23-Apr-2015

E*TRADE Financial Corp. (ETFC)

Q1 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP 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 the 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

BUSINESS HIGHLIGHTS

Brokerage Metrics

- During the quarter, we posted healthy brokerage metrics with robust asset accumulation, and the team delivered enhancements to our service offerings, earning some welcomed recognition along the way, with all of this aimed at meeting our commitment to do more for our customers
- Permit me to begin with our capital plan since I recognize that it stands as a topic of more than passing interest to many of you
- We entered 2015 with [ph] coronets (1:55) welcoming some key approvals from our regulators
    - These approvals underscored E*TRADE's progress across a number of fronts and ultimately facilitated the company's reduction of corporate debt to our target level
    - This represented a major milestone for our enterprise as we continue down the path of driving value for our owners

E*TRADE Securities

- On last quarter's call, we announced the approval to move out our two broker-dealers from under the bank
- In February, we completed the move of E*TRADE Securities, our introducing broker
- Our plan remains on track to move the Clearing broker in H2 as we work through the intricacies of that transaction
- Matthew will provide more details later

CUMULATIVE DEBT REDUCTION

- In conjunction with the move of our introducing broker, $434mm of capital become available to the parent, which we used to achieve the goal of reducing corporate debt to $1B
- The most-recent transaction brings our cumulative debt reduction to $740mm, which we completed in just four months
- Looked at from another perspective, in the time since the company first submitted its capital plan in 2012, debt service costs have been reduced by more than 70% to just $50mm

CREDIT RATING AGENCIES

- Our three credit rating agencies have recognized these achievements with a total of eight full-notch upgrades over the past 12 months, including three in conjunction with the March debt transaction
- Each upgrade is encouraging as we continue to make strides towards our goal of becoming investment grade
- With debt reduction behind us, we turn our focus to how we will next put our capital to work

CAPITAL GENERATION

- For the first time in more than five years, we have a meaningful direct source of capital generation at the parent in the form of our introducing broker-dealer
- And with our organizational realignment, clarity on bank capital ratios and plans to continue requesting quarterly dividends from the bank, we are in an attractive position when it comes to putting more capital to work for our shareholders

- With significant opportunities in front of us, we are evaluating how to most appropriately and effectively put capital to use

Earnings

- Turning to results, excluding the early extinguishment of debt charge, we recorded earnings of $0.29 per share for the quarter on an income of $85mm
- Our results were driven by solid customer engagement, including record high margin loan balances, lower-than-expected provision and a benefit to corporate interest expense from our March debt transaction

DARTS

- DARTs for the quarter were just shy of $170,000, up slightly from the prior quarter, but down 14% from last year's unusual buoyant Q1
- Options represented approximately 23% of total trading activity, in line with trends over the past couple of years
- We've seen a pullback in activity in April to-date with DARTs tracking down 6% from March
- Margin balances grew by approximately $500mm to end the quarter to record $8.2B.
- Balances dipped at the beginning of the year, which is reflected in the quarterly average of $7.9B, but steadily rebounded in the latter half of the quarter

NET NEW BROKERAGE ACCOUNTS

- Our customers were net buyers of $3.1B of securities in the quarter, continuing the multiyear trend of customers putting their money to work
- We added 39,000 net new brokerage accounts in Q1, up from 17,000 in the prior quarter, but down from 72,000 a year ago, which was a five-year record
- Attrition of 8.8% improved from 9.1% in the prior quarter
- Net new brokerage assets of $3.5B represented annualized growth of 5.7%
    - This matched our asset gatherings from the prior quarter, but was down from a record $4.1B one year ago

ASSET GATHERING

- This asset gathering is encouraging, especially when you consider the type of assets customers are bringing to E*TRADE
- Becoming known as a trusted place for investors to build their financial health is central for us
- And we have devoted much time and energy to that side of the business
- As a measure of our success, roughly one-fourth of our net new assets in the quarter were in retirement accounts
- We closed out retirement season strong ending Q1 with nearly $50B in retirement assets, up 11% from last year

ADVICE-BASED SOLUTIONS

- A key component of growth here is advice-based solutions and we're encouraged by how these assets continue to perform
- Assets in managed accounts reached $3.2B this quarter, up an impressive 24% from a year ago

- We also continued our steady drumbeat of customer-driven digital enhancements
  - These included making it easier for our customers to manage taxes related to their investments, creating an even better experience for our most-active traders and delivering more functionality to already leading mobile platform

NEW TAX CENTER

- A new tax center delivers a more intuitive and helpful experience by centralizing tax documents and better positioning resources and education for cost-based reporting, gains and losses and tax-efficient investing
- We also made multiple improvements to E*TRADE Pro, our platform for active traders, including tax lot trading, pattern day trading enhancements and order entry updates, which when taken together deliver more customized, intuitive and hassle-free experience for our most-active customers

MOBILE TRADING AND INVESTING

- With a record 13% of our total DARTs placed through our mobile application this quarter, we continue to fortify our position as a leader in mobile trading and investing, adding multi-leg options functionality, employee stock plan trading and stock alerts, to name a few
- Just weeks ago, we announced a meaningful step forward in the wearable space with our app for the Apple Watch
- The Apple delivers essential market data in an engaging and simple format to help investors and traders monitor their portfolios, watch lists and the markets
  - It also includes handoff functionality that delivers a seamless transition from watch to phone

Leading-Edge Technology Offerings

- Our continuous improvements in leading-edge technology offerings are not going unnoticed as we've received a number of accolades from well-recognized external sources
- Barron's rated us four out of five stars in their Annual Online Broker Survey, scoring high marks in research amenities and customer service and education
- StockBrokers.com gave us three first-place awards; Number-One Smartphone App, Number One Client Dashboard and Best New Tool for E*TRADE Browser Trading in their 2015 Online Broker Review

BEST-IN-CLASS RATINGS

- In the same review, we earned five best-in-class ratings for Offering of Investments, Investor Education, Research, Mobile Trading and New Investors
- We were also recognized by Benzinga in their first-annual Fintech Awards for our Browser Trading web app
- And lastly, I recognize that I run the risk of being ungracious and boring you when I talk about the importance of risk
- And my sermon on the subject hasn't changed
  - We've built out these capabilities, we're running a world-class ERM department, and risk management is at the heart of everything we do

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Michael A. Pizzi
Executive Vice President and Chief Risk Officer

HIGHLIGHTS

Risk Management

- I first want to first take a moment to talk about the central role risk management plays here at E*TRADE, and then I'll move into credit risk and an update on the legacy loan portfolio
- In 2012, we devoted significant focus to bolstering our enterprise risk management as a key component of our capital plan
- At the time, we had prudent and strong financial risk management, but significant work remained to establish a fulsome operational risk framework
- We looked to a number of outside experts for input and best practices and collectively determined that there was a need for much clearer and more robust governance, escalation and root cause analysis
  - We have spent the past several years putting these systems and processes in place, in conjunction with building out robust and highly-credible stress testing capabilities, as well as making significant enhancements in third-party oversight, model risk management, ongoing risk assessment and monitoring

ERM FRAMEWORK

- Our hard work has resulted in an enterprise risk management function that is consistent with that of much larger institutions
- In practice, our ERM framework consists of three lines of defense:
  - The first line, the various lines of business within the company
  - The second line, the risk organization along with our colleagues in compliance and legal
  - And the third line, the internal audit group

COVERAGE MODEL

- We have built a coverage model where each area of the company's business has a dedicated partner in the risk, legal and compliance areas
- We have also worked to improve and develop the company's risk culture, having conducted workshops throughout the entire organization to ingrain risk management into the very fabric of our organization and to make sure each colleague knows they are risk owners within their respective areas

PERFORMANCE MEASURES

- We have built a strong risk management culture, tying risk to performance measures down to the individual level
- In short, risk management is part of everything we do at E*TRADE
- As you've heard Matt and Paul say before, the build out is key, but sustainability is critical
- The latter is how I would characterize the phase we are in today, demonstrating the sustainability and effectiveness of the program we've worked so hard to install
  - And while I feel good about how far we have come, we will of course continue to fine tune our practices to evolve both with the operating and regulatory landscapes

Credit Risk Management

- Now, on to credit risk management, an important, yet diminishing component of my role
- The loan portfolio ended the quarter at $6.1B, down $317mm from the prior quarter

  - This was essentially all paid-outs, as charge-offs were flat to the prior quarter at just $7mm
- We expect quarterly runoff of the portfolio to remain in the 4% to 5% range throughout 2015
- Provision for loan losses was $5mm in Q1, down from $10mm in the prior period
- Matt will give you more color around our provision expectations, but clearly this quarter was better than we anticipated

HELOC CONVERSIONS

- As we navigate through the upcoming HELOC conversions throughout the remainder of this year and next, this will be the most-prominent variable in determining our provision expense
- Thus far we have a very small sample of loans that have converted
  - They are generally our higher credit quality loans
  - And while they have largely performed more favorably than expected, it is very early days
- As we approach a more meaningful amount of conversions, we are working with our servicers on proactive borrower outreach and loss mitigation, where possible
- Meanwhile our allowance ended the quarter relatively unchanged at $402mm
- The reserve shifted slightly with an increase in the 1-4 family book and a decrease in home equity
  - The 1-4 reserves increased $4mm to $31mm, home equity reserves declined $7mm to end the quarter at $360mm
  - The decline related to better-than-expected performance following a planned servicer transfer, for which we previously booked reserves

EARLY-STAGE DELINQUENCIES

- The transfer took place in February and is also the driving force behind the increase in early-stage delinquencies this quarter
- We also had a planned servicer transfer in the 1-4 portfolio, which drove an associated increase in early-stage delinquencies
  - However, we did not recognize reserves for this transfer as 1-4 loans typically self-correct, whereas the cure rate for home equity is much lower

Summary

- So, in summary, credit risk is becoming a smaller issue with each passing quarter and we are proud of the progress we have made to become an institution known internally and externally as one that is serious about and committed to risk management

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Matthew J. Audette
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Debt and Net Income

- We'd a pretty tremendous start to the year
- After a multi-year effort, our corporate debt is now where it belongs
- And on top of that, we posted strong operating results driven by a number of factors

- We reported first quarter net income of $85mm or $0.29 per share, excluding $73mm pre-tax charge related to our corporate debt transaction
  - Excluding a similar charge of $59mm in the prior quarter, this compares to net income of $78mm or $0.26 per share and net income of $97mm or $0.33 per share in the year-ago quarter

Net Revenues

- Net revenues of $456mm were down from $461mm in the prior quarter and $475mm in the year-ago quarter
- Revenue included net interest income of $271mm, down $8mm from the prior quarter, as net interest spread contracted 7 BPS and our average assets increased approximately $200mm
- Although spread contracted sequentially, at 262 BPS, it was above our expectations as we once again benefited from elevated margin loan balances and strong securities lending results
  - After experiencing declines in both of these at the beginning of Q1, both trended upward in the second two months of the quarter

Spread Compression

- We also saw some spread compression as a result of a slight increase in prepayments and lower reinvestment rates on the securities portfolio
- In Q2 to-date, rates continue to be challenging
- If we hold today's environment constant, our net interest spread would be in the low to mid-250 basis point in Q2

BALANCE SHEET

- Our balance sheet ended the quarter at $46.8B, up $1.3B from the prior quarter
- We completed the conversion of our sweep deposits to a new platform during the quarter and began to put it to work in March, moving $1.25B of customer deposits held by third-party banks back on our balance sheet
- With this new platform, we can much more efficiently move deposits on and off-balance sheet giving us a powerful tool for managing balance sheet size

Brokerage Customer Cash

- We have converted approximately $15B of our $42B in brokerage customer cash to the new platform
- Of that $15B that has converted, a little under $4B is held by third-party banks and a little over $11B is on our balance sheet
- One component of our customer cash is money funds, where approximately $8B resides, largely as a result of our deleveraging efforts
- We would ultimately like to move that portion into the sweep program as it has benefits for both us and the customer
  - It's a more lengthy process, involving system changes and customer consents, but we are working on it and will keep you posted

Revenue

- With the rollout of the new sweep platform, we've determined that classifying the revenue generated from off-balance sheet deposits in fees and service charges as opposed to net interest income is more consistent with how this type of revenue is generally presented within the industry
- Accordingly, Q1 has about $5mm of reclassified revenue in this line, which is up from $4mm in the prior quarter and $3mm the year-ago quarter
- For comparability purposes, prior periods have also been reclassified

Commissions, Fees, Service Charges and Other Revenue

- Commissions, fees and service charges and other revenue in Q1 were $176mm, flat with the prior quarter and down 6% from the year-ago quarter
- Average commission per trade of $10.94 increased $0.10 on the prior quarter and $0.30 from the year-ago period
- The quarterly increase was driven by higher stock plan trading, while the y-over-y increase was driven by a more favorable options and customer mix
- Fees and service charges revenues of $52mm included $23mm of payment for order flow, flat with the prior quarter

Net Gains and Operating Expenses

- Net gains on loans and securities were $9mm this quarter, up from $6mm in the prior quarter and in line with our expectations of $5mm to $10mm
- We stated last quarter that if rates remain low, we would likely be at the high end of the range and that is exactly what you saw this quarter
- Our operating expenses for the quarter were $300mm, up $6mm from the prior quarter, driven primarily by comp and ben, which reflected a seasonal increase
- Our operating expenses for Q1 were well in line with our expectations and we are still planning for full-year 2015 expenses to increase in the low- to mid-single digits

Provision

- As Mike discussed, provision for the quarter was $5mm
- Given what we have experienced and the healthy reserves we maintain, we are adjusting our expected provision range for this year to zero to $20mm per quarter, effectively expanding and lowering our prior range of $10mm to $20mm
- Looking ahead to 2016, we are also adjusting our expectations, now forecasting provision to land at or above the top end of our current range
  - This is slightly improved from our prior range of $20mm to $30mm per quarter
  - However, I must caution the visibility into performance this far out is certainly limited, and we will adjust our expectations as we gain clarity

HELOC Conversions

- As Mike mentioned, HELOC conversions will be the most-important variable here
- There's still only a small population of loans that have actually converted

- We will have more significant data throughout the year as there are approximately $500mm of loans that will convert over the course of the next three quarters
- We will then have $900mm converting next year, after which this event will largely be behind us
    - We will certainly keep you apprised of any trends that we see in the performance of these loans

Capital Plan

- Turning now to the capital plan, to re-emphasize what Paul said earlier, we've accomplished a lot in 2015 already
- To recap Q1, we utilized $432mm of corporate cash to pay down $340mm of debt and refinanced another $460mm at 4.625%, the lowest coupon in the company's history, while extending our maturity profile by more than two years, with our nearest maturity now in 2022

Debt Reduction

- Debt reduction was a central goal of the capital plan, when we first laid it out in June of 2012
- As we worked on our plans for a number of reasons, it became clear that $1B was the right amount
- Now that we are sitting at $1B and with no more space on my shelf for [ph] dead (20:35) deal toys, it feels good to be done talking about debt reduction and focusing on what is next

Capital and Liquidity

- At the moment, we are working to ensure a smooth transition of our Clearing broker from under the bank
    - Since this entity has been under the bank, it has benefited from a shared surplus of capital and liquidity
    - As we prepare to move it out, we have to establish and formalize new lines of liquidity, even though these may ultimately remain undrawn
    - In conjunction with this, we are also evaluating whether it makes sense to move additional capital into that entity
- So, the bottom line is that until we determine how E*TRADE Clearing will be situated from a capital and liquidity standpoint, it is prudent to wait on further capital actions
- As a reminder, we intend to move the entity in H2 this year

Tier 1 Leverage Ratio

- With the approval to manage the bank to a 9% Tier 1 leverage ratio, we ended the quarter nicely above that threshold, at 9.8%
- The implementation of Basel III benefited that ratio by approximately 90BPS
    - Keep in mind that this still includes E*TRADE Clearing and its existing capital and assets
    - Excluding it would have decreased our ratio by approximately 10BPS
    - So, on a pro forma basis, we have approximately $240mm of capital in excess of our regulatory threshold at the bank

Dividends and Net Income

- As a reminder, we plan to request quarterly dividends from the bank to the parent equal to its prior quarter net income
- In Q1, net income for the bank was $92mm

- Also, during Q1, E*TRADE Securities generated approximately $50mm in excess capital, which we plan to move to the parent next week
- So, to echo Paul, we are in a position of strength when it comes to the capital available to us and we are very deliberately working through how to most appropriately put it to use
- I don't have specifics for you today, but I would like to offer my thoughts on a few of the options
- To start, under our new structure, we will have capital available for use at both the bank and the parent
- At the bank, we will have the ability to utilize capital in excess of our 9.0% Tier 1 leverage ratio

Share Repurchase

- Our most-prominent options include balance sheet growth and the acceleration of legacy risk reduction, meaning potentially eliminating wholesale funding obligations ahead of schedule and selling the remainder of the loan portfolio
    - While neither of these actions are in our plans today, we are constantly assessing the path forward as it relates to legacy risks
- At the parent, we have the ability to utilize capital from the broker, plus the planned quarterly dividend requests equivalent to the bank's net income
- Obvious uses include share buybacks, dividends and investing in the business where we see opportunity for healthy returns

Assets

- For a little more detail on these items, balance sheet growth is certainly an option, especially in a more attractive rate environment than the one we find ourselves in today
- We ended the quarter with $46.8B of assets, up $1.3B from the prior quarter, which is largely the result of the implementation of our new sweep deposit program
- So, we still have some room to utilize capital by growing the balance sheet, while staying below $50B, which remains our intention

Wholesale Funding

- On wholesale funding, we ended the quarter at $4.6B, with $365mm scheduled to expire primarily in H2 this year
- The cost to eliminate these borrowings would be approximately $450mm pre-tax, which is essentially the acceleration of future costs, so relatively neutral from an economic standpoint
- While there are certain benefits of accelerating the path toward normalized earnings, there are also other considerations which we would need to work through
    - Incurring a loss of this magnitude at the bank could have implications for the capital plan and intercompany tax-sharing arrangements
    - Additionally, keep in mind that the duration profile of wholesale funding is generally longer than that of our deposits, impacting the economic benefit analysis of replacing wholesale with deposits
    - In short, our current position is to keep this funding source on our books; however, we are doing the work across multiple complex dimensions to determine if this should change

Loan Portfolio

- The loan portfolio is a similar story

- It is still our intention to hold those loans on our books, as that is precisely where we believe the value is maximized
- However, as they continue to season and the risk become more visible, we are keeping a watchful eye on the secondary market
    - The bottom line is they are worth more today to hold on to, but if the secondary market for our portfolio were to firm up significantly, our thinking could change

Capital

- Now, turning to capital at the parent, with the introducing broker-dealer directly under the parent, we have a more definitive source of capital and some additional flexibility for how we put our capital to use
- At quarter end, we had $258mm in parent cash, approximately $150mm above our target of two years' debt service coverage of $100mm
- Over the near-term at least, our flexibility here is limited by other considerations, including covenants within our corporate debt, which will be a factor as long as our credit rating is sub-investment grade
    - And obviously, our board and regulators are constituencies that are involved in these matters
    - What I want you to take from all of this is that we have some items to work through
    - And as we have throughout the course of our capital plan progress, we will update you when appropriate
    - But I can assure you that our objective is to deploy this capital in a way that maximizes value for our shareholders

SUMMARY

- In summary, and speaking for the entirety of our management team at E*TRADE, we are full steam ahead
- We have checked a number of exceptional accomplishments off our to-do list already and we are eager to keep moving down this track

QUESTION AND ANSWER SECTION

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

I guess, the first question is for Mr. pellucid, the CFO, and it has to do with the clearing that you mentioned, the capital use – the potential capital usage for the [ph] clear (27:08) as you move it out from underneath the bank. And I guess the question is, can you frame that at all as far as what you think the high end could be or what the range could be, because it's really difficult – I don't have a feel for what the even potential could be? And then also, the DTA, I believe you recognized $240mm of a benefit from the DTA that – could you verify that as well?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. Sure, Rich. So, the DTA, you've got right. If you remember last quarter, and specifically down at the bank, we had about $600mm, half of which was included in capital. And looking at where we are today, the majority of it's included in capital. So, I think that number you used is correct. On the Clearing side, I don't have specific numbers for you, but I would say that the vast majority of what we are working on is making sure it has external lines of credit, appropriate for its size and activity. And at most broker-dealers, those lines of credit typically remain undrawn.

As I said, we are also looking at the capital side of things, but I would say that the vast majority of the things that we need to set up are on the liquidity side, not the capital side. So, hopefully that gives you some directional comfort without a number.

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

Okay. And I guess, just one follow-up, would the improved guidance on the provision going forward – was that a result of – you probably said it, but I didn't get it, but the early indication from the home equity loan amortization, the results you saw so far, what – I didn't get what the driver was there.

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. I'll let Mr. distinguished take that one.

Michael A. Pizzi
Executive Vice President and Chief Risk Officer

A

It's a number of factors. As we move through, new loans move into the period of the allowance, we look at the behavior of credit of the loans – of the period. And essentially, we are coming in better than expected.

Alexander V. Blostein
Goldman Sachs & Co.

Q

So, lots of great detail there. Appreciate all the color there. So, just a couple of quick follow-ups, I guess, on capital. I think, there is – so, understand you guys are going to be distributing all the capital, all the net income from the bank into the holdco. Can you give us a sense of what the difference is on kind of pro forma run rate basis between capital generation vs. net income at the bank, i.e. there seems like there might be some extra capital buildup still at the bank even after you guys distribute it to the holdco?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Sure, Alex. I think in the past the majority of that difference was really driven by the DTA benefit. Now, under BASEL III, and kind of building off of Rich's observation or comment, the majority of that is now already included in capital. So, when you think about capital generation at the bank, there could still be a little bit more. But I would say it's going to be much closer to earnings than it was in the past, because the DTA is pretty much included in capital now.

Alexander V. Blostein
Goldman Sachs & Co.

Q

Got it. Okay. Just double checking that. And then as far, I guess, as just the process goes from deploying capital both out of the bank as well as out of the holdco on a go-forward basis, and I understand you guys are evaluating lots of options and the timing might differ. But the way the regulators will approach this topic with you guys, just maybe give us a sense of how onerous would it be for you to take capital actions at the holdco and now that a lot of capital sits out of the bank, would you have to talk to the same regulators or is it perhaps – might be little bit easier to do out of the holding company? And then, with respect to breaking wholesale funding at the bank, would you have to get a pretty explicit check from the regulators, I guess, to do that?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Alex, I want to be careful how we answer this, just so that we're clear about it. We have constant dialog with our regulators, whether it's Matthew covering our progress on the capital plan, whether it's Mr. Pizzi covering how we're doing on certain risks and how we're doing building risk elements out. And so, whether somebody requires a formal notification or otherwise, we are working with the regulators on our plans and the direction we're taking. So, I don't think of it as onerous as otherwise with the clarity on our bank capital ratios that we recently achieved, it just makes having some of those discussions take place just more quickly, simply because the parameters are much clearer and because we've continued to work on making sure that our regulatory standings where it should be.

So, is it any easier? I'm not sure it's any easier or not easier. I think it's just clearer the direction we're traveling and I would say that both the board and the regulators are provided with the clarity that's required and this could dialog other way around. So, there's no surprises and sort of no sudden movements.

Chris M. Harris
Wells Fargo Securities LLC

Q

Just a few follow-up clarification items. The off-balance sheet deposits, I just want to make sure we have it correct. How much of that total could you guys theoretically access, assuming – I know you don't want to go over the $50B asset threshold, but what is really readily accessible today or in a short period of time?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. So, I think I'd highlight a couple of things there. One, keep in mind we moved $1.25B on balance sheet during the quarter. So, we have – in the new sweep program, I highlighted we have $15B, of which $4B is off-balance sheet today. You wouldn't bring all of that back, because there's a decent amount of it that's off-balance sheet in that for FDIC insurance purposes. So, I would think about a portion of the $4B from a max possible perspective, a portion as the $4B. And in addition to that, over the long term, which we're working on, is that $8B or so in money funds that ultimately we would want to have into the program, which would then give us the flexibility. So, hopefully, it gives you some color there.

Chris M. Harris
Wells Fargo Securities LLC

Q

It dose. Yeah. Thank you. And then, a few on capital. Last quarter, when your guys announced the separation of Securities and Clearing, I thought we were showing that about $900mm of capital is going to Clearing. Is that still a good rough estimate about what might be there? That's one question. Then the other is how much capital is sitting at Securities today?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

So, on the Clearing side, that's a good estimation. But keep in mind, it's got its own balance sheet. So, from impact to a capital ratio standpoint, it's only going to reduce the leverage ratio at the bank by about 10 BPS. As far as E*TRADE Securities go, it generated about $50mm of excess capital and that's what we plan to move next week.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. Great. And last question just kind of a bigger picture question, I suppose. All of the work you've guys have done in risk management, you've certainly highlighted that on tonight's call. How do you guys think that positioned you when the day comes where you want to kind of exceed the $50B threshold at the bank? I mean we know a lot of other smaller banks getting into some trouble just because they didn't seem to have – had a robust system. And I'm just trying to get my arms around whether all the work you guys have done really puts you in a good spot there?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Chris, as you know, and I think we've been fairly pointed on this topic in the past calls, we have no intention to go over $50B in any timeframe that could be considered near term. I would say that the enterprise risk management capabilities we've built out puts us in a position where should we ever decide to do that that we would just be beginning from a stronger base than we would otherwise.

And as we continue to do the things under Mr. Pizzi, they just – to continue sustaining and strengthening and using the [ph] TrimTabs (35:48) to adjust based upon the environment and what our regulatory requirements are, we'll maintain a posture that says should we wish to do that, we'll have a very good idea of what we need to do. We'll have some credibility with the regulators. We'll get good counsel from the regulators. So, we feel we're in a stronger position to move in a direction we want to should that ever occur.

Michael R. Carrier
Bank of America Merrill Lynch

Q

If I look at what you said in terms of what you guys have the flexibility at both, like, the bank and the parent your priorities, when you're looking at the options, are you analyzing them based on what you can do, like, at the bank and then separately at the parent, or if one of those opportunities – let's just take the wholesale funding – is the most attractive once to do the analysis and you get the approvals, can you use the amount of capital that would be necessary to do that, or is it more of a separate decision based on where the capital resides?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. So, there is a – it's almost both, Mike. So, the issue is, when you look at our plans, we've got excess capital at the bank that we could utilize, we also have capital at the parent. But using I think wholesales is a perfect example. To the extent we did that down at the bank and the reason that we're spending a lot of time analyzing this, there could be repercussions up at the parent. As an example, our intention to request the bank's prior quarter earnings as a dividend, while if we took out wholesale, that's $450mm pre-tax loss down at the bank. And then, you also have intercompany tax-sharing arrangements that could be impacted as well. So, it's kind of, yes, we look at them separately, but certain transactions can impact the other. So, there is a lot of work to do here. We are working on it to understand it, but there is a lot of work to do.

Michael R. Carrier
Bank of America Merrill Lynch

Q

Okay. Thanks. And then just a follow up, based on, with the DOL put out on fiduciary standard, just wanted to get a sense, in the different businesses that E*TRADE's in, do you see any potential impacts and then obviously the proposal, it's early, and then on the flip side any areas of potential opportunities?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, we're working through all the documents and statements and assessing how the evolving standards may impact our business. Given our model, we don't expect that impact to be too extreme. But we're doing more work both internally and externally to fully understand the implications. Overall, our intention is to work to do what's best for our customers each day, irrespective of any regulatory changes. So, we are going to continue to keep a watchful eye and what changes may through with the final rules and then update what we do, as appropriate.

Bulent Ozcan
RBC Capital Markets LLC

Q

So, there have been many positive developments on the regulatory perspective, which is great. I spent a lot of time going through my initiation, going through the various risk factors and disclosures. And I have noticed that there is an understanding – or Memorandum of Understanding at the bank. Could you give us an update on this MOU and any other restrictions? And did you under – are there any new developments as of recently?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, let me first put a little bit of context around this and congratulations on doing your homework.

Bulent Ozcan
RBC Capital Markets LLC

Q

Thank you.

Paul Thomas Idzik
Chief Executive Officer & Director

A

MOUs, they lay out a number of actions which an institution such as ours agrees to undertake with their supervisors, and many of these are really meat-and-potatoes tasks; things we need to do, things we need to put in place. But importantly, these have to seasoned with the right culture and the right attitude. I'm pleased to confirm that we've satisfied the OCC's requirements and that we are no longer subject to that MOU. But I also want to emphasize that we have close and continuous supervision from our two chief banking regulators that's the OCC and the Fed. And maintaining good regulatory standing remains a priority of this management team. So, as the environment and our business evolves, so logically will regulatory expenses and we'll give those our full attention. Does that answer your question?

Bulent Ozcan
RBC Capital Markets LLC

Q

Yeah. And maybe a second question, if I may. So, now that you've optimized your sweep program, I'm just wondering – maybe it's a different angle at the previous question, but what sort of a buffer would you need to stay below the $50B threshold? And just given the sweep program organization also, in terms of the changes, how long does it take you now to basically transfer monies to third-party institutions and then back again to you? Just about the duration, is that a much faster process and what kind of buffer do we need?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. So, on the buffer, I mean, just using the – under the old program, where customer activity drove the amount of deposits that were on or off-balance sheet, meaning it was outside of our control, we wanted a fairly decent buffer, which is why you've seen us around the $45B, $46B for quite some time. Under the new program, which is impacted by the – your second question, timing, which I'll answer, but under the renew program, to oversimplify, we really just choose our balance sheet size. And again, I will repeat it, it's oversimplifying, but it's in that ballpark. So, I think our comfort on a buffer is much closer to $50B, but it is absolutely a number below $50B. So, we'll see that where that takes us now, meeting in the – call it, the $49B range.

With respect to timing, the timing is relatively efficient. I mean, if you – I think in your research and your initiation coverage discussing all of the different things that we did from a deleveraging standpoint, those took a lot of work, a lot of time, a lot of individual negotiations with banks, so months and months and months to get in place. Whereas now, it's literally just planning with our third-party sweep service provider about when and how we want balances to be on and off-balance sheet, so it is incredibly quick and efficient from a timing standpoint as well.

Bulent Ozcan
RBC Capital Markets LLC

Q

I understand. And then, maybe a final one, and that will be it for me. So, if you think about your systems that you have in place, and I'm not suggesting that should be over $50B in terms of the threshold, but could you go over the systems and your ERM and how much it could actually handle in terms of the balance sheet size? Would you need to add a lot more in terms of CapExs and investments into your business to build that system at this point?

Michael A. Pizzi
Executive Vice President and Chief Risk Officer

A

Yeah, we've scaled – built an ERM platform that is scalable. I mean, we knew where we were balance sheet size when we set out on this journey. That said, there are some very specific things you need to do as you become larger. Those things will have costs that need to be built out. Probably the easiest one you can point to is the resolution point. But there are lots of other things that we can go through. There are things that will then drive explicit investment, but we've built the underlying platform to be scalable. And so, knowing that growth is important, but keep in mind Matt's comments around the wholesale funding and other items; there's plenty in flexibility to accommodate that growth and remain under $50B.

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)

Q

So, just a lot of noise around robo-advisors here. And I think one of your peers gave us a little bit update earlier this morning on one of the new offerings. I know you have one of your own. Just curious if you're seeing increased flows into your offering. And as you look at the – as you assess some of the new competitive offerings out there, if you think there's anything you need to add from a capability perspective to your current offerings.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Yes. Thanks for the question. It's certainly topic du jour in the industry right now. And we've offered those capabilities given our heritage, which is intending to make the playing field level for small investors to be able to compete with bigger investors and bigger traders. So, our heritage has always been to put the educational resources and the tools in the hands of our customers. So, we've had robo-advisory capabilities built into our platform for quite some time.

Now, frankly, I'm a bit disappointed that we haven't marketed this capability as well as we might and there are some additional capabilities we're working on building into our robo-advisory platform. But we're pretty satisfied that today we have the core tools we need and we'll be building out more as we have when some of the other things you've heard us winning awards on. So, thank you for the question.

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Thank you. That's helpful. Just a couple of questions, Matt. Just on the risk-weighted assets book for the total firm, pretty steep decline in tradition to Basel III. Was that just the margin loans being risk-weighted to zero or was something else driving that?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

No, you got it, margin loans.

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Pretty simple. And then, consultant headcounts fell pretty sharply in the quarter. It's a small number, but just curious if anything is going on there?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah. Nothing is going on. Some cleanup in the metric; we had some heads in there that weren't really consultants, they were just third-party providers that really shouldn't have been in that headcount. So, really, cleanup in the metric; no change in costs or anything like that.

Daniel T. Fannon
Jefferies LLC

Q

A question on the loan portfolio and just clarifying, I think, some of the comments about the uptick in the early-stage delinquencies with regards to change in servicing – or change in servicers. So, does that mean that all else equal, the normalized number would have been lower and we can think about that progression through this year as – I'm just trying to think about how we should think about this as a starting point vs. where we can go from – throughout this year?

Michael A. Pizzi
Executive Vice President and Chief Risk Officer

A

Yeah. There were a number of servicing transfers that occurred in the quarter, both in the home equity book as well as in the 1-4 family. In the home equity portfolio, because of our history with those transfers, we've increased the reserve around that in prior quarters. The actual performance came in better. That's what we've – the note that we highlighted. That's related – that is essentially flowing through. In the 1-4 book there are also transfers. The transfers there also are affecting the delinquency levels, but we expect those to fully cure.

Daniel T. Fannon
Jefferies LLC

Q

Okay. And then, just thinking about the comments for March and the actual trading activity, I think 6% down for March. Wondering kind of how – I'm sorry, for March and April, and then if you could talk about margin balances in April. And then, generally, your expense guidance is still the same. If activity levels continue to kind of decline and you're in a little bit more of a softer environment from a revenue perspective, how are you thinking about the cost guidance in that backdrop?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah, Dan, so on margin then, without giving you a number, margin has been consistent with the prior quarters. It remained strong. So, it has not moved backwards like we saw in the trading side. On expenses, and I think a good opportunity to just take in our overall P&L and where and how we make our money.

Each quarter that goes by, when you look at the distribution of our earnings, where trading commissions fall out is not an enormous driver of our bottom line, from the amount we make on deposits, from the amount we make on margin and stock loan to the growing amount of fees and service charges from our managed products and programs. So, I think the growth and the diversification of our business model is really providing many opportunities, including not having to start projects when trading is up and stop them when it's down. So, a long way of saying, I think we feel quite comfortable with the expense guidance.

Joel Michael Jeffrey
Keefe, Bruyette & Woods, Inc.

Q

I know you guys have been talking about the last couple of quarters being able to move the total earnings from the bank – or making request to move the last quarter's earnings from the bank into the parent company. But I'm just curious, have you already received regulatory approval to do that and is it just a function of actually making the requests? And is there any risk that the regulators would say no to this?

Matthew J. Audette
Chief Financial Officer & Executive Vice President

A

Yeah, Joel. So, like every step on the capital plan, we need individual approvals. So, the plan is to request the prior quarter's earnings. But we need to get approval each and every step along the way. So, no approvals until we get them.

Joel Michael Jeffrey
Keefe, Bruyette & Woods, Inc.

Q

Okay. So, is there any level of risk that a regulator would say no to this?

Matthew J. Audette
Chief Financial Officer & Executive Vice President
A

Well, I think the level of risk is on us to execute our plans well. I think we need to focus on that and continue to do it. And I think the capital plan and successes under it will follow. So, I think it's on us to execute.

Devin P. Ryan
JMP Securities LLC
Q

But just coming back to the Securities yields and, I guess, the net interest spread overall, just given kind of the ongoing pressure on Securities yields still occurring this quarter, I know that Securities book management is dynamic. But have you guys made any changes to where you're targeting duration and putting new cash to work? And then, also appreciate the color on the net interest spread and what that will look like if rates hold constant into Q2. But if we look beyond Q2, how much more compression could we expect into the back half of the year if rates weren't to move from here?

Matthew J. Audette
Chief Financial Officer & Executive Vice President
A

Yeah. So, Devin, no changes on where we're deploying cash. And our philosophy here is really to manage a balance sheet off of the duration of the deposits coming in. So, that's for our focus. With respect to where are spread's going, I mean, there's really two data points I have for you, which is the low- to mid-250BPS for next quarter and then ultimately migrating up to 300BPS in a normalized environment. The steps along the way, just have to wait for another data point next quarter.

Devin P. Ryan
JMP Securities LLC
Q

Okay. Fair enough. And then just with respect to the Clearings sub and when that moves, I know the margin balances will move as well. Are there any other considerations on the asset side that we should think about?

Matthew J. Audette
Chief Financial Officer & Executive Vice President
A

Yeah, stock borrow as well. So, that's – I mean, it's not a dramatic number, less than $1B, but the stock lending book goes along with it