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# E*TRADE Financial Corp. (ETFC)

Q1 2014 Earnings Call

# CORPORATE PARTICIPANTS

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# MANAGEMENT DISCUSSION SECTION

## [Operator]

### FINANCIAL MEASURES

- During the call the company may also discuss non-GAAP financial measures
  - For a reconciliation of such non-GAAP measures to the comparable GAAP figures and for a discussion of additional risks and uncertainties that may affect the future results of E*TRADE Financial please refer to our earnings release furnished with Forms 8-K and our 10-Ks, 10-Qs and other documents the company has filed with the SEC
  - All of these documents are available at about.etrade.com

## Paul Thomas Idzik
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

### Q1 REVIEW

Q1 Highlights

- We had a very positive first quarter with progress across multiple fronts

- Favorable economic conditions catalyzed retail engagement at levels not seen in years
- And we seized opportunities to actively reduce legacy risks
- This solid performance gave us the fuel to power our investment engine as we continued sharpening our focus on the customer and on productivity
- To share some highlights from the quarter, our net income was the highest in nearly seven years
- We posted company records across several retail performance metrics
- We completed the sale of our market-making unit
- The team further curtailed our risk exposure capitalizing on opportunities to sell legacy assets and terminate costly liabilities
- We continue to execute on our capital plan, recording our third consecutive quarterly dividend from the bank to the parent, and finally we evolved the public face of E*TRADE with a launch of a completely revamped brand platform, Type E*
- Needless to say, we're quite pleased with how we performed during the quarter and more importantly with the steps we took to improve the long-term position of the franchise for our owners

Risk Reduction

- On the risk reduction front, after years of diligently managing down exposures to legacy risks we capitalized on opportunities to accelerate those reductions
    - This included the landmark sale of $800mm of TDRs at a gain
- We also sold the remaining balance of non-agency CMOs and eliminated $100mm of costly wholesale funding
- Matthew will provide more details on all of this shortly, but suffice it to say that any one of these items alone would have represented good progress in reducing risk
- Along the same lines we also continue to sharpen our focus on the core business with the completion of the sale of our market-making unit in February, adding $76mm to our parent cash position

Key Area of Focus

- A key area of focus since my arrival has been the recasting of our marketing efforts to better reflect how we engage with our customers today
- After lots of hard work, mountains of analysis, and detailed customer research, we launched a completely new brand platform, which encapsulates our desire to build deeper relationships with our customers, Type E*
    - This launch is an important milestone in our ongoing evolution as we work to expand our presence as a trusted destination for advice and assets
- This new campaign underscores E*TRADE's commitment to do more for our customers and also leverages digital media in a way that resonates with these customers
- Additionally we've added new capabilities to more actively track effectiveness, including the customer response
    - So while it's just a few weeks old, we're encouraged by what we've seen thus far and we're closely monitoring our progress

Earnings

- Turning to our results, we recorded earnings of $0.33 for the quarter on net income of $97mm
- Earnings benefited from robust investor activity, better engagement with our customers, and continued reductions in legacy costs

Trading Activity

- Trading activity was at its highest level in nearly five years with DARTs of 198,000, just below our 2009 company record when market volatility was more than double this quarter's levels
- Our customers were overwhelmingly bullish with net buying activity of $3.9B in the quarter, the most we've seen in nearly two years
- Just over 20% of customer trades were in options, a decrease in the past several quarters where it approached one-fourth of our trades
    - This shift was driven by a significant ramp-up in equity trading consistent with past periods of Main Street re-engagement
- We crossed into the double digits in terms of the portion of our trades executed through our mobile application at about 11% for the quarter
- Worthy of note, trading activity has somewhat subsided since quarter end with DARTs in April to -date tracking down a little over 10% from March, but still at healthy levels

Margin Loan Balances

- Margin loan balances for the quarter averaged $6.9B and exited the quarter at $7.3B, the highest levels in more than six years
- Across growth metrics we set a record with net new brokerage assets of $4.1B representing annualized growth of 7.5%, and we added 72,000 net new accounts, the highest in more than five years while attrition was a company record low at 7.1% annualized
- We also showed continue progress in helping our customers with their retirement, investment, and savings needs
- With retirement assets up 21% from the prior year and representing 22% of our net new growth bridge assets in the quarter
- We continue to see attractive growth in our managed products which ended the quarter at $2.6B, up 11% during the quarter and up more than 60% from a year ago

Recognitions

- We also received external validation for the team's hard work across a handful of recognized outlets
- Barron's awarding us four stars in their annual best of the online brokerage feature including very high marks for research amenities, customer service and education, as well as range of offerings
- Stockbrokers.com acknowledged our products and services with two first place ratings for number one smartphone app and number one client dashboard and five additional best-in-class ratings
    - And finally we were recognized with two Webby Awards for our website and mobile applications, a high distinction for all things Internet
- Now while it's nice to be recognized for our hard work, the true proof is in what we're hearing and seeing from our customers and with retention at an all-time high and engagement at record levels, we feel quite gratified by our progress

High-Frequency Trading

- I'd now like to take a moment to briefly address topics that have garnered extensive media attention of late:
    - High-frequency trading
    - Fairness for retail investors

  - And the current market structure
- E*TRADE was founded on the principle of fairness, with a determination to level the playing field for retail investors
  - This principle continues to govern our every decision and underscores the company's commitment to our customers
- As a trusted partner in helping retail investors navigate the markets and improve their financial well-being, we take our role quite seriously
- Ensuring best execution for our customers is, and always has been top-of-mind for us
- And while almost any measure will indicate that it is a great time to be a retail investor, E*TRADE continues in its determination to obtain price improvement for its customers
  - This means that we're helping our customers obtain a better price for their trades than the prevailing market and achieve it frequently
- Last quarter alone we obtained more than $20mm of net price improvement across all equities and options trades, direct savings for our customers

### Current Market Structure

- Our ability to help our customers realize better pricing is predicated on the current market structure, where multiple trading venues, both on and off exchange attract business through incentive models, exchanging volume for improved prices, payment for order flow, and rebates
- This model helps reduce overall customer costs, delivering outstanding execution quality
- Internally, we apply great rigor to reviewing this process and conduct regular reviews to ensure our customers receive the best execution quality including improved pricing
  - With this commitment to our customers as our top priority, we vehemently condemn efforts by any market participant, high frequency or otherwise, to attempt to gain the system at the cost to the retail investor

## SUMMARY

- Now, turning back to the quarter, and before I hand the baton to Matthew, I'd like to say how pleased I am to start the year with such strong results and such impactful actions
- On top of our solid performance we took confident steps to better position this company for the future
  - We have a talented group of colleagues and a sound financial strategy in place while we are evolving our approach to better support our customers and to me that sounds like the right recipe

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**Matthew J. Audette**

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

## FINANCIAL PERFORMANCE

### Net Income and Revenues

- I couldn't agree more
- I've been with the company nearly 15 years and when I look at our results and metrics, this feels like the best-combined quarter we've ever had
  - And in conjunction with the actions we took to improve the company's risk profile and financial position, we're off to a great start to the year

- On the results, for Q1, we reported net income of $97 mm, or $0.33 per share, an improvement of net income of $0.58 per share in Q4, and also from $35mm, or $0.12 per share in the year-ago quarter
- Our first quarter net revenues were $475mm, up from $446mm in the prior quarter and $420mm in the year-ago quarter

NET INTEREST SPREAD

- Revenues included net interest income of $266mm, up 4% q-over-q, as Q1 net interest spread improved seven basis points sequentially, while our average balance sheet grew by $400mm
- The spread exceeded our expectations as a result of more favorable stock lending results, higher margin balances, and lower pre-payments on our securities portfolio
- Given the key drivers of our spread are becoming more and more business and macro driven, with margin growth, stock loan and prepayment levels on securities becoming the key drivers of our spread changes of late, predicting this metrics is becoming more and more difficult, in akin to predicting customer activity, which is nearly impossible to do
- So rather than a spread forecast, which requires predicting these things, I would just highlight the following
- If we use the current forward curve and assume margin, stock loan and prepayments stay at their current levels, spread would be in the low to mid 240s [basis points] for 2014

COMMISSIONS, FEES AND SERVICE CHARGES

- Commissions, fees and service charges, principal transactions, and other revenue in Q1 were $194mm, up 10% from the prior quarter and up 18% from the same quarter of 2013
- Average commission per trade of $10.64 was down $0.33 from the prior quarter, and $0.66 from the year-ago period
- The decrease was primarily due to the mix shift of more equity trades relative to options
- Principal transactions revenue was $10mm, which reflected the inclusion of G1X through February 10th, when the sale closed
- The pre-tax income on that revenue was less than $2mm
- Going forward, the principal transactions line will be zero and we will see an increase in the fees and service charges line, where we book payment received from volume right into third parties
    - And given the recent focus on payment for order flow, I'd like to give a little more detail here
- In Q1 we received $25mm in payment for order flow
- The split was roughly even between equity and options

NET GAINS ON LOANS AND SECURITIES

- Net gains on loans and securities were $15mm this quarter, including $6mm related to the sale of the remaining balance and non-agency CMOs
- During the quarter we also terminated $100mm of high-cost repo, resulting in an early extinguishment of debt charge of $12mm
- We also had $90mm of natural runoff in wholesale obligations
    - I would also point out that we have an additional $600mm of obligations set to expire during the remainder of 2014, all scheduled to roll off in Q2

Operating Expenses

- Our operating expenses for the quarter were $290mm, in line with our expectations
- As a reminder, we expected Q1 to be above our range of $270mm to $280mm due to seasonal factors and the inclusion of G1X for a portion of the quarter
- With respect to investment spend, as we said last quarter, we will continue to be mindful of the operating environment, and dynamic in our thinking, maintaining the ability to dial back should conditions warrant
    - That said, with current market conditions putting the wind at our back, and with very clear plans, we still feel that now is the right time to invest in the business
- Accordingly, we expect expenses for the remainder of the year to be near the high end of the range

Tax Rate

- One final point on the P&L
- Our effective tax rate in the quarter was 33%, which was reduced by $7mm benefit related to recently approved New York State tax reform
- Excluding this benefit, our effective tax rate was 38%, which is our general expectation for a go-forward tax rate

Loan Portfolio

- Moving on to the loan portfolio, I am quite pleased to report that we sold $800mm of our one-to-four family modified loans
    - That's about 10% of the entire portfolio and the bulk of our one-to-four family modified portfolio
- Thanks to recent market improvements, we were able to complete the transaction at a slight gain to where the loans were held
- Because these are TDRs, we reserve for total expected losses through a combination of prior write-downs and reserves in the allowance
    - Furthermore, the sale is accretive to earnings going forward, is the benefit from the associated reduction and servicing and FDIC insurance costs will outweigh the corresponding reduction in net interest income
- This represents the first sale of its kind since the portfolio transitioned to runoff in late 2007
- The purchaser is the current servicer of those loans, making this a swift transaction for us and a smooth one for the borrowers
    - We actually closed on the transaction yesterday
- The TDR sale should indicate that we are always mindful of market opportunities to reduce our legacy risks, but I would note that we do not plan to sell any more loans in the foreseeable future

PROVISION FOR LOAN LOSSES

- This quarter's provision for loan losses was $4mm, including an $11mm benefit from a third-party settlement
    - This settlement brings us to the end of a long road of put-back and recovery settlements which we have actively pursued since 2007, accumulating a total of $450mm
    - While we continue to pursue one-off recoveries, there is nothing of this magnitude remaining on our radar
- Excluding the settlement, this quarter's provision would have been about $15mm, $2mm less than the prior quarter and at the bottom of our expected range

- For the remainder of the year we expect quarterly provisions within a range of $10mm to $30mm, which includes an expectation for a 4% improvement in home prices

CHARGE-OFFS

- Charge-offs for the quarter of $54mm were impacted by two unique items
  - First they were increased by $42mm related to the TDR sale as we charged off the full reserves related to these loans
  - Second they were reduced by $11mm from the third-party settlement
- Excluding these items charge-offs for the quarter would have been $23mm, flat with the prior quarter and nearly zero for the one to four family portfolio as impact of improved home prices coupled with improved delinquency trends offset any new losses on this portfolio

HOME PRICES

- Specific to our portfolio, home prices improved 1.3% during the quarter, leading to continued improvement in our LTVs
- The average CLTV for the home equity book improved slightly to 97% while the average LTV for the one to four book improved to 84%, due in large part to the TDR sale
- The portfolio ended the quarter at $7.4B, a reduction of $1.2B from the prior quarter
  - Excluding the impact of the TDR sale, our portfolio contracted about $350mm during the quarter, which includes $330mm of pay-downs
- For the remainder of this year we expect runoff in the range of $300mm to $325mm per quarter

HOME EQUITY PORTFOLIO

- Our allowance ended the quarter at $403mm, decreasing $50mm from the prior quarter
- While the portfolio is clearly in a better position than it has been in a very long time, we continue to be mindful of future conversions in the home equity portfolio
- Currently there are $700mm of loans set to convert in 2015 and another $1.1 B in 2016
- As a reminder these loans continue to voluntarily pre-pay with the balances converting in 2014 and beyond having come down by more than 40% over the past three years
- To date, $300mm of HELOCs have converted to amortizing payments
- The performance of these loans has been encouraging, experiencing a spike in delinquency in the month immediately following conversion but then reducing to a manageable level in the following months as borrowers adjust their payments to the updated amounts
- Keep in mind that those loans that have converted to-date represent a very small portion of the convertible balance and may not be representative of the performance of loans that will convert in the future
- For loans with balloon payments the losses on conversion have been slightly better than our expectation
  - Recall that we reserve for our full loss expectation on these loans, which is roughly half of the $220mm balance

Capital and Financial Position

- Moving to capital and our financial position, we ended the quarter with $525mm in corporate cash, approximately $300mm above our target of two years of debt service coverage

- Corporate cash benefited during the quarter from both $75mm dividend from the bank as well as $76mm in proceeds from the sale of G1X
    - And importantly we submitted our first ever OCC-administered stress test at the end of Q1
- We hope to receive feedback on our submission during the current quarter, and it's our objective to share more with you regarding our capital planning process later in the year
- At that time we also hope to be in a better position to give you some more specifics on our thinking around usage of corporate cash

CAPITAL RATIOS

- As for our capital ratios we posted improvement on our Tier 1 leverage ratios with the bank ending the quarter at 9.7% with approximately $165mm of capital generation funding $75mm dividend and balance sheet growth of $150mm
- The parent's leverage ratio ended the quarter at 7%, up from 6.7% in the prior quarter
    - We also remain well positioned under the new Basel III capital rules, which would significantly improve our risk-based capital ratios across the board, which are all currently more than double and triple current well-capitalized thresholds

### CONCLUSION

- So in closing we had an enormously positive first quarter
- Growth in our business was accompanied by many steps we took to reduce our risk profile
    - I'm proud of where we stand and look forward to continuing to execute on our strategy and capital plan throughout the year

## QUESTION AND ANSWER SECTION

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

This is, the question is for the allegiant and implacable CFO. So the sale of the TDRs was impressive, and I'm trying to get more color on the environment. Like you sort of warned or implied that future sales weren't in the making. But could you go through how this occurred and whether the environment, whether there's any opportunities say in home equity, even in the home equity or TDR portfolio to duplicate any of what you did this quarter?

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

Definitely, Rich. So the secondary market in the being generic, the troubled asset space, there has been a ton of buyer interest and demand. So that's the area that we really saw change and you can see that on the TDR sale. You can see that in the sale of the remaining non-agency CMO portfolio so two very good transactions from our standpoint. And when I look at the rest of the portfolio things have not changed especially on the home equity side. The secondary market, when we look at those values vs. the value for shareholders to keep it and keep managing through it, that dynamic has not changed. The secondary market on the first lien side just simply when compared to home equity is definitely better but again that equation of is it better to keep it or sell it has not changed as well. So that's why we don't view any other sales in the foreseeable future. But from my chair it does not take away to the positive nature and the power of getting the TDR sale done.

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

Q

Okay. And then one follow-up would be back to Matt, is another bank today, Flagstar upped its reserve significantly based on its IO loan portfolio and I guess I'm trying to see, you've been building reserve for several quarters now on the home equity IO portfolio and just trying to see whether there's any potential, like is this fully vetted whether the reserve policy you have for the home equity portfolio is fully vetted by the regulators, and what's the chance of having to do a reserve bill like what happened at another bank today?

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

A

Yes, Rich. I am quite comfortable with our reserves, as a somewhat statement of the obvious. I mean, we have a very good and active dialog with our regulators. I think they understand our portfolio. They look at our portfolio a lot. I think that trends in reserves that you highlight are the trends that we have seen for a while and I would expect going forward which are slight increases on the home equity side, where those IOs are and improvements on the one-to-four side, so yeah I think this is another quarter of validating our views that that's occurring and nothing new from my standpoint that gives me concern about reserves from this quarter.

**Steven J. Chubak**
*Analyst, Nomura Securities International, Inc.*

Q

I guess I wanted to start off with two questions pertaining to the regulatory landscape specifically. The first on balance sheet growth, we've seen that some of the tougher regulatory provisions are now being assessed on those banks, really specifically being targeted at those which exceed the $50B asset threshold. And you managed to produce some fairly steady earning asset growth and you're gradually building towards that $50B marker. I was hoping you could give us a sense of when you evaluate the risk/reward proposition of tripping the $50B wire? Does the increase in earnings power as you grow the balance sheet outweigh the more onerous regulatory burden, or vice-versa?

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

A

Yes, Steve. So we – before we think about the $50B mark, just going back to our objectives of getting our leverage ratio back up to 9.5% and we're now at that and above it at 9.7%, in a big way the manner that we got there was through de-leveraging and having the balance sheet come down. So sitting at $46B, having a little over $5B of wholesale funding that's going to roll off over time, I think that the primary focus we have is getting comfortable with our leverage ratio, getting comfortable through the stress tests and seeing where go from there. I think $50B is something obviously we're aware of and focused on, but it's not the primary area of focus for us right now, given that we're below it.

**Steven J. Chubak**
*Analyst, Nomura Securities International, Inc.*

Q

Okay. Fair enough. Then focusing on another area of regulation, the LCR, have you assessed your liquidity strength? Or calculated the LCR based on the latest proposal from the Fed? And would achieving LCR compliance require any meaningful changes to how you're currently managing your balance sheet? Or simply compel some smaller balance sheet adjustment, such as replacing Fannie and Freddie Securities with more favorably treated Ginnies?

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

A

Yeah. So I think in the bucket of a silver lining of our investing strategy is solely an incredibly liquid asset. So when we look at LCR we look at that very closely. We do pro forma calculations. We don't disclose that calculation, but I will say I'm quite comfortable with our positioning and where we stand on LCR just given the liquid nature of our balance sheet.

**Steven J. Chubak**
*Analyst, Nomura Securities International, Inc.*

Q

Okay. Thanks. And then just one more addition on capital management priorities, I may be jumping the gun here, Matt, given that you said you'd focus on the corporate cash discussion next quarter, but many of us on the call have gone through the exercise of modeling the path towards normalized, and I suppose barring any negative surprises on credit, the level of capital accretion from retained earnings and DTA utilization over long term contacts is going to be very substantial. And when you look at the various levers that are going to drive earnings accretion and from different capital deployment opportunities, whether it's reduction in corporate debt, on-boarding of the off-balance sheet deposits, accelerated reduction in high cost repo or even share repurchase. When you look at all those in a long-term context, how do you prioritize each? And I suppose what considerations are influencing your current ranking?

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

A

So a well laid out question. I think that – I'd put it in the bucket of if those things pan out, the capital accretion that you highlighted, we'd be in the position to having a pretty high quality problem of looking at a host of options, all of which I feel like would be beneficial for shareholders. So I think the very first part of your question I think is probably the takeaway here. We're looking at all those options. We hope to be in a position to give you more details on our thinking later in the year, and that's really all I have to say today. The only other thing I would highlight is one of the things that we have been, that's high on our list that we're focused on is debt reduction, but again that doesn't mean we've decided anything. So we're hopeful later in the year we'll give you more details on the thinking.

**Chris M. Harris**
*Analyst, Wells Fargo Securities LLC*

Q

Hey, guys. So a follow-up question on credit. Matt, you had talked about the HELOCs and that there's been some prior experiences of HELOCs that have converted due to their amortization period. I know it's a really small sample size, but can you give us an idea as to what those initial loss rates were in those – that $300mm bucket?

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

A

Yeah. So what it – it is, they are very small numbers, right? It's a few hundred million. I think that the main point I would make without getting into the details or the numbers is it's manageable, right? They're small amounts, and we do see a spike in delinquency in that first month, and then you see it come right back down to a manageable level. Still a little bit higher than it was before it converted but at a manageable level, which to us speaks to someone who's got a payment on automatic bill pay, just didn't realize the payment was going up. Once they notice that, they correct it and the vast majority come back down. So from my standpoint they're manageable numbers, but it is a very small sample so it is not necessarily indicative of much.

Chris M. Harris
*Analyst, Wells Fargo Securities LLC*

Q

Okay. Yeah. Understood. And then a follow-up question on a different topic, I guess, payments or order flow. We appreciate you guys providing the level of detail that you do, it's more than most, but I'm wondering, I know there's a variety of sources of payment for order flow, whether it's selling the order flow to wholesalers or whether it's rebates from exchanges. Is there any way you guys could give us a little clarity on what percentage of the payment for order flow falls in each of those buckets? And kind of the reason I'm asking is that the selling of the order flow to wholesalers doesn't seem to be that much of a focus but there is some regulatory focus on, say, doing something with make-take. So having that breakout would be really, really helpful for us to try to assess what kind of risk we could be looking at.

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

A

Yeah. So Chris, with given the amount and the breakout between equities and options is probably as helpful as I'm going to be. We're not breaking anything out for you on that.

Chris M. Harris
*Analyst, Wells Fargo Securities LLC*

Q

Okay. Maybe one final question then on the business. You guys have been trending favorably for quite some time now. And really what's sticking out, and this isn't really a new phenomenon, but your attrition rate being kind of at a record low, do you guys think there's any more upside to this number? Or do you think, kind of where you have it now is kind of a reasonable level to expect going forward? Because if it gets much lower than that, you guys are going to be looking at competing with some of the best-in-class numbers, I think.

Paul Thomas Idzik
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Well, we certainly don't hope to see an uptick in that number. We certainly hope that it stays steady or goes down a bit, right, given how we report it. That's pretty difficult for us to predict. I think we're doing the right things to engage better with our customers. You see our net new account growth at attractive levels, net new assets. And important to us is not only keeping the attrition number at an attractive rate but growing the existing customer relationship. So I think that's all we can really say on this topic.

Alex Blostein
*Analyst, Goldman Sachs & Co.*

Q

So, on the leverage ratio so you guys are at 9.7% at the bank so clearly above your 9.5% target. I guess what needs to happen for you to kind of come back to the regulators to see if you could adjust the amount of capital you could dividend back to the bank? And the also – sorry back to the HoldCo? And on the flip side do you need to actually get a regulatory approval if you decide to bring some of the deposits back? Or is this just a function of we have excess capital at the bank, we don't want to, we can't give it into the HoldCo, we could bring some of these deposits back? So like how would that process work?

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

A

So it would all be part of the capital planning process and discussion, Alex. So I would look at them together. We have a very good and active dialogue with the regulators on discussing a host of matters. And when we look at the short-term nature of capital distribution, which includes the level of the leverage ratio at that 9.7%, short-term plans are still the same and that prior-quarter up to the amount of the prior-quarter bank earnings. The longer-term plans are still the same, just slows down 50BPS a year from that 9.5% per year beginning this year. But the big next step or the big next process for us is really focused around the stress testing. So that is submitted. We really hope that this quarter is a good quarter of dialoguing back and forth putting us in a position to, or putting us in a position to speak with more specificity later in the year on this exact topic. So that's our goal to work towards that. So we'll talk later in the year.

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**Alex Blostein** Q
*Analyst, Goldman Sachs & Co.*

Okay. Gotcha. And then shifting gears to the business for a second, clearly really strong organic growth, I think one of the best we've seen from you guys in a while. Maybe you guys could spend a minute just talking about the sources of those net new assets coming in, whether that's some of the existing clients where you're starting to gain a little bit more wallet share? I know that's been a strategic priority for you in the past. Or is it winning business from some of the competitors?

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

Yep. So I'll take it first, Alex, and then I'm sure Paul can add in on that. So, net new assets at $4.1B definitely is the record quarter for us. I think the new vs. existing roughly a 50/50 split, so nice $2B number on each. I think the general sources of those new assets really hasn't changed, meaning there's not a bunch of assets moving back and forth within our sector; it's really assets coming over from the traditional space to our space. We've seen that for a very long time. And I think this quarter just validated to us that that is continuing.

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**Paul Thomas Idzik** A
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

It sounds good.

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

All right.

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**Paul Thomas Idzik** A
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

Yeah.

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

That's good?

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**Paul Thomas Idzik** A
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

That's good.

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**Alex Blostein** Q
*Analyst, Goldman Sachs & Co.*

All right. Great. Last, a quick number question. So margin balances clearly strong for everybody really exiting the quarter. I'm wondering if you could provide where things stood on margin balances in April.

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

A

Yeah. So as Paul covered in the prepared remarks, trading has gone down in the month in April around 10% vs. March. Without giving a number on margin, margin has largely held in where we ended the quarter.

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**Michael R. Carrier**
*Analyst, Bank of America Merrill Lynch*

Q

All right. Thanks, guys. Matt, maybe first question just on the net interest spread outlook and somewhat related to the sale, and I understand your comments on with margin stock loan, it is more volatile in terms of the outlook. Just any color on what the impact on the prepay side was? And then when we think about the sale and then also the reduction in the wholesale funding and then the reduction in FDIC and service costs, can you just go through some of those items in terms of what the impact will be or the offsets to get to somewhat of a neutral impact or a positive impact to the P&L?

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

A

Sure. So in general on the TDR sale, I mean it had three impacts. A little bit of a decline in net interest income going forward and a bit of an improvement, meaning a decline on the expense side on both FDIC and servicing. All those three things together I'd characterize as a slight benefit going forward. On the prepay on security side, so prepayments on securities continue to be at incredibly low levels for us. So they were roughly a 7 CPR in Q4 which was incredibly low. They came down even further in Q1 to a 6 CPR, a level at which even with really no rate incentive to refinance, a level at which you would expect to be higher. So if those prepayments stay, you know, that's part of my scenario on spread going forward in the low to mid 240s [basis points]. That's one that is incredibly difficult to predict, which is why I'm not doing it. But it is a very low number and was a low number in Q1.

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**Michael R. Carrier**
*Analyst, Bank of America Merrill Lynch*

Q

Okay. And then just a follow up. In terms of the investment spend, when we think about if it's on the technology side, on the headcount side, just in terms of what that should be driving in terms of revenue. So whether it's net new assets and bringing money in, something on the trading side, whether it's mobile or new strategies. Just want to get a sense. Then if you do start to get slippage on the revenue side, how quickly can some of that be pulled back?

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**Paul Thomas Idzik**
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

We are – I'd say our investment spending is in three broad categories. The first is in technology, as you mentioned, and that's quite important for us to stay at the right level of technological innovation, and stability that our customers expect. I think you seeing us go over 11% for mobile trades this past quarter is indicative of the type of things we need to do to help our customers do the things they want to do. The second category is advertising spending y-over-y. We've launched a new platform. We've launched it in a way that we think is quite smart. We're engaging more robustly on the digital front here and that has made an increase in there. And third is in talent. And we've added teams and individuals in the marketing area, and technology, et cetera, and certainly have had to add teams as we continued to improve our regulatory standing and respond to the requests that regulators have for us as we go forward with our business. Those costs are reasonably dirigible. The area that's less controllable of course is the things we do to respond to regulators. But we certainly have the opportunity to use the trim tabs on both technology spend and advertising spend as the revenues warrant what we do, and drive what we do. The type of things you're starting to see those drive are net new accounts, more growth in existing customers, lower attrition. So you should look that we certainly keep our eyes on those targets and those categories of indications that our customers are responding to what we're doing.

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**Devin P. Ryan**
*Analyst, JMP Securities LLC*

Q

Just want to follow-up on the stress test. I'm trying to get a little bit better sense around the timing, and I guess the progression of dialog with the regulators. It sounds like you're expecting feedback this quarter. But just given that they're already pretty intimately familiar with the portfolio and capital plan, do you expect that at that point where you get that feedback, if they're comfortable with the test that you'll receive approval to move forward with that capital plan in relatively short order? Or is that feedback as part of a bigger process, in your view, so the back and forth here can carry on for some time thereafter?

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**Paul Thomas Idzik**
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

We have close and fairly continuous dialogues with our regulators, including submitting a multi-year capital plan which they are very intimate with and we submitted our stress test in March. The requirement was we use Q3 2013 numbers for that. It's the first time we were required to officially submit a stress test but it's not the first time that we've shared stress test results with the regulators because we run that as a matter of being good business people. So as Matthew said, it's our objective to be able to share more with you regarding our capital planning process later in the year. We'd like to be able to tell you when we actually know better what we're going to do and what we're able to do and we look forward to having a constructive dialogue around that subsequently.

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**Devin P. Ryan**
*Analyst, JMP Securities LLC*

Q

Okay. Fair enough. Okay. And then also just wanted to circle back on the strength in DARTs that you've been experiencing recently, and also the slight change in mix that you saw with higher cash and lower derivatives of percentage, and I'm just trying to get a better sense of, are you seeing that longer term investor re-engaging? It seems like the active trader has continued to be active but I'm just trying to think about the engagement that we're seeing from the long-term investor. Do they feel more entrenched today with margin balances increasing? Or does it still feel pretty fragile to the extent we saw some volatility? I know it's difficult to predict but I just wanted to get a little more color there from what you guys are seeing from the actual investor bases there within your customers.

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**Paul Thomas Idzik**
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Well I would say the number that indicates how Main Street's feeling is that increase in equity trades relative to options trades, as we've been tracking it about 25% option trades in prior quarters and it was down 20% because the cash equity trades were much higher. I spend quite a bit of time with customers and I would say they realize they really need to put their money to work but the level of uncertainty with what's happening around the world and still some of the economic indicators are leaving them bullish about needing to invest but still really keeping their eye on the dashboards and paying probably more attention to what's been happening than we might suspect otherwise.

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Devin P. Ryan
*Analyst, JMP Securities LLC*

Q

Got it. Okay. And then just lastly with respect to the loss on the early extinguishment of debt, the $12mm loss that resulted from the decision to terminate the $100mm in wholesale funding, that seemed like a little bit of a large penalty so just curious what drove that decision and whether we can expect there to be some more termination of contracts moving forward.

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

A

Sure. So just looking at the wholesale book overall, if we go back before we started focusing on deleveraging, we had about $7B book. And we look at that from the perspective of over time, we want that to run down, which it will on its own. But if there is anything we can do to accelerate that that makes sense economically, that makes sense from a capital ratio standpoint, we want to do that. So we did about $1.5B of that during our deleveraging focus. What we saw, we saw an opportunity this quarter on a specific tranche of $100mm. The $12mm pre-payment penalty should really indicate that it was very high rate stuff, meaning while the penalty was high, the benefit going forward should also be high, so it's just something that we thought made sense to do. And I've put it in the bucket of accelerating balance sheet cleanup, and I was very happy to do it, very excited about it. And it brings wholesale down to $5.2B. We've got another $600mm that are maturing on their own next quarter, bringing us down to $4.6B. So all in all, I feel good about wholesale, and I feel good about that transaction.

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

Q

Just wanted to ask about the fees and service charges and the sequential increase, I'm assuming some of that is driven by increased payment for order flow after the T1X sale, but I was wondering if you could give any color on that, and just how to think about the run-rate moving forward?

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

A

Yeah, Chris. I mean there's two – payment for order flow is by far the biggest item in that line, so the $25mm as payment for order flow out of $47mm, so that line is largely going to move with customer activity. The second biggest item in there is really recurring fee income related to assets that we manage, primarily the mix, but it is predominantly a payment for order flow, meaning its going to move the volume.

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

Q

Got it. I mean assuming it was a full quarter the number would have been a couple of million above that in terms of payment for order flow of $25mm because Q1 had some [indiscernible] (45:54), I think it was.

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

A

Yeah. I mean I would put that in the bucket of noise. It's only five weeks of the quarter that we had [indiscernible] (46:01) so it would be biased up a little bit, but not meaningfully.

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

Q

Got it. Any thoughts in terms of what would happen if the restriction on payment for order flow, I mean any thoughts in terms as how you might monetize your order flow, or how the impact of a modification to the trade-out, if there was an implementation of the trade-out rule would impact payment for order flow for you guys?

Paul Thomas Idzik
*Chief Executive Officer & Director, E*TRADE Financial Corp.*

A

Well first of all, we're committed to offering our customers value beyond price through customer service education, professional guidance. And we believe our offering is really compelling and competitive. If anything happens in the competitive landscape, we'd evaluate it and address it at that time. But I can't really speculate on what's going to happen in that space. I can just assure you that we're just going to continue to put, making sure that we offer the best to our customers at the forefront of what we're doing.