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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**Form 10-Q**

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

For the fiscal quarter ended June 30, 2008

or

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

Commission file number 0-27559

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**TEXTRON FINANCIAL CORPORATION**

*(Exact name of registrant as specified in its charter)*

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**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**40 Westminster Street,  
P.O. Box 6687, Providence, RI**  
*(Address of principal executive offices)*

**05-6008768**

*(I.R.S. Employer  
Identification No.)*

**02940-6687**

*(Zip code)*

**401-621-4200**

*(Registrant's telephone number, including area code)*

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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, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

All of the shares of common stock of the registrant are owned by Textron Inc.

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**TEXTRON FINANCIAL CORPORATION**

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**TEXTRON FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>
	(In millions)			
Finance charges . . . . .	\$127	\$173	\$282	\$339
Securitization gains . . . . .	20	15	40	30
Rental revenues on operating leases . . . . .	8	8	17	16
Other income . . . . .	<u>22</u>	<u>43</u>	<u>52</u>	<u>64</u>
<b>Total revenues</b> . . . . .	177	239	391	449
Interest expense . . . . .	71	102	157	202
Depreciation of equipment on operating leases . . . . .	<u>4</u>	<u>4</u>	<u>9</u>	<u>8</u>
<b>Net interest margin</b> . . . . .	102	133	225	239
Selling and administrative expenses . . . . .	49	54	103	103
Provision for losses . . . . .	<u>40</u>	<u>11</u>	<u>67</u>	<u>16</u>
<b>Income before income taxes</b> . . . . .	13	68	55	120
Income taxes . . . . .	<u>9</u>	<u>27</u>	<u>20</u>	<u>44</u>
<b>Net income</b> . . . . .	<u>\$ 4</u>	<u>\$ 41</u>	<u>\$ 35</u>	<u>\$ 76</u>

See Notes to the Consolidated Financial Statements.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

	<u>June 30,</u> <u>2008</u>	<u>December 29,</u> <u>2007</u>
(In millions)		
<b>Assets</b>		
Cash and equivalents . . . . .	\$ 56	\$ 60
Finance receivables, net of unearned income:		
Revolving loans . . . . .	2,225	2,254
Installment contracts . . . . .	2,055	2,052
Distribution finance receivables . . . . .	1,772	1,900
Golf course and resort mortgages . . . . .	1,403	1,240
Finance leases . . . . .	610	613
Leveraged leases . . . . .	<u>535</u>	<u>544</u>
Total finance receivables . . . . .	8,600	8,603
Allowance for losses on finance receivables . . . . .	<u>(126)</u>	<u>(89)</u>
Finance receivables — net . . . . .	8,474	8,514
Equipment on operating leases — net . . . . .	258	259
Goodwill . . . . .	169	169
Other assets . . . . .	<u>572</u>	<u>381</u>
Total assets . . . . .	<u>\$9,529</u>	<u>\$9,383</u>
<b>Liabilities and shareholder's equity</b>		
<b>Liabilities</b>		
Accrued interest and other liabilities . . . . .	\$ 508	\$ 437
Amounts due to Textron Inc. . . . .	23	25
Deferred income taxes . . . . .	431	472
Debt . . . . .	<u>7,547</u>	<u>7,311</u>
Total liabilities . . . . .	8,509	8,245
<b>Shareholder's equity</b>		
Capital surplus . . . . .	592	592
Investment in parent company preferred stock . . . . .	(25)	(25)
Accumulated other comprehensive income . . . . .	15	26
Retained earnings . . . . .	<u>438</u>	<u>545</u>
Total shareholder's equity . . . . .	<u>1,020</u>	<u>1,138</u>
Total liabilities and shareholder's equity . . . . .	<u>\$9,529</u>	<u>\$9,383</u>

See Notes to the Consolidated Financial Statements.

Item 1. *Financial Statements (Continued)*

**TEXTRON FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**SIX MONTHS ENDED JUNE 30, 2008 AND 2007**  
**(Unaudited)**

	<b>2008</b>	<b>2007</b>
	(In millions)	
<b>Cash flows from operating activities:</b>		
Net income . . . . .	\$ 35	\$ 76
Adjustments to reconcile net income to net cash provided by operating activities:		
(Decrease) increase in accrued interest and other liabilities . . . . .	(8)	12
Provision for losses . . . . .	67	16
Depreciation . . . . .	14	14
Amortization . . . . .	5	5
Deferred income tax provision . . . . .	(41)	12
Non-cash gains in excess of collections on securitizations and syndications . . . . .	(9)	(2)
Other — net . . . . .	20	20
Net cash provided by operating activities . . . . .	83	153
<b>Cash flows from investing activities:</b>		
Finance receivables originated or purchased . . . . .	(6,338)	(6,489)
Finance receivables repaid . . . . .	5,690	5,795
Proceeds from receivable sales, including securitizations . . . . .	617	711
Proceeds from disposition of operating leases and other assets . . . . .	16	33
Purchase of assets for operating leases . . . . .	(14)	(28)
Other capital expenditures . . . . .	(6)	(4)
Other investments . . . . .	(99)	5
Net cash (used) provided by investing activities . . . . .	(134)	23
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of long-term debt . . . . .	822	1,069
Principal payments on long-term debt . . . . .	(833)	(958)
Net decrease in commercial paper . . . . .	(103)	(119)
Net increase in other short-term debt . . . . .	55	18
Proceeds from issuance of secured debt . . . . .	300	—
Principal payments on nonrecourse debt . . . . .	(53)	(31)
Capital contributions from Textron Inc. . . . .	5	5
Dividends paid to Textron Inc. . . . .	(147)	(140)
Net cash provided (used) by financing activities . . . . .	46	(156)
Effect of exchange rate changes on cash . . . . .	1	(1)
Net (decrease) increase in cash and equivalents . . . . .	(4)	19
Cash and equivalents at beginning of year . . . . .	60	47
Cash and equivalents at end of period . . . . .	\$ 56	\$ 66

See Notes to the Consolidated Financial Statements.

Item 1. *Financial Statements (Continued)*

**TEXTRON FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY**  
**(Unaudited)**

	<u>Capital Surplus</u>	<u>Investment in Parent Company Preferred Stock</u>	<u>Accumulated Other Comprehensive Income</u> (In millions)	<u>Retained Earnings</u>	<u>Total Share- holder's Equity</u>
<b>Balance December 30, 2006</b> .....	\$592	\$(25)	\$ 7	\$ 568	\$1,142
Comprehensive income:					
Net income .....	—	—	—	145	145
Other comprehensive income:					
Foreign currency translation .....	—	—	19	—	19
Change in unrealized net losses on hedge contracts, net of income taxes .....	—	—	2	—	2
Change in unrealized net gains on interest-only securities, net of income taxes .....	—	—	(2)	—	(2)
Other comprehensive income .....	—	—	19	—	19
Comprehensive income .....	—	—	—	—	164
Cumulative effect of a change in accounting principle .....	—	—	—	(33)	(33)
Capital contributions from Textron Inc. ....	9	—	—	—	9
Dividends to Textron Inc. ....	(9)	—	—	(135)	(144)
<b>Balance December 29, 2007</b> .....	592	(25)	26	545	1,138
Comprehensive income:					
Net income .....	—	—	—	35	35
Other comprehensive loss:					
Foreign currency translation .....	—	—	(11)	—	(11)
Other comprehensive loss .....	—	—	(11)	—	(11)
Comprehensive income .....	—	—	—	—	24
Capital contributions from Textron Inc. ....	5	—	—	—	5
Dividends to Textron Inc. ....	(5)	—	—	(142)	(147)
<b>Balance June 30, 2008</b> .....	<u>\$592</u>	<u>\$(25)</u>	<u>\$ 15</u>	<u>\$ 438</u>	<u>\$1,020</u>

See Notes to the Consolidated Financial Statements.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 1. Basis of Presentation**

The Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in Textron Financial Corporation's Annual Report on Form 10-K for the year ended December 29, 2007. The accompanying Consolidated Financial Statements include the accounts of Textron Financial Corporation ("Textron Financial" or the "Company") and its subsidiaries. All significant intercompany transactions are eliminated. The Consolidated Financial Statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments), which are, in the opinion of management, necessary for a fair presentation of Textron Financial's consolidated financial position at June 30, 2008, and its consolidated results of operations and cash flows for each of the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year.

**Note 2. Other Income**

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(In millions)			
Servicing income . . . . .	\$11	\$ 9	\$21	\$17
Investment income . . . . .	6	4	10	7
Prepayment income . . . . .	1	1	2	3
Late charges . . . . .	1	—	2	1
Syndication income . . . . .	—	2	2	2
Other . . . . .	<u>3</u>	<u>27</u>	<u>15</u>	<u>34</u>
Total other income . . . . .	<u>\$22</u>	<u>\$43</u>	<u>\$52</u>	<u>\$64</u>

The Other component of Other income includes commitment fees, residual gains, gains from asset sales (excluding syndications), insurance fees and other miscellaneous fees, which are primarily recognized as income when received. Impairment charges related to assets and investments acquired through repossession of collateral are also recorded in the Other component of Other income.

We recorded gains of \$5 million and \$21 million on the sale of interests in a leveraged lease investment in the first quarter of 2008 and the second quarter of 2007, respectively, which are included in the Other component of Other income.

**Note 3. Managed and Serviced Finance Receivables**

Textron Financial manages and services finance receivables for a variety of investors, participants and third-party portfolio owners. Managed and serviced finance receivables are summarized as follows:

	<u>June 30,</u>	<u>December 29,</u>
	<u>2008</u>	<u>2007</u>
	(In millions)	
Total managed and serviced finance receivables . . . . .	\$12,837	\$12,478
Nonrecourse participations . . . . .	(798)	(760)
Third-party portfolio servicing . . . . .	<u>(575)</u>	<u>(595)</u>
Total managed finance receivables . . . . .	11,464	11,123
Securitized receivables . . . . .	<u>(2,864)</u>	<u>(2,520)</u>
Owned finance receivables . . . . .	<u>\$ 8,600</u>	<u>\$ 8,603</u>

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

Third-party portfolio servicing largely relates to finance receivable portfolios of resort developers and loan portfolio servicing for third-party financial institutions.

Nonrecourse participations consist of undivided interests in loans originated by Textron Financial, primarily in Resort Finance, Golf Finance and Asset-Based Lending, which are sold to independent investors.

Owned receivables at June 30, 2008 include approximately \$491 million of Finance leases which have been legally sold to a special purpose entity (“SPE”), which is a consolidated subsidiary of Textron Financial. The assets of the SPE are pledged as collateral for its debt, which has been reflected as a secured borrowing in Note 6 Debt and Credit Facilities. Owned receivables also include approximately \$163 million and \$119 million of finance receivables that were unfunded at June 30, 2008 and December 29, 2007, primarily as a result of holdback arrangements and payables to manufacturers for inventory financed by dealers. The corresponding liability is included in Accrued interest and other liabilities on Textron Financial’s Consolidated Balance Sheets.

The table below provides a summary of the Company’s net investment in leveraged leases:

	<u>June 30, 2008</u>	<u>December 29, 2007</u>
	(In millions)	
Rental receivable . . . . .	\$1,505	\$ 1,561
Nonrecourse debt . . . . .	(977)	(1,030)
Estimated residual values of leased assets . . . . .	<u>290</u>	<u>297</u>
	818	828
Less unearned income . . . . .	<u>(283)</u>	<u>(284)</u>
Investment in leveraged leases . . . . .	535	544
Deferred income taxes . . . . .	<u>(413)</u>	<u>(408)</u>
Net investment in leveraged leases . . . . .	<u>\$ 122</u>	<u>\$ 136</u>

In accordance with the provisions of Financial Accounting Standards Board (“FASB”) Staff Position No. 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”), the Company recorded a \$9 million reduction in Leveraged leases and Finance charges during the second quarter of 2008 representing the cumulative effect of a change in the expected timing of leveraged lease cash flows associated with leases discussed in Note 10 Contingencies. This change was based on court decisions involving other companies issued during the second quarter of 2008.

**Note 4. Loan Impairment**

Textron Financial periodically evaluates finance receivables, excluding homogeneous loan portfolios and finance leases, for impairment. A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. In addition, the Company identifies loans that are considered impaired due to the significant modification of the original loan terms to reflect deferred principal payments generally at market interest rates, but which continue to accrue finance charges since full collection of principal and interest is not doubtful. Nonaccrual finance receivables include impaired nonaccrual

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

finance receivables and accounts in homogeneous portfolios that are contractually delinquent by more than three months.

	<b>June 30, 2008</b>	<b>December 29, 2007</b>
(In millions)		
Impaired nonaccrual finance receivables . . . . .	\$149	\$ 59
Impaired accrual finance receivables . . . . .	60	143
Total impaired finance receivables . . . . .	\$209	\$202
Impaired nonaccrual finance receivables with identified reserve requirements . . . . .	\$ 95	\$ 40
Allowance for losses on impaired nonaccrual finance receivables . . . . .	\$ 44	\$ 15

Nonperforming assets include nonaccrual finance receivables and repossessed assets and properties, which are recorded in Other assets.

	<b>June 30, 2008</b>	<b>December 29, 2007</b>
(In millions)		
Impaired nonaccrual finance receivables . . . . .	\$149	\$ 59
Nonaccrual homogeneous finance receivables . . . . .	27	20
Total nonaccrual finance receivables . . . . .	176	79
Repossessed assets and properties . . . . .	40	44
Total nonperforming assets . . . . .	\$216	\$123

The average recorded investment in impaired nonaccrual finance receivables during the first six months of 2008 was \$108 million compared to \$50 million in the corresponding period in 2007. The average recorded investment in impaired accrual finance receivables amounted to \$28 million in the first six months of 2008. There were no impaired accrual finance receivables during the first six months of 2007.

Nonaccrual finance receivables resulted in Textron Financial’s finance charges being reduced by \$6 million and \$4 million in the first six months of 2008 and 2007, respectively. No finance charges were recognized using the cash basis method.

Textron Financial has a performance guarantee from Textron for leases with the U.S. and Canadian subsidiaries of Collins & Aikman Corporation (“C&A”). In 2005, C&A filed for bankruptcy protection and the lease terms expired. During the fourth quarter of 2007, C&A ceased making lease payments and under its performance guarantee, Textron made a \$20 million payment to the Company, which was utilized to reduce the outstanding balance. The outstanding balance on these leases totaled \$16 million at June 30, 2008 and \$23 million at the end of 2007. We have not classified these leases as nonaccrual due to the performance guarantee from Textron.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 5. Other Assets**

	<u>June 30, 2008</u>	<u>December 29, 2007</u>
	(In millions)	
Retained interests in securitizations . . . . .	\$275	\$203
Investments in other marketable securities . . . . .	118	20
Repossessed assets and properties . . . . .	40	44
Other long-term investments . . . . .	34	32
Fixed assets — net . . . . .	34	33
Other . . . . .	<u>71</u>	<u>49</u>
Total other assets . . . . .	<u>\$572</u>	<u>\$381</u>

Interest-only securities within retained interests in securitizations were \$53 million and \$43 million at June 30, 2008 and December 29, 2007, respectively.

Investments in other marketable securities represent investments in notes receivable issued by timeshare securitization trusts. We have classified these investments as held to maturity.

Other long-term investments and Repossessed assets and properties include assets received in satisfaction of troubled loans. Declines in the value of these assets subsequent to receipt are recorded as impairment charges in the Other component of Other income.

The Other category primarily represents the fair value of derivative instruments, debt acquisition costs, and an intangible asset, which is being amortized over its contractual term of five years.

Item 1. *Financial Statements (Continued)*

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 6. Debt and Credit Facilities**

	<u>June 30,</u> <u>2008</u>	<u>December 29,</u> <u>2007</u>
(In millions)		
Short-term debt:		
Commercial paper . . . . .	\$1,340	\$1,447
Other short-term debt . . . . .	<u>69</u>	<u>14</u>
Total short-term debt . . . . .	1,409	1,461
Long-term debt:		
Fixed-rate notes		
Due 2008 (weighted-average rates of 4.71% and 4.15%, respectively) . . .	54	654
Due 2009 (weighted-average rates of 5.59% and 5.60%, respectively) . . .	714	726
Due 2010 (weighted-average rates of 4.82% and 4.83%, respectively) . . .	1,017	1,007
Due 2011 (weighted-average rates of 5.04% and 5.05%, respectively) . . .	453	442
Due 2012 (weighted-average rates of 4.43% and 4.39%, respectively) . . .	52	42
Due 2013 and thereafter (weighted-average rates of 5.20% and 5.19%, respectively) . . . . .	<u>655</u>	<u>177</u>
Total Fixed-rate notes . . . . .	2,945	3,048
Variable-rate notes		
Due 2008 (weighted-average rates of 2.95% and 5.23%, respectively) . . .	395	605
Due 2009 (weighted-average rates of 2.90% and 5.22%, respectively) . . .	849	825
Due 2010 (weighted-average rates of 2.96% and 5.18%, respectively) . . .	954	906
Due 2011 (weighted-average rates of 3.07% and 5.15%, respectively) . .	275	150
Due 2013 and thereafter (weighted-average rate of 3.54)% . . . . .	<u>100</u>	<u>—</u>
Total Variable-rate notes . . . . .	2,573	2,486
Secured debt:		
Due 2009 (3.43)% . . . . .	300	—
Subordinated debt:		
Due 2017 and thereafter (6.00)% . . . . .	300	300
Unamortized discount . . . . .	(3)	(4)
Fair value adjustments . . . . .	<u>23</u>	<u>20</u>
Total long-term, secured and subordinated debt . . . . .	<u>6,138</u>	<u>5,850</u>
Total debt . . . . .	<u>\$7,547</u>	<u>\$7,311</u>

We have a policy of maintaining unused committed bank lines of credit in an amount not less than outstanding commercial paper balances. Since Textron Financial is permitted to borrow under Textron's multi-year facility, these lines of credit include both Textron Financial's multi-year facility and Textron's multi-year facility. These facilities are in support of commercial paper and letter of credit issuances only, and neither of these lines of credit was drawn at June 30, 2008 or December 29, 2007.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

The Company's committed credit facilities at June 30, 2008 were as follows:

	<u>Facility Amount</u>	<u>Commercial Paper Outstanding</u>	<u>Letters of Credit Issued under Facility</u> (In millions)	<u>Amount Not Reserved as Support for Commercial Paper and Letters of Credit</u>
Textron Financial multi-year facility expiring in 2012 . . . . .	\$1,750	\$1,340	\$ 7	\$ 403
Textron multi-year facility expiring in 2012 . . . . .	<u>1,250</u>	<u>89</u>	<u>22</u>	<u>1,139</u>
Total . . . . .	<u>\$3,000</u>	<u>\$1,429</u>	<u>\$29</u>	<u>\$1,542</u>

The weighted-average interest rates on short-term borrowings at June 30, 2008 and June 30, 2007 were as follows:

	<u>June 30, 2008</u>	<u>June 30, 2007</u>
Commercial paper:		
USD . . . . .	2.90%	5.41%
CAD . . . . .	3.25%	4.39%
Other short-term debt . . . . .	3.16%	4.51%

The combined weighted-average interest rates on these borrowings during the first six months of 2008 and 2007 were 3.40% and 5.13%, respectively. The weighted-average interest rates on short-term borrowings have been determined by relating the annualized interest cost including fees to the daily average dollar amounts outstanding.

During the second quarter of 2008, the Company sold finance receivables to a SPE which is a consolidated subsidiary of Textron Financial. These receivables were used by the SPE as collateral for the issuance of \$300 million of secured notes to third-party investors under a 364 day revolving credit facility. Since the SPE is consolidated with Textron Financial, the third-party notes are reflected as Debt in Consolidated Balance Sheets. If the notes are not paid in full at the maturity date of the facility, any outstanding balance will bear interest at an increased interest rate and will amortize from collateral collections.

During 2007, we issued \$300 million of 6% Fixed-to-Floating Rate Junior Subordinated Notes, which are unsecured and rank junior to all of our existing and future senior debt. The notes mature on February 15, 2067; however, we have the right to redeem the notes at par on or after February 15, 2017, and are obligated to redeem the notes beginning on February 15, 2042. Pursuant to the terms of the notes or the replacement capital covenant described below, any redemption of the notes must be made from the sale of certain replacement capital securities or a capital contribution from Textron. Interest on the notes is fixed at 6% until February 15, 2017, and floats at three-month LIBOR + 1.735% thereafter. We may defer payment of interest on one or more occasions, in each case, for a period of up to 10 years.

We agreed, in a replacement capital covenant for the benefit of the holders of a specified class of covered debt, that we will not redeem the notes on or before February 15, 2047, unless we have received a capital contribution from Textron and/or net proceeds from the sale of certain replacement capital securities in certain specified amounts. The initial class of covered debt holders are the holders of the Company's 5.125% Medium Term Notes, Series E, due August 15, 2014, in the principal amount of \$100 million.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

The Company had interest rate exchange agreements related to the conversion of fixed-rate debt to variable-rate debt of \$2.1 billion and \$2.3 billion at June 30, 2008 and December 29, 2007, respectively, whereby the Company makes periodic floating-rate payments in exchange for periodic fixed-rate receipts. The weighted-average rate of these borrowings considering the impact of interest rate exchange agreements, including fees was 4.27% and 6.11% for the six months ended June 30, 2008 and June 30, 2007, respectively. The weighted-average rate on remaining fixed-rate notes not subject to interest rate exchange agreements including fees was 5.42% and 5.63% for the six months ended June 30, 2008 and June 30, 2007, respectively.

Interest on Textron Financial's variable-rate notes is predominantly tied to the three-month LIBOR for U.S. dollar deposits. The weighted-average interest rate on these notes before consideration of the effect of interest rate exchange agreements including fees were 3.93% and 5.55% during the six months ended June 30, 2008 and June 30, 2007, respectively.

Securitizations are an important source of liquidity for Textron Financial and involve the periodic transfer of finance receivables to qualified special purpose trusts. The outstanding amount of debt issued by qualified special purpose trusts not consolidated by the Company was \$2.6 billion and \$2.3 billion at June 30, 2008 and December 29, 2007, respectively.

Through its subsidiary, Textron Financial Canada Funding Corp. ("Textron Canada Funding"), the Company periodically issues debt securities. Textron Financial owns 100% of the common stock of Textron Canada Funding. Textron Canada Funding is a financing subsidiary of Textron Financial with operations, revenues and cash flows related to the issuance, administration and repayment of debt securities that are fully and unconditionally guaranteed by Textron Financial.

In the first six months of 2008, Textron Financial declared and paid dividends of \$147 million. The terms of the Company's credit facility limit the payment of dividends to an additional \$204 million at June 30, 2008.

**Note 7. Accumulated Other Comprehensive Income and Comprehensive Income**

Accumulated other comprehensive income is as follows:

	<u>Six Months Ended</u>	
	<u>June 30,</u>	<u>June 30,</u>
	<u>2008</u>	<u>2007</u>
	(In millions)	
Beginning of year . . . . .	\$ 26	\$ 7
Foreign currency translation . . . . .	(11)	9
Amortization of deferred losses on hedge contracts, net of income taxes of \$2 million in 2007 . . . . .	—	3
Net deferred loss on hedge contracts, net of income tax benefit of \$1 million in 2007 . . . . .	<u>—</u>	<u>(2)</u>
End of period . . . . .	<u>\$ 15</u>	<u>\$17</u>

Comprehensive income is summarized below:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(In millions)			
Net income . . . . .	\$4	\$41	\$ 35	\$76
Other comprehensive income (loss) . . . . .	<u>3</u>	<u>10</u>	<u>(11)</u>	<u>10</u>
Comprehensive income . . . . .	<u>\$7</u>	<u>\$51</u>	<u>\$ 24</u>	<u>\$86</u>

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 8. Fair Value of Financial Instruments**

In September 2006, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements,” effective for financial statements issued for fiscal years beginning after November 15, 2007. SFAS No. 157 replaces multiple existing definitions of fair value with a single definition, establishes a consistent framework for measuring fair value and expands financial statement disclosures regarding fair value measurements. This Statement applies only to fair value measurements that already are required or permitted by other accounting standards and does not require any new fair value measurements. In February 2008, the FASB issued FASB Staff Position (“FSP”) No. 157-2, which delayed until the first quarter of 2009, the effective date of SFAS No. 157 for nonfinancial assets and liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis.

The adoption of SFAS No. 157 for our financial assets and liabilities in the first quarter of 2008 did not have a material impact on our financial position or results of operations. Our nonfinancial assets and liabilities that meet the deferral criteria set forth in FSP No. 157-2 include goodwill, fixed assets — net, other long-term investments, which primarily represent collateral that is received in satisfaction of troubled loans, and an intangible asset. We do not expect that the adoption of SFAS No. 157 for these nonfinancial assets and liabilities will have a material impact on our financial position or results of operations.

In accordance with the provisions of SFAS No. 157, we measure fair value at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Statement prioritizes the assumptions that market participants would use in pricing the asset or liability (the “inputs”) into a three-tier fair value hierarchy. This fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and the lowest priority (Level 3) to unobservable inputs in which little or no market data exists, requiring companies to develop their own assumptions. Observable inputs that do not meet the criteria of Level 1, and include quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets and liabilities in markets that are not active, are categorized as Level 2. Level 3 inputs are those that reflect our estimates about the assumptions market participants would use in pricing the asset or liability, based on the best information available in the circumstances. Valuation techniques for assets and liabilities measured using Level 3 inputs may include methodologies such as the market approach, the income approach or the cost approach, and may use unobservable inputs such as projections, estimates and management’s interpretation of current market data. These unobservable inputs are only utilized to the extent that observable inputs are not available or cost-effective to obtain.

*Assets Recorded at Fair Value on a Recurring Basis*

The table below presents the assets measured at fair value on a recurring basis categorized by the level of inputs used in the valuation of each asset.

<u>Assets</u>	<u>June 30, 2008</u>			
	<u>Total</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
	(In millions)			
Interest-only strips . . . . .	\$53	\$—	\$—	\$53
Derivative financial instruments, net . . .	<u>22</u>	<u>—</u>	<u>22</u>	<u>—</u>
Total assets . . . . .	<u>\$75</u>	<u>\$—</u>	<u>\$22</u>	<u>\$53</u>

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
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*Valuation Techniques*

Interest-only strips are generally retained upon the sale of finance receivables to qualified special purpose trusts. These interest-only strips are initially recorded at the allocated carrying value, which is determined based on the relative fair values of the finance receivables sold and the interests retained. We estimate fair value upon the initial recognition of the retained interest based on the present value of expected future cash flows using our best estimates of key assumptions — credit losses, prepayment speeds, forward interest rate yield curves and discount rates commensurate with the risks involved. These inputs are classified as Level 3 since they reflect our own assumptions about the assumptions market participants would use in pricing these assets based on the best information available in the circumstances. We review the fair values of the interest-only strips quarterly using a discounted cash flow model and updated assumptions, and compare such amounts with the carrying value. When a change in fair value is deemed temporary, we record a corresponding credit or charge to Other comprehensive income for any unrealized gains or losses. If a decline in the fair value is determined to be other than temporary, we record a corresponding charge to income.

Derivative financial instruments are measured at fair value based on observable market inputs for various interest and foreign currency rates published by third-party leading financial news and data providers. This is observable data that represents the rates used by market participants for instruments entered into at that date; however, they are not based on actual transactions so they are classified as Level 2. Changes in fair value for these instruments are primarily recorded in Interest expense.

*Changes in Fair Value for Unobservable Input*

The table below presents the change in fair value measurements that used significant unobservable inputs (Level 3) during the three and six month periods ended June 30, 2008:

	<b>Three Months Ended June 30, 2008</b>	<b>Six Months Ended June 30, 2008</b>
	<b>(In millions)</b>	
<b>Interest-only Strips</b>		
<b>Balance, beginning of period</b> . . . . .	\$ 52	\$ 43
Net gains for the period:		
Increase due to securitization gains on sale of finance receivables . . .	21	42
Change in value recognized in Other income . . . . .	—	1
Change in value recognized in Other comprehensive income . . . . .	(2)	—
Collections . . . . .	(18)	(33)
<b>Balance, end of period</b> . . . . .	<b>\$ 53</b>	<b>\$ 53</b>

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 9. Income Taxes**

A reconciliation of the federal statutory income tax rate to the effective income tax rate is provided below:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>
Federal statutory income tax rate . . . . .	35.0%	35.0%	35.0%	35.0%
Increase (decrease) in taxes resulting from:				
State income taxes . . . . .	43.8	2.5	11.7	2.1
Foreign tax rate differential . . . . .	15.2	(0.9)	(6.1)	(1.3)
Canadian dollar functional currency . . . . .	0.2	—	0.1	(1.7)
Change in state valuation allowance . . . . .	(83.8)	1.3	(20.1)	0.7
Tax contingencies . . . . .	73.8	3.4	21.4	3.8
Tax credits . . . . .	(6.8)	(1.0)	(3.0)	(1.2)
Other, net . . . . .	<u>(9.1)</u>	<u>(0.1)</u>	<u>(2.4)</u>	<u>(0.1)</u>
Effective income tax rate . . . . .	<u>68.3%</u>	<u>40.2%</u>	<u>36.6%</u>	<u>37.3%</u>

For the three and six months ended June 30, 2008, the difference between the statutory tax rate and the effective tax rate is primarily attributable to a change in management’s assessment of the amount of the state deferred tax asset that is realizable, offset by interest on tax contingencies, the majority of which is associated with leveraged leases and a finance lease, as discussed in Note 10 Contingencies and below, and state tax expense, as a result of changes in the income apportionable to certain jurisdictions.

The increase in tax contingencies is the result of a change in the second quarter of 2008 related to the Company’s tax position on certain leveraged leases and one finance lease. The change was based on court decisions involving other companies that addressed the tax treatment of certain lease transactions challenged by the Internal Revenue Service (“IRS”), and resulted in the accrual of \$10 million of additional interest, net of taxes, on this tax contingency. As required by FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” for all income tax positions taken, the Company’s financial statements only reflect tax benefits for which it is more likely than not that a tax benefit will be sustained, and for the largest amount estimated to have a greater than 50 percent likelihood of being realized upon settlement with the taxing authority having full knowledge of all relevant information. This change in assessment also was the primary factor in the reduction of our state tax valuation allowance.

For the three months ended June 30, 2007, the difference between the statutory tax rate and the effective tax rate is primarily attributable to interest on tax contingencies, the majority of which is associated with leveraged leases, state tax expense and a change in management’s assessment of the amount of the state deferred tax asset that is realizable.

For the six months ended June 30, 2007, the difference between the statutory tax rate and the effective tax rate is primarily attributable to interest on tax contingencies, the majority of which is associated with leveraged leases, and state tax expense, partially offset by benefits relating to a non-recurring increase to the benefit attributable to the adoption of the Canadian dollar as the functional currency for U.S. tax purposes of one of the Company’s wholly-owned Canadian subsidiaries.

**Note 10. Contingencies**

Textron Financial is subject to challenges from tax authorities regarding amounts of tax due. These challenges may alter the timing or amount of taxable income or deductions, or the allocation of income among tax jurisdictions.

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

Textron Financial is currently under examination by the IRS for the years 1998 through 2003. The IRS has issued Notices of Proposed Adjustment that may affect certain leveraged lease transactions with a total initial investment of approximately \$168 million and one finance lease transaction with a current investment balance of \$34 million related to the 1998 through 2003 tax years. The Company entered into additional transactions with similar characteristics and a total initial investment of approximately \$41 million related to the 2004 tax year. Resolution of these issues may result in an adjustment to the timing of taxable income and deductions that reduce the effective yield of the leveraged lease transactions. In addition, resolution of these issues could result in the acceleration of cash payments to the IRS. At June 30, 2008, \$216 million of deferred tax liabilities were recorded on our Consolidated Balance Sheets related to these leases. Despite certain recent court decisions, which were in favor of the IRS, we continue to believe the proposed IRS adjustments are inconsistent with the tax law in existence at the time the leases were originated.

There are other pending or threatened lawsuits and other proceedings against Textron Financial and its subsidiaries. Some of these suits and proceedings seek compensatory, treble or punitive damages in substantial amounts. These suits and proceedings are being defended by, or contested on behalf of, Textron Financial and its subsidiaries. On the basis of information presently available, Textron Financial believes any such liability would not have a material effect on Textron Financial's financial position or results of operations.

**Note 11. Financial Information about Operating Segments**

The Company aligns its business units into six operating segments based on the markets serviced and the products offered: Asset-Based Lending, Aviation Finance, Distribution Finance, Golf Finance, Resort Finance and Structured Capital. In addition, the Company maintains a Corporate and Other segment that includes non-core franchise finance, media finance and liquidating portfolios related to a strategic realignment of the Company's business and product lines into core and non-core businesses, and unallocated Corporate expenses.

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>	<u>June 30,</u>
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(In millions)			
Revenues:				
Distribution Finance . . . . .	\$ 60	\$ 76	\$125	\$159
Aviation Finance . . . . .	46	44	96	84
Golf Finance . . . . .	32	37	66	71
Resort Finance . . . . .	31	33	66	65
Asset-Based Lending . . . . .	17	23	37	46
Structured Capital . . . . .	(9)	24	—	21
Corporate and Other . . . . .	<u>—</u>	<u>2</u>	<u>1</u>	<u>3</u>
Total revenues . . . . .	<u>\$177</u>	<u>\$239</u>	<u>\$391</u>	<u>\$449</u>
Income before income taxes:(1)(2)				
Distribution Finance . . . . .	\$ (3)	\$ 27	\$ 9	\$ 55
Aviation Finance . . . . .	17	11	34	22
Golf Finance . . . . .	(7)	11	2	19
Resort Finance . . . . .	15	10	30	23
Asset-Based Lending . . . . .	4	4	(8)	12
Structured Capital . . . . .	(11)	19	(6)	11
Corporate and Other . . . . .	<u>(2)</u>	<u>(14)</u>	<u>(6)</u>	<u>(22)</u>
Income before income taxes . . . . .	<u>\$ 13</u>	<u>\$ 68</u>	<u>\$ 55</u>	<u>\$120</u>

**Item 1. Financial Statements (Continued)**

**TEXTRON FINANCIAL CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

	<u>June 30,</u> <u>2008</u>	<u>December 29,</u> <u>2007</u>
(In millions)		
Finance assets:(3)		
Aviation Finance . . . . .	\$2,317	\$2,279
Distribution Finance . . . . .	1,832	1,936
Golf Finance . . . . .	1,829	1,680
Resort Finance . . . . .	1,644	1,521
Asset-Based Lending . . . . .	982	1,004
Structured Capital . . . . .	621	631
Corporate and Other . . . . .	<u>100</u>	<u>109</u>
Total finance assets . . . . .	<u>\$9,325</u>	<u>\$9,160</u>

- 
- (1) Interest expense is allocated to each segment in proportion to its net investment in finance assets. Net investment in finance assets includes finance assets less deferred income taxes, security deposits and other specifically identified liabilities. The interest allocated matches all variable-rate finance assets with variable-rate debt costs and all fixed-rate finance assets with fixed-rate debt costs and includes only debt issued during historical periods with credit spreads consistent with those in existence during the periods in which the current receivable portfolio was originated. If this allocation results in greater or less interest expense than was actually incurred by the Company, the remaining balance is included in the Corporate and Other segment's interest expense.
  - (2) Indirect expenses are allocated to each segment based on the use of such resources. Most allocations are based on the segment's proportion of net investment in finance assets, headcount, number of transactions, computer resources and senior management time.
  - (3) Finance assets include: finance receivables; equipment on operating leases, net of accumulated depreciation; repossessed assets and properties; retained interests in securitizations; investment in equipment residuals; Acquisition, Development and Construction arrangements; and other short- and long-term investments (some of which are classified in Other assets on Textron Financial's Consolidated Balance Sheets).

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **TEXTRON FINANCIAL CORPORATION**

#### **Key Business Initiatives and Trends**

Textron Financial Corporation ("Textron Financial" or the "Company") is a diversified commercial finance company with operations in six segments: Asset-Based Lending, Aviation Finance, Distribution Finance, Golf Finance, Resort Finance and Structured Capital.

Portfolio quality statistics weakened during the first six months of 2008 compared to year-end 2007. Nonperforming assets as a percentage of finance assets increased to 2.31% at June 30, 2008 compared to 1.34% at year-end, and 60+ days contractual delinquency as a percentage of finance receivables was 0.61% at June 30, 2008 compared to 0.43% at year-end 2007. The increase in nonperforming assets is primarily the result of one troubled account in the Asset-Based Lending segment and one troubled account in the Golf Finance segment. In addition, nonperforming assets and net charge-offs increased in the Distribution Finance segment reflecting weakening U.S. economic conditions. We expect nonperforming assets and charge-offs to remain higher for the remainder of 2008 compared to the strong portfolio performance of 2007. As a result of this trend, we have increased our Allowance for losses on finance receivables by \$37 million during the first six months of 2008.

Net interest margin as a percentage of average net investment ("net interest margin percentage") decreased to 5.35% during the first six months of 2008, as compared to 5.81% during the first six months of 2007. The most significant contributor to the decrease is a \$19 million increase in borrowing costs relative to various market rate indices. Volatility has continued in the credit markets, and while we continue to have the ability to access the capital markets to refinance our maturing debt obligations, we have experienced higher relative borrowing costs. Dramatic reductions in the target Federal Funds rate from January through April were generally reflected in our finance receivable portfolio yield in advance of being reflected in our borrowing costs. In addition, LIBOR rates, on which the majority of our variable-rate debt portfolio is based, have remained high relative to the Federal Funds rate and credit spreads have widened on issuances of commercial paper and term debt as compared to 2007. This increase in borrowing costs was partially mitigated by a \$6 million benefit received from variable-rate receivables with interest rate floors which began earning higher yields relative to market rate indices as market interest rates decreased compared to 2007.

Selling and administrative expenses as a percentage of average managed and serviced receivables improved during the first six months of 2008 (1.62%) compared to the same period in 2007 (1.72%). The improvement is primarily the result of reduced employee compensation expense as a result of lower levels of incentive based compensation associated with a reduction in profitability and continued process improvement initiatives, which have enabled growth in the managed and serviced receivable portfolio with a reduction in staffing levels as compared to 2007.

#### **Financial Condition**

##### *Liquidity and Capital Resources*

Textron Financial mitigates liquidity risk (i.e., the risk that we will be unable to fund maturing liabilities or the origination of new finance receivables) by developing and preserving reliable sources of capital. We use a variety of financial resources to meet these capital needs. Cash is provided from finance receivable collections, sales and securitizations, as well as the issuance of commercial paper and term debt in the public and private markets. This diversity of capital resources enhances our funding flexibility, limits dependence on any one source of funds, and results in cost-effective funding. We also, on occasion, borrow available cash from Textron when it is in the collective economic interest of Textron Financial and Textron. In making particular funding decisions, management considers market conditions, prevailing interest rates and credit spreads, and the maturity profile of its assets and liabilities.

We have a policy of maintaining unused committed bank lines of credit in an amount not less than outstanding commercial paper balances. Since Textron Financial is permitted to borrow under Textron's multi-year facility,

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

these lines of credit include both Textron Financial's multi-year facility and Textron's multi-year facility. These facilities are in support of commercial paper and letters of credit issuances only, and neither of these lines of credit was drawn at June 30, 2008 or December 29, 2007.

The Company's committed credit facilities at June 30, 2007 were as follows:

	<u>Facility Amount</u>	<u>Commercial Paper Outstanding</u>	<u>Letters of Credit Issued under Facility</u> (In millions)	<u>Amount Not Reserved as Support for Commercial Paper and Letters of Credit</u>
Textron Financial multi-year facility expiring in 2012 . . . . .	\$1,750	\$1,340	\$ 7	\$ 403
Textron multi-year facility expiring in 2012 . . . . .	<u>1,250</u>	<u>89</u>	<u>22</u>	<u>1,139</u>
Total . . . . .	<u>\$3,000</u>	<u>\$1,429</u>	<u>\$29</u>	<u>\$1,542</u>

Textron Financial and Textron Financial Canada Funding Corp. have a joint shelf registration statement with the Securities and Exchange Commission enabling the issuance of an unlimited amount of public debt securities. During the first six months of 2008, \$675 million of term debt was issued under this registration statement.

During the second quarter of 2008, the Company sold finance receivables to a SPE which is a consolidated subsidiary of Textron Financial. These receivables were used by the SPE as collateral for the issuance of \$300 million of secured notes to third-party investors under a 364 day revolving credit facility. Since the SPE is consolidated with Textron Financial, the third-party notes are reflected as Debt in Consolidated Balance Sheets. If the notes are not paid in full at the maturity date of the facility, any outstanding balance will bear interest at an increased interest rate and will amortize from collateral collections.

Cash flows provided by operating activities were \$83 million during the first six months of 2008 compared to \$153 million in the corresponding period of 2007. The decrease in cash flows was primarily due to a decrease in Net interest margin and the timing of accrued interest and other liabilities.

Cash flows used by investing activities were \$134 million during the first six months of 2008 compared to cash flows provided of \$23 million in the corresponding period of 2007. The increase in cash flows used was primarily due to the purchase of notes receivable issued by timeshare securitization trusts and lower Proceeds from receivable sales, including securitizations.

Cash flows provided by financing activities were \$46 million during the first six months of 2008 compared to cash flows used of \$156 million in the corresponding period of 2007. The increase in cash flows provided was primarily attributable to less reliance on Proceeds from receivable sales, including securitizations to fund the growth in finance assets in the first six months of 2008 as compared to the corresponding period of 2007.

Because the finance business involves the purchase and carrying of receivables, a relatively high ratio of borrowings to net worth is customary. Debt as a percentage of total capitalization was 88% at June 30, 2008 compared to 86% at December 29, 2007. Textron Financial's ratio of earnings to fixed charges was 1.35x for the six months ended June 30, 2008 compared to 1.59x for the corresponding period in 2007. Commercial paper and Other short-term debt as a percentage of total debt was 19% at June 30, 2008 compared to 20% at the end of 2007.

During the first six months of 2008, Textron Financial declared and paid dividends to Textron of \$147 million compared to dividends declared and paid of \$140 million during the corresponding period of 2007. The payment of these dividends represents the distribution of retained earnings to achieve our targeted leverage ratio. Textron contributed capital of \$5 million to Textron Financial in the first six months of 2008 and 2007, which consisted of Textron's dividend on preferred stock owned by Textron Funding Corporation, which is a wholly-owned subsidiary of Textron Financial.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

*Off-Balance Sheet Arrangements*

Textron Financial primarily sells finance receivables utilizing asset-backed securitization structures. As a result of these transactions, finance receivables are removed from the balance sheet, and the proceeds received are used to reduce recorded debt levels. Despite the reduction in the recorded balance sheet position, we generally retain a subordinated interest in the finance receivables sold through securitizations, which may affect operating results through periodic fair value adjustments.

Textron Financial utilizes off-balance sheet financing arrangements to further diversify funding alternatives. Proceeds provided by these transactions generated \$541 million and \$549 million in cash in the first six months of 2008 and 2007, respectively. Proceeds from securitizations include amounts received related to incremental increases in the level of Distribution finance receivables sold, and exclude amounts received related to the ongoing replenishment of the outstanding sold balance of these short-duration receivables.

During 2008, \$802 million of the outstanding notes issued by the Distribution Finance revolving securitization trust matured and the trust issued variable funding notes in the amount of \$559 million and \$419 million. The Company has retained \$103 million of these notes. Both notes have an interest rate equal to the commercial paper costs of the conduit purchasers and are scheduled to mature in September 2009 and May 2009, respectively.

The Company recognized net pre-tax gains related to securitization transactions as follows:

	<u>Six Months Ended</u>	
	<u>June 30,</u>	<u>June 30,</u>
	<u>2008</u>	<u>2007</u>
	(In millions)	
Distribution finance receivables . . . . .	\$30	\$30
Aviation finance loans . . . . .	8	—
Other finance receivables . . . . .	<u>2</u>	<u>—</u>
Total net pre-tax gains . . . . .	<u>\$40</u>	<u>\$30</u>

Securitization gains related to recurring finance receivables sales into the Distribution Finance revolving securitization were \$28 million and \$25 million for the first six months of 2008 and 2007, respectively. Securitization gains related to incremental finance receivable sales into the Distribution Finance revolving securitization were \$2 million and \$5 million for the first six months of 2008 and 2007, respectively.

Cash collections on current and prior period securitization gains were \$33 million and \$30 million for the first six months of 2008 and 2007, respectively.

*Managed Finance Receivables*

Managed finance receivables consist of owned finance receivables, and finance receivables that we continue to service, but have sold in securitizations or similar structures in which substantial risks of ownership are retained. The managed finance receivables of our business segments are presented in the following table.

	<u>June 30,</u>		<u>December 29,</u>	
	<u>2008</u>		<u>2007</u>	
	(Dollars in millions)			
Distribution Finance . . . . .	\$ 3,827	33%	\$ 3,812	34%
Aviation Finance . . . . .	2,638	23%	2,448	22%
Golf Finance . . . . .	1,816	16%	1,663	15%
Resort Finance . . . . .	1,535	13%	1,506	14%
Asset-Based Lending . . . . .	982	9%	1,004	9%
Structured Capital . . . . .	592	5%	608	5%
Corporate and Other . . . . .	<u>74</u>	<u>1%</u>	<u>82</u>	<u>1%</u>
Total managed finance receivables . . . . .	<u>\$11,464</u>	<u>100%</u>	<u>\$11,123</u>	<u>100%</u>

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

*Nonperforming Assets*

Nonperforming assets include nonaccrual finance receivables and repossessed assets. We classify receivables as nonaccrual and suspend the recognition of earnings when accounts are contractually delinquent by more than three months, unless collection of principal and interest is not doubtful. In addition, earlier suspension may occur if we have significant doubt about the ability of the obligor to meet current contractual terms. Doubt may be created by payment delinquency, reduction in the obligor's cash flows, deterioration in the loan to collateral value relationship or other relevant considerations.

The following table sets forth certain information about nonperforming assets and the related percentages of each business segment's owned finance assets.

	<u>June 30, 2008</u>		<u>December 29, 2007</u>	
	(Dollars in millions)			
Golf Finance . . . . .	\$ 55	3.03%	\$ 21	1.24%
Distribution Finance . . . . .	53	2.88%	23	1.20%
Asset-Based Lending . . . . .	52	5.30%	23	2.31%
Aviation Finance . . . . .	19	0.81%	20	0.89%
Resort Finance . . . . .	9	0.54%	9	0.57%
Corporate and Other . . . . .	<u>28</u>	<u>27.72%</u>	<u>27</u>	<u>24.73%</u>
Total nonperforming assets . . . . .	<u>\$216</u>	<u>2.31%</u>	<u>\$123</u>	<u>1.34%</u>

We believe that nonperforming assets will generally be in the range of 1% to 4% of finance assets depending on economic conditions. The increase in nonperforming assets is primarily the result of one troubled account in the Asset-Based Lending segment and one troubled account in the Golf Finance segment. In addition, nonperforming assets and net charge-offs increased in the Distribution Finance segment reflecting weakening U.S. economic conditions.

*Interest Rate Sensitivity*

Textron Financial's mix of fixed and floating-rate debt is continuously monitored by management and is adjusted, as necessary, based on evaluations of internal and external factors. Management's strategy of matching floating-rate assets with floating-rate liabilities limits Textron Financial's risk to changes in interest rates. This strategy includes the use of interest rate exchange agreements. At June 30, 2008, floating-rate liabilities in excess of floating-rate assets were \$2.5 billion, net of \$2.1 billion of interest rate exchange agreements, which effectively converted fixed-rate debt to a floating-rate equivalent. Classified within fixed-rate assets are \$2.3 billion of floating rate loans with index rate floors that are, on average, 95 basis points above the applicable index rate (predominately the Prime rate). As a consequence, these assets are classified as fixed-rate, and will remain so until the Prime rate increases above the floor rates. The Company has benefited from these and other interest rate floor agreements in the recent low rate environment. However, in a rising rate environment, this benefit will dissipate until the Prime rate exceeds the floor rates embedded in these agreements.

We believe that our asset/liability management policy provides adequate protection against interest rate risks. Changes in interest rates, however, could have an adverse effect on our interest margin percentage. Variable-rate finance receivables are generally tied to changes in the prime rate offered by major U.S. and Canadian banks and typically have index resets on a monthly basis. Variable-rate debt is generally tied to changes in LIBOR and variable-rate term debt typically has index resets on a quarterly basis. As a consequence, changes in short-term borrowing costs do not always coincide with changes in variable-rate receivable yields. We do not hedge this basis risk between different variable-rate indices and reset frequencies, as we believe the cost is disproportionately high in comparison to the magnitude of the risk over long periods of time.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

We assess our exposure to interest rate changes using an analysis that measures the potential loss in net income, over a twelve-month period, resulting from a hypothetical change in interest rates of 100 basis points across all maturities occurring at the outset of the measurement period (sometimes referred to as a "shock test"). The analysis also assumes that prospective receivable additions will be match-funded, existing portfolios will not prepay and contractual maturities of both debt and assets will result in issuances or reductions of commercial paper. This shock test model, when applied to our asset and liability position at June 30, 2008, indicates that an increase in interest rates of 100 basis points would have a negative \$24 million impact and a decrease in interest rates of 100 basis points would have a positive \$18 million impact on net income or cash flows for the following twelve-month period, respectively.

*Financial Risk Management*

Textron Financial's results are affected by changes in U.S. and, to a lesser extent, foreign interest rates. As part of managing this risk, we enter into interest rate exchange agreements. The objective of entering into such agreements is not to speculate for profit, but generally to convert variable-rate debt into fixed-rate debt and vice versa. The overall objective of our interest rate risk management is to achieve match-funding objectives. These agreements do not involve a high degree of complexity or risk. The fair values of interest rate exchange agreements are recorded in either Other assets or Accrued interest and other liabilities on the Consolidated Balance Sheets. We do not trade in interest rate exchange agreements or enter into leveraged interest rate exchange agreements.

We manage our foreign currency exposure by funding foreign currency denominated assets with liabilities in the same currency or by entering into foreign currency exchange agreements to convert foreign currency denominated assets, liabilities and cash flows into functional currency denominated assets, liabilities and cash flows. In addition, as part of managing our foreign currency exposure, we may enter into foreign currency forward exchange contracts. The objective of such agreements is to manage any remaining foreign currency exposures to changes in currency rates. The notional amounts outstanding for these agreements were \$39 million and \$21 million at June 30, 2008 and December 29, 2007, respectively. The fair values of these agreements are recorded in either Other assets or Accrued interest and other liabilities on the Company's Consolidated Balance Sheets. As we hedge all substantial non-functional currency exposures within each of our subsidiaries, future changes in foreign currency rates would not have a significant impact on each subsidiary's functional currency earnings. We do not hedge the earnings of, or investment in our Canadian subsidiaries as we plan to continue investing these earnings in Canada for the foreseeable future. As a result, changes in the currency exchange rate between the Canadian dollar and the U.S. dollar could impact our consolidated earnings.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

**RESULTS OF OPERATIONS**

*For the three and six months ended June 30, 2008 vs. June 30, 2007*

**Revenues and Net Interest Margin**

A comparison of revenues and net interest margin is set forth in the following table.

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(Dollars in millions)			
Finance charges . . . . .	\$ 127	\$ 173	\$ 282	\$ 339
Securitization gains . . . . .	20	15	40	30
Rental revenues on operating leases . . . . .	8	8	17	16
Other income . . . . .	<u>22</u>	<u>43</u>	<u>52</u>	<u>64</u>
Total revenues . . . . .	177	239	391	449
Interest expense . . . . .	71	102	157	202
Depreciation of equipment on operating leases . . . . .	<u>4</u>	<u>4</u>	<u>9</u>	<u>8</u>
Net interest margin . . . . .	<u>\$ 102</u>	<u>\$ 133</u>	<u>\$ 225</u>	<u>\$ 239</u>
Portfolio yield . . . . .	6.31%	8.67%	6.92%	8.49%
Net interest margin as a percentage of average net investment . . . . .	4.91%	6.47%	5.35%	5.81%

Finance charges decreased \$46 million and \$57 million for the three and six months ended June 30, 2008, compared with 2007, primarily due to a decrease in market interest rates of \$41 million and \$69 million, respectively, and a \$9 million cumulative reduction in leveraged lease earnings as a result of a change in our estimate of the timing of tax related cash flows related to certain leveraged leases. These decreases were partially offset by a \$6 million benefit recognized in the second quarter of 2008 from variable-rate receivables with interest rate floors, which began earning higher yields relative to market rate indices as market interest rates decreased compared to 2007. For the six months ended June 30, 2008, the decrease in Finance charges also was offset by an \$8 million increase in leveraged lease earnings resulting from larger unfavorable cumulative earnings adjustments in 2007 attributable to the recognition of residual value impairments. Other income decreased for the three and six months ended June 30, 2008 as compared to 2007 primarily as a result of a \$21 million gain from the sale of a leveraged lease investment in the second quarter of 2007, which was partially offset by a \$5 million gain from the sale of the remaining investment in the first quarter of 2008.

Net interest margin and net interest margin percentage decreased during the three and six months ended June 30, 2008 as compared to 2007, principally reflecting the impact of \$9 million and \$19 million higher borrowing costs, respectively, relative to various market rate indices as discussed in "Key Business Initiatives and Trends", lower Other income and the \$9 million cumulative reduction in leveraged lease earnings. These factors were partially offset by the \$6 million benefit from receivables with interest rate floors in the second quarter and an increase in securitization gains of \$5 million and \$10 million for the three and six months ended June 30, 2008, respectively.

**Selling and Administrative Expenses**

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(Dollars in millions)			
Selling and administrative expenses . . . . .	\$ 49	\$ 54	\$ 103	\$ 103
Selling and administrative expenses as a percentage of average managed and serviced finance receivables . . . . .	1.53%	1.76%	1.62%	1.72%
Operating efficiency ratio . . . . .	48.0%	40.6%	45.8%	43.1%

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

Selling and administrative expenses as a percentage of average managed and serviced receivables improved during the three and six months ended June 30, 2008 as compared to the corresponding periods of 2007. The improvement is primarily the result of reduced employee compensation expense as a result of lower levels of incentive based compensation associated with a reduction in profitability and continued process improvement initiatives, which have enabled growth in the managed and serviced receivable portfolio with a reduction in staffing levels as compared to 2007. The deterioration in the operating efficiency ratio is a result of the reduction in net interest margin.

**Provision for Losses**

Allowance for losses on finance receivables is presented in the following table.

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>	<u>June 30,</u> <u>2008</u>	<u>June 30,</u> <u>2007</u>
	(In millions)			
Allowance for losses on finance receivables beginning of period . . . . .	\$105	\$94	\$ 89	\$93
Provision for losses . . . . .	40	11	67	16
Less net charge-offs:				
Distribution Finance . . . . .	14	3	23	6
Asset-Based Lending . . . . .	4	8	4	8
Aviation Finance . . . . .	1	1	3	1
Golf Finance . . . . .	—	2	1	2
Resort Finance . . . . .	—	(1)	(1)	(1)
Corporate and Other . . . . .	—	6	—	7
Total net charge-offs . . . . .	<u>19</u>	<u>19</u>	<u>30</u>	<u>23</u>
Allowance for losses on finance receivables end of period . .	<u>\$126</u>	<u>\$86</u>	<u>\$126</u>	<u>\$86</u>

The increase in provision for losses for the three and six months ended June 30, 2008 as compared to the corresponding period of 2007 primarily reflects increases for one account in Asset-Based Lending segment in the first quarter (\$15 million), one account in the Golf Finance segment in the second quarter (\$12 million) and increases in the rates utilized to establish the allowance for losses in several portfolios (\$10 million).

As a result of these provisions, the allowance for losses on finance receivables increased by \$37 million in the first six months of 2008. This increase corresponds with a \$97 million increase in nonaccrual finance receivables during the same six months and results in an allowance for losses on finance receivables as a percentage of nonaccrual finance receivables of 71.8% compared to 111.7% at the end of 2007.

Although management believes it has made adequate provision for anticipated losses on finance receivables, realization of these amounts remains subject to uncertainties. Subsequent evaluations of portfolio quality, in light of factors then prevailing, including economic conditions, may require additional increases or decreases in the allowance for losses on finance receivables.

**Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

**Income Taxes**

A reconciliation of the federal statutory income tax rate to the effective income tax rate is provided below:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
Federal statutory income tax rate . . . . .	35.0%	35.0%	35.0%	35.0%
Increase (decrease) in taxes resulting from:				
State income taxes . . . . .	43.8	2.5	11.7	2.1
Foreign tax rate differential . . . . .	15.2	(0.9)	(6.1)	(1.3)
Canadian dollar functional currency . . . . .	0.2	—	0.1	(1.7)
Change in state valuation allowance . . . . .	(83.8)	1.3	(20.1)	0.7
Tax contingencies . . . . .	73.8	3.4	21.4	3.8
Tax credits . . . . .	(6.8)	(1.0)	(3.0)	(1.2)
Other, net . . . . .	<u>(9.1)</u>	<u>(0.1)</u>	<u>(2.4)</u>	<u>(0.1)</u>
Effective income tax rate . . . . .	<u>68.3%</u>	<u>40.2%</u>	<u>36.6%</u>	<u>37.3%</u>

For the three and six months ended June 30, 2008, the difference between the statutory tax rate and the effective tax rate is primarily attributable to a change in management’s assessment of the amount of the state deferred tax asset that is realizable, offset by interest on tax contingencies, the majority of which is associated with leveraged leases and a finance lease, as discussed in Note 10 Contingencies and below, and state tax expense, as a result of changes in the income apportionable to certain jurisdictions.

The increase in tax contingencies is the result of a change in the second quarter of 2008 related to the Company’s tax position on certain leveraged leases and one finance lease. The change was based on court decisions involving other companies that addressed the tax treatment of certain lease transactions challenged by the Internal Revenue Service (“IRS”), and resulted in the accrual of \$10 million of additional interest, net of taxes, on this tax contingency. As required by FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” for all income tax positions taken, the Company’s financial statements only reflect tax benefits for which it is more likely than not that a tax benefit will be sustained, and for the largest amount estimated to have a greater than 50 percent likelihood of being realized upon settlement with the taxing authority having full knowledge of all relevant information. This change in assessment also was the primary factor in the reduction of our state tax valuation allowance.

For the three months ended June 30, 2007, the difference between the statutory tax rate and the effective tax rate is primarily attributable to interest on tax contingencies, the majority of which is associated with leveraged leases, state tax expense and a change in management’s assessment of the amount of the state deferred tax asset that is realizable.

For the six months ended June 30, 2007, the difference between the statutory tax rate and the effective tax rate is primarily attributable to interest on tax contingencies, the majority of which is associated with leveraged leases, and state tax expense, partially offset by benefits relating to a non-recurring increase to the benefit attributable to the adoption of the Canadian dollar as the functional currency for U.S. tax purposes of one of the Company’s wholly-owned Canadian subsidiaries.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

**Operating Results by Segment**

Segment income presented in the tables below represents income before income taxes.

*Distribution Finance*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$60	\$76	\$125	\$159
Net interest margin . . . . .	\$45	\$53	\$ 92	\$109
Selling and administrative expenses . . . . .	26	23	51	46
Provision for losses . . . . .	<u>22</u>	<u>3</u>	<u>32</u>	<u>8</u>
Segment (loss) income . . . . .	<u>\$ (3)</u>	<u>\$27</u>	<u>\$ 9</u>	<u>\$ 55</u>

Distribution Finance segment income decreased \$30 million during the second quarter of 2008 primarily due to higher loss provision and a decrease in net interest margin. The decrease in net interest margin is primarily attributable to an increase in borrowing costs relative to various market rate indices, partially offset by the benefit obtained from floor rates in effect for a substantial portion of the portfolio. Provision for losses increased \$19 million, reflecting deterioration in portfolio quality as weakening general U.S. economic conditions affected borrowers in certain industries.

Distribution Finance segment income decreased \$46 million during the first six months of 2008 primarily due to higher loss provision and a decrease in net interest margin. The decrease in net interest margin is primarily attributable to an increase in borrowing costs relative to various market rate indices, partially offset by the benefit obtained from floor rates in effect for a substantial portion of the portfolio. Provision for losses increased \$24 million, reflecting deterioration in portfolio quality as weakening general U.S. economic conditions affected borrowers in certain industries.

*Aviation Finance*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$46	\$44	\$96	\$84
Net interest margin . . . . .	\$25	\$18	\$50	\$35
Selling and administrative expenses . . . . .	6	5	13	10
Provision for losses . . . . .	<u>2</u>	<u>2</u>	<u>3</u>	<u>3</u>
Segment income . . . . .	<u>\$17</u>	<u>\$11</u>	<u>\$34</u>	<u>\$22</u>

Aviation Finance segment income increased \$6 million during the second quarter of 2008. The increase was driven by \$7 million of higher net interest margin, which was primarily attributable to a gain on the securitization of \$124 million of receivables (\$3 million) and \$223 million of growth in average finance receivables (\$2 million).

Aviation Finance segment income increased \$12 million during the first six months of 2008. The increase was driven by \$15 million of higher net interest margin, which was primarily attributable to gains on the securitization of \$304 million of receivables (\$8 million) and \$349 million of growth in average finance receivables (\$5 million). The increase in net interest margin was partially offset by a \$3 million increase in selling and administrative expenses, primarily due to \$496 million of growth in managed finance receivables.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

*Golf Finance*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$32	\$37	\$66	\$71
Net interest margin . . . . .	\$14	\$17	\$29	\$32
Selling and administrative expenses . . . . .	5	5	11	10
Provision for losses . . . . .	<u>16</u>	<u>1</u>	<u>16</u>	<u>3</u>
Segment (loss) income . . . . .	<u>\$ (7)</u>	<u>\$11</u>	<u>\$ 2</u>	<u>\$19</u>

Golf Finance segment income decreased \$18 million and \$17 million during the second quarter and first six months of 2008, respectively. The decrease for both periods is primarily due to an increase in provision for losses, the majority of which is attributable to a specific reserving action taken on one account. Increases in net interest margin from the increase in average finance receivables of \$175 million and \$176 million, for the three- and six-month periods, respectively, were more than offset by an increase in borrowing costs relative to various market rate indices and the impact of competitive pricing pressures on yields.

*Resort Finance*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$31	\$33	\$66	\$65
Net interest margin . . . . .	\$20	\$16	\$40	\$32
Selling and administrative expenses . . . . .	5	6	11	12
Provision for losses . . . . .	<u>—</u>	<u>—</u>	<u>(1)</u>	<u>(3)</u>
Segment income . . . . .	<u>\$15</u>	<u>\$10</u>	<u>\$30</u>	<u>\$23</u>

Resort Finance segment income increased \$5 million during the second quarter of 2008. The increase is primarily due to \$4 million of higher net interest margin. The higher net interest margin is primarily attributable to \$3 million of higher fee income primarily associated with investments in notes receivable issued by timeshare securitization trusts. An increase in net interest margin from a \$162 million increase in average finance receivables was offset by an increase in borrowing costs relative to various market rate indices.

Resort Finance segment income increased \$7 million during the first six months of 2008. The increase is primarily due to \$8 million of higher net interest margin attributable to \$7 million of higher fee income associated with increases in investment income, other income and syndication fees. An increase in net interest margin from a \$188 million increase in average finance receivables was offset by an increase in borrowing costs relative to various market rate indices.

*Asset-Based Lending*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$17	\$23	\$37	\$46
Net interest margin . . . . .	\$10	\$12	\$21	\$24
Selling and administrative expenses . . . . .	6	7	12	12
Provision for losses . . . . .	<u>—</u>	<u>1</u>	<u>17</u>	<u>—</u>
Segment income (loss) . . . . .	<u>\$ 4</u>	<u>\$ 4</u>	<u>\$ (8)</u>	<u>\$12</u>

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

Asset-Based Lending segment income was unchanged during the second quarter of 2008 compared to the corresponding period in 2007. Net interest margin decreased \$2 million due to the impact of higher borrowing costs relative to various market rate indices and competitive pricing pressures on yields, partially offset by a \$76 million increase in average finance receivables.

Asset-Based Lending segment income decreased \$20 million during the first six months of 2008. The decrease is primarily due to a \$15 million specific reserving action taken in the first quarter of 2008 for one account, whose operations have been significantly impacted by weakening residential real estate values. Net interest margin decreased \$3 million due to the impact of higher borrowing costs relative to various market rate indices and competitive pricing pressures on yields, partially offset by an \$81 million increase in average finance receivables.

*Structured Capital*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$ (9)	\$24	\$—	\$21
Net interest margin . . . . .	\$(11)	\$20	\$(5)	\$13
Selling and administrative expenses . . . . .	<u>—</u>	<u>1</u>	<u>1</u>	<u>2</u>
Segment (loss) income . . . . .	<u>\$(11)</u>	<u>\$19</u>	<u>\$(6)</u>	<u>\$11</u>

Structured Capital segment income decreased \$30 million during the second quarter of 2008. The decrease is primarily due to a \$21 million gain from the sale of a leveraged lease investment in the second quarter of 2007 and \$9 million of lower leveraged lease earnings representing the cumulative effect of a change in our estimate of the timing of tax related cash flows in the second quarter of 2008.

Structured Capital segment income decreased by \$17 million during the first six months of 2008. The decrease is primarily due to a \$21 million gain from the sale of a leveraged lease investment in the second quarter of 2007 and \$9 million of lower leveraged lease earnings representing the cumulative effect of a change in our estimate of the timing of tax related cash flows in the second quarter of 2008. These decreases were partially offset by \$8 million of higher leveraged lease earnings associated with lower unfavorable cumulative earnings adjustments attributable to the recognition of residual value impairments in 2008 as compared to 2007 and a \$5 million gain recognized upon the sale of our remaining interest in a leveraged lease investment in the first quarter of 2008.

*Corporate and Other Segment*

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
	(In millions)			
Revenues . . . . .	\$—	\$ 2	\$ 1	\$ 3
Net interest margin . . . . .	\$(1)	\$(3)	\$(2)	\$(6)
Selling and administrative expenses . . . . .	1	7	4	11
Provision for losses . . . . .	<u>—</u>	<u>4</u>	<u>—</u>	<u>5</u>
Segment loss . . . . .	<u>\$(2)</u>	<u>\$(14)</u>	<u>\$(6)</u>	<u>\$(22)</u>

Corporate and Other segment loss decreased \$12 million and \$16 million for the three and six month periods ended June 30, 2008, respectively. The three- and six-month decreases, respectively, are primarily due to \$6 million and \$7 million of lower selling and administrative expenses, as our non-core portfolios continue to liquidate, and lower provision for losses.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

**Selected Financial Ratios**

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
Net interest margin as a percentage of average net investment(1) . . . . .	4.91%	6.47%	5.35%	5.81%
Return on average equity . . . . .	1.60%	15.73%	6.46%	14.09%
Return on average assets . . . . .	0.17%	1.79%	0.72%	1.67%
Selling and administrative expenses as a percentage of average managed and serviced finance receivables(2) . . .	1.53%	1.76%	1.62%	1.72%
Operating efficiency ratio(3) . . . . .	48.0%	40.6%	45.8%	43.1%
Net charge-offs as a percentage of average finance receivables . . . . .	0.89%	0.91%	0.68%	0.52%
			<u>June 30, 2008</u>	<u>December 29, 2007</u>
60+ days contractual delinquency as a percentage of finance receivables(4) . . . . .			0.61%	0.43%
Nonperforming assets as a percentage of finance assets(5) . . . . .			2.31%	1.34%
Allowance for losses on finance receivables as a percentage of finance receivables . . . . .			1.46%	1.03%
Allowance for losses on finance receivables as a percentage of nonaccrual finance receivables . . . . .			71.8%	111.7%
Total debt to tangible shareholder's equity(6) . . . . .			9.04x	7.76x

- (1) Represents revenues earned less interest expense on borrowings and operating lease depreciation as a percentage of average net investment. Average net investment includes finance receivables plus operating leases, less deferred taxes on leveraged leases.
- (2) Average managed and serviced finance receivables include owned receivables, receivables serviced under securitizations, participations and third-party portfolio servicing agreements.
- (3) Operating efficiency ratio is selling and administrative expenses divided by net interest margin.
- (4) Delinquency excludes any captive finance receivables with recourse to Textron. Captive finance receivables represent third-party finance receivables originated in connection with the sale or lease of Textron manufactured products. Percentages are expressed as a function of total Textron Financial independent and nonrecourse captive receivables.
- (5) Finance assets include: finance receivables; equipment on operating leases, net of accumulated depreciation; repossessed assets and properties; retained interests in securitizations; interest-only securities; investment in equipment residuals; Acquisition, Development and Construction arrangements; and short- and long-term investments (some of which are classified in Other assets on Textron Financial's Consolidated Balance Sheets). Nonperforming assets include independent and nonrecourse captive finance assets.
- (6) Tangible shareholder's equity equals Shareholder's equity, excluding Accumulated other comprehensive income (loss), less Goodwill.

## **Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)***

### **Forward-looking Information**

*Certain statements in this Quarterly Report on Form 10-Q and other oral and written statements made by Textron Financial from time to time are forward-looking statements, including those that discuss strategies, goals, outlook or other non-historical matters; or project revenues, income, returns or other financial measures. These forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update or revise any forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements, such as the Risk Factors contained in our 2007 Annual Report on Form 10-K and including the following: (a) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (b) the occurrence of slowdowns or downturns in customer markets in which Textron products are sold or supplied and financed or where we offer financing; (c) the ability to realize full value of receivables and investments in securities; (d) the ability to control costs and successful implementation of various cost reduction programs; (e) increases in pension expenses and other post-retirement employee costs; (f) the impact of changes in tax legislation; (g) the ability to maintain portfolio credit quality; (h) access to financing, including securitizations, at competitive rates; (i) access to equity in the form of retained earnings and capital contributions from Textron; (j) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies; (k) the launching of significant new products or programs which could result in unanticipated expenses; and (l) risks and uncertainties related to acquisitions and dispositions.*

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

For information regarding Textron Financial's Quantitative and Qualitative Disclosure About Market Risk, see "Interest Rate Sensitivity" and "Financial Risk Management" in Item 2 of this Form 10-Q.

### **Item 4. *Controls and Procedures***

We have carried out an evaluation, under the supervision and with the participation of our management, including our Chairman and Chief Executive Officer (the "CEO") and our Executive Vice President and Chief Financial Officer (the "CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Act")) as of the end of the fiscal quarter covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures are effective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in Textron Financial's internal control over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**  
**TEXTRON FINANCIAL CORPORATION**

**Item 6. Exhibits**

- 4.1 Series 2008-CP-2 Supplement, dated as of May 13, 2008, to the Amended and Restated Indenture, dated as of May 26, 2005, by and among Textron Financial Floorplan Master Note Trust, The Bank of New York, as indenture trustee, and Textron Financial, as servicer. Incorporated by reference to Exhibit 4.1 to Textron Financial Corporation's Current Report on Form 8-K filed May 15, 2008.
- 4.2 Amendment No. 1, dated as of May 13, 2008, to Series 2008-CP-1 Supplement, dated as of March 20, 2008, to the Amended and Restated Indenture, dated as of May 26, 2005, by and among Textron Financial Floorplan Master Note Trust, The Bank of New York, as indenture trustee, and Textron Financial, as servicer. Incorporated by reference to Exhibit 4.1 to Textron Financial Corporation's Current Report on Form 8-K filed May 15, 2008.
- 12 Computation of Ratio of Earnings to Fixed Charges
- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Textron Financial Corporation

/s/ Thomas J. Cullen

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Thomas J. Cullen  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: July 25, 2008

**TEXTRON FINANCIAL CORPORATION**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**  
**(Dollars in millions)**

	<u>Six Months Ended</u> <u>June 30, 2008</u>
Income before income taxes . . . . .	\$ 55
<b>FIXED CHARGES:</b>	
Interest on debt. . . . .	157
Estimated interest portion of rents . . . . .	<u>1</u>
Total fixed charges . . . . .	<u>158</u>
Adjusted income. . . . .	\$ 213
Ratio of earnings to fixed charges(1) . . . . .	<u><u>1.35x</u></u>

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(1) The ratio of earnings to fixed charges has been computed by dividing income before income taxes and fixed charges by fixed charges. Fixed charges consist of interest on debt and one-third rental expense as representative of interest portion of rentals.

**TEXTRON FINANCIAL CORPORATION**  
**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**  
**PURSUANT TO RULE 13a-14(a)**

I, Ted R. French, Chairman and Chief Executive Officer of Textron Financial Corporation certify that:

1. I have reviewed this quarterly report on Form 10-Q of Textron Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Ted R. French

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Ted R. French  
Chairman and Chief Executive Officer

Date: July 25, 2008

**TEXTRON FINANCIAL CORPORATION**  
**CERTIFICATION OF CHIEF FINANCIAL OFFICER**  
**PURSUANT TO RULE 13a-14(a)**

I, Thomas J. Cullen, Executive Vice President and Chief Financial Officer of Textron Financial Corporation certify that:

1. I have reviewed this quarterly report on Form 10-Q of Textron Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Thomas J. Cullen

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Thomas J. Cullen  
Executive Vice President and Chief Financial Officer

Date: July 25, 2008

**TEXTRON FINANCIAL CORPORATION**  
**CERTIFICATION PURSUANT TO**  
**18 U.S.C. SECTION 1350,**  
**AS ADOPTED PURSUANT TO**  
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Textron Financial Corporation (the “Company”) on Form 10-Q for the period ended June 30, 2008 as filed with the Securities and Exchange Commission on the Date hereof (the “Report”), I, Ted R. French, Chairman and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Textron Financial Corporation

/s/ Ted R. French

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Ted R. French  
Chairman and Chief Executive Officer

Date: July 25, 2008

**TEXTRON FINANCIAL CORPORATION**  
**CERTIFICATION PURSUANT TO**  
**18 U.S.C. SECTION 1350,**  
**AS ADOPTED PURSUANT TO**  
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Textron Financial Corporation (the “Company”) on Form 10-Q for the period ended June 30, 2008 as filed with the Securities and Exchange Commission on the Date hereof (the “Report”), I, Thomas J. Cullen, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Textron Financial Corporation

/s/ Thomas J. Cullen

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Thomas J. Cullen  
Executive Vice President and Chief Financial Officer

Date: July 25, 2008