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24-Jul-2013

E*TRADE Financial Corp. (ETFC)

Q2 2013 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 Form 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

Industry Environment

- It's a pleasure to be speaking with you again
- There is plenty on which to update you since we last spoke, so I'll get right into it
- I joined E*TRADE a little over six months ago, and I face each day with more enthusiasm for this company and the opportunities that lie ahead of us
- As you are aware, the last few years have been quite challenging, not only for our industry but particularly for this company
- My colleagues here have put in a lot of hard work through these times, toughed it out, and we are now ready to drive the franchise forward
  - We now sit in a position where through proper focus and execution we can crisply turn the corner and deliver for our customers and our owners in a meaningful way

Key Focus Areas

EXECUTION OF CAPITAL PLAN

- I have the senior team focused on a number of key areas to help our company and help our company seize the opportunities that lie ahead of us
- First, the ruthless execution of our capital plan about which we have been speaking for quite some time
  - Successful execution of this plan is the most visible, meaningful, and measurable way to delivery near-term value to our shareholders
- And we've made significant progress in a number of key elements within the plan, including:
  - Derisking and deleveraging the balance sheet
  - Building out our enterprise risk management capabilities, particularly internal audit, bank compliance, and operational risk management
  - Reducing our costs, have completed damn near all of our identified cost saves
  - And finally, bolstering our capital position, reaching our target for the bank's Tier 1 leverage ratio during Q2
- We remain intensely focused on execution of this plan and are increasingly confident in our ability to achieve our capital goals going forward

BUSINESS LEADERSHIP

- Our second area of focus and something of particular interest of mine is to ensure that this business receives the level of attention and leadership it deserves
- In that regard, I have completed the build-out of my executive committee, adding some serious firepower this quarter
  - First, with the appointment of Navtej Nandra as the company's President
- Mr. Nandra has taken the reins on reshaping some of our internal structures to better align our colleagues with their talents and our business goals
- Further, he is ensuring that our day-to-day business activities advance the ball on improving our customer experience and reshaping the P&L
- With the good fortune of a great depth of talent here at E*TRADE and Navtej's incisive way of thinking, I believe we are well positioned to succeed

- We also recently brought on a new Chief Marketing Officer in Liza Landsman, who joins us following impactful tenures at Citigroup and Blackrock
- She has wasted no time since her arrival, completing a thorough review of marketing agencies and selecting a partner to help us define our path towards the next phase of this company's evolution
- Liza is in the final stages of bringing on Ogilvy & Mather to help us drive a marketing and advertising platform that more fulsomely engages with our existing customers
    - While emphasizing our brand as a trusted destination for assets and advice to the broader market

DRIVING PRODUCTIVITY AND VALUE

- And our third area of focus, driving productivity – driving productivity and value through constant process improvement and unwavering focus to deliver for our customers and our owners
- While this is fairly comprehensive and embedded within the other areas of attention I described, my goal is to more effectively drive the theme of executional excellence and process perfection across the depth and breadth of this organization
- No matter how good processes are, they can always be improved, so this will never cease to be an area of our concentration
- Somewhat in this same vein, I am proud to announce the team has completed essentially 100% of our targeted cost reductions as outlined in our capital plan
- Cutting unnecessary spend and reshaping our cost structure sets us up for significant operating leverage, particularly if we continue to move into a more helpful macroeconomic environment, marked by improving investor sentiment, more beneficial interest rates, and continuing improvement in credit
    - If these trends continue in the right directions, I hope to be in a position where we are discussing the areas in which we are investing, as opposed to providing updates on cost reductions

Q2 Net Loss

- Moving on to our results in the business
- For Q2, we posted a net loss of $54mm, or $0.19 per share, which included a one-time charge of $142mm, related to the impairment of goodwill resulting from our decision to exit our market making business
- We acquired the market maker in 2001
- As my team has looked at where we want to allocate our resources, both financial and management energy, we decided our owners would best be served by exiting this business unit
- Matthew is orchestrating the sale of this business and will cover more on this topic later in this call
- Excluding the impact of our decision to exit the market maker on the quarter's results, we had a respectable Q2, recording net income of $60mm, or $0.21 per share, on revenues of $440mm

Customer Activity

- Our results reflected ongoing customer engagement, with quarterly DARTs of 150,000, up slightly from Q1, and up 8% from Q2 2012
- We were pleased to see customer activity remain in line with Q1, but are mindful that Q3 is typically slower due to seasonality
    - So we are not surprised that our July to-date trading levels are tracking down 4% from June, but pleased they are up from July of last year by 8%
- Derivatives continue to be an important component of how our customers manage their financial well-being

Trading Activity

- Second quarter trading activity included 24% of our customer volume in options, a fairly consistent mix for the past year
- Mobile transactions continue to trend upwards amongst our customers, as approximately 8% of DARTs came from mobile devices during the quarter, a nice improvement over last quarter and more than double their levels from two years ago
- Net new brokerage assets for the quarter were $1.7 B, bringing the YTD total to $4.8B, representing an annualized growth rate of 5.6%, behind our 8.5% annualized growth in H1 2012

Asset Growth

- Our comparatively slower asset growth is attributable to seasonal outflows around tax season
- In April of this year, our net new brokerage assets were essentially zero, weighing on our full-quarter growth metrics
- We brought in 30,000 net new brokerage accounts, which is off the pace of 46,000 in the same quarter last year
    - However, our teams did an exceptional job in retaining existing accounts as we posted 8.4% annualized brokerage account attrition in Q2, matching our record low set in the same period of last year and delivering our renewed commitment to improving the quality of our customer experience

Area of Opportunity

- An important area of opportunity continues to be created by expanding customer awareness around our retirement, investing, and savings offerings, in particular our managed accounts
- Within these product groups, we ended the quarter with $1.8B in assets under management, a significant achievement given we launched these products just three years ago
    - We obviously look forward to driving even more meaningful growth in these products to make them a more impactful and visible contributor to our customers' financial well-being and to our shareholders' returns

SUMMARY

- In summary of the quarter, I'm pleased with our results
- The team executed well on a number of our initiatives, including sharpening our customer focus, cost reductions, and our capital plan
- You have heard me talk more about what we, as a team at E*TRADE, are doing about improving what we deliver in support of our customers
- You should expect this to increasingly feature in our expositions about the business
- As we have gained tempo regarding the capital plan and have successfully delivered against virtually all of our targeted cost reduction efforts, the team can now sharpen its focus on things it is well-armed to do, and to do well: improve the customer experience; deliver exceptional value; increase productivity; drive returns for our shareholders; and get back to having some fun
    - We still have our work cut out for us for the remainder of the year and beyond, but I am confident in our capabilities and motivation to seize the opportunities that we see ahead of us

NEW APPOINTMENT

- One final note before I turn the microphone over to Matthew
- I wanted to take a moment to properly announce and welcome our newest member of E*TRADE's board of directors, Mr. Mohsen Fahmi
- Mohsen brings a superb record of financial services experience, particularly in the area of risk management
- We are fortunate to have him on the team and look forward to his contributions and insight
  - We are still in the process of searching for other talented individuals to join our board, and we will obviously update when there is more to share in that regard

Matthew J. Audette

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

FINANCIAL RESULTS

Net Income

- For Q2, we reported a net loss of $54mm, or $0.19 loss per share, which includes impairment of goodwill of $142mm associated with our intent to exit our market making business
- Excluding this charge, we reported solid net income of $60mm, or $0.21 per share, up from net income of $35mm, or $0.12 per share, in Q1, and up from net income of $40mm, or $0.14 per share, in the year ago period
  - Our second quarter net revenues were $440mm, up from $420mm in the prior quarter

Revenues

- Revenues included net interest income of $243mm, up slightly quarter over quarter as a result of five basis points of net interest spread improvement to 235BPS, partially offset by $730mm reduction in the average balance sheet size
  - The increase in spread this quarter was primarily driven by an improvement in the interest rate environment as we saw rates rise across the curve
- Given this rise in rates, we now anticipate our net interest spread for the full-year 2013 to be slightly above 230BPS
  - Additionally, if rates move in line with what the forward curve assumes, we anticipate further spread improvement in 2014, with an average spread of approximately 240BPS

COMMISSIONS, FEES AND SERVICE CHARGES

- Commissions, fees and service charges, principal transactions, and other revenue in Q2 were $177mm, up 8% from the prior quarter and up 15% from the same quarter of 2012
- Average commission per trade was $11.10, down from $11.30 last quarter, due to a lower mix of stock plan trades in Q2
- Principal transactions revenue was down slightly q-over-q despite a slight increase in volatility as spreads tightened and a smaller portion of our customer trades were handled internally
- Revenue this quarter also included $20mm of net gains on loans and securities, net of impairment, up from $15mm in the prior quarter

  - The significant volatility in rates and mortgage spreads that occurred late in the quarter resulted in the repositioning of portfolio assets, driving gains above our forecasted range
- Despite the sequential increase, we continue to expect these gains to be in the $10mm to $15mm range per quarter, barring potential deleveraging needs or volatility in the rate environment

Legacy Loan Portfolio

- Our legacy loan portfolio ended the quarter at $9.6B, a contraction of approximately $500mm during the quarter, and is now down more than 70% from its peak
  - We expect loan run-off to average approximately $400mm per quarter for the rest of 2013, generally consistent with the 4% to 5% quarterly decline we have experienced for some time

Provision for Loan Losses

- This quarter's provision for loan losses was $46mm, compared with $43mm in the prior quarter, which was positively impacted by $13mm settlement
  - So, adjusted for last quarter's settlement, this quarter's provision marked a sequential improvement of approximately $10mm
- For the remainder of this year, barring any unforeseen external disruptions, we expect quarterly provision expense to be in the range of $40mm to $60mm
  - However, I must emphasize the nature of the quarterly provision is inherently uncertain
  - So this range, while our best estimate today, could vary meaningfully

Net Charge-Offs

- Total net charge-offs in the quarter were $50mm, down considerably from last quarter's $81mm, excluding the $13mm settlement
  - Total special mention delinquencies in the quarter were down 14% sequentially, and delinquencies for the entire loan portfolio were at their lowest levels since mid-2007
- The total allowance for loan losses ended the quarter at $451mm, down $4mm from last quarter
- With delinquencies at their lowest levels in the past six years, our coverage for potential losses on non-modified loans increased significantly, and this quarter's allowance represents coverage of 95% of loans at least 90 days past due
  - This compares to 80% last quarter
- For modified loans, our total expected losses remain at 35%, unchanged from Q1
- Improvements in the housing market so far this year had positive impacts on our loan portfolio

Risk Profile

- The overall risk profile has improved with the average LTV of our 1-4 family portfolio ending the quarter at 98%, down nearly seven percentage points and below 100% for the first time since 2010
  - The average CLTVs of our home equity book also saw marked improvement, ending the quarter just under 105%, the lowest since 2009
- During the quarter we modified $35mm of loans, slightly up from $34mm in the prior quarter
- We continue to expect modifications to remain at low levels over the near-term
  - However, modifications may increase in future periods as our HELOCs convert from interest-only to amortizing in the years to come

- As we've indicated in past presentations, these conversions will not take place in a material way until 2015 and beyond
  - Of our $3B HELOC portfolio, 26% are scheduled to convert in 2015, with an additional 41% in 2016

Exit from Market Making Unit

- Moving on, as we mentioned earlier, we have decided to exit our market making unit, G1X; a conclusion reached in light of the tightening economics for that business, coupled with the potential associated risks, both operational and regulatory, and most important, because it is not core to our retail customer business
  - The sale process is currently underway, and we aim to announce a transaction in the next three to six months
- We will update you once there is more to share
- For the moment, I will only highlight that we do not expect a material impact on our future financials once we sell this business, as the majority of its value to the firm lies in our ongoing customer order flow
- Said differently, once the sale is complete, all revenue in the principal transactions line will be gone, and the fees and service charges line will reflect payment for order flow as all volume is sent externally
- One other impact of our decision to exit the market making business relates to the reclassification of its assets and liabilities to held-for-sale, which are now captured within other assets and other liabilities
  - This included the reclassification of, approximately, $90mm in trading securities and, approximately, $20mm of intangible assets

Operating Expenses

- Excluding the impairment of goodwill and restructuring, operating expenses for the quarter were $262mm, down sequentially predominantly on lower advertising, compensation, and FDIC premiums
  - While the sequential decline in advertising and compensation expenses reflected seasonality, the reduction in FDIC insurance premiums relates to the continued improvement in the quality of our balance sheet
- We expect this line will continue to improve over time, commensurate with the improvement to our overall risk profile

Expense Reduction Plan

- On expenses broadly, I am proud to say that we have substantially completed all of the targeted cost savings captured in our $110mm expense reduction plan
- As a reminder, when we began the program last year, we set out to drive efficiency across the company by reducing recurring, controllable expenses in areas that were not directly driving value for our owners
- We took a hard look at every dollar spent across the organization and made determinations based on overall return and ultimate benefit to our customers
- Through this review, we identified and implemented savings across a number of fronts, most notably through our people costs
- Since we began the program, our total headcount, including outsource support, is down from a peak of around nearly 4,000 to, approximately, 3,300 today

Investments

- With that, we feel good about our cost reductions being complete, and are focused on ensuring we have the right levels of investments going forward
  - Additionally, as we have dug further into the details of building out our enterprise risk management capabilities, we have determined that we need to make additional investments
- As such, our initial investment – estimate for our investment in ERM of $10mm is now closer to $15mm
  - This is a crucially important area for us, and given the importance we place on doing this right, we feel good about this additional investment
- Accordingly, our estimated net cost reductions are, approximately, $95mm
  - And the clean quarterly expense run rate should wind up in the mid-260s

Corporate Cash

- Turning to corporate cash, we ended the quarter at $251mm, above two years' worth of debt service coverage
- The sequential decline of $101mm related to corporate interest payments as well as other tax payments and intercompany settlements
- As a reminder, there can be noise in the individual quarters related to tax and intercompany allocations, which do not necessarily impact corporate cash in a meaningful way over the long term

Capital Ratios

- Our capital ratios improved across all measures during the quarter, for bank and consolidated calculations
- At the bank, our Tier 1 leverage ratio ended the quarter at 9.5%, up 20BPS from last quarter and at the targeted level outlined in our capital plan
- For all other bank risk-based ratios, we were between 21% and 23%, well in excess of regulatory thresholds
- At the parent, our ratios increased across the board as well
- We ended the quarter with a Tier 1 leverage ratio of 6.4%, up 40BPS from the prior quarter
- Our risk-based measures at the parent are between 12% and 16%, again, well in excess of regulatory requirements

Implementation of Basel III Capital Requirements

- In addition, the Fed recently announced the final rules for its implementation of Basel III capital requirements
  - The phase-in of the adopted rules is scheduled to begin in 2015, and banks will be required to comply with the fully phased-in requirements by 2019
- I would like to highlight the changes that impact us the most, noting that we view the overall impact of the new rules as very favorable
- First, the risk weightings for our mortgage loans will remain unchanged from their treatment under current Fed rules
  - This is a favorable change from what was previously outlined in the NPR
- Second, the risk weightings for our margin loans, which we currently weight at 100%, will decline as they are considered fully-collateralized and generally qualify for 0% risk weighting under the new rules

- Third, the final rules give us the option as to whether we include in our regulatory capital unrealized gains or losses on securities carried in AOCI
  - Given our balance sheet structure of deposits funding securities and the potential volatility related to changes in the securities markets, we certainly intend to elect for the exclusion of AOCI from our capital
- Fourth, and consistent with the initial NPR, trust preferred securities will be excluded from capital, with the phase-out beginning in 2015

TIER 1 COMMON CALCULATIONS

- So, in summary, with respect to our Tier 1 common calculations, assuming the full implementation of the revised capital rules, our current levels of 21.6% and 12.2% for the bank and parent, respectively, would improve to 30.8% and 18%, based on the new rules
- The full phase-out of TruPS on our consolidated Tier 1 leverage ratio would reduce our current level of 6.4% to 5.3% on a pro forma basis
  - Overall, we feel very good about our capital position

Progress on Capital Plan

- Moving to progress on our capital plan, we continue to execute well on the plan and feel confident in our ability to achieve our capital goals
- Our de-risking continues to progress, the build-out of ERM is on track, and our capital ratios are improving, driven by earnings and our deleveraging actions
- In that vein, during Q2, we completed an additional $800mm in deleveraging actions, to bring our completed total to $8.7B
- This falls within our original plan of $5B to $10B in deleveraging and just above our goal of $8.5B
- While we may take some tactical actions in future periods, we consider our deleveraging efforts to be complete
- With respect to our wholesale borrowings, we had a slight increase during the quarter, specifically on our repo and Federal Home Loan Bank advances of $500mm
- This was simply due to large amounts of customer net buying activity right at the quarter end
  - This activity was temporarily funded with wholesale borrowings to allow for an orderly reduction in the balance sheet, which has already occurred in the month of July

CONCLUSION

- In closing, we feel very good about the quarter and our solid results across our customer, capital, and credit metrics
- As I sit here today and reflect back on our capital plan that we developed just one year ago, we are quite proud of what we accomplished
- We have refinanced our high-cost debt, completed the planned amounts of deleveraging, completed our cost reduction programs, and achieved a 9.5% leverage ratio at the Bank
  - These were not easy tasks, but our teams worked incredibly hard and were able to make significant progress on our capital plan in a relatively short period of time

QUESTION AND ANSWER SECTION

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

Q

I guess my first question is on the market maker and the sale, and I guess you did go through that there won't be, I guess, income statement impact, but could you walk us through, Matt, like even an estimate of what do you think of the proceeds and where does this – where would any gains or benefit go if – given that the market maker doesn't fit under the bank? Would it go – would any proceeds go right to the parent?

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

A

Sure Rich. So I think – I'd look at it in two pieces. So any proceeds directly associated with selling the business would be outside the bank, so would go to the parent. To the extent there were any proceeds or prepayments associated with an order flow agreement or payment that would go to E*TRADE Securities, which is within the bank, so it really all depends on what structure we ultimately have.

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

Q

Okay and – okay, I can ask more about that after. The one follow up I have to change the subject would be, the enterprise risk management, it seems like you upped the investment there. That looks like the remaining thing. If you look at – from what you said in the past conference calls about requesting the regulators to upstream capital, your earnings improved, you are at 9.5% Tier 1 leverage at the bank. Your cost cutting is done. So is there a possibility that you could request upstreaming capital before year end given you've got everything else, looks like in place?

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

A

So we feel good about the momentum, Rich. I think our plans are still the same. We laid out the capital plan a year ago. It feels very good to be executing on that plan and executing well. But I think our plans are still the same towards the end of this year. I think you are right on the specific quantifiable measurable things in the capital plan. We've done those, but it's really an overall picture, so making sure we get all the year-end built out is incredibly important. I can't speak for the regulators, but I suspect they look at this in a very sophisticated way and they are going to look at the entire picture. So while we feel good about the path that we're on, that path is still towards the end of this year.

Steven J. Chubak
Analyst, Autonomous Research US LP

Q

I guess my first question is regarding some of the color you provided on the FDIC assessment fees and your expectation that that will continue to come down gradually. I didn't know what the process was on the regulator side in terms of how they would go about I guess reviewing your CAMELS rating, how often that would occur. Because my understanding is that it's usually an annual process and therefore typically you'll see, I guess, potentially a meaningful step-down if they decide that you've executed well on the balance sheet cleansing, implemented the enterprise risk management, and basically undergone all the initiatives that would support a reduction in those fees.

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

A

So the FDIC rate is – it sounds like is a very complex formula. So regulatory ratings are part of that formula. Your capital ratios are part of that formula, and your liquidity levels, and there's a lot of different things that go in there and it is refreshed every quarter, right. So just – we'll file our financial reports and it will be refreshed each quarter. So, it's going to change every quarter depending on how those things go. Obviously, can't speak to any details on the regulatory rating side, but that's how that formula works. So, I would expect it to change over time.

Steven J. Chubak
Analyst, Autonomous Research US LP

Q

Okay, and you have no sense as to how long it would potentially take given some of the initiatives that you've taken to get to that $60mm target or is it just within their control, so it's difficult to project?

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

A

Yes, I have no additional color. I mean all the things that we are working on, improving our capital ratios, improving our credit quality, all of those things are things that ultimately lead to a lower FDIC rate. So, they're all in sync and there's really – there's no additional color beyond that.

Steven J. Chubak
Analyst, Autonomous Research US LP

Q

Okay thanks. And then I suppose moving to another part of the expense base, just the clearing and servicing expense. We've seen a pretty consistent reduction in the size of your loan portfolio. And didn't know how we should be thinking about the pace of, I guess, the reduction in clearing and servicing costs as the loan portfolio continues to shrink? Is it going to follow in lockstep? Is there a lag that we should be thinking about or – any incremental color will be helpful?

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

A

Yes, so it will trend down over time with the size of the loan portfolio. The only nuance there is the servicing of delinquent loans, foreclosing of loans, those type of costs don't necessarily trend with the loan balance size. They get a little bit lumpy. So that makes it a little bit difficult to predict in the short term, right, in individual quarters, but over the long-term those costs should trend down in line with the loan portfolio.

Steven J. Chubak
Analyst, Autonomous Research US LP

Q

Thanks. And then last one for me. Just – thank you for providing a lot of detailed color on the capital ratio. I didn't know if you could disclose your Tier 1 leverage ratio on a Basel III basis?

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

A

Yes, we did. So it comes down at the parent around 100BPS, a little over 100BPS, so 6.4%, the parent down to 5.3%.

Steven J. Chubak
Analyst, Autonomous Research US LP

Q

At 5.3% okay.

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

A

And then basically the primary impact is trust preferreds coming out.

Mike Carrier
Analyst, Bank of America Merrill Lynch

Q

First, just on the market making, Matt, I don't know, did you give the expenses like related to that business, you know when you were giving some of the items in terms of how the revenues would be impacted?

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

A

I [ph] didn't, (30:22) but if you look at the income statement, the revenues for market making are the principal transactions line, which has been just over $20mm for the past few quarters. The expenses are primarily in the clearing line as well as compensation and benefits. The margins for that business I would put in the 10% to 20% range, right, so without giving all the details of where the expenses go. I would view margins as 10% to 20% off of that $21mm per quarter revenue.

Mike Carrier
Analyst, Bank of America Merrill Lynch

Q

Okay got it. And then probably just two other kind of items is, the first is just, the reduction on the overall Tier 1 leverage ratio, would that have any impact? I know you guys have focused on the bank leverage ratio, but would that have any impact on the capital plan? And then just in terms of the items in the income statement, the fees and service charges, you might have mentioned this, but I just missed it in your prepared comments. Was there anything in there that elevated that this quarter?

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

A

Sure, so the leverage ratio at the parent, so that's – you can imagine that our capital plan is both a bank capital plan and a parent capital plan, so it's covered in there. I think the most measurable thing is really getting to a point where you have dividends going from the bank to the parent. So I think our objective is absolutely to increase the leverage ratio at the parent as well, but I'd say the more near-term objective is to focus on the bank, so that's why we – that's why we tend to focus on that. Now fees and service charges, so there's a few things going on there. One, you've got payment for order flow, so to the extent you've got a quarter where commissions are going up, you would also expect fees and service charges going up. Our DARTs were up slightly this quarter, but there was four more trading days in the quarter, so the commissions went up a little bit more than the DART increase would imply. So you have the same nuance going on in fees and service charges. The other thing that goes into fees and service charges is the revenue associated with our managed products, right, so our managed investment portfolios and mutual funds and things like that, so that nice recurring income. As that product continues to build and as all those products continue to build, that recurring fee income is going to increase. And then we've got a little bit of seasonality. So Q2 is proxy season, so you've got the proxy fees in there. So everything else being equal, you've got a little bit of seasonality pushing the fees and service charges up. So a good run rate would be a slight decline in the mid – mid-to-upper 30s next quarter, everything else being equal.

Chris M. Harris
Analyst, Wells Fargo Securities LLC

Q

So a question about the spread this quarter. I was just wondering if you guys can give us a little bit more detail as to how exactly that spread went up. And I got it that net interest rates generally rose, but I don't think really any of your competitors are going to be able to achieve a growth in the spread, plus your rate on your securities portfolio tends to be higher than your peers, so can you help us understand exactly what dynamics were driving the spread higher?

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

A

Sure, so it's the overall interest rate environment improving which manifests itself in a spread improvement in two places; one is prepayments slowing down, particularly on the securities portfolio. So if you look at the yield table we put out in the release, the available-for-sale securities and held-to-maturity securities, you see those yields going up, and it's really a slowdown of prepayments on securities that are on the books at a premium, right, so when you have prepayments at premium hurt your spread. So as those prepayments slow down, it helps improve it. And then second, which is less of an impact this quarter, but we would expect to be more of an impact over the long-term if interest rates continue on the path that they are on. The reinvestment rates have improved. So if you go back six months ago, our reinvestment rates were more in the 100 basis point range. I would say for this quarter they were – you know interest rates are pretty volatile, so it's anywhere from 150BPS to 200BPS of reinvestment rates in the quarter. And if you look at the forward curves, it would imply that those reinvestment rates are going continue to go up from here. So those are really the two big buckets that impacted prepayments and reinvestment rates.

Chris M. Harris
Analyst, Wells Fargo Securities LLC

Q

And where are you reinvesting today? I mean what kind of securities are you – and what is the average portfolio duration would you say?

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

A

Yes, so there has been no change – no change in the types of securities that we're investing in, right. So they are government guarantees or government-backed, mortgage backed securities that we put in the either available-for-sale or held-to-maturity bucket. Our general interest rate philosophy is to run a relatively matched book, not completely matched but relatively matched, so we are going to focus on the duration of our deposits. It's really going to drive where we are investing on the asset side, and that's anywhere from 2.5 years to 3.5 years of duration, so that's kind of where we mirror it on the asset side.

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

Q

So, my first question is, how do you think about growth of the bank and bank assets at this point? If I recall correctly, you've kind of said that, now you're done with these different measures you've taken to shrink the bank. It's probably going to grow along with client deposits. Is that the right way to think about it?

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

A

It is Patrick. Keep in mind, over the long term, we want to run off the wholesale funding, right. So if you take the $500mm growth that's already run off the month of July, you've got $5.5B of wholesale funding that over the very long term we want to run off. But absent that customer deposits are absolutely going to drive the size of the balance sheet.

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

Q

Okay that's helpful. Thank you. And then I guess my second question is, just give a little more color on your operating expense run rate. I think you did a little bit better this quarter than the guidance last quarter led us to, but it sounds like you're going to be doing some reinvestments over the next couple of quarters to pursue some growth opportunities. And so, the mid-260s is kind of the right run rate to think about going forward?

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

A

It is. So if you look at this quarter and you back out the goodwill impairment as well as the restructuring and other exit activity line which are really cost to implement the cost reduction program, we're at $262mm, so I think that's – the mid 260s is a good run rate for the remainder of the year.

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

Q

Congrats on all the progress. Thanks for taking the questions. Matt, the 240 basis point net interest spread in 2014 you spoke to, assuming the forward curve holds true, can you just walk through what you're assuming for overall balance sheet size and mix, duration of the securities portfolio, any further funding actions you might take to get to that broad level?

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

A

Sure Howard. It's really the interest rate environment. So the assumptions in the balance sheet are really driven by customer activity. You could – you would assume that we'd have some level of growth on deposit side. But I wouldn't say it's meaningful. I'd say that the primary driver of the spread would be a change in the interest rate environment, not a change in the balance sheet or a change of duration or anything like that.

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

Q

So it assumes just the normal gravity of the loan burn down and remix into the securities portfolio, correct?

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

A

Correct, correct.

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

Q

Okay.

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

A

So we're – from a loan coming down around $400mm per quarter for at least for the rest of this year. I would expect as we get into 2014 that $400mm is probably going to get a little bit smaller, but it does assume the continued run down of the loan portfolio.

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

Q

And what does that do to the duration of the securities book during the course of 2014?

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

A

So consistent with the earlier question, so we would focus the securities book really to be relatively matched on the liability side, so the 2.5 to 3.5 years is how we view it.

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

Q

Okay thanks. And then just a quick numbers related question. Was there any severance expense this quarter?

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

A

Yes. So if you look, in the facility restructuring and other activities, that rounded $10mm, about $7mm of that was severance.

Alex Blostein
Analyst, Goldman Sachs & Co.

Q

So just I guess staying on the net interest margin outlook and the comment you guys made about prepaying amortization in the quarter. Can you – two questions there, I guess, A, can you size how much premium amortization is on a run rate basis going forward? And the modeling assumptions you guys make while calculating that, does that include sort of any one-time catch-up benefits that we might have seen this quarter or are you doing this kind of like more on a linear basis?

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

A

So, yes, we don't have the breakout here of how much the premium is impacting it, but the impact to the rates, we're not assuming prepayment rates over time and impacting them on the yield this quarter. It's really the prepayments that occurred during the quarter. So inherent in those comments are we had less prepayments and therefore less premium write-offs this quarter vs. last quarter, was the driver of the increase.

Alex Blostein
Analyst, Goldman Sachs & Co.

Q

Okay. But I guess you're not assuming further slowdown on prepayments from here, is that fair?

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

A

No, we absolutely are. So if you think about the improvement from slightly above 230BPS this year to 240BPS next year, the primary driver of that is going to be an improvement in the interest rate environment, and the two ways that that will manifest itself to drive that spread up are going to be better reinvestment rates and lower prepayments. So that's the driver both in this quarter and in our expectations for 240BPS next year.

Alex Blostein Q
Analyst, Goldman Sachs & Co.

Got it. All right, that's helpful. Would you say it's about even or reinvestment is more of a benefit than the slowdown in prepays?

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

Yes, I don't have a breakdown between the two.

Alex Blostein Q
Analyst, Goldman Sachs & Co.

Okay. And then question on the home equity book, I think in the past you guys mentioned how much of the loans that are not yet amortizing, already paying down the principal even today. Is there a sense how much that was in the quarter?

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

Yes, we didn't update that. I would say it hasn't changed meaningfully. What we said last quarter was 40% of those had made principal payments of $500 or more in the past year. And of that, half of them, or 20%, had made principal payments of $2,500 or more. That's what we said last quarter, it hasn't – we didn't update it, but it hasn't moved meaningfully.

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

Just a quick question, it looks like for the average – average for the quarter margin loans stayed relatively flat, which seems kind of consistent with a lot of your peers were reporting, but looks like there might have been an uptick towards the end of the quarter. Is that a trend that's continuing into Q3?

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

So, we don't have a third quarter update on it, but you're right. So the average for the quarter was $5.7 B. We did end the quarter at $6B, but I don't have an update for July for you.

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

Okay. But I mean, would you say that people are getting more willing to put on risk in terms of the equities market at this point?

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

Well, I think it would be a fair assumption that with DARTs coming down in the month of July vs. June, margins probably moved a little bit in the same direction and then came down a little bit.

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

Okay, great. And then just last for me, I apologize if I missed this, but what percentage of your agency securities are floating and what percentage are fixed?

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

A

We didn't break it down on the call. We usually break it out in the Qs and Ks, so we'll have – we should have that in the filing, but I don't have it here today.

Chris J. Allen
Analyst, Evercore Partners (Securities)

Q

Just wanted to ask a little bit about marketing, came down again – obviously, it came down this quarter. It sounds like you're engaging all of the amount there going forward. I know you wanted to do smarter spending on the marketing front. But how should we think about that moving forward and longer term?

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

A

Well, I think we're still in the beginning of having Liza develop her plan both internally and with her external agencies. And I think you're going to have to stay tuned to find out what that is. I'd suggest that it's likely to tick up a bit. But I think what's most important is not only what you see us doing outside, but what we're doing to do a better job representing good value and good opportunities to our client base. So some of the marketing you won't see going outside. You'll see it directed to the existing customers and that's – we think that's an attractive way to drive more money to the bottom line for our shareholders.

David J. Chiaverini
Analyst, BMO Capital Markets (United States)

Q

So you mentioned about how you're running a matched book, but at the same time you'll benefit from higher reinvestment rate. So are you able to highlight the sensitivity to the net interest spread assuming, say, 100 basis point parallel upward shift in the yield curve?

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

A

So, we run a relatively matched book, right, not an exactly matched book. So there's certainly some interest rate sensitivity there. So I don't have the precise numbers other than we absolutely do benefit in a rising rate environment. But I don't have the specific numbers vs. 100BPS, but it will definitely go up.

David J. Chiaverini
Analyst, BMO Capital Markets (United States)

Q

Okay, okay. And then shifting to the HELOC portfolio, so do you have a sense of how much the payment would increase out in 2015 and 2016? You mentioned 26% of the book changing in – changing payments in 2015, 41% in 2016. Do you have a dollar amount before and after that shift occurs?

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

A

Yes, so the home equity – the HELOC books are relatively – the average loan balances are relatively small. So for the entire portfolio, the average balance is around $75,000. So the payment increase we're talking about is a few hundred dollars a month. So it's certainly relatively small.

David J. Chiaverini
Analyst, BMO Capital Markets (United States)

Q

Now that's a few hundred dollars on what base?

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

A

A 100% increase. When you think about a payment increase, it's not a few thousand, it's a hundred. So that's how we look at it, but I don't have the percent increase for you.