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Schwab Wants to Fix Its Struggling Bank

By Hannah Miao
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Charles Schwab's biggest moneymaker is its bank. It is also a sore spot the company is trying to fix.

Schwab's playbook of making easy money on customer deposits was upended when interest rates rose rapidly and people moved their cash to chase higher yields. Now, Schwab is looking to change how it uses customer deposits, and make more money from lucrative services including loans and financial advice.

There is a lot riding on the makeover. While Schwab is the largest publicly traded U.S. brokerage, roughly half of its revenue comes from the bank. Banking helped Schwab cut trading fees over the years and eventually eliminate commissions on online stock trades.

Executives haven't specified the timing or magnitude of potential changes, so it isn't clear what Schwab's bank will ultimately look like. Schwab has called 2024 a transition year, but the market is skeptical.

After a 17% pullback in 2023, Schwab's stock is down about 6% year to date, while the broader S&P 500 is up 18%.

"Their track record on execution over the last couple years has not been good as it relates to balance-sheet management," said Bill Katz, a research analyst at TD Cowen who downgraded his rating on Schwab after second-quarter earnings.

Schwab is in the midst of a C-suite shake-up. Chief Financial Officer Peter Crawford is retiring and is set to be succeeded on Oct. 1 by Mike Verdeschi, formerly Citigroup's treasurer. Chief Operating Officer Joe Martinetto earlier this year became executive chairperson of Schwab Banks, and Bernie Clark, head of adviser services, moved to an advisory role.

Banks make money off customer deposits in a variety of ways. At Schwab, the focus has largely been on investing the cash in such assets as Treasurys and mortgage-backed securities, and less so on making loans directly to consumers and businesses.

That strategy was squeezed when rates rose. The value of the longer-term bonds in Schwab's investment portfolio declined, just as many customers moved their deposits into higher-yielding alternatives such as money-market funds. To avoid taking losses on its longer-term investments, Schwab had to turn to pricier short-term funding sources, such as borrowing from the Federal Home Loan Bank system.

Schwab is now looking to make its bank more nimble. On the company's earnings call last month, Walt Bettinger, chief executive officer and co-chairman, said Schwab plans to put more of its investment portfolio into shorter-term assets. It might also offload more of its deposits to third-party banks.

"These various actions should lead -- again, over time -- to a bank that is somewhat smaller than our bank has been in recent years," Bettinger said.

By outsourcing deposits, Schwab can shrink its balance sheet and free up capital, which the company could reinvest into the business or return to shareholders by doing share buybacks.

"It provides us with greater flexibility," Crawford said in an interview.

Schwab already offloads some deposits to TD Bank, which offers a model for how such arrangements might work. TD Bank pays Schwab a monthly fee for the deposits, and Schwab pays a service fee to TD Bank.

The arrangement brought in about $153 million of revenue for Schwab in the second quarter, on average balances of $87 billion swept off its balance sheet. In comparison, Schwab made more than $2 billion of net interest revenue during the same period from a mix of assets, which were mostly funded by the bank deposits on its balance sheet.

Analysts largely believe the shift in bank strategy could benefit Schwab over time, but some question how Schwab would replace its interest-related earnings.

A Schwab spokesperson said that the company would only consider offloading more deposits if doing so was beneficial for customers and shareholders, and that such a move would take years.

Meanwhile, executives see plenty of room to use deposits for lending. Schwab only had about $40 billion of bank loans on its balance sheet in the latest quarter, compared with more than $250 billion of deposits. Those loans had an average interest rate of 4.4% in the second quarter.

Schwab's bank loans are primarily mortgages, home equity lines of credit and pledged asset lines, which use customer portfolios as collateral. The company said it is investing in **technology** to streamline the loan application and approval process, and hiring experienced bankers to work on more-complex loans.

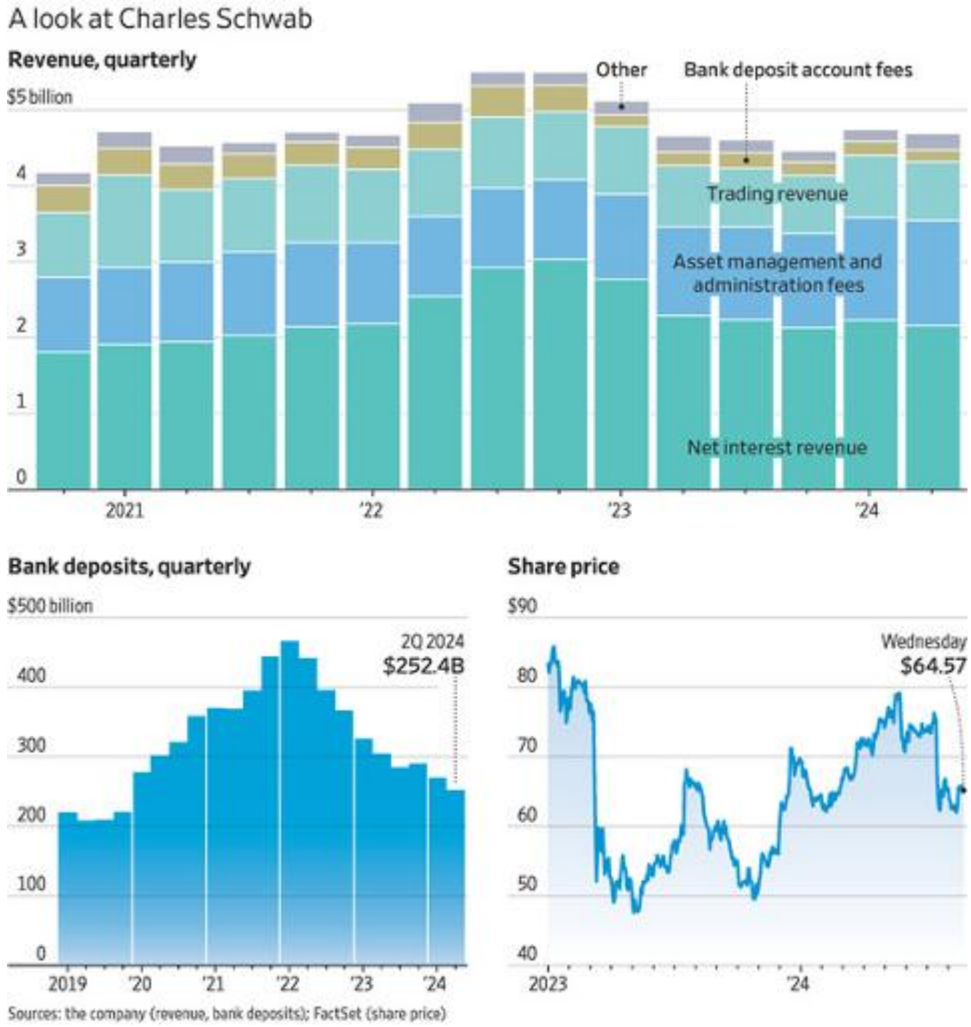
Another area Schwab wants to expand is its financial advice and wealth management services, which bring in fee-based revenue that isn't as dependent on market conditions. Advice solutions brought in about $510 million in the second quarter, accounting for 11% of total revenue.

Schwab will be competing with such banking giants as JPMorgan Chase, Bank of America and Morgan Stanley. But Schwab thinks it has an advantage: former customers of TD Ameritrade, which the company acquired in 2020. Those customers were converted to Schwab accounts recently, and Schwab thinks it can get them to use more of its services.

Some analysts said Schwab won't be able to shift its strategy until its balance-sheet troubles are behind it. In the second quarter, bank deposits continued to decline and Schwab was still paying off short-term borrowings.

Another headache: More than $150 billion of its balance sheet remained tied up in assets that are held to maturity, meaning they won't be sold. Those assets earned an average yield of 1.7%, well below the Federal Reserve's current benchmark interest rate of 5.25% to 5.5%.

"It all comes down to the bank," said Alex Blostein, an analyst at Goldman Sachs.



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Trading Surge Brings Platform Outages --- Charles Schwab, Vanguard, Fidelity customers report problems logging on

By Hannah Miao and Alexander Osipovich
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Dr. William Auch couldn't access his brokerage account as the stock market tumbled on Monday morning.

Shortly after the U.S. market opened, the retired cardiologist tried to log into his Charles Schwab account. He saw stocks were selling off and thought it could be a good opportunity to buy shares at a lower price. Instead, he was locked out of his account for a few hours, unable to sign in online or through the mobile app, or to reach a customer-service representative over the phone.

"You have one of the biggest trading days of the year and you can't get in," said Auch, a 65-year-old in Sacramento, Calif. "It's completely ridiculous."

Monday's market meltdown was nerve-racking for traders around the world, but many self-directed individual investors couldn't do much about it because of outages at major retail brokerages. The Dow Jones Industrial Average dropped about 1,000 points, and the S&P 500 and Nasdaq Composite each shed about 3%.

Charles Schwab, Vanguard Group and Fidelity Investments acknowledged that some customers experienced difficulties logging into their accounts on Monday morning. The brokerages said the issues had been resolved by around midday. It is unclear exactly how many customers experienced problems with their brokerages, but thousands of users reported outages on downdetector.com.

"We were impacted by some of the slowness that's happening all across the industry as a result of higher volumes," Vanguard Chief Executive Salim Ramji said on Bloomberg TV on Monday morning.

A spokesperson for Schwab said the platform experienced the highest level of volatility during the first few trading hours of Monday's session since the early days of the pandemic. The spokesperson said elevated trading volumes and a technical issue with a key vendor affected its systems, which led to the logon issues and longer call wait times. Schwab didn't specify which vendor affected its operations.

Some customers of other brokerages including Robinhood Markets were affected by an outage at Blue Ocean, a trading platform that helps brokerages provide 24-hour trading by executing stock trades between 8 p.m. ET and 4 a.m. ET.

Blue Ocean was down for more than two hours early Monday morning because of a surge in activity, forcing it to cancel a small percentage of trades, according to Blue Ocean Technologies CEO Brian Hyndman.

Monday's technical issues came just a few weeks after a botched update from **cybersecurity** company CrowdStrike disrupted everything from air travel to payments around the world, including some online functions for Schwab customers.

Retail brokerages have a long history of becoming inaccessible to their customers at periods of heavy market volatility -- often when investors are most eager to log in and adjust their portfolios. As customers pile into their accounts, it can overload the systems that connect brokerages' websites and apps to the underlying plumbing that manages their stock trades and account balances.

During the Covid-19 pandemic, outages repeatedly hit brokerages such as Fidelity Investments, Schwab, Robinhood and Vanguard. The brokers often blamed extreme trading volumes. At the time, pandemic lockdowns and the brokerage industry's recent adoption of zero-commission trading had drawn millions of new investors into the stock market.

Monday's glitches show the problem hasn't gone away.

"Every time there's a large market move, it seems like this happens," said Chris Nagy, a former managing director at TD Ameritrade who now works for Healthy Markets Association, an investor-advocacy group. "It makes you wonder, Have the brokers really done anything to improve their **technology**?"

Nagy said that stock exchanges and larger off-exchange trading platforms are subject to regulations setting strict standards for systems integrity, a rule adopted by the Securities and Exchange Commission after the May 2010 "flash crash." But those rules don't apply to retail brokerages, even though their websites and apps serve millions of customers.

Brokers can be penalized for serious outages. In 2021, Robinhood paid nearly $70 million to settle a range of allegations by the Financial Industry Regulatory Authority, Wall Street's self-regulator. Some of Finra's allegations focused on Robinhood's handling of technical glitches, including a March 2020 outage that locked out millions of customers. Robinhood neither admitted nor denied the allegations.

Jack Pitcher contributed to this article.

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