SCHWAB CHARLES CORP
Form 10-Q
November 06, 2008
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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 September 30, 2008

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 of incorporation or organization)	(I.R.S. Employer Identification No.)

120 Kearny Street, San Francisco, CA 94108

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (415) 636-7000

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 x 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 x	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 x

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

1,155,200,311 shares of $.01 par value Common Stock

Outstanding on October 23, 2008

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THE CHARLES SCHWAB CORPORATION

Quarterly Report on Form 10-Q

For the Quarter Ended September 30, 2008

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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 September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net Revenues				
Asset management and administration fees	$ 596	$ 610	$ 1,827	$ 1,730
Interest revenue	497	593	1,485	1,697
Interest expense	(50)	(160)	(192)	(491)
Net interest revenue	447	433	1,293	1,206
Trading revenue	252	218	728	618
Other	(44)	30	18	95
Total net revenues	1,251	1,291	3,866	3,649
Expenses Excluding Interest				
Compensation and benefits	390	447	1,265	1,326
Professional services	86	81	254	236
Occupancy and equipment	75	70	221	208
Advertising and market development	47	44	181	162
Communications	51	50	155	150
Depreciation and amortization	38	39	113	117
Other	65	48	156	123
Total expenses excluding interest	752	779	2,345	2,322
Income from continuing operations before taxes on income	499	512	1,521	1,327
Taxes on income	(195)	(189)	(599)	(512)
Income from continuing operations	304	323	922	815
(Loss) income from discontinued operations, net of tax		1,211	(18)	1,284
Net Income	$ 304	$ 1,534	$ 904	$ 2,099
Weighted-Average Common Shares Outstanding Diluted	1,158	1,201	1,157	1,242
Earnings Per Share - Basic				
Income from continuing operations	$ .26	$ .27	$ .80	$ .66
(Loss) income from discontinued operations, net of tax	$	$ 1.02	$ (.01)	$ 1.05

Net income	$	.26	$	1.29	$	.79	$	1.71
Earnings Per Share - Diluted								
Income from continuing operations	$	.26	$	.27	$	.80	$	.66
(Loss) income from discontinued operations, net of tax	$		$	1.01	$	(.02)	$	1.03
Net income	$	.26	$	1.28	$	.78	$	1.69
Dividends Declared Per Common Share	$	.06	$	1.05	$	.16	$	1.15

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Balance Sheets

(In millions, except share and per share amounts)

(Unaudited)

	September 30, 2008	December 31, 2007
Assets		
Cash and cash equivalents	$ 5,323	$ 6,764
Cash and investments segregated and on deposit for regulatory purposes	13,754	8,803
Securities owned at fair value	14,230	8,201
Receivables from brokers, dealers, and clearing organizations	1,045	725
Receivables from brokerage clients net	10,604	12,314
Loans to banking clients net	5,527	3,443
Loans held for sale	49	44
Equipment, office facilities, and property net	633	617
Goodwill	528	525
Deferred tax assets net	462	254
Other assets	605	596
Total	$ 52,760	$ 42,286
Liabilities and Stockholders Equity		
Deposits from banking clients	$ 21,959	$ 13,822
Payables to brokers, dealers, and clearing organizations	2,446	1,922
Payables to brokerage clients	21,514	20,290
Accrued expenses and other liabilities	1,897	1,621
Long-term debt	881	899
Total liabilities	48,697	38,554
Stockholders equity:		
Preferred stock 9,940,000 shares authorized; $.01 par value per share; none issued		
Common stock 3 billion shares authorized; $.01 par value per share; 1,392,091,544 shares issued	14	14
Additional paid-in capital	2,213	2,107
Retained earnings	6,496	5,776
Treasury stock 237,352,820 and 231,274,906 shares in 2008 and 2007, respectively, at cost	(4,375)	(4,148)
Accumulated other comprehensive loss	(285)	(17)
Total stockholders equity	4,063	3,732
Total	$ 52,760	$ 42,286

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Cash Flows

(In millions)

(Unaudited)

	Nine Months Ended September 30, 2008	2007
Cash Flows from Operating Activities		
Net income	$ 904	$ 2,099
Adjustments to reconcile net income to net cash (used for) provided by operating activities:		
Loss (income) from discontinued operations, net of tax	18	(1,284)
Depreciation and amortization expense	113	117
Stock-based compensation expense	49	40
Excess tax benefits from stock-based compensation	(47)	(85)
Other	64	192
Originations of loans held for sale	(1,316)	(628)
Proceeds from sales of loans held for sale	1,305	615
Net change in:		
Cash and investments segregated and on deposit for regulatory purposes	(4,951)	1,461
Securities owned (excluding securities available for sale)	(319)	51
Receivables from brokers, dealers, and clearing organizations	(310)	(167)
Receivables from brokerage clients	1,701	(239)
Other assets	7	(37)
Payables to brokers, dealers, and clearing organizations	524	438
Payables to brokerage clients	1,224	(1,692)
Accrued expenses and other liabilities	322	(102)
Net cash provided by discontinued operations		389
Net cash (used for) provided by operating activities	(712)	1,168
Cash Flows from Investing Activities		
Purchases of securities available for sale	(7,566)	(3,100)
Principal payments on securities available for sale	1,335	1,471
Net increase in loans to banking clients	(2,111)	(748)
Purchase of equipment, office facilities, and property	(128)	(116)
Proceeds from sale of U.S. Trust, net of transaction costs		3,237
Cash payments for business combinations, net of cash acquired	(5)	(117)
Net cash provided by discontinued operations		67
Net cash (used for) provided by investing activities	(8,475)	694
Cash Flows from Financing Activities		
Net change in deposits from banking clients	8,137	1,450
Issuance of long-term debt		249
Repayment of long-term debt	(19)	(10)
Excess tax benefits from stock-based compensation	47	85
Dividends paid	(185)	(1,442)
Purchase of treasury stock	(350)	(2,740)
Proceeds from stock options exercised and other	116	345
Net cash provided by discontinued operations		563

Net cash provided by (used for) financing activities	7,746	(1,500)
(Decrease) increase in Cash and Cash Equivalents	(1,441)	362
Cash and Cash Equivalents at Beginning of Period	6,764	4,507
Cash and Cash Equivalents at End of Period	$ 5,323	$ 4,869
Supplemental Cash Flow Information		
Cash paid during the period for:		
Interest	$ 184	$ 491
Income taxes (amounts include discontinued operations)	$ 626	$ 421

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

1. Basis of Presentation

The Charles Schwab Corporation (CSC) is a savings and loan holding company engaged, through its subsidiaries, in securities brokerage, banking, and related financial services. Charles Schwab & Co., Inc. (Schwab) is a securities broker-dealer with 309 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®. In January 2008, the Charles Schwab Trust Company, formerly a subsidiary of CSC, which served as a trustee for employee benefit plans, was merged into Schwab Bank.

The accompanying unaudited condensed consolidated financial statements include CSC and its majority-owned subsidiaries (collectively referred to as the Company). These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and, in the opinion of management, reflect all adjustments necessary to present fairly the financial position, results of operations, and cash flows for the periods presented in conformity with generally accepted accounting principles in the U.S. (GAAP). All adjustments were of a normal recurring nature. All material intercompany balances and transactions have been eliminated. These 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, 2007. The Company s results for any interim period are not necessarily indicative of results for a full year or any other interim period.

On July 1, 2007, the Company completed the sale of all of the outstanding stock of U.S. Trust Corporation (USTC, and with its subsidiaries collectively referred to as U.S. Trust). U.S. Trust was a subsidiary that provided wealth management services. U.S. Trust is presented as a discontinued operation for all periods prior to the completion of the sale. All other information contained in this Form 10-Q is presented on a continuing operations basis unless otherwise noted.

2. New Accounting Standards

Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS No. 157) was effective beginning January 1, 2008. This statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. The adoption of SFAS No. 157 did not have a material impact on the Company s financial position, results of operations, earnings per share (EPS), or cash flows, but expanded the disclosures in the Company s condensed consolidated financial statements. See note 3 Fair Value of Financial Instruments, for disclosures pursuant to SFAS No. 157.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities was effective beginning January 1, 2008. This statement permits entities to elect to measure eligible financial instruments, commitments, and certain other arrangements at fair value at specified election dates with changes in fair value recognized in earnings at each subsequent reporting period. The Company made no such election on January 1, 2008 or during the first nine months of 2008. The adoption of SFAS No. 159 did not have any impact on the Company s financial position, results of operations, EPS, or cash flows.

SFAS No. 141R Business Combinations, was issued in December 2007. This statement generally requires an acquirer to recognize the assets acquired, the liabilities assumed, contingent purchase consideration, and any noncontrolling interest in the acquiree, at fair value on the date of acquisition. SFAS No. 141R also requires an acquirer to expense most transaction and restructuring costs as incurred, and not include such items in the cost of the acquired entity. The adoption of SFAS No. 141R will not have an impact on the Company s financial

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(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

position, results of operations, EPS, or cash flows, as SFAS No. 141R applies prospectively for all business acquisitions with an acquisition date on or after January 1, 2009. Early adoption is prohibited.

SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements, was issued in December 2007 and is effective beginning January 1, 2009. This statement amends Accounting Research Bulletin No. 51 Consolidated Financial Statements by establishing financial statement presentation and disclosure requirements for reporting noncontrolling ownership interests. SFAS No. 160 also establishes consistent accounting methods for changes in ownership interest and for the valuation of retained noncontrolling investments upon deconsolidation. The adoption of SFAS No. 160 is not expected to have a material impact on the Company s financial position, results of operations, EPS, or cash flows.

SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities, was issued in March 2008 and is effective beginning January 1, 2009. This statement amends the disclosure requirements of SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities by requiring qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative agreements. SFAS No. 161 does not require any new derivative or hedging measurements. The adoption of SFAS No. 161 will not impact the Company s financial position, results of operations, EPS, or cash flows, but will expand the disclosures in the Company s condensed consolidated financial statements.

FASB Staff Position (FSP) on EITF Issue 03-6-1 (FSP EITF 03-6-1) Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities, was issued in June 2008 and is effective beginning January 1, 2009. This statement requires the inclusion of unvested share-based payment awards with non-forfeitable rights to dividends or dividend equivalents as participating securities in the computation of earnings per share under the two-class method described in SFAS No. 128 Earnings per Share. The requirements of this statement require retrospective adjustment to all prior-period earnings per share data presented. Early adoption is not permitted. The Company is currently evaluating the impact of the adoption of FSP EITF 03-6-1 on its disclosures of EPS. The adoption of FSP EITF 03-6-1 will not impact the Company s financial position, results of operations, or cash flows.

3. Fair Value of Financial Instruments

SFAS No. 157 defines fair value as the price that would be received to sell an asset or the price paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are based on market pricing data obtained from sources independent of the Company. Unobservable inputs reflect management s judgment about the assumptions market participants would use in pricing the asset or liability. The fair value hierarchy includes three levels based on the objectivity of the inputs as follows:

Level 1 inputs are quoted prices in active markets as of the measurement date for identical assets or liabilities that the Company has the ability to access. This category includes active exchange-traded money market funds, mutual funds, and equity securities.

Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. This category includes mortgage-backed securities, asset-backed securities, corporate debt securities, long-term certificates of deposit, U.S. agency and municipal debt securities, U.S. treasury securities, and derivative contracts.

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(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The Company does not have any financial assets or liabilities utilizing Level 3 inputs as of September 30, 2008.

The following table presents the Company s fair value hierarchy as of September 30, 2008 for assets and liabilities measured at fair value:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at Fair Value
Assets				
Investments segregated and on deposit for regulatory purposes	$	$ 5,291	$	$ 5,291
Securities owned:				
U.S. agency mortgage-backed securities		7,697		7,697
Non-agency mortgage-backed securities		2,793		2,793
Certificates of deposit		1,119		1,119
Corporate debt securities		897		897
Asset-backed securities		716		716
U.S. agency notes		15		15
Total available-for-sale securities		13,237		13,237
Schwab Funds® money market funds	777			777
Fixed income, equity, and other securities	87	114		201
Equity and bond mutual funds	15			15
Total securities owned	879	13,351		14,230
Other assets:				
Derivative contracts		8		8
Total other assets		8		8
Total assets at fair value	$ 879	$ 18,650	$	$ 19,529
Liabilities				
Accrued expenses and other liabilities:				
Securities sold, not yet purchased	$ 465	$	$	$ 465
Derivative contracts		2		2
Total accrued expenses and other liabilities	465	2		467
Total liabilities at fair value	$ 465	$ 2	$	$ 467

4. Securities Owned

A summary of securities owned is as follows:

	September 30, 2008	December 31, 2007
Securities available for sale	$ 13,237	$ 7,526
Schwab Funds® money market funds	777	413
Fixed income, equity, and other securities	201	175
Equity and bond mutual funds	15	87
Total securities owned [1]	$ 14,230	$ 8,201

(1) Amounts include securities pledged of $6 million at both September 30, 2008 and December 31, 2007.

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The amortized cost, fair value, and gross unrealized gains and losses on securities available for sale at September 30, 2008 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency mortgage-backed securities	$ 7,742	$ 32	$ 77	$ 7,697
Non-agency mortgage-backed securities	3,178		385	2,793
Certificates of deposit	1,120		1	1,119
Corporate debt securities	928	1	32	897
Asset-backed securities	724		8	716
U.S. agency notes	15			15
Total	$ 13,707	$ 33	$ 503	$ 13,237

A summary of investments with unrealized losses, aggregated by category and period of continuous unrealized loss at September 30, 2008 is as follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. agency mortgage-backed securities	$ 4,184	$ 66	$ 381	$ 11	$ 4,565	$ 77
Non-agency mortgage-backed securities	2,089	186	697	199	2,786	385
Certificates of deposit	944	1	75		1,019	1
Corporate debt securities	467	5	354	27	821	32
Asset-backed securities	716	8			716	8
Total temporarily impaired securities [1]	$ 8,400	$ 266	$ 1,507	$ 237	$ 9,907	$ 503

[1] The number of investment positions with unrealized losses totaled 372.

Management evaluates securities available for sale for other-than-temporary impairment on a quarterly basis. The evaluation of whether other-than-temporary impairment exists is a matter of judgment. The evaluation includes the assessment of several factors including: 1) whether the unrealized loss is solely due to changes in interest rates, 2) the length of time and the extent to which the fair value has been less than amortized cost, 3) the financial condition of the issuer, if applicable, 4) the credit ratings of the issuer or security, 5) the collateral underlying the security, including the credit default experience of the underlying collateral for non-agency mortgage-backed securities, and 6) the Company s intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery. If management determines other-than-temporary impairment exists, the cost basis of the security is adjusted to the then-current fair value, with a corresponding loss recognized in current earnings. If future evaluations conclude that an impairment now considered to be temporary is other-than-temporary, the Company would recognize a realized loss through earnings at that time.

Securities available for sale with unrealized losses of $503 million as of September 30, 2008 included U.S. agency and non-agency mortgage-backed securities, corporate debt securities, asset-backed securities, and long-term certificates of deposit. U.S. agency mortgage-backed securities do not have explicit credit ratings, however management considers these to be of the highest credit quality given the guarantee of principal and interest by the U.S. agencies. At September 30, 2008, approximately 99% of the non-agency mortgage-backed securities, based on fair value, were rated AAA by at least one of the Nationally Recognized Statistical Rating Agencies. At September 30, 2008, the corporate debt securities were rated investment grade (defined as a rating equivalent to a Moody s rating of Baa or higher, or a Standard and Poor s rating of BBB- or higher), with the exception of debt securities issued by Lehman Brothers Holdings, Inc. (Lehman). Based on management s

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(Unaudited)

evaluation of the factors described in the preceding paragraph, management determined the unrealized losses were temporary as of September 30, 2008, except as described below.

The Company recorded losses of $73 million related to two corporate debt securities in the third quarter and first nine months of 2008. On September 15, 2008, Lehman filed a Chapter 11 bankruptcy petition and therefore the Company recognized an other-than-temporary impairment charge of $44 million on debt securities issued by Lehman. The Company sold these securities in October 2008. On September 25, 2008, the Federal Deposit Insurance Corporation seized Washington Mutual Bank and as a result the Company sold debt securities issued by Washington Mutual Bank prior to September 30, 2008, and recorded a loss of $29 million. The sale of these securities reflected significant unanticipated changes in the financial condition of their issuers during the third quarter of 2008 and does not impact the Company s ability and intent to hold the remaining securities. There were no gross realized gains on sales of securities available for sale during the third quarter and first nine months of 2008. Realized gains and losses from sales of securities available for sale and other-than-temporary impairment charges are included in other revenue on the Company s condensed consolidated statements of income.

The maturities of securities available for sale at September 30, 2008 are as follows:

	Within 1 Year	1-5 Years	5-10 Years	After 10 Years	Total
U.S. agency mortgage-backed securities [1]	$	$	$ 161	$ 7,536	$ 7,697
Non-agency mortgage-backed securities [1]			20	2,773	2,793
Certificates of deposit	969	150			1,119
Corporate debt securities	374	523			897
Asset-backed securities		554	162		716
U.S. agency notes	15				15
Estimated fair value	$ 1,358	$ 1,227	$ 343	$ 10,309	$ 13,237
Total amortized cost	$ 1,380	$ 1,243	$ 344	$ 10,740	$ 13,707
Net unrealized losses	$ 22	$ 16	$ 1	$ 431	$ 470

(1) Mortgage-backed securities have been allocated over maturity groupings based on contractual maturities. Expected maturities may differ from contractual maturities because borrowers have the right to prepay obligations with or without prepayment penalties.

Securities sold, but not yet purchased were $465 million at September 30, 2008 and consisted primarily of overnight positions related to clients money market fund trading activity. Securities sold, but not yet purchased were $6 million at December 31, 2007 and consisted primarily of mutual fund shares that are distributed to clients to satisfy their dividend reinvestment requests. These securities are recorded at market value in accrued expenses and other liabilities.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

5. Loans to Banking Clients and Related Allowance for Credit Losses

An analysis of the composition of the loan portfolio is as follows:

	September 30, 2008	December 31, 2007
Residential real estate mortgages	$ 3,147	$ 2,101
Home equity lines of credit	2,175	1,234
Secured personal loans	202	102
Other	19	13
Total loans to banking clients	5,543	3,450
Less: allowance for credit losses	(16)	(7)
Loans to banking clients net	$ 5,527	$ 3,443

Included in the loan portfolio are nonaccrual loans totaling $8 million and $4 million at September 30, 2008 and December 31, 2007, respectively. Nonperforming assets, which include nonaccrual loans and other real estate owned, totaled $10 million and $4 million at September 30, 2008 and December 31, 2007, respectively. The Company did not have any impaired loans during the first nine months of 2008 and 2007. At September 30, 2008 and December 31, 2007, there were no loans accruing interest that were contractually 90 days or more past due. For the first nine months of 2008 and 2007, the amount of interest revenue which would have been earned on non-accrual loans versus interest revenue recognized on these loans was not material to the Company s results of operations.

Changes in the allowance for credit losses are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Balance at beginning of period	$ 12	$ 5	$ 7	$ 4
Charge-offs	(1)		(2)	
Recoveries				
Provision for credit loss	5	1	11	2
Balance at end of period	$ 16	$ 6	$ 16	$ 6

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

6. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income is presented in the following table:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net income	$ 304	$ 1,534	$ 904	$ 2,099
Other comprehensive (loss) income:				
Change in net unrealized loss on securities available for sale:				
Unrealized (loss) gain	(306)	15	(513)	(21)
Reclassification of realized loss included in net income [1,2]	73	59	73	59
Income tax effect	91	(31)	173	(16)
Net	(142)	43	(267)	22
Minimum pension liability adjustment, net of tax [2]		5		5
Net change in net unrealized loss on cash flow hedging instruments		(4)		(3)
Foreign currency translation adjustment	(1)		(1)	
Total other comprehensive (loss) income	(143)	44	(268)	24
Comprehensive income	$ 161	$ 1,578	$ 636	$ 2,123

(1) In the third quarter and first nine months of 2008, the Company reclassified realized losses of $73 million related to the sale and other-than-temporary impairment of two corporate debt securities.

(2) Reclassification adjustment in the third quarter and first nine months 2007 is related to the sale of U.S. Trust.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

7. Earnings Per Share

Basic EPS is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed by dividing net income by the weighted-average number of common shares plus the effect of dilutive potential common shares outstanding for the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and unvested restricted stock awards. EPS under the basic and diluted computations are presented in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net income	$ 304	$ 1,534	$ 904	$ 2,099
Weighted-average common shares outstanding basic	1,148	1,188	1,147	1,227
Common stock equivalent shares related to stock incentive plans	10	13	10	15
Weighted-average common shares outstanding diluted (1)	1,158	1,201	1,157	1,242
Basic EPS:				
Income from continuing operations	$ .26	$ .27	$ .80	$ .66
(Loss) income from discontinued operations, net of tax	$	$ 1.02	$ (.01)	$ 1.05
Net income	$ .26	$ 1.29	$ .79	$ 1.71
Diluted EPS:				
Income from continuing operations	$ .26	$ .27	$ .80	$ .66
(Loss) income from discontinued operations, net of tax	$	$ 1.01	$ (.02)	$ 1.03
Net income	$ .26	$ 1.28	$ .78	$ 1.69

(1) Total antidilutive stock options and restricted stock awards excluded from the calculation of diluted earnings per share were 19 million shares for both the third quarters of 2008 and 2007, and 22 million and 23 million shares for the first nine months of 2008 and 2007, respectively.

8. Regulatory Requirements

CSC is a savings and loan holding company and Schwab Bank is a federal savings bank. CSC and Schwab Bank are both subject to supervision and regulation by the Office of Thrift Supervision (OTS). CSC s depository institution subsidiary is Schwab Bank.

As a savings and loan holding company, CSC is not subject to specific statutory capital requirements. CSC is required to maintain capital that is sufficient to support the holding company and its subsidiaries business activities, and the risks inherent in those activities. Schwab Bank is required to maintain a capital level that at least equals minimum capital levels specified in federal banking laws and regulations. Failure to meet the minimum levels will result in certain mandatory and possibly additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on Schwab Bank. At September 30, 2008, CSC and Schwab Bank met the capital level requirements.

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(Unaudited)

The regulatory capital and ratios for Schwab Bank at September 30, 2008 are as follows:

	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Capital	$ 1,530	16.0%	$ 382	4.0%	$ 572	6.0%
Total Capital	$ 1,547	16.2%	$ 763	8.0%	$ 954	10.0%
Leverage	$ 1,530	6.4%	$ 960	4.0%	$ 1,200	5.0%
Tangible Equity	$ 1,530	6.4%	$ 480	2.0%	N/A	

N/A Not applicable.

Based on its regulatory capital ratios at September 30, 2008, Schwab Bank is considered well capitalized (the highest category) pursuant to banking regulatory guidelines. There are no conditions or events that management believes have changed Schwab Bank s well-capitalized status.

Schwab is subject to Rule 15c3-1 under the Securities Exchange Act of 1934 (the Uniform Net Capital Rule). Schwab computes net capital under the alternative method permitted by the Uniform Net Capital Rule. This method requires the maintenance of minimum net capital, as defined, of the greater of 2% of aggregate debit balances arising from client transactions or a minimum dollar requirement, which is based on the type of business conducted by the broker-dealer. At September 30, 2008, 2% of aggregate debits was $229 million, which exceeded the minimum dollar requirement for Schwab of $250,000. At September 30, 2008, Schwab s net capital was $1.1 billion (10% of aggregate debit balances), which was $882 million in excess of its minimum required net capital and $539 million in excess of 5% of aggregate debit balances. Under the alternative method, a broker-dealer may not repay subordinated borrowings, pay cash dividends, or make any unsecured advances or loans to its parent or employees if such payment would result in net capital of less than 5% of aggregate debit balances or less than 120% of its minimum dollar requirement.

9. Commitments and Contingent Liabilities

The Company has clients that sell (i.e., write) listed option contracts that are cleared by various clearing houses. The clearing houses establish margin requirements on these transactions. The Company satisfies the margin requirements by arranging standby letters of credit (LOCs), in favor of the clearing houses, which are issued by multiple banks. At September 30, 2008, the aggregate face amount of these outstanding LOCs totaled $750 million. Schwab pays a fee to maintain these arrangements. In connection with its securities lending activities, Schwab is required to provide collateral to certain brokerage clients. Schwab satisfies the collateral requirements by arranging LOCs, in favor of these brokerage clients, which are issued by multiple banks. Schwab also pays a fee to maintain these arrangements. At September 30, 2008, the aggregate face amount of these outstanding LOCs totaled $307 million. No funds were drawn under these LOCs at September 30, 2008.

The Company also provides guarantees to securities clearing houses and exchanges under their standard membership agreement, which requires members to guarantee the performance of other members. Under the agreement, if another member becomes unable to satisfy its obligations to the clearing houses and exchanges, other members would be required to meet shortfalls. The Company s liability under these arrangements is not quantifiable and may exceed the cash and securities it has posted as collateral. However, the potential requirement for the Company to make payments under these arrangements is remote. Accordingly, no liability has been recognized for these transactions.

Legal contingencies: The Company is subject to claims and lawsuits in the ordinary course of business, including arbitrations, class actions and other litigation, some of which include claims for substantial or unspecified damages. The Company is also the subject of inquiries, investigations, and proceedings by regulatory and other governmental agencies. In addition, the Company is responding to certain litigation claims brought against former

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subsidiaries pursuant to indemnities it has provided to purchasers of those entities. Certain of these matters are described below.

The Company believes it has strong defenses in all significant matters currently pending and is contesting liability and the damages claimed. Nevertheless, some of these matters may result in adverse judgments or awards, including penalties, injunctions, or other relief, and the Company may also determine to settle a matter because of the uncertainty and risks of litigation. Predicting the outcome of a matter is inherently difficult, particularly where claimants seek substantial or unspecified damages, or when investigations or legal proceedings are at an early stage. In many cases, including those matters described below, it is not possible to determine whether a loss will be incurred or to estimate the range of that loss until the matter is close to resolution. However, based on current information and consultation with counsel, management believes that the resolution of matters currently pending will not have a material adverse impact on the financial condition or cash flows of the Company, but could be material to the Company s operating results for a particular future period, depending on results for that period.

YieldPlus Fund Litigation: The Company is the subject of nine purported class action lawsuits filed between March and May 2008 on behalf of investors in the Schwab YieldPlus Fund® alleging violations of state law and federal securities law in connection with the fund s investment policy, disclosures and fund marketing. Defendants named in one or more of the lawsuits include the Company, Schwab, CSIM, the fund itself, Schwab Investments (registrant and issuer of the fund s shares), Charles R. Schwab, Randall W. Merk (current president of the fund), and current and former trustees and officers of the fund and/or Schwab. Claimants seek unspecified compensatory and rescission damages, unspecified equitable and injunctive relief, and costs and attorneys fees. On July 3, 2008, the U.S. District Court for the Northern District of California consolidated all nine lawsuits into a single action for purposes of pre-trial proceedings and appointed a group of fund investors as lead plaintiff. On October 2, 2008, plaintiffs filed a consolidated amended complaint which seeks certification of two separate classes of plaintiffs for the federal and state law claims.

Total Bond Market Fund Litigation: On August 28, 2008, a class action lawsuit was filed in the U.S. District Court for the Northern District of California on behalf of investors in the Schwab Total Bond Market Fund. The lawsuit, which alleges violations of state law and federal securities law in connection with the fund s investment policy, names the fund, Schwab Investments (registrant and issuer of the fund s shares), Schwab, and CSIM as defendants. Claimants seek unspecified compensatory and rescission damages, unspecified equitable and injunctive relief, and costs and attorneys fees.

SoundView Litigation: As part of the sale of Schwab Capital Markets L.P. and all of the outstanding capital stock of SoundView Technology Group, Inc. (SoundView), (collectively referred to as Schwab Soundview Capital Markets, or SSCM), to UBS Securities LLC and UBS Americas Inc. (collectively referred to as UBS), the Company agreed to indemnify UBS for certain litigation. SoundView and certain of its subsidiaries are among the numerous financial institutions named as defendants in multiple purported securities class actions filed in the United States District Court for the Southern District of New York (the IPO Allocation Litigation) between June and December 2001. The IPO Allocation Litigation was brought on behalf of persons who either directly or in the aftermarket purchased IPO securities between March 1997 and December 2000. The plaintiffs allege that SoundView entities and the other underwriters named as defendants required customers receiving allocations of IPO shares to pay excessive and undisclosed commissions on unrelated trades and to purchase shares in the aftermarket at prices higher than the IPO price, in violation of the federal securities laws. SoundView entities have been named in 31 of the actions, each involving a different company s IPO, and had underwriting commitments in approximately 90 other IPOs that are the subject of lawsuits. SoundView entities have not been named as defendants in these cases, although the lead underwriters in those IPOs have asserted that depending on the outcome of the cases, SoundView entities may have indemnification or contribution obligations based on underwriting commitments in the IPOs. The parties, with the assent of the District Court, selected 17 cases as focus cases for the purpose of case-specific discovery, and on October 13, 2004, the District Court allowed six of the focus cases to proceed as class actions. Defendants appealed that decision to the United States Court of Appeals for the Second Circuit, which issued an order on December 5, 2006 reversing the District Court s decision to allow the six focus cases to proceed as class actions. On April 6, 2007, the Court of Appeals denied the plaintiffs request for rehearing. In August and September 2007, plaintiffs filed amended class action complaints and renewed motions for class certification, which again seek approval for the cases to proceed as

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class actions. On March 26, 2008, the District Court denied defendants motion to dismiss the amended class action complaints, except with respect to certain claims of a limited number of plaintiffs who sold securities at prices in excess of the initial offering price or who purchased securities outside the class period. Plaintiffs motion for class certification remains pending.

10. Segment Information

The Company structures its segments according to its various types of clients and the services provided to those clients. The Company s three reportable segments are Schwab Investor Services, Schwab Institutional, and Schwab Corporate and Retirement Services. The Company evaluates the performance of its segments on a pre-tax basis excluding items such as restructuring charges, impairment charges on non-financial assets, discontinued operations, and extraordinary items. Segment assets are not disclosed because the balances are not used for evaluating segment performance and deciding how to allocate resources to segments. There are no revenues from transactions with other segments within the Company.

Financial information for the Company s reportable segments is presented in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net revenues:				
Schwab Investor Services	$ 820	$ 862	$ 2,557	$ 2,450
Schwab Institutional	299	287	911	818
Schwab Corporate and Retirement Services	129	134	388	371
Unallocated	3	8	10	10
Total net revenues	$ 1,251	$ 1,291	$ 3,866	$ 3,649
Income from continuing operations before taxes on income:				
Schwab Investor Services	$ 315	$ 343	$ 969	$ 886
Schwab Institutional	150	125	454	342
Schwab Corporate and Retirement Services	35	40	98	104
Unallocated	(1)	4		(5)
Income from continuing operations before taxes on income:	499	512	1,521	1,327
Taxes on income	(195)	(189)	(599)	(512)
(Loss) income from discontinued operations, net of tax		1,211	(18)	1,284
Net income	$ 304	$ 1,534	$ 904	$ 2,099

11. Discontinued Operations

On July 1, 2007, the Company completed the sale of all of the outstanding stock of U.S. Trust. The components of (loss) income from discontinued operations related to U.S. Trust are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues	$	$	$	$ 446
Income from discontinued operations, before taxes	$	$	$	$ 116
Gain on sale of U.S. Trust, before taxes		1,862		1,862
Taxes on income		(651)	(18)	(694)
(Loss) income from discontinued operations, net of tax	$	$ 1,211	$ (18)	$ 1,284

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When calculating the Company s gain on the sale of U.S. Trust for income tax purposes, the acquisition date tax basis is the basis of U.S. Trust s prior stockholders in their shares as of the date U.S. Trust was acquired by the Company, since the transaction qualified as a tax-free exchange. In 2006, the Company recorded a $205 million income tax benefit related to the estimated difference between the tax and book bases of the Company s U.S. Trust stock. This amount was included in income from discontinued operations, net of tax on the Company s condensed consolidated statements of income. This initial estimate of the tax benefit was based on publicly available information, including information on the composition of U.S. Trust s stockholders at the acquisition date and the market price of U.S. Trust stock during relevant periods, and was subject to adjustment following a survey of former U.S. Trust stockholders. The Company completed the survey in the third quarter of 2007. Based upon the results of this survey, the Company recorded an additional $72 million income tax benefit in the third quarter of 2007. The IRS completed their examination of the acquisition date tax basis under a pre-filing agreement in the second quarter of 2008. In connection with the determination of the final income tax gain on the sale of U.S. Trust, the Company recorded additional tax expense of $18 million in the second quarter of 2008. This amount was recorded in loss from discontinued operations.

12. Restructuring Reserve

A summary of the activity in the facilities restructuring reserve related to the Company s past restructuring initiatives, as well as certain retained restructuring-related obligations for the third quarter and first nine months of 2008 is as follows:

	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2008
Beginning balance	$ 65	$ 77
Restructuring credit		(3)
Cash payments - net	(4)	(14)
Other		1
Ending balance at September 30, 2008 (1)	$ 61	$ 61

(1) The Company expects to substantially utilize the remaining facilities restructuring reserve through cash payments for the net lease expense over the respective lease terms through 2017.

The actual costs of these restructuring initiatives could differ from the estimated costs, depending primarily on the Company s sublease activities at the properties.

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Management s Discussion and Analysis of Financial Condition and Results of Operations

(Tabular Amounts in Millions, Except Ratios, and as Noted)

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

OVERVIEW

Management of The Charles Schwab Corporation (CSC) and its subsidiaries (collectively referred to as the Company) focuses on several key financial and non-financial metrics in evaluating the Company s financial position and operating performance. All information contained in this Form 10-Q is presented on a continuing operations basis unless otherwise noted. Results for the third quarters and first nine months of 2008 and 2007 are shown in the following table:

	Three Months Ended September 30,	Percent Change