FIFTH THIRD BANCORP
Form 10-Q
May 09, 2008
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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 March 31, 2008

Commission File Number 0-8076

(Exact name of Registrant as specified in its charter)

Ohio	**31-0854434**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer 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, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

There were 532,106,075 shares of the Registrant s Common Stock, without par value, outstanding as of March 31, 2008.

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This report may contain forward-looking statements about Fifth Third Bancorp and/or the company as combined 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 Fifth Third Bancorp 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) general economic conditions and weakening in the economy, specifically the real estate market, either national or in the states in which Fifth Third, one or more acquired entities and/or the combined company do business, are less favorable than expected; (2) deteriorating credit quality; (3) political developments, wars or other hostilities may disrupt or increase volatility in securities markets or other economic conditions; (4) changes in the interest rate environment reduce interest margins; (5) prepayment speeds, loan origination and sale volumes, charge-offs and loan loss provisions; (6) Fifth Third s ability to maintain required capital levels and adequate sources of funding and liquidity; (7) changes and trends in capital markets; (8) competitive pressures among depository institutions increase significantly; (9) effects of critical accounting policies and judgments; (10) changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board (FASB) or other regulatory agencies; (11) legislative or regulatory changes or actions, or significant litigation, adversely affect Fifth Third, one or more acquired entities and/or the combined company or the businesses in which Fifth Third, one or more acquired entities and/or the combined company are engaged; (12) ability to maintain favorable ratings from rating agencies; (13) fluctuation of Fifth Third s stock price; (14) ability to attract and retain key personnel; (15) ability to receive dividends from its subsidiaries; (16) potentially dilutive effect of future acquisitions on current shareholders ownership of Fifth Third; (17) effects of accounting or financial results of one or more acquired entities; (18) difficulties in combining the operations of acquired entities; (19) ability to secure confidential information through the use of computer systems and telecommunications networks; and (20) the impact of reputational risk created by these developments 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 Bancorp s Annual Report on Form 10-K for the year ended December 31, 2007, 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 Fifth Third s web site at www.53.com. Fifth Third 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 (Bancorp 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 Bancorp incorporates the parent holding company and all consolidated subsidiaries.

TABLE 1: Selected Financial Data

For the three months ended March 31 ($ in millions, except per share data)	2008	2007	Percent Change
Income Statement Data			
Net interest income *(a)*	$ **826**	742	11%
Noninterest income	**864**	608	42
Total revenue *(a)*	**1,690**	1,350	25
Provision for loan and lease losses	**544**	84	550
Noninterest expense	**715**	753	(5)
Net income	**286**	359	(20)
Common Share Data			
Earnings per share, basic	$ **.54**	.65	(17)%
Earnings per share, diluted	**.54**	.65	(17)
Cash dividends per common share	**.44**	.42	5
Book value per share	**17.57**	17.82	(1)
Dividend payout ratio	**81.8%**	64.5	27
Financial Ratios			
Return on average assets	**1.03%**	1.47	(30)%
Return on average equity	**12.3**	14.6	(16)
Average equity as a percent of average assets	**8.43**	10.05	(16)
Tangible equity	**6.22**	7.65	(19)
Net interest margin *(a)*	**3.41**	3.44	(1)
Efficiency *(a)*	**42.3**	55.8	(24)
Credit Quality			
Net losses charged off	$ **276**	71	289%
Net losses charged off as a percent of average loans and leases	**1.37%**	.39	251
Allowance for loan and lease losses as a percent of loans and leases	**1.49**	1.05	42
Allowance for credit losses as a percent of loans and leases *(b)*	**1.62**	1.15	41
Nonperforming assets as a percent of loans, leases and other assets, including other real estate owned	**1.96**	.66	197
Average Balances			
Loans and leases, including held for sale	$ **84,912**	75,860	12%
Total securities and other short-term investments	**12,597**	11,710	8
Total assets	**111,291**	99,192	12
Transaction deposits *(c)*	**53,458**	50,103	7
Core deposits *(d)*	**64,342**	61,140	5
Wholesale funding *(e)*	**33,219**	24,193	37
Shareholders equity	**9,379**	9,970	(6)
Regulatory Capital Ratios			
Tier I capital	**7.72%**	8.71	(11)%

Total risk-based capital	**11.34**	11.19	1
Tier I leverage	**8.28**	9.36	(12)

(a) Amounts presented on a fully taxable equivalent basis. The taxable equivalent adjustments for the three months ended March 31, 2008 and 2007 were $6 million.

(b) The allowance for credit losses is the sum of the allowance for loan and lease losses and the reserve for unfunded commitments.

(c) Includes demand, interest checking, savings, money market and foreign office deposits.

(d) Includes transaction deposits plus other time.

(e) Includes certificates $100,000 and over, other foreign deposits, federal funds purchased, short-term borrowings and long-term debt.

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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 Bancorp 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 Bancorp s financial condition, results of operations and cash flows.

The Bancorp is a diversified financial services company headquartered in Cincinnati, Ohio. At March 31, 2008, the Bancorp had $111.4 billion in assets, operated 18 affiliates with 1,232 full-service Banking Centers including 107 Bank Mart® locations open seven days a week inside select grocery stores and 2,221 Jeanie® ATMs in the Midwestern and Southeastern regions of the United States. The Bancorp reports on five business segments: Commercial Banking, Branch Banking, Consumer Lending, Fifth Third Processing Solutions (FTPS) and Investment Advisors.

The Bancorp 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 Bancorp s revenues are fairly evenly dependent on net interest income and noninterest income. For the three months ended March 31, 2008, net interest income, on a fully taxable equivalent (FTE) basis, and noninterest income provided 49% and 51% 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 Bancorp. 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 Bancorp.

Net interest income is the difference between interest income earned on assets such as loans, leases and securities, and interest expense incurred on liabilities such as deposits, short-term borrowings and long-term debt. Net interest income is affected by the general level of interest rates, the relative level of short-term 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 Bancorp earns on its assets and pays on its liabilities are established for a period of time. The change in market interest rates over time exposes the Bancorp to interest rate risk through potential adverse changes to net interest income and financial position. The Bancorp 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 Bancorp enters into certain derivative transactions as part of its overall strategy to manage its interest rate and prepayment risks. The Bancorp 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 due to a weakening economy within the Bancorp s footprint.

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 Bancorp that are not taxable for federal income tax purposes. The Bancorp 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.

Noninterest income is derived primarily from electronic funds transfer (EFT) and merchant transaction processing fees, card interchange, fiduciary and investment management fees, corporate banking revenue, service charges on deposits and mortgage banking revenue. Noninterest expense is primarily driven by personnel costs and occupancy expenses, in addition to expenses incurred in the processing of credit and debit card transactions for its customers and merchant and financial institution clients.

On August 16, 2007, the Bancorp announced an agreement to acquire First Charter Corporation (First Charter), a regional financial services company with assets of $4.8 billion and that operates 57 branches in North Carolina and 2 in suburban Atlanta. The Bancorp has received legal and regulatory approvals and the acquisition will close on June 6, 2008.

Earnings Summary

The Bancorp s net income was $286 million in the first quarter of 2008, a 20% decrease compared to $359 million for the same period last year. First quarter 2008 results reflected the impact of a gain of $273 million pre-tax related to the redemption of a portion of Fifth Third s ownership interests in Visa, Inc. (Visa), as well as the reversal of a portion of previously recorded litigation reserves of $152 million pre-tax, both related to Visa s initial public offering (IPO). Current quarter results also reflect an increase in the provision for loan and lease losses due to deteriorating credit quality within the Bancorp s footprint. Reported results also included a non-cash charge of $152 million pre-tax to further reduce the current cash surrender value of one of the

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

Bancorp s bank-owned life insurance (BOLI) policies. This charge reflected an additional $8 million recorded subsequent to the Bancorp s issuance of its first quarter 2008 earnings. See Note 5 of the Notes to Condensed Consolidated Financial Statements for further information on the Bancorp s BOLI policies.

Net interest income (FTE) increased 11%, from $742 million to $826 million, compared to the same period last year reflecting a widening of the net interest rate spread coupled with a 12% increase in average loans and leases. Net interest margin was 3.41% in the first quarter of 2008, a decrease of 3 basis points (bp) from the first quarter of 2007. The decrease in net interest margin from the first quarter of 2007 was largely due to widening of the net interest rate spread offset by growth in earning assets and lower free funding in the first quarter of 2008.

Noninterest income increased 42%, from $608 million to $864 million, over the same period last year. As mentioned previously, the increase was positively impacted by $273 million in gains associated with Visa s IPO in the first quarter of 2008, and negatively impacted by the $152 million charge taken to reduce the cash surrender value of one of the Bancorp s BOLI policies. First quarter results also included net securities gains of $30 million. Excluding these items, noninterest income increased 17% from a year ago due to growth in mortgage banking revenue, payments processing, deposit service charges and corporate banking revenue.

Noninterest expense decreased five percent compared to the first quarter of 2007. Noninterest expense in the first quarter of 2008 included the reversal of $152 million in litigation reserves related to the Bancorp s indemnification of Visa litigation settlements, $9 million in severance-related costs and $7 million in acquisition-related expenses. Noninterest expense in the first quarter of 2007 included $1 million in severance-related costs. Excluding the above items, noninterest expense increased 13% from the first quarter of 2007, primarily due to the inclusion of approximately $20 million in mortgage origination costs related to the adoption of Statement of Financial Accounting Standards No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159) that were historically recorded in mortgage banking net revenue along with increases in volume-related processing expense, incentive compensation, branch expansion related expenses including R-G Crown Bank (Crown) and investments in technology. Refer to the Noninterest Income section in Management s Discussion and Analysis and Note 15 of the Notes to Condensed Consolidated Financial Statements for more information on the adoption of SFAS No. 159.

The Bancorp maintains a conservative approach to both lending and investing activities as it does not originate or hold subprime loans, nor does it hold collateralized debt obligations (CDO s) or asset-backed securities backed by subprime loans in its securities portfolio. However, the Bancorp has exposure to the housing markets, which continued to weaken considerably during the first quarter of 2008, particularly in the upper Midwest and Florida. Consequently, the provision for loan and lease losses increased to $544 million for the three months ended March 31, 2008 compared to $84 million during the first quarter of 2007. In addition, net charge-offs as a percent of average loans and leases were 1.37% in the first quarter of 2008 compared to .39% in the first quarter of 2007. At March 31, 2008, nonperforming assets as a percent of loans, leases and other assets, including other real estate owned increased to 1.96% from .66% at March 31, 2007. Refer to the Credit Risk Management section in Management s Discussion and Analysis for more information on credit quality.

The Bancorp s capital ratios exceed the well-capitalized guidelines as defined by the Board of Governors of the Federal Reserve System (FRB). As of March 31, 2008, the Tier I capital ratio was 7.72%, the Tier I leverage ratio was 8.28% and the total risk-based capital ratio was 11.34%. The Bancorp had senior debt ratings of Aa3 with Moody s, A+ with Standard & Poor s, AA- with Fitch Ratings and AAL with DBRS Ltd. at March 31, 2008, which indicate the Bancorp s strong capacity to meet financial commitments. The well-capitalized capital ratios along with strong credit ratings provide the Bancorp with access to the capital markets.

The Bancorp continues to invest in the geographic areas that offer the best growth prospects through acquisitions and de novo expansion, while at the same time meeting the banking needs of our existing communities through a well-distributed banking center network. During the first quarter of 2008, the Bancorp opened 5 additional banking centers with plans to open an additional 32 banking centers throughout the remainder of 2008. New banking centers in 2008 will mostly be in high growth markets such as Florida, Chicago, Tennessee, Georgia and North Carolina.

RECENT ACCOUNTING STANDARDS

Note 2 of the Notes to Condensed Consolidated Financial Statements provides a complete discussion of the significant new accounting standards adopted by the Bancorp during 2008 and 2007 and the expected impact of significant accounting standards issued but not yet required to be adopted.

CRITICAL ACCOUNTING POLICIES

The Bancorp s Condensed Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America. Certain accounting polices require management to exercise judgment in determining methodologies, economic assumptions and estimates that may materially affect the value of the Bancorp s assets or liabilities and

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

results of operations and cash flows. The Bancorp has five critical accounting policies, which include the accounting for loan and lease losses, reserve for unfunded commitments, income taxes, valuation of servicing rights and fair value measurements.

Allowance for Loan and Lease Losses

The Bancorp maintains an allowance to absorb probable loan and lease losses inherent in the portfolio. The allowance is maintained at a level the Bancorp 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 Bancorp 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 Bancorp estimates losses using a range derived from base and conservative estimates. The Bancorp 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. When individual loans are impaired, allowances are allocated based on management s estimate of the borrower s ability to repay the loan given the availability of collateral and other sources of cash flow, as well as an evaluation of legal options available to the Bancorp. The review of individual loans includes those loans that are impaired as provided in Statement of Financial Accounting Standards (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 Bancorp evaluates the collectibility of both principal and interest when assessing the need for a loss accrual. Historical loss rates are applied to commercial loans which are not impaired and thus not subject to specific allowance allocations. The loss rates are derived from a migration analysis, which tracks the historical 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.

Homogenous loans and leases, such as consumer installment and residential mortgage, 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. 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, are necessary to reflect losses inherent in the portfolio. Factors that management considers in the analysis include the effects of the national and local economies; trends in the nature and volume of 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 Bancorp s internal credit examiners.

The Bancorp s current methodology for determining the allowance for loan and lease losses is based on historical loss rates, current credit grades, specific allocation on impaired commercial credits and other qualitative adjustments. 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. An unallocated allowance is maintained to recognize the imprecision in estimating and measuring loss when evaluating allowances for individual loans or pools of loans.

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

The Bancorp 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 $81 million at March 31, 2008. The Bancorp 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 consumer loans would increase by approximately $45 million at March 31, 2008. 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 estimated loss rates and do not imply any expectation of future deterioration in the risk ratings or loss rates. Given current processes employed by the Bancorp, management believes the risk grades and estimated loss rates currently assigned are appropriate.

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

The Bancorp s primary market areas for lending are the Midwestern and Southeastern regions of the United States. When evaluating the adequacy of allowances, consideration is given to these regional geographic concentrations and the closely associated effect changing economic conditions have on the Bancorp s customers.

In the current year, the Bancorp has not substantively changed any material aspect of its overall approach to determining its allowance for loan and lease losses. There have been no material changes in criteria or estimation techniques as compared to prior periods that impacted the determination of the current period allowance for loan and lease losses.

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.

Income Taxes

The Bancorp estimates income tax expense based on amounts expected to be owed to the various tax jurisdictions in which the Bancorp 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 to the extent they exist and are subject to a valuation allowance based on management s judgment that realization is more-likely-than-not.

Accrued taxes represent the net estimated amount due to taxing jurisdictions and are reported in accrued taxes, interest and expenses in the Condensed Consolidated Balance Sheets. The Bancorp 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 Bancorp. As of January 1, 2007, the Bancorp adopted Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes. Refer to Note 2 of the Notes to Condensed Consolidated Financial Statements for the impact of adopting this Interpretation. As described in greater detail in Note 8 of the Notes to Condensed Consolidated Financial Statements, the Internal Revenue Service is currently challenging the Bancorp s tax treatment of certain leasing transactions. For additional information on income taxes, see Note 10 of the Notes to Condensed Consolidated Financial Statements.

Valuation of Servicing Rights

When the Bancorp sells loans through either securitizations or individual loan sales in accordance with its investment policies, it often obtains servicing rights. Servicing rights resulting from loan sales are initially recorded at fair value and subsequently amortized in proportion to, and over the period of, estimated net servicing income. 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 Bancorp monitors risk and adjusts its valuation allowance as necessary to adequately reserve for any probable impairment in the servicing portfolio. For purposes of measuring impairment, the servicing rights are stratified into classes based on the financial asset type and interest rates. 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 mortgage servicing rights (MSRs) at March 31, 2008, due to immediate 10% and 20% adverse changes in the current prepayment assumption would be approximately $30 million and $58 million, respectively, and due to immediate 10% and 20% favorable changes in the current prepayment assumption would be approximately $33 million and $70 million, respectively. The change in the fair value of the MSR portfolio at March 31, 2008, due to immediate 10% and 20% adverse

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

changes in the discount rate assumption would be approximately $20 million and $39 million, respectively, and due to immediate 10% and 20% favorable changes in the discount rate assumption would be approximately $22 million and $45 million, respectively. Sensitivity analysis related to other consumer and commercial servicing rights is not material to the Bancorp s Condensed Consolidated Financial Statements. These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes 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 the change in fair value may not be linear. Also, the effect of variation in a particular assumption on the fair value of the interests that continue to be held by the transferor 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 Bancorp 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.

Fair Value Measurements

Effective January 1, 2008, the Bancorp adopted SFAS No. 157, Fair Value Measurements , which provides a framework for measuring fair value under accounting principles generally accepted in the United States of America. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 addresses the valuation techniques used to measure fair value. These valuation techniques include the market approach, income approach and cost approach. The market approach uses prices or relevant information generated by market transactions involving identical or comparable assets or liabilities. The income approach involves converting future amounts to a single present amount. The measurement is valued based on current market expectations about those future amounts. The cost approach is based on the amount that currently would be required to replace the service capacity of the asset.

SFAS No. 157 establishes a fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). A financial instrument s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the instrument s fair value measurement. The three levels within the fair value hierarchy are described as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Bancorp has the ability to access at the measurement date.

Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include: quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability; and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 - Unobservable inputs for the asset or liability for which there is little, if any, market activity at the measurement date. Unobservable inputs reflect the Bancorp s own assumptions about what market participants would use to price the asset or liability. The inputs are developed based on the best information available in the circumstances, which might include the Bancorp s own financial data such as internally developed pricing models, discounted cash flow methodologies, as well as instruments for which the fair value determination requires significant management judgment.

The Bancorp measures financial assets and liabilities at fair value in accordance with SFAS No. 157. These measurements involve various valuation techniques and models, which involve inputs that are observable, when available, and include the following significant financial instruments; available-for-sale securities, residential mortgage loans held for sale and certain derivatives. The following is a summary of valuation techniques utilized by the Bancorp for its significant financial assets and liabilities.

Available- for-sale securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows and classified within Level 2 of the fair value hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. A significant portion of the Bancorp s available-for-sale securities are agency mortgage-backed securities that are fair valued using a market approach and the Bancorp has determined them to be Level 2 in the fair value hierarchy.

Residential mortgage loans held for sale

For residential mortgage loans held for sale, fair value is estimated based upon mortgage backed securities prices and spreads to those prices or, for certain assets, discounted cash flow models that may incorporate the anticipated portfolio composition, credit spreads of asset-backed securities with similar collateral, and market conditions. Residential mortgage

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

loans held for sale are fair valued using a market approach and the Bancorp has determined them to be Level 2 in the fair value hierarchy.

Derivatives

Exchange-traded derivatives valued using quoted prices are classified within Level 1 of the valuation hierarchy. However, few classes of derivative contracts are listed on an exchange. The majority of the Bancorp s derivative positions are valued utilizing models that use as their basis readily observable market parameters and are classified within Level 2 of the valuation hierarchy. Derivatives that are valued based upon models with significant unobservable market parameters are classified within Level 3 of the valuation hierarchy. A majority of the derivatives are fair valued using an income approach and the Bancorp has determined them to be Level 2 in the fair value hierarchy.

No material changes have been made during the three months ended March 31, 2008 to the valuation techniques or models described previously.

Valuation techniques and models utilized for measuring financial assets and liabilities are reviewed and validated by the Bancorp on a quarterly basis. Additionally, the Bancorp monitors the fair values of significant assets and liabilities using a variety of methods including the evaluation of pricing runs and exception reports based on certain analytical criteria, comparison to previous trades and overall review and assessments for reasonableness.

Effective January 1, 2008, the Bancorp adopted SFAS No. 159, which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on an instrument-by-instrument basis. Upon election of the fair value option in accordance with SFAS No. 159, subsequent changes in fair value are recorded as an adjustment to earnings. The Bancorp elected to measure residential mortgage loans originated on or after January 1, 2008 and designated as held for sale at fair value in accordance with the provisions of SFAS No. 159.

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

STATEMENTS OF INCOME ANALYSIS

Net Interest Income

Net interest income is the interest earned on debt securities, loans and leases (including yield-related fees) and other interest-earning assets less the interest paid for core deposits (includes transaction deposits and other time deposits) and wholesale funding (includes certificates $100,000 and over, other foreign office deposits, federal funds purchased, short-term borrowings and long-term debt). The net interest margin is calculated by dividing net interest income by average interest-earning assets. Net interest spread is the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities. Net interest margin is greater than net interest rate spread due to the interest income earned on those assets that are funded by non-interest-bearing liabilities, or free funding, such as demand deposits or shareholders equity.

Net interest income (FTE) was $826 million for the first quarter of 2008, an increase of $41 million from the fourth quarter of 2007 and $84 million from the first quarter of 2007. The increase from the first quarter of 2007 resulted from a 12% increase in average loan and lease balances combined with a 28 bp increase in net interest spread. The sequential increase in net interest income was related to a 26 bp increase in net interest rate spread primarily caused by a decrease in the cost of interest-bearing liabilities compared to interest-earning assets and an overall increase in interest-earning assets offset by the impact of a lower day count in the quarter.

Net interest margin decreased to 3.41% in the first quarter of 2008 compared to 3.44% in the first quarter of 2007 and increased from 3.29% in the fourth quarter of 2007. The decrease in net interest margin from the first quarter of 2007 was the result of an 11% increase in interest-earning assets, a 12% decrease in average yield on those assets coupled with a 37% increase in wholesale funding and a 15% decrease in the Bancorp s net free funding position. The sequential increase of 12 bp was primarily the result of an increase of 26 bp in the net interest rate spread from 2.74% in the fourth quarter of 2007 to 3.00% in the first quarter of 2008.

Total average interest-earning assets increased 3% on a sequential basis and 11% from the first quarter of 2007. Average total commercial loans increased six percent from the fourth quarter of 2007 while consumer loans and interest-bearing investments were relatively flat. On a year-over-year basis, average total commercial loans increased 17% and consumer loans increased six percent from the first quarter of 2007, respectively. This increase was concentrated in commercial and industrial loans, which increased 27% and credit cards, which increased 63% since the first quarter of 2007. Additionally, the investment portfolio increased eight percent compared to the first quarter of 2007.

The growth in average loans and leases since the first quarter of 2007 outpaced core deposit growth by $5.9 billion. In the first quarter of 2008, wholesale funding represented 39% of interest-bearing liabilities, up from 34% in the first quarter of 2007. The increase in wholesale funding as a percentage of interest-bearing liabilities was the result of the issuance of $1.0 billion in subordinated notes in February 2008 and $2.2 billion of trust preferred securities during 2007 offset by the repurchase of $690 million of mandatorily redeemable securities, which occurred in the fourth quarter of 2007.

Interest income (FTE) from loans and leases decreased $22 million, or two percent, compared to the first quarter of 2007 and decreased $95 million, or seven percent, compared to the fourth quarter of 2007. The decrease from the first quarter of 2007 was the result of a 91 bp decrease in average rates offset by a $9 billion, or 12%, increase in average loan and lease balances. The decrease from the fourth quarter of 2007 was due to a 57 bp decrease in average rates offset by a $3 billion, or three percent, increase in average loan and lease balances.

Interest income (FTE) from investment securities and short-term investments increased seven percent compared to the first quarter of 2007 and decreased five percent compared to the fourth quarter of 2007. The increase from the first quarter of 2007 was the result of an eight percent, or $887 million, increase in the average investment portfolio offset by a decrease in the weighted-average yield of 7 bp. The decrease from the fourth quarter of 2007 was due to a decrease in the weighted-average yield of 21 bp while the average balances remained relatively flat.

Core deposits increased $3.2 billion, or five percent, compared to the first quarter of last year and increased $1.4 billion, or two percent compared to the sequential quarter. During the first quarter of 2008, the Bancorp continued to adjust its consumer deposit rates, which has resulted in the migration of balances from interest checking into higher interest rate accounts such as savings and money markets accounts. The Bancorp also experienced a $1.1 billion increase in foreign office deposits since the first quarter of last year primarily due to an increase in

Eurodollar sweep accounts for the Bancorp s commercial customers. Interest rates on these deposits are comparable to other commercial deposit accounts. During the first quarter of 2008, interest checking balances represented 29% of average interest-bearing core deposits, compared to 32% in the first quarter of 2007.

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

For the three months ended	March 31, 2008			March 31, 2007			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	$ 26,617	$ 397	5.99%	$ 20,908	$ 387	7.50%	$ 94	$ (84)	$ 10
Commercial mortgage	12,052	188	6.28	10,566	190	7.31	25	(27)	(2)
Commercial construction	5,577	78	5.64	6,014	115	7.74	(8)	(29)	(37)
Commercial leases	3,723	40	4.30	3,661	39	4.34	1		1
Subtotal commercial	47,969	703	5.89	41,149	731	7.20	112	(140)	(28)
Residential mortgage loans	11,699	179	6.14	10,166	155	6.17	23	1	24
Home equity	11,846	190	6.46	12,072	229	7.69	(4)	(35)	(39)
Automobile loans	10,542	168	6.41	10,230	156	6.17	5	7	12
Credit card	1,660	38	9.15	1,021	30	12.17	16	(8)	8
Other consumer loans/leases	1,196	16	5.52	1,222	15	5.10		1	1
Subtotal consumer	36,943	591	6.43	34,711	585	6.84	40	(34)	6
Total loans and leases	84,912	1,294	6.13	75,860	1,316	7.04	152	(174)	(22)
Securities:									
Taxable	11,560	147	5.13	10,951	137	5.06	7	3	10
Exempt from income taxes *(b)*	403	7	7.31	534	10	7.40	(3)		(3)
Other short-term investments	634	5	3.08	225	3	5.71	4	(2)	2
Total interest-earning assets	97,509	1,453	5.99	87,570	1,466	6.79	160	(173)	(13)
Cash and due from banks	2,236			2,251					
Other assets	12,477			10,140					
Allowance for loan and lease losses	(931)			(769)					
Total assets	$ 111,291			$ 99,192					
Liabilities									
Interest-bearing liabilities:									
Interest checking	$ 14,836	$ 53	1.44%	$ 15,509	$ 88	2.31%	$ (4)	$ (31)	$ (35)
Savings	16,075	73	1.81	13,689	111	3.27	17	(55)	(38)
Money market	6,896	47	2.74	6,377	70	4.46	5	(28)	(23)
Foreign office deposits	2,443	15	2.48	1,343	14	4.32	8	(7)	1
Other time deposits	10,884	116	4.30	11,037	125	4.59	(2)	(7)	(9)
Certificates $100,000 and over	5,835	64	4.44	6,682	85	5.17	(10)	(11)	(21)
Other foreign office deposits	3,861	31	3.22	364	5	5.31	29	(3)	26
Federal funds purchased	5,258	43	3.26	2,505	33	5.30	26	(16)	10

Other short-term borrowings	**4,937**	**37**	**3.02**	2,400	26	4.37	21	(10)	11
Long-term debt	**13,328**	**148**	**4.48**	12,242	167	5.54	14	(33)	(19)
Total interest-bearing liabilities	**84,353**	**627**	**2.99**	72,148	724	4.07	104	(201)	(97)
Demand deposits	**13,208**			13,185					
Other liabilities	**4,351**			3,889					
Total liabilities	**101,912**			89,222					
Shareholders equity	**9,379**			9,970					
Total liabilities and shareholders equity	**$ 111,291**			$ 99,192					
Net interest income		**$ 826**			$ 742		$ 56	$ 28	$ 84
Net interest margin			**3.41%**			3.44%			
Net interest rate spread			**3.00**			2.72			
Interest-bearing liabilities to interest-earning assets			**86.51**			82.39			

(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 fully taxable-equivalent adjustments included in the above table are $6 million for the three months ended March 31, 2008 and 2007.

The cost of interest-bearing core deposits was 2.39% in the first quarter of 2008, which was a decrease of 106 bp from 3.45% in the first quarter of 2007 and 67 bp from 3.06% in the fourth quarter of 2007. The decrease in the cost of interest-bearing core deposits is a result of effective management of interest rates offered on these products during a period of declining market rates.

The interest expense on wholesale funding increased two percent to $323 million compared to the prior year quarter primarily due to the $9.0 billion increase in average balances. This increase in average balances was offset by decreases in the federal funds rate

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totaling 300 bp since the first quarter of 2007. Interest on wholesale funding decreased $64 million, or 17%, since the fourth quarter of 2007. This decrease was a result of decreases in the federal funds rate totaling 200 bp during the first quarter of 2008 offset by a six percent increase in average balances.

The Bancorp s net free funding position decreased 15% from $15.4 billion in the first quarter of 2007 to $13.2 billion in the first quarter of 2008. The decrease in the net free funding position since the first quarter of 2007 was primarily a result of share repurchases of $1.1 billion or 27 million shares in 2007.

Provision for Loan and Lease Losses

The Bancorp provides as an expense an amount for probable loan and lease losses within the loan portfolio that is based on factors previously 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 Bancorp. 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 on previously charged-off loans and leases.

The provision for loan and lease losses increased to $544 million in the first quarter of 2008 compared to $84 million in the same period last year. The primary factors in the increase was the increase in delinquencies, the deterioration in residential real estate collateral values in certain of the Bancorp s key lending markets and declines in general economic conditions. As of March 31, 2008, the allowance for loan and lease losses as a percent of loans and leases increased to 1.49% from 1.05% at March 31, 2007.

Refer to the Credit Risk Management section for more detailed information on the provision for loan and lease losses including an analysis of loan portfolio composition, non-performing assets, net charge-offs, and other factors considered by the Bancorp in assessing the credit quality of the loan portfolio and the allowance for loan and lease losses.

Noninterest Income

For the three months ended March 31, 2008, noninterest income increased by $256 million, or 42%, on a year-over-year basis. The components of noninterest income for these periods are as follows:

TABLE 3: Noninterest Income

For the three months ended March 31 ($ in millions)	2008	2007	Percent Change
Electronic payment processing revenue	**$ 213**	185	15
Service charges on deposits	**147**	126	17
Corporate banking revenue	**107**	83	30
Mortgage banking net revenue	**97**	40	144
Investment advisory revenue	**93**	96	(3)
Other noninterest income	**177**	78	128
Securities gains, net	**27**		NM*(a)*
Securities gains, net non-qualifying hedges on mortgage servicing rights	**3**		NM*(a)*
Total noninterest income	**$ 864**	608	42

(a) *Percentage change is not meaningful.*

Electronic payment processing revenue increased $28 million, or 15%, in the first quarter of 2008 compared to the same period last year as FTPS realized growth in each of its three product lines. Merchant processing revenue increased 23%, to $76 million, compared to the same period in 2007 due to an increase in revenue of $6 million resulting from the addition of new national merchant customers and $5 million resulting from increases in merchant transaction volumes. Financial institutions revenue increased to $80 million, up $5 million or six percent, compared to the first quarter of 2007 as a result of continued success in attracting financial institution customers. The Bancorp handles processing for approximately 2,700 financial institutions compared to approximately 2,400 in the same quarter last year. Card issuer interchange increased 17%, to $57 million, compared to the same period in 2007 due to continued growth related to credit card usage. The Bancorp processes over 26.7 billion transactions annually and handles electronic processing for over 157,000 merchant locations worldwide.

Service charges on deposits were up $21 million, or 17%, in the first quarter of 2008 compared to the same period last year. Commercial deposits revenue increased $10 million, or 17%, compared to the prior year. This increase included a positive impact of $7 million to revenue due to a decrease in earnings credits on compensating balances resulting from the change in short-term interest rates. Commercial customers receive earnings credits to offset the fees charged for banking services on their deposit accounts such as account maintenance, lockbox, ACH transactions, wire transfers and other ancillary corporate treasury management services. Earnings credits are based on the customer s average balance in qualifying deposits multiplied by the crediting rate. Qualifying deposits include demand deposits and interest-bearing checking accounts. The Bancorp has a standard crediting rate that is adjusted as necessary based on competitive market conditions and changes in short-term interest rates. Retail deposit revenue increased 17% in the first quarter of 2008 compared to the same period last year. The increase in retail service

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charges was attributable to higher customer activity and growth in the number of customer accounts. Growth in the number of customer deposit account relationships and deposit generation continues to be a primary focus of the Bancorp.

Corporate banking revenue increased $24 million to $107 million in the first quarter of 2008, up 30% over the comparable period in 2007. The growth in corporate banking revenue was largely attributable to higher foreign exchange derivative income of $24 million, an increase of $11 million compared to the prior year quarter. Growth also occurred in lease remarketing fees, which were $9 million in the first quarter of 2008 compared to less than $1 million in the first quarter of 2007. The Bancorp is committed to providing a comprehensive range of financial services to large and middle-market businesses and continues to see opportunities to expand its product offering.

Mortgage banking net revenue increased to $97 million in the first quarter of 2008 from $40 million in the same period last year. The components of mortgage banking net revenue for the three months ended March 31, 2008 and 2007 are shown in Table 4.

TABLE 4: Components of Mortgage Banking Net Revenue

For the three months ended March 31 ($ in millions)	2008	2007
Origination fees and gains (losses) on loan sales	**$ 93**	26
Servicing revenue:		
Servicing fees	**40**	34
Servicing rights amortization	**(33)**	(20)
Net valuation adjustments on servicing rights and free-standing derivatives entered into to economically hedge MSR	**(3)**	
Net servicing revenue	**4**	14
Mortgage banking net revenue		