Fitch Affirms U.S. Retail Broker Ratings Following Industry Peer Review
Monday, March 18, 2013 04:09:00 PM (GMT)

Fitch Ratings has affirmed the ratings of Charles Schwab Corporation (Schwab, rated 'A/F1') and Scottrade Financial Services (Scottrade, rated 'BBB-'). The Rating Outlooks for Schwab and Scottrade are Stable. A complete list of ratings follows at the end of this release.

RATING ACTION AND RATIONALE

Today's rating affirmations are reflective of the retails brokers' continued evolution towards a business model that is more based on net interest revenue and fee revenue than trading revenue, offset by continued moderated trading volumes and low interest rates. While industry leaders such as Schwab have been diversifying their sources of revenue for several years, other smaller players such as Scottrade are now more aggressively growing these sources of revenue.

Fitch believes that revenue from both asset management and banking operations provides diversity of revenue sources that tends to be more stable than trading revenue over time, which is a positive from a credit perspective over the long term. Trading revenue tends to be somewhat fickle and moves in tandem with stock market trends.

Fitch would note that while daily average revenue trades (DARTs) have been weak over the last few years for the retail brokers, there has been a pick-up in trading with the stock market gains in early 2013. Net interest revenue has increased as deposit growth has been strong, though the net interest margin has continued to decline as the new deposits are invested at lower rates. Fitch continues to believe that earnings for the retail brokers are at cyclical lows, and given the scalability of their business models, they should have meaningful earnings growth with either better stock market trends and/or higher interest rates.

While returns on equity remain below historical lows for the retail brokers, they have still improved over the last year. Leverage as measured by adjusted debt-to-EBITDA has also improved from the past year which helps support each institution's Stable Rating Outlook.

Fitch believes that the main threat to the retail brokers' business model and ratings could result from a technological or operational loss that is particular to an individual company that results in reputational damage that could cause clients to flee a particular firm. While Fitch believes these risks to be controlled and monitored, Fitch would also note that these types of risks are inherently difficult to predict and quantify, but a large occurrence at any one firm would likely prompt Fitch to review ratings to determine if a negative action was appropriate. An industry-wide event that affects each firm equally may still impact ratings, but may allow each firm to better maintain its client base.

An additional risk to ratings is from the continued growth of banking operations. While Fitch generally views the contribution to earnings positively, should the retail brokers aggressively expand their loan portfolios such that they are exposed to adverse selection in growing assets or should they begin to reach of yield in their investment portfolios, ratings or Rating Outlooks could be negatively impacted.

KEY RATING DRIVERS - IDRs and Senior Debt:

Charles Schwab Corporation

Fitch's affirmations reflect Schwab's continued growth in earnings in spite of a challenging interest rate environment and fickle equity markets. Due to a mix of modest revenue growth and continued expense discipline, Schwab's net margin expanded to 19% in 2012 from 18.4% in 2011. Due to some de-leveraging as well as growth in retained earnings, Schwab's return on equity modestly declined to 9.7% in 2012 from 11.2% in 2011. Given Schwab's highly scalable business model, an improvement in equity markets or interest rates could meaningfully increase Schwab's earnings and therefore return on equity.

As Schwab continues to grow and expand in asset management and fee-based products as well as expand Schwab Bank's balance sheet primarily through deposit growth, the company has become less reliant on its historical trading revenue. From a credit perspective in terms of earnings stability, Fitch views this mix shift positively. In 2012, fee based revenue accounted for 42% of total net revenue, net interest revenue accounted for 36% of total net revenue, and trading revenue accounted for 18% of total net revenue. Fitch would expect revenue to skew even more towards fee-based revenue and net interest revenue over time.

Deposits on Schwab Bank's balance sheet now amount to nearly $80bn as of YE2012 from a mix of both organic growth as well as client balance transfers from Schwab's brokerage subsidiary. Fitch views credit risk in the bank balance sheet as relatively low given that it is comprised of only $10.7 billion of loans, which are primarily mortgage related loans to Schwab clients, and with the balance of deposits being invested in primarily government backed securities. In particular, 51.3% of the banks securities portfolio is invested in highly rated agency mortgage backed securities. Given this posture, as well as a relatively short-duration on the portfolio, Schwab's net interest margin (NIM) declined to 1.49% at 4Q'12 and Fitch would expect this to continue to decline into the mid-1.40% range in 2013.

Given some debt repayments and refinancing in 2012 as well as continued growth in earnings, Schwab's leverage as measured by adjusted debt-to-EBITDA declined to 0.88x at YE2012, down from 1.14x at YE2011. Fitch views the decline in leverage metrics positively and notes that it is indicative of Schwab's already strong ratings and supports the Stable Rating Outlook.

Scottrade Financial Services

Fitch's affirmation is based Scottrade's ability to continue to adequately service its debt obligations despite a challenging interest rate environment and volatile equity markets. Decreasing daily average revenue trades (DARTs) contributed to a 20% decrease in transaction based revenue in fiscal 2012. After a challenging fiscal 2012, Scottrade made expense reductions which combined with a 5.2% improvement in net revenue led to an increase in net margin to 15.6% in fiscal 1Q'13 compared to 5.3% in fiscal 2012. Return on equity improved to 7.9% in fiscal 1Q'13 compared to 2.8% in fiscal 2012. Fitch believes Scottrade's business model is scalable and should benefit from improvements in equity markets while the deposit growth at Scottrade Bank should provide a benefit to earnings in an increasing rate environment.

Scottrade's strategy is to continue to grow deposits at Scottrade Bank, thereby continuing to increase the contribution of revenues from net interest revenue as a percentage of total revenue. In fiscal 1Q'13, net interest revenue represented 49% of total revenue compared to just 38% in fiscal 2011, while trading revenue declined to 35.5% in fiscal 1Q'13 from 50% in fiscal 2011. Fitch views the shift in revenue mix from transaction based revenue into more stable spread based revenues positively as it should provide increasing stability to earnings in future periods.

Scottrade Bank had $15.3 billion in deposits at Dec. 31, 2012 compared to $11.9bn at September 30, 2011. Scottrade continues to grow deposits by sweeping deposits from the broker-dealer to the bank. Fitch views the credit risk in Scottrade Bank's investment portfolio as relatively low. As of Dec. 31, 2012, 91% of the assets in the portfolio were directly or indirectly guaranteed by the U.S. government, including $7.2 billion invested in asset-backed securities backed by Federal Family Education Loan Program (FFELP) loans and $5.7 billion invested in U.S. government agency securities.

As Scottrade Bank grows, they will continue to invest assets, including continued growth of their loan portfolio, which was $284 million as of Dec. 31, 2012. In February 2013, Scottrade Bank purchased a small Missouri based bank which will help serve as part of their loan origination platform. Historically, Scottrade had purchased most of its loans in the secondary market but will now begin to expand their loan origination capabilities. Fitch acknowledges this growth in the loan portfolio does not come without risks and will continue to monitor the asset quality going forward.

Scottrade's net interest margin (NIM) improved to 1.46% in fiscal 1Q'13 compared to 1.45% in fiscal 2012. Increasing net interest income and reduced expenses contributed to stronger earnings and lower leverage in the first quarter of fiscal 2013. As of Dec. 31, 2012, adjusted debt-to-EBITDA declined to 2.03(x) compared to 2.76(x) at fiscal 4Q'12 and 3.27(x) at fiscal 3Q'12. Fitch notes its adjusted EBITDA metric is annualized to calculate quarterly ratios. Fitch views this decrease in leverage positively and supports the Stable Rating Outlook.

RATING SENSITIVITIES - IDRs and Senior Debt:

Charles Schwab Corporation

Fitch notes that there is limited upside to Schwab's current ratings given the company's elevated sensitivity to stock market trends and interest rates. However, should Schwab's revenue mix continue to shift and exhibit more stable trends over an extended period through various market cycles, there could be some modest upside to ratings or the Rating Outlook.

The key risk to Schwab's ratings is from either poor investment performance that causes client assets to leave the firm or a large idiosyncratic operational loss that similarly causes clients to pull their business from the firm. The latter type of risk is particularly difficult to predict and quantify but has the potential to be harmful to the company and its ratings should the loss impact only Schwab and not all industry participants. This risk also constrains upwards rating potential.

An additional risk that could impact ratings over time is the growth of Schwab Bank. While presently Fitch views it to be well and relatively conservatively managed, should the mix of the loan portfolio change or the company begin to reach for yield in its investment portfolio such that it increases the credit or interest rate risk profile of the balance sheet, ratings or the Rating Outlook could come under pressure.

Scottrade Financial Services

Fitch believes that Scottrade has limited upside potential to current ratings in the near term given the company's sensitivity to stock market trends and challenges regarding the growth of banking. Given Scottrade's limited current revenue diversity, the company is also viewed as more sensitive to adverse market conditions and decreased trading volumes relative to peers. However, should Scottrade maintain current leverage metrics, continue to shift their revenue mix to more stable based spread revenues, and execute on the measured and profitable growth of Scottrade Bank over an extended period of time, there could be some upside to ratings or the Rating Outlook.

The primary risk to Scottrade's rating is from a large idiosyncratic operational loss or data breach that causes clients to leave the firm. This risk is difficult to predict and quantify but has the potential to be harmful to the company and its ratings should the loss impact only Scottrade and not all industry participants. This risk also constrains upwards rating potential.

Other risks to ratings include the growth at Scottrade Bank and its potential to impact credit quality, as Fitch believes Scottrade could be subject to some adverse selection as the company focuses on organically growing its loan portfolio across various product categories. An additional risk to ratings is the potential for leverage to return and remain at levels seen in 2012 through either reduced earnings power or additional debt issuances, either of which could negatively impact ratings.

Fitch also notes that Scottrade's corporate investment portfolio, while small and short duration, is highly concentrated in the financial services industry. In a stress, this could result in correlated adverse performance amongst the securities, as well as relative to Scottrade's primary business activities. Given the increasing risks involved with Scottrade's expansion into new product categories, particularly within the loan portfolio, Fitch feels that Scottrade is more susceptible to downward ratings pressure relative to Schwab.

KEY RATING DRIVERS - Support Ratings and Support Floor Ratings:
Schwab has a support rating of '5' and a support floor rating of 'NF' indicating that support is unlikely.

RATING SENSITIVITIES - Support Ratings and Support Floor Ratings:

Not applicable.

KEY RATING DRIVERS - Subordinated Debt and Other Hybrid Securities:

Schwab has a preferred stock rating of 'BB+' which is five notches below its IDR given its position in the capital structure and potential for non-performance compared with other issuances.

RATING SENSITIVITIES - Subordinated Debt and Other Hybrid Securities:

Ratings for Schwab's preferred stock are notched five notches from the IDR based on Fitch's treatment of preferreds in bank capital as this source of capital for Schwab has historically been downstreamed to support its banking operations. As such, changes in ratings on the preferred are primarily sensitive to any change in the IDR, where the notching would be realigned in conjunction with any change in the IDR.

Fitch has affirmed the following ratings:

Charles Schwab Corporation
--Long-term Issuer Default Rating (IDR) at 'A'; Outlook Stable.
--Short-term IDR at 'F1';
--Senior unsecured notes at 'A';
--Short-term debt at 'F1';
--Preferred stock at 'BB+';
--Support at '5';
--Support floor at 'NF'.

Scottrade Financial Services
--Long-term Issuer Default Rating (IDR) at 'BBB-'; Outlook Stable.
--Senior unsecured notes at 'BBB-'

Additional information is available at www.fitchratings.com. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

In addition to the source(s) of information identified in Fitch's Master Criteria, these actions were additionally informed by information provided by the companies.

Applicable Criteria and Related Research:
--'Risk Radar' (Jan. 16, 2013);
--'U.S. Banks: Rationalizing the Branch Network (Witness the Incredible Shrinking Branch Network)' (Sept. 17, 2012);
--'U.S. Banks: Mortgage Representations and Warranties (Banks Increase Reserves; Uncertainty Remains)' (Aug. 20, 2012)
--'Global Financial Institutions Rating Criteria' (Aug. 15, 2012);
--'Securities Firms Criteria' (Aug. 15, 2012)
--'Treatment of Unrealized Losses in U.S. Bank Capital Rule Proposal (Pro-Cyclical Capital Policy to Create Greater Capital Volatility for Banks)' (Aug. 7, 2012);
--'Basel III: Return and Deleveraging Pressures' (May 17, 2012);
--'Assessing and Rating Bank Subordinated and Hybrid Securities' (Dec. 05, 2012).

Applicable Criteria and Related Research
Treatment of Unrealized Losses in U.S. Bank Capital Rule Proposal (Pro-Cyclical Capital Policy to Create Greater Capital Volatility for Banks)
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685638
Basel III: Return and Deleveraging Pressures
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=678273
Assessing and Rating Bank Subordinated and Hybrid Securities
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695542
Risk Radar Update
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=699014
U.S. Banks: Rationalizing the Branch Network (Witness the Incredible Shrinking Branch Network)
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=688330
U.S. Banks: Mortgage Representations and Warranties (Banks Increase Reserves; Uncertainty Remains)
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=684038
Global Financial Institutions Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686181
Securities Firms Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686137

FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

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