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E*TRADE Financial Corp. *(ETFC)*

Q1 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator

FINANCIAL MEASURES

- During this call, E*TRADE Financial may also discuss some non-GAAP financial measures in talking about its performance
- The company provides these measures due to its belief that they provide important information about its operating results
  - These measures will be reconciled to the most directly comparable GAAP financial measures, either during the course of this call or in the company's press release, which can be found on its website at investor.etrade.com
  - These non-GAAP financial measures should be considered in conjunction with the comparable GAAP measures

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

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Q1 REVIEW

- Q1 was a solid one on several fronts, as we generated some of the strongest customer metrics in the firm's history, made good progress in reducing risk on the legacy loan portfolio and grew revenues sequentially despite a difficult interest rate environment
- We reported EPS of $0.22, which included $0.09 per share income tax benefit on total net revenue of $489mm, representing a 3% sequential growth

Brokerage Business

- Our brokerage business was quite robust this quarter, DARTs grew by 12% sequentially while generating record net new brokerage assets of $4B in the quarter and 11% annualized growth rate and more than doubled the $1.7B in the prior quarter
- Net new brokerage accounts of 46,000, well above last quarter's 10,000
- Our brokerage account attrition rate hit a record low 8.7% annualized, marking the second consecutive quarter this metric has tracked below 10%
    - This is a significant improvement in the previous three years, which averaged 12%, and is a testament to our ongoing efforts to improve the customer experience
- During the quarter we were recognized by the American Customer Service Index with the first place score among online brokers, the result of a 4% improvement in our score, the largest in our peer group
- Brokerage-related cash also ended the quarter at the highest level on record at $31B, enabling us to offset the majority of net interest spread compression through volume

Credit Front

- On the credit front, we made meaningful progress on our review of loan modification practices and procedures which we discussed last quarter, and Matt will cover the details later in the call
    - I would point out that our legacy loan portfolio ended the quarter at $12.4B, down 6% sequentially and down 62% from its peak
    - Our overall delinquencies are down 56% from their peak and are at their lowest level in over four years
    - Meanwhile, special mention delinquencies are down 20% sequentially at their lowest level in five years

Customer Offering

- As for our customer offering, we launched several new products and enhancements during the quarter and unveiled two important website redesigns, rebuilding our storefront through a comprehensive retooling of our public website and completing the rollout of E*TRADE 360, bringing a unique and streamlined experience to our customers
    - Both cites have been well received, and we continue to make refinements and optimize based on feedback and in-market testing
- We will further enhance the prospect experience this year, with the incorporation of new planning tools and improvements to the Investor Education Section of our site with the goal of deepening engagement and strengthening E*TRADE's brand position as the place to receive the best investing experience
    - We also integrated a Retail Forex offer into our product set for those more sophisticated active traders

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Enhancements to Existing Platforms

- In addition to these major launches, we rolled out a number of enhancements and upgrades to our existing platforms
- We redesigned our Bond Resource Center to offer streamlined access to news, unbiased education, intuitive screeners to select individual bonds and tools to help our customers quickly and easily build out the fixed income portion of their portfolio
  - We also made enhancements to E*TRADE Mobile on both iPhone and Android, including mobile check deposit capability, complex options trading and mutual fund trading
  - Yesterday, we announced voice recognition for the iPhone allowing users to verbally prompt quotes and order tickets as well as barcode scanning for iPhone and Android

Mobile Strategy

- We believe our mobile strategy is a highly differentiating element of our offerings and we have seen a steady increase in customer utilization, with 6% of our trades this quarter executed via mobile applications, up from 3% a year ago
  - We continue to bolster our retirement offering and believe we are on the right track to attain a meaningful presence in this category
  - The combination of our education and product offerings and our certified retirement planning counselors and financial consultants are helping us develop momentum in this area
- Retirement assets now account for 16% of our total assets and retirement accounts make up 28% of total brokerage accounts
- During the quarter, we hosted our first-ever all-day retirement education event, with over 3,400 participants, comprised of both current and prospective customers

Brand Positioning

- We continue to enhance our brand positioning, having used the Super Bowl to kick off a broad marketing campaign gear toward retirement and investing products and services
- In summary, we feel good about our performance during the quarter, both in terms of our customer value proposition as well as our financial results, which Matt will now walk you through

Matthew J. Audette

*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

FINANCIAL RESULTS

Net Income and Revenue

- For Q1, we reported net income of $63mm, or $0.22 per share, inclusive of $0.09 per share tax benefit, which I will describe in more detail shortly
- We generated $489mm in net revenue, up from $475mm in Q4 2011 but down from $537mm in Q1 2011
- Our first quarter revenue included net interest income of $285mm, a sequential decline of just $4mm despite 17BPS of net interest spread contraction
  - While this decline in spread was in line with our expectations, growth in brokerage cash to its current levels is well above what we expected for the quarter

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Net Interest Spread

- While this growth drove an increase in net interest income, it's a negative for net interest spread, as the marginal spread on a balance sheet that is increasing in size is lower given our philosophy to maintain a modest level of interest rate risk
- Last quarter, when we communicated expectations for net interest spread in 2012 to be slightly below 250BPS, we not predicted this significant growth in brokerage cash we experienced this quarter
  - Therefore, if our balance sheet remains at this elevated level, we expect that our net interest spread for the full year would be approximately 240BPS

Capital Ratios

- While we are incredibly pleased with the growth of the franchise and the customer cash that comes with it, our near-term priority is to improve our capital ratios through a reduction in our balance sheet size, with an eye on bolstering our leverage ratio
- We are focused on reducing less efficient or non-strategic liabilities that are not core to our franchise
- We do not have any specific actions to announce on this today, but we will provide an update when there's something specific to share

Commissions, Fees and Service Charges

- Commissions, fees and service charges, principle transactions and other revenue in Q1 were $173mm, up 11% from Q4 but down 14% from the same quarter of 2011
  - This sequential increase is driven by higher DARTs and a higher average commission, while the y-over-y change reflects the declines in both of those metrics
- Revenue this quarter also included $31mm of net gains on loans and securities inclusive of $3.5mm impairment

Operating Expenses

- Total operating expenses rose sequentially by $2mm, mainly as a result of a seasonal increase in advertising and compensation partially offset by the fact that the prior quarter included unique items of approximately $12.5mm
- During the quarter, we recorded an income of benefit of approximately $26mm related to certain losses on the 2009 debt exchange previously considered non-deductible
  - In 2009, we exchanged $1.7B of interest-bearing debt for zero coupon convertible debt, which generated a non-cash loss of $968mm with a portion of that loss being nondeductible for tax purposes
  - Through additional research completed this quarter, we identified a portion of these losses that are deductible for tax purposes over the life of the debt
  - The results of this finding was a benefit to tax expense in Q1 approximately $26mm with a corresponding increase to our DTA, which now stands at $1.6B

Effective Tax Rate

- Without this adjustment, our effective tax rate this quarter was 45%

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- We continue to estimate our effective tax rate would trend in the mid 40%s, primarily driven from the nondeductible portion of our interest expense on the 12.5% notes, which impacts tax expense by approximately $15mm annually

Brokerage Metrics

- Our brokerage metrics this quarter reflected a better retail trading environment as well as the strength of our franchise
- DARTs for Q1 were 157,000, a 12% increase from last quarter, but down 11% from a year ago
- Net new brokerage accounts were 46,000 in Q1, up from 10,000 in the prior quarter, but down slightly from 51,000 in Q1 2011
- Net new brokerage assets totaled $4B during the quarter, representing 11% annualized growth
    - This was up from $1.7B last quarter and $3.9B in Q1 2011
- We ended the quarter with $31B in brokerage-related cash, an increase of $3.3B during the quarter
- Meanwhile, customers were net buyers of $100mm of securities
- Margin receivables ended the quarter at $5.3B, up $500mm from year-end and averaging $4.9B during the quarter, flat with the prior quarter

Legacy Loan Portfolio

- Our legacy loan portfolio ended the quarter at $12.4B, a contraction of $780mm during the quarter
    - It is now down over 62% from its size at the peak
- I will cover more on the quality of the book, but first I would like to address this quarter's provisions
- During the quarter, we completed an evaluation of our portfolio of TDRs and certain modification policies and procedures to align with the guidance of our new primary banking regulator, the OCC
- You may recall that we announced an evaluation last quarter and increased our reserves in anticipation of the results, specific to existing modifications

CHARGE-OFFS

- The review resulted in a significant increase in charge-offs this quarter, which we believe address the key issues raised last quarter by our new regulator with respect to our TDRs
    - The majority of these charge-offs were previously reserved for through our standard allowance process and the increase of the qualitative component of the reserve recorded last quarter
- With respect to our modification programs going forward, we have discontinued the programs that we suspended last quarter, particularly in home equity
- Also, it's important to note that the level of loan modifications expected to occur through these programs in future periods was modest

Allowance for Loan Losses

- Turning now to the allowance for loan losses for the quarter
    - It declined by $244mm to end the period at $579mm, including a general reserve of $326mm, which represents a coverage ratio of 63% of non-modified non-performing loans
    - This coverage ratio is consistent with the trends reported in recent periods

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- The allowance also includes a reserve for TDRs of $205mm, which, combined with prior write-offs and TDRs totaling $445mm, constitutes a total expected loss of 37% of total TDRs, also consistent with trends reported in recent periods

QUALITATIVE RESERVE

- The last component of the allowance is $48mm qualitative reserve, which accounts for factors not considered in the quantitative loss model
- Last quarter, we increased the qualitative component of the allowance by $67mm, to $124mm, reflecting additional estimated losses due to reduced modification activity as well as uncertainty around certain loans modified under previous programs
- During Q1, we completed our review and charged off loan balances as a result, decreasing the specific valuation allowance and the qualitative reserve
  - Based upon this review and the associated balances that were charged off this quarter, we have returned the qualitative component of our allowance to 15% of our general reserve, so it currently stands at $48mm
- The consistency of the reserve metrics I just described provides additional comfort that the level of our current reserve is adequate

Net Charge-Offs

- Total net charge-offs in the quarter were $316mm, with approximately half related to this review and the remainder from the standard process of charging off loans
  - I gave a lot of numbers there and realize this may be difficult to follow, so let me try and sum it up simply
- Last quarter we announced a review to align certain policies and procedures with the guidance of our new regulators
- We increased our reserves in anticipation of the outcome of that review
- During Q1, we completed this review and charged off the increased reserves as a result

TDR PORTFOLIO PERFORMANCE

- Now, I'd just add one final point to close out this topic, which is to stress that we expect our regulators to continue to review the treatment and performance of our TDR portfolio, which could have an impact on provision of future periods
  - And while we are confident that our current reserves are adequate, ultimately we believe the actual performance of our loans, including those we have modified, will be the primary driver of our reserve levels

Average Re-Delinquency Rate

- With regards to the performance of our existing modifications, the average re-delinquency rate 12 months after modification has remained stable at 28% for one-to-four-family loans and 42% for home equity loans
- Delinquency performance on all loans this quarter was quite positive, as the 30-day to 89-day delinquent category improved 20% sequentially and 26% from a year ago
- Total at-risk delinquencies are the 30-days to 179-day delinquent category, improved by 19% in the period and 33% from a year ago

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Home Equity Loans

- One additional point on home equity
- New supervisory guidance on the treatment of second lien home equity loans has garnered a lot of attention in the last week and I'd like to address our status in implementing this guidance, specifically on the treatment of performing second liens behind non-performing first mortgages
- Since the vast majority of our loans are purchased in the secondary market, situations where we hold both the first and second lien mortgage for the same borrower represent less than 1% of our portfolio

Delinquency on Other Debt Obligation

- Given our lack of visibility into this population of loans, we rely on credit bureau data currently available to us to determine whether a borrower has a reported delinquency on any other debt obligation
    - Using this information, which is currently the best available to us, we estimate that less than 10% of our performing junior liens would be reclassified to non-accrual status pursuant to this guidance
    - It is important to emphasize, however, that in its current form, the credit bureau data that we use does not provide the specificity needed to determine whether the reported delinquency is tied directly to the corresponding first lien mortgage underlying our home equity loans
    - Accordingly, we are working to enhance this reporting
    - We expect to be in a position to have the necessary information to implement this guidance within the next quarter and that the final amount of junior liens ultimately impacted by this guidance should be considerably less than our current estimate

Operating Interest Income

- Please note that interest payments received a non-performing loans are recognized on a cash basis on operating interest income until it is doubtful that the full payment will be collected, at which point, payments are applied to principal and not recognized as income
- (Sic) We do anticipate [We do not anticipate] this updated guidance will have any meaningful impact on our allowance for loan losses, as this credit bureau data is already a factor incorporated into our risk segmentation and provisioning process, so we do not anticipate this guidance will impact that

Loan Resets

- With respect to initial loan resets, as I mentioned last quarter, we do not expect these to be a material driver of credit costs this year
- Thus far in 2012, we have seen approximately $560mm of one-to-four family mortgages reset for the first time and we expect an additional $500mm to reset for the first time throughout the course of this year
    - Of the remaining balances which will reset this year, approximately 1%, or 6mm, is expected to experience a payment increase of 20% or more

Home Equity Lines of Credit

- On our home equity lines of credit, which represent three quarters of the home equity portfolio, we have approximately $285mm that are already amortizing with an additional $80mm expected to be amortizing in the remainder of this year
    - As we have previously stated, the majority of these lines do not amortize until 2014 or later

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Capital

- On capital, at both the bank and the parent, our absolute levels of capital grew slightly from the previous quarter on both Tier-1 and risk-based measures
- However, as I previously mentioned, growth in brokerage customer cash and the resulting increase to the size of our balance sheet drove a sequential decline in our leverage ratios
- As for our progress in establishing a more comprehensive capital distribution plan with our regulators, our key next step is to submit a long-term capital forecast including internally-developed stress tests by the end of Q2
    - And while we can't be certain on the timing or nature of their response, our objective is to get feedback on the plan, including the dividend process, by the end of the current CY

Corporate Cash

- Corporate cash ended the quarter at $484mm, or just under three times our annual debt service
- In general, we expect corporate cash to decline in line with our corporate interest expense, which is paid in the second and fourth quarters
    - I will also remind you that our parent houses roughly $0.5B dollars of deferred tax assets, which will ultimately become sources of parent cash as the company subsidiaries will reimburse the parent for the use of its DTA

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

CLOSING REMARKS

- This was clearly a very positive quarter for us, as we posted some of the best retail metrics in the firm's history
- We exit the quarter with good momentum in the brokerage business and, while trading has moderated in April, currently down 7% from March, we remain encouraged for 2012

Retail Brokerage

- Although we are pleased with our progress this quarter, as evidenced by our strong performance in retail brokerage, we will continue to aggressively focus on the retirement and investing category, as this is a key component of our long-term growth strategy
- We remain focused on ensuring current and prospective customers are aware of our extensive capabilities in this area through our enhanced marketing and advertising efforts as well as our financial consultants and retirement specialists
- Our legacy risks are less of an overhang each day and we expect continued run-off of the loan portfolio of approximately $600mm to $650mm per quarter in 2012
    - And provision, while uncertain in any given period, should continue to decline over time, reflecting the long-term trend of declining delinquencies

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Corporate Governance

- One final note on our corporate governance, the board made significant enhancement this quarter with the addition of three new board members, our Non-Executive Chairman, Frank Petrilli, Rodger Lawson and Rebecca Saeger
- We feel honored to have Frank, Rodger and Becky on our board, and believe their industry experience will lead to valuable business insights and contributions

QUESTION AND ANSWER SECTION

Richard H. Repetto
Analyst, Sandler O'Neill & Partners
Q

I'm doing so many. I'm giving multiple calls here. Anyway, let me get to my question first. The retail net new assets were just up dramatically. And I'm just trying to get a little bit more color of what was – what's driving – what – how you increased them. Did it come from any single channel or how'd you more than double, I believe they doubled from the last quarter?

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Just a few comments on that. I'll give you – or at least to put it in perspective, about half of the volume has come from new customers to E*TRADE. And so, clearly, driving at higher levels of net new accounts critically important to us, and we've been on that trend now since really 2010, and it continues. About the half of the volume clearly has also come in from existing customers. Really benefiting from several, I think, from several items, one, over the last several years and basically beginning prior to my arrival here, a relentless focus on customer satisfaction and enhanced customer experience. And I said in the prepared remarks, the attrition rates running now in the 8%s is substantially better than what this company has ever experienced before. So keeping our customers is critical and, therefore, keeping our assets. And in addition to that, by providing better tools, better platforms for the products, we're seeing our customers engage more with us now than we have in the past. So it really is on several fronts. One, more high-quality new customers, better experience for existing customers and, in addition, the corporate services group continues basically to perform extraordinarily well. And it also – it's usually a seasonally high period for them in addition to that. So I think it's sort of been the aggregation of all those very positive events that translated into an extraordinary, a record quarter for the company.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners
Q

And then, Matt, the follow-up question would be, very helpful guidance or a discussion on the performing second liens. If I interpret you correctly, are you saying that you will implement this once you get certainty, more certainty, on the performance of the connected first liens? And the broader question is is this, as you talk with the regulators, I got a sense that this – you talked more about capital ratios this quarter and sale of non-core assets, are the regulators encouraging you to improve the capital ratios specifically or? I guess that's the question.

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*
A

Yeah, well, I think, Rich, every regulator on the planet would want your capital ratios to improve, of course. But I think that in the prepared remarks our focus was on putting together a long-term capital forecast, which we are

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currently working on and plan to submit at the end of Q2. So really we would hope and expect to have some dialogue on that with them in H2, and that's really where we are.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, Rich, let me just add to Matt's comments just a few points. And I think it picks up from Q1 performance. One, as part of essentially growing the franchise at a quicker pace than we originally anticipated, the balance sheet clearly has grown faster as well. And obviously in the short-term, you get the balances, you get some revenue, but you're basically your capital is deployed immediately. That said, there are a number of actions that I can at least give you perspective on that should be helpful here. One, using corporate services group is a good example. We typically have a high degree of seasonality in Q1 with some reversion, meaning some of those balances will run off, the cash balances, in the second and third, we're already experiencing that. And basically, a second point to that is we took liberty given that there seems to be a low elasticity on basically deposit pricing starting April 1 to lower prices on certain of our savings products as well, albeit, we don't see a lot of elasticity, so not sure we're going to see a lot of balance runoff, but regardless, it is the right thing to do. And, just finally to just sort of frame it on several fronts, one, even from my arrival here, we said over the long term we would expect this balance sheet to reflect more of the customer deposit base than anything else. Well, the customer deposit base today is closer to $30B, not $50B. There are number of other items on the balance sheet that either are less capital-friendly on a number of measures and/or very much nonstrategic. And to I think Matt's point in his prepared remarks, even though we won't go through specificity right now, we are looking not only for basically more, I would say more efficiency in our capital, better leverage, but basically fitting that into the strategic frame of the size of the balance sheet with the passage of time. So we're working across it. Some things are easy and some things are bit more challenging as we trade off capital, income and risk.

Michael Roger Carrier
Analyst, Deutsche Bank Securities, Inc.

Q

Maybe one follow-up on the net new assets. It does seems like every first quarter you have a very strong quarter and so, like you mentioned, there some seasonality in that. And it seems like in that corporate business it makes sense, meaning if money invests, then you have more cash that comes in. So I'm just wondering if you can size that up just a bit because it seems like each year when I look in the past that you get some moderation in the second, third quarter, but obviously the trends have been good just in terms of the core organic growth as well.

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Yeah, I mean, I can put it in perspective for you by the numbers. If you take the sequential, the $1.7B growing to $4B, roughly, the incremental $2.3B of growth, we've seen – it's almost evenly split between CSG and I would say non-CSG retail. So we've seen good growth on both fronts. And if you look at it in absolute terms, of the $4B, roughly about two-thirds of it is coming in from retail ex-corporate services and about one-third coming in from the corporate services side, rough numbers that will round in either direction. So we believe, again, a key here to sustain it is to continue to drive growth in the corporate services group. And if you look at it on a year-on-year basis, the business is getting larger and the quality of our accounts, our customers, tend to be basically improving as well. And then finally – and you have to look at it across the year because any given quarter does have volatility. The number of net new accounts that we acquired in 2011 was twice what we acquired in 2010, and we're on basically – we believe we're on a roll this year to substantially better in 2012 vs. 2011, and that would basically fall back to 2010. So the question is can we sustain it? I do agree that we tend to get a seasonal high in Q1, but we think there's a core to this that should be sustainable and give us growth on a year-on-year basis throughout the remainder of the year.

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Michael Roger Carrier
Analyst, Deutsche Bank Securities, Inc.
Q

Okay, that's helpful. And then maybe just on the regulatory side, you guys covered a lot in those comments. I think probably the two areas that tend to get focused on, whether it's for the industry or for you guys, is that leverage ratio and then probably the HELOC portfolio. So, I think on the leverage ratio, when you look at this quarter you'd benefit because you had so much cash come in. But at 5.5%, I'd say if some of the industry and the peers are at 6%, 6.5%, if you had to pare those – the assets down by, I don't know, anywhere from say $3B to $6B to get around that range, like what types of assets would those be? Or said another way, what type of a yield would you be giving up there? And then just on the HELOCs, kind of the same thing, in terms of you mentioned that a lot of those don't reset or they're not going to be starting to pay the principle until 2014. So when you think about just like the credit trends and how to kind of manage that risk, particularly under a new regulator, just how are you thinking through that?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*
A

Sure. So, on the first question the leverage ratio, so the 5.5% for the parent, I think that kind of the point Steve made earlier, so that our balance sheet is really liability-driven and specifically our core customer deposit-driven, which is the brokerage-related cash, around $30B. So the reason that we're up over $50B today is two broad buckets, the wholesale funding book, which is around $8B, and the bank cash or bank deposits, which is around $8B. So those are the two primary areas that we would look to from a de-leveraging standpoint. Kind of the comments I made in the prepared remarks, given the leverage ratio where it is, the incremental spread is actually pretty low when we're growing the balance sheet. So, while the amounts of net interest income would likely be less on a smaller balance sheet, spread would actually – could possibly improve. So those are the two big buckets we're looking at. Specific to home equities, I think the key takeaway for us is they really don't start amortizing in a meaningful way for several years, so that 2014 and beyond. The average home equity, the loan size is relatively small at $60,000. So the actual amount of payment increase that would occur once it begins to amortize is in the $150 to $200 per month range. So when you think about it in the grand scheme of things from a credit perspective, the size of the portfolio that would likely be in 2015 and then the amount of payment that's increasing, it's, from our perspective, it's not a huge credit risk.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah, I'll just add one more point, and there's no guarantee the trends sustain themselves, but even using home equity, which clearly has the highest risk profile of our legacy portfolios, if you look year-on-year, the portfolio contracted roughly 20%. And so if we think about 2014, 2015, 2016, the absolute size of these portfolios, assuming trends continue, should be substantially smaller tomorrow than they are today, and we've seen these trends – or maintained these trends for quite a period of time. So, again, it doesn't negate it, but what it would does say is it becomes smaller, more manageable, more predictable with the passage of time, all things considered.

Chris J. Allen
Analyst, Evercore Partners (Securities)
Q

I wonder if you can touch on some of the expense lines, particularly the compensation line, which last quarter you had the software charge and that was about $11mm sequential increase. I know there's some seasonality there, but that seems rather large. But in the opposite direction on the other operating expense, there's a fairly large decline even after adjusting for last quarter. So could you give us underlying trends in each; it would be helpful.

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Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Sure, Chris. It's probably best to give an overall commentary on expenses, but specific to Q1 from a seasonality perspective, typically comps are pretty high in Q1. Taxes are highest during the year in Q1, as well as on the marketing side, typically Q1 is our highest marketing quarter. So broadly we think about a good run rate for expenses on a normal quarter basis of around $290mm. And that's still what we think today. So kind of thinking about the rest of the year, $290mm is a good thought process for a run rate. Keep in mind each individual quarter can move slightly, but that's kind of how we see the rest of the year.

Chris J. Allen
Analyst, Evercore Partners (Securities)

Q

Okay. And then just following up on Mike's question in terms of taking down the balance sheet, I think you said that one of the focus you looked at is the wholesale funding side. I always understood it to be longer-term in nature. Is that still the case or is there opportunities within that piece?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

So, it's still the case. So, that $8B of wholesale funding we estimate will run off over the next 10 years. So it's a rather a long timeframe. And the prepayment penalties, if you were to just get rid of it today are rather substantial; they're just under $700mm. So it's not an easy solution, kind of to Steve's earlier point. But when you think about deleveraging, our primary focus is on the core of the companies, that brokerage related cash. And this wholesale funding of $8B and the bank funding of $8B is really where we're looking. We just don't have any answers or anything we've decided upon today.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah. And, again, and I think it's an important area to clarify. We will get reversion basically in Q2 vs. the first, which is sort of the natural seasonality of the corporate services group and not to present numbers today, but it tends to be meaningful. The second is we just did reprice about $5B worth of savings. Again, we can't predict elasticity. In the good old days, you'd think people were basically price sensitive. They're less price sensitive today, so we'll take the spread, all things being equal. But we did basically bring prices down. And then to Matt's point, the wholesale funding is more of a challenge in the short-term because of the cost benefit; that is essentially the mitigating factor. But beyond that, we are looking at opportunities potentially to move certain savings products off our books. We could if we want basically direct, for example, new customers to the off-balance sheet suite vs. a deposit product. We have a lot of degrees of freedom, and I think to Matt's point right now, what we're trying to find is the right mix of income, capital and profile. And that's what we're working on as we speak. We were on one hand pleasantly surprised that we grew much faster than we thought, on the other is we have to deal with the dynamic of that outcome beyond just income. But we will basically have a tangible set of steps in very short order.

Alexander Blostein
Analyst, Goldman Sachs & Co.

Q

I wanted to follow up again on just delinquency trends. So if you look at just the change quarter-on-quarter in delinquencies and if you adjust that for the charge offs, it actually looks like there was a substantial pickup close to $130mm, and that, again, that looks like one of the higher numbers over the last two years or so. So, I guess, the first question is is that – my math right on that? And if it is a pick-up, where you are guys seeing the duration in credit? And then as a follow up to that, it looks like your reserves to loans are now also at the lower level in the last

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since really early 2009, so is that kind of 4.5%-ish a comfortable level for us to think about going forward or there could be an incremental build up just to kind of refill that provision bucket?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*
A

Sure, Alex. So on the delinquencies, I think the broad comments that we covered in the prepared remarks is we're quite pleased with the decline in delinquencies. So the primary area we focus are special mention, or 30-days to 89-days delinquent, because those are the new loans that have gone delinquent this quarter, so kind of the indicator of where you're going. So we're down to the $375mm there; it's down 20% from last quarter. About five percentage points of that decline comes from the charge-offs that you referenced. So even when you pull that out a 15% decline, it's quite good a number from our perspective and it's really – as we talk about each quarter, the portfolio is quite seasoned. We've really – we didn't buy a loan, we haven't bought loans since early 2007. In each quarter and each year that goes by, it's more and more seasoned, and we expect delinquencies to continue to trend downward. As far as the ratios of reserve to loans, the way we look at it given that we've got a combination of a qualitative factor, we've got modified loans that we reserved for but we've charged off. We kind of look at it a little bit differently or get a little bit deeper than the overall coverage ratio that you referenced. And kind of looking at it in two buckets, first, the general reserve on non-modified loans, which is $327mm. We look at that as a coverage on non-modified, non-performing loans. And that's around 63% and it's been pretty consistent for quite some time. On the modified side, we look at a combination of the amount of charge-offs we've taken on those loans plus the amount of reserves we still have on the books together. And that's at 37% and that's actually been increasing over time. So from a coverage ratio perspective, we're most definitely comfortable, but that's the way we look at it from a management perspective.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah, Alex, just adding one more point, I think we had – I think your question started off with I would say a directional inconsistency. The delinquencies on a sequential basis showed substantial contraction, not expansion. If you looked at it from a home equity first in the quarter, the 30-days to 179-days were down 27%, the 90-days to 179-days were down 20%, and the 30-days to basically 89-days were down 31%. Those are our reported statistics. The one to four family did not have as good but had, on any basis, very good performance, 30 –days to 179-days down to 15%, 90-days to 179-days down 16%, and 30-days to 89-days down 15%. And the way we report on the first vs. the home equity – the home equity is on an actual calendar, the first lagged by one month. So even though we call the quarter, it's February actual data. When you look at March data, which we'll release in about a month or so from now, but directionally, it looks almost identical to home equity. So we feel extraordinarily good about delinquency trends in Q1. I want to make sure that nobody misinterprets that.

Alexander Blostein
Analyst, Goldman Sachs & Co.
Q

Got you. I appreciate the comment. I was basically just making an observation that the total delinquencies declined, but adjusted for the charge-offs, because...

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah, and even home equity, just to help you, because we've done the math, this home equity was where the impacts would have been most evident. That basically that roughly 30% improvement, about two-thirds of that we would describe as organic, independent of the write-downs, so about 20% if you excluded them and 30% or so if you included them. So, regardless, we do feel that the natural trend in the portfolio looks quite good and the

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reported trends look extremely good. But you have to take into account that those write-downs did in fact have some positive impact, at least on the OpEx.

Alexander Blostein
Analyst, Goldman Sachs & Co.

Q

Got you. That's very helpful. Thanks. And then the second question is just if you could comment on the trading activity so far in April. It feels like it's gotten a little bit softer, but curious to hear how you guys are – what you guys are seeing.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, again, you may have missed it. I think, again, in my prepared remarks said that on a sequential basis, March into the first – basically the first-half or so of April, we'd see a sequential decline of approximately 7%. But, as you know, it's a very volatile set of measures and 10 days or so, 10 business days really won't make up a quarter. But nonetheless, the trading is a bit subdued relative what we had seen in March.

Chris Harris
Analyst, Wells Fargo Securities LLC

Q

Hey, I just want to follow-up on that last point there. Some of your peers have commented that the retail investor is starting to kind of disengage, they're decreasing their tolerance for risk. And I kind of see what's happening with your trends here and see that margin lending I guess has kind of declined as a percentage of client assets. So I'm really just wondering what you guys are seeing out there, whether you're seeing similar things happening within the retail investor landscape, whether folks are really starting to kind of de-risk or be cautious or whether you're not really seeing as much of that?

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

I don't see precisely the same trend. Let me just give you some statistics that maybe will help you draw your own set of conclusions. One, Matt referred to it in his remarks, that even though average – on average our margin receivables were flat fourth quarter to first quarter, on a quarter-end to quarter-end basis, margin receivables were actually up about $0.5B, which is about 10%. And it's the first real significant positive movement we've seen in margin in probably close to a year because the trend in 2011 was a downward trend largely. And the trend basically has been an upward trend. In fact, if you look into the first, basically, H1 the month of April, margin is actually continuing to move in a very positive way. In addition to that, if you looked at basically Q4 2011 for us, we basically had option activity in our DARTs running around 22%, and that was up from about 19% a year ago in Q1, and Q1 this year we're a little bit above 23%. So from the standpoint of the type of instruments people are utilizing and the amount of leverage they're taking on, and obviously there's leveraging options, there's leverage – basically margin is leverage. We're not seeing the same, but we do see a fair amount of volatility depending upon the information that's released in any given period into the market as to whether the retail investors are in or out. So we see a lot of volatility in that and it's hard to discern a real trend on DARTs in any given day or week, but the trends that we do see is option activity continues to rise and, in addition to that, margin expansion continues to march on. So, again, I don't want to take that and translate that into a consumer confidence metric but, at the same time, if you look at behavior, people are behaving in a way that manifests itself possibly as more confidence. But, clearly, these trends are still over several quarters and I still think we need more data points to conclude anything. It feels better given that leverage is basically coming into play.

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Chris Harris
Analyst, Wells Fargo Securities LLC

Q

And then just my follow up question would be on the kind of the regulatory transition review period. I know it's obviously a fluid situation, but your commentary there, I think you'd mentioned that you feel pretty confident that there won't be another qualitative reserve. Just wondering if you can expand a little bit more on that; what it is that the regulators are looking at and what kind of gives you the confidence that you think you won't have additional qualitative reserve going forward?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Sure. So just to clarify the comments, I think we are quite confident that our reserves in the quarter are adequate. But I think we're also quite confident that our regulators are going to review the performance of these modified loans and our reserve levels very closely going forward. And there most certainly could be changes that can result – could happen as a result of that. But from a management perspective, we're quite comfortable with it. But just keep in mind the allowance itself, by its very nature, is an estimate, and it's inherently uncertain. So it could always change based on in future periods.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

And just let me finish up. Even in the press release, I think the best way to express it is that we're going through a regulatory transition from our bank regulator prior with the OTS to the OCC, as the parents have said. And it's not just a point in time, it is clearly a journey. We think we're on the road, we think we have a good relationship with our regulators through match point. We feel confident that what we've done is in fact aligning and adequate. But, at the same time, it's a dynamic process. The world changes, things change, and we don't want to basically say definitively we started on X date and we finished on Y date. But that said, this is an important transition, we take it very seriously. We think we are executing well and we will continue to basically march forward. But the primary focus or, I would say one of the main areas we focused in on in Q1 will be ALLL, and we work through that, and we think we've come to a reasonable solution. But, again, processes are dynamic.

Howard H. Chen
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Given the action in the HELOC TDRs to conform with your regulator's standards, I'm curious what percentage of those $250mm of charge-offs are still cash flowing?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

So you mean total charge-offs on home equities, is that what you're looking at?

Howard H. Chen
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Yeah, in home equities.

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Yeah, so I think if you think broadly of the total charge-offs for the quarter, which are $350mm, about half of that came from this review. I think the amount that's cash flowing, it's not a number we have in front us, but it's

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probably not a gating factor separate and apart from the fact that we charge them off and we feel quite comfortable where our reserves are today. The cash flowing are not, from our perspective, not going to have a meaningful impact on those reserves going forward because it is the principle amount as opposed to the interest that they would pay that's going to be the key driver of those losses.

Howard H. Chen
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Thanks, Matt. And then on your commentary regarding the reserving policy for HELOCs behind the non-performing firsts. If you current visibility isn't great and you don't have all being enhanced tools that you want yet, what's driving your confidence that the ultimate figure will be considerably less than the current estimate?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Sure, so we kind of have two buckets there. One, the confidence of getting the clarity on data specific to a borrower who's paying their second lien but delinquent on some other loan and we have clarity that they're delinquent on something. And that clarity is factored into our overall loss modeling. The clarity we don't have is whether that delinquency is specific to the first mortgage loan. So it could be on their mortgage, it could be on their auto loan payment, it could be on their Nordstrom Card payment, it could be on anything. So that's the clarity we need to get to be able to factor in this regulatory guidance. But to the provisioning itself, that delinquency is factored in.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, just to add – going back to the numbers that were cited by Matt. If you think about it, the sort of the superset, which we address the 10%, and I know Matt just made the point, but I think it is important to get just one more clarification. Is any product that could be delinquent on, it could be $100 delinquency on their credit card. Also from a logic standpoint, if you're paying your second, there's probably a low probability that you're not paying your first. Not an absolute, but a lower. So when you think about it logically, if 10% is the superset, the question is, what do you think a first mortgage behind our second would be? We think it will be a relatively speaking or considerably lower subset of that number and that's what we'll get clarity on across the quarter. It does to go to basically the accrual of interest, not so much basically provisioning because we incorporate that data already from the standpoint of delinquency into our modeling. I would bet it's a very low number, but I could be wrong. But we know basically what the absolute top is and we'll have to see where we come out.

Howard H. Chen
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Got it, thanks. And then last one from me. Earlier this year you struck an agreement with FXCM to offer foreign exchange. Could you just provide some early progress on that partnership? And maybe as a baseline, what's FX as a percentage of your DARTs today?

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, I'll give you a perspective. We think it's important from the standpoint of a service to provide to some of our more sophisticated active traders. From the standpoint of registering on DARTs at the moment, you wouldn't see it in an absolute term in our DARTs data. It's extremely small. It would round off. But, again, we're at early stages, we – actually the partnership is good, we've executed it well, we have I would say maybe a couple of hundred of our – basically of our customers engaged. But the numbers are not large at this point. So, again, they're not material, they wouldn't register, although we're at the early stages.

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Joel M. Jeffrey
Analyst, Keefe, Bruyette & Woods, Inc. Q

Just a quick clarification, I apologize if I missed this earlier. When you talked about if the balance sheet remains at current levels, did you say the spread would be at 240BPS at the end of the year or average 240BPS?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.* A

Average 240BPS for the year. So Q1 was 249BPS, so something less than 240BPS for the rest of the year.

Joel M. Jeffrey
Analyst, Keefe, Bruyette & Woods, Inc. Q

Okay, great. Thank you. And then I think in the past you've talked about sort of a more normalized spread of 3%. And sort of given your commentary about where the balance sheet is going in terms of size and your some level of inflexibility on the wholesale funding side, I mean, would we have to wait until the wholesale funding basically runs off to see that kind of number or there is anything else you could do to get an impact at that level?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.* A

So the 300BPS, Joel, is that – we think over the long-term the balance sheet would produce on a customer-driven balance sheet, meaning primarily funded by brokerage customer cash and in a more normalized environment. So that customer-funded balance sheet, the wholesale funding would have runoff and the investment strategy on the asset side would have continued. So it's a very long-term thing, so I think the odds of being in a more normalized interest rate environment any time soon are pretty slim. So our focus is more on where the spread is heading today.

Joel M. Jeffrey
Analyst, Keefe, Bruyette & Woods, Inc. Q

Okay, great. And, then just lastly, and you guys looked like you had another sort of decent pickup in the held-to-maturity bucket on the balance sheet. Can you talk about how you think about putting something in either available-for-sale vs. held-to-maturity?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.* A

Sure. So, we've been growing to held-to-maturity book in line with essentially the growth in customer cash. Where the balance sheet gets bigger, we've been growing the held-to-maturity book. Given where the balance sheet is right now, our target is to grow that to $10B and pause there.

Keith A. Murray
Analyst, Nomura Securities International, Inc. Q

Could you just spend a minute on the capital plan and the stress test? Do you have a sense yet of whether or not they'll be focusing on risk-based ratios, like the CCAR process for the large banks focused on Tier-1 common?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.* A

Well, I suspect any and all regulators are going to focus on what you're most constraining ratio is. So specific to the bank, our Tier-1 common ratio is just under 16%. So incredibly strong from our perspective vs. the leverage

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ratio, which is much lower, 7.3%. So we suspect when we do all the work, which we haven't done yet, but our plans are to get it done and submit it at the end of Q2, that the leverage ratio is likely to be the most constrained ratio, and that's where the focus would likely be.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah, you may just want to clarify that we're not going through a CCAR, a specific CCAR in Q2.

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*
A

Right.

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Nonetheless, I think that Matt's points are extremely relevant in that most of our ratios are very strong. We always look for the constraining ratio at both the patent and the bank, it tends to be the – basically the leverage ratio.

Keith A. Murray
Analyst, Nomura Securities International, Inc.
Q

Thanks. And then thoughts around refinancing the 12.5% notes, do you feel like you'd rather wait to get clarity on the capital plan from the regulators before you move forward on that or is that independent of that?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*
A

So they're most certainly connected. So the refinance of the 12.5% notes, if you just look at the last time we issued last year, we issued at 6¾%. So the economics of a refinance would be incredibly positive. At the same time, they were issued at a pretty large discount and the premium that you'd have to pay to do that collectively, you'd have a rather larger loss in the re-finance driving down the capital ratios. So we really look at balancing those two things together.

Keith A. Murray
Analyst, Nomura Securities International, Inc.
Q

Okay, thanks. And then last one. You mentioned about half the net new money coming from new accounts, can you talk about the quality of those new accounts vs. existing?

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*
A

Yeah. I mean, we keep a very, as you'd expect, a very close eye on quality. Accounts without quality are not really worth much to us. And at least over the last several years, there's been a very focused effort not just to basically look at accounts, but look at the quality of accounts coming in. And I would say on balance, and I'll give you a perspective, on balance, our average new account brings to us somewhere in the neighborhood of about $25,000 and it kind of varies by channel and varies by type. We typically think if a new account opening on average is at least $20,000, that's a good thing. And that typically grows on average to about $60,000 over the course of an 18-month or so period of time. And the accounts that we've been bringing on, at least for the two years that I've been here, have more than met that criteria. And so we like the economics, the dynamic and the payback of it. Just to reassure the group that we we're not basically looking for accounts, we are looking for quality accounts.

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Brian B. Bedell
Analyst, International Strategy & Investment Group, Inc.

Q

Just a little bit more on the balance sheet. Can you talk a little bit about what you think will be stickiness of the deposit growth in Q1 in terms of whether you think that will be deployed back into risk assets or whether the deposit pricing strategy that you're talking about for the savings rate will have any kind of material impact on that? And then can you just remind me about what exactly you're doing with the deposit rate, I think you said April 1?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Yeah, so the deposit rate is specific to a bank product from on April 1 from 15BPS deposits to 5BPS. As far as the investment strategy goes, there's no change in the investment strategy, which is to allow the loan portfolio to run off and to invest in government-backed or agency-backed securities. And so little to no credit risk on the asset side and no change there at all.

Brian B. Bedell
Analyst, International Strategy & Investment Group, Inc.

Q

And on the deposit base. In terms of the customers, I guess the behavior, if you could sort of characterize what you think customers might do in this environment in terms of the redeploying those deposits into securities or kind of stay put?

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Yeah, I'm just going to give you maybe a contextual frame. Typically our experience has been that customers keep somewhere in the neighborhood of 15% to 20% of their financial assets with us in cash. We've trended closer to I would say 18%, 19% in this environment, let's say, speculating that they have a higher degree of conservatism. As I would expect as confidence levels rise, you would see it recede back towards 15%. And if people remain conservative, it probably stays on the higher side of that range. So trying to predict over the short-term with any certainty sort of the psyche is tough. But the range tends to basically give you a pretty good indication. Now, when you talk about folks who carry today I think it's almost in excess of $200B of financial assets with us, percentage points really matter. But we're probably now in the higher end of the range, which is not unexpected. I don't know if that helps you...

Brian B. Bedell
Analyst, International Strategy & Investment Group, Inc.

Q

Yeah,

Steven J. Freiberg
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

...to build a model from, but it's sort of range bounds. We don't think let's say the 15% to 20% falls to 5% to 10% and we don't think it rises to 30% or 40%. And we've gone back over long periods of time and the range tends to be a good indicator, but within that range, there could be a lot of variation.

Brian B. Bedell
Analyst, International Strategy & Investment Group, Inc.

Q

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No, that's very helpful. And then just one more on the balance sheet. On the loans side, we're really down about 20BPS to 25BPS per quarter. Can you characterize on the ARM re-pricing what type of impact you think that might have in the second, third and fourth quarters in terms of the rate?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

Sure, Brian. Probably the best thing to reiterate is of the re-pricings or the resets that we expected this year, about half happened in Q1. So the majority of the impact happened in Q1, and we would expect that to subside a bit later in the year.

Brian B. Bedell
Analyst, International Strategy & Investment Group, Inc.

Q

Okay, great. And then just lastly on the wholesale borrowing, that went up a little bit on a net basis. Do you expect that trend to continue through the year?

Matthew J. Audette
*Chief Financial Officer & Executive Vice President, E*TRADE Financial Corp.*

A

No, I mean wholesale, it's a little bit choppy and you've got hedges applied to that book. I think the broad comment I'd stick to in wholesale is I could move around a little bit here and there. Our expectations are simply to run that portfolio off over a long period of time. And the individual items or the individual yields per quarter could be a little bit choppy.

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