Allowance for nonimpaired loans and binding commitments. Management establishes an allowance for nonimpaired loans and legally binding commitments by applying historical loss rates to existing loans with similar risk characteristics. The portion of this allowance that was related to legally binding commitments was $70 million at December 31, 2003, compared with $72 million at December 31, 2002. The loss rates used to establish the allowance may be adjusted to reflect management's current assessment of the following factors:

- changes in national and local economic and business conditions;
- changes in experience, ability and depth of lending management and staff, in lending policies or in the mix and volume of the loan portfolio;
- the trend of the volume of past due, nonaccrual and other loans; and
- external forces, such as competition, legal developments and regulatory guidelines.

LOAN SECURITIZATIONS

Key sells education loans in securitizations. A securitization involves the sale of a pool of loan receivables to investors through either a public or private issuance (generally by a SPE) of asset-backed securities. Securitized loans are removed from the balance sheet and a net gain or loss is recorded when the combined net sales proceeds and, if applicable, residual interests differ from the loans' allocated carrying amount. Net gains and losses resulting from securitizations are recorded as one component of "net gains from loan securitizations and sales" on the income statement. A servicing asset may also be recorded if Key either purchases or retains the right to service these loans and receives related fees that exceed the going market rate. Income earned under servicing or administration arrangements is recorded in "other income."

Key adopted SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which took effect for all transactions entered into after March 31, 2001. SFAS No. 140 added three significant rules to practices already in effect. These rules:

- prescribe the test that determines whether a SPE is a "qualifying" SPE, and prescribe the amount and type of derivative instruments a qualifying SPE can hold and the activities it may pursue;
- provide more restrictive guidance regarding the circumstances under which a company that transfers assets to a qualifying SPE will be deemed to have relinquished control of such assets and may account for the transaction as a sale; and
- require extensive disclosures about collateral, assets securitized and accounted for as a sale, and retained interests in securitized assets.

Under Interpretation No. 46, qualifying SPEs, including securitization trusts, established by Key under SFAS No. 140, are exempt from consolidation. Additional information on Interpretation No. 46 is summarized in this note under the headings "Basis of Presentation" on page 50 and "Accounting Pronouncements Adopted in 2003," on page 55.

In some cases, Key retains a residual interest in securitized loans that may take the form of an interest-only strip, a residual asset, a servicing asset and/or a security. The accounting for these retained interests is subject to the rules contained in SFAS No. 140. Under these rules, the previous carrying amount of the assets sold is allocated between the retained interests and the assets sold based on their relative fair values at the date of transfer. Fair value is determined by computing the present value of estimated cash flows, using a discount rate that reflects the risks associated with the cash flows and the dates that Key expects to receive such cash flows. Other assumptions used in the determination of fair value are disclosed in Note 8.

In July 2000, the Emerging Issues Task Force ("EITF"), a standard-setting group working under the auspices of the FASB, issued EITF 99-20. This guidance specifies how to record interest income and measure impairment on beneficial interests retained in a securitization transaction accounted for as a sale under SFAS No. 140, and on purchased beneficial interests in securitized financial assets. Assets subject to this accounting guidance are presented on the balance sheet as "securities available for sale" or as "trading account assets." This guidance became effective for fiscal quarters beginning after March 15, 2001, causing Key to record a cumulative after-tax loss of $24 million in earnings for the second quarter of 2001. This loss is presented on Key's income statement as a "cumulative effect of accounting change."

Key conducts a review to determine whether all retained interests are valued appropriately in the financial statements on a quarterly basis. Management reviews the historical performance of each retained interest and the assumptions used to project future cash flows. Assumptions are revised if past performance and future expectations dictate, and the present values of cash flows are recalculated based on the revised assumptions.

The present value of these cash flows is referred to as the "retained interest fair value." For retained interests classified as trading account assets, any increase or decrease in the asset's fair value is recognized in "other income" on the income statement. Generally, if the carrying amount of a retained interest classified as securities available for sale exceeds its fair value, impairment is indicated and recognized in earnings. Conversely, if the fair value of the retained interest exceeds its carrying amount, the write-up to fair value is recorded in equity as a component of "accumulated other comprehensive income (loss)," and the yield on the retained interest is adjusted prospectively.

SERVICING ASSETS

Servicing assets purchased or retained by Key in a sale or securitization of loans are reported at the lower of amortized cost or fair value ($117 million at December 31, 2003, and $99 million at December 31, 2002) and included in "accrued income and other assets" on the balance sheet. Fair value is initially measured by allocating the previous carrying amount of the assets sold or securitized to the retained interests and the assets sold based on their relative fair values at the date of transfer. Fair value is determined by estimating the present value of future cash flows associated with the serviced loans. The estimate is based on a number of assumptions, including the cost of servicing, discount rate, prepayment rate and default rate. The amortization of servicing assets is determined in proportion to, and over the period of, the estimated net servicing income and is recorded in "other income" on the income statement.