

PNC FINANCIAL SERVICES GROUP INC

Form 10-Q

November 09, 2006

Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

---

**FORM 10-Q**

---

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-09718

---

**The PNC Financial Services Group, Inc.**

(Exact name of registrant as specified in its charter)

---

Pennsylvania  
(State or other jurisdiction of

incorporation or organization)

One PNC Plaza, 249 Fifth Avenue, Pittsburgh, Pennsylvania 15222-2707

(Address of principal executive offices)

25-1435979  
(I.R.S. Employer

Identification No.)

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

(Zip Code)

(412) 762-2000

(Registrant's telephone number, including area code)

---

(Former name, former address and former fiscal year, if changed since last report)

---

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant 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  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

As of October 31, 2006, there were 293,812,255 shares of the registrant's common stock (\$5 par value) outstanding.

---

**Table of Contents**

**The PNC Financial Services Group, Inc.**

**Cross-Reference Index to 2006 Third Quarter Form 10-Q**

	<b>Pages</b>
<b>PART I FINANCIAL INFORMATION</b>	
Item 1. Financial Statements (Unaudited).	37-62
<u>Consolidated Income Statement</u>	37
<u>Consolidated Balance Sheet</u>	38
<u>Consolidated Statement Of Cash Flows</u>	39
<u>Notes To Consolidated Financial Statements (Unaudited)</u>	
<u>Note 1 Accounting Policies</u>	40
<u>Note 2 Acquisitions</u>	47
<u>Note 3 Securities</u>	48
<u>Note 4 Asset Quality</u>	49
<u>Note 5 Mortgage Loan Portfolio Repositioning</u>	50
<u>Note 6 Goodwill And Other Intangible Assets</u>	50
<u>Note 7 Variable Interest Entities</u>	51
<u>Note 8 Capital Securities Of Subsidiary Trusts</u>	51
<u>Note 9 Certain Employee Benefit And Stock-Based Compensation Plans</u>	52
<u>Note 10 Financial Derivatives</u>	53
<u>Note 11 Earnings Per Share</u>	55
<u>Note 12 Shareholders' Equity And Other Comprehensive Income</u>	56
<u>Note 13 Legal Proceedings</u>	57
<u>Note 14 Segment Reporting</u>	58
<u>Note 15 Commitments And Guarantees</u>	61
<u>Note 16 Subsequent Event</u>	62
<u>Statistical Information (Unaudited)</u>	
Average Consolidated Balance Sheet And Net Interest Analysis	63-64
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.	1-36, 63-64
<u>Consolidated Financial Highlights</u>	1-2
<u>Financial Review</u>	
<u>Executive Summary</u>	3
<u>Consolidated Income Statement Review</u>	7
<u>Consolidated Balance Sheet Review</u>	10
<u>Off-Balance Sheet Arrangements And Variable Interest Entities</u>	14
<u>Business Segments Review</u>	15
<u>Critical Accounting Policies And Judgments</u>	23
<u>Status Of Qualified Defined Benefit Pension Plan</u>	23
<u>Risk Management</u>	24
<u>Internal Controls And Disclosure Controls And Procedures</u>	33
<u>Glossary Of Terms</u>	33
<u>Cautionary Statement Regarding Forward-Looking Information</u>	35
Item 3. Quantitative and Qualitative Disclosures About Market Risk.	24-30
Item 4. Controls and Procedures.	33
<b><u>PART II OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings.</u>	65
<u>Item 1A. Risk Factors.</u>	65
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.</u>	65

<u>Item 6. Exhibits.</u>	65
<u>Exhibit Index.</u>	65
<u>Signature</u>	65
<u>Corporate Information</u>	66

**Table of Contents**

**CONSOLIDATED FINANCIAL HIGHLIGHTS**

THE PNC FINANCIAL SERVICES GROUP, INC.

Dollars in millions, except per share data Unaudited	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>FINANCIAL PERFORMANCE</b>				
Revenue				
Net interest income, taxable-equivalent basis (a)	\$574	\$566	\$1,699	\$1,619
Noninterest income (b)	2,943	1,116	5,358	3,019
Total revenue (b)	\$3,517	\$1,682	\$7,057	\$4,638
Net income (c)	\$1,484	\$334	\$2,219	\$970
Per common share				
Diluted earnings (c)	\$5.01	\$1.14	\$7.46	\$3.35
Cash dividends declared	\$0.55	\$0.50	\$1.60	\$1.50
<b>SELECTED RATIOS</b>				
Net interest margin	2.89%	2.96%	2.92%	2.99%
Noninterest income to total revenue (d)	84	67	76	65
Efficiency (e)	34	69	50	69
Return on				
Average common shareholders equity	65.94%	16.13%	33.87%	16.49%
Average assets	6.17	1.45	3.17	1.48

See page 33 for a glossary of certain terms used in this Report.

Certain prior period amounts included in these Consolidated Financial Highlights have been reclassified to conform with the current period presentation.

- (a) The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable asset. To provide more meaningful comparisons of yields and margins for all earning assets, we also provide revenue on a taxable-equivalent basis by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income on other taxable assets. This adjustment is not permitted under GAAP in the Consolidated Income Statement.

The following is a reconciliation of net interest income as reported in the Consolidated Income Statement to net interest income on a taxable-equivalent basis (in millions):

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
Net interest income, GAAP basis	\$567	\$559	\$1,679	\$1,599
Taxable-equivalent adjustment	7	7	20	20
Net interest income, taxable-equivalent basis	\$574	\$566	\$1,699	\$1,619

- (b) Noninterest income for the three months and nine months ended September 30, 2006 included the pre-tax impact of the net gain on the BlackRock/MLIM transaction of \$2.1 billion. This category also included the impact of pre-tax charges from third quarter 2006 balance sheet repositioning activities totaling \$244 million. Further information is included in the Executive Summary portion of the Financial Review section of this Report.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

- (c) Net income and earnings per share for the three months and nine months ended September 30, 2006 included the after-tax impact of the items referred to in note (b) above, in addition to the after-tax impact of integration costs related to the BlackRock/MLIM transaction. These integration costs totaled \$72 million and \$91 million on a pre-tax basis for the three months and nine months ended September 30, 2006, respectively, or \$31 million and \$39 million on an after-tax basis, net of related minority interest.
  
- (d) Calculated as noninterest income divided by the sum of net interest income (GAAP basis) and noninterest income. See note (b) above regarding certain items impacting noninterest income for both 2006 periods.
  
- (e) Calculated as noninterest expense divided by the sum of net interest income (GAAP basis) and noninterest income. See notes (b) and (c) above regarding certain items impacting noninterest income and expense for both 2006 periods.

**Table of Contents**

Unaudited	September 30 2006	December 31 2005	September 30 2005
<b>BALANCE SHEET DATA</b> (dollars in millions, except per share data)			
Assets	<b>\$98,436</b>	\$91,954	\$93,241
Loans, net of unearned income	<b>48,900</b>	49,101	50,510
Allowance for loan and lease losses	<b>566</b>	596	634
Securities	<b>19,512</b>	20,710	20,658
Loans held for sale	<b>4,317</b>	2,449	2,377
Investment in BlackRock (a)	<b>3,836</b>		
Deposits	<b>64,572</b>	60,275	60,214
Borrowed funds	<b>14,695</b>	16,897	18,374
Shareholders' equity	<b>10,758</b>	8,563	8,317
Common shareholders' equity	<b>10,751</b>	8,555	8,309
Book value per common share	<b>36.60</b>	29.21	28.54
Common shares outstanding (millions)	<b>294</b>	293	291
Loans to deposits	<b>76%</b>	81%	84%
<b>ASSETS ADMINISTERED</b> (billions)			
Managed (b)	<b>\$52</b>	\$494	\$469
Nondiscretionary	<b>89</b>	84	85
<b>FUND ASSETS SERVICED</b> (billions)			
Accounting/administration net assets	<b>\$774</b>	\$835	\$793
Custody assets	<b>399</b>	476	475
<b>CAPITAL RATIOS</b>			
Tier 1 risk-based (c)(d)	<b>10.4%</b>	8.3%	8.4%
Total risk-based (c)(d)	<b>13.6</b>	12.1	12.5
Leverage (c)(d)	<b>9.4</b>	7.2	7.1
Tangible common equity	<b>7.5</b>	5.0	4.9
Common shareholders' equity to assets	<b>10.9</b>	9.3	8.9
<b>ASSET QUALITY RATIOS</b>			
Nonperforming assets to loans, loans held for sale and foreclosed assets	<b>.36%</b>	.42%	.29%
Nonperforming loans to loans	<b>.34</b>	.39	.25
Net charge-offs to average loans (for the three months ended)	<b>.37</b>	.33	.12
Allowance for loan and lease losses to loans	<b>1.16</b>	1.21	1.26
Allowance for loan and lease losses to nonperforming loans	<b>339</b>	314	499

(a) See BlackRock/MLIM Transaction in the Executive Summary portion of the Financial Review section of this Report for additional information.

(b) Assets under management at September 30, 2006 do not include BlackRock's assets under management as we deconsolidated BlackRock effective September 29, 2006. Excluding the impact of BlackRock, our assets under management (consisting of Retail Banking assets under management) totaled \$49 billion at December 31, 2005 and \$50 billion at September 30, 2005.

(c) The regulatory minimums are 4.0% for Tier 1, 8.0% for Total, and 3.0% for Leverage ratios. The well-capitalized levels are 6.0% for Tier 1, 10.0% for Total, and 5.0% for Leverage ratios.

(d) The ratios for September 30, 2006 reflect the impact of the deconsolidation of BlackRock effective September 29, 2006.

**Table of Contents**

***FINANCIAL REVIEW***

THE PNC FINANCIAL SERVICES GROUP, INC.

This Financial Review should be read together with our unaudited Consolidated Financial Statements and unaudited Statistical Information included elsewhere in this Report and with Items 6, 7, 8 and 9A of our 2005 Annual Report on Form 10-K ( 2005 Form 10-K ). We have reclassified certain prior period amounts to conform with the current period presentation. For information regarding certain business and regulatory risks, see the Risk Factors and Risk Management sections in this Financial Review and Items 1A and 7 of our 2005 Form 10-K. Also, see the Cautionary Statement Regarding Forward-Looking Information and Critical Accounting Policies And Judgments sections in this Financial Review for certain other factors that could cause actual results or future events to differ, perhaps materially, from those anticipated in the forward-looking statements included in this Report or from historical performance. See Note 14 Segment Reporting in the Notes To Consolidated Financial Statements included in Part I, Item 1 of this Report for a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a generally accepted accounting principles ( GAAP ) basis.

***EXECUTIVE SUMMARY***

***THE PNC FINANCIAL SERVICES GROUP, INC.***

PNC is one of the largest diversified financial services companies in the United States based on assets, operating businesses engaged in retail banking, corporate and institutional banking, asset management and global fund processing services. We provide many of our products and services nationally and others in our primary geographic markets located in Pennsylvania; New Jersey; the greater Washington, DC area, including Maryland and Virginia; Ohio; Kentucky; and Delaware. We also provide certain global fund processing services internationally.

***KEY STRATEGIC GOALS***

Our strategy to enhance shareholder value centers on achieving revenue growth in our various businesses underpinned by prudent management of risk, capital and expenses. In each of our business segments, the primary drivers of growth are the acquisition, expansion and retention of customer relationships. We strive to achieve such growth in our customer base by providing convenient banking options, leading technological systems and a broad range of asset management products and services. We also intend to grow through appropriate and targeted acquisitions and, in certain businesses, by expanding into new geographical markets.

In recent years, we have managed our interest rate risk to achieve a moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Our actions have created a balance sheet characterized by strong asset quality and significant flexibility to take advantage, where appropriate, of changing interest rates and to adjust to changing market conditions.

***BLACKROCK/MLIM TRANSACTION***

As previously reported, in February 2006, BlackRock, Inc. ( BlackRock ), then a majority-owned subsidiary of PNC, and Merrill Lynch entered into a definitive agreement pursuant to which Merrill Lynch agreed to contribute its investment management business ( MLIM ) to BlackRock in exchange for 65 million shares of newly issued BlackRock common and preferred stock. This transaction closed on September 29, 2006.

BlackRock accounted for the MLIM transaction under the purchase method of accounting. The value of the 65 million shares issued to Merrill Lynch was allocated among the MLIM assets acquired, including intangibles, and the MLIM liabilities assumed to the extent of their fair market value, with any excess purchase price being allocated to goodwill. Immediately following the closing, PNC continued to own approximately 44 million shares of BlackRock common stock, representing an ownership interest of approximately 34% of the combined company after the closing (as compared with 69% immediately prior to the closing). Although PNC's share ownership percentage

declined, BlackRock's equity increased due to the increase in total net assets recorded by BlackRock as a result of the MLIM transaction.

Upon the closing of the BlackRock/MLIM transaction, the carrying value of our investment in BlackRock increased by approximately \$3.1 billion to \$3.8 billion, primarily reflecting PNC's portion of the increase in BlackRock's equity resulting from the value of shares issued in that transaction. Based on BlackRock's closing market price of \$149 per common share on September 29, 2006, the market value of PNC's investment in BlackRock was approximately \$6.6 billion at that date. As such, an additional \$2.8 billion of value is not recognized in PNC's investment



account.

We also recorded a liability at September 30, 2006 for deferred taxes of approximately \$.9 billion, related to the excess of the book value over the tax basis of our investment in BlackRock, and a liability of approximately \$.6 billion related to our obligation to provide shares of BlackRock common stock to help fund BlackRock long-term incentive plan ( LTIP ) programs. The LTIP liability will be adjusted quarterly based on changes in BlackRock s common stock price and the number of remaining committed shares.

The overall balance sheet impact was an increase to our shareholders equity of approximately \$1.6 billion. The increase to equity was comprised of an after-tax gain of approximately \$1.3 billion, net of the expense associated with the LTIP liability and the deferred taxes, and an after-tax increase to capital surplus of approximately \$.3 billion. The recognition of the gain is consistent with our existing accounting policy for the sale or issuance by subsidiaries of their stock to third parties. The gain represents the difference between our basis in BlackRock stock prior to the BlackRock/MLIM transaction and the new book value per share and resulting increase in value of our investment realized from the transaction. The direct increase to capital surplus rather than inclusion in the gain resulted from the accounting treatment required due to existing BlackRock repurchase commitments or programs.

For the three months and nine months ended September 30, 2006, our Consolidated Income Statement included our former 69% ownership interest in BlackRock s net income through the closing date. However, our Consolidated Balance Sheet as of September 30, 2006 reflects the deconsolidation of BlackRock s balance sheet amounts and recognizes our 34% ownership interest in BlackRock as an investment to be accounted for under the equity method. On a prospective basis, this accounting will result in a reduction in certain revenue and noninterest expense categories on PNC s Consolidated Income Statement as the net pretax earnings impact of our net investment in BlackRock will be reported on a separate line item within noninterest income.

Additional information on the BlackRock/MLIM transaction is included in Current Reports on Form 8-K ( Form 8-K ) dated February 15, 2006 and September 29, 2006 filed by PNC and BlackRock.

---

## **Table of Contents**

### ***MERCANTILE BANKSHARES ACQUISITION***

As previously reported, on October 8, 2006 we entered into a definitive agreement with Mercantile Bankshares Corporation ( Mercantile ) for PNC to acquire Mercantile for 52.5 million shares of PNC common stock and \$2.13 billion in cash. Based on PNC's common stock price on October 6, 2006, the consideration represents \$6.0 billion in stock and cash or \$47.24 per Mercantile share.

Mercantile is a \$17 billion asset banking company that provides banking and investment and wealth management services through 240 offices in Maryland, Virginia, the District of Columbia, Delaware and Southeastern Pennsylvania. This transaction will enable us to significantly expand our presence in the mid-Atlantic region, particularly within the attractive Baltimore and Washington, DC markets.

The transaction is subject to customary closing conditions, including regulatory approval and the approval of Mercantile's shareholders, and is expected to close during the first quarter of 2007. We refer you to our Form 8-K dated October 8, 2006 for additional information on this transaction.

### ***THE ONE PNC INITIATIVE***

As further described in our 2005 Form 10-K, the One PNC initiative began in January 2005 and is an ongoing, company-wide initiative with goals of moving closer to the customer, improving our overall efficiency and targeting resources to more value-added activities. PNC expects to realize \$400 million of total annual pretax earnings benefit by mid-2007 from this initiative.

PNC plans to achieve approximately \$300 million of cost savings through a combination of workforce reduction and other efficiencies. Of the approximately 3,000 positions to be eliminated, approximately 2,700 had been eliminated as of September 30, 2006. We estimate that these changes will result in employee severance and other implementation costs of approximately \$74 million, including \$54 million recognized during full year 2005 and \$9 million recognized during the first nine months of 2006. We expect that the remaining charges of approximately \$11 million will be incurred in the remainder of 2006 and early 2007. In addition, PNC intends to achieve at least \$100 million in net revenue growth through the implementation of various pricing and business growth enhancements driven by the One PNC initiative. The initiative is progressing according to plan.

We realized a net pretax financial benefit from the One PNC program of approximately \$185 million in the first nine months of 2006, including \$65 million in the third quarter. We achieved an annualized run rate benefit of \$260 million in the third quarter of 2006.

### ***KEY FACTORS AFFECTING FINANCIAL PERFORMANCE***

Our financial performance is substantially affected by several external factors outside of our control, including:

- General economic conditions,
- Loan demand and utilization of credit commitments,
- Movement of customer deposits from lower to higher rate accounts or to off-balance sheet accounts,
- The level of interest rates, and the shape of the interest rate yield curve,
- The performance of the capital markets, and
- Customer demand for other products and services.

In addition to changes in general economic conditions, including the direction, timing and magnitude of movement in interest rates and the performance of the capital markets, our

success in the remainder of 2006 will depend, among other things, upon:

- Further success in the acquisition, growth and retention of customers,
- Successful execution of the One PNC initiative,
- Revenue growth,
- A sustained focus on expense management and improved efficiency,
- Maintaining strong overall asset quality, and
- Prudent risk and capital management.

### ***SUMMARY FINANCIAL RESULTS***

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

	Three months ended		Nine months ended	
	Sept. 30 2006	Sept. 30 2005	Sept. 30 2006	Sept. 30 2005
In millions, except per share data				
Net income	\$1,484	\$334	\$2,219	\$970
Diluted earnings per share	\$5.01	\$1.14	\$7.46	\$3.35
Return on				
Average common shareholders equity	65.94%	16.13%	33.87%	16.49%
Average assets	6.17%	1.45%	3.17%	1.48%

Results for the third quarter and first nine months of 2006 included the impact of the following items:

- The gain on the third quarter BlackRock/MLIM transaction totaling \$1.3 billion after-tax, or \$4.36 per diluted share;
- Securities portfolio rebalancing charges recognized in the third quarter totaling \$127 million after-tax, or \$.43 per diluted share;
- The third quarter mortgage loan portfolio repositioning loss of \$31 million after-tax, or \$.10 per diluted share; and
- Our share of the after-tax impact of BlackRock/MLIM integration costs, which totaled \$31 million, or \$.10 per diluted share, for the third quarter of 2006 and \$39 million, or \$.13 per diluted share, for the first nine months of 2006.

In addition to the closing of the BlackRock/MLIM transaction and our balance sheet repositioning activities, our third quarter 2006 performance included the following accomplishments:

- Average loans of \$50.3 billion for the third quarter of 2006 increased \$888 million, or 2 percent, compared with \$49.5 billion for the third quarter 2005, primarily as a result of increased commercial, commercial real estate and residential mortgage loans. Average loans increased \$3.0 billion, or 6 percent, compared with the prior year third quarter excluding the \$2.1 billion of average loans in the prior year period related to Market Street Funding, PNC's commercial paper conduit that was deconsolidated in October 2005.
- Average deposits for the third quarter increased \$5.0 billion, or 8 percent, compared with the same quarter in the prior year, primarily as a result of an increase in money market deposits, retail certificates of deposit, Eurodollar deposits and noninterest-bearing deposits.
- Asset quality remained very strong, with the ratio of nonperforming assets to loans, loans held for sale and foreclosed assets declining to .36% from .42% at December 31, 2005.

**Table of Contents****BALANCE SHEET HIGHLIGHTS**

Total assets were \$98.4 billion at September 30, 2006. Total average assets were \$93.7 billion for the first nine months of 2006 compared with \$87.4 billion for the first nine months of 2005. This increase was primarily attributable to a \$5.5 billion increase in average interest-earning assets. An increase of \$2.9 billion in average loans was the primary factor for the increase in average interest-earning assets. In addition, average total securities increased \$2.6 billion in the first nine months of 2006 compared with the prior year period.

Our deconsolidation of BlackRock effective September 29, 2006 and recognition of our investment in BlackRock under the equity method of accounting as of September 30, 2006 did not significantly impact average balances in the nine-month comparison.

Average total loans were \$49.8 billion for the first nine months of 2006 and \$46.9 billion in the first nine months of 2005. This increase was driven by continued improvements in market loan demand and targeted sales efforts across our banking businesses, as well as our expansion into the greater Washington, DC area that began in May 2005. The increase in average total loans reflected growth in residential mortgages of approximately \$1.5 billion, commercial loans of approximately \$1.1 billion, and commercial real estate loans of approximately \$.6 billion. In addition, average loans for the first nine months of 2005 included \$2.1 billion related to Market Street Funding ( Market Street ) which was deconsolidated in October 2005. Loans represented 64% of average interest-earning assets for the first nine months of 2006 and 65% for the first nine months of 2005.

Average securities totaled \$21.3 billion for the first nine months of 2006 and \$18.8 billion for the first nine months of 2005. Of this increase, \$3.0 billion was attributable to increases in mortgage-backed, asset-backed, and other debt securities, partially offset by a \$.4 billion decline in US Treasury and government agencies securities. Our third quarter 2006 securities portfolio rebalancing actions are further described in the Consolidated Balance Sheet Review section of this Report. The overall higher average securities balances reflected our desire to continue investing through the interest rate cycle and the impact of the May 2005 Riggs acquisition. Securities comprised 28% of average interest-earning assets for the first nine months of 2006 and 26% for the first nine months of 2005.

Average total deposits were \$62.7 billion for the first nine months of 2006, an increase of \$6.2 billion over the first nine months of 2005. The increase in average total deposits was primarily driven by the impact of higher retail certificates of deposit, money market account and noninterest-bearing deposit balances, and by higher Eurodollar deposits. Growth in deposits from commercial mortgage loan servicing activities also contributed to the increase. Similar to its impact on average loans and securities described above, our expansion into the greater Washington, DC area also contributed to the increase in average total deposits.

Average total deposits represented 67% of average total assets for the first nine months of 2006 and 65% for the first nine months of 2005. Average transaction deposits were \$41.7

billion for the first nine months of 2006 compared with \$38.7 billion for the first nine months of 2005.

Average borrowed funds were \$15.2 billion for the first nine months of 2006 and \$16.2 billion for the first nine months of 2005. This decrease reflected a \$2.3 billion decline in commercial paper due to the deconsolidation of Market Street in October 2005, partially offset by net increases in federal funds purchased, subordinated debt and bank notes and senior debt.

Shareholders' equity totaled \$10.8 billion at September 30, 2006, compared with \$8.6 billion at December 31, 2005. The increase resulted from the BlackRock/MLIM transaction. See the Consolidated Balance Sheet Review section of this Financial Review for additional information.

**BUSINESS SEGMENT HIGHLIGHTS**

In millions	Three months ended		Nine months ended	
	Sept.30 2006	Sept. 30 2005	Sept. 30 2006	Sept. 30 2005
Total segment earnings	\$422	\$383	\$1,217	\$1,101

Total business segment earnings for the first nine months of 2005 included the benefit of a second quarter \$53 million loan recovery included in the Corporate & Institutional Banking business segment. A summary of results for both the first nine months and third quarter 2006 comparisons with the prior year periods follows. Further analysis of business segment results for the nine-month periods is found on pages 15 through 24.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

We provide a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a GAAP basis in Note 14 Segment Reporting in the Notes To Consolidated Financial Statements in this Report and in the Results of Businesses - Summary table on page 15.

### Retail Banking

Retail Banking's earnings were \$581 million for the first nine months of 2006 compared with \$487 million for the same period in 2005. Compared with the prior year, revenues increased 10% and noninterest expenses increased 4%, resulting in a 19% earnings improvement. The increase in earnings was driven by improved fee income from customers, higher taxable-equivalent net interest income fueled by continued customer and balance sheet growth, and a sustained focus on expense management.

Earnings from Retail Banking totaled \$206 million in the third quarter of 2006 compared with \$176 million in the third quarter of 2005. Revenue increased 7% compared with the prior year third quarter, while noninterest expense increased only 2%, driving a 17% increase in earnings and creating positive operating leverage.

### Corporate & Institutional Banking

Earnings from Corporate & Institutional Banking for the first nine months of 2006 totaled \$334 million compared with \$372 million for the first nine months of 2005. This decline was primarily attributable to the benefit of a \$53 million loan recovery recognized in the second quarter of 2005 compared with a \$36 million provision for credit losses in the first nine

**Table of Contents**

months of 2006. In addition to the negative impact of the \$89 million change in the provision for credit losses, total revenue increased \$101 million and noninterest expenses grew by \$69 million for the first nine months of 2006 compared with the first nine months of 2005.

Corporate & Institutional Banking earned \$113 million in the third quarter of 2006 compared with \$118 million in the third quarter of 2005. The decrease compared with the prior year quarter was largely the result of an increase in the provision for credit losses. The increase in noninterest revenue and expense was driven by the acquisition of Harris Williams. Revenue increased \$10 million compared with the third quarter of 2005, driven by a \$22 million increase in noninterest income, partly offset by a \$12 million decrease in taxable-equivalent net interest income.

**BlackRock**

BlackRock reported net income of \$153 million for the first nine months of 2006 and \$161 million for the first nine months of 2005. BlackRock's reported net income for the first nine months of 2006 and 2005 included after-tax MLIM and State Street Research and Management (SSRM) integration costs of \$56 million and \$6 million, respectively. The BlackRock business segment earned \$209 million in the first nine months of 2006 and \$167 million for the first nine months of 2005 excluding the impact of these costs, which we have reported in Other for PNC business segment reporting. Adjusted earnings in 2006 reflected higher investment advisory and administration fees due to an increase in assets under management and increased performance fees. These factors more than offset the increase in expense due to increased compensation and benefits, general and administration expense, and a one-time expense of \$34 million incurred in the first quarter of 2006 related to the January 2005 acquisition of SSRM.

BlackRock reported net income of \$19 million for the third quarter of 2006, compared with \$61 million for the third quarter of 2005. BlackRock's reported net income included after-tax MLIM integration costs of \$44 million in the third quarter of 2006. BlackRock earned \$63 million in the third quarter of 2006, an increase of \$2 million compared with the third quarter of 2005, excluding the impact of MLIM integration costs. The increase compared with the third quarter of 2005 was a result of higher investment and advisory fees due to growth in assets under management, partly offset by lower nonoperating income, due principally to unrealized losses on energy-related investments.

We refer you to the BlackRock/MLIM Transaction section of this Executive Summary for further information related to this transaction that closed on September 29, 2006. Information on this transaction is also included in Note 2 Acquisitions in the Notes To Consolidated Financial Statements included in this Report.

**PFPC**

PFPC's earnings of \$93 million in the first nine months of 2006 increased \$18 million, or 24%, compared with the first nine months of 2005. Earnings for the 2006 period included the impact of a \$14 million reversal of deferred taxes related to earnings from foreign subsidiaries following management's determination that the earnings would be indefinitely reinvested outside of the United States. In addition, higher earnings in the first nine months of 2006 reflected servicing revenue contributions from several growth areas of the business and the successful implementation of expense control initiatives which improved the company's operating margin. Earnings for the first nine months of 2005 included a \$3 million tax benefit identified as part of the One PNC initiative.

PFPC earned \$40 million in the third quarter of 2006 compared with \$28 million in the third quarter of 2005. The earnings increase from the third quarter of 2005 resulted from the \$14 million reversal of deferred taxes referred to above.

**Other**

Other earnings for the first nine months of 2006 totaled \$1.1 billion, while Other for the first nine months of 2005 was a net loss of \$80 million. Other earnings for the 2006 period included the \$1.3 billion after-tax gain on the BlackRock/MLIM transaction recorded in the third quarter of 2006, partially offset by the impact of charges related to the following, all on an after-tax basis:

- Third quarter 2006 balance sheet repositioning activities amounting to \$158 million,
- MLIM integration costs of \$39 million, and
- Reversal in the third quarter of 2006 of trust preferred securities hedge accounting of \$13 million.

The first nine months of 2005 included the impact of third quarter 2005 implementation costs related to the One PNC initiative totaling \$29 million after-tax, net securities losses of \$24 million after-tax, and Riggs acquisition integration costs totaling \$19 million after-tax. These factors were partially offset by the first quarter 2005 benefit recognized from a \$45 million deferred tax liability reversal related to the internal transfer of our investment in BlackRock as described above under Summary Financial Results.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

We recorded earnings of \$1.1 billion in Other for the third quarter of 2006 primarily due to the reasons outlined above for the nine-month earnings. Other for the third quarter of 2005 was a net loss of \$30 million. The net loss for the prior year quarter reflected the One PNC implementation costs referred to above.

**Table of Contents*****CONSOLIDATED INCOME STATEMENT REVIEW******NET INTEREST INCOME AND NET INTEREST MARGIN***

	Three months ended		Nine months ended	
	Sept. 30 2006	Sept. 30 2005	Sept. 30 2006	Sept. 30 2005
Dollars in millions				
Taxable-equivalent net interest income	<b>\$574</b>	\$566	<b>\$1,699</b>	\$1,619
Net interest margin	<b>2.89%</b>	2.96%	<b>2.92%</b>	2.99%

We provide a reconciliation of net interest income as reported under GAAP to net interest income presented on a taxable-equivalent basis in the Consolidated Financial Highlights section on page 1 of this Report.

Changes in net interest income and margin result from the interaction of the volume and composition of interest-earning assets and related yields, interest-bearing liabilities and related rates paid, and noninterest-bearing sources. See Statistical Information-Average Consolidated Balance Sheet And Net Interest Analysis included on pages 63 and 64 of this Report for additional information.

The increase in taxable-equivalent net interest income for the first nine months of 2006 compared with the first nine months of 2005 reflected the impact of a \$5.5 billion increase in average interest-earning assets in 2006, driven by organic growth and our expansion into the greater Washington, DC area. The \$2.9 billion increase in average interest-earning assets for the third quarter of 2006 compared with the third quarter of 2005 drove the increase in taxable-equivalent net interest income in the third quarter of 2006.

The following factors contributed to the decline in net interest margin for the first nine months of 2006 compared with the first nine months of 2005:

- An increase in the average rate paid on deposits of 106 basis points for the first nine months of 2006 compared with the 2005 period. The average rate paid on money market accounts, the largest single component of interest-bearing deposits, increased 116 basis points. The average rate paid on Retail Banking money market accounts increased only 98 basis points while the average rate paid on Corporate & Institutional Banking money market accounts increased 152 basis points. The average rate paid on money market accounts reported in Other increased 190 basis points. These accounts are utilized as an alternative source of short-term liquidity and pay interest at rates that closely approximate short-term market rates.
- An increase in the average rate paid on borrowed funds of 156 basis points for the first nine months of 2006 compared with the first nine months of 2005.
- By comparison, the yield on interest-earning assets increased only 83 basis points. Loans, the single largest component, increased 86 basis points.
- These factors were partially offset by the favorable impact on net interest margin in 2006 of an increase of 21 basis points related to noninterest-bearing sources of funding.

During the first nine months of 2006, the average federal funds rate was 4.88% compared with 2.97% for the first nine months of 2005.

The decline in net interest margin for the third quarter of 2006 compared with the third quarter of 2005 reflected the following:

- An increase in the average rate paid on deposits of 110 basis points for the third quarter of 2006 compared with the third quarter of 2005. The average rate paid on money market accounts, the largest single component of interest-bearing deposits, increased 114 basis points. The average rate paid on Retail Banking money market accounts increased only 89 basis points while the average rate paid on Corporate & Institutional Banking money market accounts increased 153 basis points. The average rate paid on money market accounts reported in Other increased 173 basis points.
- An increase in the average rate paid on borrowed funds of 161 basis points for the third quarter of 2006 compared with the prior year period.
- By comparison, the yield on interest-earning assets increased only 86 basis points. Loans, the single largest component, increased 84 basis points.
-



## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

These factors were partially offset by the favorable impact on net interest margin in 2006 of an increase of 22 basis points related to noninterest-bearing sources of funding.

During the third quarter of 2006, the average federal funds rate was 5.25% compared with 3.46% for the third quarter of 2005.

We believe that net interest margins for our industry will continue to be challenged if the yield curve remains flat or inverted, as competition for loans and deposits remains intense and as customers continue to migrate from lower cost to higher cost deposits. However, we believe that our balance sheet repositioning will have a positive impact on taxable-equivalent net interest income and net interest margin.

### ***PROVISION FOR CREDIT LOSSES***

The provision for credit losses increased \$85 million, to \$82 million, in the first nine months of 2006 compared with the first nine months of 2005. For the third quarter of 2006, the provision for credit losses was unchanged at \$16 million compared with the prior year third quarter. The increase in the nine-month comparison reflected the following:

- A \$53 million loan recovery in the second quarter of 2005 resulting from a litigation settlement,
- The impact of overall loan growth, as total average loans grew \$2.9 billion in the first nine months of 2006 compared with the respective prior year period,
- The effect of a single large overdraft situation that occurred during the second quarter of 2006, and
- Growth in unfunded commitments.

We do not expect to sustain asset quality at its current level. However, based on the assets we currently hold and current business trends and activities, we believe that overall asset quality will remain strong by historical standards for at least the near term. See the Credit Risk Management portion of the Risk Management section of this Financial Review for additional information regarding factors that impact the provision for credit losses.

---

**Table of Contents**

***NONINTEREST INCOME***

**Summary**

Noninterest income was \$5.358 billion for the first nine months of 2006 compared with \$3.019 billion for the first nine months of 2005. Noninterest income for the third quarter of 2006 totaled \$2.943 billion and totaled \$1.116 billion in the prior year third quarter. Both the first nine months and third quarter of 2006 included the impact of the gain on the BlackRock transaction, which totaled \$2.078 billion, partially offset by the effects of our third quarter balance sheet repositioning activities that resulted in charges totaling \$244 million.

**Additional Analysis**

Asset management fees totaled \$1.271 billion in the first nine months of 2006, an increase of \$259 million compared with the first nine months of 2005. The increase in the nine-month comparison reflected the impact of higher performance fees, BlackRock's first quarter 2005 acquisition of SSRM and other growth in assets managed. Asset management fees increased \$17 million, to \$381 million, for the third quarter of 2006 compared with the third quarter of 2005. An increase in investment advisory base fees at BlackRock, partially offset by lower performance fees, drove the increase in the quarter comparison.

While asset management fees reflected the consolidated impact of BlackRock for all income statement periods presented, assets managed at September 30, 2006 totaled \$52 billion compared with \$469 billion at September 30, 2005, due to our deconsolidation of BlackRock effective September 29, 2006.

Fund servicing fees of \$644 million for the first nine months of 2006 represented a \$13 million decline from the prior year period. For the third quarter of 2006, fund servicing fees totaled \$213 million, a decline of \$5 million from the third quarter of 2005. The decrease in fund servicing fees in both comparisons was primarily due to lower fund accounting and transfer agent fees during 2006 due to loss of clients and price concessions.

PFPC provided fund accounting/administration services for \$774 billion of net fund investment assets and provided custody services for \$399 billion of fund investment assets at September 30, 2006, compared with \$793 billion and \$475 billion, respectively, at September 30, 2005. The decreases in domestic accounting/administration net fund assets and custody fund assets at September 30, 2006 resulted primarily from the deconversion of a major client during the first quarter of 2006 which was partially offset by new business, asset inflows from existing customers and equity market appreciation.

Service charges on deposits grew \$35 million, to \$234 million, in the first nine months of 2006 compared with the prior year nine-month period. Service charges on deposits increased \$8 million in the third quarter of 2006, to \$81 million, compared with the third quarter of 2005. These increases can be attributed to customer growth, expansion of the branch network, including the expansion into the greater Washington, DC area that began in May 2005, and various pricing actions resulting from the One PNC initiative.

Brokerage fees totaled \$183 million in the first nine months of 2006 and \$168 million in the first nine months of 2005. Brokerage fees increased \$5 million, to \$61 million, for the third quarter of 2006 compared with the third quarter of 2005. These increases reflected higher annuity income and mutual fund-related revenues in 2006.

Consumer services fees grew \$59 million, to \$272 million, for the first nine months of 2006 compared with the first nine months of 2005. Consumer services fees increased \$13 million, to \$89 million, in the third quarter of 2006 compared with the third quarter of 2005. Higher fees reflected the impact of consolidating our merchant services activities in the fourth quarter of 2005 as a result of our increased ownership interest in the merchant services business. The increases in fees were also due to higher debit card revenues resulting from higher transaction volumes, our expansion into the greater Washington, DC area and pricing actions related to the One PNC initiative. These factors were partially offset by lower ATM surcharge revenue in the 2006 periods compared with the respective prior year periods as a result of changing customer behavior and a strategic decision to reduce the out-of-footprint ATM network.

Corporate services revenue totaling \$449 million in the first nine months of 2006 represented a \$107 million, or 31%, increase over the comparable prior year period. Corporate services revenue increased \$36 million, or 30%, in the third quarter of 2006 compared with the third quarter of 2005. Both 2006 periods benefited from the impact of our October 2005 Harris Williams acquisition that resulted in higher revenues.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Equity management (private equity) net gains on portfolio investments totaled \$82 million for the first nine months of 2006 compared with \$80 million for the first nine months of 2005. For the third quarter of 2006, net gains on portfolio investments totaled \$21 million compared with \$36 million in the prior year quarter. Based on the nature of private equity activities, net gains or losses may be volatile from period to period.

Net securities losses amounted to \$207 million for the first nine months of 2006 compared with net securities losses of \$37 million in the first nine months of 2005. Net securities losses totaled \$195 million in the third quarter of 2006 and \$2 million in the third quarter of 2005. We refer you to the Securities portion of our Consolidated Balance Sheet Review section of this Report for further information regarding the actions we took during the third quarter of 2006 that resulted in the sale of approximately \$6 billion of securities available for sale at an aggregate pretax loss of \$196 million during that quarter.

Net securities losses for the first nine months of 2005 reflect actions taken during the second quarter of that year regarding our securities portfolio that resulted in realized net securities and other losses of approximately \$31 million.

Noninterest revenue from trading activities, which is primarily customer-related, was \$150 million for the first nine months of 2006 compared with \$108 million for the first nine months of 2005. For the third quarter of 2006, noninterest revenue from trading activities was \$38 million, compared with \$47 million in the prior year third quarter. We provide additional information on our trading activities under Market Risk

---

## **Table of Contents**

Management Trading Risk in the Risk Management section of this Financial Review.

Other noninterest income of \$202 million for the first nine months of 2006 represented a \$75 million decrease compared with the prior year first nine months. Other noninterest income totaled \$19 million in the third quarter of 2006 compared with \$127 million in the third quarter of 2005. Other noninterest income for both 2006 periods included the impact of the following:

- A \$48 million pretax loss incurred in the third quarter of 2006 in connection with the rebalancing of our residential mortgage portfolio. Further information on these actions is included in the Loans Held For Sale portion of the Consolidated Balance Sheet Review section of this Report;
- A \$20 million charge for an accounting adjustment related to our trust preferred securities hedges recognized during the third quarter of 2006; and
- Lower other equity management income.

Other noninterest income for the first nine months of 2006 included gains totaling \$39 million, including \$13 million recognized in the third quarter, related to our contributions of BlackRock stock to the PNC Foundation. The comparable 2005 amount was \$16 million, recognized in the third quarter. These transactions also impacted noninterest expense in each of those periods.

Other noninterest income typically fluctuates from period to period depending on the nature and magnitude of transactions completed.

### ***PRODUCT REVENUE***

In addition to credit products to commercial customers, Corporate & Institutional Banking offers treasury management and capital markets-related products and services, commercial loan servicing and equipment leasing products that are marketed by several businesses across PNC.

Treasury management revenue, which includes fees as well as net interest income from customer deposit balances, totaled \$316 million for first nine months of 2006 and \$305 million for first nine months of 2005. For the third quarter of 2006, revenue totaled \$108 million compared with \$105 million for the third quarter of 2005. The higher revenue in both comparisons reflected continued expansion and client utilization of commercial payment card services, strong revenue growth in various electronic payment and information services, and a steady increase in business-to-business processing volumes.

Revenue from capital markets products and services, including mergers and acquisitions advisory activities, was \$204 million for the first nine months of 2006, compared with \$113 million in the first nine months of 2005. The acquisition of Harris Williams in October 2005 together with improved customer and proprietary trading activities drove the increase in capital markets revenue in the nine-month comparison. Consolidated revenue from capital markets products and services for the third quarter of 2006 totaled \$64 million compared with \$42 million for the third quarter of 2005. The increase in capital markets revenue for the third quarter of 2006 compared with the prior year quarter was primarily due to the acquisition of Harris Williams.

Midland Loan Services offers servicing, real estate advisory and technology solutions for the commercial real estate

finance industry. Midland's revenue, which includes servicing fees and net interest income from servicing portfolio deposit balances, totaled \$131 million for first nine months of 2006 and \$103 million for first nine months of 2005. Third quarter 2006 revenue totaled \$47 million compared with \$39 million for the third quarter of 2005. Revenue growth in both comparisons was primarily driven by growth in the commercial mortgage servicing portfolio and related services.

As a component of our advisory services to clients, we provide a select set of insurance products to fulfill specific customer financial needs. Primary insurance offerings include:

- Annuities,
- Life,
- Credit life,
- Health,
- Disability, and
- Commercial lines coverage.

Client segments served by these insurance solutions include those in Retail Banking and Corporate & Institutional Banking. Insurance products are sold by licensed PNC insurance agents and through licensed third-party arrangements. Revenue from these products was \$53 million in the first nine months of 2006 and \$46 million in first nine months of 2005. Revenue for the third quarter of 2006 totaled \$18 million compared with

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

\$15 million for the third quarter of 2005. The increases resulted from higher annuity fee revenue.

PNC, through subsidiary companies Alpine Indemnity Limited and PNC Insurance Corp., participates as a direct writer for its general liability, automobile liability, workers' compensation, property and terrorism programs.

In the normal course of business, Alpine Indemnity Limited and PNC Insurance Corp. maintain insurance reserves for reported claims and for claims incurred but not reported based on actuarial assessments. We believe these reserves were adequate at September 30, 2006.

### ***NONINTEREST EXPENSE***

#### *Year-to-date September 30, 2006 and 2005*

Total noninterest expense was \$3.498 billion for the first nine months of 2006 and \$3.199 billion for the first nine months of 2005.

The Consolidated Financial Highlights section of this Report includes our efficiency ratios for the third quarter and first nine months of both 2006 and 2005, along with notes regarding certain items impacting noninterest income and expense for both 2006 periods.

Noninterest expense for the first nine months of 2006 included the following:

- An increase of \$270 million in BlackRock operating expenses (including integration costs related to the MLIM transaction of \$91 million), reflecting growth in that business,
- Expenses totaling \$65 million related to Harris Williams, which we acquired in October 2005, and
- An increase of \$40 million related to the consolidation of our merchant services activities in the fourth quarter of 2005.

**Table of Contents**

Apart from the impact of these items, noninterest expense for the first nine months of 2006 decreased \$76 million over the prior year period as the benefit of the One PNC initiative more than offset the impact of our expansion into the greater Washington, DC area and contributions of BlackRock stock to the PNC Foundation.

*Third quarter 2006 and 2005*

Total noninterest expense was \$1.178 billion for the third quarter of 2006 and \$1.159 billion for the third quarter of 2005.

Noninterest expense for the third quarter of 2006 reflected a \$76 million increase in operating expenses at BlackRock (including MLIM integration costs of \$72 million), \$22 million of expenses related to Harris Williams and an increase of \$11 million related to the fourth quarter 2005 consolidation of our merchant services activities. Apart from the impact of these items, noninterest expense for the third quarter of 2006 decreased \$90 million compared with the prior year third quarter.

We expect that the percentage increase in total noninterest expense for full year 2006 compared with 2005, excluding the BlackRock business segment and MLIM transaction integration costs, will be in the low single-digit range, with the increase primarily attributable to the acquisition of Harris Williams and the consolidation of merchant services in the fourth quarter of 2005. However, noninterest expense will continue to be impacted by ongoing investments in our businesses.

Period-end employees totaled 23,539 at September 30, 2006 (comprised of 21,374 full-time and 2,165 part-time) compared with 25,348 at December 31, 2005 (comprised of 23,593 full-time and 1,755 part-time) and 25,369 at September 30, 2005 (comprised of 23,811 full-time and 1,558 part-time). The decline in full-time employees at September 30, 2006 reflects the deconsolidation of BlackRock effective September 29, 2006. The increase in part-time employees reflects Retail Banking initiatives to utilize more customer-facing employees during peak business hours versus full-time employees for the entire day.

*EFFECTIVE TAX RATE*

Our effective tax rate for the first nine months of 2006 was 35.1% compared with 29.7% for the first nine months of 2005. The higher effective rate for first nine months of 2006 was primarily due to a \$57 million cumulative adjustment to deferred taxes in connection with the BlackRock/MLIM transaction. The lower effective tax rate in 2005 reflected the impact of the first quarter 2005 reversal of deferred tax liabilities in connection with the transfer of our ownership in BlackRock to our intermediate bank holding company. This transaction reduced our first quarter 2005 tax provision by \$45 million.

**CONSOLIDATED BALANCE SHEET REVIEW****SUMMARIZED BALANCE SHEET DATA**

In millions	September 30 2006	December 31 2005
<b>Assets</b>		
Loans, net of unearned income	\$48,900	\$49,101
Securities available for sale and held to maturity	19,512	20,710
Loans held for sale	4,317	2,449
Investment in BlackRock	3,836	
Other	21,871	19,694
<b>Total assets</b>	<b>\$98,436</b>	<b>\$91,954</b>
<b>Liabilities</b>		
Funding sources	\$79,267	\$77,172
Other	8,003	5,629
<b>Total liabilities</b>	<b>87,270</b>	<b>82,801</b>
Minority and noncontrolling interests in consolidated entities	408	590
<b>Total shareholders' equity</b>	<b>10,758</b>	<b>8,563</b>

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Total liabilities, minority and noncontrolling interests, and shareholders' equity	<b>\$98,436</b>	\$91,954
--	-----------------	----------

Our Consolidated Balance Sheet is presented in Part I, Item 1 on page 38 of this Report.

Various seasonal and other factors impact our period-end balances whereas average balances (discussed under the Balance Sheet Highlights section of this Financial Review above and included in the Statistical Information section of this Report on pages 63 and 64) are more indicative of underlying business trends.

The impact of the deconsolidation of BlackRock's balance sheet amounts and recognition of our approximate 34% ownership interest in BlackRock as an equity investment upon the closing of the BlackRock/MLIM transaction is discussed in the Executive Summary section of this Financial Review and in our Form 8-K dated September 29, 2006.

**Table of Contents**

An analysis of changes in certain balance sheet categories follows.

***LOANS, NET OF UNEARNED INCOME***

Loans decreased \$201 million, to \$48.9 billion, at September 30, 2006 compared with the balance at December 31, 2005. A decline in residential mortgage loans in connection with the third quarter 2006 mortgage loan repositioning more than offset increases in several other loan categories. Targeted sales efforts across our banking businesses drove the increase in commercial lending and consumer loans.

***Details Of Loans***

In millions	September 30 2006	December 31 2005
Commercial		
Retail/wholesale	\$5,245	\$4,854
Manufacturing	4,318	4,045
Other service providers	2,155	1,986
Real estate related	3,000	2,577
Financial services	1,423	1,438
Health care	685	616
Other	3,858	3,809
Total commercial	20,684	19,325
Commercial real estate		
Real estate projects	2,691	2,244
Mortgage	794	918
Total commercial real estate	3,485	3,162
Equipment lease financing	3,609	3,628
Total commercial lending	27,778	26,115
Consumer		
Home equity	13,876	13,790
Automobile	1,061	938
Other	1,419	1,445
Total consumer	16,356	16,173
Residential mortgage	5,234	7,307
Other	347	341
Unearned income	(815)	(835)
Total, net of unearned income	\$48,900	\$49,101

As the table above indicates, our total loan portfolio continued to be diversified among types of loan products and numerous industries and businesses. The loans that we hold are also diversified across the geographic areas where we do business.

***Commercial Lending Exposure (a)***

	September 30 2006	December 31 2005
Investment grade or equivalent	49%	46%
<u>Non-investment grade</u>		
\$50 million or greater	3	2
All other non-investment grade	48	52
Total	100%	100%

(a) Includes total commercial lending in the Retail Banking and Corporate & Institutional Banking business segments.

Commercial loans are the largest category and are the most sensitive to changes in assumptions and judgments underlying the determination of the allowance for loan and lease losses. We have allocated approximately \$455 million, or 80%, of the total allowance for loan and lease losses at September 30, 2006 to the commercial loan category. This allocation also considers other relevant factors such as:



## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

- Actual versus estimated losses,
- Regional and national economic conditions,
- Business segment and portfolio concentrations,
- Industry competition and consolidation,
- The impact of government regulations, and
- Risk of potential estimation or judgmental errors, including the accuracy of risk ratings.

### *Net Unfunded Credit Commitments*

In millions	September 30 2006	December 31 2005
Commercial	<b>\$30,018</b>	\$27,774
Consumer	<b>10,164</b>	9,471
Commercial real estate	<b>2,998</b>	2,337
Other	<b>624</b>	596
<b>Total</b>	<b>\$43,804</b>	\$40,178

Commitments to extend credit represent arrangements to lend funds or provide liquidity subject to specified contractual conditions. Commercial commitments are reported net of participations, assignments and syndications, primarily to financial institutions, totaling \$6.8 billion at September 30, 2006 and \$6.7 billion at December 31, 2005.

Unfunded liquidity facility commitments and standby bond purchase agreements totaled \$6.1 billion at September 30, 2006 and \$5.1 billion at December 31, 2005 and are included in the preceding table primarily within the Commercial and Consumer categories.

In addition to credit commitments, our net outstanding standby letters of credit totaled \$4.4 billion at September 30, 2006 and \$4.2 billion at December 31, 2005. Standby letters of credit commit us to make payments on behalf of our customers if specified future events occur.

### *Cross-Border Leases and Related Tax and Accounting Matters*

The equipment lease portfolio totaled \$3.6 billion at September 30, 2006. Aggregate residual value at risk on the lease portfolio at September 30, 2006 was \$1.1 billion. We have taken steps to mitigate \$.6 billion of this residual risk, including residual value insurance coverage with third parties, third party guarantees, and other actions. The portfolio included approximately \$1.7 billion of cross-border leases at September 30, 2006. Cross-border leases are leveraged leases of equipment located in foreign countries, primarily in western Europe and Australia. We have not entered into cross-border lease transactions since 2003.

Upon completing examination of our 1998-2000 consolidated federal income tax returns, the IRS provided us with an examination report which proposes increases in our tax liability, principally arising from adjustments to several of our cross-border lease transactions.

The IRS has begun an audit of our 2001-2003 consolidated federal income tax returns. We expect them to again make adjustments to the cross-border lease transactions referred to above as well as to new cross-border lease transactions entered into during those years. We believe our reserves for these exposures were adequate at September 30, 2006.

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction ( FSP 13-2 )*. FSP 13-2 is

**Table of Contents**

effective January 1, 2007 and will require a recalculation of the timing of income recognition and the reevaluation of lease classification for actual or projected changes in the timing of tax benefits for leveraged leases. Any cumulative adjustment will be recognized through retained earnings upon adoption of FSP 13-2. See Note 1 Accounting Policies in the Notes To Consolidated Financial Statements in this Report for additional information. We estimate that the cumulative adjustment that we will record effective January 1, 2007 from the recalculations required by FSP 13-2 will be in the range of approximately \$140 million to \$160 million, after-tax. Any immediate or future reductions in earnings from our adoption of FSP 13-2 would be recovered in subsequent years.

In addition to these transactions, three lease-to-service contract transactions that we were party to were structured as partnerships for tax purposes. These partnerships are under audit by the IRS. However, we do not believe that our exposure from these transactions is material to our consolidated results of operations or financial position.

Additional information on cross-border lease transactions is included under *Cross-Border Leases and Related Tax and Accounting Matters* in the Consolidated Balance Sheet Review section of Item 7 of our 2005 Form 10-K.

**SECURITIES****Details Of Securities (a)**

In millions	Amortized Cost	Fair Value
<b>September 30, 2006</b>		
<i>SECURITIES AVAILABLE FOR SALE</i>		
Debt securities		
Mortgage-backed	<b>\$14,799</b>	<b>\$14,673</b>
US Treasury and government agencies	<b>556</b>	<b>552</b>
Commercial mortgage-backed	<b>2,342</b>	<b>2,334</b>
Asset-backed	<b>1,527</b>	<b>1,519</b>
State and municipal	<b>141</b>	<b>139</b>
Other debt	<b>89</b>	<b>87</b>
Corporate stocks and other	<b>209</b>	<b>208</b>
Total securities available for sale	<b>\$19,663</b>	<b>\$19,512</b>
December 31, 2005		
<i>SECURITIES AVAILABLE FOR SALE</i>		
Debt securities		
Mortgage-backed	<b>\$13,794</b>	<b>\$13,544</b>
US Treasury and government agencies	<b>3,816</b>	<b>3,744</b>
Commercial mortgage-backed	<b>1,955</b>	<b>1,919</b>
Asset-backed	<b>1,073</b>	<b>1,063</b>
State and municipal	<b>159</b>	<b>158</b>
Other debt	<b>87</b>	<b>86</b>
Corporate stocks and other	<b>196</b>	<b>196</b>
Total securities available for sale	<b>\$21,080</b>	<b>\$20,710</b>

(a) Securities held to maturity at September 30, 2006 and December 31, 2005 were less than \$.5 million.

Securities represented 20% of total assets at September 30, 2006 and 23% of total assets at December 31, 2005.

We evaluate our portfolio of securities available for sale in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall positioning.

At September 30, 2006, securities available for sale included a net unrealized loss of \$151 million, which represented the difference between fair value and amortized cost. The comparable amount at December 31, 2005 was a net unrealized loss of \$370 million. Net unrealized gains and losses in the securities available for sale portfolio are included in shareholders' equity as accumulated other comprehensive income or loss, net of tax.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

The fair value of securities available for sale decreases when interest rates increase and vice versa. Consequently, increases in interest rates after September 30, 2006, if sustained, will adversely impact the fair value of securities available for sale compared with the balance at September 30, 2006.

During mid-August through early September 2006, we performed a comprehensive review of our securities available for sale portfolio and, by the end of September 2006, completed the process of executing portfolio rebalancing actions in response to the changing economic landscape, recent statements and actions by the Federal Open Market Committee (in particular, the decision not to raise the Fed funds target rate) and our desire to position the securities portfolio to optimize total return performance over the long term.

As a result, we have repositioned our securities portfolio according to our market views. This included reallocating exposure to certain sectors, selling securities holdings we believed would likely underperform on a relative value basis, retaining certain existing securities and purchasing incremental securities all of which we believe will outperform the market going forward.

As part of the rebalancing, we assessed the entire securities available for sale portfolio of which, for the majority of positions, fair value was less than amortized cost. We executed a strategy to reduce our US government agency and mortgage-backed security sector allocations and increase our interest rate swap sector allocation. We sold substantially all of our US government agency securities to reduce our interest rate spread exposure to that asset class. The US government agency securities that we retained are characterized by relatively short terms to maturity and smaller individual security balances. We also sold specific securities in the mortgage-backed portfolio (e.g. all of our holdings of specific coupon US government agency pass-through securities and collateralized mortgage obligations having specific collateral characteristics), and in the commercial mortgage-backed portfolio (e.g. all of our holdings of specific vintage securities) that we believe, given the underlying collateral, will underperform on a relative value basis. We retained the remaining holdings in our mortgage-backed portfolio including all of our holdings of mortgage-backed securities collateralized by hybrid adjustable rate mortgage loans, our commercial mortgage-backed portfolio and our asset-backed portfolio. Our objective was to reduce the portfolio credit spread and interest rate volatility exposures, to position the portfolio for a steeper yield curve and to optimize the relative value performance of the portfolio. We assessed the securities retained relative to the same portfolio objectives, our market view and outlook, our desired sector allocations, our expectation of performance relative to market benchmarks and, given our assessment, we confirmed our intent to hold these remaining securities until either recovery of fair value or maturity. Accordingly, we do not believe that any individual unrealized losses at September 30, 2006 represent an other-than-temporary impairment.

The portfolio rebalancing resulted in the sale during the third quarter of 2006 of \$6.0 billion of securities available for sale at an aggregate pretax loss of \$196 million, or \$127 million after-tax. We repurchased approximately \$1.8 billion of securities and added approximately \$4.0 billion of interest rate swaps to maintain our interest rate risk position. We also reduced wholesale funding as a result of the actions taken.

The resulting net realized losses on the sale of the securities during the third quarter of 2006 were previously reflected as net unrealized securities losses within accumulated other comprehensive loss in the shareholders' equity section of PNC's Consolidated Balance Sheet. Accordingly, total shareholders' equity did not change as a result of these actions.

The expected weighted-average life of securities available for sale (excluding corporate stocks and other) was 3 years and 11 months at September 30, 2006 and 4 years and 1 month at December 31, 2005.

We estimate that at September 30, 2006 the effective duration of securities available for sale is 2.6 years for an immediate 50 basis points parallel increase in interest rates and 2.2 years for an immediate 50 basis points parallel decrease in interest rates. Comparable amounts at December 31, 2005 were 2.7 years and 2.4 years, respectively.

**Table of Contents*****LOANS HELD FOR SALE***

As reported in our Form 8-K dated September 22, we plan to sell or securitize approximately \$2.1 billion of loans from our residential mortgage portfolio. We expect these transactions to be substantially consummated during the fourth quarter of 2006. In accordance with GAAP, these loans were transferred to loans held for sale as of September 30, 2006. We recognized a pretax loss in the third quarter of 2006 of \$48 million as a reduction of noninterest income, or \$31 million after-tax, representing the mark to market valuation of these loans upon transfer to held for sale status. This loss, which is reported in the Other business segment, represented the decline in value of the loans almost entirely from the impact of increases in interest rates. We expect to replace these loans with other residential mortgage loans, with the expectation of increasing the overall yield on our total loan portfolio and improving net interest income relative to current estimates.

Education loans held for sale totaled \$1.5 billion at September 30, 2006 and \$1.9 billion at December 31, 2005. We classify substantially all of our education loans as loans held for sale. Generally, we sell education loans when the loans are placed into repayment status. Gains on sales of education loans are reflected in the Other noninterest income line item in our Consolidated Income Statement and in the results for the Retail Banking business segment.

***FUNDING AND CAPITAL SOURCES******Details of Funding Sources***

In millions	September 30 2006	December 31 2005
Deposits		
Money market	\$27,677	\$24,462
Demand	16,105	17,157
Retail certificates of deposit	14,767	13,010
Savings	1,924	2,295
Other time	1,403	1,313
Time deposits in foreign offices	2,696	2,038
Total deposits	64,572	60,275
Borrowed funds		
Federal funds purchased	3,475	4,128
Repurchase agreements	2,275	1,691
Bank notes and senior debt	2,177	3,875
Subordinated debt	4,436	4,469
Other	2,332	2,734
Total borrowed funds	14,695	16,897
Total	\$79,267	\$77,172

The decline in total borrowed funds compared with the balance at December 31, 2005 reflects a decrease in federal funds purchased, maturities of \$1.95 billion of bank notes and senior debt during the first nine months of 2006, and the deconsolidation of BlackRock's \$250 million of convertible debentures. These factors were partially offset by an issuance of \$500 million of bank notes in June 2006 and an increase in repurchase agreements.

***Capital***

We manage our capital position by making adjustments to our balance sheet size and composition, issuing debt and equity instruments, making treasury stock transactions, maintaining dividend policies and retaining earnings.

The increase of \$2.2 billion in total shareholders' equity at September 30, 2006 compared with December 31, 2005 reflected the following:

- Net income to date in 2006,
- An increase in capital surplus in connection with the BlackRock/MLIM transaction, and

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

- A lower accumulated other comprehensive loss.

The securities repositioning described within the Securities section of the Consolidated Balance Sheet Review section was the primary factor in the reduction in accumulated other comprehensive loss at September 30, 2006 compared with December 31, 2005.

Common shares outstanding at September 30, 2006 were 293.8 million compared with 292.9 million at December 31, 2005. The increase in shares outstanding during the first nine months of 2006 reflected share issuances related to various employee stock-based compensation plans and the exercise of employee stock options.

We purchased 3.7 million common shares under our common stock repurchase program during the first nine months of 2006, with all purchases occurring in the second and third quarters. Our current program, which permits us to purchase up to 20 million shares on the open market or in privately negotiated transactions, will remain in effect until fully utilized or until modified, superseded or terminated. As of September 30, 2006, remaining availability for purchases under this program was 15.8 million shares. The extent and timing of additional share repurchases under this program will depend on a number of factors including, among others, market and general economic conditions, economic and regulatory capital considerations, alternative uses of capital, regulatory limitations resulting from merger activity, and the potential impact on our credit rating. Subject to limitations related to the pending Mercantile acquisition, we expect to continue to be active in share repurchases under favorable market conditions.

See Mercantile Bankshares Acquisition in the Executive Summary section of this Report regarding our plans to issue PNC common stock and cash in connection with this planned acquisition.

**Table of Contents*****Risk-Based Capital***

Dollars in millions	September 30 2006	December 31 2005
<b>Capital components</b>		
<b>Shareholders' equity</b>		
Common	<b>\$10,751</b>	\$8,555
Preferred	7	8
Trust preferred capital securities	<b>1,417</b>	1,417
Minority interest	3	291
Goodwill and other intangibles	<b>(3,593)</b>	(4,122)
Net unrealized securities losses, after-tax	<b>98</b>	240
Net unrealized losses on cash flow hedge derivatives, after-tax	7	26
Equity investments in nonfinancial companies	<b>(28)</b>	(40)
Other, net	<b>(8)</b>	(11)
Tier 1 risk-based capital	<b>8,654</b>	6,364
Subordinated debt	<b>2,054</b>	2,216
Eligible allowance for credit losses	<b>684</b>	697
<b>Total risk-based capital</b>	<b>\$11,392</b>	\$9,277
<b>Assets</b>		
Risk-weighted assets, including off-balance sheet instruments and market risk equivalent assets	<b>\$83,513</b>	\$76,673
Adjusted average total assets	<b>92,235</b>	88,329
<b>Capital ratios</b>		
Tier 1 risk-based	<b>10.4%</b>	8.3%
Total risk-based	<b>13.6</b>	12.1
Leverage	<b>9.4</b>	7.2
Tangible common equity	<b>7.5</b>	5.0

The access to, and cost of, funding new business initiatives including acquisitions, the ability to engage in expanded business activities, the ability to pay dividends, the level of deposit insurance costs, and the level and nature of regulatory oversight depend, in part, on a financial institution's capital strength. At September 30, 2006, each of our banking subsidiaries was considered well-capitalized based on regulatory capital ratio requirements, as indicated in the Capital Ratios section of Consolidated Financial Highlights on page 2 of this Report. We believe our bank subsidiaries will continue to meet these requirements during the remainder of 2006.

***OFF-BALANCE SHEET ARRANGEMENTS AND VARIABLE INTEREST ENTITIES***

We engage in a variety of activities in the normal course of business that involve unconsolidated entities or that are otherwise not reflected in our Consolidated Balance Sheet that are generally referred to as off-balance sheet arrangements. Further information on these types of activities is included in Note 15 Commitments And Guarantees included in the Notes To Consolidated Financial Statements in Part I, Item 1 of this Report.

Further information on the variable interest entities (VIEs) in the following tables is included in our 2005 Form 10-K under this same heading in Part I, Item 7 and in Note 3 Variable Interest Entities in the Notes To Consolidated Financial Statements included in Part II, Item 8 of that report.

We hold significant variable interests in VIEs that have not been consolidated because we are not considered the primary beneficiary. Information on these VIEs follows:

***Non-Consolidated VIEs - Significant Variable Interests***

In millions	Aggregate Assets	Aggregate Liabilities	PNC Risk
-------------	---------------------	--------------------------	----------

	of Loss		
<b>September 30, 2006</b>			
Market Street	<b>\$4,049</b>	<b>\$4,049</b>	<b>\$6,205(a)</b>
Collateralized debt obligations	<b>956</b>	<b>727</b>	<b>21</b>
Partnership interests in low income housing projects	<b>33</b>	<b>30</b>	<b>7</b>
<b>Total</b>	<b>\$5,038</b>	<b>\$4,806</b>	<b>\$6,233</b>
December 31, 2005			
Collateralized debt obligations (b)	\$6,290	\$5,491	\$51(c)
Private investment funds (b)	5,186	1,051	13(c)
Market Street	3,519	3,519	5,089(a)
Partnership interests in low income housing projects	35	29	2
<b>Total</b>	<b>\$15,030</b>	<b>\$10,090</b>	<b>\$5,155</b>

(a) Includes off-balance sheet liquidity commitments to Market Street of \$5.7 billion and other credit enhancements of \$5 billion at September 30, 2006. The comparable amounts at December 31, 2005 were \$4.6 billion and \$4 billion, respectively. Events whereby PNC may be liable for funding include bankruptcies, delinquencies, or covenant violations.

(b) Primarily held by BlackRock. We deconsolidated BlackRock effective September 29, 2006. See Note 2 Acquisitions in the Notes To Consolidated Financial Statements for additional information.

(c) Includes both PNC's direct risk of loss and BlackRock's risk of loss, limited to PNC's ownership interest in BlackRock.

The aggregate assets and liabilities of VIEs that we have consolidated in our financial statements are as follows:

**Consolidated VIEs PNC Is Primary Beneficiary**

In millions	Aggregate	
	Assets	Aggregate Liabilities
<b>September 30, 2006</b>		
Partnership interests in low income housing projects	<b>\$870</b>	<b>\$870</b>
Other	<b>18</b>	<b>18</b>
<b>Total</b>	<b>\$888</b>	<b>\$888</b>
December 31, 2005		
Partnership interests in low income housing projects	\$680	\$680
Other	12	10
<b>Total</b>	<b>\$692</b>	<b>\$690</b>

We also have subsidiaries that invest in and act as the investment manager for private equity funds organized as limited partnerships as part of our equity management activities. The funds invest in private equity investments to generate capital appreciation and profits. As permitted by FASB Interpretation No. 46 (Revised 2003), Consolidation of Variable Interest Entities, we have deferred applying the provisions of the interpretation for these entities pending further action by the FASB. Information on these entities follows:

**Investment Company Accounting Deferred Application**

In millions	PNC Risk		
	Aggregate Assets	Aggregate Equity	of Loss
<u>Private Equity Funds</u>			
<b>September 30, 2006</b>	<b>\$82</b>	<b>\$82</b>	<b>\$103</b>
December 31, 2005	\$109	\$109	\$35

PNC's risk of loss in the tables above includes both the value of our equity investments and any unfunded commitments to the respective entities.

**Table of Contents*****BUSINESS SEGMENTS REVIEW***

We have four major businesses engaged in providing banking, asset management and global fund processing products and services. Business segment results, including inter-segment revenues, and a description of each business are included in Note 14 Segment Reporting included in the Notes To Consolidated Financial Statements under Part I, Item 1 of this Report.

Results of individual businesses are presented based on our management accounting practices and our management structure. There is no comprehensive, authoritative body of guidance for management accounting equivalent to GAAP; therefore, the financial results of individual businesses are not necessarily comparable with similar information for any other company. We refine our methodologies from time to time as our management accounting practices are enhanced and our businesses and management structure change. Financial results are presented, to the extent practicable, as if each business operated on a stand-alone basis. As permitted under GAAP, we have aggregated the business results for certain operating segments for financial reporting purposes.

Our capital measurement methodology is based on the concept of economic capital for our banking businesses. However, we have increased the capital assigned to Retail Banking to 6% of funds to reflect the capital required for well-capitalized banks and to approximate market comparables for this business. The capital for BlackRock and PFPC currently reflects average legal entity shareholders' equity, which exceeds required economic capital.

BlackRock business segment results for the three months and nine months ended September 30, 2006 and 2005 reflect our majority ownership in BlackRock during each of these periods.

***RESULTS OF BUSINESSES - SUMMARY***

(Unaudited)

Nine months ended September 30 - dollars in millions	Earnings		Revenue (a) (b)		Return on Average Capital (c)		Average Assets (d)	
	2006	2005	2006	2005	2006	2005	2006	2005
Retail Banking	\$ 581	\$ 487	\$ 2,326	\$ 2,113	26%	23%	\$ 29,319	\$ 27,138

Subsequent to the September 29, 2006 BlackRock/MLIM closing, which had the effect of reducing our ownership interest to approximately 34%, our investment in BlackRock is being accounted for under the equity method of accounting but will continue to be a separate reportable business segment of PNC. Our prior period business segment information for BlackRock will not be restated. See Note 2 Acquisitions in the Notes To Consolidated Financial Statements for additional information.

We have allocated the allowances for loan and lease losses and unfunded loan commitments and letters of credit based on our assessment of risk inherent in the loan portfolios. Our allocation of the costs incurred by operations and other support areas not directly aligned with the businesses is primarily based on the use of services.

Total business segment financial results differ from total consolidated results. The impact of these differences is primarily reflected in minority interest in income of BlackRock up to September 29, 2006, and in the Other category in the Results of Businesses Summary table that follows. Other includes residual activities that do not meet the criteria for disclosure as a separate reportable business, such as the third quarter 2006 gain on the BlackRock/MLIM transaction, 2006 BlackRock/MLIM integration costs, One PNC implementation costs, asset and liability management activities, related net securities gains or losses, certain trading activities, equity management activities and minority interest in income of BlackRock up to September 29, 2006, differences between business segment performance reporting and financial statement reporting (GAAP), most corporate overhead and intercompany eliminations.

The period-end employee statistics disclosed for each business segment in the tables that follow reflect staff directly employed by the respective business segment and may exclude operations, technology and staff services employees not directly managed by the respective business segment.



Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Corporate & Institutional Banking	334	372	1,078	977	23	29	26,237	25,303
BlackRock (e)	209	167	1,103	854	29	28	3,865	1,673
PFPC	93	75	634	637	31	34	2,053	2,082
Total business segments	1,217	1,101	5,141	4,581	26	26	61,474	56,196
Minority interest in income of BlackRock	(64)	(51)						
Other (e) (f)	1,066	(80)	1,916	57			32,178	31,165
Total consolidated (a)	\$ 2,219	\$ 970	\$ 7,057	\$ 4,638	34%	16%	\$ 93,652	\$ 87,361

(a) Business segment revenue is presented on a taxable-equivalent basis. A reconciliation of total consolidated revenue on a book (GAAP) basis to total consolidated revenue on a taxable-equivalent basis follows:

Nine months ended September 30 (in millions)	2006	2005
Total consolidated revenue, book (GAAP) basis	\$ 7,037	\$ 4,618
Taxable-equivalent adjustment	20	20
Total consolidated revenue, taxable-equivalent basis	\$ 7,057	\$ 4,638

- (b) Amounts for the BlackRock segment represent the sum of total operating revenue and nonoperating income. Amounts for PFPC represent the sum of servicing revenue and net nonoperating income (expense) less debt financing costs.
- (c) Percentages for the BlackRock segment and PFPC reflect return on average equity.
- (d) Period-end balances for BlackRock and PFPC.
- (e) BlackRock reported GAAP earnings of \$153 million and \$161 million for the nine months ended September 30, 2006 and September 30, 2005, respectively. For this business segment reporting presentation, pretax integration costs incurred by BlackRock for the MLIM transaction totaling \$91 million for the nine months ended September 30, 2006 have been reclassified from BlackRock to Other. Similarly, pretax integration costs of \$9 million related to BlackRock's January 2005 acquisition of State Street Research and Management have been reclassified from BlackRock to Other for the nine months ended September 30, 2005.
- (f) Other in the Business Segment Highlights portion of the Executive Summary section of this Report provides further information regarding Other results.

**Table of Contents****RETAIL BANKING (Unaudited)**

Nine months ended September 30

Taxable-equivalent basis

Dollars in millions	2006	2005
<b>INCOME STATEMENT</b>		
Net interest income	\$1,259	\$1,176
Noninterest income		
Asset management	261	251
Service charges on deposits	227	193
Brokerage	176	163
Consumer services	260	200
Other	143	130
Total noninterest income	1,067	937
Total revenue	2,326	2,113
Provision for credit losses	46	43
Noninterest expense	1,342	1,292
Pretax earnings	938	778
Minority interest	14	
Income taxes	343	291
Earnings	\$581	\$487
<b>AVERAGE BALANCE SHEET</b>		
Loans		
Consumer		
Home equity	\$13,814	\$13,216
Indirect	1,025	920
Other consumer	1,224	1,174
Total consumer	16,063	15,310
Commercial		
Floor plan	929	988
Residential mortgage	1,578	1,301
Other	245	265
Total loans	24,473	22,895
Goodwill and other intangible assets	1,583	1,338
Loans held for sale	1,641	1,468
Other assets	1,622	1,437
Total assets	\$29,319	\$27,138
Deposits		
Noninterest-bearing demand	\$7,844	\$7,543
Interest-bearing demand	7,920	7,895
Money market	14,725	13,377
Total transaction deposits	30,489	28,815
Savings	2,089	2,664
Certificates of deposit	13,580	11,098
Total deposits	46,158	42,577
Other liabilities	537	392
Capital	2,970	2,814
Total funds	\$49,665	\$45,783
<b>PERFORMANCE RATIOS</b>		
Return on average capital	26%	23%
Noninterest income to total revenue	46	44
Efficiency	58	61

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

At September 30

Dollars in millions except as noted	2006	2005
<b>OTHER INFORMATION (a)</b>		
<u>Credit-related statistics:</u>		
Total nonperforming assets (b)	\$95	\$87
Net charge-offs	\$64	\$41
Annualized net charge-off ratio	.35%	.24%
<u>Home equity portfolio credit statistics:</u>		
% of first lien positions	44%	47%
Weighted average loan-to-value ratios	69%	70%
Weighted average FICO scores	728	721
Loans 90 days past due	.22%	.18%

At September 30

Dollars in millions except as noted	2006	2005
<b>OTHER INFORMATION (a)</b>		
<u>Checking-related statistics:</u>		
Retail Banking checking relationships	1,958,000	1,921,000
Consumer DDA households using online banking	920,000	830,000
% of consumer DDA households using online banking	52%	48%
Consumer DDA households using online bill payment	361,000	188,000
% of consumer DDA households using online bill payment	20%	11%
<u>Small business managed deposits:</u>		
On-balance sheet		
Noninterest-bearing demand	\$4,349	\$4,285
Interest-bearing demand	\$1,464	\$1,527
Money market	\$2,660	\$2,818
Certificates of deposit	\$591	\$372
Off-balance sheet (c)		
Small business sweep checking	1,555	1,275
Total managed deposits	\$10,619	\$10,277
<u>Brokerage statistics:</u>		
Margin loans	\$170	\$223
Financial consultants (d)	752	784
Full service brokerage offices	99	99
Brokerage account assets (billions)	\$44	\$42
<u>Other statistics:</u>		
Gains on sales of education loans (e)	\$22	\$15
Full-time employees	9,531	9,891
Part-time employees	1,660	934
ATMs	3,594	3,770
Branches (f)	848	830
<b>ASSETS UNDER ADMINISTRATION</b>		
(billions) (g)		
<u>Assets under management:</u>		
Personal	\$42	\$41
Institutional	10	9
Total	\$52	\$50
<u>Asset Type</u>		
Equity	\$32	\$31
Fixed income	12	13
Liquidity/Other	8	6
Total	\$52	\$50
<u>Nondiscretionary assets under administration:</u>		
Personal	\$27	\$27
Institutional	62	58
Total	\$89	\$85
<u>Asset Type</u>		
Equity	\$32	\$32

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Fixed income	27	25
Liquidity/Other	<b>30</b>	28
Total	<b>\$89</b>	\$85

- (a) Presented as of September 30 except for net charge-offs, annualized net charge-off ratio, gains on sales of education loans, and small business deposits, which are for the nine months ended September 30.
- (b) Includes nonperforming loans of \$85 million at September 30, 2006 and \$78 million at September 30, 2005.
- (c) Represents small business balances, a portion of which are calculated on a one-month lag. These balances are swept into liquidity products managed by other PNC business segments, the majority of which are off-balance sheet.
- (d) Financial consultants provide services in full service brokerage offices and PNC traditional branches.
- (e) Included in Noninterest income-Other.
- (f) Excludes certain satellite branches that provide limited products and service hours.
- (g) Excludes brokerage account assets.

## Table of Contents

Retail Banking's earnings were \$581 million for the first nine months of 2006 compared with \$487 million for the same period in 2005. Compared with the prior year, revenues increased 10% and noninterest expenses increased 4%, resulting in a 19% earnings improvement. The increase in earnings was driven by improved fee income from customers, higher taxable-equivalent net interest income fueled by continued customer and balance sheet growth, and a sustained focus on expense management. Retail Banking's sustained focus on expense management has allowed for additional investments in the business which include branch expansion and renovation, a new checking account line, and a credit card program.

Highlights of Retail Banking's performance during the first nine months of 2006 include the following:

- A component of our strategy is to be the preferred payments provider for our consumer and small business customers. We are going to market through our Banking Made Easy initiative, which was launched during the third quarter of 2006. Two key product changes occurred in the third quarter as a part of this strategy.
  - We announced a simplified choice of checking accounts for our customers that offer free access to ATMs worldwide.
  - We also launched a new credit card program for our consumer and small business customers.
- Consumer and small business checking relationships increased by 37,000, or 2%, compared with September 30, 2005. Checking relationship growth has been mitigated by our focus on consolidating low-activity and low-balance accounts, while seeking higher quality deposits.
- Since September 30, 2005, consumer-related checking households using online banking increased 11% and checking households using online bill payment increased 92%.
- The small business area continued its positive momentum. Average small business loans increased 14% over the first nine months of 2005 on the strength of increased demand from both existing customers and new relationships. Small business checking relationships increased 4%.
- Customer assets in brokerage accounts totaled \$44 billion at September 30, 2006 compared with \$42 billion at September 30, 2005. Brokerage fees increased \$13 million or 8% over the first nine months of 2005.
- Retail Banking's year-to-date efficiency ratio improved to 58% compared with 61% a year earlier.
- The branch network increased a net 18 branches to a total of 848 branches at September 30, 2006 compared with 830 at September 30, 2005. This increase was comprised of 30 new branches, offset by 12 branch consolidations. Our strategy is to continue to optimize our network by opening new branches in high growth areas and consolidating branches in areas of declining market opportunity and/or growth.
- Asset quality remained very strong.

Total revenue for the first nine months of 2006 was \$2.326 billion compared with \$2.113 billion for the same period last year. Taxable-equivalent net interest income of \$1.259 billion increased \$83 million, or 7%, compared with 2005 due to an 8% increase in average deposits and a 7% increase in average loan balances. The net interest income growth has been somewhat mitigated by declining spreads on the loan portfolio. In the current rate environment, we expect the spread on both loans and deposits to be under pressure.

Noninterest income increased \$130 million, or 14%, compared with the first nine months of 2005 primarily driven by increased consumer services fees and service charges on deposits. This growth can be attributed primarily to the following:

- Customer growth,
- Expansion of the branch network, including a new market,
- Consolidation of our merchant services activities,
- Increased brokerage account assets and activities,
- Improved asset management fees,
- Increased third party loan servicing activities, and
- Various pricing actions resulting from the One PNC initiative.

The provision for credit losses increased \$3 million in the first nine months of 2006 compared with 2005. Excluding the impact of a single large overdraft situation, net charge-offs are consistent with the prior year and with corresponding loan growth.

Noninterest expense in the first nine months of 2006 totaled \$1.342 billion, an increase of \$50 million, or 4%, compared with the first nine months of 2005. Operating costs increased \$43 million compared with the prior year period as a result of our expansion into the greater Washington, DC area. Other expense increases were primarily attributable to continued growth of the company's branch network, the consolidation of the company's merchant services activities, investments in various initiatives such as the new checking account product line and

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

credit card, and an increase in volume-related expenses tied to revenue, partially offset by lower staff-related expense as a result of One PNC initiatives.

The new simplified checking product line is expected to increase checking account households and average balances per account. Two features of the new product line, free access to ATMs worldwide and a first time overdraft waiver, will negatively impact service charges on deposits fee income and noninterest expenses.

Full-time employees at September 30, 2006 totaled 9,531, a decline of 360 from September 30, 2005. Part-time employees have increased by 726 since September 30, 2005. The decline in full-time employees and increase in part-time employees is a direct result of various cost-saving initiatives. These initiatives include utilizing more part-time customer-facing employees during peak business hours versus full-time employees for the entire day.

## **Table of Contents**

We have adopted a relationship-based lending strategy to target specific customer sectors (homeowners, small businesses and auto dealerships) while seeking to maintain a moderate risk profile in the loan portfolio.

- Average commercial loans grew \$627 million, or 12%, on the strength of increased loan demand from existing small business customers and the acquisition of new relationships through our sales efforts.
- Average home equity loans grew by \$598 million, or 5%, compared with the first nine months of 2005. Consumer loan demand has slowed as a result of the current rate environment.
- Average indirect loans grew \$105 million, or 11%, compared with the first nine months of 2005. The indirect auto business benefited from increased sales and marketing efforts.
- Average residential mortgage loans increased \$277 million, or 21%, primarily due to the addition of loans from the greater Washington, DC area acquisition. Payoffs in our existing portfolio, which will continue throughout 2006, reduced the impact of the additional loans acquired. Additionally, the transfer of residential mortgages to held for sale at the end of September will reduce the size of this loan portfolio moving forward.

Growing core checking deposits as a lower cost-funding source and as the cornerstone product to build customer relationships is the primary objective of our deposit strategy. Average total deposits increased \$3.6 billion, or 8%, compared with the first nine months of 2005. The deposit growth was driven by increases in the number of checking relationships and the recapture of consumer certificate of deposit balances as interest rates have risen.

During this current rate environment, we expect the rate of growth in demand deposit balances to be equal to or less than the rate of growth for customer checking relationships. Additionally, we expect to see customers shift their funds from lower yielding interest-bearing deposits to higher yielding deposits or investment

products, and to pay off loans. The shift has been evident during the past year and has impacted the level of average demand deposits in that period.

- Certificates of deposits increased \$2.5 billion and money market deposits increased \$1.3 billion. These increases were attributable to the current interest rate environment attracting customers back into these products.
- Average demand deposit growth of \$.3 billion, or 2%, was driven by a \$.5 billion increase from the expansion into the greater Washington, DC area and a decline of \$.2 billion in the core business due to customers shifting funds into higher yielding deposits, small business sweep checking products, and investment products.
- Small business and consumer-related checking relationships retention remains strong and stable. Consumer-related checking relationship retention has benefited from improved penetration rates of debit cards, online banking and online bill payment.

Assets under management of \$52 billion at September 30, 2006 increased \$2 billion compared with the balance at September 30, 2005. The effect of comparatively higher equity markets more than offset client net asset outflows. Client net asset outflows are the result of ordinary course distributions from trust and investment management accounts and account closures exceeding investment additions from new and existing clients.

Nondiscretionary assets under administration of \$89 billion at September 30, 2006 increased \$4 billion compared with the balance at September 30, 2005. The effect of comparatively higher equity markets combined with client net positive asset inflows accounted for the increase.

**Table of Contents****CORPORATE & INSTITUTIONAL BANKING***(Unaudited)*

Nine months ended September 30

Taxable-equivalent basis

Dollars in millions except as noted	2006	2005
<b>INCOME STATEMENT</b>		
Net interest income	\$530	\$555
Noninterest income		
Corporate service fees	377	280
Other	171	142
Noninterest income	548	422
Total revenue	1,078	977
Provision for (recoveries of) credit losses	36	(53)
Noninterest expense	550	481
Pretax earnings	492	549
Income taxes	158	177
Earnings	\$334	\$372
<b>AVERAGE BALANCE SHEET</b>		
Loans		
Corporate (a)	\$9,835	\$10,934
Commercial real estate	2,786	2,178
Commercial real estate related	2,515	2,021
Asset-based lending	4,424	4,195
Total loans (a)	19,560	19,328
Loans held for sale	869	694
Goodwill and other intangible assets	1,336	997
Other assets	4,472	4,284
Total assets	\$26,237	\$25,303
Deposits		
Noninterest-bearing demand	\$6,623	\$5,856
Money market	2,321	2,597
Other	902	678
Total deposits	9,846	9,131
Commercial paper (b)		2,284
Other liabilities	3,683	3,330
Capital	1,950	1,702
Total funds	\$15,479	\$16,447

Earnings from Corporate & Institutional Banking for the first nine months of 2006 totaled \$334 million compared with \$372 million for the first nine months of 2005. This decline was primarily attributable to the benefit of a \$53 million loan recovery recognized in the second quarter of 2005 compared with a \$36 million provision for credit losses in the first nine months of 2006. In addition to the negative impact of the \$89 million change in the provision for credit losses, total revenue increased \$101 million and noninterest expenses grew by \$69 million for the first nine months of 2006 compared with the first nine months of 2005.

Nine months ended September 30

Taxable-equivalent basis

Dollars in millions except as noted	2006	2005
<b>PERFORMANCE RATIOS</b>		



Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Return on average capital	23%	29%
Noninterest income to total revenue	51	43
Efficiency	51	49
<b>COMMERCIAL MORTGAGE SERVICING PORTFOLIO (in billions)</b>		
Beginning of period	\$136	\$98
Acquisitions/additions	69	53
Repayments/transfers	(25)	(25)
End of period	\$180	\$126
<b>OTHER INFORMATION</b>		
Consolidated revenue from: (c)		
Treasury Management	\$316	\$305
Capital Markets	\$204	\$113
Midland Loan Services	\$131	\$103
Total loans (a) (d)	\$20,405	\$21,084
Nonperforming assets (d) (e)	\$94	\$67
Net charge-offs (recoveries)	\$30	\$(51)
Full-time employees (d)	1,925	1,740
Net gains on commercial mortgage loan sales	\$37	\$48
Net carrying amount of commercial mortgage servicing rights (d)	\$414	\$297

(a) Includes lease financing and Market Street. Effective October 17, 2005, Market Street was deconsolidated from our Consolidated Balance Sheet.

(b) Amount for 2005 includes Market Street.

(c) Represents consolidated PNC amounts.

(d) At September 30.

(e) Includes nonperforming loans of \$81 million at September 30, 2006 and \$48 million at September 30, 2005.

Highlights of the first nine months of 2006 for Corporate & Institutional Banking included:

- Average loan balances increased \$232 million, or 1%, over 2005. The prior year average included \$2.1 billion in loans from the Market Street Funding commercial paper conduit that was deconsolidated in October 2005. Excluding the impact of deconsolidating the conduit, average loan balances increased 13%. The growth in loans was driven by continuing customer demand, increasing utilization and our expansion into the greater Washington, DC area in May 2005. Based upon the impact of increasing competitive pressures and shrinking loan spreads on PNC's risk reward criteria, the rate of loan growth has slowed from that experienced in the first half of 2006 and we expect this trend to continue during the remainder of the year.
- Average deposits increased \$715 million, or 8%, over the comparable prior year period driven by growth in our commercial mortgage servicing portfolio and related deposits and the sale of treasury management products. Corporate & Institutional Banking has experienced a modest decline in interest-bearing deposits as more clients improve the management of their overall liquidity given the higher rate environment. This trend in interest-bearing deposits is anticipated to reverse during the remainder of 2006 due to new business activities.
- Total revenue increased 10% compared with 2005 as strong growth in fee income offset a decline in taxable-equivalent net interest income. Fee income growth was driven by increases in merger and acquisition advisory activity, capital market-related activities, treasury management products and services, and commercial mortgage servicing.

**Table of Contents**

Commercial mortgage servicing revenue, which includes fees and net interest income, totaled \$131 million for the first nine months of 2006. The 27% revenue growth over the first nine months of 2005 was driven by growth in the commercial mortgage servicing portfolio, which increased to \$180 billion, and other commercial real estate related services.

Taxable-equivalent net interest income declined \$25 million, to \$530 million, for the first nine months of 2006 compared with the first nine months of 2005. This decline was attributable to narrowing loan and interest-bearing deposits spreads, an increase in goodwill and other intangible assets, the deconsolidation of Market Street Funding, and lower average interest-bearing deposit volumes partially offset by an increase in average loans outstanding and average noninterest-bearing demand deposits.

Noninterest income totaled \$548 million in the first nine months of 2006, an increase of \$126 million, or 30%, compared with the prior year first nine months. The increase in corporate service fees reflects fee income attributable to the Harris Williams acquisition completed in October 2005 and growth in net commercial mortgage servicing and treasury management, partially offset by lower loan syndications income. Improved trading results modestly offset by a decline in net gains on commercial mortgage loan sales drove the increase in other noninterest income.

The provision for credit losses was \$36 million for the first nine months of 2006 compared with a credit of \$53 million for the first nine months of 2005. The prior year provision reflected the impact of a \$53 million loan recovery recognized in the second quarter of 2005. The higher provision for credit losses in the first nine months of 2006 reflected \$30 million of net chargeoffs during this period. Nonperforming assets at September 30, 2006 increased \$27 million compared with September 30, 2005, and are below levels at December 31, 2005. Based on the assets we currently hold and current business trends and activities, we believe that overall asset quality will remain strong at least for the near term.

Noninterest expense increased 14%, compared with the first nine months of 2005. The increases in noninterest expense and full-time employees were primarily due to acquisition activity, customer growth and the increase in the commercial mortgage servicing portfolio.

See the additional revenue discussion regarding treasury management and capital markets-related products and services and commercial loan servicing on page 9.

**Table of Contents****BLACKROCK** (Unaudited)

Nine months ended September 30

Taxable-equivalent basis

Dollars in millions except as noted	2006	2005
<b>INCOME STATEMENT</b>		
Investment advisory and administrative fees	\$938	\$698
Other income	141	124
Total operating revenue	1,079	822
Operating expense (a)	732	553
Fund administration and servicing costs	32	32
Total expense (a)	764	585
Operating income	315	237
Nonoperating income	24	32
Pretax earnings	339	269
Minority interest	2	2
Income taxes	128	100
Earnings (a)	\$209	\$167
<b>PERIOD-END BALANCE SHEET (b)</b>		
Investment in BlackRock	\$3,836	
Goodwill and other intangible assets	29	\$492
Other assets		1,181
Total assets	\$3,865	\$1,673
Liabilities and minority interest	\$1,541	\$806
Stockholders' equity	2,324	867
Total liabilities and stockholders' equity	\$3,865	\$1,673
Return on average equity	29%	28%

- (a) BlackRock reported GAAP earnings of \$153 million and \$161 million for the nine months ended September 30, 2006 and September 30, 2005, respectively. For this PNC business segment reporting presentation, pretax integration costs incurred by BlackRock for the MLIM transaction totaling \$91 million for the nine months ended September 30, 2006 have been reclassified from BlackRock to Other. Similarly, pretax integration costs of \$9 million related to BlackRock's January 2005 acquisition of State Street Research and Management (SSRM) have been reclassified from BlackRock to Other for the nine months ended September 30, 2005. The following is a reconciliation of BlackRock's earnings as reported in this PNC business segment reporting presentation to BlackRock's reported GAAP earnings (in millions):

Nine months ended September 30	2006	2005
BlackRock earnings, as reported in PNC's business reporting presentation	\$209	\$167
Less: BlackRock/MLIM transaction integration costs, after-tax	56	
Less: SSRM acquisition integration costs, after-tax		6
BlackRock reported GAAP earnings	\$153	\$161

- (b) We deconsolidated BlackRock effective September 29, 2006. As of September 30, 2006, we recorded our 34% ownership interest in BlackRock under the equity method of accounting. Goodwill and other intangible assets of \$29 million at September 30, 2006 consist of goodwill recognized as a result of changes in our ownership interest in BlackRock. See Note 6 Goodwill And Other Intangible Assets in the Notes To Consolidated Financial Statements in this Report for additional information.

BlackRock reported GAAP net income of \$153 million for the first nine months of 2006 and \$161 million for the first nine months of 2005. BlackRock's reported net income for the first nine months of 2006 and 2005 included after-tax MLIM and SSRM integration costs of \$56 million and \$6 million, respectively. The BlackRock business segment earned \$209 million in the first nine months of 2006 and \$167 million for the

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

first nine months of 2005 excluding the impact of these costs, which we have reported in Other for PNC business segment reporting. The remainder of this discussion of BlackRock business segment results for these periods excludes the impact of MLIM and SSRM integration costs.

Higher earnings in 2006 reflected higher investment advisory and administrative fees due to an increase in assets under management and increased performance fees. These factors more than offset increased compensation and benefits expense, general and administration expense, and a one-time expense of \$34 million incurred in the first quarter of 2006 related to the January 2005 acquisition of SSRM.

Total operating revenue increased \$257 million, or 31%, in the first nine months of 2006 compared with the prior year period. The impact of higher assets under management and increased investment advisory and administrative fees in 2006 was reflected in the significantly higher revenue. The increase in investment advisory and administrative fees was the result of increases in fees earned across all asset classes as well as increased performance fees principally related to a large institutional real estate equity client account and an energy equity hedge fund acquired in the 2005 SSRM transaction.

Total expense for the first nine months of 2006 increased \$179 million, or 31%, compared with the first nine months of 2005, primarily due to an increase in compensation and benefits. This increase reflected higher incentive compensation associated with higher performance fees and increased operating income growth, and higher salaries and benefits primarily attributable to higher staffing levels associated with business growth. Higher general and administration expense and the SSRM one-time expense of \$34 million recognized in 2006 were also evident in the increase over the first nine months of 2005.

We refer you to the BlackRock/MLIM Transaction section of the Executive Summary section of this Financial Review for further information related to this transaction that closed on September 29, 2006. Information on this transaction is also included in Note 2 Acquisitions in the Notes To Consolidated Financial Statements included in this Report.

BlackRock is listed on the New York Stock Exchange under the symbol BLK. Additional information about BlackRock is available in its SEC filings, which can be found at [www.sec.gov](http://www.sec.gov) and on BlackRock's website, [www.blackrock.com](http://www.blackrock.com).

**Table of Contents****PFPC (Unaudited)**

Nine months ended September 30

Dollars in millions except as noted	2006	2005
<b>INCOME STATEMENT</b>		
Servicing revenue	\$663	\$662
Other revenue		10
Total operating revenue	663	672
Operating expense	496	510
Amortization of other intangibles, net	10	10
Total expense	506	520
Operating income	157	152
Debt financing	32	28
Nonoperating income (expense) (a)	3	(7)
Pretax earnings	128	117
Income taxes	35	42
Earnings	\$93	\$75
<b>PERIOD-END BALANCE SHEET</b>		
Goodwill and other intangible assets	\$1,015	\$1,029
Other assets	1,038	1,053
Total assets	\$2,053	\$2,082
Debt financing	\$813	\$939
Other liabilities	772	799
Shareholder's equity	468	344
Total funds	\$2,053	\$2,082
<b>PERFORMANCE RATIOS</b>		
Return on average equity	31%	34%
Operating margin (b)	24	23
<b>SERVICING STATISTICS (at September 30)</b>		
Accounting/administration net fund assets (in billions) (c)		
Domestic	\$695	\$726
Offshore	79	67
Total	\$774	\$793
Asset type (in billions)		
Money market	\$260	\$333
Equity	331	284
Fixed income	111	114
Other	72	62
Total	\$774	\$793
Custody fund assets (in billions)	\$399	\$475
Shareholder accounts (in millions)		
Transfer agency	18	19
Subaccounting	48	40
Total	66	59
<b>OTHER INFORMATION</b>		
Full-time employees (at September 30)	4,317	4,457

(a) Net of nonoperating expense.

(b) Operating income divided by total operating revenue.

(c) Includes alternative investment net assets serviced.

PFPC's earnings of \$93 million in the first nine months of 2006 increased \$18 million, or 24%, compared with the first nine months of 2005. Earnings for the 2006 period included the impact of a \$14 million reversal of deferred taxes related to earnings from a foreign subsidiary following management's determination that the earnings would be indefinitely reinvested outside of the United States. In addition, higher earnings in the first nine months of 2006 reflected servicing revenue contributions from several growth areas of the business and the successful implementation of expense control initiatives which improved the company's operating margin. Earnings for the first nine months of 2005 included a \$3 million tax benefit identified as part of the One PNC initiative.

Highlights of PFPC's performance in the first nine months of 2006 included:

- Offshore revenues increased 30% compared with the first nine months of 2005 fueled by new business in the alternative arena.
- Managed account service revenue increased 30% as assets serviced increased by 70%.
- Subaccounting revenues were up 13% as shareholder accounts grew by 20%.

Servicing revenue for the first nine months of 2006 increased slightly over the first nine months of 2005, to \$663 million. Excluding the \$9 million comparative decline in revenue related to out-of-pocket and pass-through items that had no impact on earnings, servicing revenue increased \$10 million compared with the first nine months of 2005. Revenue increases related to offshore activities, custody, managed account services, subaccounting and securities lending drove the higher servicing revenue in 2006, partially offset by a decline in fund accounting and transfer agency revenue due to loss of clients and price concessions.

Operating expense declined \$14 million, to \$496 million, in the first nine months of 2006 compared with the first nine months of 2005. Out-of-pocket and pass-through items declined by \$9 million. The remainder of the decline is attributable to expense control and efficiencies implemented during the past year that resulted in a lower head count and associated lower compensation costs.

The decreases in domestic accounting/administration net fund assets and custody fund assets at September 30, 2006 compared with September 30, 2005 resulted primarily from the deconversion of a major client during the first quarter of 2006, which was partially offset by new business, asset inflows from existing customers, and equity market appreciation. Subaccounting shareholder accounts serviced by PFPC increased over the year-earlier period due to net new business and growth in existing client accounts. Total assets serviced by PFPC amounted to \$2.0 trillion at September 30, 2006 and \$1.8 trillion at September 30, 2005.

PFPC's performance is partially dependent on the underlying performance of its fund clients and, in particular, their ability to attract and retain customers. As a result, to the extent that PFPC clients' businesses are adversely affected by ongoing governmental investigations into the practices of the mutual and hedge fund industries, PFPC's results also could be adversely impacted. In addition, this regulatory and business environment is likely to continue to result in operating margin pressure for our various services.

**Table of Contents**

***CRITICAL ACCOUNTING POLICIES AND JUDGMENTS***

Note 1 Accounting Policies in the Notes To Consolidated Financial Statements included in Part I, Item 1 of this Report and in Part II, Item 8 of our 2005 Form 10-K describe the most significant accounting policies that we use. Certain of these policies require us to make estimates and strategic or economic assumptions that may prove inaccurate or be subject to variations that may significantly affect our reported results and financial position for the period or in future periods.

We must use estimates, assumptions, and judgments when financial assets and liabilities are required to be recorded at, or adjusted to reflect, fair value. Assets and liabilities carried at fair value inherently result in a higher degree of financial statement volatility. Fair values and the information used to record valuation adjustments for certain assets and liabilities are based on either quoted market prices or are provided by other independent third-party sources, when available. When such third-party information is not available, we estimate fair value primarily by using cash flow and other financial modeling techniques. Changes in underlying factors, assumptions, or estimates in any of these areas could materially impact our future financial condition and results of operations.

We discuss the following critical accounting policies and judgments under this same heading in Item 7 of our 2005 Form 10-K:

- Allowances for loan and lease losses and unfunded loan commitments and letters of credit
- Private equity asset valuation
- Lease residuals
- Goodwill
- Revenue recognition
- Income taxes
- Legal contingencies

Additional discussion and information on the application of these policies is found in other portions of this Financial Review and in the Notes To Consolidated Financial Statements in Part I, Item 1 of this Report.

***STATUS OF QUALIFIED DEFINED BENEFIT PENSION PLAN***

We have a noncontributory, qualified defined benefit pension plan ( plan or pension plan ) covering eligible employees. Retirement benefits are derived from a cash balance formula based on compensation levels, age and length of service. Pension contributions are based on an actuarially determined amount necessary to fund total benefits payable to plan participants. Plan assets are currently approximately 60% invested in equity investments with most of the remainder invested in fixed income instruments. Plan fiduciaries determine and review the plan s investment policy.

We calculate the expense associated with the pension plan in accordance with Statement of Financial Accounting Standards No. ( SFAS ) 87, Employers Accounting for Pensions, and we use assumptions and methods that are compatible with the requirements of SFAS 87, including a policy of reflecting trust assets at their fair market value. On an annual basis, we review the actuarial assumptions related to the pension plan, including the discount rate, rate of compensation increase and the expected return on plan assets. Neither the discount rate nor the compensation increase assumptions significantly affect pension expense.

The expected long-term return on assets assumption does significantly affect pension expense. We decreased the expected long-term return on plan assets assumption from the 8.5% used for 2005 to 8.25% for determining net periodic cost for 2006. This change will increase pension expense in 2006 by approximately \$4 million. Also, under current accounting rules, the differences between expected long-term returns and actual returns are accumulated and amortized to pension expense over future periods. Each one percentage point difference between our actual return and the expected return causes our expense in the following year to change by approximately \$3 million.

The table below reflects the estimated effects on current year pension expense of certain changes in assumptions, using 2006 estimated expense as a baseline.

Change in Assumption	Estimated Increase to 2006 Pension Expense
----------------------	--

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

	(in millions)
.5% decrease in discount rate	\$2
.5% decrease in expected long-term return on assets	8
.5% increase in compensation rate	1

We currently estimate a pretax pension benefit of \$12 million in 2006 compared with a pretax benefit of \$8 million in 2005. Actual pension benefit recognized for the first nine months of 2006 totaled \$9 million.



**Table of Contents**

Plan asset investment performance has the most impact on contribution requirements. However, contribution requirements are not particularly sensitive to actuarial assumptions. Investment performance will drive the amount of permitted contributions in future years. Also, current law sets limits as to both minimum and maximum contributions to the plan. In any event, any large near-term contributions to the plan will be at our discretion, as we currently expect that the minimum required contributions under the law will be minimal or zero for several years.

In September 2006, the FASB issued SFAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. This statement affects the accounting and reporting for our qualified pension plan, our nonqualified retirement plans, and our postretirement welfare benefit plans. SFAS 158 requires recognition on the balance sheet of the over- or underfunded position of these plans as the difference between the fair value of plan assets and the related benefit obligations. To the extent that a plan's net funded status differs from the amounts currently recognized on the balance sheet, the difference, net of tax, will be recorded as part of accumulated other comprehensive income or loss ( AOCI ) within the shareholders' equity section of the balance sheet. This guidance also requires the reclassification of any unrecognized actuarial gains and losses and unrecognized prior service costs to AOCI, net of tax. Post-adoption changes in unrecognized actuarial gains and losses as well as unrecognized prior service costs will be recognized in other comprehensive income, net of tax. The current year-end after-tax estimate of adjusting our plans' funded status for any unamortized net actuarial losses and prior service costs is approximately \$200 million. Additionally, each 1% change in pension trust investment returns between now and year-end 2006 will affect this estimate by approximately \$10 million after-tax, and each 10 basis point change in discount rates will affect the current estimate by approximately \$7 million after-tax. SFAS 158 will be effective for PNC as of December 31, 2006, with no restatement permitted for prior year-end reporting periods.

**RISK MANAGEMENT**

We encounter risk as part of the normal course of our business and we design risk management processes to help manage these risks. The Risk Management section included in Item 7 of our 2005 Form 10-K provides a general overview of the risk measurement, control strategies and monitoring aspects of our corporate-level risk management processes. Additionally, our 2005 Form 10-K provides an analysis of the risk management processes for what we view as our primary areas of risk: credit, operational, market and liquidity, as well as a discussion of our use of financial derivatives as part of our overall asset and liability risk management process. In appropriate places within that section, historical performance is also addressed. The following information in this Risk Management section updates our 2005 Form 10-K disclosures in these areas.

**CREDIT RISK MANAGEMENT**

Credit risk represents the possibility that a customer, counterparty or issuer may not perform in accordance with contractual terms. Credit risk is inherent in the financial services business and results from extending credit to customers, purchasing securities, and entering into financial derivative transactions. Credit risk is one of the most common risks in banking and is one of our most significant risks.

**Nonperforming, Past Due And Potential Problem Assets**

See Note 4 Asset Quality in the Notes To Consolidated Financial Statements of this Report and included here by reference for details of the types of nonperforming assets that we held at September 30, 2006 and December 31, 2005. In addition, certain performing assets have interest payments that are past due or have the potential for future repayment problems.

Total nonperforming assets at September 30, 2006 decreased \$25 million, to \$191 million, compared with December 31, 2005 driven by a \$23 million decrease in nonperforming loans.

Foreclosed lease assets of \$12 million at September 30, 2006 and \$13 million at December 31, 2005 primarily represent our repossession of collateral related to a single airline industry credit. This repossessed collateral is currently being leased.

The amount of nonperforming loans that was current as to principal and interest was \$93 million at September 30, 2006 and \$115 million at December 31, 2005. While we believe that overall asset quality will remain strong for the near term, we anticipate an increase in nonperforming loans going forward. The current level of asset quality is not sustainable for the foreseeable future.



**Table of Contents****Nonperforming Assets By Business**

In millions	Sept. 30 2006	Dec. 31 2005
Retail Banking	\$95	\$90
Corporate & Institutional Banking	94	124
Other	2	2
Total nonperforming assets	\$191	\$216

**Change In Nonperforming Assets**

In millions	2006	2005
January 1	\$216	\$175
Transferred from accrual	182	182
Returned to performing	(15)	(11)
Principal activity including payoffs	(93)	(128)
Asset sales	(14)	(11)
Charge-offs and valuation adjustments	(85)	(51)
September 30	\$191	\$156

**Accruing Loans And Loans Held For Sale Past Due 90 Days Or More**

Dollars in millions	Amount		Percent of Total Outstandings	
	Sept. 30 2006	Dec. 31 2005	Sept. 30 2006	Dec. 31 2005
Commercial	\$12	\$12	.06%	.06%
Commercial real estate	2	2	.06	.06
Consumer	23	22	.14	.14
Residential mortgage	8	10	.15	.14
Other	2		.58	
Total loans	47	46	.10	.09
Loans held for sale	8	47	.19	1.92
Total loans and loans held for sale	\$55	\$93	.10%	.18%

Loans that are not included in nonperforming or past due categories but cause us to be uncertain about the borrower's ability to comply with existing repayment terms over the next six months totaled \$23 million at September 30, 2006 compared with \$67 million at December 31, 2005. Approximately 45% of these loans are in the Corporate & Institutional Banking portfolio.

**Allowances For Loan And Lease Losses And Unfunded Loan Commitments And Letters Of Credit**

We maintain an allowance for loan and lease losses to absorb losses from the loan portfolio. We determine the allowance based on quarterly assessments of the probable estimated losses inherent in the loan portfolio. While we make allocations to specific loans and pools of loans, the total reserve is available for all loan and lease losses.

We refer you to Note 4 Asset Quality in the Notes To Consolidated Financial Statements in this Report regarding changes in the allowance for loan and lease losses and changes in the allowance for unfunded loan commitments and letters of credit for additional information which is included herein by reference.

**Allocation Of Allowance For Loan And Lease Losses**

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

	September 30, 2006		December 31, 2005	
	Loans to	Total	Loans to	Total
Dollars in millions	Allowance	Loans	Allowance	Loans
Commercial	\$455	42.1%	\$489	39.2%
Commercial real estate	31	7.1	32	6.4
Consumer	25	33.6	24	33.1
Residential mortgage	6	10.7	7	14.9
Lease financing	45	5.8	41	5.7
Other	4	.7	3	.7
<b>Total</b>	<b>\$566</b>	<b>100.0%</b>	<b>\$596</b>	<b>100.0%</b>

In addition to the allowance for loan and lease losses, we maintain an allowance for unfunded loan commitments and letters of credit. We report this allowance as a liability on our Consolidated Balance Sheet. We determine this amount using estimates of the probability of the ultimate funding and losses related to those credit exposures. This methodology is similar to the one we use for determining the adequacy of our allowance for loan and lease losses.

The provision for credit losses for the first nine months of 2006 and the evaluation of the allowances for loan and lease losses and unfunded loan commitments and letters of credit as of September 30, 2006 reflected loan growth, changes in loan portfolio composition, the impact of refinements to our reserve methodology, and changes in asset quality. The provision includes amounts for probable losses on loans and credit exposure related to unfunded loan commitments and letters of credit.

We do not expect to sustain asset quality at its current level. However, based on the assets we currently hold and current business trends and activities, we believe that overall asset quality will remain strong by historical standards for at least the near term. This outlook, combined with expected loan growth, may result in an increase in the allowance for loan and lease losses in future periods.

The allowance as a percent of nonperforming loans was 339% and as a percent of total loans was 1.16% at September 30, 2006. The comparable percentages at December 31, 2005 were 314% and 1.21%.

**Table of Contents****Charge-Offs And Recoveries**

Nine months ended

September 30 Dollars

in millions	Charge-offs	Recoveries	Net Charge-offs	Percent of Average Loans
<b>2006</b>				
<b>Commercial</b>	<b>\$85</b>	<b>\$16</b>	<b>\$69</b>	<b>.46%</b>
<b>Commercial real estate</b>	<b>2</b>		<b>2</b>	<b>.09</b>
<b>Consumer</b>	<b>37</b>	<b>11</b>	<b>26</b>	<b>.22</b>
<b>Residential mortgage</b>	<b>2</b>		<b>2</b>	<b>.04</b>
<b>Lease financing</b>		<b>4</b>	<b>(4)</b>	<b>(.19)</b>
<b>Total</b>	<b>\$126</b>	<b>\$31</b>	<b>\$95</b>	<b>.26</b>
<b>2005</b>				
Commercial (a)	\$44	\$76	\$(32)	(.23)%
Commercial real estate		1	(1)	(.05)
Consumer	33	11	22	.18
Residential mortgage	1		1	.02
Lease financing		1	(1)	(.04)
Total	\$78	\$89	\$(11)	(.03)

(a) Includes a \$53 million loan recovery.

We establish reserves to provide coverage for probable losses not considered in the specific, pool and consumer reserve methodologies, such as, but not limited to, industry concentrations and conditions; credit quality trends; recent loss experience in particular sectors of the portfolio; ability and depth of lending management; changes in risk selection and underwriting standards; and the timing of available information. The amount of reserves for these qualitative factors is assigned to loan categories and to business segments based on the relative specific and pool allocation amounts. The amount of reserve allocated for qualitative factors represented 10.6% of the total allowance and .12% of total loans at September 30, 2006.

**CREDIT DEFAULT SWAPS**

Credit default swaps provide, for a fee, an assumption by a third party of a portion of the credit risk related to the underlying financial instruments. We use the contracts to mitigate credit risk associated with commercial lending activities as well as proprietary derivative and convertible bond trading. Credit default swaps are included in the Free-Standing Derivatives table in the Financial Derivatives section of this Risk Management discussion. We realized a net loss of \$10.5 million during the first nine months of 2006 and a minimal net loss during the same period of 2005 in connection with credit default swaps.

**MARKET RISK MANAGEMENT OVERVIEW**

Market risk is the possibility of a loss in earnings or economic value due to adverse movements in market factors such as interest rates, credit spreads, foreign exchange rates, and equity prices.

**MARKET RISK MANAGEMENT INTEREST RATE RISK**

Interest rate risk results primarily from our traditional banking activities of gathering deposits and extending loans. Many factors, including economic and financial conditions, movements in interest rates, and consumer preferences, affect the difference between the interest that we earn on assets and the interest that

we pay on liabilities. Because of repricing term mismatches and embedded options inherent in certain of these products, changes in market interest rates not only affect expected near-term earnings, but the economic values of these assets and liabilities as well.

PNC's Asset and Liability Management group centrally manages interest rate risk subject to interest rate risk limits and certain policies approved by the Asset and Liability Committee and the Risk Committee of the Board.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Sensitivity estimates and market interest rate benchmarks for the third quarter of 2006 and 2005 follow:

### *Interest Sensitivity Analysis*

	Third Quarter 2006	Third Quarter 2005
<b>Net Interest Income Sensitivity Simulation</b>		
Effect on net interest income in first year from gradual interest rate change over following 12 months of:		
100 basis point increase	(2.2)%	.7%
100 basis point decrease	2.0%	(1.1)%
Effect on net interest income in second year from gradual interest rate change over the preceding 12 months of:		
100 basis point increase	(5.1)%	1.2%
100 basis point decrease	4.0%	(4.7)%
<b>Duration of Equity Model</b>		
Base case duration of equity (in years):	.8	(1.5)
<b>Key Period-End Interest Rates</b>		
One-month LIBOR	5.32%	3.86%
Three-year swap	5.05%	4.60%

In addition to measuring the effect on net interest income assuming parallel changes in current interest rates, we routinely simulate the effects of a number of nonparallel interest rate environments. The following Net Interest Income Sensitivity To Alternate Rate Scenarios table reflects the estimated percentage change in net interest income over the next two 12-month periods assuming (i) the PNC Economist's most likely rate forecast, (ii) implied forward rates, which result in an essentially flat rate scenario, and (iii) a Two-Ten Inversion (a 200 basis point inversion between two-year and ten-year rates superimposed on current base rates) scenario. We are inherently sensitive to a flatter or inverted yield curve.

### *Net Interest Income Sensitivity To Alternate Rate Scenarios (for third quarter 2006)*

	PNC Economist	Market Forward	Two-Ten Inversion
First year sensitivity	1.4%	0.8%	(5.1)%
Second year sensitivity	8.2%	3.3%	(5.1)%

## **Table of Contents**

All changes in forecasted net interest income are relative to results in a base rate scenario where current market rates are assumed to remain unchanged over the forecast horizon.

When forecasting net interest income, we make assumptions about interest rates and the shape of the yield curve, the volume and characteristics of new business, and the behavior of existing positions. These assumptions determine the future level of simulated net interest income in the base interest rate scenario and the other interest rate scenarios presented in the table above. These simulations assume that as assets and liabilities mature, they are replaced or repriced at market rates.

The graph below presents the yield curves for the base rate scenario and each of the alternative scenarios one year forward.

Our risk position has become increasingly liability sensitive in part due to the increase in market interest rates and in part due to our balance sheet management strategy. We believe that we have the deposit funding base and balance sheet flexibility to take advantage, where appropriate, of changing interest rates and to adjust to changing market conditions.

### ***MARKET RISK MANAGEMENT    TRADING RISK***

Our trading activities primarily include customer-driven trading in fixed income securities, equities, derivatives, and foreign exchange contracts. They also include the underwriting of fixed income and equity securities and proprietary trading.

We use value-at-risk ( VaR ) as the primary means to measure and monitor market risk in trading activities. The Risk Committee of the Board establishes an enterprise-wide VaR limit on our trading activities.

During the first nine months of 2006, our VaR ranged between \$3.8 million and \$6.8 million, averaging \$5.2 million.

To help ensure the integrity of the models used to calculate VaR for each portfolio and enterprise-wide, we use a process known as backtesting. The backtesting process consists of comparing actual observations of trading-related gains or losses against the VaR levels that were calculated at the close of the prior day. We would expect a maximum of two to three instances a year in which actual losses exceeded the prior day VaR measure. During the first nine months of 2006, there were no such instances at the enterprise-wide level.

The following graph shows a comparison of enterprise-wide trading-related gains and losses against prior day VaR for the period.

**Table of Contents**

Total trading revenue for the first nine months and third quarter of 2006 and 2005 was as follows:

Nine months ended September 30 in millions	2006	2005
Net interest income (loss)	<b>\$(4)</b>	\$7
Noninterest income	<b>150</b>	108
<b>Total trading revenue</b>	<b>\$146</b>	\$115
Securities underwriting and trading (a)	<b>\$14</b>	\$12
Foreign exchange	<b>42</b>	27
Financial derivatives	<b>90</b>	76
<b>Total trading revenue</b>	<b>\$146</b>	\$115
Three months ended September 30 in millions	2006	2005
Net interest income (loss)	<b>\$(1)</b>	\$1
Noninterest income	<b>38</b>	47
<b>Total trading revenue</b>	<b>\$37</b>	\$48
Securities underwriting and trading (a)	<b>\$8</b>	\$2
Foreign exchange	<b>11</b>	10
Financial derivatives	<b>18</b>	36
<b>Total trading revenue</b>	<b>\$37</b>	\$48

(a) Includes changes in fair value for certain loans accounted for at fair value.

Average trading assets and liabilities consisted of the following:

Nine months ended September 30 - in millions	2006	2005
<b>Assets</b>		
Securities (a)	<b>\$1,577</b>	\$1,849
Resale agreements (b)	<b>413</b>	687
Financial derivatives (c)	<b>1,127</b>	746
Loans at fair value (c)	<b>113</b>	
<b>Total assets</b>	<b>\$3,230</b>	\$3,282
<b>Liabilities</b>		
Securities sold short (d)	<b>\$767</b>	\$1,004
Repurchase agreements and other borrowings (e)	<b>744</b>	1,064
Financial derivatives (f)	<b>1,085</b>	797
Borrowings at fair value (f)	<b>29</b>	
<b>Total liabilities</b>	<b>\$2,625</b>	\$2,865
Three months ended September 30 - in millions	2006	2005
<b>Assets</b>		
Securities (a)	<b>\$1,460</b>	\$1,734
Resale agreements (b)	<b>537</b>	411
Financial derivatives (c)	<b>1,220</b>	695
Loans at fair value (c)	<b>168</b>	
<b>Total assets</b>	<b>\$3,385</b>	\$2,840
<b>Liabilities</b>		
Securities sold short (d)	<b>\$867</b>	\$806
Repurchase agreements and other borrowings (e)	<b>708</b>	933
Financial derivatives (f)	<b>1,151</b>	814
Borrowings at fair value (f)	<b>40</b>	
<b>Total liabilities</b>	<b>\$2,766</b>	\$2,553

(a) Included in Interest-earning assets-Other on the Average Consolidated Balance Sheet and Net Interest Analysis.

(b) Included in Federal funds sold and resale agreements.

(c) Included in Noninterest-earning assets-Other.

(d) Included in Other borrowed funds.

(e) Included in Repurchase agreements and Other borrowed funds.



(f) Included in Accrued expenses and other liabilities.

**MARKET RISK MANAGEMENT EQUITY AND OTHER**

**INVESTMENT RISK**

Equity investment risk is the risk of potential losses associated with investing in both private and public equity markets.

**Private Equity**

The private equity portfolio is comprised of investments that vary by industry, stage and type of investment.

At September 30, 2006, private equity investments carried at estimated fair value totaled \$411 million compared with \$449 million at December 31, 2005. As of September 30, 2006, approximately 36% of the amount was invested directly in a variety of companies and approximately 64% was invested in various limited partnerships. Private equity unfunded commitments totaled \$131 million at September 30, 2006 compared with \$78 million at December 31, 2005. The increase resulted from our \$75 million commitment to a new equity fund, PNC Equity Partners II, LP, which has \$226 million of total commitments. Future closings are anticipated into the first half of 2007. Our commitment is expected to be funded over a five-year period. This fund is not consolidated as we have less than a 50% ownership interest. See Note 15 Commitments And Guarantees in the Notes To Consolidated Financial Statements regarding our commitment to PNC Mezzanine Partners III, LP, which is consolidated for financial reporting purposes as PNC has a 57% ownership interest.

**Other Investments**

We also make investments in affiliated and non-affiliated funds with both traditional and alternative investment strategies. The economic values could be driven by either the fixed-income market or the equity markets, or both.

In July 2006, we committed to invest an aggregate of \$100 million in FIM Holdings, LLC ( FIM ) as a non-managing member with a 1.25% ownership interest. FIM was formed to acquire a 51% ownership position in GMAC LLC from General Motors Corporation ( GM ) and to make a purchase of redeemable preferred stock from GMAC LLC. Our commitment, presently unfunded, is subject to satisfaction of certain conditions to the obligations of FIM contained in an agreement between FIM and GM. The current timetable for the closing and funding of this investment is the fourth quarter of 2006. However, delays in satisfying pre-closing conditions included in the agreements, including regulatory approval, may delay this investment until 2007.

**LIQUIDITY RISK MANAGEMENT**

Liquidity risk is the risk of potential loss if we were unable to meet our funding requirements at a reasonable cost. We manage liquidity risk to help ensure that we can obtain cost-effective funding to meet current and future obligations under both normal business as usual and stressful circumstances.

Our largest source of funding on a consolidated basis is the deposit base that comes from our retail and wholesale banking activities. Other borrowed funds come from a diverse mix of long and short-term funding sources. Liquid assets and unused borrowing capacity from a number of sources are also available to maintain our liquidity position.

## **Table of Contents**

Liquid assets consist of short-term investments (federal funds sold, resale agreements and other short-term investments) and securities available for sale. At September 30, 2006, our liquid assets totaled \$25 billion, with \$10.8 billion pledged as collateral for borrowings, trust, and other commitments.

PNC Bank, N.A. is a member of the Federal Home Loan Bank of Pittsburgh ( FHLB-Pittsburgh ) and as such has access to advances from FHLB-Pittsburgh secured generally by residential mortgages, other real estate related loans, and mortgage-backed securities. At September 30, 2006, our total unused borrowing capacity from FHLB-Pittsburgh under current collateral requirements was \$23.8 billion.

We can also obtain funding through alternative forms of borrowing, including federal funds purchased, repurchase agreements, and short-term and long-term debt issuances. In July 2004, PNC Bank, N.A. established a program to offer up to \$20 billion in senior and subordinated unsecured debt obligations with maturities of more than nine months. Through September 30, 2006, PNC Bank, N.A. had issued \$2.9 billion of debt under this program.

PNC Bank, N.A. established a program in December 2004 to offer up to \$3.0 billion of its commercial paper. As of September 30, 2006, \$110 million of commercial paper was outstanding under this program.

Our parent company's routine funding needs consist primarily of dividends to PNC shareholders, share repurchases, debt service, the funding of non-bank affiliates, and acquisitions.

Parent company liquidity guidelines are designed to help ensure that sufficient liquidity is available to meet these requirements over the succeeding 12-month period. In managing parent company liquidity we consider funding sources, such as expected dividends to be received from PNC Bank, N.A. and potential debt issuance, and discretionary funding uses, the most significant of which is the external dividend to be paid on PNC's stock.

The principal source of parent company cash flow is the dividends it receives from PNC Bank, N.A., which may be impacted by the following:

- Capital needs,
- Laws and regulations,
- Corporate policies,
- Contractual restrictions, and
- Other factors.

Also, there are statutory and regulatory limitations on the ability of national banks to pay dividends or make other capital distributions or to extend credit to the parent company or its non-bank subsidiaries. The amount available for dividend payments to the parent company by PNC Bank, N.A. without prior regulatory approval was approximately \$464 million at September 30, 2006.

In addition to dividends from PNC Bank, N.A., other sources of parent company liquidity include cash and short-term investments, as well as dividends and loan repayments from other subsidiaries. As of September 30, 2006, the parent company had approximately \$348 million in funds available from its cash and short-term investments.

We can also generate liquidity for the parent company and PNC's non-bank subsidiaries through the issuance of securities in public or private markets. At September 30, 2006, we had unused capacity under effective shelf registration statements of approximately \$1.6 billion of debt or equity securities. In October 2006, we issued \$450 million of floating rate senior notes that mature on October 3, 2008. Interest will be reset monthly to 1-month LIBOR plus 2 basis points and will be paid monthly. During the third quarter 2006, \$1.1 billion of parent company senior debt matured.

In July 2006, PNC Funding Corp established a program to offer up to \$3.0 billion of commercial paper to provide the parent company with additional liquidity. As of September 30, 2006, there were no issuances outstanding under this program.

As of September 30, 2006, there were \$350 million of parent company contractual obligations with maturities of less than one year.

In connection with our planned acquisition of Mercantile, we expect to issue approximately \$2.0 billion of parent company debt securities and hybrid capital instruments during the fourth quarter of 2006 and the first quarter of 2007 to fund the cash portion of this transaction.



**Table of Contents****Commitments**

The following tables set forth contractual obligations and various other commitments representing required and potential cash outflows as of September 30, 2006.

**Contractual Obligations**

September 30, 2006 - in millions	Total
Remaining contractual maturities of time deposits	<b>\$18,866</b>
Borrowed funds	<b>14,695</b>
Minimum annual rentals on noncancellable leases	<b>925</b>
Nonqualified pension and postretirement benefits	<b>299</b>
Purchase obligations (a)	<b>270</b>
Total contractual cash obligations	<b>\$35,055</b>

(a) Includes purchase obligations for goods and services covered by noncancellable contracts and contracts including cancellation fees.

**Other Commitments (a)**

September 30, 2006 - in millions	Total Amounts Committed
Credit commitments	<b>\$43,804</b>
Standby letters of credit	<b>4,416</b>
Other commitments (b)	<b>173</b>
Total commitments	<b>\$48,393</b>

(a) Other commitments are funding commitments that could potentially require performance in the event of demands by third parties or contingent events.

Loan commitments are reported net of participations, assignments and syndications.

(b) Includes equity funding commitments related to equity management and affordable housing.

**FINANCIAL DERIVATIVES**

We use a variety of financial derivatives as part of the overall asset and liability risk management process to help manage interest rate, market and credit risk inherent in our business activities. Substantially all such instruments are used to manage risk related to changes in interest rates. Interest rate and total return swaps, interest rate caps and floors and futures contracts are the primary instruments used by us for interest rate risk management.

Financial derivatives involve, to varying degrees, interest rate, market and credit risk. For interest rate swaps and total return swaps, options and futures contracts, only periodic cash payments and, with respect to options, premiums, are exchanged. Therefore, cash requirements and exposure to credit risk are significantly less than the notional amount on these instruments. Further information on our financial derivatives, including the credit risk amounts of these derivatives as of September 30, 2006 and December 31, 2005, is presented in Note 1 Accounting Policies and Note 10 Financial Derivatives in the Notes To Consolidated Financial Statements in Part I, Item 1 of this Report.

Not all elements of interest rate, market and credit risk are addressed through the use of financial or other derivatives, and such instruments may be ineffective for their intended purposes due to unanticipated market characteristics, among other reasons.

**Table of Contents**

The following tables provide the notional amount and fair value of financial derivatives used for risk management and designated as accounting hedges as well as free-standing derivatives at September 30, 2006 and December 31, 2005. Weighted-average interest rates presented are based on contractual terms, if fixed, or the implied forward yield curve at each respective date, if floating.

**Financial Derivatives - 2006**

September 30, 2006 - dollars in millions	Notional/ Contract Amount	Net Fair Value	Weighted Average Maturity	Weighted-Average Interest Rates	
				<b>Paid</b>	<b>Received</b>
<b>Accounting Hedges</b>					
Interest rate risk management					
Asset rate conversion					
Interest rate swaps (a)					
Receive fixed	\$7,218	\$22	3 yrs. 11 mos.	4.96%	5.09%
Pay fixed					
Interest rate floors (b)	7		4 yrs. 6 mos.	NM	NM
Forward purchase commitments					
Futures contracts					
	67		9 mos.	NM	NM
Total asset rate conversion	7,292	22			
Liability rate conversion					
Interest rate swaps (a)					
Receive fixed	4,245	4	7 yrs. 2 mos.	5.11	5.43
Total liability rate conversion	4,245	4			
Total interest rate risk management	11,537	26			
Commercial mortgage banking risk management					
Pay fixed interest rate swaps (a)	274	(8)	8 yrs. 10 mos.	5.44	5.05
Pay total return swaps designated to loans held for sale (a)	150	(1)	1 mo.	NM	4.99
Total commercial mortgage banking risk management	424	(9)			
Total accounting hedges (c)	\$11,961	\$17			
<b>Free-Standing Derivatives</b>					
Customer-related					
Interest rate					
Swaps					
	\$47,041	\$10	4 yrs. 8 mos.	4.95%	4.98%
Caps/floors					
Sold					
	1,814	(4)	6 yrs. 1 mos.	NM	NM
Purchased					
	893	3	7 yrs. 4 mos.	NM	NM
Futures					
	3,485		6 mos.	NM	NM
Foreign exchange					
	4,868	3	7 mos.	NM	NM
Equity					
	3,029	(35)	1 yr. 3 mos.	NM	NM
Swaptions					
	7,409	15	7 yrs. 2 mos.	NM	NM
Other					
	20		10 yrs. 9 mos.	NM	NM
Total customer-related	68,559	(8)			
Other risk management and proprietary					
Interest rate					
Swaps					
	19,037	(26)	6 yrs. 11 mos.	4.80%	4.94%
Caps/floors					
Sold					
	6,000	(54)	3 yrs. 3 mos.	NM	NM
Purchased					
	6,510	64	3 yrs. 4 mos.	NM	NM
Futures					
	13,451	(6)	1 yr. 4 mos.	NM	NM

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Foreign exchange					
Credit derivatives	3,230	(8)	7 yrs. 5 mos.	NM	NM
Risk participation agreements	685		5 yrs. 10 mos.	NM	NM
Commitments related to mortgage-related assets	1,574	36	3 mos.	NM	NM
Options					
Futures	30,827	(5)	8 mos.	NM	NM
Swaptions	15,635	59	8 yrs. 7 mos.	NM	NM
Total other risk management and proprietary	96,949	60			
Total free-standing derivatives	\$165,508	\$52			

(a) The floating rate portion of interest rate contracts is based on money-market indices. As a percent of notional amount, 68% were based on 1-month LIBOR, 32% on 3-month LIBOR.

(b) Interest rate floors have a weighted-average strike of 3.21%.

(c) Fair value amounts include accrued interest of \$43 million.

NM Not meaningful

**Table of Contents****Financial Derivatives - 2005**

December 31, 2005 - dollars in millions	Notional/ Contract Amount	Net Fair Value	Weighted Average Maturity	Weighted-Average	
				Interest Rates Paid	Interest Rates Received
<b>Accounting Hedges</b>					
Interest rate risk management					
Asset rate conversion					
Interest rate swaps (a)					
Receive fixed	\$2,926	\$(9)	2 yrs. 10 mos.	4.75%	4.42%
Pay fixed	12		2 yrs. 1 mo.	3.68	4.77
Futures contracts	42		1 yr. 1 mo.	NM	NM
Total asset rate conversion	2,980	(9)			
Liability rate conversion					
Interest rate swaps (a)					
Receive fixed	5,345	84	6 yrs. 5 mos.	4.87	5.37
Total liability rate conversion	5,345	84			
Total interest rate risk management	8,325	75			
Commercial mortgage banking risk management					
Pay fixed interest rate swaps (a)	251	(4)	10 yrs. 9 mos.	5.05	4.88
Pay total return swaps designated to loans held for sale (a)	250	(2)	1 mo.	NM	4.37
Total commercial mortgage banking risk management	501	(6)			
Total accounting hedges (b)	\$8,826	\$69			
<b>Free-Standing Derivatives</b>					
Customer-related					
Interest rate					
Swaps	\$43,868	\$34	4 yrs. 2 mos.	4.69%	4.69%
Caps/floors					
Sold	1,710	(4)	1 yr. 11 mos.	NM	NM
Purchased	1,446	3	11 mos.	NM	NM
Futures	2,570		10 mos.	NM	NM
Foreign exchange	4,687	4	5 mos.	NM	NM
Equity	2,744	(79)	1 yr. 6 mos.	NM	NM
Swaptions	2,559	(1)	8 yrs. 11 mos.	NM	NM
Other	230	1	10 yrs. 8 mos.	NM	NM
Total customer-related	59,814	(42)			
Other risk management and proprietary					
Interest rate					
Swaps	2,369	1	4 yrs. 11 mos.	4.56%	4.65%
Basis swaps	756	1	6 yrs. 10 mos.	4.14	4.85
Pay fixed swaps	2,474	(2)	7 yrs. 7 mos.	4.37	4.57
Caps/floors					
Sold	2,000	(10)	2 yrs. 7 mos.	NM	NM
Purchased	2,310	14	2 yrs. 10 mos.	NM	NM
Futures	10,901	2	1 yr. 2 mos.	NM	NM
Credit derivatives	1,353		4 yrs. 7 mos.	NM	NM
Risk participation agreements	461		3 yrs. 11 mos.	NM	NM
Commitments related to mortgage-related assets	1,695	1	2 mos.	NM	NM
Options					
Futures	33,384	3	5 mos.	NM	NM

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Swaptions	15,440	30	7 yrs. 7 mos.	NM	NM
Other	24	4	4 mos.	NM	NM
Total other risk management and proprietary	73,167	44			
Total free-standing derivatives	\$132,981	\$2			

(a) The floating rate portion of interest rate contracts is based on money-market indices. As a percent of notional amount, 67% were based on 1-month LIBOR, 33% on 3-month LIBOR.

(b) Fair value amounts include accrued interest of \$81 million.

NM Not meaningful



## **Table of Contents**

### ***INTERNAL CONTROLS AND DISCLOSURE CONTROLS AND PROCEDURES***

As of September 30, 2006, we performed an evaluation under the supervision and with the participation of our management, including the Chairman and Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures and of changes in our internal control over financial reporting.

Based on that evaluation, our management, including the Chairman and Chief Executive Officer and the Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2006, and that there has been no change in internal control over financial reporting that occurred during the third quarter of 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### ***GLOSSARY OF TERMS***

Accounting/administration net fund assets - Net domestic and foreign fund investment assets for which we provide accounting and administration services. We do not include these assets on our Consolidated Balance Sheet.

Adjusted average total assets - Primarily comprised of total average quarterly (or annual) assets plus (less) unrealized losses (gains) on available-for-sale debt securities, less goodwill and certain other intangible assets.

Annualized - Adjusted to reflect a full year of activity.

Assets under management - Assets over which we have sole or shared investment authority for our customers/clients. We do not include these assets on our Consolidated Balance Sheet.

Basis point - One hundredth of a percentage point.

Charge-off - Process of removing a loan or portion of a loan from our balance sheet because it is considered uncollectible. We also record a charge-off when a loan is transferred to held for sale and the loan's market value is less than its carrying amount.

Common shareholders' equity to total assets - Common shareholders' equity divided by total assets. Common shareholders' equity equals total shareholders' equity less the liquidation value of preferred stock.

Credit derivatives - Contractual agreements that provide protection against a credit event of one or more referenced credits. The nature of a credit event is established by the protection buyer and protection seller at the inception of a transaction, and such events include bankruptcy, insolvency and failure to meet payment obligations when due. The buyer of the credit derivative pays a periodic fee in return for a payment by the protection seller upon the occurrence, if any, of a credit event.

Custody assets - Investment assets held on behalf of clients under safekeeping arrangements. We do not include these assets on our Consolidated Balance Sheet. Investment assets held in custody at other institutions on our behalf are included in the appropriate asset categories on the Consolidated Balance Sheet as if physically held by us.

Derivatives - Financial contracts whose value is derived from publicly traded securities, interest rates, currency exchange rates or market indices. Derivatives cover a wide assortment of financial contracts, including forward contracts, futures, options and swaps.

Duration of equity - An estimate of the rate sensitivity of our economic value of equity. A negative duration of equity is associated with asset sensitivity (*i.e.*, positioned for rising interest rates), while a positive value implies liability sensitivity (*i.e.*, vulnerable to rising rates). For example, if the duration of equity is +1.5 years, the economic value of equity declines by 1.5% for each 100 basis point increase in interest rates.

Earning assets - Assets that generate income, which include: federal funds sold; resale agreements; other short-term investments, including trading securities; loans held for sale; loans, net of unearned income; securities; and certain other assets.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Economic capital - Represents the amount of resources that our business segments should hold to guard against potentially large losses that could cause insolvency. It is based on a measurement of economic risk, as opposed to risk as defined by regulatory bodies. The economic capital measurement process involves converting a risk distribution to the capital that is required to support the risk, consistent with our target credit rating. As such, economic risk serves as a common currency of risk that allows us to compare different risks on a similar basis.

Economic value of equity ( EVE ) - The present value of the expected cash flows of our existing assets less the present value of the expected cash flows of our existing liabilities, plus the present value of the net cash flows of our existing off-balance sheet positions.

Effective duration - A measurement, expressed in years, that, when multiplied by a change in interest rates, would approximate the percentage change in value of on- and off- balance sheet positions.

Efficiency - Noninterest expense divided by the sum of net interest income and noninterest income.

Foreign exchange contracts - Contracts that provide for the future receipt and delivery of foreign currency at previously agreed-upon terms.

Funds transfer pricing - A management accounting methodology designed to recognize the net interest income effects of sources and uses of funds provided by the assets and liabilities of our business segments. We assign these balances LIBOR-based funding rates at origination that represent the interest cost for us to raise/invest funds with similar maturity and repricing structures.

## **Table of Contents**

**Futures and forward contracts** - Contracts in which the buyer agrees to purchase and the seller agrees to deliver a specific financial instrument at a predetermined price or yield. May be settled either in cash or by delivery of the underlying financial instrument.

**GAAP** - Accounting principles generally accepted in the United States of America.

**Interest rate floors and caps** - Interest rate protection instruments that involve payment from the seller to the buyer of an interest differential, which represents the difference between a short-term rate (e.g., three-month LIBOR) and an agreed-upon rate (the strike rate) applied to a notional principal amount.

**Interest rate swap contracts** - Contracts that are entered into primarily as an asset/liability management strategy to reduce interest rate risk. Interest rate swap contracts are exchanges of interest rate payments, such as fixed-rate payments for floating-rate payments, based on notional principal amounts.

**Intrinsic value** - The amount by which the fair value of an underlying stock exceeds the exercise price of an option on that stock.

**Leverage ratio** - Tier 1 risk-based capital divided by adjusted average total assets.

**Net interest margin** - Annualized taxable-equivalent net interest income divided by average earning assets.

**Nondiscretionary assets under administration** - Assets we hold for our customers/clients in a non-discretionary, custodial capacity. We do not include these assets on our Consolidated Balance Sheet.

**Noninterest income to total revenue** - Noninterest income divided by the sum of net interest income and noninterest income.

**Nonperforming assets** - Nonperforming assets include nonaccrual loans, troubled debt restructured loans, nonaccrual loans held for sale, foreclosed assets and other assets. We do not accrue interest income on assets classified as nonperforming.

**Nonperforming loans** - Nonperforming loans include loans to commercial, commercial real estate, equipment lease financing, consumer, and residential mortgage customers as well as troubled debt restructured loans. Nonperforming loans do not include nonaccrual loans held for sale or foreclosed and other assets. We do not accrue interest income on loans classified as nonperforming.

**Notional amount** - A number of currency units, shares, or other units specified in a derivatives contract.

**Operating leverage** - The period to period percentage change in total revenue less the percentage change in noninterest expense. A positive percentage indicates that revenue growth exceeded expense growth (*i.e.*, positive operating leverage) while a negative percentage implies expense growth exceeded revenue growth (*i.e.*, negative operating leverage).

**Options** - Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to either purchase or sell the associated financial instrument at a set price during a period or at a specified date in the future.

**Recovery** - Cash proceeds received on a loan that we had previously charged off. We credit the amount received to the allowance for loan and lease losses.

**Return on average capital** - Annualized net income divided by average capital.

**Return on average assets** - Annualized net income divided by average assets.

**Return on average common equity** - Annualized net income divided by average common shareholders' equity.

**Risk-weighted assets** - Primarily computed by the assignment of specific risk-weights (as defined by The Board of Governors of the Federal Reserve System) to assets and off-balance sheet instruments.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Securitization - The process of legally transforming financial assets into securities.

Swaptions - Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to enter into an interest rate swap agreement during a period or at a specified date in the future.

Tangible common equity ratio - Period-end common shareholders' equity less goodwill and other intangible assets (excluding mortgage servicing rights) divided by period-end assets less goodwill and other intangible assets (excluding mortgage servicing rights).

Taxable-equivalent interest - The interest income earned on certain assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable asset. To provide more meaningful comparisons of yields and margins for all interest-earning assets, we also provide revenue on a taxable-equivalent basis by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income on other taxable assets. This adjustment is not permitted under GAAP on the Consolidated Income Statement.

Tier 1 risk-based capital - Tier 1 risk-based capital equals: total shareholders' equity, plus trust preferred capital securities, plus certain minority interests that are held by others; less goodwill and certain other intangible assets, less equity investments in nonfinancial companies and less net unrealized holding losses on available-for-sale equity securities. Net unrealized holding gains on available-for-sale equity securities, net unrealized holding gains (losses) on available-for-sale debt securities and net unrealized holding gains (losses) on cash flow hedge derivatives are excluded from total shareholders' equity for tier 1 risk-based capital purposes.

---

## **Table of Contents**

**Tier 1 risk-based capital ratio** - Tier 1 risk-based capital divided by period-end risk-weighted assets.

**Total fund assets serviced** - Total domestic and offshore fund investment assets for which we provide related processing services. We do not include these assets on our Consolidated Balance Sheet.

**Total return swap** - A non-traditional swap where one party agrees to pay the other the total return of a defined underlying asset (e.g., a loan), usually in return for receiving a stream of LIBOR-based cash flows. The total returns of the asset, including interest and any default shortfall, are passed through to the counterparty. The counterparty is therefore assuming the credit and economic risk of the underlying asset.

**Total risk-based capital** - Tier 1 risk-based capital plus qualifying senior and subordinated debt, other minority interest not qualified as tier 1, and the allowance for loan and lease losses, subject to certain limitations.

**Total risk-based capital ratio** - Total risk-based capital divided by period-end risk-weighted assets.

**Transaction deposits** - The sum of money market and interest-bearing demand deposits and demand and other noninterest-bearing deposits.

**Value-at-risk ( VaR )** - A statistically-based measure of risk which describes the amount of potential loss which may be incurred due to severe and adverse market movements. The measure is of the maximum loss which should not be exceeded on 99 out of 100 days.

**Yield curve** - A graph showing the relationship between the yields on financial instruments or market indices of the same credit quality with different maturities. For example, a normal or positive yield curve exists when long-term bonds have higher yields than short-term bonds. A flat yield curve exists when yields are the same for short-term and long-term bonds. A steep yield curve exists when yields on long-term bonds are significantly higher than on short-term bonds. An inverted or negative yield curve exists when short-term bonds have higher yields than long-term bonds.

## ***CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION***

We make statements in this Report, and we may from time to time make other statements, regarding our outlook or expectations for earnings, revenues, expenses and/or other matters regarding or affecting PNC that are forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Forward-looking statements are typically identified by words such as believe, expect, anticipate, intend, outlook, estimate, forecast, project and other similar words and expressions.

Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Forward-looking statements speak only as of the date they are made. We do not assume any duty and do not undertake to update our forward-looking statements. Actual results or future events could differ, possibly materially, from those that we anticipated in our forward-looking statements, and future results could differ materially from our historical performance.

Our forward-looking statements are subject to the following principal risks and uncertainties. We provide greater detail regarding some of these factors in our 2005 Form 10-K and in our current year Form 10-Qs, including in the Risk Factors and Risk Management sections of those reports. Our forward-looking statements may also be subject to other risks and uncertainties, including those discussed elsewhere in this Report or in our other filings with the SEC.

- Our business and operating results are affected by business and economic conditions generally or specifically in the principal markets in which we do business. We are affected by changes in our customers' financial performance, as well as changes in customer preferences and behavior, including as a result of changing economic conditions.
- The value of our assets and liabilities as well as our overall financial performance are affected by changes in interest rates or in valuations in the debt and equity markets. Actions by the Federal Reserve and other government agencies, including those that impact money supply and market interest rates, can affect our activities and financial results.

- Competition can have an impact on customer acquisition, growth and retention, as well as on our credit spreads and product pricing, which can affect market share, deposits and revenues.
- Our ability to implement our One PNC initiative, as well as other business initiatives and strategies we may pursue, could affect our financial performance over the next several years.
- Our ability to grow successfully through acquisitions is impacted by a number of risks and uncertainties related both to the acquisition transactions themselves and to the integration of the acquired businesses into PNC after closing. These uncertainties are present in transactions such as our pending acquisition of Mercantile Bankshares Corporation.

**Table of Contents**

- Legal and regulatory developments could have an impact on our ability to operate our businesses or our financial condition or results of operations or our competitive position or reputation. Reputational impacts, in turn, could affect matters such as business generation and retention, our ability to attract and retain management, liquidity and funding. These legal and regulatory developments could include: (a) the unfavorable resolution of legal proceedings or regulatory and other governmental inquiries; (b) increased litigation risk from recent regulatory and other governmental developments; (c) the results of the regulatory examination process, our failure to satisfy the requirements of agreements with governmental agencies, and regulators' future use of supervisory and enforcement tools; (d) legislative and regulatory reforms, including changes to laws and regulations involving tax, pension, and the protection of confidential customer information; and (e) changes in accounting policies and principles.
- Our business and operating results are affected by our ability to identify and effectively manage risks inherent in our businesses, including, where appropriate, through the effective use of third-party insurance and capital management techniques.
- Our ability to anticipate and respond to technological changes can have an impact on our ability to respond to customer needs and to meet competitive demands.
- The adequacy of our intellectual property protection, and the extent of any costs associated with obtaining rights in intellectual property claimed by others, can impact our business and operating results.
- Our business and operating results can be affected by widespread natural disasters, terrorist activities or international hostilities, either as a result of the impact on the economy and financial and capital markets generally or on us or on our customers, suppliers or other counterparties specifically.
- Also, risks and uncertainties that could affect the results anticipated in forward-looking statements or from historical performance relating to our interest in BlackRock, Inc. are discussed in more detail in BlackRock's 2005 Form 10-K, including in the Risk Factors section, and in BlackRock's other filings with the SEC, accessible on the SEC's website at [www.sec.gov](http://www.sec.gov) and on or through BlackRock's website at [www.blackrock.com](http://www.blackrock.com).

In addition, our pending acquisition of Mercantile Bankshares presents us with a number of risks and uncertainties related both to the acquisition transaction itself and to the integration of the acquired businesses into PNC after closing. These risks and uncertainties include the following:

- Completion of the transaction is dependent on, among other things, receipt of regulatory and Mercantile shareholder approvals, the timing of which cannot be predicted with precision at this point and which may not be received at all. The impact of the completion of the transaction on PNC's financial statements will be affected by the timing of the transaction.
- The transaction may be substantially more expensive to complete (including the integration of Mercantile's businesses) and the anticipated benefits, including anticipated cost savings and strategic gains, may be significantly harder or take longer to achieve than expected or may not be achieved in their entirety as a result of unexpected factors or events.
- The integration of Mercantile's business and operations into PNC, which will include conversion of Mercantile's different systems and procedures, may take longer than anticipated or be more costly than anticipated or have unanticipated adverse results relating to Mercantile's or PNC's existing businesses.
-

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

The anticipated benefits to PNC are dependent in part on Mercantile's business performance in the future, and there can be no assurance as to actual future results, which could be impacted by various factors, including the risks and uncertainties generally related to PNC's and Mercantile's performance (with respect to Mercantile, see Mercantile's SEC reports, accessible on the SEC's website) or due to factors related to the acquisition of Mercantile and the process of integrating it into PNC.

In addition to the pending Mercantile Bankshares transaction, we grow our business from time to time by acquiring other financial services companies. Acquisitions in general present us with risks other than those presented by the nature of the business acquired. In particular, acquisitions may be substantially more expensive to complete (including as a result of costs incurred in connection with the integration of the acquired company) and the anticipated benefits (including anticipated cost savings and strategic gains) may be significantly harder or take longer to achieve than expected. In some cases, acquisitions involve our entry into new businesses or new geographic or other markets, and these situations also present risks resulting from our inexperience in these new areas. As a regulated financial institution, our pursuit of attractive acquisition opportunities could be negatively impacted due to regulatory delays or other regulatory issues. Regulatory and/or legal issues related to the pre-acquisition operations of an acquired business may cause reputational harm to PNC following the acquisition and integration of the acquired business into ours and may result in additional future costs and expenses arising as a result of those issues.



**Table of Contents****CONSOLIDATED INCOME STATEMENT**

THE PNC FINANCIAL SERVICES GROUP, INC.

In millions, except per share data	Three months ended		Nine months ended	
	September 30 2006	2005	September 30 2006	2005
Unaudited				
<b><i>Interest Income</i></b>				
Loans	\$ 838	\$ 718	\$ 2,382	\$ 1,942
Securities available for sale and held to maturity	271	219	769	589
Other	94	58	244	169
Total interest income	1,203	995	3,395	2,700
<b><i>Interest Expense</i></b>				
Deposits	434	270	1,140	676
Borrowed funds	202	166	576	425
Total interest expense	636	436	1,716	1,101
Net interest income	567	559	1,679	1,599
Provision for (recoveries of) credit losses	16	16	82	(3)
Net interest income less provision for (recoveries of) credit losses	551	543	1,597	1,602
<b><i>Noninterest Income</i></b>				
Asset management	381	364	1,271	1,012
Fund servicing	213	218	644	657
Service charges on deposits	81	73	234	199
Brokerage	61	56	183	168
Consumer services	89	76	272	213
Corporate services	157	121	449	342
Equity management gains	21	36	82	80
Net securities losses	(195)	(2)	(207)	(37)
Trading	38	47	150	108
Gain on BlackRock transaction	2,078		2,078	
Other	19	127	202	277
Total noninterest income	2,943	1,116	5,358	3,019
<b><i>Noninterest Expense</i></b>				
Compensation	573	545	1,686	1,505
Employee benefits	86	86	249	255
Net occupancy	79	86	241	231
Equipment	77	73	234	221
Marketing	39	30	81	75
Other	324	339	1,007	912
Total noninterest expense	1,178	1,159	3,498	3,199
Income before minority and noncontrolling interests and income taxes	2,316	500	3,457	1,422
Minority and noncontrolling interests in income (loss) of consolidated entities	(5)	14	23	29
Income taxes	837	152	1,215	423
Net income	\$ 1,484	\$ 334	\$ 2,219	\$ 970
<b><i>Earnings Per Common Share</i></b>				
Basic	\$ 5.09	\$ 1.16	\$ 7.60	\$ 3.40
Diluted	\$ 5.01	\$ 1.14	\$ 7.46	\$ 3.35
<b><i>Average Common Shares Outstanding</i></b>				
Basic	291	289	292	285
Diluted	296	292	297	288

See accompanying Notes To Consolidated Financial Statements.



**Table of Contents****CONSOLIDATED BALANCE SHEET**

THE PNC FINANCIAL SERVICES GROUP, INC.

In millions, except par value	September 30	December 31
	2006	2005
<b>Unaudited</b>		
<b>Assets</b>		
Cash and due from banks	\$ 3,018	\$ 3,518
Federal funds sold and resale agreements	2,818	350
Other short-term investments, including trading securities	2,718	2,543
Loans held for sale	4,317	2,449
Securities available for sale and held to maturity	19,512	20,710
Loans, net of unearned income of \$815 and \$835	48,900	49,101
Allowance for loan and lease losses	(566)	(596)
Net loans	48,334	48,505
Goodwill	3,418	3,619
Other intangible assets	590	847
Investment in BlackRock	3,836	
Other	9,875	9,413
Total assets	\$ 98,436	\$ 91,954
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 14,840	\$ 14,988
Interest-bearing	49,732	45,287
Total deposits	64,572	60,275
Borrowed funds		
Federal funds purchased	3,475	4,128
Repurchase agreements	2,275	1,691
Bank notes and senior debt	2,177	3,875
Subordinated debt	4,436	4,469
Other	2,332	2,734
Total borrowed funds	14,695	16,897
Allowance for unfunded loan commitments and letters of credit	117	100
Accrued expenses	3,855	2,770
Other	4,031	2,759
Total liabilities	87,270	82,801
Minority and noncontrolling interests in consolidated entities	408	590
<b>Shareholders Equity</b>		
Preferred stock (a)		
Common stock - \$5 par value		
Authorized 800 shares, issued 353 shares	1,764	1,764
Capital surplus	1,679	1,358
Retained earnings	10,771	9,023
Deferred compensation expense	(51)	(59)
Accumulated other comprehensive loss	(109)	(267)
Common stock held in treasury at cost: 59 and 60 shares	(3,296)	(3,256)
Total shareholders equity	10,758	8,563
Total liabilities, minority and noncontrolling interests, and shareholders equity	\$ 98,436	\$ 91,954
(a) Less than \$.5 million at each date.		

See accompanying Notes To Consolidated Financial Statements.



**Table of Contents****CONSOLIDATED STATEMENT OF CASH FLOWS**

THE PNC FINANCIAL SERVICES GROUP, INC.

Nine months ended September 30 - in millions

Unaudited	2006	2005
<b>Operating Activities</b>		
Net income	\$ 2,219	\$ 970
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for (recoveries of) credit losses	82	(3)
Depreciation, amortization and accretion	268	277
Deferred income taxes	855	(20)
Net securities losses	207	37
Valuation adjustments	45	(5)
Gain on BlackRock transaction	(2,078)	
Excess tax benefits from share-based payment arrangements	(21)	
Net change in		
Loans held for sale	244	(692)
Other short-term investments	140	(561)
Accrued expenses and other liabilities	(70)	(1,203)
Other	(371)	228
Net cash provided (used) by operating activities	1,520	(972)
<b>Investing Activities</b>		
Repayment of securities	2,663	3,121
Sales		
Securities	10,619	11,627
Loans	27	31
Foreclosed and other nonperforming assets	11	13
Purchases		
Securities	(11,567)	(18,136)
Loans	(875)	(2,273)
Net change in		
Loans	(1,208)	(1,971)
Federal funds sold and resale agreements	(2,468)	1,218
Cash received from divestitures		26
Net cash paid for acquisitions	(55)	(372)
Purchase of corporate and bank-owned life insurance	(300)	
Other	(83)	(217)
Net cash used by investing activities	(3,236)	(6,933)
<b>Financing Activities</b>		
Net change in		
Noninterest-bearing deposits	(148)	(1,169)
Interest-bearing deposits	4,442	4,366
Federal funds purchased	(653)	1,257
Repurchase agreements	583	368
Commercial paper	100	1,196
Other short-term borrowed funds	5	198
Sales/issuances		
Bank notes and senior debt	509	1,873
Subordinated debt		494
Other long-term borrowed funds	274	1,551
Common stock	292	138
Repayments/maturities		
Bank notes and senior debt	(2,200)	(750)

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Subordinated debt		(351)
Other long-term borrowed funds	(1,142)	(466)
Excess tax benefits from share-based payment arrangements	21	
Acquisition of treasury stock	(396)	(127)
Cash dividends paid	(471)	(429)
Net cash provided by financing activities	1,216	8,149
<b><i>Net Increase (Decrease) In Cash And Due From Banks</i></b>	<b>(500)</b>	<b>244</b>
Cash and due from banks at beginning of period	3,518	3,230
Cash and due from banks at end of period	\$ 3,018	\$ 3,474
<b><i>Cash Paid For</i></b>		
Interest	\$ 1,693	\$ 1,040
Income taxes	473	363
<b><i>Non-cash Items</i></b>		
Investment in BlackRock, net	3,126	
Transfer from loans to loans held for sale, net	2,157	10
Transfer from loans to other assets	9	12
See accompanying Notes To Consolidated Financial Statements.		

---

**Table of Contents**

***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)***

THE PNC FINANCIAL SERVICES GROUP, INC.

***BUSINESS***

We are one of the largest diversified financial services companies in the United States based on assets, with businesses engaged in:

- Retail banking,
- Corporate and institutional banking,
- Asset management, and
- Global fund processing services.

We provide many of our products and services nationally and others in our primary geographic markets located in Pennsylvania; New Jersey; the greater Washington, DC area, including Maryland and Virginia; Ohio; Kentucky; and Delaware. We also provide certain global fund processing services internationally. We are subject to intense competition from other financial services companies and are subject to regulation by various domestic and international authorities.

***NOTE 1 ACCOUNTING POLICIES***

**BASIS OF FINANCIAL STATEMENT PRESENTATION**

Our unaudited interim consolidated financial statements include the accounts of the parent company and its subsidiaries, most of which are wholly owned, and certain partnership interests and variable interest entities. See Note 2 Acquisitions regarding the deconsolidation of BlackRock, Inc. ( BlackRock ) from PNC's Consolidated Balance Sheet effective September 29, 2006. Our investment in BlackRock will be accounted for under the equity method of accounting as of that date. We prepared these unaudited interim consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ( generally accepted accounting principles or GAAP ). We have eliminated all significant intercompany accounts and transactions. We have also reclassified certain prior period amounts to conform with the 2006 presentation. These reclassifications did not have a material impact on our consolidated financial condition or results of operations.

In our opinion, the unaudited interim consolidated financial statements reflect all normal, recurring adjustments needed to present fairly our results for the interim periods.

When preparing these unaudited interim consolidated financial statements, we have assumed that you have read the audited consolidated financial statements included in our 2005 Annual Report on Form 10-K.

**SPECIAL PURPOSE ENTITIES**

Special purpose entities are broadly defined as legal entities structured for a particular purpose. We use special purpose entities in various legal forms to conduct normal business activities. Special purpose entities that meet the criteria for a Qualifying Special Purpose Entity ( QSPE ) as defined in Statement of Financial Accounting Standards No. ( SFAS ) 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, are not required to be consolidated. We review special purpose entities that are not QSPEs for consolidation in accordance with Financial

Accounting Standards Board ( FASB ) Interpretation No. 46 (Revised 2003), Consolidation of Variable Interest Entities ( FIN 46R ).

In general, a variable interest entity ( VIE ) is a special purpose entity formed as a corporation, partnership, limited liability corporation, or any other legal structure used to conduct activities or hold assets that either:

- Does not have equity investors with voting rights that can directly or indirectly make decisions about the entity's activities through those voting rights or similar rights, or
- Has equity investors that do not provide enough cash or other financial resources for the entity to support its activities.

A VIE often holds financial assets, including loans or receivables, real estate or other property.

We consolidate a VIE if we are considered to be its primary beneficiary. The primary beneficiary is subject to a majority of the risk of loss from the VIE's activities, is entitled to receive a majority of the entity's residual returns, or both. Upon consolidation of a VIE, we generally record all of the VIE's assets, liabilities and noncontrolling interests at fair value, with future changes based upon consolidation accounting principles. See Note 7 Variable Interest Entities for more information about non-consolidated VIEs in which we hold a significant interest.

#### **BUSINESS COMBINATIONS**

We record the net assets of companies that we acquire at their estimated fair value at the date of acquisition and we include the results of operations of the acquired business in our consolidated income statement from the date of acquisition. We recognize as goodwill the excess of the purchase price over the estimated fair value of the net assets acquired.

#### **SUBSIDIARY STOCK TRANSACTIONS**

We recognize as income, when appropriate, any gain from the sale or issuance by subsidiaries of their stock to third parties. The gain is the difference between our basis in the stock and the increase in the book value per share of the subsidiaries' equity and is recorded in noninterest income in the Consolidated Income Statement. We provide applicable taxes on the gain.

#### **USE OF ESTIMATES**

We prepare the unaudited interim consolidated financial statements using financial information available at the time, which requires us to make estimates and assumptions that affect the amounts reported. Actual results may differ from these estimates and the differences may be material to the consolidated financial statements.

#### **REVENUE RECOGNITION**

We earn net interest and noninterest income from various sources, including:

- Lending,
- Securities portfolio,
- Investment management and fund servicing,
- Customer deposits,
- Loan servicing,
- Brokerage services, and
- Securities and derivatives trading activities, including foreign exchange.



---

## **Table of Contents**

We also earn revenue from selling loans and securities, and we recognize income or loss from certain private equity activities. We also earn fees and commissions from:

- Issuing loan commitments, standby letters of credit and financial guarantees,
- Selling various insurance products,
- Providing treasury management services, and
- Participating in certain capital markets transactions.

Revenue earned on interest-earning assets is recognized based on the effective yield of the financial instrument.

We recognize asset management and fund servicing fees primarily as the services are performed. Asset management fees are generally based on a percentage of the fair value of the assets under management and performance fees are generally based on a percentage of the returns on such assets. Certain performance fees are earned upon attaining specified investment return thresholds and are recorded as earned. Fund servicing fees are primarily based on a percentage of the fair value of the fund assets and the number of shareholder accounts we service.

Service charges on deposit accounts are recognized as charged. Brokerage fees and gains on the sale of securities and certain derivatives are recognized on a trade-date basis.

We record private equity income or loss based on changes in the valuation of the underlying investments or when we dispose of our interest. Dividend income from private equity investments is generally recognized when received.

We recognize revenue from loan servicing, securities and derivatives and foreign exchange trading, and securities underwriting activities as they are earned based on contractual terms, as transactions occur or as services are provided. We recognize revenue from the sale of loans upon closing of the transaction.

In certain circumstances, revenue is reported net of associated expenses in accordance with GAAP.

## **INVESTMENTS**

We have interests in various types of investments. The accounting for these investments is dependent on a number of factors including, but not limited to, items such as:

- Marketability of the investment,
- Ownership interest,
- Our plans for the investment, and
- The nature of the investment.

### ***Investment in BlackRock***

As described in Note 2 Acquisitions, we deconsolidated the assets and liabilities of BlackRock from our Consolidated Balance Sheet at September 30, 2006 and now account for our investment in BlackRock under the equity method of accounting. Under the equity method, our investment in the equity of BlackRock is reflected as a single line on our Consolidated Balance Sheet, Investment in BlackRock, while our proportionate share of BlackRock's earnings will be reported on our Consolidated Income Statement under the caption BlackRock investment.

### ***Private Equity Investments***

We report private equity investments, which include direct investments in companies, interests in limited partnerships, and affiliated partnership interests, at estimated fair values. These estimates are based on available information and may not necessarily represent amounts that we will ultimately realize through distribution, sale or liquidation of the investments. The valuation procedures applied to direct

investments include techniques such as multiples of cash flow of the entity, independent appraisals of the entity or the pricing used to value the entity in a recent financing transaction. We value affiliated partnership interests based on the underlying investments of the partnership using procedures consistent with those applied to direct investments. We generally value limited partnership investments based on the financial statements we receive from the general partner. We include all private equity investments on the Consolidated Balance Sheet in other assets. Changes in the fair value of these assets are recognized in noninterest income.

We consolidate private equity investments when we are the general partner in a limited partnership and have determined that we have control of the partnership.

***Equity Securities and Partnership Interests***

We account for equity investments other than private equity investments under one of the following methods:

- Marketable equity securities are recorded on a trade-date basis and are accounted for at fair value based on the securities' quoted market prices from a national securities exchange. Dividend income on these securities is recognized in net interest income. Those purchased with the intention of recognizing short-term profits are placed in the trading account, carried at market value and classified as short-term investments. Gains and losses on trading securities are included in noninterest income. Marketable equity securities not classified as trading are designated as securities available for sale and are carried at fair value with unrealized gains and losses, net of income taxes, reflected in accumulated other comprehensive income or loss. Any unrealized losses that we have determined to be other-than-temporary are recognized in the period that the determination is made.
- Investments in nonmarketable equity securities are recorded using the cost or equity method of accounting. The cost method is used for those investments in which we do not have significant influence over the investee. Under this method, there is no change to the cost basis unless there is an other-than-temporary decline in value. If the decline is determined to be other than temporary, we write down the cost basis of the investment to a new cost basis that represents realizable value. The amount of the write-down is accounted for as a loss included in noninterest income in the period the determination is made. Distributions received from income on cost method investments are included in interest or noninterest income depending on the type of investment. We use the equity method for those investments in which we have significant influence over the operations of the investee. Under the equity method, we record our equity ownership share of the net income or loss of the investee in noninterest income. We include nonmarketable equity securities in other assets on the consolidated balance sheet.

For investments in limited partnerships that are not required to be consolidated, we use either the cost method or the equity method as described above for nonmarketable equity securities. We use the equity method if our limited partner ownership interest in the partnership is greater than 3%. We use the cost method for the remaining limited partnership investments. We account for general partnership interests under the equity method when we have determined that we do not have control over these entities and are not required to consolidate them. General and limited partnership investments are included in other assets on the Consolidated Balance Sheet.

---

**Table of Contents*****Debt Securities***

Debt securities are recorded on a trade-date basis. We classify debt securities as securities and carry them at amortized cost if we have the positive intent and ability to hold the securities to maturity. Debt securities that we purchase for short-term appreciation or other trading purposes are carried at market value and classified as short-term investments. Gains and losses on these securities are included in noninterest income. Debt securities not classified as held to maturity or trading are designated as securities available for sale and carried at fair value with unrealized gains and losses, net of income taxes, reflected in accumulated other comprehensive income or loss. Other-than-temporary declines in the fair value of available for sale debt securities are recognized as a securities loss included in noninterest income in the period in which the determination is made. We review for impairment on a quarterly basis all debt securities that are in an unrealized loss position.

We include all interest on debt securities, including amortization of premiums and accretion of discounts using the interest method, in net interest income. We compute gains and losses realized on the sale of debt securities available for sale on a specific security basis and include them in noninterest income.

**LOANS AND LEASES**

Except as described below, loans are stated at the principal amounts outstanding, net of unearned income, unamortized deferred fees and costs on originated loans, and premiums or discounts on loans purchased. Interest income related to loans other than nonaccrual loans is accrued based on the principal amount outstanding and credited to net interest income as earned using the interest method. Loan origination fees, direct loan origination costs, and loan premiums and discounts are deferred and amortized to income, over periods not exceeding the contractual life of the loan, using methods that are not materially different from the interest method.

As of January 1, 2006, we adopted SFAS 155, *Accounting for Certain Hybrid Instruments* an amendment of FASB Statements No. 133 and 140, which was issued in February 2006. SFAS 155 permits a fair value election for previously bifurcated hybrid financial instruments on an instrument-by-instrument basis, clarifies the scope of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, regarding interest-only and principal-only strips, and provides further guidance on certain issues regarding beneficial interests in securitized financial assets, concentrations of credit risk and qualifying special purpose entities. Beginning January 1, 2006, we elected to account for certain previously bifurcated hybrid instruments with loan host contracts under this standard. As such, certain loans are accounted for at fair value with changes in fair value reported in trading revenue. The fair value of these loans was \$166 million, or less than .5% of the total loan portfolio, at September 30, 2006.

We also provide financing for various types of equipment, aircraft, energy and power systems, and rolling stock through a variety of lease arrangements. Direct financing leases are

carried at the aggregate of lease payments plus estimated residual value of the leased property, less unearned income. Leveraged leases, a form of financing lease, are carried net of nonrecourse debt. We recognize income over the term of the lease using methods that are not materially different from the interest method. Lease residual values are reviewed for other-than-temporary impairment on at least an annual basis. Gains or losses on the sale of leased assets are included in other noninterest income while valuation adjustments on lease residuals are included in other noninterest expense.

**LOAN SALES, SECURITIZATIONS AND RETAINED INTERESTS**

We recognize the sale of loans or other financial assets when the transferred assets are legally isolated from our creditors and the appropriate accounting criteria are met. We also sell mortgage and other loans through secondary market securitizations. In certain cases, we may retain a portion or all of the securities issued, interest-only strips, one or more subordinated tranches, servicing rights and, in some cases, cash reserve accounts, all of which are considered retained interests in the transferred assets. Our loan sales and securitizations are generally structured without recourse to us and with no restrictions on the retained interests. In the event we are obligated for recourse liabilities in a sale, our policy is to record such liabilities at fair value upon closing of the transaction. Gains or losses recognized on the sale of the loans depend on the allocation of carrying value between the loans sold and the retained interests, based on their relative fair market values at the date of sale. We generally estimate fair value based on the present value of future expected cash flows using assumptions as to discount rates, interest rates, prepayment speeds, credit losses and servicing costs, if applicable. Gains or losses on these transactions are reported in noninterest income.

As of January 1, 2006, we adopted SFAS 156, *Accounting for Servicing of Financial Assets* an amendment of FASB Statement No. 140. SFAS 156 was issued in March 2006 and requires all newly recognized servicing rights and obligations to be initially measured at fair value. For separately recognized servicing rights and obligations retained or purchased, we have elected to account for them under the amortization method, which requires us to amortize servicing assets or liabilities in proportion to and over the periods of estimated net servicing income or net

servicing loss.

Each quarter, we evaluate our servicing assets for impairment by categorizing the pools of assets underlying servicing rights by product type. A valuation allowance is recorded and reduces current income when the carrying amount of a specific asset category exceeds its fair value.

We classify other securities retained as debt securities available for sale or other assets, depending on the form of the retained interest. Retained interests that are subject to prepayment risk are reviewed on a quarterly basis for impairment. If the fair value of the retained interest is below its carrying amount and the decline is determined to be other-than-temporary, then the decline is reflected as a charge to noninterest income. We recognize other adjustments to the fair market value of retained interests classified as available for

---

## **Table of Contents**

sale securities through accumulated other comprehensive income or loss.

### **NONPERFORMING ASSETS**

Nonperforming assets include:

- Nonaccrual loans,
- Troubled debt restructurings,
- Nonaccrual loans held for sale, and
- Foreclosed assets.

Other than consumer loans, we generally classify loans and loans held for sale as nonaccrual when we determine that the collection of interest or principal is doubtful or when a default of interest or principal has existed for 90 days or more and the loans are not well-secured or in the process of collection. When the accrual of interest is discontinued, accrued but uncollected interest credited to income in the current year is reversed and unpaid interest accrued in the prior year, if any, is charged against the allowance for loan and lease losses. We charge off loans other than consumer loans based on the facts and circumstances of the individual loan.

Consumer loans well-secured by residential real estate, including home equity and home equity lines of credit, are classified as nonaccrual at 12 months past due. We charge off these loans based on the facts and circumstances of the individual loan.

Consumer loans not well-secured or in the process of collection are classified as nonaccrual at 120 days past due if they are home equity loans and at 180 days past due if they are home equity lines of credit. These loans are recorded at the lower of cost or market value, less liquidation costs and the unsecured portion of these loans is generally charged off in the month they become nonaccrual.

A loan is categorized as a troubled debt restructuring in the period of restructuring if a significant concession is granted due to deterioration in the financial condition of the borrower.

Nonperforming loans are generally not returned to performing status until the obligation is brought current and the borrower has performed in accordance with the contractual terms for a reasonable period of time and collection of the contractual principal and interest is no longer doubtful. Nonaccrual commercial and commercial real estate loans and troubled debt restructurings are designated as impaired loans. We recognize interest collected on these loans on the cash basis or cost recovery method.

Foreclosed assets are comprised of any asset seized or property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure. These assets are recorded on the date acquired at the lower of the related loan balance or market value of the collateral less estimated disposition costs. We estimate market values primarily based on appraisals when available or quoted market prices on liquid assets. Subsequently, foreclosed assets are valued at the lower of the amount recorded at acquisition date or the current market value less estimated disposition costs. Valuation

adjustments on these assets and gains or losses realized from disposition of such property are reflected in noninterest expense.

### **ALLOWANCE FOR LOAN AND LEASE LOSSES**

We maintain the allowance for loan and lease losses at a level that we believe to be adequate to absorb estimated probable credit losses inherent in the loan portfolio. The allowance is increased by the provision for credit losses, which is charged against operating results, and decreased by the amount of charge-offs, net of recoveries. Our determination of the adequacy of the allowance is based on periodic evaluations of the loan and lease portfolios and other relevant factors. This evaluation is inherently subjective as it requires material estimates, all of which may be susceptible to significant change, including, among others:

- Expected default probabilities,
- Loss given default,
- Exposure at default,
- Amounts and timing of expected future cash flows on impaired loans,
- Value of collateral,
- Estimated losses on consumer loans and residential mortgages, and
- Amounts for changes in economic conditions and potential estimation or judgmental errors.

In determining the adequacy of the allowance for loan and lease losses, we make specific allocations to impaired loans, to pools of watchlist and nonwatchlist loans and to consumer and residential mortgage loans. We also allocate reserves to provide coverage for probable losses not

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

covered in specific, pool and consumer reserve methodologies related to qualitative and measurement factors. While allocations are made to specific loans and pools of loans, the total reserve is available for all credit losses.

Specific allocations are made to significant impaired loans and are determined in accordance with SFAS 114, Accounting by Creditors for Impairment of a Loan, with impairment measured generally based on the present value of the loan's expected cash flows, the loan's observable market price or the fair value of the loan's collateral. We establish a specific allowance on all other impaired loans based on their loss given default credit risk rating.

Allocations to loan pools are developed by business segment based on probability of default and loss given default risk ratings by using historical loss trends and our judgment concerning those trends and other relevant factors. These factors may include, among others:

- Actual versus estimated losses,
- Regional and national economic conditions, and
- Business segment and portfolio concentrations.

Loss factors are based on industry and/or internal experience and may be adjusted for significant factors that, based on our judgment, impact the collectibility of the portfolio as of the balance sheet date. Consumer and residential mortgage loan allocations are made at a total portfolio level based on historical loss experience adjusted for portfolio activity.

## **Table of Contents**

While our pool reserve methodologies strive to reflect all risk factors, there continues to be a certain element of uncertainty associated with, but not limited to, potential estimation errors and imprecision in the estimation process due to the inherent lag of information. We provide additional reserves that are designed to provide coverage for expected losses attributable to such risks. In addition, these incremental reserves also include factors which may not be directly measured in the determination of specific or pooled reserves. These factors include:

- Industry concentration and conditions,
- Credit quality trends,
- Recent loss experience in particular segments of the portfolio,
- Ability and depth of lending management,
- Changes in risk selection and underwriting standards, and
- Bank regulatory considerations.

### **COMMERCIAL MORTGAGE SERVICING RIGHTS**

We provide servicing under various commercial loan servicing contracts. These contracts are either purchased in the market place or retained as part of a commercial mortgage loan securitization or loan sale. Prior to January 1, 2006, purchased contracts were recorded at cost and the servicing rights retained from the sale or securitization of loans were recorded based on their relative fair value to all of the assets securitized or sold. As a result of the adoption of SFAS 156, beginning January 1, 2006 all newly acquired servicing rights are initially measured at fair value. Fair value is based on the present value of the expected future cash flows, including assumptions as to:

- Interest rates for escrow and deposit balance earnings,
- Discount rates,
- Estimated prepayment speeds, and
- Estimated servicing costs.

We have elected to account for our commercial mortgage servicing rights as a class of assets under the amortization method. This determination was made based on the unique characteristics of the commercial mortgages underlying these servicing rights with regard to market inputs used in determining fair value and how we manage the risks inherent in the commercial mortgage servicing rights asset. We record the servicing asset as an other intangible asset and amortize it over its estimated life in proportion to estimated net servicing income. On a quarterly basis, we test the asset for impairment. If the estimated fair value of the asset is less than the carrying value, an impairment loss is recognized. Servicing fees are recognized as they are earned and are reported net of amortization expense in noninterest income.

### **DEPRECIATION AND AMORTIZATION**

For financial reporting purposes, we depreciate premises and equipment principally using the straight-line method over their estimated useful lives.

We use estimated useful lives for furniture and equipment ranging from one to 10 years, and depreciate buildings over an estimated useful life of up to 40 years. We amortize leasehold improvements over their estimated useful lives of up to 15 years or the respective lease terms, whichever is shorter.

We purchase, as well as internally develop and customize, certain software to enhance or perform internal business

functions. Software development costs incurred in the planning and post-development project stages are charged to noninterest expense. Costs associated with designing software configuration and interfaces, installation, coding programs and testing systems are capitalized and amortized using the straight-line method over periods ranging from one to five years.

### **DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

We use a variety of financial derivatives as part of our overall asset and liability risk management process to manage interest rate, market and credit risk inherent in our business activities. We use substantially all such instruments to manage risk related to changes in interest rates. Interest rate and total return swaps, interest rate caps and floors and futures contracts are the primary instruments we use for interest rate risk management.

Financial derivatives involve, to varying degrees, interest rate, market and credit risk. We manage these risks as part of our asset and liability management process and through credit policies and procedures. We seek to minimize counterparty credit risk by entering into transactions with only high-quality institutions, establishing credit limits, and generally requiring bilateral netting and collateral agreements.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

We recognize all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income.

For those derivative instruments that are designated and qualify as hedging instruments, we must designate the hedging instrument, based on the exposure being hedged, as a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. We have no derivatives that hedge the net investment in a foreign operation.

We formally document the relationship between the hedging instruments and hedged items, as well as the risk management objective and strategy before undertaking a hedge. To qualify for hedge accounting, the derivatives and related hedged items must be designated as a hedge. For hedging relationships in which effectiveness is measured, we formally assess, both at the inception of the hedge and on an ongoing basis, if the derivatives are highly effective in offsetting changes in fair values or cash flows of the hedged item. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued.

For derivatives that are designated as fair value hedges (i.e., hedging the exposure to changes in the fair value of an asset or a liability attributable to a particular risk), changes in the fair value of the hedging derivative are recognized in earnings and offset by recognizing changes in the fair value of the hedged item attributable to the risk being hedged. To the extent the hedge is ineffective, the changes in fair value will not offset and the difference is reflected in the same financial statement category as the hedged item.

For derivatives designated as cash flow hedges (i.e., hedging the exposure to variability in expected future cash flows), the effective portions of the gain or loss on derivatives are reported as a component of accumulated other comprehensive



---

**Table of Contents**

income or loss and subsequently reclassified in interest income in the same period or periods during which the hedged transaction affects earnings. The change in fair value of any ineffective portion of the hedging derivative is recognized immediately as a charge to earnings.

We discontinue hedge accounting when it is determined that the derivative is no longer an effective hedge; the derivative expires or is sold, terminated or exercised; or the derivative is de-designated as a fair value or cash flow hedge or it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period. If we determine that the derivative no longer qualifies as a fair value or cash flow hedge and therefore hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings. For a discontinued fair value hedge, the previously hedged item is no longer adjusted for changes in fair value.

When hedge accounting is discontinued because it is no longer probable that a forecasted transaction will occur, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings, and the gains and losses in accumulated other comprehensive income or loss will be recognized immediately into earnings. When we discontinue hedge accounting because the hedging instrument is sold, terminated or no longer designated, the amount reported in other comprehensive income or loss up to the date of sale, termination or de-designation continues to be reported in other comprehensive income or loss until the forecasted transaction affects earnings.

We occasionally purchase or originate financial instruments that contain an embedded derivative. Prior to January 1, 2006, we assessed at the inception of the transaction if economic characteristics of the embedded derivative were clearly and closely related to the economic characteristics of the financial instrument (host contract), whether the financial instrument that embodied both the embedded derivative and the host contract were measured at fair value with changes in fair value reported in earnings, and whether a separate instrument with the same terms as the embedded instrument would not meet the definition of a derivative. If the embedded derivative did not meet these three conditions, the embedded derivative would qualify as a derivative and be recorded apart from the host contract and carried at fair value with changes recorded in current earnings. On January 1, 2006, we adopted SFAS 155, which, among other provisions, permits a fair value election for hybrid financial instruments requiring bifurcation on an instrument-by-instrument basis. Beginning January 1, 2006, we elected to account for certain previously bifurcated hybrid instruments and certain newly acquired hybrid instruments under this fair value election on an instrument-by-instrument basis. As such, certain previously reported embedded derivatives are now reported with their host contracts at fair value in loans or other borrowed funds.

We enter into commitments to make loans whereby the interest rate on the loan is set prior to funding (interest rate lock commitments). We also enter into commitments to purchase mortgage loans (purchase commitments). Both interest rate lock commitments and purchase commitments on mortgage loans that will be held for resale are accounted for as free-standing derivatives. Interest rate lock commitments and purchase commitments that are considered to be derivatives are recorded at fair value in other assets or other liabilities. Fair value of interest rate lock commitments and purchase commitments is determined as the change in value that occurs after the inception of the commitment considering the projected security price, fees collected from the borrower and costs to originate, adjusted for anticipated fallout risk. We recognize the gain or loss from the change in fair value of these derivatives in trading noninterest income.

**STOCK-BASED COMPENSATION**

We did not recognize stock-based employee compensation expense related to stock options before 2003 under prior GAAP.

Effective January 1, 2003, we adopted the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, as amended by SFAS 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, prospectively to all employee awards granted, modified or settled after January 1, 2003. We did not restate results for prior years upon our adoption of SFAS 123. Since we adopted SFAS 123 prospectively, the cost related to stock-based employee compensation included in net income for the three months and nine months ended September 30, 2005 is less than what we would have recognized if we had applied the fair value based method to all awards since the original effective date of the standard.

In December 2004, the FASB issued SFAS 123R, which replaced SFAS 123 and superseded APB 25. SFAS 123R requires compensation cost related to share-based payments to employees to be recognized in the financial statements based on their fair value. We adopted SFAS 123R effective January 1, 2006, using the modified prospective method of transition, which requires the provisions of SFAS 123R be applied to new awards and awards modified, repurchased or cancelled after the effective date. It also requires changes in the timing of expense recognition for awards granted to retirement-eligible employees and clarifies the accounting for the tax effects of stock awards. The adoption of SFAS 123R did not have a significant impact on our consolidated financial statements.



**Table of Contents**

The following table shows the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS 123, as amended, to all outstanding and unvested awards in each period.

**Pro Forma Net Income And Earnings Per Share**

In millions, except for per share data	Three months ended	
	September 30, 2006	September 30, 2005
Net income as reported	\$ 1,484	\$ 334
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	17	16
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(17)	(18)
Pro forma net income	\$ 1,484	\$ 332
Earnings per share		
Basic-as reported	\$ 5.09	\$ 1.16
Basic-pro forma	\$ 5.09	\$ 1.15
Diluted-as reported	\$ 5.01	\$ 1.14
Diluted-pro forma	\$ 5.01	\$ 1.13

In millions, except for per share data	Nine months ended	
	September 30, 2006	September 30, 2005
Net income as reported	\$ 2,219	\$ 970
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	50	39
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(50)	(44)
Pro forma net income	\$ 2,219	\$ 965
Earnings per share		
Basic-as reported	\$ 7.60	\$ 3.40
Basic-pro forma	\$ 7.60	\$ 3.38
Diluted-as reported	\$ 7.46	\$ 3.35
Diluted-pro forma	\$ 7.46	\$ 3.33

See Note 9 Certain Employee Benefit And Stock-Based Compensation Plans for additional information.

**Recent Accounting Pronouncements**

In September 2006, the FASB issued the following:

- SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*—an amendment of FASB Statements No. 87, 88, 106, and 132(R). This statement affects the accounting and reporting for our qualified pension plan, our nonqualified retirement plans, and our postretirement welfare benefit plans. SFAS 158 requires recognition on the balance sheet of the over- or underfunded position of these plans as the difference between the fair value of plan assets and the related benefit obligations. To the extent that a plan's net funded status differs from the amounts currently recognized on the balance sheet, the difference, net of tax, will be recorded as part of accumulated other comprehensive income or loss (AOCI) within the shareholders' equity section of the balance sheet. This guidance also requires the reclassification of any unrecognized actuarial gains and losses and unrecognized prior service costs to AOCI, net of tax. Post-adoption changes in unrecognized actuarial gains and losses as well as unrecognized prior service costs will be recognized in other comprehensive income, net of tax. The current year-end after-tax estimate of adjusting our plans' funded status for any unamortized net actuarial losses and prior service costs is approximately \$200 million. Additionally, each 1% change in pension trust investment returns between now and year-end 2006 will

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

affect this estimate by approximately \$10 million after-tax, and each 10 basis point change in discount rates will affect the current estimate by approximately \$7 million after-tax. SFAS 158 will be effective for PNC as of December 31, 2006, with no restatement permitted for prior year-end reporting periods.

- SFAS 157, Fair Value Measurements. SFAS 157 defines fair value and establishes a framework for measuring fair value which includes permissible valuation techniques and a hierarchy of inputs utilized in the measurement process. This statement applies whenever other accounting standards require or permit fair value measurement. We anticipate applying SFAS 157 prospectively beginning January 1, 2008, as required.

In July 2006, the FASB issued the following:

- FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements and sets forth recognition, derecognition and measurement criteria for tax positions taken or expected to be taken in a tax filing. For PNC, this guidance will apply to all tax positions taken or expected to be taken beginning on January 1, 2007. We do not expect the adoption of FIN 48 to have a significant impact on our consolidated financial statements.
- FASB Staff Position No. ( FSP ) FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction. This guidance requires a recalculation of the timing of income recognition for a leveraged lease under SFAS 13, Accounting for Leases, when a change in the timing of income tax deductions directly related to the leveraged lease transaction occurs or is projected to occur. Any tax positions taken regarding the leveraged lease transaction must be recognized and measured in accordance with FIN 48 described above. This guidance will be effective for PNC beginning January 1, 2007 with the cumulative effect of applying the provisions of this FSP being recognized through an adjustment to opening retained earnings. Based on our current estimate, we believe the adoption of the guidance in FSP 13-2 would result in an after-tax charge to opening retained

**Table of Contents**

earnings at January 1, 2007 in the range of approximately \$140 million to \$160 million. Any immediate or future reductions in earnings from the change in accounting would be recovered in subsequent years.

As described under the *Loan Sales, Securitizations And Retained Interests* section of this Note 1, we adopted SFAS 156 as of January 1, 2006. As described under the *Loans And Leases* section of this Note 1, we also adopted SFAS 155 as of January 1, 2006. The adoption of neither SFAS 156 nor SFAS 155 had a material impact on our consolidated financial statements.

In November 2005, the FASB issued FSP FAS 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This FSP clarified and reaffirmed existing guidance as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. Certain disclosures about unrealized losses on available for sale debt and equity securities that have not been recognized as other-than-temporary impairments are required under FSP 115-1. Application of this guidance, which was effective January 1, 2006, did not have a significant impact on our consolidated financial statements.

In June 2005, the Emerging Issues Task Force ( EITF ) of the FASB issued EITF Issue 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. EITF 04-5 provides that the general partner(s) is presumed to control the limited partnership (including certain limited liability companies), unless the limited partners possess either substantive participating rights or the substantive ability to dissolve the limited partnership or otherwise remove the general partner(s) without cause ( *kick-out rights* ). Kick-out rights are substantive if they can be exercised by a simple majority of the limited partners voting interests. The guidance was effective for all limited partnerships as of January 1, 2006. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS 154 generally requires retrospective application to prior periods financial statements of all voluntary changes in accounting principle and changes required when a new pronouncement does not include specific transition provisions. This standard was effective for PNC beginning January 1, 2006.

See the *Stock-Based Compensation* section of this Note 1 for a discussion of SFAS 123R.

***NOTE 2 ACQUISITIONS***

As previously reported, in February 2006 BlackRock, then a majority-owned subsidiary of PNC, and Merrill Lynch entered into a definitive agreement pursuant to which Merrill Lynch agreed to contribute its investment management business ( *MLIM* ) to BlackRock in exchange for 65 million shares of newly issued BlackRock common and preferred stock. This transaction closed on September 29, 2006. BlackRock accounted for the MLIM transaction under the purchase method of accounting. The value of the 65 million shares

issued to Merrill Lynch was allocated among the MLIM assets acquired, including intangibles, and the MLIM liabilities assumed to the extent of their fair market value, with any excess purchase price being allocated to goodwill. Immediately following the closing, PNC continued to own approximately 44 million shares of BlackRock common stock representing an ownership interest of approximately 34% of the combined company (as compared with 69% immediately prior to the closing). Although PNC's share ownership percentage declined, BlackRock's equity increased due to the increase in total net assets recorded by BlackRock as a result of the MLIM transaction.

Upon the closing of the BlackRock/MLIM transaction, the carrying value of our investment in BlackRock increased by approximately \$3.1 billion to \$3.8 billion, primarily reflecting PNC's portion of the increase in BlackRock's equity resulting from the value of shares issued in the transaction. Based on BlackRock's closing market price of \$149 per common share on September 29, 2006, the market value of PNC's investment in BlackRock was approximately \$6.6 billion at that date. As such, an additional \$2.8 billion of value is not recognized in PNC's investment account.

We also recorded a liability at September 30, 2006 for deferred taxes of approximately \$.9 billion, related to the excess of the book value over the tax basis of our investment in BlackRock, and a liability of approximately \$.6 billion related to our obligation to provide shares of BlackRock common stock to help fund BlackRock long-term incentive plan ( *LTIP* ) programs. The LTIP liability will be adjusted quarterly based on changes in BlackRock's common stock price and the number of remaining committed shares.

The overall balance sheet impact was an increase to our shareholders' equity of approximately \$1.6 billion. The increase to equity was comprised of an after-tax gain of approximately \$1.3 billion, net of the expense associated with the LTIP liability and the deferred taxes, and an after-tax increase to capital surplus of approximately \$.3 billion. The recognition of the gain is consistent with our existing accounting policy for the sale or issuance by subsidiaries of their stock to third parties. The gain represents the difference between our basis in BlackRock stock prior to the BlackRock/MLIM transaction and the new book value per share and resulting increase in value of our investment realized from the transaction.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

The direct increase to capital surplus rather than inclusion in the gain resulted from the accounting treatment required due to existing BlackRock repurchase commitments or programs.

For the three months and nine months ended September 30, 2006, our Consolidated Income Statement included our former 69% ownership interest in BlackRock's net income through the closing date. However, our Consolidated Balance Sheet as of September 30, 2006 no longer reflected the consolidation of BlackRock's balance sheet but recognized our ownership interest in BlackRock as an investment to be accounted for under the equity method. On a prospective basis, this accounting will result in a reduction in certain revenue and noninterest expense categories on PNC's Consolidated Income Statement as the net pretax earnings impact of our net investment in BlackRock will be reported on a separate line item within noninterest income.

**Table of Contents****NOTE 3 SECURITIES**

In millions	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<b>September 30, 2006 (a)</b>				
<i>SECURITIES AVAILABLE FOR SALE</i>				
Debt securities				
Mortgage-backed	\$14,799	\$37	\$(163)	\$14,673
US Treasury and government agencies	556		(4)	552
Commercial mortgage-backed	2,342	14	(22)	2,334
Asset-backed	1,527	3	(11)	1,519
State and municipal	141		(2)	139
Other debt	89		(2)	87
Total debt securities	19,454	54	(204)	19,304
Corporate stocks and other	209		(1)	208
Total securities available for sale	\$19,663	\$54	\$(205)	\$19,512
<b>December 31, 2005 (a)</b>				
<i>SECURITIES AVAILABLE FOR SALE</i>				
Debt securities				
Mortgage-backed	\$13,794	\$1	\$(251)	\$13,544
US Treasury and government agencies	3,816		(72)	3,744
Commercial mortgage-backed	1,955	1	(37)	1,919
Asset-backed	1,073		(10)	1,063
State and municipal	159	1	(2)	158
Other debt	87		(1)	86
Total debt securities	20,884	3	(373)	20,514
Corporate stocks and other	196			196
Total securities available for sale	\$21,080	\$3	\$(373)	\$20,710

(a) Securities held to maturity at September 30, 2006 and December 31, 2005 totaled less than \$.5 million at each date.

Securities represented 20% of total assets at September 30, 2006 and 23% at December 31, 2005.

We evaluate our securities available for sale portfolio in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall positioning.

At September 30, 2006, securities available for sale included a net unrealized loss of \$151 million, which represented the difference between fair value and amortized cost. The comparable amount at December 31, 2005 was a net unrealized loss of \$370 million. Net unrealized gains and losses in the securities available for sale portfolio are included in shareholders' equity as accumulated other comprehensive income or loss, net of tax.

During mid-August through early September 2006, we performed a comprehensive review of our securities available for sale portfolio and, by the end of September 2006, completed the process of executing portfolio rebalancing actions in response to the changing economic landscape, recent statements and actions by the Federal Open Market Committee (in particular, the decision not to raise the Fed funds target rate) and our desire to position the securities portfolio to optimize total return performance over the long term.

As a result, we have repositioned our securities portfolio according to our market views. This included reallocating exposure to certain sectors, selling securities holdings we believed would likely underperform on a relative value basis, retaining certain existing securities and purchasing incremental securities all of which we believe will outperform the market going forward.

As part of the rebalancing, we assessed the entire securities available for sale portfolio of which, for the majority of positions, fair value was less than amortized cost. We executed a strategy to reduce our US government agency and mortgage-

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

backed security sector allocations and increase our interest rate swap sector allocation. We sold substantially all of our US government agency securities to reduce our interest rate spread exposure to that asset class. The US government agency securities that we retained are characterized by relatively short terms to maturity and smaller individual security balances. We also sold specific securities in the mortgage-backed portfolio (e.g. all of our holdings of specific coupon US government agency pass-through securities and collateralized mortgage obligations having specific collateral characteristics), and in the commercial mortgage-backed portfolio (e.g. all of our holdings of specific vintage securities) that we believe, given the underlying collateral, will underperform on a relative value basis. We retained the remaining holdings in our mortgage-backed portfolio including all of our holdings of mortgage-backed securities collateralized by hybrid adjustable rate mortgage loans, our commercial mortgage-backed portfolio and our asset-backed portfolio. Our objective was to reduce the portfolio credit spread and interest rate volatility exposures, to position the portfolio for a steeper yield curve and to optimize the relative value performance of the portfolio. We assessed the securities retained relative to the same portfolio objectives, our market view and outlook, our desired sector allocations, our expectation of performance relative to market benchmarks and, given our assessment, we confirmed our intent to hold these remaining securities until either recovery of fair value or maturity. Accordingly, we do not believe that any individual unrealized losses at September 30, 2006 represent an other-than-temporary impairment.

Of the \$205 million gross unrealized loss amount at September 30, 2006, \$195 million related to securities that had been in a loss position for 12 months or more. The fair value of those securities totaled approximately \$9.3 billion. Of those securities in an unrealized loss position for 12 months or more as of September 30, 2006, eleven positions with fair value totaling \$313 million had an unrealized loss of more than 5% when compared with their amortized cost. The



**Table of Contents**

unrealized loss on these positions totaled \$24 million and, the unrealized loss amount on any individual position did not exceed \$5 million. These securities are included in the mortgage-backed classification in the above table, and are primarily collateralized mortgage obligations where amortized cost closely approximates the par value of the security. These securities are all rated AAA. The majority of the reported unrealized loss related to these securities and the remaining other available for sale securities is attributable to changes in interest rates and not from the deterioration in the credit quality of the issuer.

The portfolio rebalancing resulted in the sale during the third quarter of 2006 of \$6.0 billion of securities available for sale at an aggregate pretax loss of \$196 million, or \$127 million after-tax. We repurchased approximately \$1.8 billion of securities and added approximately \$4.0 billion of interest rate swaps to maintain our interest rate risk position. We also reduced wholesale funding as a result of the actions taken.

The resulting net realized losses on the sale of securities during the third quarter of 2006 were previously reflected as net unrealized securities losses within accumulated other comprehensive loss in the shareholders' equity section of PNC's Consolidated Balance Sheet. Accordingly, total shareholders' equity did not change as a result of these actions.

The expected weighted-average life of securities available for sale (excluding corporate stocks and other) was 3 years and 11 months as of September 30, 2006 and 4 years and 1 month at December 31, 2005.

Information relating to securities sold is set forth in the following table:

**Securities Sold**

Nine months ended September 30	Gross	Gross	Net	Income	
				Tax Expense/ Benefit	
In millions	Proceeds	Gains	Losses	Gains (Losses)	(Benefit)
<b>2006</b>	<b>\$10,619</b>	<b>\$2</b>	<b>\$(209)</b>	<b>\$(207)</b>	<b>\$(72)</b>
2005	11,627	19	(56)	(37)	(13)

The value of securities pledged to secure public and trust deposits and repurchase agreements and for other purposes was \$10.8 billion at both September 30, 2006 and December 31, 2005. The pledged securities include positions held in our portfolio of securities available for sale, trading securities that are included in other interest earning assets on our Average Consolidated Balance Sheet, and securities accepted as collateral from others that we are permitted by contract or custom to sell or repledge.

The fair value of securities accepted as collateral that we are permitted by contract or custom to sell or repledge was \$2.6 billion at September 30, 2006 and \$273 million at December 31, 2005 and is a component of federal funds sold and resale agreements on our Consolidated Balance Sheet. The increase is due primarily from the use of collateral accepted to fulfill pledging requirements previously met with positions held in our portfolio of securities available for sale. An increase in securities sold short that are included in other borrowed funds on the Average Consolidated Balance Sheet also contributed to the increase. Of the permitted amount, all was repledged to others at September 30, 2006 and December 31, 2005.

**NOTE 4 ASSET QUALITY**

The following table sets forth nonperforming assets and related information.

	September 30 2006	December 31 2005
Dollars in millions		
<b>Nonaccrual loans</b>		
Commercial	<b>\$112</b>	\$134

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Commercial real estate	14	14
Consumer	14	10
Residential mortgage	13	15
Lease financing	14	17
Total nonaccrual loans	167	190
Nonperforming loans held for sale (a)		1
Foreclosed and other assets		
Lease	12	13
Residential mortgage	9	9
Other	3	3
Total foreclosed and other assets	24	25
Total nonperforming assets (b)	\$191	\$216
Nonperforming loans to total loans	.34%	.39%
Nonperforming assets to total loans, loans held for sale and foreclosed assets	.36	.42
Nonperforming assets to total assets	.19	.23

(a) Amount represents troubled debt restructured loans held for sale.

(b) Excludes equity management assets carried at estimated fair value of \$12 million as of September 30, 2006 and \$25 million as of December 31, 2005. These assets included troubled debt restructured assets of \$4 million at September 30, 2006 and \$7 million at December 31, 2005.

Changes in the allowance for loan and lease losses were as follows:

In millions	2006	2005
Allowance at January 1	\$596	\$607
Charge-offs		
Commercial	(85)	(44)
Commercial real estate	(2)	
Consumer	(37)	(33)
Residential mortgage	(2)	(1)
Total charge-offs	(126)	(78)
Recoveries		
Commercial (a)	16	76
Commercial real estate		1
Consumer	11	11
Lease financing	4	1
Total recoveries (a)	31	89
Net recoveries (charge-offs)		
Commercial (a)	(69)	32
Commercial real estate	(2)	1
Consumer	(26)	(22)
Residential mortgage	(2)	(1)
Lease financing	4	1
Total net recoveries (charge-offs) (a)	(95)	11
Provision for (recoveries of) credit losses	82	(3)
Acquired allowance (b)		23
Net change in allowance for unfunded loan commitments and letters of credit	(17)	(4)
Allowance at September 30	\$566	\$634

(a) Amounts for 2005 reflect a \$53 million loan recovery received during the second quarter.

(b) Related to the May 2005 acquisition of Riggs National Corporation.

**Table of Contents**

Changes in the allowance for unfunded loan commitments and letters of credit were as follows:

In millions	2006	2005
Allowance at January 1	<b>\$100</b>	\$75
Net change in allowance for unfunded loan commitments and letters of credit	<b>17</b>	4
Allowance at September 30	<b>\$117</b>	\$79

**NOTE 5 MORTGAGE LOAN PORTFOLIO REPOSITIONING**

During the third quarter of 2006, we announced our plan to sell or securitize approximately \$2.1 billion of loans from our residential mortgage portfolio. We expect these transactions to be substantially consummated during the fourth quarter of 2006. In accordance with GAAP, these loans were transferred to loans held for sale as of September 30, 2006. We recognized a pretax loss in the third quarter of 2006 of \$48 million as a reduction of noninterest income, representing the mark to market valuation of these loans upon transfer to held for sale status. This loss, which is reported in the Other business segment, represented the decline in value of the loans almost entirely from the impact of increases in interest rates. We expect to replace these loans with other residential mortgage loans, with the expectation of increasing the overall yield on our total loan portfolio and improving net interest income relative to current estimates.

**NOTE 6 GOODWILL AND OTHER INTANGIBLE ASSETS**

A summary of the changes in goodwill by business for the nine months ended September 30, 2006 follows:

**Goodwill**

	December 31	Additions/ Adjustments	September 30
In millions	2005		2006
Retail Banking	\$1,471	\$11	\$1,482
Corporate & Institutional Banking	935	3	938
BlackRock (a)	190	(190)	
PFPC	968		968
Other	55	(25)	30
Total	\$3,619	\$(201)	\$3,418

(a) Additions/Adjustments include BlackRock deconsolidation and BlackRock, other in the Changes in Goodwill and Other Intangibles table.

The gross carrying amount, accumulated amortization and net carrying amount of other intangible assets by major category consisted of the following:

**Other Intangible Assets**

	September 30	December 31
In millions	2006	2005
Customer-related and other intangibles		
Gross carrying amount (a)	<b>\$342</b>	\$646
Accumulated amortization (a)	<b>(166)</b>	(143)
Net carrying amount	<b>\$176</b>	\$503
Mortgage and other loan servicing rights		
Gross carrying amount	<b>\$613</b>	\$511
Accumulated amortization	<b>(199)</b>	(167)
Net carrying amount	<b>\$414</b>	\$344
Total	<b>\$590</b>	\$847

(a) Amounts for September 30, 2006 were reduced by \$305 million related to the BlackRock deconsolidation. See Note 2 Acquisitions for additional information regarding our deconsolidation of BlackRock effective September 29, 2006.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Most of our other intangible assets have finite lives and are amortized primarily on a straight-line basis or, in the case of mortgage and other loan servicing rights and certain core deposit intangibles, on an accelerated basis.

For customer-related intangibles, the estimated remaining useful lives range from approximately one year to 12 years, with a weighted-average remaining useful life of approximately six years. Our mortgage and other loan servicing rights are amortized primarily over a period of seven to 10 years in proportion to the estimated net servicing income from the related loans.

The changes in the carrying amount of goodwill and net other intangible assets for the nine months ended September 30, 2006, are as follows:

### *Changes in Goodwill and Other Intangibles*

In millions	Goodwill	Customer- Related	Servicing Rights
Balance at December 31, 2005	\$3,619	\$503	\$344
Additions/adjustments:			
BlackRock deconsolidation (a)	(209)	(305)	
BlackRock stock activity, net	(25)		
BlackRock, other	19		
Riggs acquisition	11		
Corporate & Institutional Banking	3	1	102
Reduction in accumulated amortization			2
Amortization (b)		(23)	(34)
Balance at September 30, 2006	<b>\$3,418</b>	<b>\$176</b>	<b>\$414</b>

(a) See note (a) under the Other Intangible Assets table.

(b) Amount is net of \$17 million of accumulated amortization that was eliminated during the third quarter of 2006 in connection with the deconsolidation of BlackRock.

Servicing revenue from mortgage servicing assets and liabilities generated servicing fees, net interest income from servicing portfolio deposit balances and ancillary fees totaling \$99 million and \$35 million for the nine months and three months ended September 30, 2006, respectively. We also generate servicing revenue from fee-based activities provided to others.

We recognized a reduction to goodwill of approximately \$25 million related to BlackRock stock activity, primarily due to the decrease in our ownership interest in BlackRock from approximately 69% to approximately 34% as a result of the BlackRock/MLIM transaction in the third quarter of 2006. The reduction in goodwill reduced the gain realized by PNC from the transaction. Our ownership of BlackRock changes primarily when BlackRock repurchases its shares in the open market and issues shares for an acquisition or pursuant to its employee compensation plans. We recognize goodwill because BlackRock repurchases its shares at an amount greater than book value per share and this results in an increase in our percentage ownership interest.

**Table of Contents**

Amortization expense on intangible assets for the first nine months of 2006 was \$74 million. Amortization expense on existing intangible assets for the remainder of 2006 and for 2007 through 2011 is estimated to be as follows:

- Remainder of 2006: \$25 million,
- 2007: \$89 million,
- 2008: \$84 million,
- 2009: \$79 million,
- 2010: \$58 million, and
- 2011: \$43 million.

**NOTE 7 VARIABLE INTEREST ENTITIES**

As discussed in our 2005 Form 10-K, we are involved with various entities in the normal course of business that may be deemed to be VIEs. We consolidated certain VIEs at September 30, 2006 and December 31, 2005 for which we were determined to be the primary beneficiary. These consolidated VIEs and relationships with PNC are described in our 2005 Form 10-K.

We hold significant variable interests in VIEs that have not been consolidated because we are not considered the primary beneficiary. Information on these VIEs follows:

**Non-Consolidated VIEs Significant Variable Interests**

In millions	Aggregate Assets	Aggregate Liabilities	PNC Risk of Loss
<b>September 30, 2006</b>			
Market Street	\$ 4,049	\$ 4,049	\$ 6,205(a)
Collateralized debt obligations	956	727	21
Partnership interests in low income housing projects	33	30	7
<b>Total</b>	<b>\$ 5,038</b>	<b>\$ 4,806</b>	<b>\$ 6,233</b>
<b>December 31, 2005</b>			
Collateralized debt obligations (b)	\$ 6,290	\$ 5,491	\$ 51(c)
Private investment funds (b)	5,186	1,051	13(c)
Market Street	3,519	3,519	5,089(a)
Partnership interests in low income housing projects	35	29	2
<b>Total</b>	<b>\$ 15,030</b>	<b>\$ 10,090</b>	<b>\$ 5,155</b>

(a) Includes off-balance sheet liquidity commitments to Market Street of \$5 billion and other credit enhancements of \$5 billion at September 30, 2006. The comparable amounts at December 31, 2005 were \$4.6 billion and \$.4 billion, respectively. Events whereby PNC may be liable for funding include bankruptcies, delinquencies, or covenant violations.

(b) Primarily held by BlackRock. We deconsolidated BlackRock effective September 29, 2006. See Note 2 Acquisitions for additional information.

(c) Includes both PNC's direct risk of loss and BlackRock's risk of loss, limited to PNC's ownership interest in BlackRock.

The aggregate assets and liabilities of VIEs that we have consolidated in our financial statements are as follows:

**Consolidated VIEs PNC Is Primary Beneficiary**

In millions	Aggregate Assets	Aggregate Liabilities
<b>September 30, 2006</b>		
Partnership interests in low income housing projects	\$ 870	\$ 870
Other	18	18
<b>Total</b>	<b>\$ 888</b>	<b>\$ 888</b>
<b>December 31, 2005</b>		
Partnership interests in low income housing projects	\$ 680	\$ 680
Other	12	10

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Total \$ 692 \$ 690

We also have subsidiaries that invest in and act as the investment manager for private equity funds organized as limited partnerships as part of our equity management activities. The funds invest in private equity investments to generate capital appreciation and profits. As permitted by FIN 46R, we have deferred applying the provisions of the interpretation for these entities pending further action by the FASB. Information on these entities follows:

*Investment Company Accounting - Deferred Application*

In millions	Aggregate Assets	Aggregate Equity	PNC Risk of Loss
<u>Private Equity Funds</u>			
<b>September 30, 2006</b>	<b>\$82</b>	<b>\$82</b>	<b>\$103</b>
December 31, 2005	\$109	\$109	\$35

PNC's risk of loss in the tables above includes both the value of our equity investments and any unfunded commitments to the respective entities.

**NOTE 8 CAPITAL SECURITIES OF SUBSIDIARY TRUSTS**

These capital securities represent non-voting preferred beneficial interests in the assets of PNC Institutional Capital Trusts A and B, PNC Capital Trusts C and D, UNB Capital Trust I and Capital Statutory Trust II, and the Riggs Capital Trust and Capital Trust II (the Trusts). Trust A is a wholly owned finance subsidiary of PNC Bank, N.A., PNC's principal bank subsidiary. All other Trusts are wholly owned finance subsidiaries of PNC. With the exception of the Riggs Capital Trust, the financial statements of the Trusts are not included in PNC's consolidated financial statements.

PNC has elected to redeem, effective December 2006, all of the underlying Capital Securities relating to the PNC Institutional Capital Trust A, UNB Capital Statutory Trust II, and Riggs Capital Trust. The total outstanding Capital Securities expected to be redeemed is \$453 million.

The obligations of the respective parent of each Trust, when taken collectively, are the equivalent of a full and unconditional guarantee of the obligations of such Trust under the terms of the Capital Securities. Such guarantee is subordinate in right of payment in the same manner as other

**Table of Contents**

junior subordinated debt. There are certain restrictions on PNC's overall ability to obtain funds from its subsidiaries. For additional disclosure on these funding restrictions, including an explanation of dividend and intercompany loan limitations, see Note 4 Regulatory Matters in our 2005 Form 10-K.

We have more information on the Trusts in Note 14 Capital Securities of Subsidiary Trusts in our 2005 Form 10-K.

**NOTE 9 CERTAIN EMPLOYEE BENEFIT AND STOCK-BASED COMPENSATION PLANS**

**Pension and Post-Retirement Plans**

As more fully described in our 2005 Form 10-K, we have a noncontributory, qualified defined benefit pension plan covering eligible employees. Retirement benefits are derived from a cash balance formula based on compensation levels, age and length of service. Pension contributions are based on an actuarially determined amount necessary to fund total benefits payable to plan participants.

We also maintain nonqualified supplemental retirement plans for certain employees. All retirement benefits provided under these nonqualified supplemental plans are unfunded and we make any payments to plan participants. We also provide certain health care and life insurance benefits for qualifying retired employees ( post-retirement benefits ) through various plans.

The components of our net periodic pension and post-retirement benefit cost for the third quarter and first nine months of 2006 and 2005 were as follows:

Three months ended	Qualified Pension Plan		Nonqualified Pension Plan		Post-retirement Benefits	
	2006	2005	2006	2005	2006	2005
In millions						
September 30						
Service cost	\$9	\$9	\$1	\$1	\$1	\$1
Interest cost	17	18	3	3	3	3
Expected return on plan assets	(32)	(34)				
Amortization of prior service cost	(1)	(1)			(1)	(2)
Recognized net actuarial loss	4	6	1	1		1
Net periodic cost	\$(3)	\$(2)	\$2	\$2	\$3	\$3

Nine months ended	Qualified Pension Plan		Nonqualified Pension Plan		Post-retirement Benefits	
	2006	2005	2006	2005	2006	2005
In millions						
September 30						
Service cost	\$26	\$25	\$1	\$1	\$2	\$2
Interest cost	51	48	3	3	10	10
Expected return on plan assets	(97)	(95)				
Amortization of prior service cost	(1)	(1)			(5)	(5)
Recognized net actuarial loss	12	18	2	2	1	3
Net periodic cost	\$(9)	\$(5)	\$6	\$6	\$8	\$10

**Stock-Based Compensation Plans**

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

We have long-term incentive award plans ( Incentive Plans ) that provide for the granting of incentive stock options, nonqualified stock options, stock appreciation rights, incentive shares/performance units, restricted stock, other share-based awards and dollar-denominated awards to executives and, other than incentive stock options, to non-employee directors. As of September 30, 2006, no incentive stock options or stock appreciation rights were outstanding.

### *Nonqualified Stock Options*

Options are granted at exercise prices not less than the market value of common stock on the grant date. Generally, options granted since 1999 become exercisable in installments after the grant date. Options granted prior to 1999 are mainly exercisable 12 months after grant date. No option may be exercisable after 10 years from its grant date. Payment of the option price may be in cash or previously owned shares of common stock at market value on the exercise date.

Generally, options granted under the Incentive Plans vest ratably over a three-year period as long as the grantee remains an employee or, in certain cases, retires from PNC. For all options granted prior to the adoption of SFAS 123R, we recognized compensation expense over the three-year vesting period. If an employee retired prior to the end of the three-year vesting period, we accelerated the expensing of all unrecognized compensation costs at the retirement date. As required under SFAS 123R, we recognize compensation expense for options granted to retirement-eligible employees after January 1, 2006 in the period granted, in accordance with the service period provisions of the options. Total compensation expense recognized related to PNC stock options during the third quarter and first nine months of 2006 was approximately \$7 million and \$20 million, respectively.

For purposes of computing stock option expense and pro forma results, we estimated the fair value of stock options using the Black-Scholes option pricing model. The model requires the use of numerous assumptions, many of which are very subjective. Therefore, the pro forma results are estimates of results of operations as if compensation expense had been recognized for all stock-based compensation awards and are not indicative of the impact on future periods.

We used the following assumptions in the option pricing model for purposes of estimating pro forma results in 2005 and to determine 2006 and 2005 stock option expense:

- The risk-free interest rate is based on the US Treasury yield curve,
- The dividend yield represents average yields over the previous three-year period,
- Volatility is measured using the fluctuation in month-end closing stock prices over a five-year period, and
- The expected life assumption represents the period of time that options granted are expected to be outstanding and is based on a weighted average of historical option activity.



**Table of Contents****Option Pricing Assumptions**

Weighted average for the nine months ended September 30	<b>2006</b>	2005
Risk-free interest rate	<b>4.4%</b>	3.8%
Dividend yield	<b>3.7%</b>	3.8%
Volatility	<b>20.6%</b>	25.9%
Expected life	<b>5.3 yrs.</b>	4.9 yrs.

The status of PNC stock options at September 30, 2006 follows:

	Shares (thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (millions)
Outstanding	15,586	\$ 58.40	5.8	\$ 229
Vested and expected to vest	14,912	\$ 58.48	5.7	\$ 218
Exercisable	11,502	\$ 57.75	5.3	\$ 178

During the first nine months of 2006 we issued approximately 4.2 million shares from treasury stock in connection with stock option exercise activity, including 1 million shares in the third quarter. As with past exercise activity, we intend to utilize treasury stock for future stock option exercises.

**Incentive Share and Restricted Stock Awards**

The fair value of nonvested incentive shares and restricted stock awards is initially determined based on the average of the high and low of our common stock price on the date of grant. Incentive shares are subsequently valued subject to the achievement of one or more financial and other performance goals over a three-year period. The Personnel and Compensation Committee of the Board of Directors approves the final award of incentive shares. Restricted stock awards have various vesting periods ranging from 36 months to 60 months. There are no financial or performance goals associated with any of our restricted stock awards.

We recognize compensation expense for incentive shares and restricted stock awards ratably over the corresponding vesting and/or performance periods for each type of program. Total compensation expense recognized related to PNC incentive share and restricted stock awards during the first nine months of 2006 was approximately \$35 million, including \$11 million during the third quarter.

The status of PNC nonvested incentive shares and restricted stock awards at September 30, 2006, follows:

	Shares	Weighted-Average Grant Date Fair Value
Shares in thousands		
Nonvested incentive shares	184	\$69.59
Nonvested restricted stock	2,823	\$55.49

At September 30, 2006, there was \$51 million of unrecognized deferred compensation expense related to nonvested share-based compensation arrangements granted under the Incentive Plans.

This cost is expected to be recognized as expense over a period of no longer than five years.

**NOTE 10 FINANCIAL DERIVATIVES**

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

We use a variety of derivative financial instruments to help manage interest rate, market and credit risk and reduce the effects that changes in interest rates may have on net income, fair value of assets and liabilities, and cash flows. These instruments include interest rate swaps, interest rate caps and floors, futures contracts, and total return swaps.

### **Fair Value Hedging Strategies**

We enter into interest rate and total return swaps, interest rate caps, floors and futures derivative contracts to hedge designated commercial mortgage loans held for sale, commercial loans, bank notes, senior debt and subordinated debt for changes in fair value primarily due to changes in interest rates. Adjustments related to the ineffective portion of fair value hedging instruments are recorded in interest income, interest expense or noninterest income depending on the hedged item.

### **Cash Flow Hedging Strategy**

We enter into interest rate swap contracts to modify the interest rate characteristics of designated commercial loans from variable to fixed in order to reduce the impact of interest rate changes on future interest income. We are hedging our exposure to the variability of future cash flows for all forecasted transactions for a maximum of 10 years for hedges converting floating-rate commercial loans to fixed. The fair value of these derivatives is reported in other assets or other liabilities and offset in AOCI for the effective portion of the derivatives. When the hedged transaction culminates, any unrealized gains or losses related to these swap contracts are reclassified from AOCI into earnings in the same period or periods during which the hedged forecasted transaction affects earnings and are included in interest income. Ineffectiveness of the strategy, as defined by risk management policies and procedures, if any, is reported in interest income.

During the next twelve months, we expect to reclassify to earnings \$25 million of pretax net losses, or \$16 million after-tax, on cash flow hedge derivatives currently reported in AOCI. This amount could differ from amounts actually recognized due to changes in interest rates and the addition of other hedges subsequent to September 30, 2006. These net losses are anticipated to result from net cash flows on receive fixed interest rate swaps that would impact interest income recognized on the related floating rate commercial loans.

As of September 30, 2006 we have determined that there were no hedging positions where it was probable that certain forecasted transactions may not occur within the originally designated time period.

For those hedge relationships that require testing for ineffectiveness, any ineffectiveness present in the hedge relationship is recognized in current earnings. The ineffective portion of the change in value of these derivatives resulted in a \$4 million net loss for the nine months ended September 30,

## **Table of Contents**

2006 and a \$2 million net loss for the nine months ended September 30, 2005.

During the third quarter of 2006, we recognized a \$20 million pretax loss charged to other noninterest income associated with our application of the short-cut method of fair value hedge accounting for trust preferred securities.

### **Free-Standing Derivatives**

To accommodate customer needs, we also enter into financial derivative transactions primarily consisting of interest rate swaps, interest rate caps and floors, futures, swaptions, and foreign exchange and equity contracts. We primarily manage our market risk exposure from customer positions through transactions with third-party dealers. The credit risk associated with derivatives executed with customers is essentially the same as that involved in extending loans and is subject to normal credit policies. We may obtain collateral based on our assessment of the customer. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income.

Also included in free-standing derivatives are transactions that we enter into for risk management and proprietary purposes that are not designated as accounting hedges, primarily interest rate and basis swaps, interest rate caps and floors, credit default swaps, option contracts and certain interest rate-locked loan origination commitments as well as commitments to buy or sell mortgage loans.

Basis swaps are agreements involving the exchange of payments, based on notional amounts, of two floating rate financial instruments denominated in the same currency, one pegged to one reference rate and the other tied to a second reference rate (e.g., swapping payments tied to one-month LIBOR for payments tied to three-month LIBOR). We use these contracts to mitigate the impact on earnings of exposure to a certain referenced interest rate.

We purchase and sell credit default swaps to mitigate the economic impact of credit losses on specifically identified existing lending relationships or to generate revenue from proprietary trading activities. The fair value of these derivatives typically are based on the change in value, due to changing credit spreads.

Interest rate lock commitments for, as well as commitments to buy or sell, mortgage loans that we intend to sell are considered free-standing derivatives. Our interest rate exposure on certain commercial mortgage interest rate lock commitments is economically hedged with pay-fixed interest rate swaps and forward sales agreements. These contracts mitigate the impact on earnings of exposure to a certain referenced rate.

Free-standing derivatives also include positions we take based on market expectations or to benefit from price differentials between financial instruments and the market based on stated risk management objectives.

### **Derivative Counterparty Credit Risk**

By purchasing and writing derivative contracts we are exposed to credit risk if the counterparties fail to perform. Our credit risk is equal to the fair value gain in the derivative contract. We minimize credit risk through credit approvals, limits, monitoring procedures and collateral requirements. We generally enter into transactions with counterparties that carry high quality credit ratings.

We enter into risk participation agreements to share some of the credit exposure with other counterparties related to interest rate derivative contracts or to take on credit exposure to generate revenue. We will make/receive payments under these guarantees if a customer defaults on its obligation to perform under certain credit agreements. Risk participation agreements entered into prior to July 1, 2003 are considered financial guarantees and therefore are not included in derivatives. Agreements entered into subsequent to June 30, 2003 are included in the derivatives table that follows. We determine that we meet our objective of reducing credit risk associated with certain counterparties to derivative contracts when the participation agreements share in their proportional credit losses of those counterparties.

We generally have established agreements with our major derivative dealer counterparties that provide for exchanges of marketable securities or cash to collateralize either party's positions. At September 30, 2006 we held cash and US government and mortgage-backed securities with a fair value of \$74 million and pledged mortgage-backed securities with a fair value of \$161 million under these agreements.



**Table of Contents**

The total notional or contractual amounts, net fair value and credit risk for derivatives at September 30, 2006 and December 31, 2005 were as follows:

In millions	September 30, 2006			December 31, 2005		
	Notional/Contract amount	Net fair value	Credit risk	Notional/Contract amount	Net fair value	Credit risk
<b>ACCOUNTING HEDGES</b>						
Fair value hedges	\$4,743	\$(5)	\$61	\$5,900	\$78	\$108
Cash flow hedges	7,218	22	37	2,926	(9)	5
Total	\$11,961	\$17	\$98	\$8,826	\$69	\$113
<b>FREE-STANDING DERIVATIVES</b>						
Interest rate contracts	\$98,231	\$(13)	\$556	\$70,404	\$39	\$372
Equity contracts	3,029	(35)	132	2,744	(79)	347
Foreign exchange contracts	4,868	3	43	4,687	4	60
Credit contracts	3,230	(8)	3	1,353		7
Options	53,871	69	302	51,383	32	168
Risk participation agreements	685			461		
Commitments related to mortgage- related assets	1,574	36	37	1,695	1	6
Other	20			254	5	9
Total	\$165,508	\$52	\$1,073	\$132,981	\$2	\$969

**NOTE 11 EARNINGS PER SHARE**

Basic and diluted earnings per common share calculations follow:

In millions, except share and per share data	Nine months ended			
	Three months ended		September 30	
	September 30 2006	2005	2006	2005
<b>CALCULATION OF BASIC EARNINGS PER COMMON SHARE</b>				
Net income	\$1,484	\$334	\$2,219	\$970
Less: Preferred dividends declared		1		1
Net income applicable to basic earnings per common share	\$1,484	\$333	\$2,219	\$969
Basic weighted-average common shares outstanding (in thousands)	291,444	288,618	292,046	284,963
Basic earnings per common share	\$5.09	\$1.16	\$7.60	\$3.40
<b>CALCULATION OF DILUTED EARNINGS PER COMMON SHARE (a)</b>				
Net income	\$1,484	\$334	\$2,219	\$970
Less: BlackRock adjustment for common stock equivalents	2	2	5	5
Net income applicable to diluted earnings per common share	\$1,482	\$332	\$2,214	\$965
Basic weighted-average common shares outstanding (in thousands)	291,444	288,618	292,046	284,963
Conversion of preferred stock Series A and B	69	78	72	79
Conversion of preferred stock Series C and D	581	614	587	623
Conversion of debentures	2	2	2	2
Exercise of stock options	2,076	1,098	2,162	1,004
Incentive share awards	1,757	1,511	1,782	1,489

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Diluted weighted-average common shares outstanding (in thousands)	<b>295,929</b>	291,921	<b>296,651</b>	288,160
Diluted earnings per common share	<b>\$5.01</b>	\$1.14	<b>\$7.46</b>	\$3.35
(a) Excludes stock options considered to be anti-dilutive ( <i>in thousands</i> )	<b>3,992</b>	10,903	<b>4,688</b>	12,459

**Table of Contents**

**NOTE 12 SHAREHOLDERS EQUITY AND OTHER COMPREHENSIVE INCOME**

Activity in shareholders' equity for the first nine months of 2006 follows. Our preferred stock outstanding as of September 30, 2006 and December 31, 2005 totaled less than \$.5 million at each date and, therefore, is excluded from the table.

In millions, except per share data	Shares Outstanding		Capital Surplus	Retained Earnings	Deferred Compensation Expense	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	Common Stock	Common Stock						
Balance at December 31, 2005	293	\$1,764	\$1,358	\$9,023	\$(59)	\$(267)	\$(3,256)	\$8,563
Net income				2,219				2,219
Other comprehensive income (loss), net of tax								
Net unrealized securities gains						142		142
Net unrealized gains on cash flow hedge derivatives						19		19
Other (a)						(3)		(3)
Comprehensive income								2,377
Cash dividends declared								
Common (\$1.60 per share)				(471)				(471)
BlackRock/MLIM transaction (b)			265					265
Treasury stock activity	1		(16)				(40)	(56)
Tax benefit of stock option plans			29					29
Stock options granted			21					21
Subsidiary stock transactions			22					22
Deferred compensation activity					8			8
Balance at September 30, 2006	294	\$1,764	\$1,679	\$10,771	\$(51)	\$(109)	\$(3,296)	\$10,758

A summary of the components of the change in accumulated other comprehensive income (loss) follows:

Nine months ended September 30, 2006

In millions	Pretax	Tax Benefit	After-tax
Change in net unrealized securities losses			
Increase in net unrealized gains on securities held at period end	\$118	\$(42)	\$76
Less: Net losses realized in net income (c)	(101)	35	(66)
Change in net unrealized securities losses	219	(77)	142
Change in net unrealized losses on cash flow hedge derivatives			
Increase in net unrealized gains on cash flow hedge derivatives	25	(9)	16
Less: Net losses realized in net income	(5)	2	(3)
Change in net unrealized losses on cash flow hedge derivatives	30	(11)	19
Other (a)	(5)	2	(3)
Other comprehensive income (loss)	\$244	\$(86)	\$158

The accumulated balances related to each component of other comprehensive income (loss) are as follows:

In millions	September 30, 2006		December 31, 2005	
	Pretax	After-tax	Pretax	After-tax
Net unrealized securities gains (losses)	\$(151)	\$(98)	\$(370)	\$(240)

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Net unrealized gains (losses) on cash flow hedge derivatives	(10)	(7)	(40)	(26)
Other, net (a)	(7)	(4)	(2)	(1)
Accumulated other comprehensive loss	<b>\$(168)</b>	<b>\$(109)</b>	\$(412)	\$(267)

(a) Consists of interest-only strip valuation adjustments, foreign currency translation adjustments and minimum pension liability adjustments.

(b) Represents the portion of our gain on the BlackRock/MLIM transaction that was credited to capital surplus.

(c) The pretax amount represents net unrealized losses at December 31, 2005 that were realized in 2006 when the related securities were sold. This amount differs from net securities losses included in the Consolidated Income Statement primarily because it does not include gains or losses realized on securities that were purchased and then sold during 2006.



---

**Table of Contents*****NOTE 13 LEGAL PROCEEDINGS***

On July 13, 2006, the United States District Court for the Western District of Pennsylvania approved the settlement of the consolidated class action arising out of the three 2001 PAGIC transactions. This settlement and related matters arising out of the PAGIC transactions are described in our 2005 Annual Report on Form 10-K for the year ended December 31, 2005. The defendant in that class action not participating in this settlement had objected to it and on August 10, 2006 appealed the decision of the district court approving the settlement to the United States Court of Appeals for the Third Circuit.

Some of our subsidiaries are defendants (or have potential contractual contribution obligations to other defendants) in several pending lawsuits brought during late 2002 and 2003 arising out of the bankruptcy of Adelphia Communications Corporation and its subsidiaries. There also are threatened additional proceedings arising out of the same matters. One of the lawsuits was brought, on Adelphia's behalf by the unsecured creditors' committee and equity committee in Adelphia's consolidated bankruptcy proceeding and was removed to the United States District Court for the Southern District of New York by order dated February 9, 2006. The other lawsuits, one of which is a putative consolidated class action, were brought by holders of debt and equity securities of Adelphia and have been consolidated for pretrial purposes in that district court. These lawsuits arise out of lending and securities underwriting activities engaged in by these PNC subsidiaries together with other financial services companies. In the aggregate, more than 400 other financial services companies and numerous other companies and individuals have been named as defendants in one or more of the lawsuits. Collectively, with respect to some or all of the defendants, the lawsuits allege federal law claims, including violations of federal securities and other federal laws, violations of common law duties, aiding and abetting such violations, voidable preference payments, and fraudulent transfers, among other matters. The lawsuits seek unquantified monetary damages, interest, attorneys' fees and other expenses, and a return of the alleged voidable preference and fraudulent transfer payments, among other remedies. The bank defendants, including the PNC defendants, have entered into a tentative settlement of the consolidated class action referred to above. This settlement is subject to conditions, including court approval. The amount for which we would be responsible under this settlement is insignificant. We believe that we have defenses to the claims against us in these lawsuits, as well as potential claims against third parties, and intend to defend the remaining lawsuits vigorously. These lawsuits involve complex issues of law and fact, presenting complicated relationships among the many financial and other participants in the events giving rise to these lawsuits, and have not progressed to the point where we can predict the outcome of the lawsuits other than the one for which a tentative settlement is pending. It is not possible to determine what the likely aggregate recoveries on the part of the plaintiffs in these remaining matters might be or the portion of any such recoveries for which we would ultimately be responsible, but the final consequences to PNC could be material.

On April 29, 2005, an amended complaint was filed in the putative class action against PNC, PNC Bank, N.A., our Pension Plan and its Pension Committee in the United States District Court for the Eastern District of Pennsylvania

(originally filed in December 2004). The complaint claims violations of the Employee Retirement Income Security Act of 1974, as amended (ERISA), arising out of the January 1, 1999 conversion of our Pension Plan from a traditional defined benefit formula into a cash balance formula, the design and continued operation of the Plan, and other related matters. Plaintiffs seek to represent a class of all current and former employee-participants in and beneficiaries of the Plan as of December 31, 1998 and thereafter. Plaintiffs also seek to represent a subclass of all current and former employee-participants in and beneficiaries of the Plan as of December 31, 1998 and thereafter who were or would have become eligible for an early retirement subsidy under the former Plan at some time prior to the date of the amended complaint. The plaintiffs are seeking unquantified damages and equitable relief available under ERISA, including interest, costs, and attorneys' fees. On November 21, 2005, the court granted our motion to dismiss the amended complaint. Plaintiffs have appealed this ruling to the United States Court of Appeals for the Third Circuit. We believe that we have substantial defenses to the claims against us in this lawsuit and intend to defend it vigorously.

On March 28, 2006, a first amended complaint was filed in the United States District Court for the Eastern District of Texas by Data Treasury Corporation against PNC and PNC Bank, N.A., as well as more than 50 other financial institutions, vendors, and other companies, claiming that the defendants are infringing, and inducing or contributing to the infringement of, the plaintiff's patents, which allegedly involve check imaging, storage and transfer. The plaintiff seeks unspecified damages and interest and trebling of both, attorneys' fees and other expenses, and injunctive relief against the alleged infringement. We are not in a position to assess the likely outcome of this matter, including our exposure, if any. We believe that we have defenses to the claims against us in this lawsuit and intend to defend it vigorously.

On August 21, 2006, a lawsuit was filed in the United States District Court for the Eastern District of Texas by Ronald A. Katz Technology Licensing L. P. (RAKTL) against PNC, PNC Bank, N.A., and other defendants. On September 7, 2006, this lawsuit was divided into separate actions, and amended complaints were then filed, one of which is against PNC and PNC Bank, N.A. This lawsuit is one of many related RAKTL patent infringement actions pending in various federal district courts against a large number of defendants. Each of the actions involves a single family of related patents that RAKTL refers to as the interactive call processing patents. The amended complaint alleges that PNC and PNC Bank, N.A. are infringing, and inducing or contributing to the infringement of, certain of the plaintiff's patents. RAKTL seeks unspecified damages (including treble damages), interest, attorneys' fees and other expenses, and injunctive relief against the alleged infringement. We are not in a position to assess the likely outcome of this matter, including our exposure, if any. We believe that we have defenses to the claims

against us in this lawsuit and intend to defend it vigorously.

In its Form 10-Q for the quarter ended March 31, 2005, Riggs National Corporation ( Riggs ) disclosed a number of pending lawsuits. All material lawsuits have been finally resolved except one where a settlement agreement has been reached, subject

---

## **Table of Contents**

to final documentation. The pending settlement is not material to PNC.

As a result of the acquisition of Riggs, PNC is now responsible for Riggs' obligations to provide indemnification to its directors, officers, and, in some cases, employees and agents against certain liabilities incurred as a result of their service on behalf of or at the request of Riggs. PNC is also now responsible for Riggs' obligations to advance on behalf of covered individuals costs incurred in connection with certain claims or proceedings, subject to written undertakings to repay all amounts so advanced if it is ultimately determined that the individual is not entitled to indemnification. Since the acquisition, we have advanced such costs on behalf of covered individuals from Riggs and expect to continue to do so in the future at least with respect to lawsuits and other legal matters identified in Riggs' first quarter 2005 Form 10-Q.

In connection with industry-wide investigations of practices in the mutual fund industry including market timing, late day trading, employee trading in mutual funds and other matters, several of our subsidiaries have received requests for information and other inquiries from state and federal governmental and regulatory authorities. These subsidiaries are fully cooperating in all of these matters. In addition, as a result of the regulated nature of our business and that of a number of our subsidiaries, particularly in the banking and securities areas, we and our subsidiaries are the subject from time to time of investigations and other forms of regulatory inquiry, often as part of industry-wide regulatory reviews of specified activities. Our practice is to cooperate fully with these investigations and inquiries.

In addition to the proceedings or other matters described above, PNC and persons to whom we may have indemnification obligations, in the normal course of business, are subject to various other pending and threatened legal proceedings in which claims for monetary damages and other relief are asserted. We do not anticipate, at the present time, that the ultimate aggregate liability, if any, arising out of such other legal proceedings will have a material adverse effect on our financial position. However, we cannot now determine whether or not any claims asserted against us or others to whom we may have indemnification obligations, whether in the proceedings or other matters specifically described above or otherwise, will have a material adverse effect on our results of operations in any future reporting period.

### ***NOTE 14 SEGMENT REPORTING***

We have four major businesses engaged in providing banking, asset management and global fund processing products and services:

- Retail Banking,
- Corporate & Institutional Banking,
- BlackRock, and
- PFPC.

Results of individual businesses are presented based on our management accounting practices and our management structure. There is no comprehensive, authoritative body of guidance for management accounting equivalent to GAAP; therefore, the financial results of individual businesses are not

necessarily comparable with similar information for any other company. We refine our methodologies from time to time as our management accounting practices are enhanced and our businesses and management structure change. Financial results are presented, to the extent practicable, as if each business operated on a stand-alone basis. As permitted under GAAP, we have aggregated the business results for certain operating segments for financial reporting purposes.

Assets receive a funding charge and liabilities and capital receive a funding credit based on a transfer pricing methodology that incorporates product maturities, duration and other factors. Capital is intended to cover unexpected losses and is assigned to the banking and processing businesses using our risk-based economic capital model. We have increased the capital assigned to Retail Banking to 6% of funds to reflect the capital required for well-capitalized banks and to approximate market comparables for this business. The capital for BlackRock and PFPC reflects average legal entity shareholders' equity, which exceeds required economic capital.

BlackRock business segment results for the three months and nine months ended September 30, 2006 and 2005 reflect our majority ownership in BlackRock during each of these periods. Subsequent to the September 29, 2006 BlackRock/MLIM closing, which had the effect of reducing our ownership interest to approximately 34%, our investment in BlackRock is being accounted for under the equity method of accounting but will continue to be a separate reportable business segment of PNC. Our prior period business segment information for BlackRock will not be restated. See Note 2 Acquisitions regarding the BlackRock/MLIM transaction.

We have allocated the allowances for loan and lease losses and unfunded loan commitments and letters of credit based on our assessment of risk inherent in the loan portfolios. Our allocation of the costs incurred by operations and other support areas not directly aligned with the businesses is primarily based on the use of services.

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Total business segment financial results differ from total consolidated results. The impact of these differences is reflected in the Intercompany Eliminations and Other categories. Intercompany Eliminations reflects activities conducted among our businesses that are eliminated in the consolidated results. Other includes residual activities that do not meet the criteria for disclosure as a separate reportable business, such as the third quarter 2006 gain on BlackRock/MLIM transaction, 2006 BlackRock/MLIM integration costs, One PNC implementation costs, asset and liability management activities, related net securities gains or losses, certain trading activities, equity management activities and minority interest in income of BlackRock up to September 29, 2006, differences between business segment performance reporting and financial statement reporting (GAAP), and most corporate overhead.

Assets, revenue and earnings attributable to foreign activities were not material in the periods presented.

## **Table of Contents**

**BUSINESS SEGMENT PRODUCTS AND SERVICES Retail Banking** provides deposit, lending, brokerage, trust, investment management, and cash management services to approximately 2.5 million consumer and small business customers within our primary geographic area. Our customers are serviced through approximately 850 offices in our branch network, the call center located in Pittsburgh and the Internet [www.pncbank.com](http://www.pncbank.com). The branch network is located primarily in Pennsylvania; New Jersey; the greater Washington, DC area, including Virginia and Maryland; Ohio; Kentucky and Delaware. Brokerage services are provided through PNC Investments, LLC, and J.J.B. Hilliard, W.L. Lyons, Inc. Retail Banking also serves as investment manager and trustee for employee benefit plans and charitable and endowment assets and provides nondiscretionary defined contribution plan services and investment options through its *Vested Interest*<sup>®</sup> product. These services are provided to individuals and corporations primarily within our primary geographic markets.

See Note 16 Subsequent Event regarding a planned acquisition.

**Corporate & Institutional Banking** provides lending, treasury management, and capital markets products and services to mid-sized corporations, government entities and selectively to large corporations. Lending products include secured and unsecured loans, letters of credit and equipment leases. Treasury management services include cash and investment management, receivables management, disbursement services, funds transfer services, information reporting, and global trade services. Capital markets products and services include foreign exchange, derivatives, loan syndications, mergers and acquisitions advisory and related services to middle-market companies, securities underwriting, and securities sales and trading. Corporate & Institutional Banking also provides commercial loan servicing, real estate advisory and technology solutions for the commercial real estate finance industry. Corporate & Institutional Banking provides products and services generally within our primary geographic markets with certain products and services provided nationally.

**BlackRock** is one of the world's largest publicly traded investment management firms. As of September 30, 2006, BlackRock's assets under management, including assets under management acquired as a result of the BlackRock/MLIM transaction, were approximately \$1.1 trillion. The firm manages assets on behalf of institutions and individuals worldwide through a variety of equity, fixed income, cash management and alternative investment products. In addition, BlackRock provides BlackRock Solutions<sup>®</sup> investment system, risk management, and financial advisory services to a growing number of institutional investors. The firm has a major presence in key global markets, including the United States, Europe, Asia, Australia and the Middle East. For additional information, please visit the firm's website at [www.blackrock.com](http://www.blackrock.com).

See Note 2 Acquisitions regarding the BlackRock/MLIM transaction. Effective September 29, 2006, our ownership interest in BlackRock was reduced to approximately 34% and, accordingly, we began accounting for our investment in BlackRock under the equity method of accounting as of that date.

**PFPC** is a leading full service provider of processing, technology and business solutions for the global investment industry. Securities services include custody, securities lending, and accounting and administration for funds registered under the 1940 Act and alternative investments. Investor services include transfer agency, managed accounts, subaccounting, and distribution. PFPC serviced \$2.0 trillion in total assets and 66 million shareholder accounts as of September 30, 2006 both domestically and internationally through its Ireland and Luxembourg operations.

**Table of Contents****Business Segment Results****Three months ended September 30**

In millions	Retail	Corporate &				Intercompany	Consolidated
	Banking	Institutional Banking	BlackRock	PFPC	Other	Eliminations	
<b>2006 INCOME STATEMENT</b>							
Net interest income (expense)	\$425	\$180	\$2	\$(10)	\$(30)		\$567
Noninterest income	364	174	323	218	1,881	\$(17)	2,943
Total revenue	789	354	325	208	1,851	(17)	3,510
Provision for credit losses	9	7					16
Depreciation and amortization	17	5	10	13	26		71
Other noninterest expense	434	177	285	153	73	(15)	1,107
Earnings (loss) before minority and other interests and income taxes	329	165	30	42	1,752	(2)	2,316
Minority and other interests in income of consolidated entities	5		1		(11)		(5)
Income taxes	118	52	10	2	655		837
Earnings (loss)	\$206	\$113	\$19	\$40	\$1,108	\$(2)	\$1,484
Inter-segment revenue	\$2	\$2	\$7	\$3	\$3	\$(17)	
AVERAGE ASSETS (a)	\$29,306	\$26,910	\$3,865	\$2,053	\$35,487	\$(2,276)	\$95,345
<b>2005 INCOME STATEMENT</b>							
Net interest income (expense)	\$405	\$191	\$19	\$(10)	\$(46)		\$559
Noninterest income	333	152	301	221	134	\$(25)	1,116
Total revenue	738	343	320	211	88	(25)	1,675
Provision for (recoveries of) credit losses	14	(1)			3		16
Depreciation and amortization	18	5	8	14	34		79
Other noninterest expense	426	167	213	157	140	(23)	1,080
Earnings (loss) before minority and other interests and income taxes	280	172	99	40	(89)	(2)	500
Minority and other interests in income of consolidated entities			1		13		14
Income taxes	104	54	37	12	(29)	(26)	152
Earnings (loss)	\$176	\$118	\$61	\$28	\$(73)	\$24	\$334
Inter-segment revenue	\$3	\$2	\$9	\$1	\$10	\$(25)	
AVERAGE ASSETS (a)	\$28,546	\$26,684	\$1,673	\$2,082	\$33,742	\$(1,651)	\$91,076

**Nine months ended September 30**

In millions	Retail	Corporate &				Intercompany	Consolidated
	Banking	Institutional Banking	BlackRock	PFPC	Other	Eliminations	
<b>2006 INCOME STATEMENT</b>							
Net interest income (expense)	\$1,255	\$523	\$20	\$(29)	\$(90)		\$1,679
Noninterest income	1,067	548	1,079	663	2,053	\$(52)	5,358
Total revenue	2,322	1,071	1,099	634	1,963	(52)	7,037
Provision for credit losses	46	36					82
Depreciation and amortization	51	17	29	42	76		215
Other noninterest expense	1,291	533	826	464	217	(48)	3,283
Earnings (loss) before minority and other interests and income taxes	934	485	244	128	1,670	(4)	3,457
Minority and other interests in income of consolidated entities	14		2		7		23
Income taxes	339	151	89	35	602	(1)	1,215
Earnings (loss)	\$581	\$334	\$153	\$93	\$1,061	\$(3)	\$2,219
Inter-segment revenue	\$8	\$5	\$23	\$7	\$9	\$(52)	
AVERAGE ASSETS (a)	\$29,319	\$26,237	\$3,865	\$2,053	\$34,737	\$(2,559)	\$93,652
<b>2005 INCOME STATEMENT</b>							
Net interest income (expense)	\$1,172	\$549	\$31	\$(35)	\$(118)		\$1,599
Noninterest income	937	422	822	672	224	\$(58)	3,019
Total revenue	2,109	971	853	637	106	(58)	4,618
Provision for (recoveries of) credit losses	43	(53)			7		(3)
Depreciation and amortization	46	13	22	43	78		202
Other noninterest expense	1,246	468	572	477	286	(52)	2,997
Earnings (loss) before minority and other interests and income taxes	774	543	259	117	(265)	(6)	1,422

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Minority and other interests in income of consolidated entities			2		27		29
Income taxes	287	171	96	42	(146)	(27)	423
Earnings (loss)	\$487	\$372	\$161	\$75	\$(146)	\$21	\$970
Inter-segment revenue	\$9	\$5	\$24	\$2	\$18	\$(58)	
AVERAGE ASSETS (a)	\$27,138	\$25,303	\$1,673	\$2,082	\$32,783	\$(1,618)	\$87,361

(a) Period-end balances for BlackRock and PFPC.

Certain revenue and expense amounts shown in the preceding table differ from amounts included in the Business Segments Review section of Part I, Item 2 of this Form 10-Q due to the presentation in Item 2 of business revenues on a taxable-equivalent basis, the inclusion of BlackRock/MLIM integration costs in Other in the Item 2 presentation, and classification differences related to BlackRock and PFPC. BlackRock income classified as net interest income in the preceding table represents the net of investment income and interest expense as presented in the Business Segments Review section. PFPC income classified as net interest income (expense) in the preceding table represents the interest components of other nonoperating income (net of nonoperating expense) and debt financing as disclosed in the Business Segments Review section.

---

**Table of Contents**

***NOTE 15 COMMITMENTS AND GUARANTEES***

**EQUITY FUNDING AND OTHER COMMITMENTS**

We had commitments to make additional equity investments in certain equity management entities of \$131 million and affordable housing limited partnerships of \$42 million at September 30, 2006.

Additionally, in October 2005, we committed \$200 million to PNC Mezzanine Partners III, L.P., a \$350 million mezzanine fund that invests principally in subordinated debt securities with an equity component. Funding of this investment is expected to occur over a five-year period. The remaining unfunded commitment on September 30, 2006 was \$179 million. The limited partnership is consolidated for financial reporting purposes as PNC has a 57% ownership interest.

In July 2006, we committed to invest an aggregate of \$100 million in FIM Holdings, LLC ( FIM ) as a non-managing member with a 1.25% ownership interest. FIM was formed to acquire a 51% ownership position in GMAC LLC from General Motors Corporation ( GM ) and to make a purchase of redeemable preferred stock from GMAC LLC. Our commitment, presently unfunded, is subject to satisfaction of certain conditions to the obligations of FIM contained in an agreement between FIM and GM. The current timetable for the closing and funding of this investment is the fourth quarter of 2006. However, delays in satisfying pre-closing conditions included in the agreements, including regulatory approval, may delay this investment until 2007.

**STANDBY LETTERS OF CREDIT**

We issue standby letters of credit and have risk participations in standby letters of credit and bankers' acceptances issued by other financial institutions, in each case to support obligations of our customers to third parties. If the customer fails to meet its financial or performance obligation to the third party under the terms of the contract, then upon the request of the guaranteed party, we would be obligated to make payment to them. The standby letters of credit and risk participations in standby letters of credit and bankers' acceptances outstanding on September 30, 2006 had terms ranging from less than one year to 11 years. The aggregate maximum amount of future payments we could be required to make under outstanding standby letters of credit and risk participations in standby letters of credit and bankers' acceptances was \$6.9 billion at September 30, 2006.

Assets valued as of September 30, 2006 of approximately \$1 billion secured certain specifically identified standby letters of credit. Approximately \$2.4 billion in recourse provisions from third parties was also available for this purpose as of September 30, 2006. In addition, a portion of the remaining standby letters of credit and letter of credit risk participations issued on behalf of specific customers is also secured by collateral or guarantees that secure the customers' other obligations to us. The carrying amount of the liability for our obligations related to standby letters of credit and risk participations in standby letters of credit and bankers' acceptances was \$58 million at September 30, 2006.

**STANDBY BOND PURCHASE AGREEMENTS AND OTHER LIQUIDITY FACILITIES**

We enter into standby bond purchase agreements to support municipal bond obligations. At September 30, 2006, the aggregate of PNC's commitments under these facilities was

\$241 million. PNC also enters into certain other liquidity facilities to support individual pools of receivables acquired by commercial paper conduits including Market Street. At September 30, 2006, our total commitments under these facilities were \$5.9 billion, of which \$5.7 billion was related to Market Street.

**INDEMNIFICATIONS**

We are a party to numerous acquisition or divestiture agreements under which we have purchased or sold, or agreed to purchase or sell, various types of assets. These agreements can cover the purchase or sale of:

- Entire businesses,
- Loan portfolios,
- Branch banks,
- Partial interests in companies, or
- Other types of assets.



## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

These agreements generally include indemnification provisions under which we indemnify the third parties to these agreements against a variety of risks to the indemnified parties as a result of the transaction in question. When PNC is the seller, the indemnification provisions will generally also provide the buyer with protection relating to the quality of the assets we are selling and the extent of any liabilities being assumed by the buyer. Due to the nature of these indemnification provisions, we cannot quantify the total potential exposure to us resulting from them.

We provide indemnification in connection with securities offering transactions in which we are involved. When we are the issuer of the securities, we provide indemnification to the underwriters or placement agents analogous to the indemnification provided to the purchasers of businesses from us, as described above. When we are an underwriter or placement agent, we provide a limited indemnification to the issuer related to our actions in connection with the offering and, if there are other underwriters, indemnification to the other underwriters intended to result in an appropriate sharing of the risk of participating in the offering. Due to the nature of these indemnification provisions, we cannot quantify the total potential exposure to us resulting from them.

We enter into certain types of agreements that include provisions for indemnifying third parties, such as:

- Agreements relating to providing various servicing and processing functions to third parties,
- Agreements relating to the creation of trusts or other legal entities to facilitate leasing transactions, commercial mortgage-backed securities transactions (loan securitizations) and certain other off-balance sheet transactions,
- Confidentiality agreements,
- Syndicated credit agreements, as a syndicate member,
- Sales of individual loans and equipment leases,
- Arrangements with brokers to facilitate the hedging of derivative and convertible arbitrage activities, and
- Litigation settlement agreements.

Due to the nature of these indemnification provisions, we cannot calculate our aggregate potential exposure under them.

## **Table of Contents**

We enter into certain types of agreements, including leases, assignments of leases, and subleases, in which we agree to indemnify third parties for acts by our agents, assignees and/or sublessees, and employees. While we do not believe these indemnification liabilities are material, either individually or in total, we cannot calculate our potential exposure.

We enter into contracts for the delivery of technology service in which we indemnify the other party against claims of patent and copyright infringement by third parties. Due to the nature of these indemnification provisions, we cannot calculate our aggregate potential exposure under this type of indemnification.

We engage in certain insurance activities which require our employees to be bonded. We satisfy this bonding requirement by issuing letters of credit in a total amount of approximately \$5 million.

In the ordinary course of business, we enter into contracts with third parties under which the third parties provide services on behalf of PNC. In many of these contracts, we agree to indemnify the third party service provider under certain circumstances. The terms of the indemnity vary from contract to contract and the amount of the indemnification liability, if any, cannot be determined.

We are a general or limited partner in certain asset management and investment limited partnerships, many of which contain indemnification provisions that would require us to make payments in excess of our remaining funding commitments. While in certain of these partnerships the maximum liability to us is limited to the sum of our unfunded commitments and partnership distributions received by us, in the others the indemnification liability is unlimited. As a result, we cannot determine our aggregate potential exposure for these indemnifications.

Pursuant to their bylaws, PNC and its subsidiaries provide indemnification to directors, officers and, in some cases, employees and agents against certain liabilities incurred as a result of their service on behalf of or at the request of PNC and its subsidiaries. PNC and its subsidiaries also advance on behalf of covered individuals costs incurred in connection with certain claims or proceedings, subject to written undertakings by each such individual to repay all amounts so advanced if it is ultimately determined that the individual is not entitled to indemnification. We generally are responsible for similar indemnifications and advancement obligations that companies we acquire, including Riggs, had to their officers, directors and sometimes employees and agents at the time of acquisition. We advanced such costs on behalf of several such individuals (including some from Riggs) with respect to pending litigation or investigations during the first nine months of 2006. It is not possible for us to determine the aggregate potential exposure resulting from the obligation to provide this indemnity or to advance such costs.

In connection with the lending of securities held by PFPC as an intermediary on behalf of certain of its clients, we provide indemnification to those clients against the failure of the borrowers to return the securities. The market value of the securities lent is fully secured on a daily basis; therefore, the exposure to us is limited to temporary shortfalls in the

collateral as a result of short-term fluctuations in trading prices of the loaned securities. At September 30, 2006, the total maximum potential exposure as a result of these indemnity obligations was \$12.8 billion, although we held collateral at the time in excess of that amount.

## **OTHER GUARANTEES**

We write caps and floors for customers, risk management and proprietary trading purposes. At September 30, 2006, the fair value of the written caps and floors liability on our Consolidated Balance Sheet was \$58 million. Our ultimate obligation under written options is based on future market conditions and is only quantifiable at settlement. We manage our market risk exposure from customer positions through transactions with third-party dealers.

We also enter into credit default swaps under which we buy loss protection from or sell loss protection to a counterparty for the occurrence of a credit event of a reference entity. The fair value of the contracts sold on our Consolidated Balance Sheet was a net asset of \$2 million at September 30, 2006. The maximum amount we would be required to pay under the credit default swaps in which we sold protection, assuming all reference obligations experience a credit event at a total loss, without recoveries, was \$1.1 billion at September 30, 2006.

We have entered into various contingent performance guarantees through credit risk participation arrangements with terms ranging from less than 1 year to 11 years. We will be required to make payments under these guarantees if a customer defaults on its obligation to perform under certain credit agreements with third parties. Our exposure under these agreements is approximately \$360 million at September 30, 2006.

## **CONTINGENT PAYMENTS IN CONNECTION WITH CERTAIN ACQUISITIONS**

## Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

A number of the acquisition agreements to which we are a party and under which we have purchased various types of assets, including the purchase of entire businesses, partial interests in companies, or other types of assets, require us to make additional payments in future years if certain predetermined goals are achieved or not achieved within a specific time period. Due to the nature of the contract provisions, we cannot quantify our total exposure that may result from these agreements.

### ***NOTE 16 SUBSEQUENT EVENT***

As previously reported, on October 8, 2006 we entered into a definitive agreement with Mercantile Bankshares Corporation ( Mercantile ) for PNC to acquire Mercantile for 52.5 million shares of PNC common stock and \$2.13 billion in cash. Based on PNC 's common stock price on October 6, 2006, the consideration represents \$6.0 billion in stock and cash or \$47.24 per Mercantile share.

Mercantile is a \$17 billion asset banking company that provides banking and investment and wealth management services through 240 offices in Maryland, Virginia, the District of Columbia, Delaware and Southeastern Pennsylvania. The transaction is expected to close during the first quarter of 2007 and is subject to customary closing conditions, including regulatory approval and the approval of Mercantile 's shareholders.

**Table of Contents****STATISTICAL INFORMATION (Unaudited)****The PNC Financial Services Group, Inc.****Average Consolidated Balance Sheet And Net Interest Analysis**

Taxable-equivalent basis	Nine months ended September 30					
	2006			2005		
Dollars in millions	Average Balances	Interest Income/Expense	Average Yields/Rates	Average Balances	Interest Income/Expense	Average Yields/Rates
<b>Assets</b>						
Interest-earning assets						
Securities available for sale and held to maturity						
Mortgage-backed, asset-backed, and other debt	\$13,970	\$513	4.89 %	\$10,984	\$347	4.22 %
U.S. Treasury and government agencies/corporations	6,987	241	4.59	7,425	227	4.08
State and municipal	150	6	5.05	170	7	5.47
Corporate stocks and other	236	11	6.49	176	10	7.27
Total securities available for sale and held to maturity	21,343	771	4.81	18,755	591	4.20
Loans, net of unearned income						
Commercial	20,115	1,071	7.02	18,966	829	5.77
Commercial real estate	3,121	167	7.07	2,483	110	5.86
Consumer	16,075	746	6.21	16,173	668	5.52
Residential mortgage	7,319	296	5.39	5,785	226	5.20
Lease financing	2,774	93	4.47	2,985	100	4.49
Other	355	19	7.05	484	17	4.54
Total loans, net of unearned income	49,759	2,392	6.38	46,876	1,950	5.52
Loans held for sale	2,520	111	5.87	2,163	67	4.12
Federal funds sold and resale agreements	837	30	4.80	1,100	20	2.37
Other	2,915	111	5.09	3,027	92	4.07
Total interest-earning assets/interest income	77,374	3,415	5.86	71,921	2,720	5.03
Noninterest-earning assets						
Allowance for loan and lease losses	(603)			(634)		
Cash and due from banks	3,162			3,110		
Other	13,719			12,964		
Total assets	\$93,652			\$87,361		
<b>Liabilities, Minority and Noncontrolling Interests, and Shareholders' Equity</b>						
Interest-bearing liabilities						
Interest-bearing deposits						
Money market	\$19,363	471	3.24	\$17,504	272	2.08
Demand	8,202	61	1.00	8,172	39	.64
Savings	2,148	8	.50	2,735	13	.62
Retail certificates of deposit	13,716	412	4.01	11,225	257	3.07
Other time	1,367	48	4.63	1,569	44	3.69
Time deposits in foreign offices	3,796	140	4.86	2,303	51	2.91
Total interest-bearing deposits	48,592	1,140	3.13	43,508	676	2.07
Borrowed funds						
Federal funds purchased	3,051	114	4.95	1,957	45	3.01
Repurchase agreements	2,186	74	4.44	2,282	48	2.75
Bank notes and senior debt	3,253	121	4.91	3,076	76	3.26
Subordinated debt	4,436	200	6.00	3,911	137	4.69
Commercial paper	192	7	4.84	2,703	63	3.08
Other	2,038	60	3.90	2,274	56	3.24
Total borrowed funds	15,156	576	5.03	16,203	425	3.47
Total interest-bearing liabilities/interest expense	63,748	1,716	3.57	59,711	1,101	2.46
Noninterest-bearing liabilities, minority and noncontrolling interests, and shareholders' equity						

Edgar Filing: PNC FINANCIAL SERVICES GROUP INC - Form 10-Q

Demand and other noninterest-bearing deposits	<b>14,149</b>		13,057	
Allowance for unfunded loan commitments and letters of credit	<b>103</b>		80	
Accrued expenses and other liabilities	<b>6,264</b>		6,115	
Minority and noncontrolling interests in consolidated entities	<b>620</b>		523	
Shareholders' equity	<b>8,768</b>		7,875	
Total liabilities, minority and noncontrolling interests, and shareholders' equity	<b>\$93,652</b>		\$87,361	
Interest rate spread		<b>2.29</b>		2.57
Impact of noninterest-bearing sources		<b>.63</b>		.42
Net interest income/margin	<b>\$1,699</b>	<b>2.92 %</b>	<b>\$1,619</b>	<b>2.99 %</b>

Nonaccrual loans are included in loans, net of unearned income. The impact of financial derivatives used in interest rate risk management is included in the interest income/expense and average yields/rates of the related assets and liabilities. Basis adjustments related to hedged items are included in noninterest-earning assets and noninterest-bearing liabilities. Average balances of securities are based on amortized historical cost (excluding SFAS 115 adjustments to fair value, which are included in other assets). Average balances for certain loans and borrowed funds accounted for at fair value, with changes in fair value recorded in trading noninterest income, are included in noninterest-earning assets and noninterest-bearing liabilities.

**Table of Contents**

Third Quarter 2006			Second Quarter 2006			Third Quarter 2005		
Average Balances	Interest Income/Expense	Average Yields/Rates	Average Balances	Interest Income/Expense	Average Yields/Rates	Average Balances	Interest Income/Expense	Average Yields/Rates
<b>\$15,109</b>	<b>\$194</b>	<b>5.13 %</b>	\$13,771	\$166	4.83 %	\$12,154	\$129	4.26 %
<b>6,187</b>	<b>73</b>	<b>4.70</b>	7,263	83	4.57	7,960	84	4.24
<b>144</b>	<b>2</b>	<b>4.73</b>	152	2	5.24	167	2	5.41
<b>259</b>								