SCHWAB CHARLES CORP
Form 10-Q
August 08, 2018

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, 2018

Commission File Number: 1-9700

THE CHARLES SCHWAB CORPORATION
(Exact name of registrant as specified in its charter)

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

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

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 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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.
1,351,062,783 shares of $.01 par value Common Stock Outstanding on July 31, 2018

THE CHARLES SCHWAB CORPORATION

Quarterly Report on Form 10-Q
For the Quarter Ended June 30, 2018

Index

Part I – FINANCIAL INFORMATION

THE CHARLES SCHWAB CORPORATION
Management's Discussion and Analysis of Financial Condition and Results of Operations
(Tabular Amounts in Millions, Except Ratios, or as Noted)

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

INTRODUCTION

The Charles Schwab Corporation (CSC) is a savings and loan holding company engaged, through its subsidiaries (collectively referred to as "Schwab" or the "Company"), in wealth management, securities brokerage, banking, asset management, custody, and financial advisory services.

Significant business subsidiaries of CSC include the following:

- Charles Schwab & Co., Inc. (CS&Co), a securities broker-dealer;
- Charles Schwab Bank (CSB), a federal savings bank; and
- Charles Schwab Investment Management, Inc. (CSIM), the investment advisor for Schwab's proprietary mutual funds (Schwab Funds®) and Schwab's exchange-traded funds (Schwab ETFs™).

Unless otherwise indicated, the terms "Schwab," "the Company," "we," "us," or "our" mean CSC together with its consolidated subsidiaries.

Schwab provides financial services to individuals and institutional clients through two segments – Investor Services and Advisor Services. The Investor Services segment provides retail brokerage and banking services to individual investors, and retirement plan services, as well as other corporate brokerage services, to businesses and their employees. The Advisor Services segment provides custodial, trading, banking, and support services, as well as retirement business services, to independent registered investment advisors (RIAs), independent retirement advisors, and recordkeepers.
Schwab was founded on the belief that all Americans deserve access to a better investing experience. Although much has changed in the intervening years, our purpose remains clear – to champion every client's goals with passion and integrity. Guided by this purpose and the aspiration of creating the most trusted leader in investment services, management has adopted a strategy described as "Through Clients' Eyes."

This strategy emphasizes placing clients' perspectives, needs, and desires at the forefront. Because investing plays a fundamental role in building financial security, we strive to deliver a better investing experience for our clients – individual investors and the people and institutions who serve them – by disrupting longstanding industry practices on their behalf and providing superior service. We also aim to offer a broad range of products and solutions to meet client needs with a focus on transparency, value, and trust. In addition, management works to couple Schwab's scale and resources with ongoing expense discipline to keep costs low and ensure that products and solutions are affordable as well as responsive to client needs. In combination, these are the key elements of our "no trade-offs" approach to serving investors. We believe that following this strategy is the best way to maximize our market valuation and stockholder returns over time.

Management estimates that investable wealth in the United States (consisting of assets in defined contribution, retail wealth management and brokerage, and registered investment advisor channels, along with bank deposits) currently exceeds $45 trillion, which means the Company’s $3.40 trillion in client assets leaves substantial opportunity for growth. Our strategy is based on the principle that developing trusted relationships will translate into more assets from both new and existing clients, ultimately driving more revenue, and along with expense discipline, will generate earnings growth and build long-term stockholder value.

This Management’s Discussion and Analysis should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (2017 Form 10-K).

On our website, www.aboutschwab.com, we post the following filings after they are electronically filed with or furnished to the Securities and Exchange Commission (SEC): annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange

Act of 1934. The SEC maintains a website at www.sec.gov that contains reports, proxy, and other information that we file electronically with the SEC.

THE CHARLES SCHWAB CORPORATION
Management's Discussion and Analysis of Financial Condition and Results of Operations
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FORWARD-LOOKING STATEMENTS

In addition to historical information, this Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are identified by words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "estimate," "appear," "could," "would," and other similar expressions. In addition, any statements that refer to expectations, projections, or other characterizations of future events or circumstances are forward-looking statements.

These forward-looking statements, which reflect management's beliefs, objectives, and expectations as of the date hereof, are estimates based on the best judgment of Schwab's senior management. These statements relate to, among other things:

- Maximizing our market valuation and stockholder returns over time; our belief that developing trusted relationships will translate into more client assets which drives revenue and, along with expense discipline, generates earnings growth and builds stockholder value (see Introduction in Part I, Item 2);
- Ongoing investments to fuel growth (see Overview);
- Capital expenditures in 2018 (see Results of Operations);
- Consolidated balance sheet assets remaining above $250 billion (see Risk Management and Capital Management);
- The expected impact of new accounting standards not yet adopted (see New Accounting Standards in Part I, Item 1, Financial Information – Notes to Condensed Consolidated Financial Statements (Item 1) – Note 2);
- The likelihood of indemnification and guarantee payment obligations (see Commitments and Contingencies in Item 1 – Note 9); and
- The impact of legal proceedings and regulatory matters (see Commitments and Contingencies in Item 1 – Note 9 and Legal Proceedings in Part II, Item 1).

Achievement of the expressed beliefs, objectives, and expectations described in these statements is subject to certain risks and uncertainties that could cause actual results to differ materially from the expressed beliefs, objectives, and expectations. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q or, in the case of documents incorporated by reference, as of the date of those documents.

Important factors that may cause actual results to differ include, but are not limited to:

- General market conditions, including the level of interest rates, equity valuations, and trading activity;
- Our ability to attract and retain clients, develop trusted relationships, and grow client assets;
- Client use of our advice solutions and other products and services;
- The level of client assets, including cash balances;
- Competitive pressure on pricing, including deposit rates;
- Client sensitivity to interest rates;
- Regulatory guidance;
- Timing and amount of transfers of certain balances from sweep money market funds into bank sweep deposits;
- Capital and liquidity needs and management;
- Our ability to manage expenses;
- Our ability to develop and launch new products, services, infrastructure, and capabilities in a timely and successful manner;
- The effect of adverse developments in litigation or regulatory matters and the extent of any related charges; and
- Potential breaches of contractual terms for which we have indemnification and guarantee obligations.

Certain of these factors, as well as general risk factors affecting the Company, are discussed in greater detail in Part I – Item 1A – Risk Factors in the 2017 Form 10-K.

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OVERVIEW

Management focuses on several client activity and financial metrics in evaluating Schwab's financial position and operating performance. Results for the second quarters and first six months of 2018 and 2017 are:

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Percent Change	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017	Percent Change
Client Metrics:						
Net new client assets (in billions) [1]	$43.9	$64.5	(32)%	$25.1	$103.4	(76)%
Core net new client assets (in billions)	$53.4	$46.2	16 %	$119.0	$85.1	40 %
Client assets (in billions, at quarter end)	$3,397.0	$3,040.6	12 %			
Average client assets (in billions)	$3,370.4	$2,979.2	13 %	$3,376.2	$2,925.5	15 %
New brokerage accounts (in thousands)	384	357	8 %	827	719	15 %
Active brokerage accounts (in thousands, at quarter end)	11,202	10,487	7 %			
Assets receiving ongoing advisory services (in billions, at quarter end)	$1,768.7	$1,539.8	15 %			
Client cash as a percentage of client assets (at quarter end)	10.7 %	11.5 %				
Company Financial Metrics:						
Total net revenues	$2,486	$2,130	17 %	$4,884	$4,211	16 %
Total expenses excluding interest	1,355	1,221	11 %	2,751	2,459	12 %
Income before taxes on income	1,131	909	24 %	2,133	1,752	22 %
Taxes on income	265	334	(21)%	484	613	(21)%
Net income	866	575	51 %	1,649	1,139	45 %
Preferred stock dividends and other	53	45	18 %	90	84	7 %
Net income available to common stockholders	$813	$530	53 %	$1,559	$1,055	48 %
Earnings per common share — diluted	$.60	$.39	54 %	$1.14	$.78	46 %
Net revenue growth from prior year	17 %	17 %		16 %	17 %	
Pre-tax profit margin	45.5 %	42.7 %		43.7 %	41.6 %	
Return on average common stockholders' equity	19 %	15 %		19 %	15 %	
Expenses excluding interest as a percentage of average client assets (annualized)	0.16 %	0.16 %		0.16 %	0.17 %	
Consolidated Tier 1 Leverage Ratio (at quarter end)	7.6 %	7.4 %				

[1] Includes outflows of $9.5 billion and $93.9 billion in the second quarter and first six months of 2018, respectively, from certain mutual fund clearing services clients.

Net income grew 51% and 45% for the second quarter and first six months of 2018, respectively, compared to the same periods in 2017, driven primarily by sustained business momentum, higher interest rates, and lower corporate income taxes. Total net revenues rose 17% and 16% in the second quarter and first six months of 2018, respectively, compared to the same periods in 2017, primarily due to higher net interest revenue as a result of higher interest rates and larger client cash sweep balances. Total expenses excluding interest grew 11% and 12% during the second quarter and first six months of 2018, respectively, compared to the same periods in 2017, reflecting higher spending to support the expanding client base and ongoing investments to fuel growth. Altogether, we achieved a 570 basis point gap between revenue and expense growth, which resulted in a 45.5% and 43.7% pre-tax profit margin for the second quarter and first six months of 2018, respectively, compared to the same periods in 2017.

Taxes on income decreased 21% for both the second quarter and first six months of 2018 resulting in effective tax rates of 23.4% and 22.7% for the second quarter and first six months of 2018, respectively. The reduction in taxes on income was due to the Tax Act of 2017, which lowered the federal corporate income tax rate from 35% to 21% effective January 1, 2018.

We delivered net income of $866 million and $1.6 billion for the second quarter and first six months of 2018, respectively, up $291 million and $510 million from a year ago, lifting our return on equity to 19% for the second quarter and first six months of 2018 compared to 15% for the same periods in 2017.

During the second quarter of 2018, clients opened 384,000 new brokerage accounts, helping to bring active brokerage accounts to 11.2 million at June 30, 2018. Excluding planned mutual funding clearing outflows of $9.5 billion, core net new assets gathered during the second quarter of 2018 were $53.4 billion, compared to $46.2 billion for the same period a year ago. Client engagement remained strong during the second quarter of 2018, with daily average revenue trades rising 21% from the same period in 2017.

Effective balance sheet management remains an essential element of our financial discipline. In the second quarter, we issued $1.95 billion of Senior Notes, which we used to redeem $275 million of maturing debt and maintain appropriate liquidity given the growth we're achieving. We also transferred an additional $20 billion in the second quarter of 2018 from sweep money market funds to bank sweep deposits, bringing the total year-to-date transferred amount to $45 billion. As anticipated, we crossed the $250 billion asset threshold for heightened regulatory requirements during the second quarter of 2018, ending with $262 billion in total consolidated assets at June 30, 2018.

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RESULTS OF OPERATIONS

Total Net Revenues

The following tables present a comparison of revenue by category:

		2018		2017	
Three Months Ended June 30,	Percent Change	Amount	% of Total Net Revenues	Amount	% of Total Net Revenues
Net interest revenue					
Interest revenue	41 %	$1,590	64 %	$1,127	52 %
Interest expense	147 %	(183)	(7)%	(74)	(3)%
Net interest revenue	34 %	1,407	57 %	1,053	49 %
Asset management and administration fees					
Mutual funds and ETF service fees	(11)%	458	19 %	513	24 %
Advice solutions	11 %	283	11 %	256	12 %
Other	(4)%	73	3 %	76	4 %
Asset management and administration fees	(4)%	814	33 %	845	40 %
Trading revenue					
Commissions	11 %	157	6 %	142	6 %
Principal transactions	53 %	23	1 %	15	1 %
Trading revenue	15 %	180	7 %	157	7 %
Other	13 %	85	3 %	75	4 %
Total net revenues	17 %	$2,486	100 %	$2,130	