HAWAIIAN ELECTRIC CO INC
Form 10-K/A
March 10, 2004
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-K/A

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

For the fiscal year ended December 31, 2003

OR

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

Commission File Number	Registrant; State of Incorporation; Address; and Telephone Number	I.R.S. Employer Identification No.
1-8503	**HAWAIIAN ELECTRIC INDUSTRIES, INC.**, a Hawaii corporation (HEI) 900 Richards Street, Honolulu, Hawaii 96813 Telephone (808) 543-5662	**99-0208097**
1-4955	**HAWAIIAN ELECTRIC COMPANY, INC.**, a Hawaii corporation (HECO) 900 Richards Street, Honolulu, Hawaii 96813 Telephone (808) 543-7771	**99-0040500**

Securities registered pursuant to Section 12(b) of the Act:

Registrant	Title of each class

		Name of each exchange on which registered
Hawaiian Electric Industries, Inc.	Common Stock, Without Par Value	New York Stock Exchange
Hawaiian Electric Industries, Inc.	Guarantee with respect to 8.36% Trust Originated Preferred Securities SM (TOPrS SM)	New York Stock Exchange
Hawaiian Electric Industries, Inc.	Preferred Stock Purchase Rights	New York Stock Exchange
Hawaiian Electric Company, Inc.	Guarantee with respect to 8.05% Cumulative Quarterly Income Preferred Securities Series 1997 (QUIPSSM)	New York Stock Exchange
Hawaiian Electric Company, Inc.	Guarantee with respect to 7.30% Cumulative Quarterly Income Preferred Securities Series 1998 (QUIPSSM)	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

Registrant	Title of each class
Hawaiian Electric Industries, Inc.	None
Hawaiian Electric Company, Inc.	Cumulative Preferred Stock

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether Registrant Hawaiian Electric Industries, Inc. is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

Indicate by check mark whether Registrant Hawaiian Electric Company, Inc. is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ¨ No x

	Aggregate market value of the voting common equity held by non-affiliates of the registrants on June 30, 2003	Number of shares of common stock outstanding of the registrants on March 1, 2004
Hawaiian Electric Industries, Inc. (HEI)	$1,715,658,628.25	38,032,319
		(Without par value)
Hawaiian Electric Company, Inc. (HECO)	Not applicable	12,805,843

($6 2/3 par value)

DOCUMENTS INCORPORATED BY REFERENCE

HEI Annual Report to Shareholders for the fiscal year ended December 31, 2003	Parts I, II, III and IV
HECO Consolidated 2003 Financial Statements	Parts I, II, III and IV
Portions of Proxy Statement of Hawaiian Electric Industries, Inc., dated March 9, 2004 for the 2004 Annual Meeting of Shareholders	Part III

This combined Form 10-K/A represents separate filings by Hawaiian Electric Industries, Inc. and Hawaiian Electric Company, Inc. Information contained herein relating to any individual registrant is filed by each registrant on its own behalf. Neither registrant makes any representations as to the information relating to the other registrant.

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EXPLANATORY NOTE:

This amendment to the annual report on Form 10-K of registrants Hawaiian Electric Industries, Inc. (HEI) and Hawaiian Electric Company, Inc. (HECO) is being filed solely to correct Item 7 relating to HECO. In the original filing of this annual report on Form 10-K, part of a paragraph was inadvertently omitted from the top of page 58. This amendment to the annual report on Form 10-K includes the originally omitted partial paragraph, changes references from Form 10-K to Form 10-K/A, provides new Chief Executive Officer and Chief Financial Officer certifications in place of the original certifications (HEI Exhibits 31.1, 31.2, 32.1 and 32.2 and HECO Exhibits 31.3, 31.4, 32.3 and 32.4) and provides new independent auditors reports and consents in place of the original reports and consents.

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GLOSSARY OF TERMS

Defined below are certain terms used in this report:

Terms	Definitions
1935 Act	Public Utility Holding Company Act of 1935
AES Hawaii	AES Hawaii, Inc., formerly known as AES Barbers Point, Inc.
ASB	American Savings Bank, F.S.B., a wholly-owned subsidiary of HEI Diversified, Inc. and parent company of American Savings Investment Services Corp. (and its subsidiary since March 15, 2001, Bishop Insurance Agency of Hawaii, Inc.), ASB Service Corporation (dissolved in January 2004), AdCommunications, Inc., American Savings Mortgage Co., Inc. (dissolved in July 2003), and ASB Realty Corporation
BIF	Bank Insurance Fund
BLNR	Board of Land and Natural Resources of the State of Hawaii
Btu	British thermal unit
CDUP	Conservation District Use Permit
CERCLA	Comprehensive Environmental Response, Compensation and Liability Act
Chevron	Chevron Products Company, a fuel oil supplier
Company	When used in Hawaiian Electric Industries, Inc. sections, the Company refers to Hawaiian Electric Industries, Inc. and its direct and indirect subsidiaries, including, without limitation, Hawaiian Electric Company, Inc., Maui Electric Company, Limited, Hawaii Electric Light Company, Inc., HECO Capital Trust I, HECO Capital Trust II, HECO Capital Trust III, Renewable Hawaii, Inc., HEI Diversified, Inc., American Savings Bank, F.S.B. and its subsidiaries, Pacific Energy Conservation Services, Inc., HEI District Cooling, Inc. (dissolved in October 2003), ProVision Technologies, Inc. (sold in July 2003), HEI Properties, Inc., HEI Leasing, Inc. (dissolved in October 2003), Hycap Management, Inc., Hawaiian Electric Industries Capital Trust I, Hawaiian Electric Industries Capital Trust II, Hawaiian Electric Industries Capital Trust III, HEI Preferred Funding, LP, The Old Oahu Tug Service, Inc. (formerly Hawaiian Tug & Barge Corp.), HEI Power Corp. and its subsidiaries and Malama Pacific Corp. When used in Hawaiian Electric Company, Inc. sections, the Company refers to Hawaiian Electric Company, Inc. and its direct subsidiaries, including, without limitation, Maui Electric Company, Limited, Hawaii Electric Light Company, Inc., HECO Capital Trust I, HECO Capital Trust II, HECO Capital Trust III and Renewable Hawaii, Inc.
Consumer Advocate	Division of Consumer Advocacy, Department of Commerce and Consumer Affairs of the State of Hawaii
CT	Combustion turbine
DLNR	Department of Land and Natural Resources of the State of Hawaii
D&O	Decision and order
DOD	Department of Defense federal
DOH	Department of Health of the State of Hawaii
DSM	Demand-side management
DTCC	Dual-train combined-cycle
EAPRC	East Asia Power Resources Corporation
ECA	Energy cost adjustment
Enserch	Enserch Development Corporation
EPA	Environmental Protection Agency federal

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GLOSSARY OF TERMS *(continued)*

Terms	Definitions
ERL	Environmental Response Law of the State of Hawaii
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
federal	U.S. Government
FHLB	Federal Home Loan Bank
FICO	Financing Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
Hamakua Partners	Hamakua Energy Partners, L.P., formerly known as Encogen Hawaii, L.P.
HRD	Hawi Renewable Development, Inc.
HCPC	Hilo Coast Power Company, formerly Hilo Coast Processing Company
HC&S	Hawaiian Commercial & Sugar Company, a division of A&B-Hawaii, Inc.
HECO	Hawaiian Electric Company, Inc., an electric utility subsidiary of Hawaiian Electric Industries, Inc. and parent company of Maui Electric Company, Limited, Hawaii Electric Light Company, Inc., HECO Capital Trust I, HECO Capital Trust II, HECO Capital Trust III and Renewable Hawaii, Inc.
HECO s Consolidated Financial Statements	Hawaiian Electric Company, Inc. s Consolidated Financial Statements incorporated into Parts I, II and IV of this Form 10-K/A, which is filed as HECO Exhibit 99.4 and incorporated into this Form 10-K/A by reference
HECO s MD&A	Hawaiian Electric Company, Inc. s Management s Discussion and Analysis of Financial Condition and Results of Operations on pages 50 to 67 of this Form 10-K/A
HEI	Hawaiian Electric Industries, Inc., direct parent company of Hawaiian Electric Company, Inc., HEI Diversified, Inc., Pacific Energy Conservation Services, Inc., HEI District Cooling, Inc. (dissolved in October 2003), ProVision Technologies, Inc. (sold in July 2003), HEI Properties, Inc., HEI Leasing, Inc. (dissolved in October 2003), Hycap Management, Inc., Hawaiian Electric Industries Capital Trust I, Hawaiian Electric Industries Capital Trust II, Hawaiian Electric Industries Capital Trust III, The Old Oahu Tug Service, Inc. (formerly Hawaiian Tug & Barge Corp.), HEI Power Corp. and Malama Pacific Corp.
HEI s Annual Report	Hawaiian Electric Industries, Inc. s 2003 Annual Report to Shareholders, which is filed as HEI Exhibit 13 and incorporated into this Form 10-K/A by reference
HEI s Consolidated Financial Statements	Hawaiian Electric Industries, Inc. s Consolidated Financial Statements incorporated into Parts I, II and IV of this Form 10-K/A by reference to pages 39 to 88 of HEI s Annual Report
HEI s MD&A	Hawaiian Electric Industries, Inc. s Management s Discussion and Analysis of Financial Condition and Results of Operations incorporated into Parts I, II and IV of this Form 10-K/A by reference to pages 4 to 35 of HEI s Annual Report
HEI s 2004 Proxy Statement	Portions of Hawaiian Electric Industries, Inc. s 2004 Proxy Statement dated March 9, 2004, which portions are incorporated into this Form 10-K/A by reference
HEIDI	HEI Diversified, Inc., a wholly-owned subsidiary of Hawaiian Electric Industries, Inc. and the parent company of American Savings Bank, F.S.B.

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GLOSSARY OF TERMS *(continued)*

Terms	Definitions
HEIII	HEI Investments, Inc. (formerly HEI Investment Corp.), a wholly-owned subsidiary of HEI Power Corp.
HEIPC	HEI Power Corp., a wholly owned subsidiary of Hawaiian Electric Industries, Inc., and the parent company of numerous subsidiaries, several of which were dissolved or otherwise wound up in 2002 and 2003. On October 23, 2001, the HEI Board of Directors adopted a formal plan to exit the international power business (engaged in by HEIPC and its subsidiaries).
HEIPC Group	HEI Power Corp. and its subsidiaries
HEIPI	HEI Properties, Inc., a wholly-owned subsidiary of Hawaiian Electric Industries, Inc.
HELCO	Hawaii Electric Light Company, Inc., an electric utility subsidiary of Hawaiian Electric Company, Inc.
HITI	Hawaiian Interisland Towing, Inc.
HTB	Hawaiian Tug & Barge Corp. On November 10, 1999, HTB sold substantially all of its operating assets and the stock of Young Brothers, Limited, and changed its name to The Old Oahu Tug Services, Inc.
IPP	Independent power producer
IRP	Integrated resource plan
Kalaeloa	Kalaeloa Partners, L.P.
KCP	Kawaihae Cogeneration Partners
KDC	Keahole Defense Coalition
kV	kilovolt
KIP	Kalaeloa Investment Partners
KPP	Kahua Power Partners LLC
KWH	Kilowatthour
LSFO	Low sulfur fuel oil
MBtu	Million British thermal unit
MECO	Maui Electric Company, Limited, an electric utility subsidiary of Hawaiian Electric Company, Inc.
MPC	Malama Pacific Corp., a wholly-owned subsidiary of Hawaiian Electric Industries, Inc. On September 14, 1998, the HEI Board of Directors adopted a plan to exit the residential real estate development business engaged in by Malama Pacific Corp. and its then-existing subsidiaries. As of December 31, 2003, all of its subsidiaries had been dissolved.
MSFO	Medium sulfur fuel oil
MW	Megawatts
NA	Not applicable
NM	Not meaningful
NOV	Notice of Violation
OPA	Federal Oil Pollution Act of 1990
OTS	Office of Thrift Supervision, Department of Treasury
PCB	Polychlorinated biphenyls

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GLOSSARY OF TERMS *(continued)*

Terms	Definitions
PECS	Pacific Energy Conservation Services, Inc., a wholly-owned subsidiary of Hawaiian Electric Industries, Inc.
PGV	Puna Geothermal Venture
PPA	Power purchase agreement
PSD permit	Prevention of Significant Deterioration/Covered Source permit
PUC	Public Utilities Commission of the State of Hawaii
PURPA	Public Utility Regulatory Policies Act of 1978
QF	Qualifying Facility under the Public Utility Regulatory Policies Act of 1978
QTL	Qualified Thrift Lender
RCRA	Resource Conservation and Recovery Act of 1976
Registrant	Hawaiian Electric Industries, Inc. or Hawaiian Electric Company, Inc.
ROACE	Return on average common equity
SAIF	Savings Association Insurance Fund
SEC	Securities and Exchange Commission
ST	Steam turbine
state	State of Hawaii
Tesoro	Tesoro Hawaii Corp. dba BHP Petroleum Americas Refining Inc., a fuel oil supplier
TOOTS	The Old Oahu Tug Service, Inc. (formerly Hawaiian Tug & Barge Corp.), a wholly-owned subsidiary of Hawaiian Electric Industries, Inc. On November 10, 1999, HTB sold the stock of YB and substantially all of HTB s operating assets and changed its name.
UIC	Underground Injection Control
UST	Underground storage tank
VIE	Variable interest entities
YB	Young Brothers, Limited, which was sold on November 10, 1999, was formerly a wholly-owned subsidiary of Hawaiian Tug & Barge Corp.

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Forward-Looking Statements and Risk Factors

This report and other presentations made by Hawaiian Electric Industries, Inc. (HEI) and Hawaiian Electric Company, Inc. (HECO) and their subsidiaries contain forward-looking statements, which include statements that are predictive in nature, depend upon or refer to future events or conditions, and usually include words such as expects, anticipates, intends, plans, believes, predicts, estimates or similar expressions. In addition, any statements concerning future financial performance (including future revenues, expenses, earnings or losses or growth rates), ongoing business strategies or prospects and possible future actions, which may be provided by management, are also forward-looking statements. Forward-looking statements are based on current expectations and projections about future events and are subject to risks, uncertainties and the accuracy of assumptions concerning HEI and its subsidiaries (including HECO and its subsidiaries), the performance of the industries in which they do business and economic and market factors, among other things. **These forward-looking statements are not guarantees of future performance.**

Risks, uncertainties and other important factors that could cause actual results to differ materially from those in forward-looking statements and from historical results include, but are not limited to, the following:

- the effects of international, national and local economic conditions, including the state of the Hawaii tourist and construction industries, the strength or weakness of the Hawaii and continental U.S. housing markets, the military presence in Hawaii and the effects of the February 2004 strike in the Hawaii concrete industry;
- the effects of weather and natural disasters;
- global developments, including the effects of terrorist acts, the war on terrorism, continuing U.S. presence in Iraq and Afghanistan and potential conflict or crisis with North Korea;
- the timing and extent of changes in interest rates;
- the risks inherent in changes in the value of and market for securities available for sale and pension and other retirement plan assets;
- changes in assumptions used to calculate retirement benefits costs and changes in funding requirements;
- demand for services and market acceptance risks;
- increasing competition in the electric utility and banking industries;
- capacity and supply constraints or difficulties;
- fuel oil price changes, performance by suppliers of their fuel oil delivery obligations and the continued availability to the electric utilities of their energy cost adjustment clauses;
- the ability of independent power producers to deliver the firm capacity anticipated in their power purchase agreements;

- the ability of the electric utilities to negotiate, periodically, favorable collective bargaining agreements;
- new technological developments that could affect the operations and prospects of HEI s subsidiaries (including HECO and its subsidiaries) or their competitors;
- federal, state and international governmental and regulatory actions, such as changes in laws, rules and regulations applicable to HEI, HECO and their subsidiaries (including changes in taxation and governmental fees and assessments); decisions by the Hawaii Public Utilities Commission (PUC) in rate cases and other proceedings and by other agencies and courts on land use, environmental and other permitting issues; required corrective actions (such as with respect to environmental conditions, capital adequacy and business practices);
- the risks associated with the geographic concentration of HEI s businesses;
- the effects of changes in accounting principles applicable to HEI, HECO and their subsidiaries, including the possible effects of applying new accounting principles applicable to variable interest entities (VIEs) to power purchase arrangements with independent power producers;
- the effects of changes by securities rating agencies in the ratings of the securities of HEI and HECO;
- the results of financing efforts;
- faster than expected loan prepayments that can cause an acceleration of the amortization of premiums on loans and investments and the impairment of mortgage servicing rights of American Savings Bank, F.S.B. (ASB);
- the ultimate net proceeds from the disposition of assets and settlement of liabilities of discontinued or sold operations;
- the final outcome of tax positions taken by HEI and its subsidiaries, including with respect to ASB s real estate investment trust subsidiary;
- the risks of suffering losses that are uninsured; and
- other risks or uncertainties described elsewhere in this report and in other periodic reports previously and subsequently filed by HEI and/or HECO with the Securities and Exchange Commission (SEC).

Forward-looking statements speak only as of the date of the report, presentation or filing in which they are made. Except to the extent required by the federal securities laws, HEI and its subsidiaries undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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PART I

ITEM 1. BUSINESS

HEI

HEI was incorporated in 1981 under the laws of the State of Hawaii and is a holding company with its principal subsidiaries engaged in the electric utility, banking and other businesses operating primarily in the State of Hawaii. HEI s predecessor, HECO, was incorporated under the laws of the Kingdom of Hawaii (now the State of Hawaii) on October 13, 1891. As a result of a 1983 corporate reorganization, HECO became an HEI subsidiary and common shareholders of HECO became common shareholders of HEI.

HECO and its operating subsidiaries, Maui Electric Company, Limited (MECO) and Hawaii Electric Light Company, Inc. (HELCO), are regulated electric public utilities providing the only electric public utility service on the islands of Oahu, Maui, Lanai, Molokai and Hawaii, which islands collectively include approximately 93% of Hawaii s electric public utility market. HECO also owns all the common securities of HECO Capital Trust I, HECO Capital Trust II and HECO Capital Trust III (Delaware statutory trusts), which were formed to effect the issuances of $50 million of 8.05% cumulative quarterly income preferred securities in March 1997 (expected to be redeemed in the first half of 2004), $50 million of 7.30% cumulative quarterly income preferred securities in December 1998 and an anticipated $50 million of cumulative quarterly income preferred securities in the first half of 2004 (the proceeds of which will be used to redeem the preferred securities issued by HECO Capital Trust I), respectively, for the benefit of HECO, MECO and HELCO. In December 2002, HECO formed a subsidiary, Renewable Hawaii, Inc., to invest in renewable energy projects.

Besides HECO and its subsidiaries, HEI also owns directly or indirectly the following subsidiaries: HEI Diversified, Inc. (HEIDI) (a holding company) and its subsidiary, ASB, and the subsidiaries of ASB; Pacific Energy Conservation Services, Inc. (PECS); ProVision Technologies, Inc. (sold in July 2003); HEI Properties, Inc. (HEIPI); HEI Leasing, Inc. (dissolved in October 2003); Hycap Management, Inc. and its subsidiary; Hawaiian Electric Industries Capital Trust I; Hawaiian Electric Industries Capital Trust II and III (formed in 1997 to be available for trust securities financings); HEI District Cooling, Inc. (dissolved in October 2003); The Old Oahu Tug Service, Inc. (TOOTS); HEI Power Corp. (HEIPC) and its subsidiaries (discontinued operations); and Malama Pacific Corp. (MPC) (discontinued operations).

ASB, acquired in 1988, was the third largest financial institution in the State of Hawaii based on total assets and had 68 retail branches as of December 31, 2003. ASB has subsidiaries involved in the sale and distribution of insurance products and advertising activities for ASB and its subsidiaries and a subsidiary, ASB Realty Corporation, which elects to be taxed as a real estate investment trust and holds assets (primarily loans and mortgage-related securities) of $1.8 billion (see Note 9 to HEI s Consolidated Financial Statements).

HEIDI was also the parent company of HEIDI Real Estate Corp., which was formed in February 1998. In September 1999, HEIDI Real Estate Corp. s name was changed to HEIPI, and HEIDI transferred ownership of HEIPI to HEI. HEIPI currently holds venture capital investments.

PECS was formed in 1994 and currently is a contract services company providing limited support services in Hawaii. ProVision Technologies, Inc., formed in October 1998 to sell, install, operate and maintain on-site power generation equipment and auxiliary appliances in Hawaii and the Pacific Rim, was sold in July 2003. HEI Leasing, Inc. was formed in February 2000 to own passive investments and real estate subject to leases, but was never active and was dissolved in October 2003. Hycap Management, Inc., including its subsidiary HEI Preferred Funding, LP (a limited partnership in which Hycap Management, Inc. is the sole general partner), and Hawaiian Electric Industries Capital Trust I (a Delaware statutory trust in which HEI owns all the common securities) were formed to effect the issuance of $100 million of 8.36% HEI-obligated trust preferred securities in 1997. HEI District Cooling, Inc. was formed in August 1998 to develop, build, own, lease, operate and/or maintain, either directly or indirectly, central chilled water cooling system facilities, and other energy related products and services for commercial and residential buildings, but was dissolved in October 2003.

In November 1999, Hawaiian Tug & Barge Corp. (HTB) sold substantially all of its operating assets and the stock of YB for a nominal gain, changed its name to TOOTS and ceased maritime freight transportation operations. TOOTS currently administers certain employee and retiree-related benefits programs and monitors matters related its former operations and the operations of its former subsidiary.

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For information concerning a strike in the Hawaii concrete industry that has been ongoing since early February 2004 and is adversely affecting the construction industry and Hawaii economy generally, see the discussion under the caption Overview and strategy in HECO s MD&A. If a prolonged strike significantly impacted the Hawaii economy, the operations of the electric utilities and bank could be adversely affected.

For information about the Company s discontinued operations, see Note 13 to HEI s Consolidated Financial Statements.

For financial information about the Company s industry segments, see Note 2 to HEI s Consolidated Financial Statements.

For additional information about the Company, see HEI s MD&A, HEI s Quantitative and Qualitative Disclosures about Market Risk and HEI s Consolidated Financial Statements.

The Company s website address is www.hei.com. HEI and HECO currently make available free of charge through this website their annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports (since 1994) as soon as reasonably practicable after such material is electronically filed with the SEC.

Electric utility

HECO and subsidiaries and service areas

HECO, MECO and HELCO are regulated operating electric public utilities engaged in the production, purchase, transmission, distribution and sale of electricity on the islands of Oahu; Maui, Lanai and Molokai; and Hawaii, respectively. HECO was incorporated under the laws of the Kingdom of Hawaii (now State of Hawaii) in 1891. HECO acquired MECO in 1968 and HELCO in 1970. In 2003, the electric utilities revenues and net income from continuing operations amounted to approximately 78% and 67%, respectively, of HEI s consolidated amounts, compared to approximately 76% and 76% in 2002 and approximately 75% and 82% in 2001, respectively.

The islands of Oahu, Maui, Lanai, Molokai and Hawaii have a combined population currently estimated at 1,197,000, or approximately 95% of the population of the State of Hawaii, and comprise a service area of 5,766 square miles. The principal communities served include Honolulu (on Oahu), Wailuku and Kahului (on Maui) and Hilo and Kona (on Hawaii). The service areas also include numerous suburban communities, resorts, U.S. Armed Forces installations and agricultural operations.

The state has granted HECO, MECO and HELCO nonexclusive franchises, which authorize the utilities to construct, operate and maintain facilities over and under public streets and sidewalks. HECO s franchise covers the City & County of Honolulu, MECO s franchises cover the County of Maui and the County of Kalawao, and HELCO s franchise covers the County of Hawaii. Each of these franchises will continue in effect for an indefinite period of time until forfeited, altered, amended or repealed.

For additional information about HECO, see HEI s MD&A, HEI s Quantitative and Qualitative Disclosures about Market Risk and HEI s Consolidated Financial Statements and HECO s MD&A, HECO s Quantitative and Qualitative Disclosures about Market Risk and HECO s Consolidated Financial Statements.

Sales of electricity

HECO, MECO and HELCO provide the only electric public utility service on the islands they serve. The following table sets forth the number of electric customer accounts as of December 31, 2003, 2002 and 2001 and electric sales revenues by company for each of the years then ended:

	2003		2002		2001	
(dollars in thousands)	Customer accounts	Electric sales revenues	Customer accounts	Electric sales revenues	Customer accounts	Electric sales revenues
HECO	286,677	$ 960,717	283,161	$ 865,608	280,911	$ 882,308
MECO	61,423	213,806	59,983	191,029	58,840	203,847
HELCO	68,893	213,268	66,411	191,589	65,241	193,209
	416,993	$ 1,387,791	409,555	$ 1,248,226	404,992	$ 1,279,364

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Revenues from the sale of electricity in 2003 were from the following types of customers in the proportions shown:

	HECO	MECO	HELCO	Total
Residential	32%	36%	41%	34%
Commercial	32	35	41	34
Large light and power	35	29	18	31
Other	1			1
	100%	100%	100%	100%

HECO and its subsidiaries sales are not as strongly seasonal as compared to some utilities on the mainland. The weather in Hawaii is temperate, and has neither the cold winters nor the hot humid summers experienced in some parts of the mainland. Any seasonal variation in HECO and its subsidiaries sales is due largely to weather, with warm summers causing an increase in cooling demand. Hawaii s economic activity throughout the year is relatively steady, although, generally, the summer months (June through August) and the winter months (December, January and February) see the most visitors to the islands, and result in an increase in demand for electricity.

HECO and its subsidiaries derived approximately 10%, 9% and 10% of their operating revenues from the sale of electricity to various federal government agencies in 2003, 2002 and 2001, respectively.

Formerly one of HECO s larger customers, the Naval Base at Barbers Point, Oahu, closed in 1999 with redevelopment of the base to occur through 2020. Considering (1) that the base closure necessitated relocation of essential flight operations and support personnel to another base on Oahu and (2) the Naval Air Station Barbers Point Community Redevelopment Plan will increase development of the area, HECO continues to expect that the closure is likely to result in an overall increase in demand for electricity over time.

In 1995, HECO and the U.S. General Services Administration (GSA) entered into a Basic Ordering Agreement (GSA-BOA) under which HECO would arrange for the financing and installation of energy conservation projects at federal facilities in Hawaii. In 1996, HECO signed an umbrella Basic Ordering Agreement with the Department of Defense (DOD-BOA) and in 2001, a new DOD-BOA was signed. In 1997, HECO and the U.S. Postal Service signed a Shared Energy Savings Contract. Under these and other agreements, HECO has completed energy conservation and other projects for federal agencies over the years.

Executive Order 13123, adopted in 1994, mandates that each federal agency develop and implement a program to reduce energy consumption by 35% by the year 2010 to the extent that these measures are cost effective. The 35% reduction will be measured relative to the agency s 1985 energy use. HECO continues to work with various federal agencies to implement demand-side management (DSM) programs that will help them achieve their energy reduction objectives. Neither HEI nor HECO management can predict with certainty the impact of Executive Order 13123 on HEI s or HECO s future financial condition, results of operations or liquidity.

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Selected consolidated electric utility operating statistics

	2003	2002	2001	2000	1999
KWH sales (millions)					
Residential	2,875.9	2,778.5	2,665.2	2,627.2	2,550.5
Commercial	3,168.3	3,073.6	3,016.1	2,923.5	2,781.5
Large light and power	3,676.5	3,639.2	3,636.5	3,666.9	3,598.3
Other	54.4	53.0	52.6	54.1	54.7
	9,775.1	9,544.3	9,370.4	9,271.7	8,985.0
KWH net generated and purchased (millions)					
Net generated	6,280.2	6,249.7	6,042.4	6,247.0	6,115.1
Purchased	4,054.3	3,829.6	3,861.6	3,572.0	3,391.7
	10,334.5	10,079.3	9,904.0	9,819.0	9,506.8
Losses and system uses (%)	5.2	5.1	5.2	5.4	5.3
Energy supply (year-end)					
Net generating capability MW	1,606	1,606	1,608	1,608	1,587
Firm purchased capability MW	531	510	531	532	472
	2,137	2,116	2,139	2,140	2,059
Net peak demand MW[1]	1,638	1,583	1,564	1,527	1,478
Btu per net KWH generated	10,663	10,673	10,675	10,818	10,789
Average fuel oil cost per Mbtu (cents)	580.5	466.4	539.3	538.5	329.7
Customer accounts (year-end)					
Residential	362,400	356,244	352,132	347,316	342,957
Commercial	52,659	51,386	50,974	50,434	49,549
Large light and power	549	551	542	547	550
Other	1,385	1,374	1,344	1,342	1,299
	416,993	409,555	404,992	399,639	394,355
Electric revenues (thousands)					
Residential	$ 471,697	$ 426,291	$ 425,287	$ 421,129	$ 356,631
Commercial	474,017	425,595	436,751	422,977	345,808
Large light and power	434,319	389,312	409,977	414,067	336,434
Other	7,758	7,028	7,349	7,487	6,454
	$ 1,387,791	$ 1,248,226	$ 1,279,364	$ 1,265,660	$ 1,045,327
Average revenue per KWH sold (cents)					
Residential	16.40	15.34	15.96	16.03	13.98
Commercial	14.96	13.85	14.48	14.47	12.43
Large light and power	11.81	10.70	11.27	11.29	9.35
Other	14.26	13.26	13.98	13.84	11.80

Average revenue per KWH sold	14.20	13.08	13.65	13.65	11.63
Residential statistics					
Average annual use per customer account (KWH)	8,004	7,840	7,620	7,618	7,490
Average annual revenue per customer account	$ 1,313	$ 1,203	$ 1,216	$ 1,221	$ 1,047
Average number of customer accounts	359,288	354,419	349,782	344,882	340,528

[1] Sum of the net peak demands on all islands served, noncoincident and nonintegrated.

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Generation statistics

The following table contains certain generation statistics as of December 31, 2003 and for the year ended December 31, 2003. The capability available for operation at any given time may be more or less than the generating capability shown because of capability restrictions or temporary outages for inspection, maintenance, repairs or unforeseen circumstances.

	Island of Oahu- HECO	Island of Maui- MECO	Island of Lanai- MECO	Island of Molokai- MECO	Island of Hawaii- HELCO	Total
Net generating and firm purchased capability (MW) at December 31, 2003[1]						
Conventional oil-fired steam units	1,106.8	35.9			62.2	1,204.9
Diesel		94.9	10.3	9.6	39.0	153.8
Combustion turbines (peaking units)	101.8					101.8
Combustion turbines		41.6		2.2	44.9	88.7
Combined-cycle unit		56.8				56.8
Firm contract power[2]	406.0	16.0			109.0	531.0
	1,614.6	245.2	10.3	11.8	255.1	2,137.0
Net peak demand (MW)	1,242.0	197.7	5.0	6.5	186.7	1,637.9[3]
Reserve margin	30.5%	24.0%	105.8%	82.2%	36.6%	30.9%
Annual load factor	72.7%	70.2%	67.6%	69.6%	69.8%	72.0%[3]
KWH net generated and purchased (millions)	7,909.0	1,215.4	29.6	39.6	1,140.9	10,334.5

1 HECO units at normal ratings; MECO and HELCO units at reserve ratings.

2 Nonutility generators HECO: 180 MW (Kalaeloa Partners, L.P., oil-fired), 180 MW (AES Hawaii, Inc., coal-fired) and 46 MW (H-Power, refuse-fired); MECO: 16 MW (Hawaiian Commercial & Sugar Company, primarily bagasse-fired); HELCO: 27 MW (Puna Geothermal Venture, geothermal), 22 MW (Hilo Coast Power Company, coal-fired) and 60 MW (Hamakua Energy Partners, L.P., oil-fired).

3 Noncoincident and nonintegrated.

Generating reliability

HECO, HELCO and MECO have isolated electrical systems that are not interconnected to each other or to any other electrical grid. HECO serves the island of Oahu and HELCO serves the island of Hawaii. MECO has three separate electrical systems one each on the islands of Maui, Molokai and Lanai.

Because each island system cannot rely upon backup generation from neighboring utilities, HECO, HELCO and MECO each maintain a higher level of reserve generation than is typically carried by interconnected mainland utilities, which are able to share reserve capacity. These higher levels of reserve margins are required to meet peak electric demands, to provide for scheduled maintenance of generating units (including the units operated by independent power producers (IPPs) relied upon for firm capacity) and to allow for the forced outage of the largest generating unit in the system. Although the planning for, and installation of, adequate levels of reserve generation have contributed to the achievement of generally high levels of system reliability, service interruptions do occur from time to time as a result of unforeseen circumstances. For example, HECO implemented load shedding and temporarily shut off power to a significant number of customers on one occasion in 2002, due to unplanned generating unit outages. Load shedding is a predetermined plan that prevents overloading and possible major damage to generating units and potentially a much larger power outage.

HELCO s management is concerned about the possibility of power interruptions as a result of the current operating status of various IPPs supplying power to it and the condition and performance of aging generators on the

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HELCO system that were intended to be operated less frequently once CT-4 and CT-5 were installed at HELCO s Keahole power plant. (See discussion in Note 11 to HECO s Consolidated Financial Statements). A significant number of HELCO s customers experienced rolling blackouts on two occasions in 2002 due to unplanned generating unit outages.

Integrated resource planning and requirements for additional generating capacity

As a result of a proceeding initiated in 1990, the Public Utilities Commission of the State of Hawaii (PUC) issued an order in 1992 requiring the energy utilities in Hawaii to develop integrated resource plans (IRPs). The goal of integrated resource planning is the identification of demand- and supply-side resources and the integration of these resources for meeting near- and long-term consumer energy needs in an efficient and reliable manner at the lowest reasonable cost. In its 1992 order, the PUC adopted a framework, which established both the process and the guidelines for developing IRPs. The PUC s framework directs that each plan cover a 20-year planning horizon with a five-year program implementation schedule and states that the planning cycle will be repeated every three years. Under the framework, the PUC may approve, reject or require modifications of the utilities IRPs.

The framework also states that utilities are entitled to recover all appropriate and reasonable integrated resource planning and implementation costs, including the costs of planning and implementing DSM programs. Under appropriate circumstances, the utilities have been allowed in the past to recover lost margins resulting from DSM programs and earn shareholder incentives. The PUC has approved IRP cost recovery provisions for HECO, MECO and HELCO. Pursuant to the cost recovery provisions, the electric utilities have been allowed to recover through a surcharge the costs for approved DSM programs (including DSM program lost margins and shareholder incentives), and other incremental IRP costs incurred by the utilities and approved by the PUC, to the extent the costs are not included in their base rates.

In October 2001, HECO and the Consumer Advocate finalized agreements, which were approved by the PUC in November 2001, under which HECO s three commercial and industrial DSM programs and two residential DSM programs would be continued until HECO s next rate case, which, under the agreements, HECO committed to file using a 2003 or 2004 test year and following the PUC s rules for determining the test year. In August 2003, HECO and the Consumer Advocate agreed, and the PUC approved, a delay in the filing of HECO s next rate case, with the result that the rate case would be filed using a 2005 test year. Under the agreements, HECO will cap the recovery of lost margins and shareholder incentives if such recovery would cause HECO to exceed its current authorized return on rate base. HECO also agreed it will not pursue the continuation of lost margins recovery and shareholder incentives through a surcharge mechanism in future rate cases. Consistent with the HECO agreements, in October 2001, MECO and HELCO reached agreements with the Consumer Advocate and filed requests to continue their four existing DSM programs. In November 2001, the PUC issued orders (one of which was later amended) that, subject to certain reporting requirements and other conditions, allowed MECO and HELCO to continue temporarily their respective four existing energy efficiency DSM programs. See Other regulatory matters Demand-side management programs agreements with the Consumer Advocate at page 55 in HECO s MD&A. All of the electric utilities existing DSM programs are energy efficiency programs designed to reduce the consumption of electricity.

In August 2000, pursuant to a stipulation filed by the electric utilities and the parties in the IRP cost proceedings, the PUC issued an order allowing the electric utilities to begin recovering the 1995 through 1999 incremental IRP costs, subject to refund with interest, pending the PUC s final decision and order (D&O) approving recovery of each respective year s incremental IRP costs. Procedural schedules for the IRP cost proceedings have been established with respect to the 2000-2003 IRP costs, such that the electric utilities can begin recovering incremental IRP costs in the month after the filing of the actual costs incurred for the year, subject to refund with interest, pending the PUC s final D&O approving recovery of the costs. The Consumer Advocate has objected to the recovery of $2.5 million (before interest) of the $10.3 million of incremental IRP costs incurred during the 1995-2002 period, and the PUC s decision is pending on this matter.

The electric utilities have completed the recovery of their respective 1995 through 2001 incremental IRP costs through a surcharge on customer bills, subject to refund with interest. In addition, HECO completed the recovery of its 2002 incremental IRP costs in May 2003, subject to refund with interest. MECO is scheduled to complete the recovery of its 2002 incremental IRP costs by May 2004. As of December 31, 2003, the amount of revenues the electric utilities recorded for IRP cost recoveries, subject to refund with interest, amounted to $17 million. HECO

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and MECO expect to begin recovering their incremental 2003 IRP costs, subject to refund with interest pending a final D&O, following the filing of actual 2003 costs (which is expected to occur in late March or early April 2004).

In early 2001, the PUC issued its final D&O in the HELCO 2000 test year rate case, in which the PUC concluded that it is appropriate for HELCO to recover its IRP costs through base rates (and included an estimated amount for such costs in HELCO s test year revenue requirements) and to discontinue recovery of incremental IRP costs through the separate surcharge. HELCO recovered its incremental IRP costs incurred in 2000, which were incurred prior to the final D&O in its rate case, through its surcharge. HELCO s IRP costs incurred for 2001 and future years are recovered through HELCO s base rates. HELCO will continue to recover its DSM program costs, lost margins and shareholder incentives approved by the PUC in a separate surcharge.

The utilities have characterized their proposed IRPs as planning strategies, rather than fixed courses of action, and the resources ultimately added to their systems may differ from those included in their 20-year plans. Under the IRP framework, the utilities are required to submit annual evaluations of their plans (including a revised five-year program implementation schedule) and to submit new plans on a three-year cycle, subject to changes approved by the PUC. Prior to proceeding with the DSM programs, separate PUC approval proceedings must be completed, in which the PUC further reviews the details of the proposed programs and the utilities proposals for the recovery of DSM program expenditures, lost margins and shareholder incentives.

HECO s IRP. HECO filed its second IRP with the PUC in January 1998 and updated the status of its DSM and Supply Side Action Plans in July 1999. In January 2001, the parties to the proceeding filed a stipulation for PUC approval to expedite the proceeding and the PUC approved the stipulation, closed the docket and ordered HECO to submit its IRP annual evaluation report and program implementation schedule by October 2002 (subsequently extended to December 2002) and its third IRP by October 2005, as stipulated. The PUC also ordered HECO to immediately notify it in writing if HECO requires additional generation prior to the 2009 time frame.

In December 2002, HECO filed with the PUC its IRP evaluation report, updating the second IRP to reflect the latest sales and fuel forecasts and updated key planning assumptions.

On the supply side, HECO s updated second IRP focused on the planning for the next generating unit addition in the 2009 time frame a 107 MW simple-cycle combustion turbine. The updated second IRP also includes plans to add a second 107 MW simple-cycle combustion turbine in 2015, and in 2016, a conversion unit 105 MW steam turbine to create a dual-train combined-cycle unit. However, the report notes there is flexibility to allow HECO to defer the need for the second and third generating units should alternative generation technologies advance to where they are an economically and technically feasible substitutes for conventional generation. In addition, pursuant to HECO s generation asset management program, all existing generating units are currently planned to be operated (future environmental considerations permitting) beyond the 20-year IRP planning period (1998-2017).

On the demand side, in November 2001, the PUC issued two D&Os allowing HECO to temporarily continue its five energy efficiency DSM programs until its next rate case. The five energy efficiency DSM programs are designed to reduce the rate of increase in Oahu s energy use, defer construction of new generating units, minimize the state s use of oil, and achieve savings for utility customers who participate in the programs. The energy efficiency DSM programs include incentives for customers to install efficient lighting, refrigeration, water-heating and air-conditioning equipment and industrial motors. HECO s updated second IRP includes two load management programs scheduled for implementation in 2004 (i.e., a Residential Direct Load Control Program and a Commercial and Industrial Direct Load Control Program). HECO filed applications with the PUC requesting approval of these two load management programs in June and December 2003, respectively.

In September 2003, the PUC opened a docket to commence HECO s third IRP, which HECO expects to file by March 2005 and expects will require multiple solutions to meet Oahu s future energy needs, including renewable energy resources, energy efficiency, conservation, technology (such as CHP) and central station generation. Given the lead times needed for permitting and regulatory approvals, in October 2003, HECO submitted a covered source permit application with the DOH for a 107 MW simple cycle combustion turbine in Campbell Industrial Park. The application specifies that the unit would use diesel fuel oil or naphtha, with the ability to convert to a bio-fuel, like ethanol or bio-diesel, when it becomes commercially practicable.

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MECO s IRP. MECO filed its second IRP with the PUC in May 2000. A stipulated prehearing order was approved by the PUC in October 2000. The parties filed individual Statements of Position in May 2001. In February 2004, the parties to the proceeding filed a stipulation for PUC approval to expedite the proceeding, close the docket, and establish a schedule for MECO s next IRP annual evaluation report and program implementation schedule and its next IRP. The stipulation provided that MECO would submit IRP evaluation reports and program implementation schedules by April 2004 and April 2005 and its next (third) IRP by October 2006. The PUC s decision on the stipulation is pending.

MECO s second IRP identified changes in key forecasts and assumptions since the development of MECO s initial IRP. On the supply side, MECO s second IRP focused on the planning for the installation of approximately 150 MW of additional generation through the year 2020 on the island of Maui, including 38 MW of generation at its Maalaea power plant site in increments from 2000-2005, 100 MW at its new Waena site in increments from 2007-2018, beginning with a 20 MW combustion turbine in 2007, and 10 MW from the acquisition of a wind resource in 2003 (currently, MECO expects to receive 20 MW of wind energy in 2006). Approximately 4 MW of additional generation through the year 2020 is planned for each of the islands of Lanai and Molokai. MECO completed the installation of a 20 MW increment (the second) at Maalaea in September 2000, and the final increment of 18 MW, which was originally expected to be installed in 2005, is currently expected to be installed in September 2006 (assuming receipt in early 2004 of the necessary air permit, for which an application was submitted in December 2001).

On the demand side, in November 2001 the PUC issued a D&O allowing MECO to continue temporarily its four existing energy efficiency DSM programs, which are similar in design to HECO s programs. MECO s IRP included plans for a new energy efficiency DSM program and two new load management DSM programs. MECO does not plan to proceed with a new energy efficiency DSM program at this time, and MECO is in the process of evaluating the load management DSM programs, and will determine at a later date the need for and timing of filing load management DSM program applications.

HELCO s IRP. In September 1998, HELCO filed with the PUC its second IRP, which was updated in March 1999 and revised in June 1999. A schedule for the proceeding was approved by the PUC, and the parties to the proceeding completed two rounds of discovery. In January 2004, the parties to the proceeding filed a stipulation for PUC approval to expedite the proceeding and in February 2004 the PUC approved the stipulation, closed the docket and ordered HELCO to submit its IRP annual evaluation report by the end of March 2004 and its next IRP by October 2005, as stipulated. The PUC also ordered HELCO to immediately notify it in writing should circumstances change pertaining to, among other things, HELCO s supply-side resources and load and sales forecast. The PUC subsequently opened a docket to commence HELCO s third IRP.

The second IRP identified changes in key forecasts and assumptions since the development of HELCO s initial IRP. On the supply side, HELCO s second IRP focused on the planning for generating unit additions after near-term additions. Due to delays in adding new generation, the near-term additions proposed in HELCO s second IRP included installing two 20 MW combustion turbines (CTs) at its Keahole power plant site and proceeding in parallel with a power purchase agreement (PPA) with Hamakua Energy Partners, L.P. (Hamakua Partners, formerly Encogen Hawaii, L.P.) for a 60 MW (net) dual-train combined-cycle (DTCC) facility.

The Hamakua Partners PPA was approved in 1999 and its DTCC facility was completed in December 2000. (See the discussion of HELCO power purchase agreements in Nonutility generation.) The two Keahole CTs, CT-4 and CT-5, which were the first two phases of a planned 56 MW (net) DTCC unit, have been delayed, but are now expected to be fully operational by December 31, 2004. (See HELCO power situation in Note 11 to HECO s Consolidated Financial Statements.) A PPA with Hilo Coast Power Company (HCPC) for 18 MW of firm capacity terminated at the end of 1999, but as a result of the delays in adding new generation, HELCO has been purchasing 22 MW of firm capacity from HCPC s coal-fired facility under a restated and amended PPA, the term of which runs through 2004, but automatically extends for one-year periods thereafter, unless terminated prior to an extension period by either party. HELCO also has deferred the retirements of some of its older generating units. After CT-4 and CT-5 are installed, HELCO s current plans are to install a 16 MW steam turbine, ST-7, in 2009 or earlier pending approval of land use re-classification, zoning approval and obtaining all the necessary permits and approvals to complete the DTCC unit. After the installation of ST-7, the target date for the next firm capacity

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addition is the 2017 timeframe. The timing of the need for additional new generation may change, however, based on factors such as the condition of the units whose retirements have been deferred, and the status of the nonutility generators providing firm capacity, including Puna Geothermal Venture (PGV) and HCPC. (See the discussion of HELCO power purchase agreements in Nonutility generation.)

On the demand side, in December 2001 the PUC issued a D&O allowing HELCO to continue temporarily its four existing energy efficiency DSM programs, which are similar in design to HECO s programs.

New capital projects

The capital projects of the electric utilities may be subject to various approval and permitting processes, including obtaining PUC approval of the project, air permits from the Department of Health of the State of Hawaii (DOH) and/or the U.S. Environmental Protection Agency (EPA) and land use permits from the Hawaii Board of Land and Natural Resources (BLNR). Difficulties in obtaining, or the inability to obtain, the necessary approvals or permits could result in project delays, increased project costs and/or project abandonments. Extensive project delays and significantly increased project costs could result in a portion of the project costs being excluded from rates. If a project is abandoned, the project costs are generally written-off to expense, unless the PUC determines that all or part of the costs may be deferred for later recovery in rates.

In addition to HELCO s Keahole power plant expansion project and HECO s East Oahu Transmission Project (see discussion in Note 11 to HECO s Consolidated Financial Statements), the Company has two other significant capital projects currently in progress. In 2003, construction commenced on a $37 million project for an underground fuel pipeline that will transport fuel from an oil refinery at Campbell Industrial Park to HECO s Waiau power plant. This project is scheduled for completion in late 2004. Also in 2003, planning continued on HECO s $23 million project to construct a New Dispatch Center which will house a modernized Energy Management System, and which will be integrated with new Outage Management and Customer Information systems. The New Dispatch Center project is expected to be completed in 2007, with the Energy Management System operational in 2006.

Nonutility generation

The Company has supported state and federal energy policies which encourage the development of alternate energy sources that reduce the use of fuel oil. The Company s alternate energy sources range from wind, geothermal and hydroelectric power, to energy produced by the burning of bagasse (sugarcane waste) and municipal waste and coal.

HECO PPAs. HECO currently has three major PPAs. In March 1988, HECO entered into a PPA with AES Barbers Point, Inc. (now known as AES Hawaii, Inc. (AES Hawaii)), a Hawaii-based, indirect subsidiary of The AES Corporation. The agreement with AES Hawaii, as amended in August 1989, provides that, for a period of 30 years beginning September 1992, HECO will purchase 180 MW of firm capacity. The AES Hawaii 180 MW coal-fired cogeneration plant, which became operational in September 1992, utilizes a clean coal technology. The facility is designed to sell sufficient steam to be a Qualifying Facility (QF) under the Public Utility Regulatory Policies Act of 1978 (PURPA). See discussion of a lawsuit against The AES Corporation, AES Hawaii, HECO and HEI in Note 11 to HECO s Consolidated Financial Statements. Under the amended PPA, AES Hawaii must obtain certain consents from HECO prior to entering into any arrangement to refinance the facility. In the second quarter of 2003, HECO and AES Hawaii reached agreement on the terms upon which HECO would consent to a proposed refinancing. Under the agreement, which was contingent on obtaining certain PUC approvals and completion of the refinancing, HECO received consideration for its consent, primarily in the form of a PPA amendment that reduces the cost of firm capacity supplied to HECO pursuant to the PPA, retroactive to June 1, 2003. The benefit of the firm capacity cost reduction, totaling approximately $2.9 million annually for the remaining term of the PPA, is being passed on to ratepayers through a reduction in rates. AES Hawaii also has granted HECO an option, subject to certain conditions, to acquire an interest in portions of the AES Hawaii facility site that are not needed for the existing plant operations, and which potentially could be used for the development of another coal-fired facility. On July 1, 2003, the PUC issued a D&O approving the PPA amendment and the establishment of a rate adjustment (lowering rates) on short notice, and, on July 9, 2003, the PUC issued a D&O clarifying its July 1, 2003 D&O. On July 31, 2003, the proposed refinancing was completed and capacity payments were reduced, retroactive to June 1, 2003.

In October 1988, HECO entered into an agreement with Kalaeloa Partners, L.P. (Kalaeloa), a limited partnership whose sole general partner was an indirect, wholly-owned subsidiary of ASEA Brown Boveri, Inc. (ABB), which has guaranteed certain of Kalaeloa s obligations and, through affiliates, contracted to design, build, operate and maintain the facility. The agreement with Kalaeloa, as amended, provides that HECO will purchase 180 MW of firm capacity for a period of 25 years beginning in May 1991. The Kalaeloa facility, which was completed in the second quarter of 1991, is a combined-cycle operation, consisting of two oil-fired combustion turbines burning low sulfur fuel oil (LSFO) and a steam turbine that utilizes waste heat from the combustion turbines. The facility is designed to sell sufficient steam to be a QF. As of February 28, 1997, the ownership of Kalaeloa was restructured so that 1% was owned by the ABB subsidiary as the general partner and 99% was owned by Kalaeloa Investment Partners (KIP) as the limited partner. KIP is a limited partnership comprised of PSEG Hawaiian Management, Inc. and PSEG Hawaiian Investment, Inc. (nonregulated affiliates of Public Service Enterprise Group Incorporated) and Harbert Power Corporation. Subsequently, HECO consented to, and the PUC approved of, the transfer of the general partner partnership interest from the ABB subsidiary to an entity affiliated with the owners of KIP. During the second quarter of 2003, Kalaeloa approached HECO with plans to upgrade the combustion turbines (the M upgrade) by installing new parts designed to improve their efficiency and output. The upgraded combustion turbines would allow Kalaeloa to increase the capacity of the facility by approximately 20 MW. Under the agreement, Kalaeloa may not make any modifications to the facility that would either increase or decrease the generating capacity of the facility without the prior approval of HECO, except as required by law or regulation. The agreement also provides that HECO shall not be obligated to approve a change in facility capacity if such change would adversely impact HECO system reliability or result in an increased cost of power to HECO from the facility. On December 31, 2003, HECO and Kalaeloa entered into a Consent and Agreement (Consent) in which HECO consented to the M upgrade. The Consent provides that neither the M upgrade nor HECO s consent to the M upgrade shall obligate HECO to accept additional energy made available as a result of the M upgrade, or to enter into negotiations to accept any change in the firm capacity of the facility, and shall not affect the rights of the parties under the section of the agreement related to an increase in firm capacity.

HECO also entered into a PPA in March 1986 and a firm capacity amendment in April 1991 with the City and County of Honolulu with respect to a refuse-fired plant (H-POWER). The H-POWER facility began to provide firm energy in 1990 and currently supplies HECO with 46 MW of firm capacity. The firm capacity amendment provides that HECO will purchase firm capacity until mid-2015.

HECO purchases energy on an as-available basis from two nonutility generators, which are diesel-fired qualifying cogeneration facilities at the two oil refineries (10 MW and 18 MW) on Oahu. HECO previously purchased energy on an as-available basis from an approximately 3 MW combustion turbine fired by methane gas from a landfill. In March 2002, the combustion turbine suffered a major failure. In July 2002, the owner of the facility requested that HECO terminate the PPA and HECO agreed.

The PUC has approved and allowed rate recovery for the firm capacity and purchased energy costs related to HECO s three major PPAs that provide a total of 406 MW of firm capacity, representing 25% of HECO s total net generating and firm purchased capacity on the island of Oahu as of December 31, 2003. The PUC also has approved and allowed rate recovery for the purchased energy costs related to HECO s as-available energy PPAs.

MECO and HELCO PPAs. As of December 31, 2003, MECO and HELCO had PPAs for 16 MW (includes 4 MW of system protection) and 109 MW of currently available firm capacity, respectively.

MECO has a PPA with Hawaiian Commercial & Sugar Company (HC&S) for 16 MW of firm capacity. The HC&S generating units primarily burn bagasse (sugar cane waste) along with secondary fuels of oil or coal. In March 1998, an HC&S unit failed and HC&S lost 10 MW of generating capacity. HC&S replaced the unit and put it into operation in the second quarter of 2000. HC&S, however, has had some difficulties in meeting its contractual obligations to MECO for the years 2000 through 2003 due to operational constraints that led to several claims of force majeure by HC&S. The constraints have been primarily due to an extended drought condition on Maui that impacts HC&S s irrigation pumping load for its sugar cane operations. There has also been a higher than normal reduction in energy produced due to other equipment outages. On January 23, 2001, MECO rescinded a December 27, 1999 PPA termination notice that it had sent to HC&S and agreed with HC&S that neither party would issue to the other a notice of termination prior to the end of 2002. On June 14, 2002, MECO and HC&S agreed that neither party will give written notice of termination under the terms of the PPA, such that the PPA terminates prior to December 31, 2007. As a result, the PPA remains in force and effect through December 31, 2007, and from year to year thereafter, subject to termination on or after December 31, 2007 on not less than two years prior written notice by either party.

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HELCO has a 35-year PPA with Puna Geothermal Venture (PGV) for 30 MW of firm capacity from its geothermal steam facility expiring on December 31, 2027. PGV s output was reduced to 6 MW from April 2002 to March 2003. The loss of generation was attributed to blockage of a source well due to a failed liner 5,000 feet below the earth s surface and decreasing steam quality emanating from one of PGV s source wells. PGV completed drilling an additional source well in February 2003, and converted the blocked source well into an injection well in early March 2003. The new injection well was tested and PGV s capacity is currently between 25 to 28 MW. PGV obtained a permit from the DOH for the new injection well in March 2003. Without the new injection well, PGV was able to produce only about 10 to 11 MW due to the high moisture content of the steam from the new source well. PGV is assessing whether to drill another source well or to install new generation equipment designed to utilize the lower quality steam. While PGV indicates it is evaluating its options to enable it to restore its 30 MW commitment to HELCO as soon as possible, HELCO cannot predict when PGV will be able to meet its contractual commitment. HELCO s PPA with PGV provides for annual availability sanctions against PGV if PGV does not provide up to the contracted 30 MW of capacity. In the first quarter ending March 31, 2003, HELCO recorded $0.7 million lower purchased power expense from PGV for availability sanctions for not meeting contracted capacity for 2002. In addition, since PGV had not yet restored its 30 MW commitment to HELCO by December 31, 2003, availability sanctions for 2003, of approximately $0.2 million, will be assessed against PGV in 2004. Constellation Energy, parent company of PGV, has solicited preliminary indications of interest from potential bidders in order to explore the possibility of putting PGV up for sale. HELCO is not aware if and when a sale will be completed.

On October 4, 1999, HELCO entered into a PPA with HCPC effective January 1, 2000 through December 31, 2004, subject to early termination by HELCO after two years, whereby HELCO purchases 22 MW of firm capacity from HCPC s coal-fired facility. The PPA extends for one-year periods thereafter, unless terminated prior to an extension period. The PPA was amended on November 5, 1999, which extended the November 30, 1999 deadline for obtaining PUC approval of the PPA. The PUC approved the PPA, as amended, on December 7, 1999.

In October 1997, HELCO entered into an agreement with Encogen, a limited partnership whose general partners at the time were wholly-owned special-purpose subsidiaries of Enserch and Jones Capital Corporation. Enserch Corporation and J.A. Jones, Inc. (Jones), the parent companies of Enserch and Jones Capital Corporation, respectively, guaranteed certain of Encogen s obligations. The agreement provides that HELCO will purchase up to 60 MW (net) of firm capacity for a period of 30 years. The DTCC facility, which primarily burns naphtha, consists of two oil-fired combustion turbines and a steam turbine that utilizes waste heat from the combustion turbines. The PUC approved the agreement on July 14, 1999. On November 8, 1999, HELCO entered into a PPA Novation with Encogen and Hamakua Partners, which recognizes the transfer of the obligations of Encogen under the PPA to Hamakua Partners. Hamakua Partners was formed as a result of the sale of the general partner and limited partner partnership interests of Enserch to entities affiliated with TECO Energy Inc., which is a Florida-based energy company and parent company of Tampa Electric Company, a regulated electric utility. TECO Energy Inc. has replaced the guarantee of Enserch Corporation of certain of Hamakua Partners obligations. On August 12, 2000, Hamakua Partners began providing HELCO with firm capacity from the first phase of a two-phase construction completion schedule. On December 31, 2000, Hamakua Partners began providing firm capacity from the entire facility, following completion of the second phase of construction. In June 2001, Hamakua Partners demonstrated 60 MW of output from the facility. Subsequently, the output deteriorated due to technical problems in the steam turbine. Hamakua Partners has since resolved its nozzle plugging problems, but due to high nitrogen oxide emissions and high steam turbine vibration problems, the output had been limited to 55-57 MW in early 2003. Hamakua Partners requested maintenance outages to correct the problems and returned to providing HELCO with 60 MW later in 2003. In September 2003, Jones filed for reorganization in bankruptcy in North Carolina. Jones is the parent company of the managing general partner and a limited partner of Hamakua Partners, and is one of the two co-guarantors of the Hamakua Partners project. Jones has stated that the bankruptcy filing will have no impact on Hamakua Partners ability to meet its contractual commitments. Jones has been attempting to sell its interest in Hamakua Partners under the supervision of the bankruptcy court. An auction among the qualified bidders was held on February 23, 2004 and the court held a hearing on February 24, 2004. By Order dated March 2, 2004, the court approved a motion to sell substantially all of the assets of Jones to United States Power Fund L. P. (USPF) and directed the appropriate parties to implement the sale. HELCO will be working with Jones and USPF to evaluate the terms and conditions of the sale and any implications of the sale on the PPA with Hamakua Partners.

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HELCO purchases energy on an as-available basis from a number of nonutility generators. The largest include an 11 MW run-of-the-river hydroelectric facility and a 7 MW wind facility. Wailuku River Hydroelectric L.P., the owner of the hydroelectric facility, has an existing contract to provide HELCO with as-available power through May 2023. Apollo Energy Corporation (Apollo), the owner of the wind facility, has an existing contract to provide HELCO with as-available windpower through June 29, 2002 (and extending thereafter until terminated by HELCO or Apollo). Apollo filed a petition for hearing with the PUC on April 28, 2000, alleging that it had unsuccessfully attempted to negotiate a new power purchase agreement with HELCO. Apollo had offered to repower its existing 7 MW facility by the end of 2000 and to install additional wind turbines, up to a total allowed capacity of 15 MW, by the end of 2001. The parties agreed to limit to four issues the matters being presented to the PUC for guidance: whether Apollo is entitled to capacity payments; whether Apollo is entitled to a minimum purchase rate; whether certain performance standards should apply; and whether HELCO s proposed dispute resolution provision should apply. A hearing on these issues was held on October 3 to 5, 2000. On May 30, 2001, the PUC issued a D&O in which it ordered HELCO and Apollo to continue to negotiate a PPA, consistent with the terms of the D&O, and to submit by August 13, 2001 either a finalized PPA or status reports informing the PUC of matters preventing finalization of a PPA. HELCO and Apollo were unable to agree to a PPA by August 13, 2001, and each submitted a status report. The parties continued to negotiate in 2002 and 2003, but final agreement has not been reached on certain technical and interconnection cost issues.

On August 17, 1999, HELCO entered into a PPA with Kahua Power Partners LLC (KPP) for the purchase of as-available energy from KPP s proposed 10 MW windfarm. The PPA was amended by Amendment No. 1 dated April 4, 2000. The PUC approved the PPA, as amended, on June 1, 2001. KPP did not, however, construct its windfarm. GE Wind Energy completed the acquisition of certain assets of Enron Wind Corporation in May 2002, including the proposed KPP project. On October 7, 2003, GE Wind Energy assigned the KPP PPA to Hawi Renewable Development, Inc. (HRD). On December 9, 2003, HELCO terminated the KPP PPA pursuant to HRD s notice that it does not plan to develop that wind farm, and its request that the PPA be terminated.

On January 8, 2001, HELCO entered into a PPA with HRD for the purchase of as-available energy from HRD s proposed 5 MW windfarm. An amendment to the PPA was completed on April 30, 2002. The PPA, as amended, was approved by the PUC on January 14, 2003. Due to transmission line limitations, the output of HRD would have been limited to 3 MW if the KPP windfarm were connected to the electric grid through the same 34.5 kilovolt (kV) line.

On December 30, 2003, HELCO and Hawi Renewable Development, LLC (HRD LLC) entered into a PPA under which HRD LLC would sell energy from an expanded wind farm (approximately 10.6 MW) at HRD s 5 MW wind farm site (which can accommodate the expanded wind farm). Since the KPP wind farm would not be built, it is anticipated that the output of the 10.6 MW wind farm would not be limited by another wind farm on the 34.5 kV line (although the output of the 10.6 MW wind farm may be limited on occasion due to other factors). PUC approval of the PPA is pending.

The PUC has approved and allowed rate recovery for the firm capacity and purchased energy costs for MECO s and HELCO s approved firm capacity and as-available energy PPAs.

Fuel oil usage and supply

The rate schedules of the Company s electric utility subsidiaries include energy cost adjustment (ECA) clauses under which electric rates (and consequently the revenues of the electric utility subsidiaries generally) are adjusted for changes in the weighted-average price paid for fuel oil and certain components of purchased power, and the relative amounts of company-generated power and purchased power. See discussion below under Rates, and Regulation of electric utility rates and Electric utility revenues in HECO s MD&A.

HECO s steam power plants burn LSFO. HECO s combustion turbine peaking units burn No. 2 diesel fuel (diesel). MECO s and HELCO s steam power plants burn medium sulfur fuel oil (MSFO) and their combustion turbine and diesel engine generating units burn diesel. The LSFO supplied to HECO is primarily derived from Indonesian and other Far East crude oils processed in Hawaii refineries. The MSFO supplied to MECO and HELCO is derived from U.S. domestic crude oil processed in Hawaii refineries.

In December 1997, HECO executed contracts for the purchase of LSFO and the use of certain fuel distribution facilities with Chevron Products Company (Chevron) and BHP Petroleum Americas Refining Inc. (BHP). Subsequently, Tesoro Hawaii Corp. (Tesoro) acquired BHP and assumed all rights and obligations under the contract between HECO and BHP. The Chevron and BHP (now Tesoro) fuel supply and facilities operations contracts have a term of seven years commencing January 1, 1998. The PUC approved the contracts and permits the inclusion of

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costs incurred under these contracts in HECO s ECA clauses. HECO pays market-related prices for fuel supplies purchased under these agreements. HECO is currently negotiating with its fuel suppliers for new long-term LSFO supply agreements to replace those expiring at the end of 2004.

HECO, MECO and HELCO executed joint fuel supply contracts with Chevron and BHP (now Tesoro) for the purchase of diesel and MSFO supplies and for the use of certain petroleum distribution facilities for a period of seven years commencing January 1, 1998. The PUC approved these contracts and permits the electric utilities to include fuel costs incurred under these contracts in their respective ECA clauses. The electric utilities pay market-related prices for diesel and MSFO supplied under these agreements. HECO, HELCO and MECO are currently negotiating with its fuel suppliers for new long-term contracts for the supply of diesel and MSFO to replace those expiring at the end of 2004.

The diesel supplies acquired by the Lanai Division of MECO are purchased under a contract with a local petroleum wholesaler, Lanai Oil Co., Inc. On March 1, 2000, the PUC approved an amended contract with a term extending through December 31, 2001, and further extending through December 31, 2003 unless terminated as of the end of 2001. This agreement has been extended through December 31, 2004 and the utility anticipates that it will again continue for another year, through December 31, 2005, as provided by a provision in the existing contract.

See the fuel oil commitments information set forth in the Fuel contracts section in Note 11 to HECO s Consolidated Financial Statements.

The following table sets forth the average cost of fuel oil used by HECO, MECO and HELCO to generate electricity in the years 2003, 2002 and 2001:

	HECO		MECO		HELCO		Consolidated	
	$/Barrel	¢/MBtu	$/Barrel	¢/MBtu	$/Barrel	¢/MBtu	$/Barrel	¢/MBtu
2003	35.49	561.3	39.52	662.1	34.96	566.4	36.23	580.5
2002	27.95	442.3	32.78	548.5	30.58	496.7	29.10	466.4
2001	31.90	508.3	40.00	670.0	31.96	514.8	33.49	539.3

The average per-unit cost of fuel oil consumed to generate electricity for HECO, MECO and HELCO reflects a different volume mix of fuel types and grades. In 2003, over 99% of HECO s generation fuel consumption consisted of LSFO. The balance of HECO s fuel consumption was diesel. Diesel made up approximately 75% of MECO s and 29% of HELCO s fuel consumption. MSFO made up the remainder of the fuel consumption of MECO and HELCO. In general, MSFO is the least costly fuel, diesel is the most expensive fuel and the price of LSFO falls between the two on a per-barrel basis. During 2003, the prices of LSFO, MSFO and diesel remained at or above the high levels reached at the end of 2002 reflecting geopolitical uncertainty with the invasion of Iraq and tight U.S. crude oil and petroleum inventories. Thus the annual prices paid by the utilities for LSFO, MSFO and diesel averaged approximately 25%, 13% and 21%, respectively, above the average price for that grade of fuel in 2002. Even though the average price per barrel was lower in 2002 than 2001, the prices of LSFO, MSFO and diesel trended higher during 2002 from the level prevailing at the end of 2001. The utilities 2002 price for LSFO and diesel averaged approximately 7% and 16%, respectively, below the average price in 2001, while the price for MSFO averaged approximately 3% above the average price in 2001.

In December 2000, HELCO and MECO executed contracts of private carriage with Hawaiian Interisland Towing, Inc. (HITI) for the shipment of MSFO and diesel supplies from their fuel suppliers facilities on Oahu to storage locations on the islands of Hawaii and Maui, respectively, commencing January 1, 2002. These contracts were the result of a competitive bidding process and provide for the employment of a new double-hull bulk petroleum barge at freight rates approximately the same as prevailed under predecessor transportation contracts with HITI. The new barge entered utility service in March 2002. The contracts are for an initial term of 5 years with options for three additional 5-year extensions. On December 10, 2001, the PUC approved these contracts and issued a final order that permits HELCO and MECO to include the fuel transportation and related costs incurred under the provisions of these agreements in their respective ECA clauses.

HITI never takes title to the fuel oil or diesel fuel, but does have custody and control while the fuel is in transit from Oahu. If there were an oil spill in transit, HITI is contractually obligated to indemnify HELCO and/or MECO. HITI has liability insurance coverage for oil spill related damage of $1 billion. State law provides a cap of $700 million on liability for releases of heavy fuel oil transported interisland by tank barge. HELCO and/or MECO may be responsible for any clean-up and/or fines that HITI or its insurance carrier does not cover.

The prices that HECO, MECO and HELCO pay for purchased energy from nonutility generators are generally linked to the price of oil. The AES Hawaii energy prices vary primarily with an inflation indicator. The energy prices for Kalaeloa, which purchases LSFO from Tesoro, vary primarily with world LSFO prices. The H-POWER, HC&S, PGV and HCPC energy prices are based on the electric utilities respective PUC-filed short-run avoided energy cost rates (which vary with their respective composite fuel costs), subject to minimum floor rates specified in their approved PPAs. The Hamakua Partners energy prices vary primarily with HELCO s diesel costs.

The Company estimates that 78% of the net energy generated and purchased by HECO and its subsidiaries in 2004 will be generated from the burning of oil. Increases in fuel oil prices are passed on to customers through the electric utility subsidiaries ECA clauses. Failure by the Company s oil suppliers to provide fuel pursuant to the supply contracts and/or substantial increases in fuel prices could adversely affect consolidated HECO s and the Company s financial condition, results of operations and/or liquidity. HECO, however, maintains an inventory of fuel oil in excess of one month s supply. HELCO and MECO maintain approximately a one month s supply of both MSFO and diesel. The PPAs with AES Hawaii and Hamakua Partners require that they maintain certain minimum fuel inventory levels.

Transmission systems

HECO has 138 kV transmission and 46 kV subtransmission lines. HELCO has 69 kV transmission and 34.5 kV subtransmission lines. MECO has 69 kV transmission and 23 kV subtransmission lines on Maui and 34.5 kV transmission lines on Molokai. Lanai has no transmission lines and uses 12 kV lines to distribute electricity. The electric utilities overhead and underground transmission and subtransmission lines, as well as their distribution lines, are uninsured because the amount of insurance available is limited and the premiums are extremely high.

Lines are added when needed to serve increased loads and/or for reliability reasons. In some design districts on Oahu, lines must be placed underground. By state law, the PUC generally must determine whether new 46 kV, 69 kV or 138 kV lines can be constructed overhead or must be placed underground. The process of acquiring permits and regulatory approvals for new lines can be contentious, time consuming (leading to project delays) and costly.

HECO system. HECO serves Oahu s electricity requirements with firm capacity (net) generating units located in West Oahu (1,027 MW); Waiau, adjacent to Pearl Harbor (481 MW); and Honolulu (107 MW). HECO s nonfirm power sources (approximately 28 MW) are located primarily in West Oahu. HECO transmits power to its service areas on Oahu through approximately 219 miles of overhead and underground 138 kV transmission lines (of which approximately 8 miles are underground) and approximately 570 miles of overhead and underground 46 kV subtransmission lines.

HECO s power sources are located primarily in West Oahu, but the bulk of HECO s system load is in the Honolulu/East Oahu area. Accordingly, HECO transmits bulk power to the Honolulu/East Oahu area over two major transmission corridors (Northern and Southern). HECO had planned to construct a part underground/part overhead 138 kilovolt (kV) transmission line from the Kamoku substation to the Pukele substation in order to close the gap between the Southern and Northern corridors and provide a third 138 kV transmission line to the Pukele substation. Construction of the proposed transmission line in its originally proposed location required the BLNR to approve a CDUP for the overhead portion of the line that would have been in conservation district lands. Several community and environmental groups opposed the project, particularly the overhead portion of the line and, in June 2002, the BLNR denied HECO s request for a CDUP.

HECO continues to believe that the proposed project (the East Oahu Transmission Project) is needed to improve the reliability of the Pukele substation, which serves approximately 16% of Oahu s electrical load, including Waikiki, and to address future potential line overloads under certain contingencies. In 2003, HECO completed its evaluation of alternative ways to accomplish the project (including using 46 kV transmission lines). As part of its evaluation, HECO conducted a community-based process to obtain public views of the alternatives. In December 2003, HECO filed an application with the PUC requesting approval to commit funds (currently estimated at $55 million) for its revised East Oahu Transmission Project. See discussion in Note 11 to HECO s Consolidated Financial Statements.

In March 2004, approximately 40,000 of HECO s customers in the Honolulu//East Oahu area, including Waikiki, lost power for forty-five minutes to one and one-half hours. The areas affected are served by the Pukele substation. One of the two transmission lines serving the Pukele substation was out for scheduled maintenance when the second

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transmission line went out of service and resulted in the power outage. Management believes that the effects of the outage could have been mitigated, and that the outage might have been prevented if the East Oahu Transmission Project had been completed.

HELCO system. HELCO serves the island of Hawaii s electricity requirements with firm capacity (net) generating units located in West Hawaii (42 MW) and East Hawaii (213 MW). HELCO s nonfirm power sources total 24 MW. HELCO transmits power to its service area on the island of Hawaii through approximately 468 miles of 69 kV overhead lines and approximately 173 miles of 34.5 kV overhead lines.

MECO system. MECO serves its electricity requirements with firm capacity (net) generating units located on the island of Maui (245 MW), Molokai (12 MW) and Lanai (10 MW). MECO has no nonfirm power sources. MECO transmits power to its service area through approximately 143 miles of 69 kV overhead lines, approximately 15 miles of 34.5 kV overhead lines, and approximately 85 miles of 23 kV overhead lines.

Rates

HECO, MECO and HELCO are subject to the regulatory jurisdiction of the PUC with respect to rates, issuance of securities, accounting and certain other matters. See Regulation and other matters Electric utility regulation.

All rate schedules of HECO and its subsidiaries contain ECA clauses as described previously. Under current law and practices, specific and separate PUC approval is not required for each rate change pursuant to automatic rate adjustment clauses previously approved by the PUC. Rate increases, other than pursuant to such automatic adjustment clauses, require the prior approval of the PUC after public and contested case hearings. PURPA requires the PUC to periodically review the ECA clauses of electric and gas utilities in the state, and such clauses, as well as the rates charged by the utilities generally, are subject to change.

See Regulation of electric utility rates, Recent rate requests and Electric utility revenues in HECO s MD&A.

Public Utilities Commission of the State of Hawaii

Carlito Caliboso has been the Chairman of the PUC since April 30, 2003. Mr. Caliboso is an attorney and was in private practice prior to his appointment. Continuing to serve on the PUC is Commissioner Wayne H. Kimura, who served as Chairman from July 2002 to April 2003 and Commissioner Janet E. Kawelo.

Most recent rate requests

See Recent rate requests in HECO s MD&A.

Maui Electric Company, Limited. In January 1998, MECO filed a request to increase rates, based on a 1999 test year, primarily to recover costs relating to the addition of generating unit M17 in late 1998. In November 1998, MECO revised its requested increase to 11.9%, or $16.4 million, in annual revenues, based on a 12.75% return on average common equity (ROACE). In April 1999, MECO received an amended final D&O from the PUC which authorized an 8.2%, or $11.3 million, increase in annual revenues, based on a 1999 test year and a 10.94% ROACE. The timing of a future MECO rate increase cannot be determined at this time.

Competition

In December 1996, the PUC instituted a proceeding to identify and examine the issues surrounding electric competition and to determine the impact of competition on the electric utility infrastructure in Hawaii. See Competition in HECO s MD&A.

Electric and magnetic fields

Research on potential adverse health effects from exposure to electric and magnetic fields (EMF) continues. To date, no definite relationship between EMF and health risks has been demonstrated. In 1996, the National Academy of Sciences examined more than 500 studies and stated that the current body of evidence does not show that exposure to EMFs presents a human-health hazard. An extensive study released in 1997 by the National Cancer Institute and the Children s Cancer Group found no evidence of increased risk for childhood leukemia from EMF. In 1999, the National Institute of Environmental Health Sciences Director s Report concluded that while EMF could not be found to be entirely safe, the evidence of a health risk was weak and did not warrant aggressive regulatory actions.

While EMF has not been established as a cause of any health condition, there were developments in 2002 and 2003. EMF was classified as a possible human carcinogen in reports from two public health organizations and in 2003, the U.K. National Radiological Protection Board (NRPB) published a consultation report that considered a precautionary approach and proposed limiting exposure to EMF. The implications of the reports and the NRPB proposals have not yet been determined.

HECO and its subsidiaries are monitoring the research and continue to participate in utility industry funded studies on EMF and, where technically feasible and economically reasonable, continue to reduce EMF in the design and installation of new transmission and distribution facilities. Management cannot predict the impact, if any, the EMF issue may have on HECO, HELCO and MECO in the future.

Legislation

See Legislation in HECO s MD&A.

Commitments and contingencies

See Certain factors that may affect future results and financial condition Other regulatory and permitting contingencies in HECO s MD&A and Note 11 to HECO s Consolidated Financial Statements for a discussion of important commitments and contingencies, including (but not limited to) HELCO s Keahole power situation, HECO s East Oahu Transmission Project, the lawsuit against The AES Corporation and the Company, and the Honolulu Harbor environmental investigation.

Bank American Savings Bank, F.S.B.

General

ASB was granted a federal savings bank charter in January 1987. Prior to that time, ASB had operated since 1925 as the Hawaii division of American Savings & Loan Association of Salt Lake City, Utah. As of December 31, 2003, ASB was the third largest financial institution in the State of Hawaii based on total assets of $6.5 billion and deposits of $4.0 billion. In 2003, ASB s revenues and net income from continuing operations amounted to approximately 21% and 48%, respectively, of HEI s consolidated amounts, compared to approximately 24% and 48% in 2002 and approximately 26% and 45% in 2001, respectively.

At the time of HEI s acquisition of ASB in 1988, HEI agreed with the Office of Thrift Supervision s (OTS) predecessor regulatory agency that ASB s regulatory capital would be maintained at a level of at least 6% of ASB s total liabilities, or at such greater amount as may be required from time to time by regulation. Under the agreement, HEI s obligation to contribute additional capital was limited to a maximum aggregate amount of approximately $65.1 million. At December 31, 2003, HEI s maximum obligation to contribute additional capital has been reduced to approximately $28.3 million because of additional capital contributions of $36.8 million by HEI to ASB since the acquisition, exclusive of capital contributions made in connection with ASB s acquisition of most of the Hawaii operations of Bank of America, FSB. ASB is subject to OTS regulations on dividends and other distributions applicable to financial institutions regulated by the OTS and ASB must receive a letter of non-objection before it can declare and pay a dividend to HEI.

The accounting treatment for goodwill and other intangible assets has changed for 2002 and subsequent years such that goodwill is no longer amortized, but other intangible assets continue to be amortized, and goodwill and other intangible assets are reviewed for impairment at least annually. See Goodwill and other intangibles in Note 1 to HEI s Consolidated Financial Statements.

ASB s earnings depend primarily on its net interest income the difference between the interest income earned on interest-earning assets (loans receivable and investment and mortgage-related securities) and the interest expense incurred on interest-bearing liabilities (deposit liabilities and borrowings, including advances from the Federal Home Loan Bank (FHLB) of Seattle and securities sold under agreements to repurchase).

For additional information about ASB, see the sections under Bank in HEI s MD&A, HEI s Quantitative and Qualitative Disclosures about Market Risk and Note 4 to HEI s Consolidated Financial Statements.

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The following table sets forth selected data for ASB for the years indicated:

	Years ended December 31,		
	2003	2002	2001
Common equity to assets ratio			
Average common equity divided by average total assets [1]	7.20%	7.20%	6.65%
Return on assets			
Net income for common stock divided by average total assets [1, 2]	0.88	0.92	0.81
Return on common equity			
Net income for common stock divided by average common equity [1, 2]	12.2	12.7	12.3
Tangible efficiency ratio			
Total general and administrative expenses divided by net interest income and other income	61	58	56

1 Average balances calculated using the average daily balances (except for common equity, which is calculated using the average month-end balance).

2 In 2001, net income includes amortization of goodwill and other intangibles. In 2003 and 2002, goodwill is no longer amortized, but other intangibles are still amortized, and goodwill and other intangibles are tested for impairment at least annually.

ASB s tangible efficiency ratio the cost of earning $1 of revenue rose from 56% for 2001 to 61% for 2003 due to expenditures toward the strategic transformation which began in 2002. In 2002, general and administrative expenses grew at a faster pace than net interest income and other income as ASB began implementation of strategic changes to become a full-service community bank. It is expected that this increased expense level will continue in 2004.

Consolidated average balance sheet

The following table sets forth average balances of ASB s major balance sheet categories for the years indicated. Average balances have been calculated using the daily average balances.

	Years ended December 31,		
(in thousands)	**2003**	**2002**	**2001**
Assets			
Investment securities	$ 200,891	$ 246,321	$ 308,712
Mortgage-related securities	2,707,395	2,654,302	2,345,630
Loans receivable, net	3,071,877	2,844,341	2,963,521
Other	418,296	392,338	391,040
	$ 6,398,459	$ 6,137,302	$ 6,008,903

Liabilities and stockholder s equity			
Savings deposits	$ 2,663,325	$ 2,394,435	$ 2,059,486
Term certificates	1,224,820	1,323,118	1,578,650
Other borrowings	1,851,258	1,770,831	1,778,766
Other	123,167	132,223	117,366
Stockholder s equity	535,889	516,695	474,635
	$ 6,398,459	$ 6,137,302	$ 6,008,903

In 2003, the low interest rate environment and continued strength in the Hawaii real estate market drove record loan production and an increase in average loans receivables. The average residential mortgage portfolio as of year-end 2003 grew by $193.6 million or 8.5% over the 2002 year-end average residential mortgage portfolio. ASB s average business portfolio increased by $51.9 million or 23.5% during 2003 as ASB s transformation to a full-service community bank continued. Average savings deposits increased during the year as ASB continued to attract core deposits. Average term certificate balances decreased in 2003 as ASB did not aggressively pursue term certificates. Average other borrowings increased during 2003 to replace the outflow of term certificates. In 2002, the increase in the average balance for mortgage-related securities was due to the exchange of loans for $0.4 billion of mortgage-related securities in 2001 and the investment of excess liquidity into mortgage-related

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securities. In 2002, the decrease in the average balance of loans receivable was due to the exchange of loans for mortgage-related securities in 2001 and the high loan prepayments in 2002 as result of the low interest rate environment. In 2002, the increase in savings deposits and the decrease in term certificates were due to ASB s efforts in attracting low-costing core deposits and depositors not willing to have their funds invested for long periods of time at current interest rates as the low interest rate environment has brought term certificate interest rates down near core deposit interest rates.

Asset/liability management

See HEI s Quantitative and Qualitative Disclosures about Market Risk in HEI s Annual Report.

Interest income and interest expense

See Results of operations Bank in HEI s MD&A for a table of average balances, interest and dividend income, interest expense and weighted-average yields earned and rates paid for certain categories of interest-earning assets and interest-bearing liabilities for the years ended December 31, 2003, 2002 and 2001.

The following table shows the effect on net interest income of (1) changes in interest rates (change in weighted-average interest rate multiplied by prior year average portfolio balance) and (2) changes in volume (change in average portfolio balance multiplied by prior period rate). Any remaining change is allocated to the above two categories on a *pro rata* basis.

	Increase (decrease) due to		
(in thousands)	**Rate**	**Volume**	**Total**
Year ended December 31, 2003 vs. 2002			
Income from interest-earning assets			
Loan portfolio	$ (19,637)	$ 15,503	$ (4,134)
Mortgage-related securities	(30,425)	2,669	(27,756)
Investments	(73)	(1,439)	(1,512)
	(50,135)	16,733	(33,402)
Expense from interest-bearing liabilities			
Deposits	(18,338)	(1,485)	(19,823)
FHLB advances and other borrowings	(13,209)	3,474	(9,735)
	(31,547)	1,989	(29,558)
Net interest income	$ (18,588)	$ 14,744	$ (3,844)
Year ended December 31, 2002 vs. 2001			
Income from interest-earning assets			

Loan portfolio	$ (19,676)	$ (9,100)	$ (28,776)
Mortgage-related securities	(35,306)	18,377	(16,929)
Investments	(4,969)	(2,747)	(7,716)
	(59,951)	6,530	(53,421)
Expense from interest-bearing liabilities			
Deposits	(35,062)	(7,838)	(42,900)
FHLB advances and other borrowings	(17,372)	(431)	(17,803)
	(52,434)	(8,269)	(60,703)
Net interest income	$ (7,517)	$ 14,799	$ 7,282

Other income

In addition to net interest income, ASB has various sources of other income, including fee income from servicing loans, fee income from financial products and services, fees on deposit accounts and other income. Other income totaled approximately $58.5 million in 2003, $53.0 million in 2002 and $45.0 million in 2001. The increase in other income for 2003 was due to net gains on sales of securities totaling $4.1 million compared to a net loss of $0.6 million in 2002, higher fee income from its debit and automated teller machines (ATM) cards resulting from ASB s expansion of its debit card base and additional ATM services and higher fee income from its deposit liabilities as a result of restructuring of deposit products. Offsetting these increases were lower gains on sales of loans in 2003 compared to 2002 and a lower accrual for the costs of administering delinquent loans in 2002. The increase in other income for 2002 was due to increases in fee income from its debit and ATM cards and higher fee income from its deposit liabilities. Increased fee income from Bishop Insurance Agency of Hawaii, Inc. (BIA) which was acquired in March 2001 also contributed to the increase in other income. Offsetting these increases were lower fee income on loans serviced for others as ASB recorded writedowns of its mortgage servicing rights due to faster prepayments on its servicing portfolio and a net loss of $0.6 million on the sale of securities compared to a net gain of $8.0 million in 2001.

Lending activities

General. Loans and mortgage-related securities of $5.8 billion represented 88.8% of total assets at December 31, 2003, compared to $5.7 billion, or 90.6%, and $5.2 billion, or 86.7%, at December 31, 2002 and 2001, respectively. ASB s loan portfolio consists primarily of conventional residential mortgage loans, which are neither insured by the Federal Housing Administration nor guaranteed by the Veterans Administration.

The following tables set forth the composition of ASB s loan and mortgage-related securities portfolio:

	December 31,					
	2003		2002		2001	
(dollars in thousands)	Balance	% of total	Balance	% of total	Balance	% of total
Real estate loans [1]						
Conventional (1-4 unit residential)	$ 2,505,059	43.28%	$ 2,389,852	41.70%	$ 2,294,372	44.02%
Commercial real estate	200,320	3.46	197,371	3.45	196,515	3.77
	2,705,379	46.74	2,587,223	45.15	2,490,887	47.79
Less						
Deferred fees and discounts	(20,268)	(0.35)	(18,937)	(0.33)	(17,946)	(0.34)
Undisbursed loan funds	(27,021)	(0.47)	(21,412)	(0.37)	(22,910)	(0.45)
Allowance for loan losses	(14,734)	(0.26)	(23,708)	(0.42)	(26,085)	(0.50)
Total real estate loans, net	2,643,356	45.66	2,523,166	44.03	2,423,946	46.50
Other loans						
Consumer and other loans	222,743	3.85	245,853	4.29	252,487	4.84
Commercial loans	286,068	4.94	247,114	4.31	197,333	3.79
	508,811	8.79	492,967	8.60	449,820	8.63
Less						
Deferred fees and discounts	(606)	(0.01)	(416)			
Undisbursed loan funds	(31)		(1)		(5)	
Allowance for loan losses	(29,551)	(0.51)	(21,727)	(0.38)	(16,139)	(0.31)
Total other loans, net	478,623	8.27	470,823	8.22	433,676	8.32
Mortgage-related securities, net of discounts	2,666,619	46.07	2,736,679	47.75	2,354,849	45.18

Total loans and mortgage-related securities, net	$ 5,788,598	100.00%	$ 5,730,668	100.00%	$ 5,212,471	100.00%

[1] Includes renegotiated loans. In 2001, ASB exchanged loans for $0.4 billion of mortgage-related securities.

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(dollars in thousands)	December 31, 2000 Balance	2000 % of total	1999 Balance	1999 % of total
Real estate loans [1]				
Conventional (1-4 unit residential)	$ 2,758,667	52.23%	$ 2,769,101	53.40%
Commercial real estate	156,177	2.95	170,663	3.29
	2,914,844	55.18	2,939,764	56.69
Less				
Deferred fees and discounts	(21,588)	(0.41)	(24,083)	(0.46)
Undisbursed loan funds	(17,559)	(0.33)	(19,368)	(0.37)
Allowance for loan losses	(24,800)	(0.47)	(22,319)	(0.43)
Total real estate loans, net	2,850,897	53.97	2,873,994	55.43
Other loans				
Consumer and other loans	238,351	4.51	244,933	4.72
Commercial loans	134,784	2.55	106,098	2.05
	373,135	7.06	351,031	6.77
Less				
Deferred fees and discounts				
Undisbursed loan funds	(58)		(118)	
Allowance for loan losses	(12,649)	(0.24)	(13,029)	(0.25)
Total other loans, net	360,428	6.82	337,884	6.52
Mortgage-related securities, net of discounts	2,070,827	39.21	1,973,146	38.05
Total loans and mortgage-related securities, net	$ 5,282,152	100.00%	$ 5,185,024	100.00%

[1] Includes renegotiated loans.

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The following table summarizes ASB s loan portfolio, excluding loans held for sale, at December 31, 2003 and 2002, based upon contractually scheduled principal payments and expected prepayments allocated to the indicated maturity categories:

December 31, 2003	**Due**			
(in millions)	**Less than 1 year**	**1-5 years**	**After 5 years**	**Total**
Residential loans				
Fixed	$ 401	$ 866	$ 783	$ 2,050
Adjustable	123	237	86	446
	524	1,103	869	2,496
Commercial real estate loans				
Fixed	5	19	17	41
Adjustable	28	47	84	159
	33	66	101	200
Consumer loans				
Fixed	15	32	17	64
Adjustable	52	84	23	159
	67	116	40	223
Commercial loans				
Fixed	91	57	29	177
Adjustable	59	43	7	109
	150	100	36	286
	$ 774	$ 1,385	$ 1,046	$ 3,205

December 31, 2002	**Due**			
(in millions)	**Less than 1 year**	**1-5 years**	**After 5 years**	**Total**
Residential loans				
Fixed	$ 497	$ 484	$ 848	$ 1,829
Adjustable	208	226	112	546
	705	710	960	2,375
Commercial real estate loans				
Fixed	6	26	26	58
Adjustable	19	43	77	139

	25	69	103	197
Consumer loans				
Fixed	17	42	22	81
Adjustable	59	89	17	165
	76	131	39	246
Commercial loans				
Fixed	90	36	13	139
Adjustable	54	42	12	108
	144	78	25	247
	$ 950	$ 988	$ 1,127	$ 3,065

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Origination, purchase and sale of loans. Generally, residential and commercial real estate loans originated by ASB are secured by real estate located in Hawaii. As of December 31, 2003, approximately $14.9 million of loans purchased from other lenders were secured by properties located in the continental United States. For additional information, including information concerning the geographic distribution of ASB s mortgage-related securities portfolio and the geographic concentration of credit risk, see Note 12 to HEI s Consolidated Financial Statements.

The amount of loans originated during 2003, 2002, 2001, 2000 and 1999 were $1.6 billion, $1.2 billion, $1.0 billion, $0.5 billion and $0.6 billion, respectively. The demand for loans is primarily dependent on the Hawaii real estate market, interest rates and loan refinancing activity. The increase in loan originations in 2003, 2002 and 2001 was due to the strength in the Hawaii real estate market and low interest rates which have resulted in increased affordability of housing for consumers and higher loan refinancings.

Residential mortgage lending. ASB is permitted to lend up to 100% of the appraised value of the real property securing a loan. Its general policy is to require private mortgage insurance when the loan-to-value ratio of the property exceeds 80% of the lower of the appraised value or purchase price at origination. For nonowner-occupied residential properties, the loan-to-value ratio may not exceed 90% of the lower of the appraised value or purchase price at origination.

Construction and development lending. ASB provides both fixed- and adjustable-rate loans for the construction of one-to-four unit residential and commercial properties. Construction and development financing generally involves a higher degree of credit risk than long-term financing on improved, occupied real estate. Accordingly, all construction and development loans are priced higher than loans secured by completed structures. ASB s underwriting, monitoring and disbursement practices with respect to construction and development financing are designed to ensure sufficient funds are available to complete construction projects. As of December 31, 2003, 2002 and 2001, ASB had construction and development loans of $72.8 million, $46.2 million and $52.0 million, which represented 2.3%, 1.5% and 1.8%, respectively, of ASB s gross loan portfolio. In 2003, the increase in construction and development was due to an increase in commercial real estate lending. See Loan portfolio risk elements.

Multifamily residential and commercial real estate lending. ASB provides permanent financing and construction and development financing secured by multifamily residential properties (including apartment buildings) and secured by commercial and industrial properties (including office buildings, shopping centers and warehouses) for its own portfolio as well as for participation with other lenders. In 2003, 2002 and 2001, ASB originated $81.3 million, $66.0 million and $62.7 million loans secured by multifamily or commercial and industrial properties. Beginning in 2001, ASB enhanced its commercial real estate lending capabilities and plans to continue to increase commercial real estate lending in the future. The objective of commercial real estate lending is to diversify ASB s loan portfolio as commercial and real estate loans tend to have higher yields and shorter durations than residential mortgage loans.

Consumer lending. ASB offers a variety of secured and unsecured consumer loans. Loans secured by deposits are limited to 90% of the available account balance. ASB also offers secured and unsecured VISA cards, automobile loans, general purpose consumer loans, home equity lines of credit, checking account overdraft protection and unsecured lines of credit. In 2003, 2002 and 2001, gross consumer loan originations of $138.1 million, $131.8 million and $191.5 million, accounted for approximately 8.6%, 10.8% and 18.3%, respectively, of ASB s total loan originations. In 2001, ASB increased its VISA credit card base by approximately 50%, primarily as a result of ASB s implementation of an aggressive series of mail solicitation campaigns to extend consumer credit to existing customers.

Business lending. ASB is authorized to make both secured and unsecured business loans to business entities. This lending activity is part of ASB s strategic transformation to a full-service community bank and is designed to diversify ASB s asset structure, shorten maturities, improve rate sensitivity of the loan portfolio and attract business checking deposits. As of December 31, 2003, 2002 and 2001, business loans represented 9.2%, 8.3% and 6.9%, respectively, of ASB s total net loan portfolio.

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Loan origination fee and servicing income. In addition to interest earned on loans, ASB receives income from servicing loans, for late payments and from other related services. Servicing fees are received on loans originated and subsequently sold by ASB through a securitization process and also on loans for which ASB acts as collection agent on behalf of third-party purchasers. See Results of operations Bank in HEI s MD&A for a discussion of ASB s 2002 writedown of mortgage servicing rights.

ASB generally charges the borrower at loan settlement a loan origination fee of 1% of the amount borrowed. See Loans receivable in Note 1 to HEI s Consolidated Financial Statements.

Loan portfolio risk elements. When a borrower fails to make a required payment on a loan and does not cure the delinquency promptly, the loan is classified as delinquent. If delinquencies are not cured promptly, ASB normally commences a collection action, including foreclosure proceedings in the case of secured loans. In a foreclosure action, the property securing the delinquent debt is sold at a public auction in which ASB may participate as a bidder to protect its interest. If ASB is the successful bidder, the property is classified in a real estate owned account until it is sold. ASB s real estate acquired in settlement of loans represented 0.12%, 0.19% and 0.24% of total assets at December 31, 2003, 2002 and 2001, respectively.

In addition to delinquent loans, other significant lending risk elements include: (1) loans which accrue interest and are 90 days or more past due as to principal or interest, (2) loans accounted for on a nonaccrual basis (nonaccrual loans), and (3) loans on which various concessions are made with respect to interest rate, maturity, or other terms due to the inability of the borrower to service the obligation under the original terms of the agreement (renegotiated loans). The level of delinquent and nonaccrual loans represented 0.7%, 1.1%, 2.3%, 2.2%, and 2.4% of ASB s total net loans outstanding at December 31, 2003, 2002, 2001, 2000 and 1999, respectively. ASB had no loans that were 90 days or more past due on which interest was being accrued as of the dates presented in the table below. The following table sets forth certain information with respect to nonaccrual and renegotiated loans as of the dates indicated:

	December 31,				
(in thousands)	**2003**	**2002**	**2001**	**2000**	**1999**
Nonaccrual loans					
Real estate					
1-4 unit residential	$ 2,784	$ 9,783	$ 22,495	$ 26,738	$ 43,750
Income property		983	10,129	15,132	18,747
Total real estate	2,784	10,766	32,624	41,870	62,497
Consumer	341	1,382	1,965	2,844	3,777
Commercial	2,236	3,633	3,018	2,872	2,192
Total nonaccrual loans	$ 5,361	$ 15,781	$ 37,607	$ 47,586	$ 68,466
Nonaccrual loans to total net loans	0.2%	0.5%	1.3%	1.4%	2.1%
Renegotiated loans not included above					
Real estate					
1-4 unit residential	$ 2,148	$	$	$ 48	$ 876
Income property	3,877	7,582	3,874		5,154
Commercial	1,919	2,175	2,681		

Total renegotiated loans	$ 7,944	$ 9,757	$ 6,555	$ 48	$ 6,030
Nonaccrual and renegotiated loans to total net loans	0.4%	0.9%	1.5%	1.5%	2.3%

ASB s policy generally is to place mortgage loans on a nonaccrual status (i.e., interest accrual is suspended) when the loan becomes 90 days or more past due or on an earlier basis when there is a reasonable doubt as to its collectibility.

In 2000, the $20.9 million decrease in nonaccrual loans was primarily due to increased charge-offs and lower delinquencies. In 2001, the decrease in nonaccrual loans of $10.0 million was primarily due to lower delinquencies in residential loans and an income property loan taken into real estate owned. In 2002, the decrease in nonaccrual loans of $21.8 million was due to $12.7 million lower delinquencies in residential loans, a $5.0 million payoff of an income property loan and a $4.1 million reclassification of an income property loan to accrual status. In 2003, the

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decrease in nonaccrual loans of $10.4 million was primarily due to $7.0 million lower delinquencies in residential loans as a result of improved credit quality of ASB s loan portfolio due to the strong real estate market in Hawaii.

Allowance for loan losses. See Note 1 to HEI s Consolidated Financial Statements.

The following table presents the changes in the allowance for loan losses for the years indicated:

	Years ended December 31,				
(dollars in thousands)	**2003**	**2002**	**2001**	**2000**	**1999**
Allowance for loan losses, beginning of year	$ 45,435	$ 42,224	$ 37,449	$ 35,348	$ 39,779
Provision for loan losses	3,075	9,750	12,500	13,050	16,500
Charge-offs					
Residential real estate loans	892	2,345	4,651	8,867	4,962
Commercial real estate loans	174	441	315		10,776
Consumer loans	3,027	3,479	3,644	3,801	4,712
Commercial loans	2,601	1,479	1,013	670	1,209
Total charge-offs	6,694	7,744	9,623	13,338	21,659
Recoveries					
Residential real estate loans	1,244	858	1,210	1,926	448
Commercial real estate loans	426	52	342	214	75
Consumer loans	586	257	313	244	188
Commercial loans	213	38	33	5	17
Total recoveries	2,469	1,205	1,898	2,389	728
Allowance for loan losses, end of year	$ 44,285	$ 45,435	$ 42,224	$ 37,449	$ 35,348
Ratio of allowance for loan losses, December 31, to average loans outstanding	1.44%	1.60%	1.42%	1.16%	1.11%
Ratio of provision for loan losses during the year to average loans outstanding	0.10%	0.34%	0.42%	0.41%	0.52%
Ratio of net charge-offs during the year to average loans outstanding	0.14%	0.23%	0.26%	0.34%	0.66%

The following table sets forth the allocation of ASB s allowance for loan losses and the percentage of loans in each category to total loans at the dates indicated:

December 31	2003		2002		2001		2000		1999	
(dollars in thousands)	Balance	% of total	Balance	% of total	Balance	% of total	Balance	% of total	Balance	% of total
Residential real estate	$ 4,031	78.0%	$ 6,246	77.6%	$ 9,933	78.0%	$ 13,224	83.9%	$ 14,394	84.2%
Commercial real estate	6,008	6.2	6,343	6.4	9,031	6.7	8,928	4.7	7,963	5.2
Consumer	6,540	6.9	8,489	8.0	8,538	8.6	7,609	7.3	9,850	7.4
Commercial	14,758	8.9	12,118	8.0	6,388	6.7	4,126	4.1	3,060	3.2
Unallocated	12,948	NA	12,239	NA	8,334	NA	3,562	NA	81	NA
	$ 44,285	100.0%	$ 45,435	100.0%	$ 42,224	100.0%	$ 37,449	100.0%	$ 35,348	100.0%

NA Not applicable.

In 2003, ASB s allowance for loan losses decreased by $1.2 million compared to an increase of $3.2 million in 2002. The decrease in 2003 was due to lower net charge-offs as a result of lower delinquencies. The increasing value of Hawaii real estate and continued low interest rates gave debtors the opportunity to sell their properties or refinance before defaulting. ASB also continued to improve its collection efforts. Residential, consumer and

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commercial real estate loan delinquencies continued to decrease during 2003 and lower loan loss reserves were required for those lines of business. The growth in the commercial loan portfolio as a result of ASB s strategic focus of diversifying its loan portfolio from single-family home mortgages to commercial loans has required additional loan loss reserves. The unallocated component of the allowance for loan losses, which takes into consideration economic trends and estimation errors that are not necessarily captured in determining the allowance for loan losses for each category, increased slightly. In 2002, ASB s allowance for loan losses increased by $3.2 million compared to an increase of $4.8 million in 2001. The 2002 increase was due to a higher loans receivable balance and a higher unallocated component of the allowance for loan losses. The allowance was increased to account for ASB s strategic focus of diversifying its loan portfolio from single-family home mortgages to commercial loans that have higher credit risk. Charge-offs were lower in 2002 compared to 2001 as a result of lower delinquencies. The strong Hawaii real estate market and low interest rates gave debtors the opportunity to sell their properties or refinance before defaulting. In addition, ASB improved its collection efforts. Residential and commercial real estate loan delinquencies decreased during 2002 and lower loan loss reserves were required for those lines of business. The allowance for loan losses on consumer loans remained essentially the same during 2002. In 2001, ASB s allowance for loan losses increased by $4.8 million. Charge-offs were lower in 2001 compared to 2000 as a result of lower delinquencies. The 2001 increase in the allowance for loan losses was due to the increase in commercial real estate and commercial loans in the loan portfolio that have higher credit risk and a higher unallocated component of the allowance, which takes into consideration economic trends and estimation errors that are not necessarily captured in determining the allowance for loan losses for each loan category. In 2000, ASB s allowance for loan losses increased by $2.1 million. Charge-offs were lower in 2000 compared to 1999 as a result of lower delinquencies.

Investment activities

In recent years, ASB s investment portfolio consisted primarily of stock of the FHLB of Seattle, federal agency obligations and mortgage-related securities. ASB owns private-issue mortgage-related securities as well as investment and mortgage-related securities issued by the Federal Home Loan Mortgage Corporation (FHLMC), Government National Mortgage Association (GNMA) and Federal National Mortgage Association (FNMA). At December 31, 2003, the various securities rating agencies rated all of the private-issue mortgage-related securities as investment grade. ASB did not maintain a portfolio of securities held for trading during 2003, 2002 or 2001.

As of December 31, 2003, 2002 and 2001, ASB s held-to-maturity investment portfolio consisted of $94.6 million, $89.5 million and $84.2 million, respectively, of investment in FHLB stock. The weighted-average rate on investments during 2003, 2002 and 2001 was 5.45%, 6.19% and 7.28%, respectively. The amount that ASB is required to invest in FHLB stock is determined by regulatory requirements. See Regulation and other matters Bank regulation Federal Home Loan Bank System.

The following table summarizes ASB s investment portfolio, at December 31, 2003, based upon contractually scheduled principal payments and expected prepayments allocated to the indicated maturity categories:

(in millions)	Less than 1 year	1-5 years	6-10 years	After 10 years	Total	
Federal agency obligations	$	$ 50	$	$	$ 50	36,357
Accrued expenses and other liabilities	524		524		524	
Long-term debt	2,000		2,182		2,182	
Total	$ 102,359	$	$ 102,541	$	$ 102,541	

The following table presents the Company s fair value estimates for financial instruments at December 31, 2011, excluding short-term financial assets and liabilities, for which carrying amounts approximate fair value, and excluding financial instruments recorded at fair value:

	Carrying Amount	Fair Value
Financial Assets:		
Securities held to maturity	$ 15,108	$ 15,539
Loans to banking clients net	$ 9,812	$ 9,671
Loans held for sale	$ 70	$ 73
Financial Liabilities:		
Long-term debt	$ 2,001	$ 2,159

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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)

8. Preferred Stock

The Company was authorized to issue 9,940,000 shares of preferred stock, $0.01 par value, at both March 31, 2012, and December 31, 2011. At March 31, 2012, the Company had 400,000 shares of preferred stock issued and outstanding and none issued and outstanding at December 31, 2011.

On January 26, 2012, the Company issued and sold 400,000 shares of fixed-to-floating rate non-cumulative perpetual preferred stock, Series A, $0.01 par value, with a liquidation preference of $1,000 per share (Series A Preferred Stock) for a total liquidation preference of $400 million. Net proceeds received from the sale were $394 million and are being used for general corporate purposes, including, without limitation, to support the Company s balance sheet growth and the potential migration of certain client cash balances to deposit accounts at Schwab Bank. The Series A Preferred Stock has no stated maturity and has a fixed dividend rate of 7.000% until February 2022 and a floating rate equal to three-month LIBOR plus 4.820% thereafter. During the fixed rate period, dividends, if declared, will be payable semi-annually, in arrears, on February 1 and August 1 of each year, beginning on August 1, 2012 and ending on February 1, 2022. During the floating rate period, dividends, if declared, will be payable quarterly, in arrears, on February 1, May 1, August 1, and November 1 of each year, beginning on May 1, 2022. Dividends will not be cumulative. Under the terms of the Series A Preferred Stock, the Company s ability to pay dividends on, make distributions with respect to, or to repurchase, redeem or acquire its common stock is subject to restrictions in the event that the Company does not declare and either pay or set aside a sum sufficient for payment of dividends on the Series A Preferred Stock for the immediately preceding dividend period. The Series A Preferred Stock is redeemable at the Company s option, in whole or in part, on any dividend payment date on or after February 1, 2022, or, in whole but not in part, within 90 days following a regulatory capital treatment event as defined in its Certificate of Designations.

9. Accumulated Other Comprehensive Income

Accumulated other comprehensive income (loss) represents cumulative gains and losses that are not reflected in earnings. Accumulated other comprehensive income balances were:

	on securities available for sale		on securities available for sale		on securities available for sale	
	Net unrealized gain on securities available for sale		Other		Total accumulated other comprehensive income	
Balance at December 31, 2010	$	17	$	(1)	$	16
Other net changes		17		1		18
Balance at March 31, 2011	$	34	$		$	34
Balance at December 31, 2011	$	10	$	(2)	$	8
Other net changes		67		1		68
Balance at March 31, 2012	$	77	$	(1)	$	76

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THE CHARLES SCHWAB CORPORATION

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(Unaudited)

10. Earnings Per Share

Basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period. The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. Dilutive potential common shares include the effect of outstanding stock options and unvested restricted stock awards and units. EPS under the basic and diluted computations is as follows:

	Three Months Ended March 31,	
	2012	**2011**
Net income available to common stockholders [1]	$ 195	$ 243
Weighted-average common shares outstanding basic	1,272	1,203
Common stock equivalent shares related to stock incentive plans	1	4
Weighted-average common shares outstanding diluted [2]	1,273	1,207
Basic EPS	$ .15	$ .20
Diluted EPS	$ .15	$ .20

(1) Net income available to participating securities (unvested restricted shares) was not material for the first quarters of 2012 or 2011.

(2) Antidilutive stock options and restricted stock awards excluded from the calculation of diluted EPS totaled 60 million and 39 million shares for the first quarters of 2012 and 2011, respectively.

11. Regulatory Requirements

CSC is a savings and loan holding company and Schwab Bank, CSC s depository institution subsidiary, is a federal savings bank. CSC is subject to supervision and regulation by the Board of Governors of the Federal Reserve System and Schwab Bank is subject to supervision and regulation by the Office of the Comptroller of the Currency. CSC is currently not subject to specific statutory capital requirements, however CSC is required to serve as a source of strength for Schwab Bank. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act , CSC will be subject to new minimum leverage and minimum risk-based capital ratio requirements that will be set by the Federal Reserve that are at least as stringent as the requirements generally applicable to insured depository institutions as of July 21, 2011.

Schwab Bank is required to maintain minimum capital levels as specified in federal banking laws and regulations. Failure to meet the minimum levels could 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 March 31, 2012, CSC and Schwab Bank met the capital level requirements.

The regulatory capital and ratios for Schwab Bank at March 31, 2012, are as follows:

	Amount	Amount	Amount	Amount	Amount	Amount
	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Risk-Based Capital	$ 5,153	23.7%	$ 870	4.0%	$ 1,305	6.0%
Total Risk-Based Capital	$ 5,201	23.9%	$ 1,740	8.0%	$ 2,175	10.0%
Tier 1 Core Capital	$ 5,153	7.6%	$ 2,705	4.0%	$ 3,381	5.0%
Tangible Equity	$ 5,153	7.6%	$ 1,352	2.0%	N/A	

N/A Not applicable.

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(Unaudited)

Based on its regulatory capital ratios at March 31, 2012, Schwab Bank is considered well capitalized (the highest category) pursuant to banking regulatory guidelines. There are no conditions or events since March 31, 2012, that management believes have changed Schwab Bank s capital category.

CSC s principal U.S. broker-dealers are Schwab and optionsXpress, Inc. optionsXpress, Inc. is a wholly-owned subsidiary of optionsXpress. Schwab and optionsXpress, Inc. are both subject to Rule 15c3-1 under the Securities Exchange Act of 1934 (the Uniform Net Capital Rule). Schwab and optionsXpress, Inc. compute 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 ($250,000 for Schwab), which is based on the type of business conducted by the broker-dealer. 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 company or employees if such payment would result in a net capital amount of less than 5% of aggregate debit balances or less than 120% of its minimum dollar requirement.

optionsXpress, Inc. is also subject to Commodity Futures Trading Commission Regulation 1.17 (Reg. 1.17) under the Commodity Exchange Act, which also requires the maintenance of minimum net capital. optionsXpress, Inc., as a futures commission merchant, is required to maintain minimum net capital equal to the greater of its net capital requirement under Reg. 1.17 ($1 million), or the sum of 8% of the total risk margin requirements for all positions carried in client accounts and 8% of the total risk margin requirements for all positions carried in non-client accounts (as defined in Reg. 1.17).

Net capital and net capital requirements for Schwab and optionsXpress, Inc. at March 31, 2012, are as follows:

	Net Capital	% of Aggregate Debit Balances	Minimum Net Capital Required	2% of Aggregate Debit Balances	Net Capital in Excess of Required Net Capital	Net Capital in Excess of 5% of Aggregate Debit Balances
Schwab	$ 1,142	9%	$ 0.250	$ 251	$ 891	$ 516
optionsXpress, Inc.	$ 68	27%	$ 1	$ 5	$ 63	$ 56

12. Segment Information

The Company structures its operating segments according to its various types of clients and the services provided to those clients. The Company s two reportable segments are Investor Services and Institutional Services.

The Company evaluates the performance of its segments on a pre-tax basis, excluding items such as impairment charges on non-financial assets, discontinued operations, extraordinary items, and significant restructuring and other charges. Segment assets and liabilities are not used for evaluating segment performance or in deciding how to allocate resources to segments. There are no revenues from transactions with other segments within the Company.

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Notes to Condensed Consolidated Financial Statements

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

(Unaudited)

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

	Investor Services		**Institutional Services**		**Unallocated**		**Total**	
Three Months Ended March 31,	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**	**2011**
Net Revenues:								
Asset management and administration fees	$ 260	$ 276	$ 223	$ 226	$ 1	$	$ 484	$ 502
Net interest revenue	365	373	69	63			434	436
Trading revenue	163	160	80	80		1	243	241
Other	27	20	20	19	(1)		46	39
Provision for loan losses		(3)		(1)				(4)
Net impairment losses on securities	(16)	(6)	(2)	(1)			(18)	(7)
Total net revenues	799	820	390	386		1	1,189	1,207
Expenses Excluding Interest	606	554	270	260		(1)	876	813
Income before taxes on income	$ 193	$ 266	$ 120	$ 126	$	$ 2	$ 313	$ 394
Taxes on income							(118)	(151)
Net Income							$ 195	$ 243

13. Subsequent Event

Subsequent to March 31, 2012, the Company entered into a confidential agreement to resolve a dispute with a vendor, and expects to record a pre-tax gain of $70 million subject to receipt of the funds in the second quarter of 2012.

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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

OVERVIEW

Management of The Charles Schwab Corporation (CSC) and its subsidiaries (collectively referred to as the Company) focuses on several key client activity and financial metrics in evaluating the Company s financial position and operating performance. Results for the first quarters of 2012 and 2011 are:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011	Percent Change
Client Activity Metrics:			
Net new client assets [1] (in billions)	$ 38.9	$ 23.0	69%
Client assets (in billions, at quarter end)	$ 1,833.5	$ 1,646.9	11%
Clients daily average trades [2] (in thousands)	476.2	472.5	1%
Company Financial Metrics:			
Net revenues	$ 1,189	$ 1,207	(1%)
Expenses excluding interest	876	813	8%
Income before taxes on income	313	394	(21%)
Taxes on income	(118)	(151)	(22%)
Net income	$ 195	$ 243	(20%)
Earnings per share diluted	$ .15	$ .20	(25%)
Net revenue (decline) growth from prior year	(1%)	23%	
Pre-tax profit margin	26.3%	32.6%	
Return on stockholders equity (annualized)	10%	15%	
Annualized net revenue per average full-time equivalent employee (in thousands)	$ 340	$ 371	(8%)

(1) Includes inflows of $12.0 billion in the first quarter of 2012 from a mutual fund clearing services client.

(2) Amounts include revenue trades from commissions or principal mark-ups (i.e., fixed income), trades by clients in asset-based pricing relationships, and all commission-free trades, including Schwab Mutual Fund OneSource® funds and Exchange-Traded Funds, and other proprietary products.

The broad equity markets improved during the first quarter of 2012 compared to the first quarter of 2011 as the Nasdaq Composite Index, Dow Jones Industrial Average, and Standard & Poor s 500 Index increased 11%, 7%, and 6%, respectively. The federal funds target rate remained unchanged at a range of zero to 0.25% during the first quarter and the average three-month Treasury Bill and 10-year Treasury yields decreased by 6 and 142 basis points to 0.06% and 2.02%, respectively, compared to the first quarter of 2011.

The Company s ongoing success in building stronger client relationships and expanding client service capabilities helped deliver strong key client activity metrics during the first quarter of 2012 core net new client assets, which exclude significant one-time flows, totaled $26.9 billion, the highest since the first quarter of 2008, and total client assets ended the quarter at a record $1.83 trillion, up 11% from the first quarter of 2011. In addition, clients daily average trades were 476,200 in the first quarter of 2012, slightly up on a year-over-year basis.

Net revenues were relatively flat in the first quarter of 2012 compared to the first quarter of 2011 primarily due to a decrease in asset management and administration fees and higher net impairment losses on securities, partially offset by an increase in other revenue. Asset management and administration fees decreased primarily due to a decrease in net money market mutual fund fees, partially offset by increases in other asset management and administration fees and revenue from the Company s advice solutions. Net impairment losses in the Company s non-agency residential mortgage-backed securities portfolio were higher primarily due to further credit deterioration of the securities underlying loans and an increase in projected default rates for modified loans. Other revenue increased primarily due to the inclusion of revenues relating to education services and other service fees from the optionsXpress Holdings, Inc. (optionsXpress) acquisition in September 2011. Net interest revenue was relatively flat year-over-year, reflecting higher balances of interest-earning assets offset by the effect of lower interest rate spreads during the first quarter of 2012 due to the continued low interest rate environment.

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Expenses excluding interest increased by 8% in the first quarter of 2012 compared to the first quarter of 2011 primarily due to increases in compensation and benefits, depreciation and amortization, and advertising and market development. Compensation and benefits expense increased primarily due to an increase in full-time employees. Depreciation and amortization and advertising and market development increased primarily due to the acquisition of optionsXpress. Overall, net income declined by 20% in the first quarter of 2012 compared to the first quarter of 2011.

In comparison to the fourth quarter of 2011, both the broad equity markets and interest rate environment improved in the first quarter of 2012 the Nasdaq Composite Index, Standard & Poor s 500 Index, and Dow Jones Industrial Average increased 19%, 12%, and 8%, respectively, and the average three-month Treasury Bill yield increased by 6 basis points to 0.06%, while the average 10-year Treasury yield was relatively flat at 2.02%. The improved environment combined with the Company s strong key client activity metrics and ongoing expense discipline helped net revenues grow 7% and limit expense growth to 2%, resulting in a 20% increase in net income for the first quarter of 2012 from the fourth quarter of 2011.

Equity Offering

On January 26, 2012, the Company issued and sold 400,000 shares of fixed-to-floating rate non-cumulative perpetual preferred stock, Series A, $0.01 par value, with a liquidation preference of $1,000 per share. Net proceeds received from the sale were $394 million and are being used for general corporate purposes, including, without limitation, to support the Company s balance sheet growth and the potential migration of certain client cash balances to deposit accounts at Schwab Bank. For further discussion, see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 8. Preferred Stock.

Subsequent Event

Subsequent to March 31, 2012, the Company entered into a confidential agreement to resolve a dispute with a vendor, and expects to record a pre-tax gain of $70 million subject to receipt of the funds in the second quarter of 2012.

CURRENT MARKET AND REGULATORY ENVIRONMENT AND OTHER DEVELOPMENTS

The low interest rate environment continues to constrain growth in the Company s net revenues.

Interest rates remained at low levels during the first quarter of 2012, as the federal funds target rate was unchanged at a range of zero to 0.25% and the three-month Treasury Bill yield ranged from 0.01% to 0.12%. In addition, the average 10-year Treasury yield decreased to 2.02% during the first quarter from 3.44% in the first quarter of 2011. To the extent rates remain at these low levels, the Company s net interest revenue will continue to be constrained, even as growth in average balances helps to increase such revenue. The low interest rate environment also affects asset management and administration fees. The overall yields on certain Schwab-sponsored money market mutual funds have remained at levels at or below the management fees on those funds. The Company continues to waive a portion of its management fees so that the funds can maintain a positive return to clients. These and other money market mutual funds may not be able to replace maturing securities with securities of equal or higher yields. As a result, the yields on such funds may remain around or decline from their current levels, and therefore below the management fees on those funds. To the extent this occurs, asset management and administration fees may be negatively affected.

The Company recorded net impairment charges of $18 million related to certain non-agency residential mortgage-backed securities in the first quarter of 2012 due to further credit deterioration of the securities underlying loans and an increase in projected default rates for modified loans. Further deterioration in the performance of the underlying loans in the Company s residential mortgage-backed securities portfolio could result in the recognition of additional impairment charges.

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in July 2010. Among other things, the legislation authorizes various assessments and fees and requires the establishment of minimum leverage and risk-based capital requirements for insured depository institutions. CSC is continuing to review the impact the legislation, studies and related rule-making will have on the Company s business, financial condition, and results of operations.

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The Company is pursuing lawsuits in state court in San Francisco for rescission and damages against issuers, underwriters, and dealers of 51 individual non-agency residential mortgage-backed securities on which the Company has experienced realized and unrealized losses. The lawsuits allege that offering documents for the securities contained material untrue and misleading statements about the securities and the underwriting standards and credit quality of the underlying loans. On January 27, 2012, the court denied defendants motions to dismiss the claims with respect to all but 4 of the 51 securities, and allowed the cases to proceed to discovery.

RESULTS OF OPERATIONS

The following discussion presents an analysis of the Company s results of operations for the first quarters of 2012 and 2011.

Net Revenues

The Company s major sources of net revenues are asset management and administration fees, net interest revenue, and trading revenue. Asset management and administration fees decreased, while net interest revenue and trading revenue were relatively flat in the first quarter of 2012 compared to the first quarter of 2011.

Three Months Ended March 31,		2012		2011	
	Percent Change	**Amount**	**% of Total Net Revenues**	**Amount**	**% of Total Net Revenues**
Asset management and administration fees					
Schwab money market funds before fee waivers	5%	$ 222		$ 211	
Fee waivers	46%	(163)		(112)	
Schwab money market funds after fee waivers	(40%)	59	5%	99	8%
Equity and bond funds	10%	32	3%	29	3%
Mutual Fund OneSource®	(3%)	166	14%	172	14%
Total mutual funds	(14%)	257	22%	300	25%
Advice solutions	8%	139	12%	129	11%
Other	21%	88	7%	73	6%
Asset management and administration fees	(4%)	484	41%	502	42%
Net interest revenue					
Interest revenue	(2%)	472	40%	481	40%
Interest expense	(16%)	(38)	(3%)	(45)	(4%)
Net interest revenue		434	37%	436	36%
Trading revenue					
Commissions	2%	229	19%	225	19%
Principal transactions	(13%)	14	1%	16	1%

Trading revenue	1%	243	20%	241	20%
Other	18%	46	4%	39	3%
Provision for loan losses	N/M			(4)	
Net impairment losses on securities	157%	(18)	(2%)	(7)	(1%)
Total net revenues	(1%)	$ 1,189	100%	$ 1,207	100%

N/M Not meaningful.

Asset Management and Administration Fees

Asset management and administration fees include mutual fund service fees and fees for other asset-based financial services provided to individual and institutional clients. The Company earns mutual fund service fees for shareholder services,

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administration, and investment management provided to its proprietary funds, and recordkeeping and shareholder services provided to third-party funds. These fees are based upon the daily balances of client assets invested in these funds. The Company also earns asset management fees for advice solutions, which include advisory and managed account services that are based on the daily balances of client assets subject to the specific fee for service. The fair values of client assets included in proprietary and third-party mutual funds are based on quoted market prices and other observable market data. Other asset management and administration fees include various asset based fees, such as trust fees, 401k record keeping fees, and mutual fund clearing and other service fees. Asset management and administration fees may vary with changes in the balances of client assets due to market fluctuations and client activity. For discussion of the impact of current market conditions on asset management and administration fees, see Current Market and Regulatory Environment.

Asset management and administration fees decreased by $18 million, or 4%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to a decrease in mutual fund service fees, partially offset by increases in revenue from advice solutions and other asset management and administration fees.

Mutual fund service fees decreased by $43 million, or 14%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to a decrease in net money market mutual fund fees as a result of lower yields on fund assets, partially offset by growth in balances. Given the low interest rate environment in the first quarter of 2012, the overall yields on certain Schwab-sponsored money market mutual funds have remained at levels at or below the management fees on those funds.

Advice solutions fees increased by $10 million, or 8%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to higher average balances of client assets enrolled in retail advisory and managed account programs, which includes Windhaven®.

Other asset management and administration fees increased by $15 million, or 21%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to an increase in third-party mutual fund service fees.

Net Interest Revenue

Net interest revenue is the difference between interest earned on interest-earning assets and interest paid on funding sources. Net interest revenue is affected by changes in the volume and mix of these assets and liabilities, as well as by fluctuations in interest rates and portfolio management strategies. The Company s investment strategy is structured to produce an increase in net interest revenue when interest rates rise and, conversely, a decrease in net interest revenue when interest rates fall (i.e., interest-earning assets generally reprice more quickly than interest-bearing liabilities). When interest rates fall, the Company may attempt to mitigate some of this negative impact by extending the maturities of assets in investment portfolios to lock in asset yields, and by lowering rates paid to clients on interest-bearing liabilities. Since the Company establishes the rates paid on certain brokerage client cash balances and deposits from banking clients, as well as the rates charged on receivables from brokerage clients, and also controls the composition of its investment securities, it has some ability to manage its net interest spread. The current low interest rate environment limits the extent to which the Company can reduce interest expense paid on funding sources. However, the spread is influenced by external factors such as the interest rate environment and competition. For discussion of the impact of current market conditions on net interest revenue, see Current Market and Regulatory Environment.

In clearing its clients trades, Charles Schwab & Co., Inc. (Schwab) and optionsXpress, Inc. hold cash balances payable to clients. In most cases, Schwab and optionsXpress, Inc. pay their clients interest on cash balances awaiting investment, and in turn invest these funds and earn interest revenue. Receivables from brokerage clients consist primarily of margin loans to brokerage clients. Margin loans are loans made to clients on a secured basis to purchase securities. Pursuant to applicable regulations, client cash balances that are not used for margin lending are generally segregated into investment accounts that are maintained for the exclusive benefit of clients, which are recorded in cash and investments segregated on the Company s condensed consolidated balance sheet.

Schwab Bank maintains investment portfolios for liquidity as well as to invest funds from deposits in excess of loans to banking clients and liquidity limits. Schwab Bank s securities available for sale include residential mortgage-backed securities, certificates of deposit, corporate debt securities, U.S. agency notes, and asset-backed and other securities. Schwab Bank s securities held to maturity include residential mortgage-backed and other securities. Schwab Bank lends funds to

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banking clients primarily in the form of mortgage loans and HELOCs. These loans are largely funded by interest-bearing deposits from banking clients.

The Company s interest-earning assets are financed primarily by brokerage client cash balances and deposits from banking clients. Non-interest-bearing funding sources include non-interest-bearing brokerage client cash balances and proceeds from stock-lending activities, as well as stockholders equity.

The following table presents net interest revenue information corresponding to interest-earning assets and funding sources on the condensed consolidated balance sheet:

Three Months Ended March 31,	2012			2011		
	Average Balance	Interest Revenue/ Expense	Average Yield/ Rate	Average Balance	Interest Revenue/ Expense	Average Yield/ Rate
Interest-earning assets:						
Cash and cash equivalents	$ 6,246	$ 4	0.26%	$ 4,955	$ 3	0.25%
Cash and investments segregated	26,847	10	0.15%	23,191	14	0.24%
Broker-related receivables (1)	315		0.09%	373		0.16%
Receivables from brokerage clients	10,200	106	4.18%	10,335	117	4.59%
Securities available for sale (2)	36,197	145	1.61%	25,016	106	1.72%
Securities held to maturity	14,972	99	2.66%	17,138	140	3.31%
Loans to banking clients	9,864	79	3.22%	9,009	75	3.38%
Loans held for sale	53	1	4.15%	113	1	3.59%
Total interest-earning assets	104,694	444	1.71%	90,130	456	2.05%
Other interest revenue		28			25	
Total interest-earning assets	$ 104,694	$ 472	1.81%	$ 90,130	$ 481	2.16%
Funding sources:						
Deposits from banking clients	$ 61,105	$ 10	0.07%	$ 50,329	$ 17	0.14%
Payables to brokerage clients	30,560	1	0.01%	27,055	1	0.01%
Long-term debt	2,001	27	5.43%	2,005	27	5.46%
Total interest-bearing liabilities	93,666	38	0.16%	79,389	45	0.23%
Non-interest-bearing funding sources	11,028			10,741		
Total funding sources	$ 104,694	$ 38	0.14%	$ 90,130	$ 45	0.20%
Net interest revenue		$ 434	1.67%		$ 436	1.96%

(1) Interest revenue was less than $500,000 in the period or periods presented.
(2) Amounts have been calculated based on amortized cost.

Net interest revenue was relatively flat in the first quarter of 2012 compared to the first quarter of 2011, reflecting higher average balances of interest-earning assets offset by the effect of lower interest rate spreads due to the continued low interest rate environment. The growth in the average balance of deposits from banking clients funded the increase in the balance of securities available for sale.

Trading Revenue

Trading revenue includes commission and principal transaction revenues. Commission revenue is affected by the number of revenue trades executed and the average revenue earned per revenue trade. Principal transaction revenue is primarily comprised of revenue from client fixed income securities trading activity. Factors that influence principal transaction revenue include the volume of client trades and market price volatility.

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Trading revenue was relatively flat in the first quarter of 2012 compared to the first quarter of 2011. Daily average revenue trades remained relatively flat in the first quarter of 2012 due to a lower volume of equity and mutual fund trades, offset by a higher volume of option and future trades as a result of the inclusion of optionsXpress. Average revenue per revenue trade increased 2% in the first quarter of 2012 due to higher revenue per trade for equities and mutual funds, offset by lower revenue per trade for options and futures.

	Three Months Ended March 31,		Percent
	2012	2011	Change
Daily average revenue trades (in thousands) [1]	318.4	319.9	
Number of trading days	62.0	62.0	
Average revenue earned per revenue trade	$ 12.35	$ 12.12	2%

[1] Includes all client trades that generate trading revenue (i.e., commission revenue or revenue from fixed income securities trading).

Other Revenue

Other revenue includes software fee revenue from the Company s portfolio management services, education services revenue, exchange processing fee revenue, gains on sales of mortgage loans, and other service fee revenues. Other revenue increased by $7 million, or 18%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to the inclusion of revenues relating to education services and other service fees from the optionsXpress acquisition.

Net Impairment Losses on Securities

Net impairment losses in the Company s non-agency residential mortgage-backed securities portfolio were $18 million and $7 million in the first quarters of 2012 and 2011, respectively. These charges were higher in the first quarter of 2012 primarily due to further credit deterioration of the securities underlying loans and an increase in projected default rates for modified loans. For further discussion, see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 4. Securities Available for Sale and Securities Held to Maturity.

Expenses Excluding Interest

As shown in the table below, expenses excluding interest increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to increases in compensation and benefits, depreciation and amortization, and advertising and market development.

	Three Months Ended March 31,		Percent
	2012	2011	Change
Compensation and benefits	$ 465	$ 437	6%
Professional services	96	92	4%
Occupancy and equipment	76	71	7%
Advertising and market development	67	60	12%
Communications	58	56	4%
Depreciation and amortization	48	35	37%
Other	66	62	6%

Total expenses excluding interest	$ 876	$ 813	8%
Expenses as a percentage of total net revenues:			
Total expenses excluding interest	74%	67%	
Advertising and market development	6%	5%	

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Compensation and Benefits

Compensation and benefits expense includes salaries and wages, incentive compensation, and related employee benefits and taxes. Incentive compensation includes variable compensation, discretionary bonus costs, and stock-based compensation. Variable compensation includes payments to certain individuals based on their sales performance. Discretionary bonus costs are based on the Company s overall performance as measured by earnings per share, and therefore will fluctuate with this measure. Stock-based compensation primarily includes employee and board of director stock options, restricted stock units, and restricted stock awards.

Compensation and benefits expense increased by $28 million, or 6%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to increases in salaries and wages and incentive compensation. The following table shows a comparison of certain compensation and benefits components and employee data:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011	Percent Change
Salaries and wages	$ 271	$ 251	8%
Incentive compensation	116	110	5%
Employee benefits and other	78	76	3%
Total compensation and benefits expense	$ 465	$ 437	6%
Compensation and benefits expense as a percentage of total net revenues:			
Salaries and wages	23%	21%	
Incentive compensation	10%	9%	
Employee benefits and other	6%	6%	
Total compensation and benefits expense	39%	36%	
Full-time equivalent employees (in thousands) [(1)]			
At quarter end	14.0	13.1	7%
Average	14.0	13.0	8%

(1) Includes full-time, part-time and temporary employees, and persons employed on a contract basis, and excludes employees of outsourced service providers.

Salaries and wages increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to an increase in full-time employees, which was partially due to the addition of full-time employees from the optionsXpress acquisition. Incentive compensation increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to higher variable compensation.

Expenses Excluding Compensation and Benefits

Occupancy and equipment expense increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to an increase in software maintenance expense relating to the Company s information technology systems.

Advertising and market development expense increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to higher spending on customer promotions and seminars.

Depreciation and amortization expense increased in the first quarter of 2012 compared to the first quarter of 2011 primarily due to higher amortization of intangible assets relating to the optionsXpress acquisition.

Taxes on Income

The Company s effective income tax rate on income before taxes was 37.7% and 38.3% for the first quarters of 2012 and 2011, respectively.

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Segment Information

The Company provides financial services to individuals and institutional clients through two segments Investor Services and Institutional Services. The Investor Services segment provides retail brokerage and banking services to individual investors. The Institutional Services segment provides custodial, trading, and support services to independent investment advisors. The Institutional Services segment also provides retirement plan services, specialty brokerage services, and mutual fund clearing services, and supports the availability of Schwab proprietary mutual funds and collective trust funds on third-party platforms. Banking revenues and expenses are allocated to the Company s two segments based on which segment services the client. The Company evaluates the performance of its segments on a pre-tax basis, excluding items such as impairment charges on non-financial assets, discontinued operations, extraordinary items, and significant restructuring and other charges.

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

	Investor Services			Institutional Services		
Three Months Ended March 31,	**Percent Change**	**2012**	**2011**	**Percent Change**	**2012**	**2011**
Net Revenues:						
Asset management and administration fees	(6%)	$ 260	$ 276	(1%)	$ 223	$ 226
Net interest revenue	(2%)	365	373	10%	69	63
Trading revenue	2%	163	160		80	80
Other	35%	27	20	5%	20	19
Provision for loan losses	(100%)		(3)	(100%)		(1)
Net impairment losses on securities	167%	(16)	(6)	100%	(2)	(1)
Total net revenues	(3%)	799	820	1%	390	386
Expenses Excluding Interest	9%	606	554	4%	270	260
Income before taxes on income	(27%)	$ 193	$ 266	(5%)	$ 120	$ 126

	Unallocated			Total		
Three Months Ended March 31,	**Percent Change**	**2012**	**2011**	**Percent Change**	**2012**	**2011**
Net Revenues:						
Asset management and administration fees	N/M	$ 1	$	(4%)	$ 484	$ 502
Net interest revenue	N/M				434	436
Trading revenue	N/M		1	1%	243	241
Other	N/M	(1)		18%	46	39
Provision for loan losses	N/M			(100%)		(4)
Net impairment losses on securities	N/M			157%	(18)	(7)
Total net revenues	N/M		1	(1%)	1,189	1,207
Expenses Excluding Interest	N/M		(1)	8%	876	813

Income before taxes on income	N/M	$	$ 2	(21%)	$ 313	$ 394
Taxes on income				(22%)	(118)	(151)
Net Income				(20%)	$ 195	$ 243

N/M Not meaningful.

Investor Services

Net revenues decreased by $21 million, or 3%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to a decrease in asset management and administration fees and higher net impairment losses on securities, partially offset by an increase in other revenue. Asset management and administration fees decreased primarily due to a decrease in net money market mutual fund fees, partially offset by an increase in revenue from the Company s advice solutions relating to Windhaven. Net impairment losses in the Company s non-agency residential mortgage-backed securities portfolio were higher primarily due to further credit deterioration of the securities underlying loans and an increase in projected default

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rates for modified loans. Other revenue increased primarily due to the inclusion of revenues relating to education services and other service fees from the optionsXpress acquisition in September 2011. Expenses excluding interest increased by $52 million, or 9%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to increases in compensation and benefits, depreciation and amortization, professional services, and advertising and market development.

Institutional Services

Net revenues were relatively flat in the first quarter of 2012 compared to the first quarter of 2011 primarily due to an increase in net interest revenue, partially offset by a decrease in asset management and administration fees. Net interest revenue increased primarily due to higher average balances of interest-earning assets during the quarter, partially offset by the effect of lower interest rate spreads due to the continued low interest rate environment. Asset management and administration fees decreased primarily due to a decrease in net money market mutual fund fees, partially offset by an increase in other asset management and administration fees resulting from higher third-party mutual fund service fees. Expenses excluding interest increased by $10 million, or 4%, in the first quarter of 2012 compared to the first quarter of 2011 primarily due to increases in compensation and benefits and occupancy and equipment.

LIQUIDITY AND CAPITAL RESOURCES

CSC conducts substantially all of its business through its wholly-owned subsidiaries. The Company s capital structure is designed to provide each subsidiary with capital and liquidity to meet its operational needs and regulatory requirements.

CSC is a savings and loan holding company and Schwab Bank, CSC s depository institution, is a federal savings bank. CSC is subject to supervision and regulation by the Board of Governors of the Federal Reserve system and Schwab Bank is subject to supervision and regulation by the Office of the Comptroller of the Currency.

Liquidity

CSC

While CSC is not currently subject to specific statutory capital requirements, CSC is required to serve as a source of strength for Schwab Bank and must have the ability to provide financial assistance if Schwab Bank experiences financial distress. To manage capital adequacy, the Company currently utilizes a target Tier 1 Leverage Ratio, as defined by the Board of Governors of the Federal Reserve System, of at least 6%. At March 31, 2012, CSC s Tier 1 Leverage Ratio was 6.5%.

CSC s liquidity needs are generally met through cash generated by its subsidiaries, as well as cash provided by external financing. CSC has a universal automatic shelf registration statement (Shelf Registration Statement) on file with the SEC which enables CSC to issue debt, equity and other securities. CSC maintains excess liquidity in the form of overnight cash deposits and short-term investments to cover daily funding needs and to support growth in the Company s business. Generally, CSC does not hold liquidity at its subsidiaries in excess of amounts deemed sufficient to support the subsidiaries operations, including any regulatory capital requirements. Schwab, Schwab Bank, and optionsXpress, Inc. are subject to regulatory requirements that may restrict them from certain transactions with CSC, as further discussed below. Management believes that funds generated by the operations of CSC s subsidiaries will continue to be the primary funding source in meeting CSC s liquidity needs, providing adequate liquidity to meet Schwab Bank s capital guidelines, and maintaining Schwab and optionsXpress, Inc. s net capital.

On January 26, 2012, the Company completed an equity offering of 400,000 shares of its preferred stock under the Shelf Registration Statement. CSC s preferred stock is rated Baa2 by Moody s Investors Service (Moody s), BBB+ by Standard & Poor s Ratings Group (Standard & Poor s), and BB+ by Fitch Ratings, Ltd (Fitch). For further discussion of the equity offering, see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 8. Preferred Stock.

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CSC has liquidity needs that arise from the funding of cash dividends, acquisitions, and investments, as well as its Senior Notes, Senior Medium-Term Notes, Series A (Medium-Term Notes), and Junior Subordinated Notes. The following are details of CSC s long-term debt:

March 31, 2012	Par Outstanding	Maturity	Interest Rate	Moody s	Standard & Poor s	Fitch
Senior Notes	$ 1,450	2014 - 2020	4.45% to 4.950% fixed	A2	A	A
Medium-Term Notes	$ 250	2017	6.375% fixed	A2	A	A
Junior Subordinated Notes [1]	$ 202	2067	7.50% fixed until 2017, floating thereafter	Baa1	BBB+	BBB-

(1) The Junior Subordinated Notes themselves are not rated, however, the trust preferred securities related to these Junior Subordinated Notes are rated.

CSC has authorization from its Board of Directors to issue unsecured commercial paper notes (Commercial Paper Notes) not to exceed $1.5 billion. Management has set a current limit for the commercial paper program of $800 million. The maturities of the Commercial Paper Notes may vary, but are not to exceed 270 days from the date of issue. The commercial paper is not redeemable prior to maturity and cannot be voluntarily prepaid. The proceeds of the commercial paper program are to be used for general corporate purposes. There were no borrowings of Commercial Paper Notes outstanding at March 31, 2012. CSC s ratings for these short-term borrowings are P1 by Moody s, A1 by Standard & Poor s, and F1 by Fitch.

CSC maintains an $800 million committed, unsecured credit facility with a group of 11 banks, which is scheduled to expire in June 2012. This facility replaced a similar facility that expired in June 2011 and was unused during the first quarter of 2012. The funds under this facility are available for general corporate purposes, including repayment of the Commercial Paper Notes discussed above. The financial covenants under this facility require Schwab to maintain a minimum net capital ratio, as defined, Schwab Bank to be well capitalized, as defined, and CSC to maintain a minimum level of stockholders equity. At March 31, 2012, the minimum level of stockholders equity required under this facility was $5.1 billion (CSC s stockholders equity at March 31, 2012 was $8.3 billion). Management believes that these restrictions will not have a material effect on CSC s ability to meet foreseeable dividend or funding requirements.

CSC also has direct access to $670 million of the $795 million uncommitted, unsecured bank credit lines discussed below, that are primarily utilized by Schwab to manage short-term liquidity. These lines were not used by CSC during the first quarter of 2012.

In addition, Schwab provides CSC with a $1.0 billion credit facility, maturing December 2014. There were no funds drawn under this facility at March 31, 2012.

Schwab

Schwab is subject to regulatory requirements that are intended to ensure the general financial soundness and liquidity of broker-dealers. These regulations prohibit Schwab from repaying subordinated borrowings from CSC, paying cash dividends, or making unsecured advances or loans to its parent company or employees if such payment would result in a net capital amount of less than 5% of aggregate debit balances or less than 120% of its minimum dollar requirement of $250,000. At March 31, 2012, Schwab s net capital was $1.1 billion (9% of aggregate debit balances), which was $891 million in excess of its minimum required net capital and $516 million in excess of 5% of aggregate debit balances.

Most of Schwab s assets are readily convertible to cash, consisting primarily of short-term (i.e., less than 150 days) investment-grade, interest-earning investments (the majority of which are segregated for the exclusive benefit of clients pursuant to regulatory requirements), receivables from brokerage clients, and receivables from brokers, dealers, and clearing organizations. Client margin loans are demand loan obligations secured by readily marketable securities. Receivables from and payables to brokers, dealers, and clearing organizations primarily represent current open transactions, which usually settle, or can be closed out, within a few business days.

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Liquidity needs relating to client trading and margin borrowing activities are met primarily through cash balances in brokerage client accounts, which were $34.3 billion and $33.5 billion at March 31, 2012 and December 31, 2011, respectively. Management believes that brokerage client cash balances and operating earnings will continue to be the primary sources of liquidity for Schwab.

Schwab has a finance lease obligation related to an office building and land under a 20-year lease. The remaining finance lease obligation of $99 million at March 31, 2012, is being reduced by a portion of the lease payments over the remaining lease term of 13 years.

To manage short-term liquidity, Schwab maintains uncommitted, unsecured bank credit lines with a group of six banks totaling $795 million at March 31, 2012. The need for short-term borrowings arises primarily from timing differences between cash flow requirements, scheduled liquidation of interest-earning investments, and movements of cash to meet regulatory brokerage client cash segregation requirements. These lines were not used by Schwab during the first quarter of 2012.

To partially satisfy the margin requirement of client option transactions with the Options Clearing Corporation (OCC), Schwab has unsecured standby letter of credit agreements (LOCs) with seven banks in favor of the OCC aggregating $350 million at March 31, 2012. 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. At March 31, 2012, the aggregate face amount of these LOCs totaled $89 million. There were no funds drawn under any of these LOCs during the first quarter of 2012.

To manage Schwab s regulatory capital requirement, CSC provides Schwab with a $1.4 billion subordinated revolving credit facility, which is scheduled to expire in March 2014. The amount outstanding under this facility at March 31, 2012, was $245 million. Borrowings under this subordinated lending arrangement qualify as regulatory capital for Schwab.

In addition, CSC provides Schwab with a $2.5 billion credit facility, which is scheduled to expire in December 2014. Borrowings under this facility do not qualify as regulatory capital for Schwab. There were no funds drawn under this facility at March 31, 2012.

Schwab Bank

Schwab Bank is required to maintain capital levels as specified in federal banking laws and regulations. Failure to meet the minimum levels could result in certain mandatory, and possibly additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on Schwab Bank. Based on its regulatory capital ratios at March 31, 2012, Schwab Bank is considered well capitalized. Schwab Bank s regulatory capital and ratios at March 31, 2012, are as follows:

	$3,381	$3,381	$3,381	$3,381	$3,381	$3,381
	Actual		**Minimum Capital Requirement**		**Minimum to be Well Capitalized**	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Tier 1 Risk-Based Capital	$ 5,153	23.7%	$ 870	4.0%	$ 1,305	6.0%
Total Risk-Based Capital	$ 5,201	23.9%	$ 1,740	8.0%	$ 2,175	10.0%
Tier 1 Core Capital	$ 5,153	7.6%	$ 2,705	4.0%	$ 3,381	5.0%
Tangible Equity	$ 5,153	7.6%	$ 1,352	2.0%	N/A	

N/A Not applicable.

Management has established a target Tier 1 Core Capital Ratio for Schwab Bank of at least 7.5%. Schwab Bank s current liquidity needs are generally met through deposits from banking clients and equity capital.

The excess cash held in certain Schwab brokerage client accounts is swept into deposit accounts at Schwab Bank. At March 31, 2012, these balances totaled $41.9 billion.

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Schwab Bank has access to traditional funding sources such as deposits, federal funds purchased, and repurchase agreements. Additionally, Schwab Bank has access to short-term funding through the Federal Reserve Bank (FRB) discount window. Amounts available under the FRB discount window are dependent on the fair value of certain of Schwab Bank s securities available for sale and securities held to maturity that are pledged as collateral. Schwab Bank maintains policies and procedures necessary to access this funding and tests discount window borrowing procedures annually. At March 31, 2012, $1.9 billion was available under this arrangement. There were no funds drawn under this arrangement during the first quarter of 2012.

Schwab Bank maintains a credit facility with the Federal Home Loan Bank System. Amounts available under this facility are dependent on the amount of Schwab Bank s residential real estate mortgages and home equity lines of credit (HELOCs) that are pledged as collateral. At March 31, 2012, $5.3 billion was available under this facility. There were no funds drawn under this facility during the first quarter of 2012.

CSC provides Schwab Bank with a $100 million short-term credit facility, which is scheduled to expire in December 2014. Borrowings under this facility do not qualify as regulatory capital for Schwab Bank. There were no funds drawn under this facility during the first quarter of 2012.

optionsXpress

optionsXpress, Inc., a wholly-owned subsidiary of optionsXpress, is a registered broker-dealer and is subject to regulatory requirements that are intended to ensure the general financial soundness and liquidity of broker-dealers. These regulations prohibit optionsXpress, Inc. from paying cash dividends or making unsecured advances or loans to its parent company or employees if such payment would result in a net capital amount of less than 5% of aggregate debit balances or less than 120% of its minimum dollar requirement of $250,000. At March 31, 2012, optionsXpress, Inc. s net capital was $68 million (27% of aggregate debit balances), which was $63 million in excess of its minimum required net capital and $56 million in excess of 5% of aggregate debit balances.

optionsXpress, Inc. is also subject to Commodity Futures Trading Commission Regulation 1.17 (Reg. 1.17) under the Commodity Exchange Act, which also requires the maintenance of minimum net capital. optionsXpress, Inc. as a futures commission merchant, is required to maintain minimum net capital equal to the greater of its net capital requirement under Reg. 1.17 ($1 million), or the sum of 8% of the total risk margin requirements for all positions carried in customer accounts and 8% of the total risk margin requirements for all positions carried in non-customer accounts (as defined in Reg. 1.17).

Liquidity needs relating to client trading and margin borrowing activities are met primarily through cash balances in brokerage client accounts, which were $1.4 billion at March 31, 2012. Management believes that brokerage client cash balances and operating earnings will continue to be the primary sources of liquidity for optionsXpress, Inc.

CSC provides optionsXpress, Inc. with a $100 million credit facility, which is scheduled to expire in December 2014. Borrowings under this facility do not qualify as regulatory capital for optionsXpress, Inc. There were no borrowings outstanding under this facility at March 31, 2012.

optionsXpress has a term loan with CSC, of which $107 million was outstanding at March 31, 2012, and matures in December 2014.

Capital Resources

The Company monitors both the relative composition and absolute level of its capital structure. Management is focused on limiting the Company s use of capital and currently targets a long-term debt to total financial capital ratio not to exceed 30%. The Company s total financial capital (long-term debt plus stockholders equity) at March 31, 2012, was $10.3 billion, up $622 million, or 6%, from December 31, 2011. At March 31, 2012, the Company had long-term debt of $2.0 billion, or 19% of total financial capital, that bears interest at a weighted-average rate of 5.24%. At December 31, 2011, the Company had long-term debt of $2.0 billion, or 21% of total financial capital. The Company repaid $1 million of long-term debt in the first quarter of 2012.

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The Company s cash position (reported as cash and cash equivalents on its condensed consolidated balance sheet) and cash flows are affected by changes in brokerage client cash balances and the associated amounts required to be segregated under regulatory guidelines. Timing differences between cash and investments actually segregated on a given date and the amount required to be segregated for that date may arise in the ordinary course of business, and are addressed by the Company in accordance with applicable regulations. Other factors which affect the Company s cash position and cash flows include investment activity in securities, levels of capital expenditures, acquisition and divestiture activity, banking client deposit activity, brokerage and banking client loan activity, financing activity in long-term debt, payments of dividends, and repurchases and issuances of CSC s preferred and common stock. The combination of these factors can cause significant fluctuations in the cash position during specific time periods.

Equity Offering

On January 26, 2012, the Company issued and sold 400,000 shares of fixed-to-floating rate non-cumulative perpetual preferred stock, Series A, $0.01 par value, with a liquidation preference of $1,000 per share (Series A Preferred Stock). Net proceeds received from the sale were $394 million and are being used for general corporate purposes, including, without limitation, to support the Company s balance sheet growth and the potential migration of certain client cash balances to deposit accounts at Schwab Bank. For further discussion, see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 8. Preferred Stock.

Capital Expenditures

The Company s capital expenditures were $34 million and $37 million in the first quarters of 2012 and 2011, respectively. Capital expenditures in the first quarter of 2012 were primarily for capitalized costs for developing internal-use software, software and equipment relating to the Company s information technology systems, and leasehold improvements. Capital expenditures in the first quarter of 2011 were primarily for software and equipment relating to the Company s information technology systems and leasehold improvements. Capitalized costs for developing internal-use software were $14 million and $7 million in the first quarters of 2012 and 2011, respectively.

Dividends

CSC paid common stock cash dividends of $77 million ($0.06 per share) and $72 million ($0.06 per share) in the first quarters of 2012 and 2011, respectively.

Under the terms of the Series A Preferred Stock issued in January 2012, the Company s ability to pay dividends on, make distributions with respect to, or to repurchase, redeem or acquire its common stock is subject to restrictions in the event that the Company does not declare and either pay or set aside a sum sufficient for payment of dividends on the Series A Preferred Stock for the immediately preceding dividend period.

Share Repurchases

There were no repurchases of CSC s common stock in the first quarters of 2012 or 2011. As of March 31, 2012, CSC had remaining authority from the Board of Directors to repurchase up to $596 million of its common stock, which does not have an expiration date.

Business Acquisition

On September 1, 2011, the Company completed its acquisition of all of the outstanding common shares of optionsXpress, an online brokerage firm primarily focused on equity option securities and futures, for total consideration of $714 million. Under the terms of the merger agreement, optionsXpress stockholders received 1.02 shares of the Company s common stock for each share of optionsXpress stock. As a result, the Company issued 59 million shares of the Company s common stock valued at $710 million, based on the closing price of the Company s common stock on September 1, 2011. The Company also assumed optionsXpress stock-based compensation awards valued at $4 million.

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Off-Balance Sheet Arrangements

The Company enters into various off-balance sheet arrangements in the ordinary course of business, primarily to meet the needs of its clients. These arrangements include firm commitments to extend credit. Additionally, the Company enters into guarantees and other similar arrangements as part of transactions in the ordinary course of business. For discussion on the Company s off-balance sheet arrangements, see Part II Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, and Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 6. Commitments and Contingencies.

RISK MANAGEMENT

The Company s business activities expose it to a variety of risks, including technology, operations, credit, market, liquidity, legal, and reputational risk. Identification and management of these risks are essential to the success and financial soundness of the Company.

For a discussion on risks that the Company faces and the policies and procedures for risk identification, assessment, and management, see Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. For updated information on the Company s credit risk and concentration risk exposures, see below. See Item 3 Quantitative and Qualitative Disclosures About Market Risk for additional information relating to market risk.

Risk is inherent in the Company s business. Consequently, despite the Company s efforts to identify areas of risk and implement risk management policies and procedures, there can be no assurance that the Company will not suffer unexpected losses due to operating or other risks.

Credit Risk Exposures

The Company has exposure to credit risk associated with the Company s loans to banking clients. The Company s mortgage loan portfolios primarily include first lien residential real estate mortgage loans (First Mortgage) of $5.6 billion and HELOCs of $3.5 billion at March 31, 2012.

The Company s First Mortgage portfolio underwriting requirements are generally consistent with the underwriting requirements in the secondary market for loan portfolios. The Company s guidelines include maximum loan-to-value (LTV) ratios, cash out limits, and minimum Fair Isaac & Company (FICO) credit scores. The specific guidelines are dependent on the individual characteristics of a loan (for example, whether the property is a primary or secondary residence, whether the loan is for investment property, whether the loan is for an initial purchase of a home or refinance of an existing home, and whether the loan is conforming or jumbo). These credit underwriting standards have limited the exposure to the types of loans that experienced high foreclosures and loss rates elsewhere in the industry in recent years. There have been no significant changes to the LTV ratio or FICO credit score guidelines related to the Company s First Mortgage or HELOC portfolios during the first quarter of 2012. At March 31, 2012, the weighted-average originated LTV ratios were 60% and 59% for the First Mortgage and HELOC portfolios, respectively. The computation of the origination LTV ratio for a HELOC includes any first lien mortgage outstanding on the same property at the time of origination. At March 31, 2012, 22% of HELOCs ($748 million of the HELOC portfolio) were in a first lien position. The weighted-average originated FICO credit scores were 765 and 768 for the First Mortgage and HELOC portfolios, respectively.

The Company does not offer loans that allow for negative amortization and does not originate or purchase subprime loans (generally defined as extensions of credit to borrowers with a FICO credit score of less than 620 at origination), unless the borrower has compensating credit factors. At March 31, 2012, approximately 1% of both the First Mortgage and HELOC portfolios consisted of loans to borrowers with FICO credit scores of less than 620.

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The following table presents certain of the Company s loan quality metrics as a percentage of total outstanding loans:

	March 31, 2012	December 31, 2011
Loan delinquencies [1]	0.76%	0.81%
Nonaccrual loans	0.48%	0.53%
Allowance for loan losses	0.51%	0.55%

(1) Loan delinquencies are defined as loans that are 30 days or more past due.

The Company has exposure to credit risk associated with its securities available for sale and securities held to maturity portfolios, whose fair values totaled $37.8 billion and $15.3 billion at March 31, 2012, respectively. These portfolios include U.S. agency and non-agency residential mortgage-backed securities, certificates of deposit, corporate debt securities, U.S. agency notes, and asset-backed and other securities. U.S. agency residential mortgage-backed securities do not have explicit credit ratings, however, management considers these to be of the highest credit quality and rating given the guarantee of principal and interest by the U.S. government-sponsored enterprises. Included in non-agency residential mortgage-backed securities are securities collateralized by loans that are considered to be Prime (defined by the Company as loans to borrowers with a FICO credit score of 620 or higher at origination), and Alt-A (defined by the Company as Prime loans with reduced documentation at origination).

Residential mortgage-backed securities, particularly Alt-A securities, experienced continued credit deterioration in the first quarter of 2012, including increased payment delinquency rates and losses on foreclosures of underlying mortgages. For a discussion of the impact of current market conditions on residential mortgage-backed securities, see Current Market and Regulatory Environment. At March 31, 2012, non-agency residential mortgage-backed securities consisted of 3%, based on amortized cost, of total residential mortgage-backed securities. These securities were originated between 2003 and 2007. At March 31, 2012, all of the corporate debt securities and non-mortgage asset-backed securities were rated investment grade (defined as a rating equivalent to a Moody s rating of Baa or higher, or a Standard & Poor s rating of BBB- or higher).

Concentration Risk Exposures

The Company has exposure to concentration risk when holding large positions in financial instruments collateralized by assets with similar economic characteristics or in securities of a single issuer or industry.

The fair value of the Company s investments in residential mortgage-backed securities totaled $39.5 billion at March 31, 2012. Of these, $38.7 billion were U.S. agency securities and $859 million were non-agency securities. The U.S. agency securities are included in securities available for sale and securities held to maturity and the non-agency securities are included in securities available for sale. Included in non-agency residential mortgage-backed securities are securities collateralized by Alt-A loans. At March 31, 2012, the amortized cost and fair value of Alt-A mortgage-backed securities were $361 million and $281 million, respectively.

The Company s investments in corporate debt securities and commercial paper totaled $6.0 billion at March 31, 2012, with the majority issued by institutions in the financial services industry. These securities are included in securities available for sale, securities held to maturity, cash and investments segregated and on deposit for regulatory purposes, cash and cash equivalents, and other securities owned in the Company s condensed consolidated balance sheets. At March 31, 2012, the Company held $1.0 billion of corporate debt securities issued by financial institutions and guaranteed under the FDIC Temporary Liquidity Guarantee Program.

The Company s loans to banking clients include $5.6 billion of adjustable rate first lien residential real estate mortgage loans at March 31, 2012. The Company s adjustable rate mortgages have initial fixed interest rates for three to ten years and interest rates that adjust annually thereafter.

Approximately 55% of these mortgages consisted of loans with interest-only payment terms. The interest rates on approximately 65% of these interest-only loans are not scheduled to reset for three or more years. The Company s mortgage loans do not include interest terms described as temporary introductory rates below current market rates. At March 31, 2012, 44% of the residential real estate mortgages and 50% of the HELOC balances were secured by properties which are located in California.

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The Company also has exposure to concentration risk from its margin and securities lending activities collateralized by securities of a single issuer or industry.

The Company has indirect exposure to U.S. Government and agency securities held as collateral to secure its resale agreements. The Company s primary credit exposure on these resale transactions is with its counterparty. The Company would have exposure to the U.S. Government and agency securities only in the event of the counterparty s default on the resale agreements. The fair value of U.S. Government and agency securities held as collateral for resale agreements totaled $18.2 billion at March 31, 2012.

European Holdings

The Company has exposure to non-sovereign financial institutions in Europe. The following table shows the amortized cost and fair values of cash equivalents, cash and investments segregated and on deposit for regulatory purposes, securities available for sale, and securities held to maturity by each country in Europe in which the issuer or counterparty is domiciled. The Company has no direct exposure to sovereign governments in Europe. The Company does not have unfunded commitments to counterparties in Europe, nor does it have exposure as a result of credit default protection purchased or sold separately as of March 31, 2012.

	Fair Value as of March 31, 2012								
	Denmark[1]	France	Germany	Netherlands	Norway	Sweden	Switzerland	United Kingdom[1]	Total
Cash equivalents:									
Time deposits	$	$ 746	$	$	$ 200	$	$	$ 300	$ 1,246
Commercial paper		100							100
Cash and investments segregated and on deposit for regulatory purposes:									
Certificates of deposit					100				100
Trust deposits			400						400
Securities available for sale:									
Certificates of deposit		200	150	300		500	551	700	2,401
Corporate debt securities	213			192		100		746	1,251
Securities held to maturity:									
Corporate debt securities						117	98		215
Total fair value	$ 213	$ 1,046	$ 550	$ 492	$ 300	$ 717	$ 649	$ 1,746	$ 5,713
Total amortized cost	$ 212	$ 1,046	$ 550	$ 492	$ 300	$ 716	$ 650	$ 1,745	$ 5,711
Maturities:									
Overnight	$	$ 846	$ 400	$	$ 200	$	$	$ 300	$ 1,746
1 day < 6 months				200	100	117	175	650	1,242
6 months < 1 year		200	150	70		200	175	501	1,296
1 year 2 years	213			122		400	201	250	1,186
> 2 years				100			98	45	243

Total fair value	$ 213	$ 1,046	$ 550	$ 492	$ 300	$ 717	$ 649	$ 1,746	$ 5,713

(1) Certain of the exposures in Denmark and the United Kingdom are also backed by the full faith and credit of the Denmark and United Kingdom governments.

In addition to the direct holdings of European companies listed above, the Company also has indirect exposure to Europe through its investments in Schwab sponsored money market funds (collectively, the Funds) resulting from clearing activities. At March 31, 2012, the Company had $178 million in investments in these Funds. Certain of the Funds positions include certificates of deposits, time deposits, commercial paper and corporate debt securities issued by counterparties in Europe.

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CRITICAL ACCOUNTING ESTIMATES

Certain of the Company s accounting policies that involve a higher degree of judgment and complexity are discussed in Part II Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. There have been no changes to these critical accounting estimate categories during the first quarter of 2012.

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, aim, target, could, and other similar expres 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 necessarily estimates based on the best judgment of the Company s senior management. These statements relate to, among other things:

- the impact of current market conditions on the Company s results of operations (see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 4. Securities Available for Sale and Securities Held to Maturity and Current Market and Regulatory Environment);

- the launch of the HELOC portion of Schwab Bank s co-branded loan origination program with Quicken Loans, Inc. (see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 5. Loans to Banking Clients and Related Allowance for Loan Losses);

- the impact of changes in the likelihood of guarantee payment obligations on the Company s results of operations (see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 6. Commitments and Contingencies);

- the impact of legal proceedings and regulatory matters (see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 6. Commitments and Contingencies and Part II Other Information Item 1 Legal Proceedings);

- target capital ratios (see Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 11. Regulatory Requirements and Liquidity and Capital Resources); and

- sources of liquidity, capital, and level of dividends (see Liquidity and Capital Resources).

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:

- changes in general economic and financial market conditions;
- changes in revenues and profit margin due to changes in interest rates;
- the Company s ability to attract and retain clients and grow client assets and relationships;
- the Company s ability to develop and launch new products, services and capabilities in a timely and successful manner;
- fluctuations in client asset values due to changes in equity valuations;
- the Company s ability to monetize client assets;
- the performance or valuation of securities available for sale and securities held to maturity;
- trading activity;
- the level of interest rates, including yields available on money market mutual fund eligible instruments;
- potential breaches of contractual terms for which the Company has guarantee obligations;
- adverse developments in litigation or regulatory matters;

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

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

- amounts recovered on insurance policies;
- the extent of any charges associated with litigation and regulatory matters;
- the adverse impact of financial reform legislation and related regulations;
- the amount of loans to the Company s brokerage and banking clients;
- the level of the Company s stock repurchase activity;
- capital needs;
- level of expenses;
- acquisition integration costs;
- the level of brokerage client cash balances and deposits from banking clients; and
- the availability and terms of external financing.

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 Company s Annual Report on Form 10-K for the year ended December 31, 2011, and Part II Other Information Item 1A Risk Factors.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk
Market risk is the potential for changes in revenue or the value of financial instruments held by the Company as a result of fluctuations in interest rates, equity prices or market conditions.

For the Company s market risk related to interest rates, a sensitivity analysis, referred to as a net interest revenue simulation model, is shown below. The Company is exposed to interest rate risk primarily from changes in market interest rates on its interest-earning assets relative to changes in the costs of its funding sources that finance these assets.

Net interest revenue is affected by various factors, such as the distribution and composition of interest-earning assets and interest-bearing liabilities, the spread between yields earned on interest-earning assets and rates paid on interest-bearing liabilities, which may reprice at different times or by different amounts, and the spread between short and long-term interest rates. Interest-earning assets include residential real estate loans and mortgage-backed securities. These assets are sensitive to changes in interest rates and to changes to prepayment levels, which tend to increase in a declining rate environment.

To mitigate the risk of loss, the Company has established policies and procedures which include setting guidelines on the amount of net interest revenue at risk, and monitoring the net interest margin and average maturity of its interest-earning assets and funding sources. To remain within these guidelines, the Company manages the maturity, repricing, and cash flow characteristics of the investment portfolios. Because the Company establishes the rates paid on certain brokerage client cash balances and deposits from banking clients, the rates charged on margin loans, and controls the composition of its investment securities, it has some ability to manage its net interest spread, depending on competitive factors and market conditions.

The Company is also subject to market risk as a result of fluctuations in equity prices. The Company s direct holdings of equity securities and its associated exposure to equity prices are not material. The Company is indirectly exposed to equity market fluctuations in connection with securities collateralizing margin loans to brokerage customers, and customer securities loaned out as part of the Company s securities lending activities. Equity market valuations may also affect the level of brokerage client trading activity, margin borrowing, and overall client engagement with the Company. Additionally, the Company earns mutual fund service fees and asset management fees based upon daily balances of certain client assets. Fluctuations in these client asset balances caused by changes in equity valuations directly impact the amount of fee revenue earned by the Company.

Financial instruments held by the Company are also subject to liquidity risk that is, the risk that valuations will be negatively affected by changes in demand and the underlying market for a financial instrument. Recent conditions in the credit markets have significantly reduced market liquidity in a wide range of financial instruments, including the types of instruments held by the Company, and fair value can differ significantly from the value implied by the credit quality and actual performance of the instrument s underlying cash flows.

Financial instruments held by the Company are also subject to valuation risk as a result of changes in valuations of the underlying collateral, such as housing prices in the case of residential real estate loans and mortgage-backed securities.

For discussion of the impact of current market conditions on asset management and administration fees, net interest revenue, and securities available for sale, see Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations Current Market and Regulatory Environment.

The Company s market risk related to financial instruments held for trading and forward sale and interest rate lock commitments related to its loans held for sale portfolio is not material.

Net Interest Revenue Simulation

The Company uses net interest revenue simulation modeling techniques to evaluate and manage the effect of changing interest rates. The simulation model (the model) includes all interest-sensitive assets and liabilities. Key variables in the model include the repricing of financial instruments, prepayment, reinvestment, and product pricing assumptions. The Company uses constant balances and market rates in the model assumptions in order to minimize the number of variables

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and to better isolate risks. The simulations involve assumptions that are inherently uncertain and, as a result, cannot precisely estimate net interest revenue or predict the impact of changes in interest rates on net interest revenue. Actual results may differ from simulated results due to balance growth or decline and the timing, magnitude, and frequency of interest rate changes, as well as changes in market conditions and management strategies, including changes in asset and liability mix.

As represented by the simulations presented below, the Company s investment strategy is structured to produce an increase in net interest revenue when interest rates rise and, conversely, a decrease in net interest revenue when interest rates fall (i.e., interest-earning assets generally reprice more quickly than interest-bearing liabilities).

The simulations in the following table assume that the asset and liability structure of the consolidated balance sheet would not be changed as a result of the simulated changes in interest rates. As the Company actively manages its consolidated balance sheet and interest rate exposure, in all likelihood the Company would take steps to manage any additional interest rate exposure that could result from changes in the interest rate environment. The following table shows the results of a gradual 100 basis point increase or decrease in market interest rates relative to the Company s current market rates forecast on simulated net interest revenue over the next 12 months beginning March 31, 2012, and December 31, 2011.

	March 31, 2012	December 31, 2011
Increase of 100 basis points	16.3%	19.1%
Decrease of 100 basis points	(6.0%)	(8.1%)

The sensitivities shown in the simulation reflect the fact that short-term interest rates in the first quarter of 2012 remained at historically low levels, including the federal funds target rate, which was unchanged at a range of zero to 0.25%. The current low interest rate environment limits the extent to which the Company can reduce interest expense paid on funding sources in a declining interest rate scenario. A decline in interest rates could therefore negatively impact the yield on the Company s investment portfolio to a greater degree than any offsetting reduction in interest expense, further compressing net interest margin. Any increases in short-term interest rates result in a greater impact as yields on interest-earning assets are expected to rise faster than the cost of funding sources.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures: The management of the Company, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of March 31, 2012. Based on this evaluation, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures were effective as of March 31, 2012.

Changes in internal control over financial reporting: No change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) was identified during the quarter ended March 31, 2012, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

For a discussion of legal proceedings, see Part I Financial Information Item 1 Condensed Consolidated Financial Statements (Unaudited) Notes 6. Commitments and Contingencies.

Item 1A. Risk Factors

During the first quarter of 2012, there have been no material changes to the risk factors in Part I Item 1A Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

The following table summarizes purchases made by or on behalf of CSC of its common stock for each calendar month in the first quarter of 2012:

Month	of Shares Purchased Total Number of Shares Purchased (in thousands)	of Shares Purchased Average Price Paid per Share	of Shares Purchased Total Number of Shares Purchased as Part of Publicly Announced Program [1] (in thousands)	of Shares Purchased Approximate Dollar Value of Shares that May Yet be Purchased Under the Program (in millions)
January:				
Share repurchase program [1]		$		$ 596
Employee transactions [2]	3	$ 11.65	N/A	N/A
February:				
Share repurchase program [1]		$		$ 596
Employee transactions [2]	8	$ 12.64	N/A	N/A
March:				
Share repurchase program [1]		$		$ 596
Employee transactions [2]	20	$ 14.27	N/A	N/A
Total:				
Share repurchase program [1]		$		$ 596
Employee transactions [2]	31	$ 13.58	N/A	N/A

N/A Not applicable.

(1) There were no share repurchases under the Share Repurchase Program during the first quarter. Repurchases under this program would occur under two authorizations by CSC s Board of Directors, each covering up to $500 million of common stock that were publicly announced by the Company on April 25, 2007, and March 13, 2008. The remaining authorizations do not have an expiration date.

(2) Includes restricted shares withheld (under the terms of grants under employee stock incentive plans) to offset tax withholding obligations that occur upon vesting and release of restricted shares. The Company may receive shares delivered or attested to pay the exercise price and/or to satisfy tax withholding obligations by employees who exercise stock options (granted under employee stock incentive plans), which are commonly referred to as stock swap exercises.

Item 3. Defaults Upon Senior Securities

None.

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Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits

The following exhibits are filed as part of this Quarterly Report on Form 10-Q.

Exhibit Number	Exhibit	
3.15	Certificate of Designations of Fixed to Floating Rate Non-Cumulative Perpetual Preferred Stock, Series A of The Charles Schwab Corporation, filed as Exhibit 3.15 to the Registrant s Form 8-K dated January 24, 2012 and incorporated herein by reference.	
10.348	Separation Agreement, General Release and Waiver of Claims by and between Mr. Brigeman and the Company, filed as Exhibit 10.348 to the Registrant s Form 8-K dated March 7, 2012 and incorporated herein by reference.	(1)
12.1	Computation of Ratio of Earnings to Fixed Charges.	
31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a), As Adopted Pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.	
31.2	Certification Pursuant to Rule 13a-14(a)/15d-14(a), As Adopted Pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.	
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.	(2)
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.	(2)
101.INS	XBRL Instance Document	(3)
101.SCH	XBRL Taxonomy Extension Schema	(3)
101.CAL	XBRL Taxonomy Extension Calculation	(3)
101.DEF	XBRL Extension Definition	(3)
101.LAB	XBRL Taxonomy Extension Label	(3)
101.PRE	XBRL Taxonomy Extension Presentation	(3)

(1) *Management contract or compensatory plan.*

(2) *Furnished as an exhibit to this Quarterly Report on Form 10-Q.*

(3) *Attached as Exhibit 101 to this Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012 are the following materials formatted in XBRL (Extensible Business Reporting Language) (i) the Condensed Consolidated Statements of Income, (ii) the Condensed Consolidated Statements of Comprehensive Income, (iii) the Condensed Consolidated Balance Sheets, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.*

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE CHARLES SCHWAB CORPORATION
(Registrant)

Date: May 7, 2012

/s/ Joseph R. Martinetto
Joseph R. Martinetto
Executive Vice President and Chief Financial Officer

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