

23-Jul-2014

E*TRADE Financial Corp. (ETFC)

Q2 2014 Earnings Call

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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

Paul Thomas Idzik

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

Q2 REVIEW

- We had a good second quarter characterized by continued brokerage growth, noteworthy de-risking of the balance sheet and encouraging progress in our regulatory dialogue

- In the core franchise we continue to sharpen our focus strengthening our foundation and raising the bar internally on quality
- This quarter that took the shape of launching our new brand platform, delivering a clearer message to our customers and prospects regarding the breadth of capabilities
 - It also took the shape of focused investments in talent and infrastructure, positioning our company for future success
- The quarter brought continued accumulation of accounts and assets, even in the mist of an industry wide slowdown in trading activity
- And with respect to our overall risk and financial position, the quarter benefited from the completion of the landmark sale of modified loans and marked improvement in the composition of our investments and funding sources
- And perhaps most importantly we made meaningful progress with our regulators completing our first-ever Dodd Frank Stress Test

Stress Test Submission

- Starting with that topic since many of you have expressed more than casual interest
- During the quarter we received feedback from our regulators with respect to our stress test submission
- Matthew will share some of the details but to foreshadow a bit, the dialogue with our regulators on this topic has been quite healthy across both key dimensions of their assessment
 - First in terms of how our actual numbers fared, meaning capital adequacy and liquidity across various scenarios of macroeconomic and environmental stress
 - Second in terms of our planning process, our methodologies and stress testing capabilities
- With respect to the first, we performed well under all stress scenarios and we feel positive about our capital position over the test period
- On the second we were encouraged by the dialogues surrounding our stress testing capabilities and methodologies, our planning process, risk management and controls

Enterprise Risk Management Framework

- Over the past several quarters you've heard us talk a lot about building out our enterprise risk management framework
- Our stress testing capabilities are a prime example of this build-out as we worked to ensure our processes and procedures met the expectations of the current regulatory environment and of our owners
- Net-net our stress test results were as good as we could have hoped for
- As you can appreciate, we view the entirety of this process to be an importance step in our regulatory dialogue, and importantly our continuing progress prosecuting our capital plan

Earnings and Expenses

- Turning to our financials, we recorded earnings of \$0.24 for the quarter on net income of \$69mm
- Earnings benefited from an elevated net interest spread and the continuing trend of diminished credit costs
- Expenses of \$284mm were down sequentially and while reflecting ongoing investments in the business, including elevated marketing spend, corresponding to the launch of our new brand platform and its surrounding promotion

Investment Areas

- Now as we think about expenses, we remain confident that investing is the right thing to do at this time
- We're also very conscious of pressures to revenues and the need to balance the bottom-line impact
- Accordingly we continually assess the appropriate level and areas of investment for the current environment
 - And while one quarter of muted activity does not make a trend, we are prepared to tighten our belt should revenues wane for a sustained period of time
- Further during the quarter, we exhibited continued improvement in the complexion of our balance sheet with reductions in legacy investments and funding
- We completed a landmark sale of \$800mm of our modified loans and rolled off \$600mm high-cost wholesale funding as those obligations reached their scheduled maturities

Brokerage Metrics

- Now in terms of brokerage metrics, DARTs were 155,000 in the quarter, down 22% from a five year high in Q1, but up 4% from the prior year
- Options as a percentage of total trades were 23% and our customers continue the increasing trend of engagement via mobile devices with a record 11% of trades executed through our award-winning mobile apps
- Finally trading has held up in July to-date which has been up 3% from June
- One final point on trading, while the public discourse on this topic has calmed, our focus on delivering the best possible execution to our customers has, and always will remain our top priority

PRICE IMPROVEMENT

- During Q2 we were able to achieve price improvement for our customers of slightly over \$20mm
- That number is consistent with last quarter's, but on lower volume; meaning we did an even better job of helping our customers get better pricing on the orders they placed with us

CUSTOMER MARGIN RECEIVABLES

- Customer margin receivables remained relatively constant during the quarter, ending the period at \$7.3B and averaging the same throughout the quarter
 - These were again the highest levels we've seen in many years
- We did however see some mild yield compression here, as the number of accounts leveraging margin reduced, while the balances per account grew
- We added \$1B of net new brokerage assets during the quarter
- As expected, the pace of additions slowed relative to last quarter's record, reflecting seasonality in April
- We added 33,000 net new accounts in the quarter, bringing our total YTD beyond the total for the entirety of 2013

BROKERAGE ACCOUNT ATTRITION

- Our annualized brokerage account attrition of 8.6% edged up a bit from the prior quarter's all-time low, but was still one of the lowest quarters in the company's history
- Meeting the retirement, investing and savings needs of our customers continues to be an area of intensified focus for us

- To that end we were very encouraged with the continued growth in our managed products, ending the quarter at \$2.9B, up 11% over the prior quarter and 62% over the prior year

RETIREMENT ASSETS

- Retirement assets also accounted for the bulk of our total net new assets in the quarter
- At the Board level, we were fortunate to add Mr. Gary Stern as a Director during the quarter, significantly strengthening our skill set at the Board table
- Gary's background having spent 27 years as President and CEO of the Minneapolis Fed, is especially relevant given the focus of the company

External Validation

- With regard to external validation, we were recognized by J.D. Power during the quarter, as our overall satisfaction index showed more improvement than any other provider in the self-directed space
- And importantly, we received upgrades from each of our three credit rating agencies, DBRS Moody's and S&P, these upgrades reflecting our progress across many fronts

SUMMARY

- So in summary, I'm pleased with what we accomplished during the quarter and feel good about prospects for the future
- We have done a lot to bolster our position in the brokerage business, including our recent brand platform launch and intensified focus on the customer
- We also remained cleared-eyed and purposeful in working to strengthen the financial health of the company with a more robust balance sheet shape and the continued execution of our capital plan
- We feel encouraged by the regulatory dialogue around our stress testing, which has been especially rewarding given the amount of energy my colleagues have devoted to enhancing our risk and regulatory position over the past several years

Matthew J. Audette

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

FINANCIAL RESULTS

- I certainly echo your sentiment on the quarter and our overall position
- We have great momentum internally and externally as evidenced by the strengthening of our franchise, the improving health of our balance sheet, our regulatory progress, the confidence our customers continue to place in us, and our performance overall
- And I am especially pleased that our progress is starting to be recognized by our rating agencies with positive actions during the quarter from each

Net Income

- So to start with our results
- We reported second quarter net income of \$69mm, or \$0.24 per share; a decrease from net income of \$97mm or \$0.33 per share in Q1, and an increase from a net loss of \$54mm or \$0.19 loss per share in the year ago quarter, which included \$142mm of goodwill impairment

Net Revenues

- Our second quarter net revenues were \$438mm, down from \$475mm in the prior quarter, and \$440mm in the year ago quarter
- Revenues included net interest income of \$270mm – a 2% sequential increase as Q2 net interest spread improved eight basis points to 255BPS, while our average assets decreased by \$700mm
 - The strong spread this quarter was driven by a combination of the core business, as well as some balance sheet actions
- On the core business, despite an industry-wide decline in trading activity, our margin and related stock lending book were robust during the quarter with even higher average balances than in Q1

Balance Sheet

- On the balance sheet side, we had several factors impacting spread, including the scheduled runoff of \$600mm of wholesale borrowings, which reduced the overall size of the balance sheet, strong performance on non-accrual loans, and a one-time benefit to loan yields related to the TDR sale
- While we were quite pleased with the spread performance in Q2, the benefits of the TDR sale, along with the strong performance on non-accrual loans are not likely to recur in future quarters
- In addition, prepayments on the securities book picked up towards the end of the quarter as summer moving season started to kick in, something that is likely to continue into Q3
- So factoring in the likely decline in loan and securities yields and assuming margin and stock loan remain at Q2 levels, our spread would be in the mid 240BPS for H2 2014
 - Please keep in mind this is not a forecast, it's more of our run rate on spread as we exited Q2

Balance Sheet Size

- On balance sheet size, this quarter's decrease was driven by the reduction in wholesale funding along with customer activity, which included \$400mm in net buying
 - This brought our balance sheet down to just under \$46B
- There has been some interest recently in our expectations for future balance sheet size
- We have been around our current balance sheet size of \$46B since late 2012 which is reflective of two things:
 - First, we were focused on deleveraging to bolster our capital ratios
 - And second we've deliberately remained below the \$50B threshold which is still our intention today
- We're quite comfortable with our ability to manage the balance sheet size accordingly through levers such as those we've utilized in the past

Commissions, Fees and Service Charges

- Commissions, fees and service charges, and other revenue in Q2 were \$161mm, down 13% for the prior quarter and up 3% from the year ago quarter
- Average commission per trade of \$10.72 was up \$0.08 from the prior quarter and down \$0.38 from the year-ago period
- The sequential increase was primarily related to more options trades in the mix, along with more trades from our corporate services customers
- Fees and service charges revenues of \$46mm included \$22mm of payment for order flow, compared with \$25mm in the prior quarter

- This reflected a 19% decline in total trades, and the first full quarter impact of the sale of G1X

Net Gains on Loans and Securities

- Net gains on loans and securities were \$7mm this quarter, the majority of which related to the TDR sale
- The prior quarter's gains of \$15mm included \$6mm related to the sale of our remaining non-agency CMOs

Operating Expenses

- Our operating expenses for the quarter were \$284mm, down from \$290mm in the prior quarter
- The decrease relates primarily to the fact that G1X was included for a portion of Q1 and FDIC expense declined \$5mm sequentially, largely due to the TDR sale
 - These declines were partially offset by increases in compensation and professional services

ADVERTISING SPEND

- As Paul mentioned, our advertising spend in Q2 was higher than normal as we launched our new brand platform – Type *E
- Our plans for full year marketing spend are unchanged at roughly 10% increase from 2013 – we have just focused more of our spend in H1 in 2014
- In considering our overall expenses, I would echo Paul's comments that we are mindful of the environment when thinking about our investments under different operating conditions
- From where we stand today, we still believe it makes sense to invest, so we will continue to do so

SPREAD AND CORPORATE INTEREST EXPENSE

- As I think about the metrics that we use to gauge the appropriateness of this, we have solid momentum across a number of those; spread has increased from the lows, partially due to healthy margin loan balances – an indicator of customer engagement; credit has improved leading to lower provision and FDIC expense; and our corporate interest expense has come down, with the possibility of further declines
- So while trading activity has come down over the past three months – that isn't the only indicator of our ability to invest
- Now, given our front-loading of marketing spend, and the seasonality of H2, particularly Q3, we expect overall operating expenses to come down slightly from this quarter's level during the remainder of 2014

Loan Portfolio

- Moving on to the loan portfolio, it ended the quarter at \$7.1B – a reduction of \$325mm from the prior quarter, driven by \$310mm of pay downs
- For the next few quarters, we expect runoff in the range of approximately \$300mm per quarter
- This quarter's provision for loan losses was \$12mm – at the low end of our expected range
 - This was down slightly from Q1, which would have been \$15mm excluding a third party settlement
- Our allowance ended the quarter at \$401mm, essentially flat with the prior quarter
- Charge-offs for the quarter of \$14mm were predominately in the home equity portfolio, as 1-4 family charge-offs were zero, which is consistent with last quarter, adjusting for unique items

PROVISION EXPENSE

- As we think about provision expense going forward, we are mindful that the majority of our HELOC portfolio converts to amortizing over the next few years
- To take a step back, we think about our home equity portfolio in three separate categories when it comes to reserves:
 - The first is balloon loans of \$210mm, for which we are already reserved for the full life of loan
 - The second is home equity installment loans of \$600mm, which have always been amortizing
 - And the third is home equity lines of credit of \$2.3B, the majority of which are not amortizing
- It's this third category, where we generally reserve for the next 12 months loss expectation, and where conversions are scheduled to pick up materially in 2015, which could cause provision expense to increase in the quarters surrounding conversion

CHARGE-OFFS

- An additional point on provision expense is that we've had essentially no charge-offs in the 1-4 portfolio over the last couple quarters, which has caused our reserves for that category to come down, and keep overall provisions low
- With the current allowance for this book now relatively small at \$44mm, there is not much more room for this trend to continue
- So, we expect provision expense for the rest of 2014 to be predominantly driven by the conversion of HELOCs, and to continue to be within the range of \$10mm to \$30mm per quarter
- Actual results within that range will be driven by the performance of conversions relative to our expectations

HOME PRICES

- One final point on the loan portfolio – home prices improved approximately 5% during the quarter, leading to continued improvement in our LTVs
- The average CLTV for the home equity book improved to 94%, while the average LTV for the 1-4 book improved to 81%

Regulatory Front

- Moving on to the regulatory front – as Paul mentioned, we received feedback from the OCC on our stress tests, which were submitted at the end of Q1, as part of the first wave of Dodd-Frank Act Stress Tests for banks of our size
- The submission was based on September data, and included our operating forecasts through 2016, under varying scenarios – the most constraining being severely adverse, which contemplated inputs such as a 40% drop in the equity markets, and a 25% drop in home prices

KEY TAKEAWAYS

- Since the results for banks in the \$10B to \$50B range are not public for this first official test, I can't discuss much in the way of specific results
- But as Paul mentioned, the two key takeaways are:
 - First we remained meaningfully above the regulatory well-capitalized levels for all capital ratios across all scenarios

- And second, we were quite satisfied with the feedback around our stress testing process and our approach and methodologies
- In all, we feel incredibly good about what we have accomplished here
- Our considerable efforts to de-risk and de-leverage are proving their worth with our strong capital performance across all scenarios
- And when coupled with our company-wide focus on building out our stress testing capabilities and controls over the past couple of years, achieving results like these is quite gratifying

SUBMISSIONS

- One final point on our submissions – keep in mind that they were based on September 30, 2013 data
- And since then our risk profile has improved, through solid earnings, the continued runoff of legacy assets and funding, the sale and elimination of remaining non-agency CMO's, and most important our sale of \$800mm of modified loans, reducing a disproportionate level of tail risk

CAPITAL AND DIVIDEND PLANS

- Turning now to what this means for our capital and dividend plans going forward; the stress testing process for banks of our size differs from the CCAR process
- So, while the completion of, and response to, these stress tests is great progress and clears an important hurdle, it is not a blanket approval of our capital plan
- Each dividend request will continue to require a formal approval on a quarterly basis

Longer Term Capital Plan

- As we focus on our longer term capital plan – while this stress testing process and its results are a key milestone – equally, if not more important, will be demonstrating sustainability in the processes we have built, specifically in enterprise risk management
- Meaning, it's great progress to have built out our ERM framework – but it will be even better when we can demonstrate a sustained operating track record
- So while our longer-term plans continue to include managing the bank to a lower Tier 1 leverage ratio – of 8%, ultimately – our near term plans are to continue requesting quarterly dividends of consistent amounts
- In light of our regulatory dialogue, including the feedback on our stress tests, my hopes are unchanged in wanting to be in a position to have more clarity on our path to our longer-term plans by the end of the year
 - I think the accomplishments of the past couple quarters only bring us closer to this objective

Use of Dividends

- Turning now to the use of dividends
- We have been spending a significant amount of time thinking through what is the best use of capital
- After much thought and analysis, we believe the best use of capital today is to reduce our parent company debt
 - This is consistent with our commentary for several quarters now, and is reflective of plenty of recent work on the topic
- However, keep in mind that while this is our thinking today, this can and likely will evolve over time as we get more clarity around our dividend levels and the returns on other uses of capital improve

Debt Reduction

- Now, I'd like to add a little more color on our current thinking around debt reduction
- While we believe reducing debt is the best use of capital today, we are also mindful that paying off our debt entirely – all \$1.8B of it – would likely result in a costly and inefficient capital structure
- The key question therefore becomes how much debt reduction we should target
- After much work, and reviewing a host of different measures, including earnings capacity, competitive metrics, regulatory capital guidelines and credit rating agency data to name a few – we believe the right level of debt for us over the long term is approximately \$1B
 - So this means, based on our thinking today, we would ultimately pay off \$800mm of debt
- The timing of, and our ability to reduce debt by this magnitude will depend on several factors – most importantly the level of dividends from the bank to the parent, and costs associated with paying down our existing notes
- So I don't have precision around our plans today, but I hope to be in a position to provide more clarity on actions later in the year
- As a reminder, our nearest callable debt is the 2017 notes which are callable in November of this year
 - And our nearest maturity is May of 2016 when \$435mm comes due
- Overall, we feel strongly that reducing our corporate debt will put us in a much stronger financial position and will drive shareholder value
- But again, please be mindful that changes in the environment could shape and change our views, and there are multiple constituencies involved in these decisions, including our Board and regulators
- So for now, we are focused on executing our capital plan and getting into a position to reduce debt

CLOSING COMMENTS

- So in closing, it was a solid quarter for us
- We meaningfully improved our risk profile, and earned recognition of our efforts with upgrades from all three credit rating agencies
- We made good progress with the regulators on our dialogue around the stress test, and the receipt of our fourth consecutive quarterly dividend
 - And it feels good to be talking with more specificity on our plans for use of capital
- I look forward to continuing and evolving that dialogue in H2

QUESTION AND ANSWER SECTION

Richard H. Repetto

Analyst, Sandler O'Neill & Partners LP

Q

First question is for the assiduous CFO here. Matt, I didn't quite, when you talked about the balance sheet size, you said it was deliberate to keep it at \$46B. And what I didn't get, and maybe I just didn't hear you, but does that include going forward that you're going to do everything to stay below a SIFI-type situation at the bank? Or how do you balance that with growing the balance sheet and producing more net interest income but having more expense side if you hit that \$50B mark?

Matthew J. Audette

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

A

Yes, so Rich, so in speaking to our views on this, and speaking to our views today, right? It's been a big focus of ours to get the balance sheet sized down, to get the capital ratios up – specifically the leverage ratio, and a secondary focus of staying below \$50B. I think over the long term, things of course could change; the returns on those deposits could change. Our wholesale funding – we still have \$4.6B of that. It's scheduled to roll off over time which creates a bunch of capacity to bring deposits back on balance sheet. So we're really speaking to our views today, knowing that over time they could certainly evolve.

Richard H. Repetto

Analyst, Sandler O'Neill & Partners LP

Q

Okay. I know that they could evolve but I guess the question – well, if you do want to get to, say a 300 basis point spread in a different environment, it just appears like the balance sheet would need to be bigger. But anyway, I'll ask one more, my follow-up question. When you – thank you for the discussion on the debt and sort of the ideas and thoughts on capital usage. I guess the question is, when you say if the environment changes – like, what else, what type of environment would you not want to take down the debt level, or where that target would change and that would not become the \$800mm of debt reduction not be the priority; where you might do some other capital return, whether it be dividend, buyback, or et cetera.

Matthew J. Audette

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

A

Yes, so hopefully we got the message that debt reduction is absolutely our focus. I think the key thing to always keep in mind is we are going to be focused on what is the best use of capital for shareholders. And those things could change – I think just using the topic that we were just discussing – the return on deposits, especially those deposits off-balance sheet, in this interest rate environment, with the level of FDIC costs that we have, and running the bank at a 10.2% leverage ratio. The returns on that could be dramatically different with higher levels of interest rates, with an 8% leverage ratio, and an FDIC rate that is cut in half. So, things could evolve over time. But I want to be very clear that our focus today, and the best use of dividends is to reduce debt at the parent.

Alex Blostein

Analyst, Goldman Sachs & Co.

Q

So, thanks for a lot of color, and a lot of details obviously there on the call. But let's – I wanted to go back to the capital question. I guess, on the one hand, you guys still have a significant amount of excess capital in the bank today. So by our math it's about \$300mm. And it looks like there's also a significant amount of excess cash at the hold co [holding company] today, which should enable you to pay down the debt that's callable this year. So I

guess what I'm trying to get to is, it feels like there's flexibility in the interim to deploy some of the excess capital at the bank without necessarily funneling it to the hold co. So can you discuss that opportunity and what really goes into that decision? Because there's now a couple things you guys could do obviously both on the deposit front or breaking down the wholesale funding front.

Matthew J. Audette

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

A

Sure, Alex. So I think on the near-term focus on capital levels and uses of capital, we are really focused on continuing to generate capital and earnings at the bank. And dividend – being in a position to continue to dividend the specific amounts. When we get into the longer term plans of being able to start to run at a lower leverage ratio – that is going to involve reviewing a host of different things. I hope to be in a position by the end of the year to give more specificity and details on that. But I think the core of your question is, because we're above 9.5% is there some flexibility to do something with every dollar above 9.5%? It's not as black and white as that. We are focused on having healthy capital ratios at the bank, continuing those consistent dividends and getting to a place where we can achieve it long-term. So that's where we're focused.

Alex Blostein

Analyst, Goldman Sachs & Co.

Q

Got it. Thank you for that. And then the second question I had for you guys is the discussion around provision guidance. So, in the \$10mm to \$30mm I guess the view is, that's your expectations for the next couple quarters assuming the unamortizing loan book and the losses there perform as expected. Can you give us a sense of what that as expected is? I don't know whether there's some sort of [ph] cum (28:49) loss number that you're assuming, or something else that we can kind of use as a – to gauge the performance of that book relative to your expectations?

Matthew J. Audette

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

A

You know the answer. Short answer no, Alex. I think the longer answer though, is the range of \$10mm to \$30mm is of course informed by our views. I think if you look at the, at just the last couple quarters on home equity, the provision for the home equity component or book itself has been around \$20mm, which is coincidentally right in the midpoint of the range. So, we'll obviously see over time, but the \$10mm to \$30mm is the best I could give you.

Alex Blostein

Analyst, Goldman Sachs & Co.

Q

Got it, and just one more from me. On spread income real quick, if you look at securities lending, that's been upside surprise for the last couple quarters. How sustainable do you guys think that incremental revenue that we've seen within NII and securities lending for you?

Matthew J. Audette

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

A

It's tough to predict. I mean it's margin and securities lending go pretty much hand in hand -in-hand, so it's the same. I think it's in the same bucket of how well could we predict whether Q1 DARTs were going to hold steady as well. It's very hard to predict. We are obviously very happy with it, but it would be just hard to predict.

Steven J. Chubak

Analyst, Nomura Securities International, Inc.

Q

So, I was hoping to spend a little bit of time dissecting your logic, or rationale as to why you are reluctant to grow the balance sheet above \$50B. And I recognize that there is a risk of incurring incremental SIFI related expenses. But just taking a step back and looking at the progress you've made on the risk management front, you have all of the capital and liquidity stress test systems in place, including the regulators are pleased with your progress. And I'm simply struggling to identify what are the potential sources of incremental expense that would compel you to limit your growth at the bank beyond \$50B, because based on all of the cost benefit analysis that we do that's the opportunity that's most accretive?

Matthew J. Audette

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

A

So Steven I think we've been incredibly clear about our primary objective, which is to get the leverage ratio at the bank up. So, in order to do that we have reduced the size of the balance sheet. A secondary object there has been to stay under \$50B. Our objectives remain the same of continuing to maintain that leverage ratio at the bank until we get to a place where everyone involved is comfortable with us migrating to that longer term capital plan. I think another thing that's very important for us, the amount of time and energy, and effort that we spend on enterprise risk management, highlighting the stress test build out as we have today. But another key thing for us is demonstrating sustainability in the things that we have done. So it's not just important to build something out, it's important to build it out and show that we can do it over time. So there's lots of things to do but I think we have shown over the past couple of years, we've laid out a very long-term plan. In each quarter that goes by, feel like we are continuing to make progress on it.

Steven J. Chubak

Analyst, Nomura Securities International, Inc.

Q

Okay, so presumably if there is sustained progress that's made and you demonstrate that to regulators, is there any reason that you would then still be reluctant to grow the balance sheet beyond \$50B? I am just trying to identify whether there is an individual source or area of incremental cost that you simply haven't incurred as of yet that makes you reluctant to consider that alternative?

Paul Thomas Idzik

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

A

Steven, I think there's certainly the incremental costs, you would expect to see in legal, compliance, risk and some in IT. But we are talking about theoretical right now, we're pretty clear and have been underscoring today that our intent is to stay consistent with our capital plan and to really work on that, and to stay below \$50B. I am encouraged by the fact that in Washington and around the country there is a recognition that a bank that's \$50B or \$55B doesn't have the complexity of \$250B bank. And there is some healthy discussion which I think has been well balanced, about how do we think about that level and how might that change and as well as all banks of x billion dollars are not of the same complexity. And so we're very happy to keep driving value for our owners by prosecuting our capital plan and to maintain a watchful eye on our opportunities, but also maintain a watchful eye on the regulatory and political environment. And we're pretty happy with that current stated course of action.

Steven J. Chubak

Analyst, Nomura Securities International, Inc.

Q

All right. That's certainly fair, I do appreciate that color. And then just one more from me on the detail relating to managing your corporate debt. And Matt I did appreciate the additional color you provided there. I just wanted to get a sense as to how the trust preferreds actually fit into that whole plan and whether an improvement in your credit rating would actually prompt you to reduce the level of targeted debt?

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

A

So the trust preferreds are – they’re assets of the bank, but in the current regulatory environment they’re still included in good tier 1 capital up at the parent, because that’s being phased out starting in 2015. So I think where we sit today trust preferreds are considered capital so they are not on our focus. I think where to your second question on where our ratings go, is that going to change our thoughts on level of debt? I think that our view on the level of debt is after reviewing a host of different measures, it is our view on the right level of debt over the long-term. And I think if you just look at the financial results and the balance sheet that we’ve been producing and extrapolate that out, the credit rating associated with that over the long-term I think would be quite good. So we’ve thought that through in thinking through the right level of debt at \$1B.

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

Q

Okay, and actually just relating to the first question on the TRuPs [trust preferreds], I know that you do have one tranche that’s actually quite expensive, which if you’re going to maintain at that level of \$1B of debt outstanding, presumably you would want to take out at least some of those higher cost tranches and just wanted to know how that would fit in to the overall strategy?

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

A

So I’d put that in the bucket of tactics Steven. I don’t have any comments on that. I mean we’re well aware of course the trust preferreds we’re well aware that one of them has got a 10% coupon on it. It’s a very small amount. So I’d put that in bucket of tactics that we’ll deal with at a later time.

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

Q

Matt, first on expenses, I think you mentioned just on the \$284mm level just going forward, that’s going to pull back some. Just in that range of \$275mm to \$280mm, just want to get some color. And then if the environment does remain muted, in terms of the levers that you have to pull back, is it mostly advertising? Are there other line items that you guys have invested some that you could pull back if it lasts for a couple of quarters?

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

A

So on where expenses are heading, I think the trend is down slightly and really highlighting the seasonality of marketing, where we’re focused on spending roughly \$120mm for the year, but we spent \$70mm of it in H1. And of course typical Q3 slowdown in volumes, you would likely some sort of movement in that direction as well meaning down on the clearing costs. So I think that, those are the things to look at. If we were to conclude, we needed to pull back, I think marketing is always the most obvious one. But I think when you look at the areas that we are investing in, it’s largely associated with people. So if you look at where our expenses have grown, it’s in a combination of comp and in professional services. And there is a very specific, many specific thought processes behind that, but one of them is to have enough in professional services that if it does make sense to pull back, we’ve got the type of spend that we can pull back as opposed to doing it all through full time employees, where that’s a little bit more difficult and a little bit more costly to pull back. So I think we’ve got that right balance for many reasons, but one of them is so that we can be a little bit tactical if necessary

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

Q

Okay that's helpful, and then Paul may be just a follow up. If I think over the next year, two years you got upside on the provision side, the capital deployment once you continue to get approval. When we think about on the top line, in some of these investments that you're making, if I look out over the next two to three years where do you see the most maybe reward, for that investment? Is it on, the net new asset side and, some of the fee based products, is it on more accounts, and on the trading side or is it on the retirement side? I am just trying to get sense of, where do you kind of see the top line going.

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

A

We're in the yes/and category there. First of all we think we can do a better job and as we've repositioned the brand, do a better job capturing more of our existing customers' assets, particularly retirement assets and longer term investing assets. Secondly I think you have seen the numbers, we're doing a better job already attracting net new accounts and that's obviously a combination of bringing in new accounts and retaining, keeping our attrition low. And so we're thinking about working both sides of that P&L if you will, both sides of what comes in on the revenue side. And let me just give you an example of where the investment spending is very tangible, very oriented towards doing a better job as a digital company, being a bit smarter about how we go about things. The team has gone through and redone in a very sophisticated way in terms of doing customer testing et cetera, our online application. And we've increased the hit rate if you will, the funding rate on that online application from 50%, so half of the people who started in actually funding their accounts, to 58%. That's quite a terrific increase and we're looking for further opportunities to make it easier for people to do business with us and therefore bring us more business. In addition we think there is some real opportunities to improve the octane mix if you will of the average customer by continuing to add financial consultants, who through excellent dialogue with customers and helping them identify their needs, are growing the portfolios that we help those customers with. And helping those customers organically grow their portfolios as they make better informed and smarter decisions about their financial health. So we're not looking for just one line as we improve our relationships with our customers, we're looking for progress across a multiple number of revenue lines.

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

Q

So the whole topic around you guys needing to demonstrate sustainability in your risk management processes. Wondering if you could, maybe give us a little bit more guidance around that. How long do you guys have to demonstrate that sustainability before you can do little bit more with your capital?

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

A

Well, I would say the sustainability issue is not a single point in time issue. As our regulators get a better understanding of what we do, and a more fulsome understanding of what they want to accomplish across the industry, those expectations change. We're very gratified for example that the skills, and talent we've built around stress testing have resulted in our regulators providing us feedback that indicates that they're comfortable that we have a sustainable process with which to do the stress testing. That's very important, as I said earlier not only to our regulators, but certainly to our owners. So I don't think there is an easy answer to what constitutes sustainability. Because it's a – our regulators expect us to be improving what we do on the risk management compliance front, and logically expect us to be improving that everyday. And you certainly are seeing indications from the regulators that they're taken this very seriously and even the largest institutions are discovering you can't take your eye off the ball on this.

Chris M. Harris

Analyst, Wells Fargo Securities LLC

Q

Is it fair to say that, that process could take multiple years?

Paul Thomas Idzik

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

A

It's not a multiple year issue in terms of our build out, I feel very good with the build out we've done. But as I said the sustainability issue is not one that just stops today. New regulations come into force. We add new product lines. If we add new products, the regulators are going to want to see us build compliance and control around that and demonstrate sustainability over time. It doesn't just stop at a certain point in time.

Chris M. Harris

Analyst, Wells Fargo Securities LLC

Q

Okay.

Paul Thomas Idzik

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

A

There is no time clock on our intent and our great desire to improve our relations and our standing with our regulators. And there is no time clock on them having a very logical desire to continue improving the safety and soundness of the financial institutions around this country.

Chris M. Harris

Analyst, Wells Fargo Securities LLC

Q

Okay, then as it relates to dividends out of the bank, the bank's net income has been over \$100mm for last two quarters. And the dividend still remains at \$75mm and I'm just wondering why there is that slight difference, why you guys can't at least dividend the net income up. And then related to that why can't you at least dividend capital to get you back down to the 9.5% ratio, like why do regulators want to see this now 10% plus tier 1 leverage at the bank?

Matthew J. Audette

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

A

So, Chris, a couple of things. I mean, first it's only, it hasn't been too long since we didn't have any dividends at all, right. So this is Q4 in a row to have dividends. We're in an incredibly good position to have that. I think our view on dividends and what we have expected over the short-term has been very clear, in that consistent range. Our view on dividends over the longer term I think we have been very clear on where we want to go. And are getting between those two points, we are working on, and we hope to be in a position to have more clarity by the end of the year. I think having a bunch of different steps, and why we're not doing exactly this amount of dividends, or that amount of dividends is not something I would comment on. I think our near terms plans are clear, our long-term plans are clear. I think we've had a great track record of executing well and that's what we're focused on.

Chris M. Harris

Analyst, Wells Fargo Securities LLC

Q

Okay, just one quick and point of clarification from me regarding the flexibility on paying down the debt. Just so I'm clear, the amount that's available today, is that, I assume that's just all in the corporate cash bucket so \$570mm, or could you potentially source cash from other places?

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

A

No, that's the total amount, and keep in mind we wouldn't bring that down to zero, right? We want to – historically in our view is to keep at least two years of debt service coverage up at the parent, which would be around \$220mm at our current debt level. So we wouldn't take it down to zero, but that is the primary source of cash for debt reduction.

Devin P. Ryan*Analyst, JMP Securities LLC*

Q

Most of my questions have been asked. Maybe just one on the brokerage and it looks like another pretty solid account add quarter, and you obviously had a really robust first quarter. So with respect to the all the changes that have occurred here with marketing strategy and then I believe there was some streamlining to the accounting opening process. I mean are we actually starting to maybe see some traction tied to that yet? Or has the recent momentum just been more related to the environment and less by some of these things that have actually changed internally in the company?

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

A

All right. I think that's an insightful question. Thank you for that. Just like we had a discussion earlier on a similar topic, we want to see several more quarters of this type of trend before we're happy with believing that some of the changes we've made are sustainable. But certainly having net new accounts, past the mark we had in all of 2013 already this year is a good sign. We're seeing positive progress in our customer satisfaction and our feedback from customers. So, and further I think we stack up pretty well on many of the metrics against our competition. So we're feeling better about what's happening. We have a lot of work to do. No one is putting down tools here, so I'd say stay tuned, but I think we are on the right path.

Devin P. Ryan*Analyst, JMP Securities LLC*

Q

Okay, great and with respect to just the head count growth obviously 4%, so a pretty robust number, and you guys did allude to this with the investment spending. But can you just give a little bit more detail around where that is, is specifically located. Are these revenue driving seats vs. maybe some catch up on the support side? And is there still more hiring to come or have you guys already kind of gotten there now that you have head count up call it 10% year-on-year?

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

A

Well as we add. Well first of all as we add new accounts, et cetera in that, we need to maintain customer service levels and we engage in more dialogue with, richer dialogue with our customers and try and provide greater levels of support as they entrust us with higher asset levels, we need to add financial consultants. So there is definitely some additions in the customer facing side. We've continued to add staff on the compliance, risk and legal sides as the environment continues to change. As we've needed to do more in both the advertising space, as we've talked about wanting to be more analytical and smart about what we are doing and shifting the focus of what we do in marketing to be more focused on our customers, less advertising focused and more customizing around our customers and prospects. That requires not only marketing people but technology people, so those are the areas we are doing hiring in. And as a company that tries to support and does successfully support its customers not only with online channels, but with a dedicated high quality team of professionals, the definition around E*TRADE of what's customer facing and what's not customer facing gets a little blurred. I mean I think I am really

proud to work at a company where the great majority of my colleagues believe they're getting up everyday to make the customers' lives better and to attract more customers.

Devin P. Ryan

Analyst, JMP Securities LLC

Q

Okay great. And then just with respect to the capital plan, I apologize to beat a dead horse here, but I do want to make sure that I am clear, so the regulators, are they necessarily waiting to monitor your risk management processes further here before they potentially allow you to move forward? Is that what we are waiting for, or we're just still having that dialogue and it could happen at some point in the near future, but we just don't know the exact date? And I guess following on that, are you interacting with the same group at the OCC that reviewed the stress test on this front as well?

Matthew J. Audette

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

A

So, I think on the path from here, I mean I think the new information this quarter is our comments on the stress test. We said last quarter I had hoped to be in a position by the end of the year to give comments on our view on when and how we would head to the longer term capital plan, that's the same comments this quarter. So really nothing has changed other than we have gotten through the stress test. So I think the fact that our capital ratio has increased through the wholesale funding reduction and customers were net buyers so the balance sheet didn't actually grow during the quarter has pushed the leverage ratio up above 10%. I think the focus on what do we need to do to be able to use that incremental piece or that interim piece of capital I think is missing the broader picture. Right, we are headed towards a longer term capital plan. We have been headed to that same capital plan for quite some time. So that's what I would take away from this. As far as who we interact with we have, I feel like we have great relationships at the OCC and the Fed, we interact quite – interact constantly and have very good dialogue.

Chris J. Allen

Analyst, Evercore Partners (Securities)

Q

I was just wondering if you could tell us what the one-time benefit in the loan book that showed up in the loan yield this quarter was?

Matthew J. Audette

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

A

Yeah so there is a couple of things and you may have noticed in the delinquency tables. We had delinquent loans, curing at a much faster pace in Q2, so to the extent those were on non-accrual you can have some periods where you get more than one interest payment in a period. And then second on the TDRs, we had a subset of those that were on non-accrual as well. And when we sold those we were able to get paid for the total amount of accrued interest. So it created a little bit of a boost in the yields during the quarter. But if you look at the trends going back to in Q1 where it was just below 4%, and it popped up during Q2. Everything else being equal, I would suspect it would go back down in Q3 to the levels that we saw in Q1.

Chris J. Allen

Analyst, Evercore Partners (Securities)

Q

Got it, okay. And then in the past you've given us some metrics around the HELOC book in terms of voluntary prepayments, I am wondering if anything has changed in that front, is it still close to the same loans we've heard in the prior quarters? And the credit quality as people are starting to amortize, has that remained steady or is there any change in that front either?

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

A

Yes, the short answer is nothing new. On the home equities the metrics have been approximately 40% have made voluntary payments of around \$500 or more in the last year. And about half of those \$2500 or more so nothing has changed. On the performance of those that have gone through the end of draw, the comments there are the same, it's just such a small population that extrapolating anything from that to the larger population that is going to become amortizing in 2015 and 2016 is not something that we think makes sense to do. That being said we are encouraged by what we see in that population and that once you hit the end of draw period that there is not some dramatic credit shoe to drop, but again it's a small population.

Christian Bolu*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Just a couple of questions on some of your longer-term initiatives, would be helpful to get a progress reports on some of those initiatives. I am particularly interested in your initiatives to deepen customer wallet share, any metrics around progress there would be helpful. And then secondly, how should we think about the longer term cost implications of your push towards mobile fee based platform, should we expect some pressure on operating margins as you invest to grow or can you preserve core margins while you transform the platform?

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

A

So, I think a couple things that I'd throw out there, Christian on deepening the customer wallet. I think a good tactical example is our managed products – we continue to grow those at a much faster pace than growing our overall assets. We're up to \$2.9B in those accounts in Q2 vs. \$2.6B last quarter. And those are the types of things where you think about the classic assets and customer that we would get long ago. They would likely have that type of money, but they would keep it elsewhere. They're starting to bring that type of money to us. I think that's the type of thing you would see on deepening the customer wallet. From a fee-based platform, I mean there is no dramatic, or broad cost implications of that. I think there is a lot of things on, a lot of the areas that we're investing that Paul touched on earlier whether it's customer facing, technology or people. They're working on trading type assets as well as the fee based type assets. I don't think there is a broad cost based implication to the extent that we're successful in that.

Christian Bolu*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Okay, you don't think you incur more costs from increasing number of financial consultants, et cetera, I guess is kind of my question?

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

A

We feel pretty positive about the payback period related to specifically to the addition of the financial consultants. And I just, I just want to remind you that one of the things that we found frustrating a little while ago was the fact that we weren't doing a stellar job of explaining to existing customers the breadth of our offerings. And I'm encouraged, based upon some customer focus groups that I've personally attended as well as some of the data, that the customers are starting, and processors are starting to understand the breadth of E*TRADE's capabilities much better than they ever had before. And I think as you see the net new assets coming in both from brand new customers, and from existing customers, that message is starting to resonate.

Christian Bolu*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Great, that's helpful. And just second question on payment for order flow, and just given some of the focus around non-marketable equity limit orders and the rebates that they garner from exchanges, it would just be helpful to get your views on how you get comfort around your practices here?

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

A

We have extraordinarily thorough practices on our order routing that have been reviewed at the highest levels of the firm and include independent experts who take a look at that. We feel very, very comfortable with what's happening there and we believe in all likelihood in many cases, we are operating at or near best practices across what we do.

Daniel T. Fannon*Analyst, Jefferies LLC*

Q

Great, just one from me on kind of longer term expense trends, you clearly you've highlighted the investments that you're making today and ongoing but in an environment where the revenue environment is still okay and volumes are tracking at levels now, do you think 2015 still represents an area for which you'll still be spending in areas like professional fees and hiring, or is that where we start to see a bit more of the leverage in the model?

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

A

We're already starting to see some of the benefits of our investment, certainly as we continue to grow accounts you'll see us have to add professionals to support those customers. A significant amount of our build-out's been done in many areas, but much of that depends upon our continued analysis of what we need to build out as well as what we can afford. We're certainly not spending money simply because we've had a good couple of quarters. We are spending money with the intent to be able to support the brand as we're now portraying it to our customers and to shift the way we serve those customers both online, and over the phone, and in person. So it's not a linear relation between just a couple of variables. It's an attempt and a successful attempt to -date of starting to change the P&L dynamics of our company. So I think you will have to stay with us through several calls and you'll see what will start to happen.

Daniel T. Fannon*Analyst, Jefferies LLC*

Q

Great and I guess just one more follow up just on the FDIC expense. It seems like the benefit this quarter you highlighted was from the sale and should we just assume the trend in that associated with the runoff in the portfolio, or are there other variables that could result in kind of step functions or changes in that trajectory?

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

A

So over the longer term we would expect it to come down by half. I think in the shorter term are there any tactical things like, the TDR, the sale of the TDR portfolio that have impacted in a meaningful way. I think the short answer on that is no. I mean, when you go through the details of the calc [calculation], the high risk assets where there is surcharge for those, the TDRs were disproportionately high when you look at the rest of our portfolio. So I would view the current rate, which was \$19mm and also roughly 19BPS on assets is about where I would see it in

the near term. Keeping in mind it's if we continue to do the things that we have been doing, the bias on that is going to be a lower rate, not a higher one.

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