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E*TRADE Financial Corp. (ETFC)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Paul Thomas Idzik

Chief Executive Officer & Director

Q3 REVIEW.....

- Q3 was busy with customer engagement demonstrating a bimodal distribution, high engagement during the market turmoil, bracketed by a muted trading activity in the rest of the quarter
- Beyond this, we took yet another confident step on the capital front with the termination of legacy wholesale funding, which will significantly enhance forward earnings power, but came with one-time charges
 - Excluding those, we posted net income of \$98mm or \$0.33 per share
- Our results also reflected better than expected credit trends and performance as we reached an inflection point in the loan portfolio, releasing reserves for the first time since the portfolio transitioned to runoff more than eight years ago

Brokerage Products and Services

- During the quarter, we continued to enhance our brokerage products and services, boosting capabilities on our professional trading and mobile platforms
- We continued to tighten our focus, making the choice to discontinue the last of our international local operations, and exit a pair of ancillary products
 - Both of these actions continue to reflect our dislike of asymmetric risks

Capital Deployment

- We have also further sharpened our pencils on capital deployment and in the wake of several felicitous steps made to-date, we will share an update to our thinking on future uses later in this call
- Also in early August, we were upgraded a rare three notches to investment grade rating by Standard & Poor's
- We are obviously pleased that our corporate ratings are beginning to reflect the progress we've made and where we are as a company

DARTs and Trading Activity

- As for our metrics, we reported 156,000 DARTs, up 4% from Q2 as an intra-quarter spike in volatility propelled customer trading during a typically slow period
- Amidst the volatility in volumes of August 24, we processed a full day's worth of activity in the first hour of trading, and posted an all-time record with 394,000 trades on the day
- The ability to handle flow of this magnitude is a true testament to the work we've completed over the last couple years to strengthen our foundation, including a hearty bolstering of our tech and operations infrastructure
- Options as a percentage of total DARTs held steady at 23%, at level relatively consistent with the past couple of years

- And trades through our mobile applications represented a record 15% of total trading activity, having doubled over the past two-and-a-half years
 - Over one quarter of our unique logins came through this channel
- We again enhanced our capabilities on this front as we aim to deliver an experience that rivals the best of digital, be it desktop, tablet, smartphone or smart watch
- And finally on trading, October DARTs are tracking relatively flat with September

Margin Balances

- Margin balances ended the quarter at \$7.9B, down only 2% from Q2 despite a more substantial decline in the equity markets
- However, we've seen a slight pullback in Q4 to date with balances currently at \$7.5B
 - Excluding the impact of discontinuing our global trading platform, we added 19,000 net new brokerage accounts during the period
- Adjusted attrition for the quarter was 9.3%

Net New Brokerage Assets

- Net new brokerage assets were \$2.1B during the quarter, down slightly from the year-ago period, but more than double the prior quarter
- As we think about E*TRADE's growth, we continually refine our focus
- Last quarter, we made a decision to sunset our global trading platform, which is nearly complete
- This quarter, we made the decision to wind down our brokerage operations in Hong Kong and Singapore in consideration of the level of requisite investment to maintain a competitive platform, while continuing to meet the prudential standards of both local and U.S. regulators
 - The opportunity simply didn't justify the demand on resources
- We're in the early stages of this process and are determining which, if any, of the accounts we'll continue to service from the U.S.
- Our business in Hong Kong and Singapore comprised of approximately 25,000 accounts, with assets of around \$1.8B

FX Activity

- Also this quarter, we discontinued our FX offering as it was not core to our product suite
- We previously facilitated customer FX activity through a third-party broker, which linked to our platform for account visibility only
- The only true change for customers resulting from our de-linking these accounts is that their FX transactions and account information will no longer be visible through our platform
- There was no impact to our account metrics resulting from this change
- To dial in more closely on our products and services, being a best-in-class, digitally-centered broker means continuing to raise the bar when it comes to the customer experience on our various platforms

KEY IMPROVEMENTS

- To that end, I'm pleased to review some of the key improvements made this quarter
- We continue to expand the capabilities of our active trader platform E*TRADE Pro, this quarter, making a series of significant enhancements to our Options Analyzer

- Beyond the new streamline design, the revamped tool enables traders to build multiple options strategies, run through various strike and date scenarios, customize graphing features more easily and seamlessly send any strategy directly to trade execution
- We also added capabilities to our industry-leading mobile applications, including capitalizing on new Apple Watch functionality
- Moreover, we launched conditional orders and rolling options for our core smartphone apps
- For the more long-term investors, we made strides in enhancing our tablet functionality, particularly around mutual fund transactions
 - This is of particular note as the importance of mobile investing continues to extend beyond the realm of the active trader
 - It's become an increasingly critical channel for all investor types

Award Wins

- When it comes to accolades, which I'm never reluctant to trumpet during these calls, we have a few to report
- First, we won best overall IRA provider and best IRA for beginners by NerdWallet in their summer 2015 review
 - We were the only broker to win in two categories
- Next, NerdWallet recently rated our mobile platform five out of five stars, highlighting our data and research functionality, Web-level capabilities, easy trade execution and availability on many devices as reasons why we are best in class
- Finally, I'm also delighted to announce that for the fourth consecutive year, E*TRADE Corporate Services was rated #1 in customer satisfaction and loyalty by Group 5 with an impressive 92% satisfaction rating

Progress on Capital Front

- With respect to our progress on the capital front, this quarter witnessed a major accomplishment with the elimination of our longstanding legacy wholesale funding obligations, a non-core component of our balance sheet that had long been in a slow runoff
- To give you some context, from 2005 to 2008 with a very different balance sheet strategy in place, the company committed to future funding in the form of club advances and repurchase agreements
- The manner in which this funding was structured made it less valuable in the event of a downward shift in either rates or balance sheet size
- The unprecedented low rate environment, coupled with our own deleveraging, made this funding source quite burdensome in terms of its high effective cost and its occupation of balance sheet capacity and valuable capital
- The relatively meaningful costs of terminating this funding were a gating factor
 - However, as we continued to naturally reduce in size, and as we generated healthy levels of capital, we got to a place where we were able to absorb the acceleration of these charges
- In doing so, we immediately reduced our funding costs, transforming to a balance sheet funded predominantly by core, strategically important customer deposits, and providing capacity to onboard more of these value deposits, powerfully improving our earnings potential
- We're broadly in our capital and financial plan
- We've accomplished a lot
- And the fruits of our labors have included a more efficient organizational structure, greater capital flexibility, as well as improved regulatory standing and credit ratings

MAJOR INITIATIVES

- Since we first submitted the capital plan in 2012, we've distributed more than \$1.3B of capital to the parent and completed two major initiatives: debt reduction and wholesale funding elimination, which collectively improved our earnings power by close to \$190mm annually
- Today, we remain just as diligent about effectively deploying capital
 - And as we progress down the list of available options, it naturally becomes shorter and more focused
- To walk through what remains, starting with balance sheet growth, we're now targeting a balance sheet size just shy of \$50B, and we intend to reach that early next year
- With the flexibility provided by our new sweep deposit platform, running within \$500mm of that target is a highly achievable goal
- The return here are attractive, and Mr. Pizzi will run through our status on this initiative

Returning Capital to Shareholders

- Also on the list is returning capital to shareholders in the form of buybacks or dividends
- While this has long been considered, the recent upgrade of our debt to investment grade, there's some constraints around absolute quantum
- While the value of deploying capital in this manner is definite, we must weigh it against options that can benefit the longer-term value of the franchise or provide strategic energy via inorganic growth
- Acquisition was excluded from our narrative for many years, as we focused on improving our capital levels and regulatory standing
- And today we are paying appropriate attention to the external opportunities to bolster our market position without getting distracted by bright shiny objects

Deployment of Owners' Capital

- Regarding deployment of our owners' capital, management and our board carefully filter all opportunities, ensuring our heightened standards for risk, our demonstrated commitment to creating value for shareholders and our regulatory standing are at the forefront of any decisions
- And while nothing is imminent, I wanted to update our shareholders on our capital approach as progress across multiple dimensions has delivered us to a place where E*TRADE can shift firmly to its front foot regarding growth and value creation

SUMMARY

- To sum it up we've made a lot of progress
- And we are keenly aware of all the work it took to get where we are
- Our mandate is to precipitously maintain and build upon this position
- Lastly, it is bittersweet for me to announce that our President, Navtej S. Nandra, will be departing the company at the end of the year, having completed his mission as my lead change agent
- When I arrived at E*TRADE in 2013 with sight set on getting our house in order, I knew we needed to leverage a persistent and meticulous leader who could intensively focus on our structure and execution, better aligning our capabilities and platforms and shoring up our resources and processes
- I'll be the first to admit that these were some bold ambitions, which often required a powerful microscope and unrelenting resolve

- Mr. Nandra was uniquely qualified to lead the work and helped instill a culture of excellence from top to bottom
 - Making changes of this nature certainly do not happen overnight
 - With Navtej's help the vast majority of this work has now been accomplished
- With a reenergized and more productive E*TRADE now a reality, Navtej and I agree that now is the right time to flatten our leadership structure
- Above all for a company of E*TRADE's size, it's the prudent thing for us to do for our shareholders
- Indeed I will miss his leadership and insight, but I'm certain that Navtej's contributions will have a positive and lasting impact on E*TRADE for years to come

Michael A. Pizzi

Chief Financial Officer

OPERATING RESULTS

- To make things as clear as possible, I'll start by walking through the impact of the wholesale funding transaction as it was truly a one-time event, and then move to our results
- The action, which resulted in the elimination of \$4.4B of legacy funding obligations, reduced our net income by \$251mm or \$0.86 per share
- On a pre-tax basis the \$413mm charge consisted of two parts: first, \$370mm loss included in net revenues; and second, \$43mm of early extinguishment of debt

Adjusted Earnings

- Now onto our core results
- Excluding the impact of the wholesale funding transaction, we reported adjusted earnings of \$98mm or \$0.33 per share
- That compares to adjusted \$72mm or \$0.25 per share in the prior quarter, which excluded \$220mm tax benefit
 - It also compares to \$86mm or \$0.29 per share in the year-ago quarter

Adjusted Revenues

- Adjusted revenues were \$443mm, consistent with \$445mm in the prior quarter and \$440mm in the year-ago quarter
- Net interest income of \$263mm was down \$4mm from the prior quarter, as \$2B decrease in average assets offset the 8 basis point improvement to spread, mostly attributable to the wholesale elimination

Commissions, Fees and Other Revenue

- Commissions, fees and service charges and other revenue were \$170mm, up 2% from both the prior quarter and the year-ago quarter, largely due to the increase in total trading activity related to both periods
- Average commission per trade of \$10.87 declined \$0.09 from the prior quarter and \$0.18 from the year ago
- The changes from both comparable periods were primarily driven by fewer stock plan trades
- Fees and service charges revenue of \$52mm decreased \$3mm sequentially

- Adjusted net gains on securities were \$10mm, in line with the prior quarter and at the high end of our \$5mm to \$10mm range, as we actively were selling securities in connection with our wholesale funding termination
- Going forward, there is no change to our expected range with the current rate environment likely to keep us near the high end

Operating Expenses

- Operating expenses were \$293mm, down from \$309mm in the prior quarter, which included \$6mm of severance and \$9mm related to a contract amendment
- Excluding severance in Q2, compensation increased \$11mm sequentially, related to hitting some incentive compensation performance thresholds
- FDIC declined \$4mm sequentially, reflecting the full-quarter impact of our reduced assessment rate that went into effect in mid-Q2
- With the balance sheet of just under \$50B, \$7mm is a good quarterly run rate for this line

Communications Expense

- And lastly, communications expense increased \$5mm sequentially, which included approximately \$3mm of one-time vendor expense
- As for expenses going forward, we expect Q4 to be around \$305mm, including severance, putting our full year right around a 5% increase over 2014, in line with our original guidance
- Advertising, in particular, should increase meaningfully in Q4, consistent with our normal seasonal patterns

Adjusted Early Extinguishment of Debt

- One last line of the P&L
- Adjusted early extinguishment of debt was \$4mm gain, which related to the repurchase of 14mm of trust preferreds at a discount
- We now have \$414mm outstanding, of which 25% of the total balance is included in Tier 1 capital at the parent through year end
- While the remainder is not incredibly high on our list for capital deployment given their long-term duration and relatively low cost funding costs, we closely monitor their market for any prudent opportunities to buy them in

Loan Portfolio

- Moving onto the loan portfolio, it ended the quarter at \$5.3B, down \$370mm or 7%
- In addition to the fast pace of the portfolio runoff, loan delinquency and net charge-offs continued to trend positively
- A significant volume, \$173mm of HELOCs, reached their end of draw and converted to amortizing loans this quarter
 - However, we only have first payment data from around 25% of those loans, as many converted later in the quarter
- To-date, loan delinquency and losses related to interest-only HELOC borrowers converted to amortizing payments has been better than expected

- As a result of positive trends in our portfolio, we reduced the allowance to \$376mm or 7.1% of total loans at the end of Q3
- The lower ending reserve balance, combined with only \$1mm in net charge-offs, resulted in \$25mm provision benefit for the quarter

Net Charge-Offs and Reserve Balance

- A few factors contributed to the lower level of net charge-offs and reduced reserve balance
- First, the pace of portfolio runoff is reducing our future loss forecast and the related reserves
 - Specifically, the early payoff on balloon loans prior to maturity is a prominent contributor to the lower allowance
- Second, we continue to benefit from a steady level of recoveries through collection efforts and the recapture of prior write-downs upon pay down
- Third, over the course of the past couple years, we identified subsets of high-risk loans within our portfolio where we reserve the full life loss expectation
 - The performance of many of these loans has exceeded our original expectations
- While we are pleased with the performance to date, we will obtain more meaningful data during Q4
- While results have been better than expected, it is still too early to make changes to our estimates for future performance
- At the moment, however, with strong recoveries, we expect Q4 as well as full year 2016 provision expense to be near zero, noting that this can vary meaningfully for a number of reasons

Capital and Liquidity Position

- Moving onto capital, following the successful extraction of our clearing broker from the bank on July 1, we spent the first two months of Q3 focused on ensuring our capital and liquidity position was strong
- Once satisfied, in early September, management and the board agreed the bank was in position to execute on the termination of wholesale funding obligations
- Now diving a bit deeper into the details, with a cost of approximately 330BPS, well above our blended yield on assets and considering it displaced one basis point customer deposit that could be on the balance sheet, the decision to eliminate this funding was clear from the value creation standpoint
- We just needed sufficient excess capital in the bank entity to absorb the upfront charge, while maintaining our targeted 9% Tier 1 leverage ratio
- Accordingly, we demonstrated what we – we downstreamed \$110mm of parent capital, offsetting the \$114mm dividend we completed earlier in the quarter and reduced our balance sheet size
- Given that regulatory calculations for bank capital are based on average assets, we wouldn't capture the full benefit of the latter action until Q4
- Accordingly, we started Q4 with approximately 100BPS of excess capital, resulting from starting the period with lower average assets
- We fully intend to utilize the capital and balance sheet capacity and have begun the process of moving customer deposits from third parties back on our balance sheet
 - Since quarter end, we have moved \$1.25B
- We intend to onboard an additional \$2B of deposits by the end of this quarter
- By early next year, we expect our consolidated balance sheet size to reach our targeted \$49.5B, giving us an appropriate buffer to the daunting SIFI threshold

- For clarity, the target is for our consolidated balance sheet size, and interest-earning assets currently run about \$4B lower, as they do not include goodwill, intangible assets, PP&E and the DTA, among other items
- Returning to the impact this had on our metrics, spread was 258BPS for the quarter and would have been approximately 245BPS, pro forma, for the wholesale elimination
- For Q4, if we hold today's rate environment constant and consider the current level of margin balances, we would expect spread to be in the high 270 basis point range on average interest earning assets of \$40B

Corporate Tax and Dividend

- Lastly, with respect to corporate tax, we ended the quarter at \$432mm, an increase of \$26mm, largely attributable to the \$30mm dividend from E*TRADE Securities
- We also had some movement of capital between the bank and parent during the quarter
- We dividended Q2 net income of \$114mm up to the parent, but then subsequently downstreamed \$110mm of capital to the bank in conjunction with the wholesale termination
- As a reminder, we will not request a dividend from the bank to the parent in Q4 as the bank reported a Q3 net loss of \$186mm
 - We will resume quarterly dividend requests in Q1 of 2016
- So, in summary, we remain well positioned from a capital standpoint and are committed to continue putting that capital to work for our shareholders

QUESTION AND ANSWER SECTION

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

I guess my first question is related to the reserve and your guidance on provision for next year. Prior, it was from zero to 20%, and in the near term at the lower end. And I guess the guidance was for it to accelerate with the amortization. So, now the guidance being zero, I'm just trying to see, it didn't sound like – you did have a slight better performance in the amortization. But I guess a little bit more color on the confidence that gives you the support to guide to the zero provision.

Michael A. Pizzi

Chief Financial Officer

A

Rich, I'll start off with – we took a reserve for the life of loan expectations on the high-risk portion of HELOCs. We have seen full payoffs coming out of that portion of the portfolio. In addition to that, we have seen the portfolio accelerating in prepayment speed, so speeds faster than we had originally modeled. All of this creates a backdrop in which the risk in the portfolio is reducing. In addition to that, there's a segment of portfolio of balloon loans that we are continuing to see prepayment activity from as well. And as you know, they become fully – they become payable in full on their balloon date. All of these factors combined really to put us in a position to reduce the allowance this quarter.

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

Okay. And the question was the guidance going forward. So is – can you take away that we're over this – and again, Paul used the word inflection point in regards to credit in the prepared remarks. Are we beyond – should we look now back at this risk of the amortization of the portfolio?

Michael A. Pizzi

Chief Financial Officer

A

Well, the bulk of amortizations are still in front of us. The subset of loans that we have seen come through is outperforming our expectations to date. And we have about \$173mm that occurred in the quarter, of which we have 25% first payment on, or 25% of those loans, we have a zero to 30% delinquency estimate on.

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

Got it. Okay. I guess my last question is for Paul. And you've talked about what – and hinted at potentially things you can do with capital, including acquisitions. And I guess not – but to stay on the acquisition side of it. What things make sense to you, what size? And I would think if it isn't going to be in that retirement savings and investment area, can you give us some, I guess, flavor, what things you're looking at in a broad sense?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Yes, certainly, and thanks for joining the call, Rich. It's always nice to hear from you. Rich, one of the reasons we talked about acquisitions is just so that we're really clear that now that we're at a different level of regulatory standing, it's prudent for us to be thinking about those things and trying to drive to long-term shareholder values. So, I'd say it falls across three broad – three generic categories. The first would be finding ways to add capacity in the brokerage space because of the value of scale in that part of our business. And quite frankly, they're very attractive operating leverage. The second would be to add things more broadly in the retirement, investing and savings space, the robo space, adding things to help our E*TRADE Corporate Services business, provide a greater level of products and services. And so, that's a bit of a little more of a multi-colored opportunity, if you will. And then, the third would be in banking space in order to do a better job on monetizing the value of our customer deposits and to more broadly serve the Wealth segment that we currently serve through brokerage. So I hope that lays out the landscape, Rich. In terms of size, don't have any view on size.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

Just on slide 18 if I look at kind of the expectation for \$45mm a quarter of NII on sweeping on six – call it \$6.4B of deposits, kind of implies an incremental net interest margin of \$280mm. I guess is that the right way to think about your incremental NIM on sweeping it over?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Think about the marginal rate of investment for the portfolio as about 175BPS to 225BPS funded at a basis point. So if you look at just the marginal activity of new balance sheet, not looking at sort of the reduction of the expense from the termination event, that's really how to think about marginal activity. That's sort of the duration match to value of those sweep deposits that are coming back on.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

Okay. And then maybe just going back to the M&A comment for a moment. Can you just help us kind of understand how – I mean any deal would obviously presumably take you over the \$50B threshold. Can you kind of get us – if even if it was not capital-intensive, because there would be goodwill, can you just give us – help us understand I guess why you're comfortable? What the threshold would be for you to do a deal if it's going to involve you going through CCAR?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well it would only necessarily take us above \$50B if we were to acquire a mythical being. Since we're not sort of thinking about this right now and [ph] to diligence away (28:56), if we acquired something with significant customer deposits. And as I said many times in previous calls when this topic comes up, none of our owners are going to reward us by tiptoeing over \$50B and incurring all the costs and distraction. If we go over \$50B, it will be when Mr. Pizzi and I and the rest of the team are confident that it's going to make sense for our owners.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

Thanks. And then maybe just sneak in one more if I could, just on the broader markets. Just be curious, from your seat, how you thought the markets performed on August 24 for the retail investor? I know there were some issues with ETFs, et cetera. But I would just be curious from your seat, what you saw? And how you thought the markets performed under stress?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well we were pretty focused on making sure we were doing what was right for our customers. And we were pretty happy with our performance. As I said, we handled a full day's trades within the first hour on the 24th. And we actually during that period of time, Conor, saw our customers be net buyers. They bought \$0.75B during that time. So with the VIX down 30% in mid-August and lots of other things happening, we were just focused on helping our own customers. And we were happy to be able to do that.

Steven J. Chubak

Nomura Securities International, Inc.

Q

So given the significant progress you guys have made in terms of improving the credit loss and delinquency metrics on the loan portfolio, just looking beyond 2016, how should we think about the long-term Tier 1 leverage target that you guys could potentially manage to? Do you think it's a realistic expectation that you can get closer to some tier targets that have been laid out, closer to 7%?

Michael A. Pizzi

Chief Financial Officer

A

Well as we discussed in the past in our capital plan, we see the target coming down from 9% by about 50BPS per year in conjunction with the reduction in the riskier assets of the loan portfolio, as we move through the end of draw. So our capital plan contemplates 50BPS decline. And we are working very closely on that right now.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Okay. But it's still too early to make any determination as to whether we should think about incremental 50 bp declines in the years beyond that?

Michael A. Pizzi
Chief Financial Officer

A

Well the plan goes on to – for an additional 50BPS the subsequent year, down to about an 8%. Beyond that, we're sort of outside the range of that plan. And really we'll continue to think about that as we update our current plan for the current year.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Thanks. And, Paul, I appreciate the color you're giving on some of the acquisition opportunities you consider. One of the things where – one of the areas where we have seen strong growth within your business is the managed asset offering, if you will. And at the same time you're still relatively subscale. I just wanted to get a sense as to whether you saw any relative attractiveness in some of the independent broker-dealers or advisory platforms, some of which appear to be on the block today. Is that a capability you would add? Or is it simply something that you're reluctant to do, given uncertainties surrounding the regulatory proposals like the Department of Labor?

Paul Thomas Idzik

Chief Executive Officer & Director

A

I think – as I said we're thinking about things across those three generic frames. People bring opportunities to us. I'm delighted to say that one of the best things Mr. Pizzi and I do is tell them we're not interested. But people do drag things past our desk. There are these other people in investment banks as you know who try and make a living that way. So we would look at them if it made sense. I do agree with you that it makes sense for some of the dust to settle and see how things shake out before we were to enter into something with that degree of regulatory uncertainty.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Thanks. And maybe just one more for me. You mentioned the banking space would be one area where you might look to do a better job with monetizing value of customer deposits and maybe expanding that capability inorganically. Can you just speak in general terms as to what one of those opportunities could potentially be, I suppose? I don't really necessarily see direct or clear synergies with a traditional banking platform with the platform you guys currently operate.

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, I'm not going to speculate on what type step we might make into that field. As I said, all of this we brought up on the call because we feel it's our responsibility to make sure that our owners know which way the management team is spending its time. The vast majority of time we're spending trying to serve our customers, making sure we're executing on the things we said we would, and drive value to the bottom line. So, we're just trying to be as transparent as possible, and I hope that we can continue doing so.

Chris M. Harris

Wells Fargo Securities LLC

Q

First question relates to capital. The 100BPS of excess you talked about that should be hitting in Q4. Is that enough to get you guys to where you need to be to get the balance sheet up to \$49.5B? Or are you assuming other capital sources to kind of make the bridge there?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. As we've highlighted before, that's the 100BPS results from the lower average balance that's going to be in Q4. So as we take the balance sheet back up, we are going to deploy that. Where we come out – we had a prior question about our capital plan and sort of what the leverage ratio for the bank is, where we come out on that will determine our ability in terms of the needed capital to get to \$49.5B.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. And then just a procedural question related to the capital, when does the 50 basis point step-down potentially take affect if the approval goes through? Is it sort of beginning of the year? Is it throughout the year? Is it the end of next year? I'm just trying to gauge the timing of when that might benefit you?

Michael A. Pizzi
Chief Financial Officer

A

Well, our plan contemplates it for the beginning of the year, but obviously there's a regulatory approval process that we have to work through. So that's essentially how we have modeled it. That's what we're working towards, but there is a process, and it does require explicit approval.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. And then I guess last question here from me, the assets that came off the balance sheet, can you guys help us out? What the average yield on those assets were? Maybe just a range if you don't have an exact number?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. They were consistent really, very close to the average portfolio yield, slightly higher, that's contributed to some of the portfolio yield and the declining of the AFS portfolio, but really not far outside the average yield of the AFS portfolio.

Michael R. Carrier
Bank of America Merrill Lynch

Q

Just on the expenses, you gave some color on Q4. I just want to get a sense, when you look at the outlook for 2016 based on some of the revenue drivers that you're going to be seeing, both from growing the balance sheet and then the provision guidance, I just wanted to get a sense on what we should be expecting when you look at kind of the investment outlook vs. just the core run rate?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. This is something Paul and I have been spending a lot of time talking about as we work through our budget process for next year. It'd be a little easier if we had clarity on the rate situation or rate environment that we're going to face in terms of fed funds, as you know we are a pretty asset sensitive business. We'll have more to say about that in January, after we finalize our plan for the year, but right now it's a little bit early to be giving that information.

Michael R. Carrier
Bank of America Merrill Lynch

Q

Okay. And then just as a follow-up, just on the capital side, when you think about the cash level that you have currently, and then as you continue to build, you know, when you look into 2016, is there a certain level that the cash could get to that we should be thinking that buybacks may come into play versus, say, something on the M&A side? Meaning, I know you want to keep all your options open, but is there a certain level where cash kind of continues to creep higher, where you say it's attractive enough to do buybacks at that point in time vs. continuing to kind of navigate or scan the industry for growth areas?

Paul Thomas Idzik
Chief Executive Officer & Director

A

As we discussed in our prepared remarks, we really understand and appreciate the value of buybacks, and we're considering that option in the context of all the other things we discussed. And we understand the absolute definite value of it. We've established what I consider to be really respectable cadence on capital stewardship and intend to continue in that tradition. So I don't think you'd see us harboring cash just in case or just with a twinkle in our eye.

Kenneth W. Hill
Barclays Capital, Inc.

Q

You guys have talked a lot I think in the past about the Stock Plan business and keeping assets on the platform after they vest. I think historically it's running on the 15% range. Is that where it's at today? And what are you guys hearing from customers who are actually leaving? What kind of services are they going after? And is that something, or a capacity you could maybe add either organically or through acquisition?

Paul Thomas Idzik
Chief Executive Officer & Director

A

We keep a close watch on our attrition. We do understand many of the drivers. We actually do not believe we need acquisitions to remedy some of the reasons people leave. And so, no, that's not something that is driving any of our thinking other than the current efforts to execute better for our customers. Regarding this 15%, some of the hiring we've done in the last quarter has been explicitly aimed at improving the stock plan participant experience, as a way to start nudging up that 15% number.

Kenneth W. Hill
Barclays Capital, Inc.

Q

Okay. And I just wanted a follow-up real quick on an expense one. I think, Mike, you mentioned that rates is going to be a determinant of some of the expense trajectory into next year. What areas might you see more investment in, I guess, if you see a higher rate environment vs. a lower rate environment where you could see maybe potentially some pullback?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, I'll take that if you don't mind, Ken. We've spent a lot of money in the past period of time in the risk management and audit area, sort of affectionately known as the second and third lines of defense. And I think we've pretty much reached homeostasis there. We've really been focusing our efforts now on things that will help grow the company faster, and that is primarily in adding customer service capacity as we go towards the end of the year and into the tax – the front of the tax period at the beginning of next year, as well as IRA season. So FCs and

customer service reps as well as from the tech dev space. So that's where we're focusing most of our hurrying now I'd say in H2 last year and beginning of this year, we also focused attention on improving our capabilities and technology infrastructure.

Devin P. Ryan

JMP Securities LLC

Q

One area of uncertainty I think with the DOLs fiduciary rule is options trading within retirement accounts, and whether that will be allowed? I'm assuming the majority of that activity occurs outside of IRAs, but can you help frame any potential impact to E*TRADE if that isn't allowed? And then just with the DOL rule seeming to continue to roll forward here, is there anything else that you guys are looking at that may have an impact?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Devin, I don't think we're prepared to comment on that today.

Devin P. Ryan

JMP Securities LLC

Q

Okay. No problem. And secondly on just NIM expectations, I appreciate the commentary. If we're in a flat interest rate environment, obviously the marginal reinvestment rate is going to be lower than the current securities yields, and particularly as higher yielding securities are rolling off. So is there anything that you would look to do to maybe support your NIM further either in the types of security that you're purchasing? Or in the duration profile?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Devin, I'm not prepared to comment on that either this evening. But Mr. Pizzi is.

Michael A. Pizzi

Chief Financial Officer

A

Look, we try and match the duration liability of our sweep deposits pretty closely. That marginal reinvestment rate right now is about between 175BPS and 225BPS. We try and keep a very low overall level of exposure to interest rates, keeping in mind that we have a significant number of mortgage assets. So there is a degree of shifting as rates move. We really don't see that changing over time.

Devin P. Ryan

JMP Securities LLC

Q

Okay. Great. And then just last on fees and service charges, a little lighter than I was looking for. Transaction activity up, client assets down, so it was just a function of the lower balances? Or anything else we should be thinking about moving forward?

Michael A. Pizzi

Chief Financial Officer

A

Two items. During Q2 we get some proxy rebate fees that go through that line. We don't have those in Q3. The other item is related to FX related transactions from corporate services. Those were lower in the period.

Christopher John Allen

Evercore Group LLC

Q

Evening, guys. Just thinking about the \$50B threshold, and if you move past that, that would require a higher regulatory reporting and personnel cost, I would imagine. I'm just wondering where do you guys think you stand in terms of those capabilities? What incremental costs you would face if you were going to go through that barrier over the current run rate? If you can give us any color on that, that'd be great.

Paul Thomas Idzik

Chief Executive Officer & Director

A

Chris, we're far from being near that point or contemplating it. We've pretty much laid out our thinking on this. As we get to a point where we think we can leap over, we'll machine those numbers. But certainly when you read commentary such as by Zions Bank and some of the other ones, you recognize that these are not inexpensive moves to make. And we certainly wouldn't make a move of that nature without careful consideration and running Mr. Pizzi's slide rule over the numbers several times.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Mike, just on Q4 in net interest margin assumptions, what are your assumptions for the home portfolio yields? I saw they went up to [ph] 4.24%, 4.25% (45:17). I guess first of all what were the drivers of the yield going up to 4.25% from 3.90%? And then also the margin loans went up also almost about 7BPS or 8 eight basis points to around 3.50%. So in your guidance on NIM for Q4, are those your same assumptions as what's happened in Q3? And if you can talk about the drivers of that?

Michael A. Pizzi

Chief Financial Officer

A

Yeah. In the loan portfolio first, we had some items that moved through there last quarter that took the yield a bit lower related to some of the servicing transfers that we did. Conversely we've got a couple items related to a servicing adjustment that's going through there this quarter. Think of that loan yield at around 4% is probably the right level. On the margin side it's a lot of that's related to activity. Some of our larger balance customers will move in and out of the market. They have a bit lower of a rate. This quarter we saw a little bit of that sort of activity shift, as lower rate customers moved down and customers at higher rates remained in the balance pool. It's probably best to think about that flat to maybe slightly down.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

That's helpful. And then, Paul, just on the capital return priorities that you mentioned, of course you mentioned dividends. I mean what is your – if you were to I guess just outline the importance of either establishing a regular dividend, how important is that to you generally?

Paul Thomas Idzik

Chief Executive Officer & Director

A

That's less and less important to us right now, Brian, as opposed to really being careful and thoughtful with our capital deployment. And so I think that would be a lower priority than the other methods of returning capital to shareholders that we've discussed.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Okay. Okay. That's helpful. And then on just on the buyback potential, just the immediacy of that, is that something that can possibly happen as early as fourth quarter? Or are we thinking more of a 2016 and beyond type of event?

Paul Thomas Idzik

Chief Executive Officer & Director

A

I'm certainly not going to even speculate when we might do something we've just talked about.

Patrick J. O'Shaughnessy

Raymond James & Associates, Inc.

Q

So a question on Navtej leaving. Does that imply any change in strategy at the company? Or is it just simply a function of basically his job is done, he did what he set out to do, and now you need to flatten out the structure?

Paul Thomas Idzik

Chief Executive Officer & Director

A

It's really the latter. And we wouldn't be in position to be driving some of the things we've been driving over the past two years without his support and leadership so. But it's the latter. It's time to flatten out that organization.

Patrick J. O'Shaughnessy

Raymond James & Associates, Inc.

Q

And then a follow-up from me, as we look at your net new brokerage assets YTD, it's trailing last year's pace. And when we look at your net new clients, and that's trailing last year's pace too. And granted there's some noise in some of those numbers. But what do you think you guys can do to really reinvigorate the growth of the brokerage franchise, and to reaccelerate the growth of those net new assets in particular?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, Patrick, we've been really focusing on getting our self in position to be adding some of the digital capabilities which you've seen just been adding this year, and some of the things I talked about in the prepared remarks. I think stay tuned. We've got some pretty exciting things going to be rolled out that took us a while to get ready to do. But we're digitally centric. That's the strategy which we are focused on. And so what we're aiming to do is just continue to create a superior online experience for our customers, backed up by absolutely superb customer support, because customers do need that on occasion, and that's the approach we're going to take.

Joel Jeffrey

Keefe, Bruyette & Woods, Inc.

Q

Just a quick follow-up on the margin balances. It sounds like what you were saying is that you had some more active traders kind of pulling back their activity in that in Q3. And since you've commented that it looks like balances have declined further, I'm just wondering if it's the same group of traders that you're seeing pull back, or is this kind of spread towards more of your average trader base as well?

Paul Thomas Idzik

Chief Executive Officer & Director

A

It's probably more around the average. Look, margin activity moves throughout the quarter. So it's tough to generalize at this point in terms of what we're going to see. As we move through Q4, we'll see various activities and movement. So it's tough for me to really say. But at this point, think of it more towards the average.

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