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E*TRADE Financial Corp. *(ETFC)*

Q2 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP 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, E*TRADE Financial Corp.*

Q2 BUSINESS HIGHLIGHTS

Core Franchise

- Q2 was another significant step forward for E*TRADE, as we grew our core franchise in the face of macroeconomic challenges and a market-wide lull in retail investor engagement
- We continued to de-risk the company, submitted our strategic and capital plan to our regulators, and completed our offer to purchase auction rate securities
- We reported EPS of $0.14 on revenue of $452mm, inclusive of a few unique items, which Matt will cover in more detail

Brokerage

- On the brokerage front, DARTs were down 6% vs. the year-ago quarter, reflective of a generally weak retail trading environment
- That aside, we generated healthy growth in net new accounts and assets, comprising the key long-term growth drivers for the franchise
- Net new brokerage accounts of 46,000 brings the total for H1 to 92,000 accounts, nearly equaling the 99,000 that we brought in during the entirety of 2011, and well above the 54,000 in 2010
  - Similarly, the $2.2B in net new brokerage assets brings the YTD total to $6.2B, and places us on track to exceed our full year levels of $9.7B in 2011 and $8.1B in 2010

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CUSTOMER MARGIN RECEIVABLES

- Additionally, customer margin receivables ended the period at $5.8B, a four-year high and reflective of increases in both the number of accounts using margin and balances per account during the quarter
- We were also proud to post another quarterly franchise record for brokerage account attrition of 8.4% annualized during Q2
    - This represents an improvement of more than 200BPS from a year ago, and is a testament to our focus on an extraordinary customer experience

Credit

LEGACY LOAN PORTFOLIO AND DELINQUENCIES

- Turning to credit, our legacy loan portfolio ended the quarter at $11.8B, down 5% sequentially and 64% from its peak
- Our overall delinquencies were down 11% during the quarter, while special mention delinquencies were down 7%
- Both are at their lowest levels in approximately five years
    - We are proud of our progress on the continued de-risking of the company as we closely manage the runoff of this portfolio

Customer Offering

- As for our customer offering, we made enhancements to our E*TRADE Pro platform and simplified the overall user experience on the customer website
- We added new tools, including a trading ladder and strategy screeners, giving customers even more real-time market depth and information, including real-time quotes for all E*TRADE 360 users
- We opened two new branches during the quarter, one in Cupertino, California, and one in New York City, bringing our branch total to 30
- Over half of our 270 financial consultants reside within our branches, providing an important point of contact for our customers
    - Particularly as we expand our activities in the retirement and long-term investing segments

RETIREMENT ASSETS

- With $33B in retirement assets across nearly 800,000 accounts, we have a meaningful base from which to grow
- Additionally, we ended the quarter with just under $1B in managed assets
    - Over half of which are retirement assets
- We're encouraged by our progress and are focused on continuing to build out our brand as a trusted destination for Rollover accounts and other retirement services by providing solutions, advice and guidance, and client education

EDUCATED INVESTORS

- Educated investors are typically more engaged customers, so we remain committed to our education efforts across a broad spectrum of categories, with over 300,000 interactions during the quarter, comprising seminars, webinars, and videos, both live and on-demand

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- We believe that a clear indication of the increasing sophistication of our customers is the steady increase of options as a percentage of DARTs
  - Options were 24% of trades this quarter, up from 20% a year ago and 16% two years ago

Mobile Application Usage

- We also continue to experience steady growth in our mobile application usage
- During the quarter, 6.6% of our DARTs were executed through E*TRADE Mobile, up from 4% a year ago
  - More than half of these trades are through our iPhone application

Corporate Services Group

- We are executing well in our Corporate Services Group, and as we exit the quarter, we have a healthy pipeline of prospects
  - This remains an important strategic channel for new brokerage assets and accounts
  - The relentless pursuit to provide cutting-edge products and technology and a superior customer experience will continue to drive our core brokerage business strategy, priorities, and execution

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Matthew J. Audette

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

Q2 FINANCIAL HIGHLIGHTS

Net Income and Revenues

- For Q2, we reported net income of $40mm, or $0.14 per share
- I'll cover this in more detail later, but I wanted to highlight upfront that our results included a benefit of approximately $0.04 from a few unique items in other expense and taxes
- Our second quarter net revenues were $452mm, down from $489mm in Q1 and $518mm in Q2 2011
- Revenues included net interest income of $279mm
  - A sequential decline of $6mm, driven by a 5-basis-point decline in net interest spread, which was 244BPS for the quarter
- Given the margin growth we observed this quarter, we estimate our spread for the full year 2012 will average slightly above 240BPS

COMMISSIONS, FEES AND SERVICE CHARGES

- Commissions, fees and service charges, principal transactions, and other revenue in Q2 were $154mm, down 11% from Q1 and down 12% from the same quarter of 2011
- Average commission per trade was $10.68, down from $11.04 last quarter, as a result of lower activity from stock plan accounts
- Y-over-y, average commission per trade was down from $11.14 on less favorable product and customer mix
- Revenue this quarter also included $19mm of net gains on loans and securities, inclusive of $5mm impairment

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Operating Expenses

- Total operating expenses declined sequentially by $25mm, reflective of a seasonal decline in advertising and compensation, as well as $3mm related to legal settlements and reserves, and $10mm benefit related to our offer to purchase auction rate securities

Auction Rate Securities

- As a reminder, we established $55mm reserve in Q3 2011 related to settlements and our offer to purchase eligible auction rate securities from customers
    - In Q4 2011, we refined our estimates and reduced this reserve down to $48mm
    - During the current quarter, we completed this program having purchased in approximately $145mm from eligible holders
    - The total losses we realized on liquidating those positions was approximately $10mm less than our reserves for this program
    - With the completion of the offer to purchase, we do not believe we have any remaining material exposure related to auction rate securities

Tax Rate

- Our effective tax rate for the quarter was 35%, which included a benefit of $6.7mm primarily related to state tax credits generated from software development
    - Without these credits, our effective tax rate this quarter would have been approximately 45%, which is consistent with our expectations for the tax rate going forward

DARTs and Net New Brokerage Assets

- DARTs for Q2 were 139,000, a 12% decrease from last quarter and down 6% from a year ago
- I would note that July-to-date DARTs are tracking down 1% from June
- Net new brokerage accounts were 46,000 in Q2, flat with the prior quarter and up from 25,000 in Q2 2011
- Net new brokerage assets totaled $2.2B during the quarter, representing 5% annualized growth
    - This was down from $4B last quarter, but up from $1.5B in Q2 2011
- We ended the quarter with $29.2B in brokerage related cash
    - A decrease of $1.8B during the quarter, as customers were net buyers of $3.9B of securities

Margin Receivables and Legacy Loan Portfolio

- Margin receivables ended the quarter at $5.8B, up 9% from the prior period with average balances of $5.6B, up 14% sequentially
- Our legacy loan portfolio ended the quarter at $11.8B, a contraction of $624mm during the quarter, and is now just 36% of its size at the peak
    - The average age of the loans in this well-seasoned portfolio is now approaching 6.5 years
    - We expect loan runoff will continue at a pace of approximately $600mm per quarter for the remainder of this year

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Net Charge-Offs and Delinquencies

- Total net charge-offs in the quarter were $121mm, down from $316mm in the prior quarter
- As a reminder, approximately half of the charge-offs in Q1 related to our review of modification policies and procedures
    - If we exclude these charge-offs and look at Q1 on a more normalized basis, charge-offs declined by greater than 20% this quarter
- Delinquency performance across the portfolio trended positively, as the 30 to 89 day delinquent category improved 7% sequentially and 24% from a year ago
    - Total at-risk delinquencies or the 30 to 179 day delinquent category, improved by 6% in the period and 28% from a year ago

Loan Loss Provision

- Provision for the quarter of $67mm was down from $72mm in the prior quarter
- I will also highlight that the provision for one- to four-family loans was relatively minor this quarter at just $250,000
- This was driven by two factors
    - First, there are less newly delinquent loans
    - And second, we received $11mm in settlements from third-party mortgage originators, bringing our life-to-date total of putbacks and settlements to $370mm
- We do not expect material future benefit from settlements of this type, as the majority are behind us
- The total allowance for loan losses for the quarter declined by $53mm to end the period at $526mm
    - We modified $125mm of loans during the quarter, which was down from previous quarters
- We expect TDR volumes will continue to decline partly due to the elimination of certain home equity modification programs, but also reflective of fewer loans to modify, as the population of newly delinquent loans continues to shrink

Re-Delinquency Rate and Initial Loan Resets

- With regard to the performance of our existing modifications, the average re-delinquency rate 12 months after modification has improved slightly for one- to four-family loans to 25%, and remained stable for home equity loans at 42%
- With respect to initial loan resets, we do not expect these to be a material driver of credit costs this year
- During Q2, approximately $440mm of one- to four-family mortgages reset for the first time, bringing the YTD total to $920mm, with another $60mm in H2 this year
    - Of all one- to four-family loans that will reset this year, approximately $27mm are expected to experience a payment increase of 10% or more

Home Equity Lines of Credit

- On our home equity lines of credit, which represent 78% of the home equity portfolio, we have approximately $290mm of balances that are already amortizing, with an additional $50mm expected to begin amortizing in the remainder of the year
- The vast majority of home equity lines do not begin to amortize until 2015 or beyond

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- With the limited data of a relatively small sample of amortizing loans, it is hard to call a trend, but generally the performance of these loans is consistent with the performance of loans that are not yet amortizing
  - As of the end of Q2, 4% of amortizing home equity loans are 30 to 179 days delinquent, compared with 3.5% for home equity loans that are not yet amortized

Performing Second Liens and Non-Performing Firsts

- Last quarter, we highlighted new supervisory guidance around the treatment of interest from performing junior liens behind non-performing firsts
- At the time of last quarter's call, we estimated the affected population of loans to be something less than 10% of our performing second liens
- Having completed our analysis in Q2, the affected population is far less than our initial estimate, totaling approximately 4% or $180mm of performing second liens
  - During the quarter, we placed these loans on non-accrual status, reducing interest income by approximately $1.7mm, which was applied as a reduction to the loan balance
  - This exercise did not impact our reserves for loan losses, as we already contemplate these factors in our loss modeling

Financial Position

CORPORATE CASH AND DEFERRED TAX ASSETS

- Turning to our financial position, corporate cash ended the quarter at $437mm, representing over 2.5 years of debt service coverage
  - The decline of $47mm related primarily to $82mm of interest payments, partially offset by other reimbursements and allocations from subsidiaries
- As a reminder, our parent has approximately $400mm in deferred tax assets
  - Which is a source of corporate cash in future periods

CAPITAL

- On capital, we grew ratios at both the bank and parent during the quarter across all measures
  - This was a combination of capital generation along with a reduction in balance sheet assets, driven by the decline in brokerage customer cash during the quarter
- To highlight a nuance between the parent and bank ratios, parent capital calculations use average assets, while the bank calculations are end of period
- As such, this quarter's more pronounced improvement in the bank's ratios was indicative of a decrease in assets late in the quarter, which should benefit average assets at the parent in Q3

Capital Requirements

- Turing now to potential changes in capital requirements
- Near quarter-end, the Fed published a notice of proposed rulemaking, or NPR, for comment, regarding the implementation of Basel III capital calculations
  - We are still working through the details, but I would like to highlight a few points we believe are relevant to E*TRADE

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- First, the Fed is seeking comment on an alternative method to include in Tier 1 capital the unrealized gains and losses related to Government and Agency securities
    - If implemented, this would remove a substantial source of downside volatility from our ratios in future periods should rates eventually rise
- Second, clarity was provided on proposed risk weightings, which we estimate could actually lead to an improvement to our ratios under the calculations laid out in the NPR

MORTGAGE PORTFOLIO

- For the mortgage portfolio, which is currently risk weighted between 50% and 100%, to average about 80%, we estimate risk weightings could increase to approximately 120%
- Offsetting this is a likely reduction in the risk weighting of customer margin loans, which are currently risk weighted at 100%
    - We estimate there could be a substantial reduction, to as low as 0% for over-collateralized margin loans
        - Which would more than offset the capital impact from the residential mortgage portfolio

PARENT TIER 1 COMMON RATIO

- For our parent Tier 1 common ratio, which remains the central focus of the new guidelines, we estimate that our ratio of 10.2% under current Basel guidelines would improve by approximately 70BPS should all elements of the NPR be implemented
- I would just caution that we're not certain that will be the case, and that some or all of the proposals are subject to change before implementation
    - Which is not proposed to occur until 2015
- Under these new guidelines as well as current ones, Tier 1 leverage remains our constraining ratio

BALANCE SHEET

- And, as I discussed last quarter, we are working to address this ratio by reducing the overall size of the balance sheet
- The balance sheet declined by $2B during the quarter, mostly as a result of a decline in brokerage customer cash due to customer purchase activity
- While we don't have anything specific to announce today, we are working on several strategies to reduce the size of the balance sheet
    - And we hope to have some specifics for you by next quarter

Liabilities

WHOLESALE FUNDING AND BANKING DEPOSITS

- To highlight the liabilities we would target reducing, in order of preference
- First is wholesale funding, as it is expensive and not core to our strategy
    - However, because the costs associated with exiting these obligations would likely prove to be more punitive to capital than beneficial, we do not view this as a viable near-term option
- Second is banking deposits, specifically our Complete Savings Account
    - We recently reduced the rate paid on this account to 5BPS, and the balances declined by nearly $500mm during the quarter

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        - These deposits are also not core to our strategy, and we are reviewing other options beyond just adjusting the rate
    - It is also important to note that a portion of these deposits are tied to valuable brokerage customers, so we would be mindful in targeting these deposits

SWEEP DEPOSITS

- The third category is sweep deposits, or our core brokerage customer cash
    - While moving sweep off-balance sheet could be the easiest option to implement, it is also the option we would need to structure with maximum flexibility to recapture balances on our balance sheet and in a manner which would be seamless to customers

Regulatory

- On the regulatory front, we submitted our long-term capital plan to both the Fed and the OCC at the end of June
- The plan we submitted forecasts our business and outlines capital distribution in current and adverse operating conditions over the next five years, applying internally developed stress tests similar in nature to the recent CCAR tests
    - The extensive work that went into creating this plan facilitated a valuable assessment of all elements of our strategy and facets of our business to ensure that we are focused appropriately in consideration of the operating environment, optimal capital generation, and risk profile

Core Principles

- While the plan was quite detailed and extensive, the core principles that will be our primary strategic guide in the near term can be summed up simply as follows:
    - First, continue our focus on our core retail brokerage business, which is the heart of this company
    - Second, develop cost reduction targets and an enhanced focus on efficiencies
    - Third, strengthen our risk profile by reducing credit costs and the size of the balance sheet
    - And fourth, focus on enhancing our credit and risk management functions to ensure they meet the standards of the current regulatory environment

Organizational Realignment

- Given this revision in our focus, we have realigned the bank organization to have an exclusive focus on:
    - De-risking
    - Deleveraging
    - And Bolstering our enterprise risk management function
- Accordingly, we have ceased any plans to offer new banking products to customers, including mortgages
- With this organizational realignment, Steve has taken on the additional title of bank President
    - While select responsibilities have been distributed among other members of the senior management team

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CLOSING REMARKS

- In closing and to emphasize our top priority, from a financial and franchise standpoint, we recognize that freeing up bank capital and reducing the cost of our corporate debt is one of the most accretive things we can accomplish in the near term
  - Therefore, improving our risk profile, capital position, and regulatory relationships are the primary objectives behind all initiatives going forward

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Steven J. Freiberg

*Chief Executive Officer, E*TRADE Financial Corp.*

SUMMARY

- In summary, although it's a challenging environment, we have continued to execute well and have grown our core business, strengthened our financial position, and improved our risk profile
- I am proud of our employees and what we have accomplished so far
- Our account and asset growth coupled with high levels of customer satisfaction and improved retention are a testament to the hard work and dedication of our team
  - While we generated capital, effectively boosting or bolstering key ratios in the period, we look to continually improve these measures
- And finally, we have made significant and continuous progress in reducing our legacy credit exposure

Cost Reduction Targets

- As we have discussed, the current environment presents many challenges, although as a management team, it's incumbent upon us to focus on what we can directly control
- As Matt mentioned, we are in the process of developing cost reduction targets with an enhanced focus on efficiencies
- We are specifically targeting areas that are not core to our brokerage franchise or have a lower potential return in the current environment
  - Therefore, we plan to reduce at least $40mm from our expense base
  - This includes targeting a reduction in costs of at least $50mm, offset by $10mm investment as we build out our enterprise risk management function and fully address the heightened regulatory environment
  - We expect to have the cost reductions fully implemented by the end of 2013, although we're aiming to complete the majority of the reductions within the next 12 months

Initiatives

- Throughout the remainder of this year, we will continue to focus on the initiatives that we began in H1, including:
  - Continued growth in our core brokerage franchise
  - Deleveraging
  - De-risking
  - Expense reduction
  - And dialogue with our regulators related to our strategic and capital plan

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QUESTION AND ANSWER SECTION

Chris J. Allen
Analyst, Evercore Partners (Securities)

Q

If you'd just touch on the spread outlook to start, 240BPS over the course of the remainder of the – 240BPS for the full year. Does that account for margin balances remaining where they are right now?

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

A

If you go back to last quarter estimate for the year was around 240BPS.

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

A

And in my prepared remarks, we estimate slightly above 240BPS, and the increase in margin we saw in the quarter was one of the primary reasons for that. So if you have your own assumption that margins are going to increase dramatically, it would definitely improve our spread, and the opposite would be true as well. If that goes down, it would certainly decrease spread.

Chris J. Allen
Analyst, Evercore Partners (Securities)

Q

And then just on the cost reduction efforts, I mean, can you give us any examples of the specific areas you'd be looking to target?

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

A

At a high level, everything. So there's no one big area that we would target other than having the philosophy of being more efficient. And then in everything we do, getting an extreme focus on prioritization and making sure that everything that we do are the most important things we need to do, and things that are low on the priority list, we would stop doing. So it's each and every area of the company needs to get more efficient and more focused, and that's – so the costs will really come from everywhere.

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

Q

Just talk a little bit again about the ARM repricing on the one- to four-family. How much is left to reprice over the next one to two years?

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

A

So on the one- to four-family portfolio, it's about $6B; about $5B of that overall adjusts. So far, about half of it has already adjust, and the other half really isn't going to adjust in a meaningful way until 2015 and 2016. So it's well off into the future.

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

Q

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And then on the margin loan balances, I know they're up at the – at quarter-end. Is it your view that given the slowdown in retail trading we're seeing this summer...

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

Can you complete that? Brian? Operator?

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

Oh, just on margin loans, just trying to get a sense of the direction, obviously good performance in Q2 and into quarter-end. And just trying to get a sense of how you're seeing that play out over the summer? Where do you see that [ph] push coming (26:40)?

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

let me just give you some perspective. It's hard to be prospective on it, so maybe perspective is better. If you look at the first six months of the year, where we ended 2011 into the end of Q2, the expansion in margin balances was actually quite impressive, approximately $1B from $4.8B to $5.8B.

The amount of net buying in Q2, even though the DART activity was somewhat depressed relative to a more normalized set of trends for industry-wide, the net buying was quite extensive by our customers. I think approximately $3.9B of net buying. And so within that context, clearly our customers have made more of a bullish view and have used leverage within that frame.

What I can tell you is that we haven't really seen any change in the early going in the new quarter, but it's very hard to predict out over the horizon, so hopefully that puts a context to it.

So this has not been a one quarter phenomenon. We've seen the expansion over H1. We see substantial net buying by our customers, and it's hard to predict whether or not that trend will continue. But Matt made the point, it's a trend that we like.

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

I have a couple other follow-ups. I'll get back in the queue, then. Thanks.

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

I guess the question is on the provisioning. Matt, I didn't quite get what you said about the one-to-four being sold at $250,000, but – and also adding on to that question, the home equity provision seems like it's going up and down. I'm just trying to see what's the sort of the run rate or normalized rate should have been for the quarter or so, amount?

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

So on the one-to-four, a couple of things that I was just trying to highlight why the provision was so low at $250,000 for the quarter. The primary item was we had some settlements with third parties during the quarter, so

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putbacks, which happen all the time in every quarter. This quarter it just happened to be primarily focused on the one- to four-family books.

So if you kind of look back to last quarter was when it was around at $16mm, that's one of the – the big reason it was lower this quarter. From a more normalized perspective, I think the comments and our thoughts on provision are really the same that they've been for the past – for quite some time now, which is over the long term we expect it to decline, but in any given quarter you can definitely see some volatility. And then when you look at it by product, so by one- to four-family and by home equity and by consumer, that volatility can be even higher. So it's going to be choppy, but we think the long-term trend down will continue.

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

Q

I know you did put a lot of time and effort and thought into the capital plan. And I know it's a very recent – recently submitted at quarter-end. But any feedback or any discussion with the regulators? And how is that affecting your planning when the springing lien notes come due in December – or can be called in September?

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

A

Very much the relevant question. Given both the OCC and the Fed really have possession of both the strategic and capital plan for a matter of weeks, we really had no tangible, I would say, conversations at this point as they're digesting what we provided them. And we would expect over the coming, probably over the coming weeks and months, really on their schedule, to get good feedback on how they feel about our views on the plan as submitted.

It was, to Matt's point, a fairly comprehensive document, basically well in excess of 100 pages. We think it was in our view hitting the relative points from their level of interest. But we're just not able at this point, because we haven't had feedback, to get into any detailed discussion.

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

A

Just specific to the springing lien notes, I think that our thoughts there are similar to they've been for the past few quarters. Which is, if you look at where our existing notes trade today, and you assume that's where we could issue new debt, the economics of refinancing would be incredibly positive. But our gating factor remains the loss that would come along with that refinance, which, if you just assume we called them at the First Call date, which is the end of the year, the call premium would be something a little bit north of $100mm, around $115mm.

And then the discount on the existing debt's $150mm. So you're going to put that together and even though the economics would be great, you'd have a P&L loss in the $260mm range, which would reduce our leverage ratio at the parent by about 60BPS. So that's – so the gating factor for us is going to be really to get that ratio up to a point where we're comfortable with it, after the refinance at a level where we're comfortable and the regulators are comfortable. So it makes the reduction in the balance sheet size incredibly important from my perspective.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates

Q

A question for you on your net interest spread and I guess looking forward. Matt, are you at a point where you can kind of assess how the tenure has moved and interest rates have moved recently? And the long-term impact of that on your net interest spread?

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

I think if sitting in the environment we're in today, so it being slightly above 240BPS for 2012. I think absent anything else, we'd probably drop another 10BPS next year. But really no commentary beyond that, Patrick.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates
Q

And then I guess my follow-up, there's obviously a lot of volatility in your commission per trade, and you talked a little bit about it bouncing around. Kind of interesting there, you talk about how derivatives are a larger percentage of your trading volume. Should we not be expecting to see some benefit of that derivative trading volume in your revenue per trade?

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

When you look at the – at sort of the variance on the commissions in any particular given quarter, a number of factors. That's clearly one factor that tends to play to the positive. But if you looked on a sequential basis, a more significant factor from quarter one to quarter two was a reduction in the number of Corporate Services Group trades, which clearly come in at a substantially higher level of commissions. And it tends to be a seasonal, as well as dependent upon the conditions of the market in any given period.

And if we look on a year-on-year basis, what's interesting is, as we made the point, options and derivative trades are a higher percentage today than they were a year ago. But, that said, because of the lull in, I would say, the broad-based retail trader, so even the trades coming in are stratified now more heavily towards the active trader, which tends to basically trade at a lower level of commission than the broad middle.

It is essentially the composition of all those elements that get to the aggregation of what you see. So we see essentially on seven or eight different variables the ins and the outs. But when you take them in the aggregate, the particular quarter that you're seeing today has a heavy bias on the drop in Corporate Services Group trades, and they tend to be volatile and seasonal. But more importantly, as the broad middle has more or less retrenched at a higher rate than, I would say, the active trader, it's the level of commissions or the rate of commissions that each of those pay.

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

Your goal of alleviating leverage appears to be focused on shrinking the balance sheet, I guess, given parts of the balance sheet growth are core to the retail brokerage franchise. Are you ruling out raising common or preferred to maybe alleviate that leverage faster, pay down that expensive debt, perhaps optimize the capital structure a bit faster?

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

So I would say we don't rule out anything. I think the – any option that would improve our capital ratios that made sense for shareholders is something that we would look at. I think if you can tell by the area of our focus in, over the past few quarters in particular, and our prepared remarks this quarter, the avenue we think makes the most sense is through a reduction of the balance sheet size. So that's really where we're focused, but I think we would always consider anything that made sense for shareholders.

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

And then just my follow-up, sorry if I missed this in your prepared remarks. But is it still your view that provision expense will continue to trend lower from this quarter over the balance of this year?

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

So I didn't get that precise, Howard. I think that we certainly think the longer-term trend of going down will continue, and there could be volatility in any given quarter. I mean, there could be volatility next quarter compared to this quarter. So it's more of a longer-term comment than a precise comment to the next few quarters.

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

Broadly speaking the primary driver will be the level of delinquencies. And as delinquencies have continued to basically move down, that should give you a good level of, I guess, insight as well as confidence in the direction. But Matt's – I think Matt's comments are important that any particular quarter could have some volatility.

But broadly speaking, as long as we can sustain a trend where the portfolio is dropping in size and the level of delinquency is dropping as well, that should be a good arbiter of what's to come.

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

We've been seeing those trends over the past couple of quarters and years. I guess, just final one, looking forward out on that. I was just hoping, Matt, can you just speak about some of the historical performance that you've seen on the loans that have reset?

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

On the one- to four-family books, so we really don't have any specific data on that. I did give some commentary in the prepared remarks on the home equity side, where they've gone from non-amortizing to amortizing. And the data there is, it's really early days, and we haven't really seen any difference in performance there.

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

[Audio gap] (37:45) Then on the pace of the decline and the servicing costs and clearing, it was down a little bit in the quarter. How should we think about the decline going forward? Should it sort of go down somewhat percentage-wise on par with the loan decline?

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

So if you break it down into two parts, on the clearing side of clearing and servicing is really going to move in line with trading activity. And the servicing side, in general, I think it will – yes, it'll move down in line with the portfolio. The one caveat I'd have to that is keep in mind it can be a little bit lumpy, in that the costs associated with default servicing and REO expenses and things like that can – don't necessarily move in line with the size of the portfolio. But definitely over the long-term that's the case.

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

Q

And then back to the focus on capital. If I think about the Tier 1 leverage ratio, do you guys have a target in mind? It's 5.7% now, and do you think something in the mid-6% range is where you'd like to get to?

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

A

So for leverage ratio in general, we want to get to a place where our regulators are comfortable with our capital ratios, and we're at a point where we can efficiently distribute capital between the bank and the parent. So as you can imagine, we certainly put forth in our capital and strategic plan what we thought those ratios should be. But really the ultimate answer is we've got to get to a place where we're comfortable and our regulators are comfortable. So it's going to be something that evolves over time as opposed to something that we have today.

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

Q

As I think about the springing lien notes and the capital plan that you guys gave to the OCC and the Fed, is a partial refi or a partial retirement of the 12.5% notes included in that? Or is that a thought that you guys might have?

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

A

So separate from the plan, I think it's absolutely a thought we would have. So you can refinance the entire amount; you can certainly refinance a part. I think the most – given the economics of refinancing any of it are so incredibly compelling, our objective would be to get to a place where our balance sheet's small enough that we could refinance the whole thing. But certainly a partial refinance is a possibility.

Alexander Blostein
Analyst, Goldman Sachs & Co.

Q

Another follow-on on the springing liens is there could be one more, I guess. But do you have a view of how low, I guess, the regulators can allow you to go on the Tier 1 leverage, given the fact that it is an immediate head to capital? But it's really easy to see how economics will be very accretive. Basically, in Q1 you refinanced that. So – and then I guess from there, there's other mitigating things you could do. So can you help us understand maybe a little bit more on the minimal level of Tier 1 leverage that I guess is still possible for you to be at in order to get this done?

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

A

So it's going to be very similar to our thoughts on having target leverage ratios overall. The most important thing is that we get to a place where our regulators are going to be comfortable with the ratios, in particular to a refinance here, where they'd be comfortable with the ratio subsequent or after that refinance. So it's something that hopefully we'll have some dialogue on and we'll get to that place. I can tell you, personally, I wouldn't want to end – have a consolidated leverage ratio drop below 5.5% after a refinance, but that's just me and my feel.

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

A

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Clearly our preference is to refinance this debt, and there's no equivocation on that point. I think Matt's point is that we need to have a level of comfort, and our regulators need to have a level of comfort on the safety and soundness of the institution. I can tell you clearly the regulatory community, particularly at the parent, understands the economic value and merits of this transaction, and we just have to balance off all the elements.

There is nothing that is unattainable here, but we haven't got to a definitive stage as of yet. And if you put it into full perspective, we ended the quarter, as I think either you or Keith had made the point, at approximately a 5.7% leverage ratio at the parent. Clearly, that was based at the parent on basically on the averages, not the ending.

You can call it – it may be probably closer to 5.9% if you're using ending. But we still have to build a bit. But that said, the 5.5%, which is sort of one man's view, which I think is sort of a rational view, but the other side is the cost. If we took it all down at one particular point when they're callable, it could cost us as much, I would say, as 60BPS on our leverage ratio.

So we have to find the right level of balance working with our regulators, but the economics of the transaction are very compelling. The desire is there. We just – we will find or need to find a balance.

Alexander Blostein
Analyst, Goldman Sachs & Co.
Q

The other thing I wanted to dig into a little bit more, just looking at different rates on the balance sheet. If I look at the health of the majority of securities, you guys are still earning closer to 3% yields on that. Matt, can you give us a little more granularity on the duration of that book, what kind of reinvestment yields you guys are seeing? Because it feels like things that are I guess somewhat of comfort, if you look at the agency paper, 2% to 3.8% [ph] direction (43:18), that's now yielding sub 2%. So I guess if we roll that forward, how should we think about the repricing risk on the securities books? I guess, how the maturities of all this available for sale?

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

So I think the broad way to think about it is, from an interest rate risk perspective, we're always managing to an overall balance sheet position. The buying and selling of securities is really the final thing that we do to get to an interest rate position that we're comfortable with, based on deposits that come in or fill out that quarter, the loan paydowns that happened.

So looking at an individual line item always gets – it's a little bit skewed, because it's reflective of the purchases of the sales that we had to make to get to that overall interest rate risk position. So it's really, from a management perspective, it's not something where the duration of a particular line item is something we focus on vs. the broader view of the overall balance sheet of running a relatively matched book.

Alexander Blostein
Analyst, Goldman Sachs & Co.
Q

And just the last one from me, could you guys expand a little bit more your comments around some of the deposit strategies you mentioned with potentially trying to reduce the size of the balance sheet? I don't know, anything around the size of how much you could potentially move, or how the economics of that would work out for you?

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

So I think we're – the areas that we're targeting, as I covered a little bit earlier, are the wholesale funding, the bank-specific funding, and then lastly the brokerage-related cash or the sweep accounts. So from a sizing

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perspective, I think kind of back to the overall comments from a regulatory perspective, is the amount we would target is something that helps us get to a place where we're all comfortable with our capital ratios, particularly the leverage ratio.

I can tell you my perspective, though, just given the core of the company and the deposits that it produces, I think a reduction of $5B to $10B from here is a place that I'd be much more comfortable.

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

Just to follow-up on Alex's question a little bit, can you talk about some of the maybe, some of the specific strategies you're thinking about in terms of moving the deposits off the balance sheet?

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

So on the wholesale side, there's not a lot of strategies other than we can pick around the edges, given the cost of reducing that would be around – overall would be around $700mm.

On the bank side, the primary item that we've done so far is we've reduced the rate on our Complete Savings account, which is the primary bank product, down to 5BPS. We saw outflows of $500mm in the quarter in that, so that's something from a balance sheet perspective we certainly hope to continue going forward.

We can also look at other strategies on that account, right. For accounts that are not closely connected to our valuable brokerage customers, you could look at a sale, so that's another thing we would look at.

On the brokerage side or the sweep side, that's the type of product where from an operational perspective, we even have some of those deposits off-balance sheet today, where the customer relationship is with us, but the funds are off-balance sheet.

So specific to that fund, that's what we would look to do. We would look to really set up sweep arrangements where the sweep goes to a third-party bank as opposed to our bank. So those are probably the most notable things that we're working on.

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

Can you give us a sense for how DARTs are tracking in July?

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

You guys pointed out the $0.01, the legal benefit in the release. But, Matt, I think you mentioned like $0.04. So I just wanted to make sure, the other $0.03, is it just the tax rate or are you including that, the provision – I don't know if you want to call it an adjustment, but the provision benefit?

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

So it's really just the tax and the operating expenses. I think when you add them together it comes up to something like $0.0351 or something very close to a round up to $0.04. So it's really just those two items, the tax and the other expense.

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

And then just on the expenses, when you're talking about that net number of $40mm, are you looking at like this quarter's run rate? Or like what run rate should you be taking, because advertising in certain quarters are going to be higher or lower?

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

So we think from a – when you take seasonality out, and our – a good run rate quarterly expense for us is around $290mm. So once the costs are fully implemented, I would view our run rate at that point would be $280mm.

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

Just on the NIM, got the near-term outlook. Just given the current rate environment, the balance sheet, the runoff, and the reduction in any reinvestment, just any outlook for 2013?

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

I mean, in this environment everything else being equal, I think around a 10-basis-point reduction in 2013 is kind of how we think about it. The one thing I would keep in mind just from a pure spread metric perspective, the more successful we are in deleveraging, the smaller the balance sheet's going to be and the higher the spread would likely be, even though the overall balance sheet would be smaller, so it'd produce less net interest income. But just keep in mind there could be some volatility there on that particular metric with the deleveraging.

Faye Elliott
Analyst, BGB Securities, Inc.
Q

Have you outlined the amortization schedule of the HELOCs, not when they start amortizing, but what percent of them would have full Princeton repayment due?

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

So meaning like a maturity, once? Is that what you're looking for?

Faye Elliott
Analyst, BGB Securities, Inc.
Q

But once they start amortizing, and I know you've given that schedule out, what is the time to maturity after that, or the average time to maturity? And really what I'm interested in is if you have any bullets on there, and if you do, what percent?

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

So your typical home equity's going to have a 7- to 10-year draw period, and that's going to amortize for 15 years after that roughly. But I think the most compelling thing, the most relevant thing we view is that data that we put out, which is how many of the loans have begun to amortize or not. Because that's really going to be the credit event, and the key for us is, is very few of those have begun to amortize. And we don't get to a point where a meaningful number of those are amortizing until 2015 and beyond, so it's something well off into the future.

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Faye Elliott
Analyst, BGB Securities, Inc.

Q

So all of yours are typical then?

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

A

I'm speaking to – our portfolio is typical from an amortization perspective.

Matt Evan Fischer
Analyst, Credit Agricole Securities (USA), Inc.

Q

Regarding – back to the cost reductions, you mentioned that it's coming out of every area, and you're going to go through that. But what percent are we talking about in terms of people, taking out headcount? And then also, how does this impact the expansion of branch network? Are you still going to do that?

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

A

So from a branch network, I think, as Steve covered, we opened two new branches; we're up to 30. We don't have really any commentary or plans for a big expansion beyond that that we would stop or start. With respect to where the costs would come from, probably the only, the best color, additional color, I could provide you is from looking at a line item perspective, things like FDIC insurance, depreciation and amortization, amortization of other intangibles.

Those are really things from just a cost reduction strategy perspective, you really can't control. So it's more coming out of the other areas. So I don't have a focus on anything beyond that other than that all those line items is where it would come from, and from all areas of the company.

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

A

Let me just add without getting to a level of specificity, because again we're not prepared to have that dialogue today. We have a pretty good plan laid out, at – internally, that is actionable. And when we basically have the opportunity to convey that, we will. But we're serious about it. We believe we can do it with no harm to our core franchise and remain competitive in the marketplace, continue to basically do what we've been doing, which is de-risking the franchise, growing basically the core. And hopefully positioning ourselves well as we look forward to a more normalized environment. We just can't predict when.

Matt Evan Fischer
Analyst, Credit Agricole Securities (USA), Inc.

Q

And then back to the investor sentiment. So you kind of have two things going on. You've got margin increasing, customers or net buyers of securities, yet DARTs are down pretty considerably, and we're in this weak summer period. So I don't know if maybe mix of securities purchases, or how can you give us an idea of...?

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

A

I think the best – at least the way – I think the best way to express it is similar to the question asked earlier on the reduction in commission rate, or basically commission per trade. That what we really see is that largely the active

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traders have remained engaged, and what we really have seen is the broad, and I would say the broad middle, has diminished activity.

And so the more sophisticated, the more active investors, which tend to basically have more of a bias towards being contrarian, and more of a bias towards using leverage, remain very active within basically the market. But what you're seeing is the reduction, I think, industry-wide as well as at E*TRADE is because essentially it's that broad middle has been more reluctant to trade, given the nature of the markets and the environment. Hopefully that gives you some perspective. We see it at a segmented, very detailed level, but that is the, I think, the best way to view it, the best lens to view it through.

And so when the level of confidence, which is what we were talking about, broadly speaking consumer confidence rises, hopefully that retail engagement will broadly will take hold. And then what we'll see is an increase in overall trades, we'll see a change in the composition of commissions, and hopefully that will be a good story.

But again, there's been a lot of volatility around that at least for the two years or so that I've been here. And we have not seen, I think as an industry, a sustainable trend on that front.

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

The one thing that we will continue to emphasize, that we do believe at some point normal will return; we just can't predict when. And what we believe is most important to our franchise is to continue to do what we're doing, particularly on the core franchise, which is to grow high-quality accounts, grow the asset base, position ourselves, do more for our customers than just trade. Help them basically in their retirement needs, their long-term investing needs. And we'll basically be a much better positioned firm when normal returns.

Chris Harris Q
Analyst, Wells Fargo Securities LLC

So on the reduction of the balance sheet here as far as potential to move deposits to a third party, the number you're talking about here, $5B to $10B, that's a quarter of your – a quarter or so of your deposits, and it would have a pretty big impact on your net interest revenue, like you mentioned.

Is there some way you guys can get some clarity from the regulators or maybe some guidance from the regulators that says, hey, gee, if we do this, will we be able to kind of refinance or retire the springing lien notes? Or is there really just no way to do that, you guys just have to kind of go ahead and reduce the balance sheet, and then wait and see what the regulators say?

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

So there is. I mean, that's one of the purposes of the key tenets of our plan. So we've got – we submitted a five-year strategic and capital plan. So it's got our forecast of things that we want to do and think makes sense to do. And I think that's really the form and the item that will help facilitate that dialogue. So I think that's how we'll get to that point.

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

One, when you talk about the actual numbers, Matt's point of $5B to $10B, first, it's aspirational over an extended period of time.

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Secondarily, and I think Matt addressed it even in his first point. So, for example, and I had said – I've said this and Matt has for quite a while, that the overall size of the balance sheet over time will be more reflective of our, basically, of our customers' deposits with us than the current composition of the balance sheet.

So, for example, there's a significant amount of balances that are on that balance sheet via wholesale funding that today are net drags, meaning they actually are eroding our margins, not improving our margins. And so when we think about this, and you think about it broadly, it's not the average assets coming off. It's over time reconstructing the company in a much more compelling way both in its size and its economics. And in the short term, we have limited options, and in the longer term, we have more degrees of freedom. And it's finding that right balance. Hopefully that helps.

Chris Harris
Analyst, Wells Fargo Securities LLC

Q

So can we assume the $5B to $10B number you're talking about, that was – that number you just didn't pull out of thin air, was done in concert with the discussions with the regulators?

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

A

I'd say definitely it wasn't pulled out of thin air. I think it's where I, from my perspective, where I think the core business of the company and the deposits it produces, I think that's where I'd be much more comfortable. And I'd leave it at that.

Chris Harris
Analyst, Wells Fargo Securities LLC

Q

And along the same lines then, just wondering how you guys think about – I mean, clearly you're getting great growth at the broker. But just wondering if that's really the correct strategic core, given you're really trying to reduce or shrink your balance sheet? Just a little bit thoughts about how you manage the growth of the broker vs. when you shrink the balance sheet would be helpful. Thank you.

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

A

So I think from a – the growth of the broker, I think over the long term that it was an incredibly valuable thing to do. I think the thing that we have to manage is growth of the broker with little to no growth of the balance sheet.

So I think when you go to the strategies we're pursuing, that third strategy of brokerage cash, can we be in a place where we can grow the franchise but grow it with the cash on – off-balance sheet? I think that's the trick to make that work quite well.

Chris Harris
Analyst, Wells Fargo Securities LLC

Q

Would the incremental broker account you get without being able to manage the cash, I assume then that that's going to be a much less profitable proposition for you than one that where you can manage the cash. I'm just trying to get a sense of incremental profitability of actually adding an account where you can't manage the client cash?

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

A

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So from an income perspective, I think generically the having the deposit on your balance sheet produces more income than on someone else – than the fee you get paid for being on somebody else's balance sheet.

The key for us, though, is a return on equity, right. So the balance sheet size and the equity we have, we have to be in the place where our balance sheet size is the right size for the equity that we have. Because if your capital ratios are too low, increasing the size of your balance sheet, that incremental return on equity may not be compelling. So it's really that balance that we need to find that makes the most sense

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