and benefits	**58**	62	**180**	177
Other noninterest expenses	**128**	126	**380**	352
Income before taxes	**304**	272	**870**	812
Applicable income taxes *(a)*	**89**	82	**259**	250
Net income	$ **215**	190	**611**	562
Average Balance Sheet Data				
Commercial loans	$ **33,878**	30,602	**33,245**	29,989

Demand deposits	**6,146**	6,345	**6,107**	6,240
Interest checking	**3,881**	3,353	**3,856**	3,004
Savings and money market	**4,987**	5,120	**5,218**	4,768
Certificates over $100,000	**1,964**	1,117	**1,638**	1,042

(a) Includes taxable-equivalent adjustments of $3 million for the three months ended September 30, 2006 and 2005 and $10 million for the nine months ended September 30, 2006 and 2005, respectively.

Net income increased $25 million, or 14%, compared to the third quarter of 2005 as a result of six and eight percent increases in net interest income and noninterest income, respectively. Net interest income increased as a result of growth in loans and leases and total deposits. Average commercial loans and leases increased 11% to $33.9 billion over the third quarter of 2005, with growth occurring across all loan categories. Despite modest growth in average core deposits, average total deposits increased nine percent to $17.5 billion in the third quarter of 2006 from $16.1 billion in 2005. The increase in average total deposits and loans and the related net FTP impact led to a $24 million increase in net interest income compared to the same period last year.

Noninterest income increased eight percent compared to the same quarter last year as corporate banking revenue continued to display solid gains tempered by lower service charges on deposits. Overall, corporate banking revenue increased $8 million, or

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12% percent, largely due to growth in nearly all sub-captions. Service charges on deposits decreased $4 million, or eight percent, as a result of lower compensating balances due to increased rates from a year ago. Noninterest expense decreased modestly compared to the third quarter of 2005, as increases in loan and bankcard expense were more than offset by decreases in employee compensation.

Branch Banking

Branch Banking provides a full range of deposit and loan and lease products to individuals and small businesses through 1,145 banking centers. Branch Banking offers depository and loan products, such as checking and savings accounts, home equity lines of credit, credit cards and loans for automobile and other personal financing needs, as well as products designed to meet the specific needs of small businesses, including cash management services. The table below contains selected financial data for the Branch Banking segment.

TABLE 12: Branch Banking Selected Financial Data

	For the three months ended September 30,		For the nine months ended September 30,	
($ in millions)	**2006**	**2005**	**2006**	**2005**
Income Statement Data				
Net interest income	$ **489**	421	**1,417**	1,228
Provision for loan and lease losses	**30**	27	**77**	70
Noninterest income:				
Electronic payment processing	**51**	43	**144**	119
Service charges on deposits	**95**	96	**273**	267
Investment advisory income	**20**	22	**66**	65
Other noninterest income	**36**	25	**91**	83
Noninterest expense:				
Salaries, incentives and benefits	**113**	116	**346**	343
Net occupancy and equipment expenses	**38**	36	**114**	102
Other noninterest expenses	**119**	113	**346**	326
Income before taxes	**391**	315	**1,108**	921
Applicable income taxes	**137**	111	**390**	324
Net income	$ **254**	204	**718**	597
Average Balance Sheet Data				
Consumer loans	$ **11,434**	10,855	**11,316**	10,546
Commercial loans	**4,308**	4,082	**4,303**	3,920
Demand deposits	**5,555**	5,685	**5,612**	5,626
Interest checking	**10,169**	13,001	**10,840**	13,933
Savings and money market	**11,956**	8,827	**11,501**	8,635
Time deposits	**13,647**	10,484	**12,689**	9,943

Net income increased $50 million, or 24%, compared to the third quarter of 2005 as growth in average deposits led to a 16% increase in net interest income. Total average deposits increased nine percent over the third quarter of 2005 with double-digit increases in average savings, money market and consumer time deposits mitigated by a 22% decrease in average interest checking. As a result of the growth and the related net FTP impact from an increased short-term rate environment, net interest income increased $68 million compared to the same period last year.

Noninterest income increased $16 million, or nine percent, from the third quarter of 2005 as electronic payment processing continued to produce strong increases and the segment realized a gain on the sale of three branches. Electronic payment processing revenue increased $8 million, or 19%, with double-digit increases in interchange fees related to ATMs, debit and credit cards.

Noninterest expense increased modestly compared to the third quarter of 2005 as increases in transaction and net occupancy expense were offset by decreases in employee compensation. The Registrant continues to position itself for sustained long-term growth through new banking center additions in key markets including Nashville, Chicago and Florida.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Consumer Lending

Consumer Lending includes the Registrant s mortgage and home equity lending activities and other indirect lending activities. Mortgage and home equity lending activities include the origination, retention and servicing of mortgage and home equity loans or lines of credit, sales and securitizations of those loans or pools of loans or lines of credit and all associated hedging activities. Other indirect lending activities include loans to consumers through auto dealers and federal and private student education loans. The table below contains selected financial data for the Consumer Lending segment.

TABLE 13: Consumer Lending Selected Financial Data

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Income Statement Data				
Net interest income	$ **98**	103	**296**	313
Provision for loan and lease losses	**24**	36	**74**	77
Noninterest income:				
Mortgage banking net revenue	35	43	120	124
Other noninterest income	15	30	61	103
Noninterest expense:				
Salaries, incentives and benefits	25	25	80	72
Other noninterest expenses	53	63	154	181
Income before taxes	**46**	52	**169**	210
Applicable income taxes	**16**	18	**60**	74
Net income	$ **30**	34	**109**	136
Average Balance Sheet Data				
Consumer loans	$ **20,507**	19,471	**20,242**	18,896

Net income decreased $4 million, or 11%, compared to the third quarter of 2005. Despite average loans and leases increasing five percent, net interest income decreased $5 million versus the prior year largely due to a 18 bp decline in the spread between loan yields and the related FTP charge due to the effects of the flattening yield curve and the increasing competitive nature in this segment. The Registrant is focused on meeting its customers varying financial needs by offering new consumer products while maintaining its current credit quality.

The Registrant had mortgage originations of $2.3 billion and $2.9 billion for the three months ended September 30, 2006 and 2005, respectively. As a result of the decrease in originations and the corresponding decrease in gains on sales of mortgages, mortgage banking net revenue decreased $8 million, or 19%. Decreases in other noninterest income and expense were largely a result of the runoff of the consumer automobile lease portfolio as operating lease income and expense decreased from the third quarter of 2005 by $8 million and $6 million, respectively.

Management s Discussion and Analysis of Financial Condition and Results of Operations (continued)

Investment Advisors

Investment Advisors provides a full range of investment alternatives for individuals, companies and not-for-profit organizations. The Registrant s primary services include trust, asset management, retirement plans and custody. Fifth Third Securities, Inc., an indirect wholly-owned subsidiary of the Registrant, offers full-service retail brokerage services to individual clients and broker dealer services to the institutional marketplace. Fifth Third Asset Management, Inc., an indirect wholly-owned subsidiary of the Registrant, provides asset management services and also advises the Registrant s proprietary family of mutual funds, Fifth Third Funds.* The table below contains selected financial data for the Investment Advisors segment.

TABLE 14: Investment Advisors Selected Financial Data

($ in millions)	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Income Statement Data				
Net interest income	**$ 60**	48	**172**	139
Provision for loan and lease losses	**1**	4	**4**	6
Noninterest income:				
Investment advisory income	89	90	277	273
Other noninterest income	5	4	14	11
Noninterest expense:				
Salaries, incentives and benefits	40	43	125	127
Other noninterest expenses	51	54	158	163