Operator: Welcome to E*TRADE FINANCIAL Corporation Third 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 this call with the following Safe Harbor statement.

During this conference call 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, 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 October 27, 2009. Please note that the 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 this call or in the company’s press release which can be found on its website at investor.etrade.com.

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 the 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. The third quarter was a true watershed in our turnaround plan with the completion of our balance sheet recapitalization, as well as continuing declines in credit provisions and another quarter of our core franchise growing stronger. If we exclude the impact of the debt exchange, our net loss from continuing operations of $59 million was about 60% less than last quarter and over an 80% decline from last year’s quarterly loss.

Let’s start with our online brokerage business, which is performing very competitively. We can see this in four key customer metrics that highlight the vitality of the business this quarter. First, trading activity remained robust, with DARTs of 196,000. While this was down seasonally from the second quarter, year-over-year it was a full 7% higher. Year-to-date, we have in fact recorded our highest DART level for the first nine months of any year at 204,000.

Second, the average commission per trade increased by $0.45 during the quarter to $11.50 as we enjoyed a higher level of engagement from Main Street investors returning to the markets. Third, margin receivables at quarter end rose by 10% to $3.4 billion as customer buying power and confidence continue to improve with the markets.

And fourth, customer brokerage related cash grew by $2.1 billion from the prior quarter, including a $1.3 billion increase in sweep deposits and a $0.7 billion increase in customer payables. In fact, the small 0.2 billion decline in net new asset flows this quarter was due entirely to our ongoing strategy to reduce bank-related deposits, which declined by $1.3 billion.
Additionally, our brokerage accounts continued to grow solidly after several torrid quarters despite the usual seasonal slowdown. We added 14,000 net new brokerage accounts in the quarter for a record of 2.7 million. That's a net increase of 132,000 brokerage accounts year-to-date, which represents growth of 5% since the start of the year.

Without question, our online brokerage business is benefiting from the secular trend of customers moving from traditional to online brokers and their growing desire to take direct control over their investments. However, our competitive gains also can be traced to improved discipline and execution in serving our customers. This covers everything from addressing the underlying causes of operational complaints to improving customer service such as deposit hold times and first-call resolution.

We see the fruits of our efforts to become more customer-centric in our brokerage account attrition rate. From 15.4% a year ago to 12.6% last quarter, the annualized attrition rate has continued to decline to just 11.5% in the third quarter. We work hard to acquire customers, and we are working harder and smarter to make sure we retain them.

At the same time, we are investing in the business to ensure that our customers have the tools and services to manage their investments effectively. For example, we launched new IRA tools, and are also rolling out a new online platform for our stock plan business.

Stay tuned for more in the coming months on these and other initiatives to address the needs of our long-term investing and active trader customer base. In sum, we are firmly committed to growing our online brokerage business as our core strategic focus going forward. And as evidenced this quarter, we are competing very effectively indeed, not only against the traditional brokers but also versus our online peers. Let me now turn to our balance sheet and the significant progress we have made in strengthening our capital position.

During the quarter, we completed our comprehensive recapitalization including the shareholder approval and subsequent closing of our $1.7 billion exchange of interest bearing debt to non-interest bearing convertible debt. As a result, we have cut our annual corporate interest payments by more than half, to $160 million, and have eliminated any material debt maturities until 2013. We also raised another $150 million of common stock, bringing the total cash equity raise this year to $765 million.

We invested most of the 733 million of net proceeds in the bank, including the fulfillment of an OTS request to contribute another $100 million to the bank in September because our capital raising efforts had proved to be so successful. In total, we have contributed $600 million of Tier 1 capital to the bank this year, and are confident that we have adequate cushion against any reasonably foreseeable losses in our loan portfolio.

Our confidence is reinforced by the improving credit trends that we've been seeing this year, including the following results for the third quarter. First of all, delinquencies. During the quarter, total special mention delinquencies declined by 4%, and total at-risk delinquencies declined by 10%.

Second, the loan loss provision declined for the fourth straight quarter. It is now down to $347 million, a 14% decrease from last quarter, and a 33% decrease from its peak one year ago. It has also converged with the level of charge-offs for this quarter. Third, after peaking last quarter as expected, net charge-offs were down by 9% this quarter to a total of $352 million. Because of the convergence of the charge-offs with our loan loss provision, our allowance stayed flat at $1.2 billion.

With that, I will now turn the call over to Bruce to provide additional details on the quarter's financials.
Thanks, Don. During the quarter, we had a net loss of 832 million or $0.66 per share. However, our loss this quarter included a one-time 968 million pre-tax, non-cash charge in connection with our debt exchange. Without this charge, our net loss would have been 59 million, and our earnings per share would have been a loss of $0.05 per share. This compares with a loss of 143 million or $0.22 per share last quarter.

This one-time charge comprised two components. First, it included a 725 million charge to reflect the higher value of the newly-issued convertible debt, in relation to the face value of the debt that was extinguished. This difference was almost entirely due to the significant increase in our stock price from June 22, when we established the terms for the debt exchange, to two months later, when we consummated the exchange.

The time delay was due to the requirement to have the transaction approved by shareholders, which was accomplished at a special meeting on August 19. The accounting for this increase in value was somewhat unusual. It was treated as a loss in our income statement this quarter, but was offset by a simultaneous increase in paid-in capital on our balance sheet. Thus, this loss had no impact on book equity or book value per share.

The second component of the one-time charge related to an original issue discount of 243 million, on the Springing Lien Notes that were exchanged. The debt exchange caused the original issued discount to be written off immediately rather than being amortized as an expense over the life of the debt.

Finally, a portion of the charge for the debt exchange is deductible for tax purposes. We recorded a tax benefit of 195 million in the third quarter, which reflects the tax benefit associated with the deductible portion of the charge. This resulted in an increase to book equity and represents a future savings in cash taxes when we return to profitability.

In summary, while the one-time charge related to the debt exchange had a large impact on our reported results this quarter, it did not have a cash cost to the company, and any impact on our balance sheet was simply an acceleration of an existing expense item. The net effect to book equity, including transaction costs from the debt exchange, was a reduction of $65 million.

So after that explanation, let’s go back to a review of our income statement for the quarter. We generated 575 million of net revenue this quarter, which compares with 621 million in the previous quarter. Our revenue included net interest income of 321 million, which compares with 340 million last quarter. This included a $0.45 increase in our average commission per trade, offset by lower customer trading activity. We also benefited from the increase in principal transactions in our market-making business this quarter.
Total operating expense decreased by 28 million from the prior quarter to a total of 302 million. The decrease was primarily due to the special FDIC charge in the prior quarter, but it also reflected ongoing efforts to lower our cost base. However, compensation increased this quarter, due to higher accruals for variable compensation, reflecting our strong operating results for the year-to-date.

If we exclude the loan loss provision and any gains or losses on security sales, our adjusted operating income this quarter was 251 million, which is similar to last quarter’s results. The Trading and Investing segment delivered strong operating results in what is a seasonally slow quarter. The segment income rose 14% sequentially to 231 million on segment revenue of 434 million. In comparison with last year’s third quarter, the segment income was up 15% on a revenue increase of 2%.

Other income during this quarter included 42 million of net gains from asset sales offset by 19 million of net impairment. In addition, we incurred 37 million of prepayment charges related to 600 million of FHLB loans. The prepayment of the loans has reduced the bank’s balance sheet, thereby freeing up regulatory capital and will save us future interest expense. Thus, this loan prepayment highlights our strategy of incurring some short-term costs to position the company better for the long-term future.

Our loan loss provision of 347 million compares with 405 million in the second quarter. It also is five million below the 352 million of net charge offs during the quarter. The total allowance for loan losses was flat at 1.2 billion; however, because of the run off of our portfolio, the allowance increased as a percentage of gross loan receivables from 5.3% to 5.7%. About 144 million or 12% of the total allowance is attributable to troubled debt restructuring in connection with our loan modification program.

Total special mentioned delinquencies declined by 4% during the quarter, and total at-risk delinquencies declined by 10%. The at-risk movements included a 10% decline for home equities, and a 9% decline for the One-to-Four Family portfolio. We ended the quarter with strong capital ratios in the bank, including the additional 100 million of Tier 1 equity capital that we contributed in September. The Tier 1 capital ratio was 6.7% to total assets and 13.2% to risk-weighted assets.

We were especially pleased to have used only 26 million of risk-weighted capital in the bank during this quarter resulting in a total of 985 million of excess total capital over the regulatory well capitalized threshold. This included pre-credit bank earnings during the quarter of 243 million and the release of 131 million of capital to reductions in the loan portfolio. The loan portfolio declined by 1.7 billion during the quarter. This included the sale of 384 million pool of Home Equity loans to the originator of those loans at a price of 98% of par.

Although we incurred a modest net loss on this sale, this is more than offset by the benefits realized from freeing up capital through the transaction. We were very pleased that we could take advantage of this opportunity to reduce our loan portfolio under reasonable economic terms, but believe this is likely to be a one-off transaction that will not be easily replicated in other situations.

Including the cash raised from our common stock issuance this quarter, we had 501 million of corporate cash as of September 30, which was roughly equal to the corporate cash at the end of the prior quarter. In connection with the debt exchange, we issued 1.7 billion of non-interest bearing convertible debt at par. As of September 30, a total of 592 million had been converted into common stock, and as of last night, a cumulative total of 688 million had been converted. This amount will be reflected on our consolidated balance sheet as common equity.

We now have approximately 1.9 billion of common shares outstanding and about $1.1 billion face value of convertible debt, which can be converted into approximately one billion shares of common stock. Given the substantial changes in our common stock ownership, we triggered a tax control
change under Section 382 of the Internal Revenue Code. However, I am pleased to say that this change of control did not result in any write down of our deferred tax asset, as we anticipate being able to use the entirety of this asset against pre-tax income in future years.

At the date of the tax control change, we estimate our net operating losses amounted to 1.6 billion. These net operating losses will allow us to avoid paying taxes in the future on the first 111 million of income per year until they are fully utilized. Therefore, this amounts to a source of free cash flow when we achieve profitability in the future.

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

Donald H. Layton, Chairman and Chief Executive Officer

Thank you, Bruce. As we look forward, we generally expect the continuation of many of the trends that we saw this quarter. First, we expect to see good progress in our online brokerage business as we gain market share against traditional brokers and compete effectively against the major online firms.

We will continue to stay focused on discipline and execution, seeking to provide a superior customer experience while we invest in developing more products and tools. Although the level of customer activity is always difficult to predict, we see no forces that indicate any material change in the underlying trends and levels that we have been experiencing this year.

Second, we believe that we can maintain or possibly even improve our level of interest rate spread. However, as we shrink our balance sheet to reduce risk, it is possible and may even be likely that the dollar amount of our net interest income will decline some.

Third, we expect to see continued improvements in credit. Specifically, we believe that: one, delinquencies will continue to decline, although at a slower pace than the percentage improvements achieved year-to-date; two, loan loss provision, which peaked a year ago, will continue to decline and going forward will be less than charge offs; and three, charge offs, having peaked last quarter, will continue to decline gradually in line with delinquencies.

Fourth, the bank will soon be at the breakeven point where it internally generates, rather than uses, regulatory risk-weighted capital. As usage has been quite small for two quarters now, we expect this to occur soon, and we will continue to be opportunistic in tactical bank balance sheet transactions such as this quarter’s home loan bank prepayments or the loan portfolio sale as we continue to reduce the capital tied up in our balance sheet.

Fifth, although we don’t need any capital at this point, we may be opportunistic in further strengthening our parent company liquidity. In that regard, we note that we will be transferring about $91 million of cash from the parent to the bank in this upcoming fourth quarter as a reimbursement for tax benefits in connection with the sale last year of the Canadian brokerage subsidiary.

Also I should note that we plan to pay in kind the interest payment in November on the Springing Lien Notes due 2017. This will preserve about 55 million of parent company cash. We have not made a decision as yet with respect to the coupons we paid in May of 2010.

This is likely to be my last earnings call with you, so I want to end my remarks with a few observations about my nearly two years as CEO of E*TRADE. Most of all, I want to emphasize how proud I am of what the team here has achieved.
First, despite very large credit-related losses in the last eight quarters, we proved that our quick and direct action to fix our broken balance sheet was successful. Second, we have been able to develop a balance sheet strong enough, we believe, to see us through the rest of this horrendous economic cycle, while retaining the confidence of our customers. And third, while focused on repairing our balance sheet, we were also – were able significantly strengthen the core online brokerage business, with enhanced service quality and a full pipeline of tools and products to retain and grow our market share. And we plan to do even more in the years to come.

Many long-time industry participants and observers have told me personally that they are extremely impressed with our performance through this credit cycle. That performance, of course, was due to many factors. But perhaps the most important one is the strength of our underlying brand and customer brokerage franchise. And also how good the current management team, which will continue on after I retire again truly is. It has been a great honor to work with them.

With that operator, you may open the line for questions.
QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Mike Vinciquerra of BMO Capital Markets.

<Q – Michael Vinciquerra>: Thank you, good afternoon, guys. One question for you just on the balance sheet itself. The interest earning assets, it looks like you’re putting a lot of the cash that’s coming in from clients directly into cash and equivalents. Can you talk about your ability to, I guess, redeploy the cash that continues to come in from your clients despite the low rates you’re now offering?

<A – Donald Layton>: Yeah. We have what in banking would normally be considered a good problem. We have a large amount of liabilities deposits, and we don’t need them as the asset side shrinks as the loan portfolio shrinks. We are working on various strategies and actions to reduce the liabilities, and so in the meantime, we tend to put the money temporarily at risk at cash or near cash equivalents or some very low risk situations. But we’ve been reluctant to put them into any kind of more medium term, low credit risk, but medium term interest rate risk situations such as a three-year or five-year mortgage-backed security guaranteed by Fannie or Freddie.

So we’ve had extra cash pile up on the asset side as we work on these plans to reduce liabilities. You should note in our plans to reduce liabilities, the most obvious one is that we reduced significantly over the year, and most recently even early this quarter, fourth quarter, our primary savings brokerage rate, our main CSA rate, to 50 basis points.

Direct bank deposits from Retail are declining, but the brokerage business itself is doing so well that sweep deposits and related types of – things like that, like free credits have been growing nicely. What you will expect to see going forward is us reducing the liability sum, reducing that excess cash on the balance sheet and getting that cash lower. There’s two buckets of that cash, one is just general bank cash. Our target there is to get it down to under two billion, closer to $1 billion. This may take a quarter or two to do. And we also have restricted cash related to free credits. We’ll be working on reducing that as well.

<Q – Michael Vinciquerra>: Very good. Thank you for that. And then just one question on the credit side. It looks like you guys have built a pretty formidable reserve against the Home Equity portfolio because of that – the drop in the total balances there. Is it reasonable to expect, I know you said that the provision should start to come down, but it almost looks like we should see a pretty significant potential reduction in provision, at least on that book over the next couple of quarters?

<A – Donald Layton>: Well, we have had a reduction in provision on Home Equity. In fact if you look in the table, which is on page 12, gives you a little history here. Our provision, our allowance has been dropping on the Home Equity pretty nicely for two quarters now. For example, at the end of June, the allowance was 718 million. The allowance at the beginning of – at March 31 was 818, 100 higher, and so it’s now down to 693. So you’ve already had a drop.

So the answer is yes, in the mix of the portfolio, Home Equity, we’re more advanced and have built up allowance, first mortgages which did not go into as many delinquencies as early, there’s been more of a later buildup. And so our total corporate, if you will, the balance between provision and allowance is actually Home Equity allowance going down, Firsts going up, and the two have roughly netted this quarter. So you’re correct, and you will start to see that continuing more into the next few quarters.

<Q – Michael Vinciquerra>: Great. Thanks, Don. Thanks for all of the hard work the last couple of years.
<A – Donald Layton>: You’re quite welcome.


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

<A – Donald Layton>: Hi.

<Q – Richard Repetto>: Yeah, and my congrats as well. It’s been some rough waters, no doubt, over the last year a half or so. But with that, Don, let me ask the question, how does the new CEO search go?

<A – Donald Layton>: The search is going fine. For obvious reasons, we’re not going to give you details. The only comments I’ll make, I mean, it’s well organized, committee, the board, I work with. Headhunter been in place – oh, I’m trying to think, about a month already, and as you can imagine in this marketplace the supply of potential candidates is larger than normal, given all of the turmoil in the financial services industry, but beyond that, we’re not going to say anything until we have something to announce.

<Q – Richard Repetto>: Understood, understood. And Don, the bar seems to have been – has raised a bit on credit now. Like I think we’re expecting hopefully that things are stable, if not improving, and we have seen it stable, like home equity has been stable for the last six months; first lien for the last three months. But like – is that impacting, in that we haven’t seen anymore improvement. Is that impacting what the models are telling you that you had – when you showed that more steeper improvement earlier in the year?

<A – Donald Layton>: Well, let me – there’s a few measures. When people talk about credit metrics, there’s charge-offs, there’s provisions, there’s delinquencies of early stage, late stage total. Let me just run through it. To repeat, we’ve had for the P&L, the official accounting P&L, we’re now in our fourth quarter of declining loan loss provisions. We think the track record is very well established there.

We had outsiders we talked to many times who wanted to see at least six months of decline. We’re now into 12 months of decline, and it’s not minor declines at this point. So we think that track record’s not subject to a lot of uncertainty. A year ago before charge-offs had peaked and provisions had peaked, people didn’t know where things were going. So if you will the level of error of estimate, the standard deviation of views here has really shrunk down to whether the provisions will decline just a little faster or a litter slower.

Second, charge-offs. Everyone was worried about our credit until they saw charge-offs peak. We knew they were going to peak in the second quarter because of just the mechanics of pipeline and delinquencies working through it. We – they did in fact peak, and we were down 9% this third quarter. So we think that’s good.

In terms of delinquencies, first lien mortgages, or One-to-Four family mortgages, peaked in January, and been coming down in a slow steady way ever since. You will always have monthly bouncing around due to number of days in the month, holidays, individual idiosyncrasies of various servicers and such, but that one’s been a nice pattern.

Home Equity has been much more interesting. In early-stage delinquencies in Home Equity declined 34% in the first four months of this year. It’s not 34% per annum, that’s 34%. That’s 100% per annum rate. We knew after that blistering speed we were going to get some exhausted here, and you weren’t going to get continuing declines. So we knew we’d go into a flattish slight decline for a while as that exhaustion period worked its way through.
It’s largely happened. We still see it declining slightly. Just the many ways the circumstances of month ends and things it ended up being up 1%. But given what I’m seeing of the preliminary numbers for the month of October, which is obviously mostly over, I feel comfortable still saying we don’t see any reason to believe it’s other than slightly declining going through after that rather blistering pace earlier in the year.

<Q – Richard Repetto>: Okay. That’s very helpful. And last thing, Don, I guess this is a tribute to what you’ve done, but what – as you depart near year-end, what would be the one or two things that you most likely would recommend to the new CEO to get his arms around and watch more closely than anything else?

<A – Donald Layton>: Well, the good news for the new CEO is I’m going to tell him his first priority should be the actual franchise business and to spend a lot more time on that than the balance sheet and credit because things are so well in hand, and obviously my life the last two years was quite the opposite. So that’s what I’d tell him to focus on: Long-term value maximization of the customer business.


<A – Donald Layton>: All right. Thanks, Rich.

Operator: Your next question comes from Roger Freeman of Barclays.

<Q – Eric Bertrand>: Hi guys. This is Eric Bertrand. On the $400 million sale of – from the pool of home equity loans, just to be clear, was the 2% marked from par, i.e., the originally originated levels, or was it a 2% mark from the carried value after any allowance for the loan loss?

<A – Donald Layton>: It’s from par.

<Q – Eric Bertrand>: Okay. Fair enough. And could you give us a little bit of characteristics around that particular portfolio as it compares to the rest of the $8 billion that you still have on your books – [inaudible], that sort of thing.

<A – Donald Layton>: Yes. As Bruce indicated, that was a somewhat unique situation. It is – was an originator of a small portion of the portfolio, very high quality, not average quality of portfolio. I would not recommend you extrapolate $0.98 on the dollar to the rest of the portfolio. Please assure yourself, if we could sell other things at $0.98 to the dollar, we’d be extremely interested in doing so. But we don’t think those kind of transactions are actually available.

<Q – Eric Bertrand>: That’s fair. And did you say that you sold it back to the originator?

<A – Donald Layton>: Yes, this was the originator wishing to repurchase or purchase the loans related to their customers’ strategies.

<Q – Eric Bertrand>: Okay. And given that – seems like you have been at least shopping the portfolios at least somewhat. You should have gotten at least a bit of a look into the value of the whole portfolio. Do you have a sense as to where the remaining [inaudible] could be marked?

<A – Donald Layton>: Yeah, the answer is we did not shop the portfolio. This was the originator coming to us on a one-off basis for their strategies, contacting us. We have not done shopping of the portfolio.

<Q – Eric Bertrand>: Okay. Fair. And on the brokerage business. The net new brokerage accounts during the quarter of 14,000 was actually the lowest on a quarterly basis since the end of
2007. Do you attribute the slowdown in gross new brokerage activity to the lower advertising spending?

<A – Donald Layton>: No. Advertising spending was in fact lower in the third quarter, but that’s the usual seasonal slowdown. We don’t spend a lot – we don’t spend a lot when we know that people are on vacation and such. We attribute it more than anything else to a little bit of exhaustion after our three record quarters of extremely large numbers of net new brokerage accounts. And we figure that stole a little bit and compressed the consumer base upfront some. And so there’s a little bit of exhaustion going on there. Sort of like you read about everyone debating on Cash for Clunkers whether it’s stealing sales from later on for the auto companies. We think we had some of that going on.

<Q – Eric Bertrand>: Okay. And shifting gears lastly to the enterprise balance sheet. On the margin loans, we saw the rate actually tick up in the quarter sequentially in comparison to the dynamics seen at your closest peers, AMERITRADE and Schwab. Are you finding your customers less price sensitive, and you’re able to actually put through rate increases? Or was there a mix shift towards the lower borrowed volume tiers that’s pushing the rate up?

<A – Donald Layton>: I’m going to ask Mike Curcio, who is head of the Brokerage business to comment on that.

<A – Michael Curcio>: Yes, it was mostly a mix issue. So what we saw is some of the balances increased in the lower-balanced range, which have higher margin rates. So that was really what drove it. We were able to raise the rates in the small balances, yet remain extremely competitive in the higher balances.

<Q – Roger Freeman>: This is Roger Freeman. Just real quickly, the FHLB pay down, is there a limit to where you can go with that before the cost, those pre-payment costs, start to get more expensive. Because I thought there were some issues with interest rate swaps, hedging out the rate exposure -?

<A – Donald Layton>: The home loan bank advances that we have in the books are fixed rate advances at what are now considered above market rates because they were contracted in the past when rates were higher. But it’s a liability that if we can shrink it, we’d like to do so, so that we can allow our balance sheet to shrink on the asset side, since I explained where we have this problem with too many liabilities.

<A – Roger Freeman>: Right.

<A – Donald Layton>: We indicated we would be opportunistic in tactical balance sheet actions. Simply put, we’re willing to pay some modest prepayment penalties on those borrowings from the home loan bank, all of which have economic make-whole provisions, in order to reduce the liability and get the gain of having lower capital because the asset side shrank.

So we’re always making cost benefit trade-offs on the prepayment penalty which hits the P&L versus the balance sheet shrinkage which reduces the capital balance. So, we found we can do a few expeditiously and effectively, but it’s – and this is things we’ll look at every quarter. As time moves on by definition, the make-whole prepayment will tend to shrink because there’s less months and quarters to go. And so you may see this being done from time to time.

<A – Bruce Nolop>: And Roger, this is Bruce. The clarification I would make also is that the prepayment on the home loan that is simply an acceleration of the interest payments that would be due, the hedging constraint that you referred to, that doesn’t relate to the home loan. That relates to the repo portfolio, and that’s why you didn’t see us do any action on that portfolio this quarter.
<Q – Roger Freeman>: Okay, great. Thanks. And good luck to you, Don. It’s a credit to you and the team that we’re still having these calls, so congrats.

<A – Donald Layton>: Thank you.

Operator: Your next question comes from Keith Walsh of Citi.

<Q – Keith Walsh>: Hey. Good evening, gentlemen. First question, just for Don, just thinking about the improvement we’ve seen on the special mention loans, is there any discretion that you have in moving loans out of the say 30 to 89 day bucket into the 90 to 179? I just want to get a sense for this is true improvement.

<A – Donald Layton>: No, no, that’s strictly the action of the calendar on the portfolio. There’s no discretion allowed in that.

<Q – Keith Walsh>: Okay, great. And then for Bruce, just two quick ones. Is there any rule of thumb as far as sensitivity to upward movement in interest rates of your competitors, give that out to us, I wanted to see if you had any commentary there? And then if you could just give some more color around the commentary around opportunistic equity raises going forward as well? Thanks.

<A – Bruce Nolop>: Sure. On the interest rate movement, we don’t do that sensitivity, and partly is that we have a lot of moving pieces in our mosaic. For example, we have been lowering the rate on the savings accounts for some time, thinking that was going to reduce the deposits, and we keep lowering it, and so that has been able to help our interest spread.

We also have a lot of cash, as was pointed out earlier. So the more we can utilize that, and that not only is the unrestricted cash, but also the cash that’s available for margin loans. And we saw this quarter that we had some pick-up in margin activity, and our hope is that that will continue to grow, which will be another source of gain in that factor.

So, overall we think that there are a number of things that we can do to help grow the interest rate spread as we talked in the prepared remarks, and as much as possible try to offset the effect on interest income caused by the reduction in our loan portfolio.

Yeah, then the second question on opportunistic equity rates. We definitely are in the mode, as you said, to be on opportunistic. We don’t feel we need to raise any additional capital, and we’re under no pressure to do so. But we continue to evaluate the trade-off of issuing equity versus paying the interest on the existing debt that’s outstanding. And we will continue to monitor that and just would say that we’re conscious about dissolution, that that would do to existing shareholders. But likewise we can see that we could produce gains from the reduction in any debt burden for the company.

<Q – Keith Walsh>: Thank you.

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

<Q – Matt Snowling>: Yeah. Good evening.

<A – Donald Layton>: Hi, Matt.

<Q – Matt Snowling>: Hi. I guess I have a couple of questions. First, Don, understand that you are retiring at the end of the year, but I’m just curious just to hear your thoughts on how you envision E*TRADE down the road, once the balance sheet issues are cleared up, I guess? I’m really trying to get at – would you foresee E*TRADE actually getting back into providing credit products for customers or partnering up with another institution to do something like that?
<A – Donald Layton>: Okay. With all the caveats of forecasting the future is always a bit of a high risk game. I believe this company’s core franchise and true economic value lies in its investor franchise, as expressed to the Brokerage business. I see the growth being an outcome from that with investor clients and things related to their investing.

And we’ve talked about new products, especially building up on our active trader franchise, and expanding into more long-term investing and retirement products. If you look at us versus our larger online competitors, we are not as represented in that space. So I see the growth being still around the investor franchise.

<Q – Matt Snowling>: Okay.

<A – Donald Layton>: Yeah. That said, everyone is always interested in what I call icing on the cake with some cross sell, but my personal advice to my successor would be other products outside of direct investor space. Never confuse icing for the cake. This company did that, confused that at one point, and paid for it dearly.

And so I would suggest that partnering with others, like we have now with PHH so we can originate a few mortgages for them. It’s really their balance sheet, not our balance sheet for things. This is the white labeling cross sell. There may be some incremental opportunities there, but personal view is, it’s a few dollars, it’s not the core business.

<Q – Matt Snowling>: Understood. And I guess a couple housekeeping items. I think you said, 91 million that you were downstreaming to the bank, was that at the request of the regulators?

<A – Donald Layton>: No. The $100 million we put down in Q3, i.e., it’s already happened, that was where the regulators basically saw the success, the out performance of our capital raise and said we’d like some of that excess to go in the bank.

In the fourth quarter, we’re putting $91 million down to the bank. That’s because when we sold Canada, a little odd aspect of that transaction is that the parent must send $91 million in reimbursement to the bank related to tax position.

<A – Bruce Nolop>: And I should point out that that has no effect on the capital of the bank.

<A – Donald Layton>: Right.

<A – Bruce Nolop>: So this is just a transfer of cash, not a capital infusion.

<A – Donald Layton>: Right.

<Q – Matt Snowling>: Oh, understood. Okay. And then maybe for Bruce, just looking at the, the balance sheet management, breakout, and I think it’s, what 21 million of servicing expenses, does that number go down as the portfolio rolls off?

<A – Bruce Nolop>: That’s a very good point. It does. It can be viewed as proportionate. And even this year, it’s down from the prior year, and so something that we view as a expense reduction opportunity going forward.

<Q – Matt Snowling>: Okay. But still proportionate?

<A – Bruce Nolop>: Yes.

<Q – Matt Snowling>: Okay. Great, thanks. Good luck, Don.
<A – Donald Layton>: Thank you.

Operator: Your next question comes from Howard Chen of Credit Suisse.

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

<A – Donald Layton>: Hi.

<Q – Howard Chen>: Thanks for taking my questions. First one, could you provide some more detail on the impact from the loan modification program, and your outlook for the program going forward?

<A – Donald Layton>: Yeah. Loan modification program, I’ll spend a little time on that. First of all, we, unlike what you read in newspapers, where the government’s loan modification program is aimed at servicers because they’re not sure who the investor is in some cases with all these structures. We are the investors; the servicers work for us, and so we are directing our loan modification through our servicers.

It’s being designed by us, and I’m very proud of what we’ve done. We have basically developed programs that try to do what needs to be done here, in which you try to find those borrowers that with the right amount of help, relatively efficiently per dollar of our capital that gets used up by the modification, can really stay in their home versus not. And we’re doing this based upon real economics, and we’re not looking to make anything artificially look better or worse. So our modification program is most well developed in home equity. It’s secondarily in first mortgages, given our well known mix of where our risk has been. We have modified about, oh, let me see -

<A – Bruce Nolop>: 540 million.

<A – Donald Layton>: Yeah, we have 540 million of loans since the program began; consider that year-to-date, it’s close enough. That represents approximately 3.5% of the dollar outstanding currently of home equity, and about 2% of first lien mortgages. So we are making – so it’s significant. The modifications we’re talking about are almost – the margins I talked about are all TDR, troubled debt restructuring eligible.

The non-TDR ones are relatively de minimis additional amount. Local servicers do on their own. TDRs are relatively expensive to do. You have to believe you’re really helping a borrower that would have otherwise defaulted stay in their homes.

Remember, we not only have to charge off the economic concession to the client. We also have to switch our allowance from a four quarters forward-looking to a life of loan looking, and it was mentioned earlier about 12% of our allowance now is this longer, more conservative allowance, so it’s growing.

The impact of this has been to, we believe, reduce charge offs, currently, reduce future potential charge-offs; that’s the real economics here. We are not engaged in things which others have asked me about. We are not doing all sorts of things where we take just the delinquencies or lower the payments by tacking on things at the end.

Our most common modification is a multiyear or permanent interest rate reduction because what we have found the most important thing for the borrower is monthly payment reduction. For example in home equity loans, our average payment reduction, our interest rate reduction, is over 3% per annum, and that’s a very significant amount of reduced monthly payment to the borrowers.
So, we’re looking good. It’s impact on delinquencies is very hard to measure because of all the ins and the outs, but we don’t think it’s really giant impact in delinquencies being higher or lower than they otherwise would have been.

<Q – Howard Chen>: Okay. Thanks for the color, Don. And then I understand the long-term strategy of winding down the loan portfolio and what you’re doing on the liability side, but what do you view as the optimal size of the balance sheet to help preserve the brokerage and client franchise?

<A – Donald Layton>: Yeah. I’ll give you some thoughts on that, but it’s going to be something that the management team addresses fully, oh, probably starting six to 12 months from now. At this time, it’s still being – the balance sheet is larger than it needs to be. The ultimate balance sheet should be liability driven, where you have our brokerage-related liabilities, mainly of course sweep deposits and the associated free credits and such, a reasonable array of competitive savings products that are aligned to being an alternative investment for our investor client base. And they should be generating a liability size – our balance sheet is probably a little bit larger than optimal in those items now but not much.

I say that because certain – about one third of our savings deposits are not from brokerage clients, that’s been shrinking. It will shrink some more, and probably then stabilize. At some point, we would be able to get out of the home loan bank advances and the repo book over the long run, and that will tend to generate your size of balance sheet.

Given that it’s clear that the balance sheet will shrink for next year, which is what we’ve focused on through 2010. We have told people the plan is to shrink the balance sheet in line with the loan portfolio, no more, no less, as a general rule. After taking care of some of the excess cash that is on the asset side already, the loan portfolio is shrinking about a $1 billion a quarter at this time.

<Q – Howard Chen>: Okay, thanks. And then maybe one for Bruce. Bruce, where does the deferred tax assets stand, and what’s your outlook for need to potentially write that down? While you guys see progress in the franchise, it seems you may remain unprofitable for the foreseeable future?

<A – Bruce Nolop>: Sure. The deferred tax asset is about 1.4 billion, and we feel very confident today that we will not have any write-down of that asset. We have for the accounting rules 20 years to use the asset, and we regularly review it and see no reason why that asset won’t be fully utilized. And as I mentioned, that includes net operating losses that can shelter income up to 111 million of the first income per year. So, again, we feel very good about the preservation of that asset for the future, and that’s a great source of free cash flow, and that eventually will give us more capacity to either repay debt or repurchase stock.

<Q – Howard Chen>: Great, thanks. And then final cleanup question. Just curious, why did tangible book value per share go up, but stated book value per share go down during the quarter?

<A – Bruce Nolop>: You cut out. We couldn’t hear the beginning of the question, Howard.

<Q – Howard Chen>: Just wondering why, Bruce, why tangible book value per share went up but stated book value per share went down during the quarter?

<A – Bruce Nolop>: I’ll have to admit I’m turning to my Controller. We can maybe get back. Do you have an answer for that?

<A>: Yeah, it depends on the book value per share, I’d really stick with that as the additional shares issued during the quarter. And the tangible book value per share is really the conversions that we talked about that happened in the quarter, drove that number to increase.
<Q – Howard Chen>: Okay, thanks. And good luck, Don.

<A – Donald Layton>: All right. Thanks.

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

<Q – Michael Carrier>: Thanks, guys. It might be a bit early, just given that we’re still in the conversion process, but if you look at the improving credit trends, and then you’ve got the shrinking balance sheet, and I guess on the other side you still have last quarter the regulators wanting more capital at the bank, and then potential changing regulatory requirements for all banks. But when you start looking over the next, say, six, 12 months and 18 months, like what’s the environment where both the regulators and you guys are comfortable and confident where you can start reducing some of the capital that you have issued?

<A – Donald Layton>: Yeah. That’s a good question. One of the themes I think Bruce will be talking about a lot next year will be – there will be a time when the bank’s regulatory capital is so large versus its required, the excess grows so much that we would apply to the regulator to send capital, i.e., cash, up to the parent, providing cash flow in addition to regular earnings which could be used to – well, whatever cash is used for at the parent – retire debt early, buy it back, buy stock back, of course, is quite traditional, maybe even make acquisitions for cash, and that’s a substantial amount.

We’re not going to give specific forecasts, but it’s clear there will be a time – if you do normal extrapolation, you’ll see a time when you probably would start talking to the regulators about this next year. Given the overall economic environment, unless improved dramatically, I would say the regulators will be a little cautious. So I wouldn’t think it’s going to be ultra quick. I think it will be a little bit delayed, just because the regulatory process. But that day will come, if not sooner, definitely later. And when it does come, it could be – it will happen in large size over large period of time if the balance sheet continues to shrink.

<Q – Michael Carrier>: Okay. And then just one follow-up. The commission for trade, was there anything unusual with that just besides client mix?

<A – Donald Layton>: No, as far as we know, it’s just client mix.

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

Operator: This concludes the allotted time for questions today. I will now turn the conference back over to Mr. Don Layton for closing remarks.

Donald H. Layton, Chairman and Chief Executive Officer

Okay. Thank you. Again, I want to say how – I want to make two comments, one about the company, one personally again. The company is, I think, on a well established path back to financial health. The recap is – was fabulously successful. The creation of value between the increase in the bonds and the increase in the value of the equity was tremendous. Well capitalized company for what should happen in the future; we see that.

Credit at this point has a well established path of improvement. It’s no longer speculative. It’s no longer one quarter or just two quarters. This thing is relatively, I don’t want to say on auto pilot, but it’s much more predictable without a lot of argument as to how uncertain the numbers are.
And the business, the whole story here is this franchise has tremendous potential to perform. It has been able to maintain its competitive position through these last two years despite the difficulties of the company in terms of its financial position.

That is an unbelievable testament to the loyalty of the customers, the brand value, the easing use of our website, how much customers like it, how competitive we are. So I think this company is just on its way up, and there will be the day when the lines cross, and it becomes profitable again and starts generating excess capital and excess cash flow again.

On a personal note, again repeat, it was in fact a tough two years. It was very stressful. There were a lot of tough times here. But simple fact is we got over our humps. We were decisive, we were focused. The team came together and pulled off something that, again, our competitors – some of them directly told me, our industry observers, they really just think we totally – it was almost a minor miracle as far as they’re concerned, that we’re live, healthy, fully competitive. And it’s been great to work with everybody here to do that. And I’m happy that it worked out this way for everybody here for our shareholders and for our customers. Okay. That’s – and I will be signing off, okay. Thank you.

Operator: This concludes your conference today. You may now disconnect.