

SCHWAB CHARLES CORP
Form 10-Q
August 06, 2013

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

FORM 10-Q

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

For the quarterly period ended June 30, 2013

Commission File Number: 1-9700

THE CHARLES SCHWAB CORPORATION

(Exact name of registrant as specified in its charter)

Delaware 94-3025021
(State or other jurisdiction (I.R.S. Employer Identification No.)
of incorporation or organization)

211 Main Street, San Francisco, CA 94105
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (415) 667-7000

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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 T No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes T 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.

Large accelerated filer

Accelerated filer

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

1,284,909,433 shares of \$.01 par value Common Stock
Outstanding on July 24, 2013

THE CHARLES SCHWAB CORPORATION

Quarterly Report on Form 10-Q

For the Quarter Ended June 30, 2013

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Part I – FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Income

(In millions, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net Revenues				
Asset management and administration fees	\$ 572	\$ 496	\$ 1,124	\$ 980
Interest revenue	499	497	996	969
Interest expense	(26)	(39)	(54)	(77)
Net interest revenue	473	458	942	892
Trading revenue	235	219	458	462
Other	59	121	115	167
Provision for loan losses	1	(4)	(5)	(4)
Net impairment losses on securities ⁽¹⁾	(3)	(7)	(7)	(25)
Total net revenues	1,337	1,283	2,627	2,472
Expenses Excluding Interest				
Compensation and benefits	494	446	1,030	911
Professional services	106	93	205	189
Occupancy and equipment	77	80	154	156
Advertising and market development	67	57	141	124
Communications	56	55	110	113
Depreciation and amortization	51	48	102	96
Other	74	72	142	138
Total expenses excluding interest	925	851	1,884	1,727
Income before taxes on income	412	432	743	745
Taxes on income	156	157	281	275
Net Income	256	275	462	470
Preferred stock dividends	23	14	31	14
Net Income Available to Common Stockholders	\$ 233	\$ 261	\$ 431	\$ 456
Weighted-Average Common Shares Outstanding — Diluted	1,288	1,274	1,285	1,273

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Earnings Per Common Share — Basic	\$.18	\$.20	\$.33	\$.36
Earnings Per Common Share — Diluted	\$.18	\$.20	\$.33	\$.36

(1) Net impairment losses on securities include total other-than-temporary impairment losses of \$2 million and \$12 million, net of \$(1) million and \$5 million reclassified from or recognized in other comprehensive income, for the three months ended June 30, 2013 and 2012, respectively. Net impairment losses on securities include total other-than-temporary impairment losses of \$2 million and \$14 million, net of \$(5) million and \$(11) million reclassified from other comprehensive income, for the six months ended June 30, 2013 and 2012, respectively.

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Comprehensive (Loss) Income

(In millions)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2013	2012	2013	2012
Net Income	\$ 256	\$ 275	\$ 462	\$ 470
Other comprehensive (loss) income, before tax:				
Change in net unrealized gain on securities available for sale:				
Net unrealized (loss) gain	(477)	119	(480)	208
Reclassification of impairment charges included in net impairment losses on securities	3	7	7	25
Other reclassifications included in other revenue	(3)	(1)	(3)	(1)
Other	-	-	1	-
Other comprehensive (loss) income, before tax	(477)	125	(475)	232
Income tax effect	180	(47)	180	(86)
Other comprehensive (loss) income, net of tax	(297)	78	(295)	146
Comprehensive (Loss) Income	\$ (41)	\$ 353	\$ 167	\$ 616

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Balance Sheets

(In millions, except per share and share amounts)

(Unaudited)

	June 30, 2013	December 31, 2012
Assets		
Cash and cash equivalents	\$ 6,234	\$ 12,663
Cash and investments segregated and on deposit for regulatory purposes (including resale agreements of \$18,214 at June 30, 2013 and \$19,325 at December 31, 2012)	27,011	28,469
Receivables from brokers, dealers, and clearing organizations	395	333
Receivables from brokerage clients — net	12,825	13,458
Other securities owned — at fair value	488	636
Securities available for sale	48,414	46,123
Securities held to maturity (fair value — \$25,288 at June 30, 2013 and \$18,732 at December 31, 2012)	25,818	18,194
Loans to banking clients — net	11,732	10,726
Equipment, office facilities, and property — net	711	675
Goodwill	1,231	1,228
Intangible assets — net	290	319
Other assets	758	813
Total assets	\$ 135,907	\$ 133,637
Liabilities and Stockholders' Equity		
Deposits from banking clients	\$ 84,345	\$ 79,377
Payables to brokers, dealers, and clearing organizations	2,150	1,068
Payables to brokerage clients	36,852	40,330
Accrued expenses and other liabilities	1,210	1,641
Long-term debt	1,630	1,632
Total liabilities	126,187	124,048
Stockholders' equity:		
Preferred stock — \$.01 par value per share; aggregated liquidation preference of \$885 at both June 30, 2013 and December 31, 2012	867	865
Common stock — 3 billion shares authorized; \$.01 par value per share; 1,487,543,446 shares issued	15	15

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Additional paid-in capital	3,932	3,881
Retained earnings	8,830	8,554
Treasury stock, at cost — 203,545,769 shares at June 30, 2013 and 210,014,305 shares at December 31, 2012	(3,927)	(4,024)
Accumulated other comprehensive income	3	298
Total stockholders' equity	9,720	9,589
Total liabilities and stockholders' equity	\$ 135,907	\$ 133,637

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statement of Cash Flows

(In millions)

(Unaudited)

	Six Months Ended June 30,	
	2013	2012
Cash Flows from Operating Activities		
Net income	\$ 462	\$ 470
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Provision for loan losses	5	4
Net impairment losses on securities	7	25
Stock-based compensation	59	54
Depreciation and amortization	102	96
Premium amortization, net, on securities available for sale and securities held to maturity	92	98
Other	20	1
Originations of loans held for sale	-	(435)
Proceeds from sales of loans held for sale	-	505
Net change in:		
Cash and investments segregated and on deposit for regulatory purposes	1,458	3,311
Receivables from brokers, dealers, and clearing organizations	(62)	(86)
Receivables from brokerage clients	631	(885)
Other securities owned	148	168
Other assets	16	49
Payables to brokers, dealers, and clearing organizations	662	212
Payables to brokerage clients	(3,478)	(3,656)
Accrued expenses and other liabilities	42	(163)
Net cash provided by (used for) operating activities	164	(232)
Cash Flows from Investing Activities		
Purchases of securities available for sale	(12,587)	(14,114)
Proceeds from sales of securities available for sale	3,004	1,323
Principal payments on securities available for sale	7,017	6,904
Purchases of securities held to maturity	(9,914)	(3,029)
Principal payments on securities held to maturity	2,413	2,566

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Net increase in loans to banking clients	(976)	(62)
Purchase of equipment, office facilities, and property	(111)	(76)
Other investing activities	2	-
Net cash used for investing activities	(11,152)	(6,488)
Cash Flows from Financing Activities		
Net change in deposits from banking clients	4,968	5,403
Repayment of commercial paper	(300)	-
Repayment of long-term debt	(3)	(3)
Net proceeds from preferred stock offerings	-	864
Dividends paid	(184)	(154)
Proceeds from stock options exercised and other	81	20
Other financing activities	(3)	-
Net cash provided by financing activities	4,559	6,130
Decrease in Cash and Cash Equivalents	(6,429)	(590)
Cash and Cash Equivalents at Beginning of Period	12,663	8,679
Cash and Cash Equivalents at End of Period	\$ 6,234	\$ 8,089
Supplemental Cash Flow Information		
Cash paid during the period for:		
Interest	\$ 51	\$ 74
Income taxes	\$ 277	\$ 221
Non-cash investing activities:		
Securities purchased during the period but settled after period end	\$ 420	\$ 22

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

1. Introduction and Basis of Presentation

The Charles Schwab Corporation (CSC) is a savings and loan holding company engaged, through its subsidiaries, in securities brokerage, banking, money management, and financial advisory services. Charles Schwab & Co., Inc. (Schwab) is a securities broker-dealer with over 300 domestic branch offices in 45 states, as well as a branch in each of the Commonwealth of Puerto Rico and London, U.K. In addition, Schwab serves clients in Hong Kong through one of CSC's subsidiaries. Other subsidiaries include Charles Schwab Bank (Schwab Bank), a federal savings bank, and Charles Schwab Investment Management, Inc. (CSIM), the investment advisor for Schwab's proprietary mutual funds, which are referred to as the Schwab Funds[®], and for Schwab's exchange-traded funds, which are referred to as the Schwab ETFs[™].

The accompanying unaudited condensed consolidated financial statements include CSC and its majority-owned subsidiaries (collectively referred to as the Company). Intercompany balances and transactions have been eliminated. These condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States (U.S.), which require management to make certain estimates and assumptions that affect the reported amounts in the accompanying financial statements. Certain estimates relate to other-than-temporary impairment of securities available for sale and securities held to maturity, valuation of goodwill, allowance for loan losses, and legal and regulatory reserves. Actual results may differ from those estimates. These condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair presentation of the results for the periods presented. These adjustments are of a normal recurring nature. Certain prior period amounts have been reclassified to conform to the 2013 presentation. The Company's results for any interim period are not necessarily indicative of results for a full year or any other interim period. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, as updated by the Company's Current Report on Form 8-K filed on June 24, 2013, relating to the realignment of the Company's reportable segments.

The Company's significant accounting policies are included in note "2 – Summary of Significant Accounting Policies" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, as updated by its Current Report on Form 8-K filed on June 24, 2013. There have been no significant changes to these accounting policies during the first half of 2013.

2. Securities Available for Sale and Securities Held to Maturity

The amortized cost, gross unrealized gains and losses, and fair value of securities available for sale and securities held to maturity are as follows:

June 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
U.S. agency mortgage-backed securities	\$ 18,422	\$ 202	\$ 16	\$ 18,608
Asset-backed securities	11,895	21	77	11,839
Corporate debt securities	8,306	39	26	8,319
Certificates of deposit	4,915	7	1	4,921
U.S. agency notes	3,740	-	105	3,635
Non-agency residential mortgage-backed securities	700	5	54	651
Commercial paper	160	-	-	160
Other securities	272	9	-	281
Total securities available for sale	\$ 48,410	\$ 283	\$ 279	\$ 48,414
Securities held to maturity:				
U.S. agency mortgage-backed securities	\$ 24,887	\$ 184	\$ 643	\$ 24,428
Other securities	931	-	71	860
Total securities held to maturity	\$ 25,818	\$ 184	\$ 714	\$ 25,288

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
U.S. agency mortgage-backed securities	\$ 20,080	\$ 396	\$ -	\$ 20,476
Asset-backed securities	8,104	62	2	8,164
Corporate debt securities	6,197	61	2	6,256
Certificates of deposit	6,150	12	1	6,161
U.S. agency notes	3,465	2	3	3,464
Non-agency residential mortgage-backed securities	796	2	65	733
Commercial paper	574	-	-	574
Other securities	278	17	-	295
Total securities available for sale	\$ 45,644	\$ 552	\$ 73	\$ 46,123
Securities held to maturity:				
U.S. agency mortgage-backed securities	\$ 17,750	\$ 558	\$ 19	\$ 18,289
Other securities	444	-	1	443
Total securities held to maturity	\$ 18,194	\$ 558	\$ 20	\$ 18,732

A summary of securities with unrealized losses, aggregated by category and period of continuous unrealized loss, is as follows:

June 30, 2013	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. agency mortgage-backed securities	\$ 2,416	\$ 16	\$ -	\$ -	\$ 2,416	\$ 16
Asset-backed securities	8,704	70	481	7	9,185	77
Corporate debt securities	2,555	25	250	1	2,805	26
Certificates of deposit	774	1	-	-	774	1
U.S. agency notes	3,635	105	-	-	3,635	105
Non-agency residential mortgage-backed securities	181	5	401	49	582	54
Total	\$ 18,265	\$ 222	\$ 1,132	\$ 57	\$ 19,397	\$ 279
Securities held to maturity:						

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U.S. agency mortgage-backed securities	\$ 16,315	\$ 643	\$ -	\$ -	\$ 16,315	\$ 643
Other securities	760	71	-	-	760	71
Total	\$ 17,075	\$ 714	\$ -	\$ -	\$ 17,075	\$ 714
Total securities with unrealized losses ⁽¹⁾	\$ 35,340	\$ 936	\$ 1,132	\$ 57	\$ 36,472	\$ 993

(1) The number of investment positions with unrealized losses totaled 238 for securities available for sale and 135 for securities held to maturity.

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THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012						
Securities available for sale:						
Asset-backed securities	\$ -	\$ -	\$ 801	\$ 2	\$ 801	\$ 2
Corporate debt securities	878	2	-	-	878	2
Certificates of deposit	599	1	-	-	599	1
U.S. agency notes	2,102	3	-	-	2,102	3
Non-agency residential mortgage-backed securities	46	1	549	64	595	65
Total	\$ 3,625	\$ 7	\$ 1,350	\$ 66	\$ 4,975	\$ 73
Securities held to maturity:						
U.S. agency mortgage-backed securities	\$ 2,680	\$ 19	\$ -	\$ -	\$ 2,680	\$ 19
Other securities	240	1	-	-	240	1
Total	\$ 2,920	\$ 20	\$ -	\$ -	\$ 2,920	\$ 20
Total securities with unrealized losses ⁽¹⁾	\$ 6,545	\$ 27	\$ 1,350	\$ 66	\$ 7,895	\$ 93

⁽¹⁾ The number of investment positions with unrealized losses totaled 139 for securities available for sale and 24 for securities held to maturity.

Non-agency residential mortgage-backed securities include securities collateralized by loans that are considered to be "Prime" (defined as loans to borrowers with a Fair Isaac Corporation (FICO) credit score of 620 or higher at origination), and "Alt-A" (defined as Prime loans with reduced documentation at origination). Based on the Company's cash flow projections, management determined that it does not expect to recover all of the amortized cost of certain of its Alt-A and Prime residential mortgage-backed securities and therefore determined that these securities were other-than-temporarily impaired (OTTI). Because the Company does not intend to sell these securities and it is not "more likely than not" that the Company will be required to sell these securities, the Company recognized an impairment charge equal to the securities' expected credit losses of \$3 million and \$7 million during the second quarter and first half of 2013, respectively. The expected credit losses were measured as the difference between the present value of expected cash flows and the amortized cost of the securities. Further deterioration in the performance of the underlying loans in the Company's non-agency residential mortgage-backed securities portfolio could result in the recognition of additional impairment losses.

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The following table is a rollforward of the amount of credit losses recognized in earnings for OTTI securities held by the Company during the period for which a portion of the impairment was recognized in or reclassified from other comprehensive (loss) income:

	Three Months Ended		Six Months	
	June 30,		Ended	
	2013	2012	2013	2012
Balance at beginning of period	\$ 163	\$ 145	\$ 159	\$ 127
Credit losses recognized into current period earnings on debt securities for which an other-than-temporary impairment was not previously recognized	1	4	1	5
Credit losses recognized into current period earnings on debt securities for which an other-than-temporary impairment was previously recognized	2	3	6	20
Balance at end of period	\$ 166	\$ 152	\$ 166	\$ 152

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THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

The maturities of securities available for sale and securities held to maturity at June 30, 2013, are as follows:

	Within 1 year	After 1 year through 5 years	After 5 years through 10 years	After 10 years	Total
Securities available for sale:					
U.S. agency mortgage-backed securities ⁽¹⁾	\$ -	\$ 122	\$ 3,974	\$ 14,512	\$ 18,608
Asset-backed securities	-	856	1,060	9,923	11,839
Corporate debt securities	2,234	6,085	-	-	8,319
Certificates of deposit	3,028	1,893	-	-	4,921
U.S. agency notes	-	1,781	1,854	-	3,635
Non-agency residential mortgage-backed securities ⁽¹⁾	-	2	3	646	651
Commercial paper	160	-	-	-	160
Other securities	-	-	-	281	281
Total fair value	\$ 5,422	\$ 10,739	\$ 6,891	\$ 25,362	\$ 48,414
Total amortized cost	\$ 5,412	\$ 10,773	\$ 6,888	\$ 25,337	\$ 48,410
Securities held to maturity:					
U.S. agency mortgage-backed securities ⁽¹⁾	\$ -	\$ -	\$ 11,458	\$ 12,970	\$ 24,428
Other securities	-	100	334	426	860
Total fair value	\$ -	\$ 100	\$ 11,792	\$ 13,396	\$ 25,288
Total amortized cost	\$ -	\$ 100	\$ 12,219	\$ 13,499	\$ 25,818

⁽¹⁾ Mortgage-backed securities have been allocated to maturity groupings based on final contractual maturities. Actual maturities will differ from final contractual maturities because borrowers on a certain portion of loans underlying these securities have the right to prepay their obligations.

Proceeds and gross realized gains (losses) from sales of securities available for sale are as follows:

Three Months Ended Six Months Ended

	June 30, 2013	2012	June 30, 2013	2012
Proceeds	\$ 3,004	\$ 1,073	\$ 3,004	\$ 1,323
Gross realized gains	\$ 3	\$ 2	\$ 3	\$ 2
Gross realized losses	\$ -	\$ -	\$ -	\$ -

3.Loans to Banking Clients and Related Allowance for Loan Losses

The composition of loans to banking clients by loan segment is as follows:

	June 30, 2013	December 31, 2012
Residential real estate mortgages	\$ 7,470	\$ 6,507
Home equity lines of credit	3,125	3,287
Personal loans secured by securities	1,166	963
Other	28	25
Total loans to banking clients ⁽¹⁾	11,789	10,782
Allowance for loan losses	(57)	(56)
Total loans to banking clients – net	\$ 11,732	\$ 10,726

⁽¹⁾ All loans are evaluated for impairment by loan segment.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

The Company has commitments to extend credit related to unused home equity lines of credit (HELOCs), personal loans secured by securities, and other lines of credit, which totaled \$5.5 billion and \$5.4 billion at June 30, 2013, and December 31, 2012, respectively.

Changes in the allowance for loan losses were as follows:

Three Months Ended	June 30, 2013			June 30, 2012		
	Residential real estate mortgages	Home equity lines of credit	Total	Residential real estate mortgages	Home equity lines of credit	Total
Balance at beginning of period	\$ 40	\$ 19	\$ 59	\$ 37	\$ 13	\$ 50