
MANAGEMENT DISCUSSION SECTION

Operator: Welcome to E*TRADE Financial Corporation's second quarter 2009 business update call. At this time, all participants have been placed on a listen-only mode. Following the presentation the floor will be opened for questions. I've been asked to begin the call with the following Safe Harbor statement.

During this conference the company will be sharing with you certain projections or other forward-looking statements regarding future events or its future performance. E*TRADE Financial cautions you that certain factors, including risks and uncertainties referred to in the 10-Ks and 10-Qs and other documents E*TRADE files with the Securities and Exchange Commission could cause the company's actual results to differ materially from those indicated by its projections or forward-looking statements. This call will present information as of July 22, 2009. Please note that E*TRADE Financial disclaims any duty to update any forward-looking statements made in the presentation.

During this call, E*TRADE Financial may also discuss some non-GAAP financial measures in talking about its performance. These measures will be reconciled to GAAP either during the course of the call or in the company's press release which can be found on its website at investor.etrade.com. E*TRADE has filed a Definitive Proxy Statement with the SEC. Shareholders are advised to read that document and related proxy materials before voting at the special shareholders' meeting scheduled for August 19.

This call is being recorded. Replays of this call will be available via phone, webcast and podcast beginning today at approximately 7:00 PM Eastern Time. The call is being webcast live at investor.etrade.com. No other recordings or copies of this call are authorized or may be relied upon.

I'll now turn the call over to Don Layton, Chairman and Chief Executive Officer of E*TRADE Financial Corporation who is joined by Bruce Nolop, Chief Financial Officer and other members of E*TRADE management team. Mr. Layton, please go ahead.

Donald H. Layton, Chairman and Chief Executive Officer

Thank you all for joining us this afternoon. This quarter marked several important milestones for the company, and we appreciate the opportunity to discuss with you the progress we have made. Bruce will take you through our financial results for the quarter, but first I want to address three topics with respect to the quarter's strong results; growing our core franchise, managing our credit portfolio, and executing against our comprehensive capital plan.

First let me touch on our core franchise, which continues to perform exceptionally well. Our online brokerage business is, quite simply, thriving. We continue to take market share from traditional brokerage firms and to benefit from favorable market conditions, with increases in transactions, new customer accounts, and both commission and interest income revenue.

Second quarter trading activity was robust. We set a new quarterly record at 221,000 daily average revenue trades or DARTs, our second such trading volume record in the last three quarters. This represents a 14% increase over the prior quarter and a 28% increase over the same period in 2008. As we continued to benefit from our enhanced focus on the investing customer and favorable market conditions and as customer buying power and confidence improve with the markets, margin receivables increased 29% to 3.1 billion at the end of the quarter.

We also saw significant growth in brokerage accounts this quarter reporting a record 2.7 million accounts, a net increase of 54,000. With our emphasis on growth in brokerage accounts we now

have added more than 200,000 net new accounts during the last 12 months, far higher than historic averages. I should also point out that brokerage account attrition continues to trend lower. Attrition was just 12.6% annualized, versus 15.4% annualized for the same quarter a year ago. In addition, we averaged 1.65 brokerage accounts opened for each one closed, a 33% increase over the year ago period. The improvement in both of these metrics reflects our focus on the brokerage customer, especially in terms of improved service quality.

Total customer cash and deposits decreased \$700 million. This net reduction reflected a \$1 billion increase in brokerage cash, our most advantageous source of funding, offset by a decrease in non-sweep deposits of \$1.7 billion.

As a reminder, we are decreasing our non-sweep deposits to accommodate the reduction of our balance sheet due to the fact that our loan portfolio is in full runoff mode. We were able to achieve the reduction in non-sweep deposits chiefly by reducing the yield on the Complete Savings Account or CSA, by more than 200 basis points this year. The CSA yield began the year at 301 basis points, which was reduced to 145 basis points as of March 31, and stands at 95 basis points today. Still we added \$900 million in net new customer assets this quarter, even with the impact of the planned reduction of non-sweep deposits.

Our focus on the investor franchise and our back-to-basics approach is producing strong customer performance metrics quarter after quarter. This approach emphasizes excellence and discipline in execution, and continuously improving service quality and addressing customer dissatisfiers, along with a full product development pipeline for long-term investors as well as for our active trader client base. As a result, our vibrant and profitable online brokerage business is providing an excellent foundation from which to build future growth.

Let me now turn to credit. For the second consecutive quarter, our loan portfolio has shown improving delinquency trends. Our delinquency numbers clearly suggest that our loan portfolio is further advanced in the credit cycle than the broader industry.

In the home equity portfolio, which represents the company's greatest exposure to loan losses, special mention delinquencies – that is 30 to 89 days delinquent, declined by 12%, and at-risk delinquencies – that is 30 to 179 days, delinquent declined by 19% from the end of March. These declines seem to be indicative of both the advanced seasoning in our home equity portfolio, which carried an average seasoning of 43 months at quarter end, and our aggressive actions in 2008 to reduce open lines.

Our one-to-four family loan portfolio has begun to show encouraging signs of reduced delinquencies this quarter. Specifically special mention delinquencies are down 4% from March 31, and total at-risk delinquencies are similarly down 3% from March 31. Roll rates are stable overall, although there was a modest increase in severity at the 180 day charge-off point from 21 to 24%. For the total loan portfolio the decline in special mention and at-risk delinquencies resulted in another significant quarterly reduction in provision expense.

Before I move on from credit, I wish to mention that our increasingly successful loan modification program is contributing to the meaningful improvement in the quality of the loan portfolio. We have completed over \$250 million in loan modifications, primarily via permanent or temporary interest rate reductions, and we are pleased with the performance of this program, and its success in allowing more Americans to stay in their homes.

Finally, let me turn to the very significant progress we recently have made in executing our capital plan to strengthen our financial health and position the company for long-term growth and profitability. During the quarter we raised gross proceeds of more than \$600 million of cash common equity, materially strengthening our balance sheet.

Our capital ratios, which Bruce will take you through in detail, are now clearly stronger than they were at the beginning of the year, and will help to ensure that we remain significantly above the well-capitalized threshold as defined by our regulators, even under weaker economic conditions than are expected.

Equally important, assuming completion, our pending debt exchange for \$1.7 billion, which was more heavily subscribed than anticipated, will cut our cash interest payments at the parent company by more than half. We will hold a special shareholders meeting on August 19 to seek approval of the exchange of the irrevocably tendered bonds.

Assuming we receive shareholder and regulatory approval we'd expect to close the debt transactions by the end of the third quarter. Needless to say, we are thrilled with the results of our recapitalization to date. The success of the equity and debt transactions, we believe, demonstrate that investors see the strong franchise value and growth potential of our online brokerage business, that they see credit issues declining and becoming manageable, and that they see that our recapitalization gives our Bank a balance sheet strong enough to carry it nicely through the rest of this credit cycle.

With that I'll turn the call over to Bruce for more on the quarter's financials.

Bruce P. Nolop, Executive Vice President and Chief Financial Officer

Thank you, Don. During the quarter, we generated a net loss of 143 million or \$0.22 per share on net revenue of 621 million. The loss was due primarily to the loan loss provision of 405 million. While the provision remains high, we are pleased that it has decreased for the third straight quarter. It is more than 100 million off its peak and is nearly converging with quarterly charge-offs.

Our second quarter revenue included net interest income of 340 million, a 22% increase over the first quarter, which resulted from a 57 basis point expansion in the interest income spread to 291 basis points. The largest contributor to this significant spread expansion was the 50 basis point reduction in the annual percentage yield on our Complete Savings Account from 145 basis points to 95 basis points. We do expect to see a continuation of favorable interest rate spreads, but on a gradually declining balance sheet.

Commissions, fees, and service charges, principal transactions, and other revenue, were up 18% over last quarter, which reflected higher commission revenue from the record trading volume in the quarter and an increase in the average commission per trade by \$0.46 to \$11.05, which was due to a more favorable mix.

We continued to practice disciplined expense management, keeping down the costs that are within our control. However, operating expenses increased 35 million sequentially due to FDIC fees being higher by 29 million, which included a onetime \$22 million special assessment and 10 million in increased reserves for legal matters. Therefore, the additional volume-related costs were more than offset by our ongoing expense productivity programs.

Our loan loss provision of 405 million was slightly above the 386 million of net charge-offs during the quarter. The total allowance for loan losses thus was essentially flat at 1.2 billion as of June 30. This allowance was equal to 5.3% of gross loans receivable, which compares with 2.3% a year ago.

Total special mention delinquencies were down 8% from March 31, and total at-risk delinquencies were down 9%. The movement during the quarter included; for the home equity portfolio, at-risk delinquencies were down 19%. For the one-to-four family portfolio at-risk delinquencies were down 3% and for the consumer and other portfolio at-risk delinquencies were down 10%.

The allowance for loan losses as a percentage of non-performing loans, or the coverage ratio, ended the quarter at 83%, which was down from 92% last quarter. However, excluding the non-performing loans at least 180 days past due, as they have been written down to their expected recovery value, the coverage ratio was 169%, which was up from 149% last quarter.

To summarize, at-risk delinquencies declined across the portfolio, reflecting a consistent decline in special mention delinquencies that began at the beginning of the year for home equity loans and more recently for the remainder of the portfolio. We increased the one-to-four-family reserve, but reduced the reserves for home equity and consumer and other loans.

In terms of liquidity, we had 527 million of corporate cash at quarter-end. The bank had 4.5 billion of cash, and we had unused Federal Home Loan Bank credit lines of 6.7 billion. I should note that the decrease in unused lines this quarter reflects the Atlanta Home Loan Bank's revised rules that increased the haircuts on pledged collateral.

Finally, I want to provide more insight concerning our comprehensive capital plan to bolster the bank's capital cushion and strengthen the company's capital structure. We successfully raised 586 million of net cash equity in the second quarter. In total, we injected 500 million as equity into the bank during the quarter. The 500 million of new capital was much greater than our net usage of 28 million of risk-weighted capital during the quarter.

We generated 333 million of organic capital during the quarter through 232 million of bank earnings before taxes and credit losses and 101 million of freed-up capital through a reduction in the loan portfolio. Other sources and uses were a net contributor of 44 million. These positive amounts were then offset by the credit provision of 405 million, resulting in the net usage number of 28 million. Thus we realized a 472 million increase in the bank's capital cushion during the quarter, ending with 916 million in excess risk-based capital over the well-capitalized threshold.

We also reported bank Tier 1 capital on total adjusted assets of 6.79%, and Tier 1 capital on risk-weighted assets of 12.65%. At the same time, we are well on our way to materially reducing the Parent company's debt service burden. Assuming, we receive shareholder and regulatory approval we will exchange approximately 1.7 billion of non-interest bearing, convertible debentures for an equal principal amount of our existing high-yield debt.

Bondholder response to the exchange offer exceeded our expectations with Citadel tendering the maximum amount of 1.23 billion, and with virtually all other holders participating at their maximum levels as well. Assuming completion, this exchange will reduce the parent company's annual cash interest payments by approximately 200 million to an annual total of approximately 160 million. Our 527 million of corporate cash is up 121 million from the end of the prior quarter. Assuming the debt exchange is approved by shareholders and regulators, this should be sufficient to meet the parent company's cash debt servicing requirements through 2011.

And I will now turn the call back over to Don for his closing comments.

Donald H. Layton, Chairman and Chief Executive Officer

Let me wrap up with some forward-looking comments in the same order as my introductory ones; the customer franchise, credit exposure, and our capital position.

First, the customer franchise. The business is firing on all cylinders and we are extremely happy about how well the franchise is performing. We continue to get our fair share of volumes and revenue versus our online competitors, and are clearly gaining share against traditional brokerages. Our focus on the investor customer and the basics of the online brokerage business are really

paying off. Nevertheless, despite the high volumes in the first half of the year, and the record DARTs this quarter, we will continue to manage the business to a conservative outlook for the second half of the year, just as we did for the first half. We will continue to manage expenses closely, and as we did for the first half, we will be positioning the company to more likely be surprised on the upside and to produce strong operating income.

Second, credit exposure. Loan delinquencies, which are the precursor to losses, are declining nicely with special mention delinquencies down 17% from the end of 2008. As a result, we believe we are likely to have a material reduction in quarterly charge-offs during the remainder of the year. We believe that this past quarter marked the cyclical peak for charge-offs, and that likely we will soon reach the stage where the loan loss provision is less than the charge-offs during the quarter. We expect that this crossover probably will occur sometime later this year, which will mark a significant watershed event in our eventual return to profitability.

And last, our capital position. We have strengthened the bank's capital position considerably and we are continuing to generate bank capital organically, both through consistent pre-credit provision profitability, and with our deliberate efforts to reduce the size and risk of the bank's balance sheet.

We estimate that the breakeven credit loss provision for a quarter is about 250 to \$300 million. Therefore, with the expected decline in the loan loss provision, we anticipate that the bank will be a net generator of regulatory capital in the foreseeable future, possibly even later this year.

Assuming the debt exchange receives shareholder and regulatory approval, which we fully expect to occur, we also will have enhanced the parent company's liquidity, and reduced its debt service burden, especially through the end of 2011. As a result, we will be in a position to be flexible and opportunistic in response to market conditions with regard to our capital planning actions such as further debt for equity exchanges, additional open market equity offerings or sales of any non-core assets.

In summary, we believe we are now much better positioned; both to cope with any unforeseen problems and also to seize the opportunities that we see for our online brokerage franchise.

With that, operator, you may open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions]. Our first question comes from Rich Repetto with Sandler O'Neill.

<Q – Richard Repetto>: Good evening, Don and Bruce.

<A>: Hi, Rich.

<A>: Hi.

<Q – Richard Repetto>: I guess the first question is, you had a significant expansion in the bank net interest margin and you explained how the Complete Savings Account and you can see it in the earnings release, that the costs went down by almost half. I guess the question is 1.7 billion in deposits in CSA went away, but the average balances went up quarter-to-quarter. Does that mean we've still got a nice decline coming, going forward?

<A – Bruce Nolop>: When you say the average balances, what do you mean average balances of what item?

<Q – Richard Repetto>: Of the retail deposits that went from 26.4 billion to 27.1.

<A – Bruce Nolop>: Yeah.

<Q – Richard Repetto>: Even though you had a 1.7 billion you said sort of draw-down on the CSA.

<A – Donald Layton>: Yeah, we, simplifying some, but not a lot, we have two major components to our retail deposits, one is the sweep deposits. They are our most advantageous source of funding, they are inexpensive, they are part of our customer franchise, we like them. They have gone up well lately and that's a positive thing in most ways.

Second part, it would be our direct to the bank savings deposits, CSA being the largest one. That's the one where we're reducing the rates to show it to start coming down, because in aggregate we just do not need all the liabilities we have.

I want to highlight that for a minute. Through 2008, due to the market conditions and our particular situation, we were very concerned about liquidity at the bank level and we had liability costs competing with other firms that wanted to make sure they had good support from their depositors. We've gone from that liability position that, where we had to pay high rates in deposits to a position we're actually ultra liquid at the bank and we are literally looking to have reduction in deposits to accommodate our shrinking asset side balance sheet as the loan portfolio is in total runoff.

So we think there's more room to shrink the balance sheet. We will be doing that consistently as loans run off as well. We had a large amount of cash at the bank balance sheet at quarter-end, larger than we'd like, and we'll be looking to reduce that over time. We will however do it consistent with treating our customers reasonably and doing it in a relatively smooth manner consistent with our business franchise.

<Q – Richard Repetto>: Got it. Okay. Next question is you had pretty sizeable pre-provision, pre-tax earnings at 232 million. Now there is the agreement with Citadel on the market-making side. I was just trying to see any kind of – and I know trading activity was at a record high as you mentioned. But any sort of guidance on how to change with the market-making? I know this is a low margin business, but what guidance on that pre-provision, pre-tax earnings going forward?

<A – Bruce Nolop>: Yeah, Rich, the Citadel transaction is still subject to approval by the OTS, so it's not been implemented. But I would comment that first you do see our principal transactions, which is the market-making business, that had a good quarter. Secondly, one of the things that contributed to our net interest income this quarter in the bank was in the stock borrow transactions, that that was up considerably during the quarter and quite helpful.

And then finally the order flow transactions that we currently do with Citadel and with other, with our own in-house activity, that those order flow income were higher as well. So the gist of your question is correct, that the increase in trading activity was one of the contributors to the higher organic capital generation and income at the bank this quarter.

<Q – Richard Repetto>: Got you. And all those things seemed consistent with security lending and payment for order flow. I guess last question, Don, is it seems like you've executed barring a drastic change in the credit environment, but you've executed on a plan. I guess the last risk seems like with all companies these days, regulatory risk. So could you go through just any updated view on what the regulators have said after the capital raise, and is there any interest in TARP at this point?

<A – Donald Layton>: Okay. Well, obviously when we did the capital raise we indicated to everybody that we had developed our plans including with close consultation with our regulators. We're not going to, you can appreciate that we would never comment upon the details of the conversations we have with regulators, but it's sort of obvious that they'll be happy with extra capital and reduced parent debt burden. But beyond that, they're not going to make any comment that I wouldn't comment on their comments to us, if you will.

But just some common sense, looking at the numbers, I'll point out some numbers that as a regulator you would be interested in here. One, of course, is the provision decline. Another is the, we focus on the bank excess risk-weighted, risk assets, up to \$916 million, that is an extremely high level versus where we have been. That's obviously a positive with any kind of regulatory regime.

And I want to emphasize one of the items Bruce went through, is what we call a capital walk. Between the shrinkage and the risk-weighted assets in the bank, between the high pre-credit operating earnings and other miscellaneous items, we only used \$28 million of the \$500 million of capital. That's a very low number, and as a regulator you're going to be looking for that number to turn positive, because then you'll have a situation where the bank organically generates more and more capital.

It's going to bounce around some, and we'll make no promises, but we think that when it turns positive is not that far off in the future. So that's obviously a good thing to anyone who thinks from a regulatory perspective.

In terms of TARP we didn't mention in the press release, because honestly there's nothing new that's happened. Our application remains active. We indicated when we did the equity raise we were going to leave it active and not draw it at that time. Obviously we represent a different financial picture to the Treasury, who is the decision-maker here. But we only represent right now a partial different company. We do have our common equity, but until the – we won't represent the fully recapitalized E*TRADE until the debt exchange closes, which again we've said will be sometime later this quarter.

<Q – Richard Repetto>: Understood. That's all I have and hopefully this has been a pivotal quarter for you. Thanks.

<A – Donald Layton>: Yeah, let me just summarize, the operating business was great, credit continued to moderate and a lot of people told us that you need six months to really prove your

case. We now have six months. And clearly capital we think we hit a home run in our capital planning. So thank you.

<Q – Richard Repetto>: Thanks.

Operator: Our next question comes from Roger Freeman with Barclays.

<Q – Roger Freeman>: Hi, good evening. I guess within the one-to-four family bucket, as you pointed out the dollar amount of delinquent loans is coming down which is certainly encouraging. But how do you look at that on a percentage basis, it did pick up, although it looks like most of it was in June. So I am wondering was there anything in June where there's been other months where there's been a timing mismatch between when mortgages are due and when like once a month paychecks come through, that kind of thing that cures themselves pretty quickly. Is there anything there? Because this trend is a little different than what some of your peers have been showing this quarter where they've seen improvement.

<A – Donald Layton>: Yeah. What I want to remind you, we are not a direct servicer of any of our mortgage loans.

<Q – Roger Freeman>: Right.

<A – Donald Layton>: Because of the way the timing works in home equity, we are able to report the same month. So when we say June, it was the month of June. For first mortgages, because we have so many servicers, it's on a one-month lag, so the number you're seeing for June is...

<Q – Roger Freeman>: Is May.

<A – Donald Layton>: As reported is actual May. May, as best we can tell, is a seasonal slow point in mortgage payments first and seconds, as a generalization in history, in as much as we can tell. We don't think there's anything else going on other than that. And don't ask me why May is slow; it just seems to be that way.

<Q – Roger Freeman>: Got it. Okay. Okay. Now you, I think in your Q last quarter, I'd read you were moving the broker underneath the bank, has that occurred from a legal perspective? And can you just talk about what; was that something the regulators wanted you to do in order to be able to guarantee the upstream capital to the broker? And does it make it any more difficult to sell off just the brokerage business, were that to come up?

<A – Donald Layton>: Okay. You asked a lot of questions about...

<Q – Roger Freeman>: Yeah.

<A – Donald Layton>: I guess one topic. First of all, yes, it has legally been completed. It was completed during the month of June. Second item was – this was done at the request of the regulators. But you get into the issue of would this be more difficult to; would it now be more difficult to sell off the broker rather than the bank? The answer was, we had – it was I try as much as possible to let people know that the concept of selling off the broker, whether it was before the move under the subsidiary, of the bank, or now, is not in fact practical.

<Q – Roger Freeman>: Right.

<A – Donald Layton>: From a wide variety of perspectives. The business flows between the brokerage firm, the clearing subsidiary and the bank are intermixed from our customers, and it's really a single business with different legal entities booking.

<Q – Roger Freeman>: Understood. And then actually to that point and now that we can have a longer term discussion about how your business is going to evolve, to the point of the bank, how do you perceive the bank existing in the future of E*TRADE? To some extent you're taking down emphasis on the non-transaction deposit accounts. Are you going to be a business that someday makes mortgage loans again? Is there going to be a bank tied to E*TRADE or is it just really going to be more of a brokerage business?

<A – Donald Layton>: Yeah. We stated I think probably most clearly in the annual reports that I've written, our focus is on the investor business. And that means in terms of legal entities and product lines, a brokerage operation and clearings off a brokerage and in all sorts of investment products, it actually means a bank. A bank is necessary to get, extract full value from the sweep deposits and as well it would be emphasizing offering investment products to complement other alternative investments, in this case savings products to complement other investments to our clients, and is to be a vehicle to offer money transfer and money movement products which investors like as well.

So for the reasonable future while we work through our problems, the bank is limited to that. We are, the loan portfolio is in runoff – full runoff mode, and that's where we're aiming at this point, not to be a bank for a bank, but a bank as an adjunct to an investor business.

<Q – Roger Freeman>: Got it. And just lastly, the increase in the stock borrow revenues this quarter, how much of that was from trading at Citigroup, given the difficulty to borrow that stock?

<A – Bruce Nolop>: We won't comment on a specific stock other than to say that we were benefited by the fact that there was good demand for certain stocks in the market and you are as good at coming up with those names as anyone.

<Q – Roger Freeman>: Okay.

<A – Bruce Nolop>: But we can't comment otherwise.

<Q – Roger Freeman>: Okay. Thanks.

Operator: Your next question comes from Matt Snowling with FBR Capital Markets.

<Q – Matt Snowling>: Yeah, good evening, Don, I just wanted to...

<A – Donald Layton>: Hi, Matt.

<Q – Matt Snowling>: Hi. I just wanted to follow up on some of your earlier comments on the net interest margin. I understand what you're doing in terms of taking down your funding costs for your deposits, but when shrinking the balance sheet, why would you not first look at repo funding which is coming in at a higher rate?

<A – Donald Layton>: Yeah. We would look at it first. We have two wholesale types of funding on the bank balance sheet on the liability side. One is that repo book you mentioned and the other actually is Home Loan Bank borrowing, most of which are at, were at fixed rates, so given the way rates have gone are at rates that are now perceived as high.

Unfortunately, to reduce either of those beyond what we have done would have significant earnings impact. In terms of the Home Loan Bank, we would have to pay what is basically economic make-whole clause, and lock up against today's low rates a loss, which we don't think is desirable when we're very aimed at having good capital ratios for the bank.

The same thing is true on the repo book. The repos, while floating rate instruments in terms of interest rate sensitivity, were established several years ago, against them on the asset side were

fixed rate, longer assets and hedges were put in place. Given the way the rates have gone, those hedges are now at significant negatives, and if we took the repos down, we would have to recognize a mark to market on those hedges and that would be a significant negative.

So we wish to rather run both of those types of liabilities out and avoid having the undue accounting loss which would hurt our capital ratios.

<Q – Matt Snowling>: Okay. That makes sense. Can you tell us the duration of those, repo and Home Loan Bank funding?

<A – Donald Layton>: The answer is, Mike?

<A>: The duration of the number of the Home Loan Bank funding loans is approximately five years.

<A – Donald Layton>: Yeah.

<A>: The fixed portion of it. The duration of the repos, they extend out approximately 10 years, but they ladder down over that period.

<Q – Matt Snowling>: Okay.

<A – Donald Layton>: That was Mike Peasy. He is treasurer of the bank.

<Q – Matt Snowling>: Right. Right, right. Another question in terms of the \$5 billion of cash that you're sitting on earning 30 basis points, you said you were going to look to take that down going forward. Can you help us understand what you're going to look at? [inaudible]

<A – Donald Layton>: Our preferred method of reducing it is by having the liability side of the balance sheet shrink, not redeploying it into other assets.

<Q – Matt Snowling>: Okay. That makes sense. And one follow-up, or one more question on the Citadel payment for order flow. I think you're expecting \$100 million gain, does that fall in the next quarter?

<A – Donald Layton>: First of all, it would not be a gain, it would just be a cash pay-forward to it. And that would be in the third quarter. But, again, that's still subject to approval, so we are, we don't want to imply that it's a done deal.

<Q – Matt Snowling>: Okay. Thanks a lot.

<A – Donald Layton>: Okay. Thank you.

Operator: Your next question comes from Mike Carrier with Deutsche Bank.

<Q – Michael Carrier>: Thanks. First question is just on the core brokerage business. If I look at during the quarter advertising expense got taken down fairly significantly. And I think if you pair that with the lower rate on the savings account, it looks like obviously you had the net new assets decline from the 3.5 billion run rate over the past few quarters to less than a billion. And then your net new brokerage account growth turned negative in June, and then clearly now we're facing the seasonal headwinds with DARTs being down. So I guess, how are you guys balancing the, you want to invest in the business, so you don't turn away clients versus managing the costs and managing the balances on the liability side of the balance sheet.

<A – Donald Layton>: Yeah. You've put together a lot of different data points, and I think you're getting yourself headed in the wrong direction from our point of view. Let me just hit a few items.

Number one, our advertising has always been seasonal and the first quarter is our high point, any way. So advertising works somewhat with a lag, therefore, the first quarter is very important. Second, you're facing the summer low, so you don't do as much. So that's traditional.

Number two, you pointed at June in particular going negative. We have a tradition here of, although we're changing it, where we have a quarterly fee to people who have inactive or small accounts. The fee hits in March – end of March, June, September, December, so if you look back you will find we always have a pattern of account closures in the third month of the quarter. It's not anything strategic; it is just the normal seasonality. I'll mention it as an aside; we're reducing the impact of that fee and we'll be getting rid of it over time.

The AUM going down is, again, that is mainly due to the fact that the customer non-sweep deposits that we're pushing out went down, but we are specifically trying to manage that down for our balance sheet. If you adjust for that, you'll find it was quite a reasonable level.

Lastly, when I believe we did the first quarter call, Bruce had indicated that in our budgeting we made a conscious decision about expense levels and advertising that reflected our desire to keep advertising out there like it's normal business. But, number one, as everyone knows reading the newspapers, especially the newspapers, advertising rates are down and so you get the same bang for the buck.

I'll mention, secondly, that a lot of our advertising historically was aimed at deposits when we worried about raising a lot of deposits, whether as part of a business strategy or for liquidity. We clearly don't need to do that anymore.

And the third item is we did make a decision to shift somewhat at the margin, dollars and budgeting towards product development, and a little bit out of advertising is where we felt we got more customer bang for the buck. So we don't think we've done anything here that indicates anything other than a full-blooded approach developing the business, the rest is just kind of noise and tactics.

<Q – Michael Carrier>: Okay. All fair. The only other question is, when you're managing the balance sheet, I get the focus on the investment products, longer term. But in the near-term, like in terms of your models, how accurate are you guys in terms of taking that savings rate down by 50 bps, what are your expectations in terms of the client balances leaving? Meaning are you fairly sure that the 50 basis points is enough or do you run the risk that too many assets leave the bank maybe before the roll off or the runoff on the loans?

<A – Donald Layton>: We have – we watch carefully – well you asked two questions. One is what's happening, the other is predicting. Given the way the rates are ultra low, we've never quite been in this environment, the ability to predict exactly what's going to happen to non-sweep deposits for rate changes, we have modest ability to do so, but I wouldn't overemphasize it. Obviously, our non-sweep deposits will reflect our rate, what the competition is doing, what other business customers are doing with us and such.

What we do know is we would like to definitely run down the percentage of our non-sweep deposits which comes from bank depositors who are not brokerage customers. And we have been running down that percentage and continue to work on doing that, that it would be known more in the parlance of f internet hot money, or whatever phrase you'd like. We're trying very much to make sure our brokerage customers stay here.

We have marketing people who watch the impact on the brokerage customers and so far we haven't found any material hit to our brokerage customers. And I'd say that the second quarter's DARTs and all – most of the other aggregate numbers, net new brokerage accounts trend indicate that we're able to handle that trade off quite well.

<Q – Michael Carrier>: Okay. Thanks a lot.

Operator: Our next question comes from Howard Chen with Credit Suisse.

<Q – Howard Chen>: Good afternoon, Don and Bruce.

<A – Donald Layton>: Hi, Howard.

<Q – Howard Chen>: Thanks for taking my questions. I hear your constructive commentary on overall credit quality, but the company is still seeing new early delinquency and NPA formation, macro environment still seems uncertain. So I guess I'm just not entirely clear how about you get to a point where you're bleeding loan loss reserves later this year. So could you just detail and refresh some of the thinking on just your overall macro assumptions, what happens to home prices, and what you see in terms of the new formation, as we look out the next few quarters?

<A – Bruce Nolop>: Well, this is Bruce. I'll start it. I think that we haven't really changed the way we have done it all along, which is to do modeling, and in terms of home price assumptions, it's using Case-Shiller data. So that has an assumption of 4.5% decline over the next 12 months. So that's embedded in there.

But I think what gives us the most confidence about loan loss provision coming down is just the nature of the accounting, where you're always going out at least 12 months predicting what your charge-offs will be. So, therefore if delinquencies have been coming down, and you expect that you will be having lower charge-offs as a result, that has a compounded effect on the loan loss provision which is why we think it has to at some point start initially going at least equal to charge-offs, but then it will go lower than charge-offs. So the way the accounting works, you will actually see positive capital generation before you've seen the total decline in charge-offs. It's like loan provision is more like a leading indicator, and charge-offs are more lagging, and that's what gives us the confidence about it.

<A>: Yeah.

<Q – Howard Chen>: Okay. I understand the accounting. I was just more curious about the timing and the expectation for the back half of the year. But we can follow up...

<A – Bruce Nolop>: And I can – I'd just turn it to Paul Brandow, who is our Chief Risk Officer and maybe he can just elaborate a little bit further.

<A – Paul Brandow>: The only thing I might add if I listened to your question correctly is that the reason we get some confidence is we have actually not seen an increase in entry level delinquencies and non performing assets. Quite the opposite, the entry level delinquency's consistent in both the special mention category and particularly which Don has emphasized, has been coming down consistently, translates sort of mathematically because roll rates have been fairly stable into lower charge-offs which in turn backs, as Bruce mentioned, backs into a lower accounting number for the provision.

<A – Bruce Nolop>: Yeah.

<A – Donald Layton>: Howard, let me get back to more of a general comment. A lot of people come to us and go what are your macroeconomic assumptions in doing your loan provision or allowance creation? In fact, for a specific portfolio, it is so difficult, there is no ability to correlate, if you will, macro GDP assumptions, or unemployment assumptions. The thing we use most is just the pattern of delinquencies coming in and rolling through the pipeline to the charge-off point, it's by far the most dominant. And because allowance is based on four quarters going forward, for most of

the portfolio, leaving out modified loans, and we have the first six months virtually kind of known because the chart, the delinquency is already in and it runs off to the 188 point, we get a fair amount of confidence about where we're going.

<Q – Howard Chen>: Okay. Thanks. And then as a follow-up on a separate topic, could you provide some color on the OTTI charges and gains on sale this quarter?

<A – Bruce Nolop>: Well, first of all, the OTTI was a net charge of 30 million. There was a larger number in the income statement, but that was simply due to a change in the accounting rule, and so it has a large number of about 200 million. But that is nothing new. That is simply reflecting what is already been taken through other comprehensive income. So 30 million was the impairment this quarter.

And the other question is about the gain. We have benefited from the Agency security portfolio, essentially being up in value. And when we looked at the opportunity to lock in those gains from what we thought the value was compared to what the market was, thought this was a great time to do so. And so that was the gains that we took this quarter.

<Q – Howard Chen>: Okay. Thanks. And then a final one from me. Just a follow-up on the downsizing of the balance sheet, I hear all your commentary on the retail versus wholesale funding declines and why you can't do one or the other. But it seems like a lot of firms have always had the opposite problem that you've had in that they're asset rich and liability poor. So do you think there's any opportunity you could garner any value of those deposits rather than maybe just letting them go? Thanks.

<A – Donald Layton>: Well, first of all, you're absolutely correct. We find ourselves in a very odd position of being a company that has been, at least up until our capital raise – capital challenged, but yet at the same time be so liquidity rich. It reflects who we are, that our underlying customer base is investors, people with cash, not borrowers, such as a credit card or auto loan company or something would have. We think about the issue of the value of those deposits strategically, where we can't use them, and that there is opportunities possibly in the marketplace to do it. So we're aware of that. We think about it. But I wouldn't say anything more specific than that until someday we might announce something.

<Q – Howard Chen>: Okay. Thanks, Don.

Operator: Our next question comes from Michael Hecht with JMP Securities.

<Q – Michael Hecht>: Hey, guys, good afternoon.

<A – Donald Layton>: Hi, yep?

<Q – Michael Hecht>: So I just wanted to come back to the overall strategy of the balance sheet. You talk about, I guess the strategy of shrinking the balance sheet at the bank, but I think over the last two or three quarters your average interest earning assets have expanded and I know a lot of that is cash and cash equivalents. But also surprised to see MBS and available for sales pickup. So I guess a two part question, just what are you buying and what's the near to immediate term plan for the size of the balance sheet?

<A – Donald Layton>: Yeah, we are looking to shrink the balance sheet. We are behind in where we would like to shrink it. For the very normally great reason that our sweep deposits have been growing, not shrinking; and that despite the major reduction in our CSA rate, instead of the money dramatically declining, it has proven to be rather sticky and only started to decline really, I guess late first quarter, early second quarter, when we've done significant rate reductions. These are

normally in the financial business considered unalloyed joyful things to you have, you have good liquidity and loyal customers.

So we're behind, which is why the cash has been building up on the bank balance sheet, some of which has been channeled into growth in typical Agency MBS. The Agency MBS we use generally as a broad generalization will be relatively short duration, and by definition virtually no credit risk items. Other than that, the people on the desk, Mike Peasy you heard from a little earlier, will choose exactly which ones, types to go into at the time based on market views that they have.

<Q – Michael Hecht>: Okay. Fair enough. And then just to follow up on the question earlier about the net interest spread, which, at 291 basis points versus 230 for last quarter. I mean, it seems like there are some moving parts here. Obviously the CSA declining which is higher costs coming in, that maybe sticks and there might be some benefit going forward there if that continues to come down. But the stock lending stuff maybe not as permanent. Can you just help us think about the direction and the sustainability of the net interest spread at 291 basis points?

<A – Bruce Nolop>: Yeah, I think you've put it quite well that the stock loan business definitely helped this quarter. And we're not counting on it being at this high level going forward. But the other potential are two-fold and what Don said before, I'll just summarize, that you have two positive trends. One is, a mixed trend, in that our cost of funding is declining as the ratio of sweep deposits goes up relative to non-sweep deposits. It's just lower cost funding.

Secondly as Don also mentioned, you have the potential for further reduction in the CSA rate, and that is something. And then the other thing I would point out is that you've got much more cash right now than we would like. We have 4.7 billion, compared to a goal of more like two billion. That's money that's not really earning its full potential. So either through a reduction in the amount that we pay for funds or in reinvesting that cash in something better for earnings that also gives you the upside. So bottom line as I said in my prepared remarks, we think that the spread should be relatively constant. The issue is more of the declining balance sheet.

<Q – Michael Hecht>: Okay. Just one specific follow-up for that. I mean, the yield on margin receivables picked up a nice amount quarter-over-quarter. I mean, just any more color on that?

<A – Bruce Nolop>: Right. Yeah. That is simply due to the international essentially was higher this quarter, and if you look at where we do in our base business in U.S., it was relatively constant, and nothing there. It was just an anomaly for the quarter.

<Q – Michael Hecht>: Okay. And then a question on, I think this was mentioned in an earlier question, the pre-tax, pre-provision the bank earnings, at 232 million, that ticked up from 181 million. I just want to make sure I understand the definition of that because when I deduct that from the overall pre-tax, pre-earnings for the entire company, it implies negative earnings for the retail business. So I'm just trying to figure out where my math is wrong there.

<A – Bruce Nolop>: No. The main thing is the way, as Don said, we really run the company as a single business.

<Q – Michael Hecht>: Sure.

<A – Bruce Nolop>: And much of the profit of the broker is in the bank. In fact, at this point we moved securities under there. The clearing operation is under there. So virtually all the profit is going to be reflected in the legal entity. So you're at the point where it's really hard to distinguish between the two in most cases, and that's the key.

<A – Donald Layton>: When it's the bank pre-credit earnings will reflect part, most of the retail business, and it will reflect all of the balance sheet management segment. You can't from outside

pick apart which was which by legal entity, you can't cross-reference legal entity as segments. It's too complicated.

<A – Bruce Nolop>: And so you might ask, well why do we even pay attention to legal entities? It's simply that that is where the regulatory capital gets defined, so that's why we emphasize that.

<Q – Michael Hecht>: Okay, no that's fair. So we should just think about that more as a really a kind of consolidated type of number, I mean not clean but it's getting more and more --

<A – Bruce Nolop>: That's what I would recommend.

<Q – Michael Hecht>: Yeah. Okay. That's fair. And then just on the June trades down 18%, any color on whether it was more weighted toward ETFs or options trading kind of slowing down? And then Ameritrade has kind of noted that July is tracking down another 15, 16% or so so far. I mean, any reason to think you guys are seeing anything different?

<A – Donald Layton>: No. We, the traditional, seasonal summer slow-down seems to have started about mid-June and continues. And as my understanding of the history of the business, you'll get it unless there's some macro events that causes volatility to go up and therefore trading to be more normal.

<Q – Michael Hecht>: Okay. And then anything in terms of the June number, 18%? It's a little bit worse than your peers I think but the prior two months, I think you're a little bit better. But anything that's driving the slowdown more so than anything else?

<A – Donald Layton>: All we can, it's mainly we believe the seasonal slowdown. There is some second tier impact on some of the, there is been some articles about the leveraged ETF, kind of stuff. We regard that as very secondary.

<Q – Michael Hecht>: Okay. And I just last housekeeping thing for me, post the swap, what's Citadel's expected pro forma ownership in E*TRADE?

<A – Bruce Nolop>: On a fully diluted basis, it would be 49%.

<Q – Michael Hecht>: Okay. Great. Thanks a lot, guys.

<A – Donald Layton>: Voting common would only be 16.

<A – Bruce Nolop>: Yeah, right. Yeah that's, Don makes a good point to emphasize that because of the regulatory constraints, Citadel will not be able to convert the bonds into common stock without going through processes, and it will not be able to vote the shares. So from a pure control voting point of view it's a 16% ownership.

Operator: Thank you. Our final question comes from Mike Vinciguerra with BMO Capital Markets.

<A – Donald Layton>: Hey, Mike.

<Q – Michael Vinciguerra>: Sorry about that guys, I had my mute on. I just wanted one thing on the securities portfolio we didn't talk much about that except to say that we had a \$30 million write-down for the quarter on the credit side. Bruce, can you give us a little more detail on that? It's an \$11 billion portfolio. And can you give us any sense for trends in the payments there, and if you're seeing any indications?

<A – Bruce Nolop>: Yeah, it's really in just the CMO portfolio, so it's not the full amount, because that would include all the agencies, which there's no issues. So there is really nothing that I can

point to that's unusual. It's really pretty consistent with what we've been doing on a quarterly basis, and there's no new trends that I would be able to discern or describe.

<Q – Michael Vinciguerra>: So no real concerns in that portfolio at this point.

<A – Bruce Nolop>: No, no.

<Q – Michael Vinciguerra>: Okay. And then just to clean up a couple of your peers have talked about their auction rate securities exposure, can you just mention for us, so we have full disclosure on your clients' exposure and if there's any issues to be concerned about there?

<A – Donald Layton>: Yeah, there is nothing to announce on our side in terms of how much we have. It's about \$200 million outstanding now.

<Q – Michael Vinciguerra>: Okay. So at this point no news. Are you being approached by anybody in terms of the New York State or anyone to do something about buying those back?

<A – Donald Layton>: You know I won't comment on those kind of regulatory legal things.

<Q – Michael Vinciguerra>: Fair enough. Okay. Thank you, guys.

Operator: That was our final question. I'll now turn it back to Don Layton for closing remarks.

Donald H. Layton, Chairman and Chief Executive Officer

I think after a few tough – after a tough year and a half, E*TRADE this quarter when we look back, it will be regarded as the major turnaround quarter for the company in the three key areas: The underlying business clearly showing that it knows what it's doing, it's got its franchise back, not just generally, but to produce revenue and good bottom line profits. That credit, that we've hit the six-month point of showing trends and delinquencies to feel relatively comfortable that the numbers are heading down to much more manageable levels.

And of course a capital raise and a debt exchange that far exceeded anyone's expectations of what we might be able to do based upon our franchise value. So, we think this has been an excellent quarter for us in terms of building E*TRADE back to a position of strength. We look forward to having those times when the first one is we start to generate, be a capital generator in the bank; that quarter hopefully in the near future. And ultimately when we start to have profits on the bottom line again, we think it's visible and we look forward to working with you as we get to that point. Thank you.

Operator: Thank you for participating in today's conference call. You may now disconnect.

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