

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2014

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 1-11921

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**E\*TRADE Financial Corporation**

(Exact Name of Registrant as Specified in its Charter)

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Delaware  
(State or other jurisdiction  
of incorporation or organization)

94-2844166  
(I.R.S. Employer  
Identification Number)

1271 Avenue of the Americas, 14<sup>th</sup> Floor, New York, New York 10020  
(Address of principal executive offices and Zip Code)

(646) 521-4300  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of October 31, 2014, there were 289,161,187 shares of common stock outstanding.

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**E\*TRADE FINANCIAL CORPORATION**  
**FORM 10-Q QUARTERLY REPORT**  
**For the Quarter Ended September 30, 2014**  
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*Unless otherwise indicated, references to "the Company," "we," "us," "our" and "E\*TRADE" mean E\*TRADE Financial Corporation and its subsidiaries.*

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## **FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions based on certain assumptions and include any statement that is not historical in nature. These statements may be identified by the use of words such as "assume," "expect," "believe," "may," "will," "should," "anticipate," "intend," "plan," "estimate," "continue" and similar expressions. We caution that actual results could differ materially from those discussed in these forward-looking statements. Important factors that could contribute to our actual results differing materially from any forward-looking statements include, but are not limited to, those discussed under Part 1. Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q; and Part 1. Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC, which are incorporated herein by reference. By their nature forward-looking statements are not guarantees of future performance or results and are subject to risks, uncertainties and assumptions that are difficult to predict or quantify. Actual future results may vary materially from expectations expressed or implied in this report or any of our prior communications. The forward-looking statements contained in this report reflect our expectations only as of the date of this report. You should not place undue reliance on forward-looking statements, as we do not undertake to update or revise forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made, except as required by law.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the consolidated financial statements and the related notes that appear elsewhere in this document and with the Annual Report on Form 10-K for the year ended December 31, 2013.*

## **GLOSSARY OF TERMS**

In analyzing and discussing our business, we utilize certain metrics, ratios and other terms that are defined in the Glossary of Terms, which is located at the end of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

## **OVERVIEW**

### ***Strategy***

Our business strategy is centered on two core objectives: accelerating the growth of our core brokerage business to improve market share, and strengthening our overall financial and franchise position.

#### *Accelerate Growth of Core Brokerage Business*

- *Enhance digital and offline customer experience.*  
We are focused on maintaining our competitive position in trading, margin lending and cash management, while expanding our customer share of wallet in retirement, investing and savings. Through these offerings, we aim to continue acquiring new customers while deepening engagement with both new and existing ones.
- *Capitalize on value of corporate services business.*  
This includes leveraging our industry-leading position to improve client acquisition, and bolstering awareness among plan participants of our full suite of offerings. This channel is a strategically important driver of brokerage account growth for us.
- *Maximize value of deposits through the Company's bank.*  
Our brokerage business generates a significant amount of deposits, which we monetize through the bank by investing primarily in low-risk, agency mortgage-backed securities.

#### *Strengthen Overall Financial and Franchise Position*

- *Manage down legacy investments and mitigate credit losses.*  
We continue to manage down the size and risks associated with our legacy loan portfolio, while mitigating credit losses where possible.

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- *Execute on our capital plan.*

The core components of our capital plan include bolstering our capital levels through earnings and de-risking and building out best-in-class enterprise risk management capabilities. A key goal of this plan is to distribute capital from the bank to the parent.

### ***Key Factors Affecting Financial Performance***

Our financial performance is affected by a number of factors outside of our control, including:

- customer demand for financial products and services;
- weakness or strength of the residential real estate and credit markets;
- performance, volume and volatility of the equity and capital markets;
- customer perception of the financial strength of our franchise;
- market demand and liquidity in the secondary market for mortgage loans and securities;
- market demand and liquidity in the wholesale borrowings market, including securities sold under agreements to repurchase;
- the level and volatility of interest rates;
- our ability to obtain regulatory approval to move capital from our bank to our parent company; and
- changes to the rules and regulations governing the financial services industry.

In addition to the items noted above, our success in the future will depend upon, among other things, our ability to:

- have continued success in the acquisition, growth and retention of brokerage customers;
- generate meaningful growth in our retirement, investing and savings customer products;
- enhance our risk management capabilities;
- mitigate credit costs;
- achieve the capital ratios stated in our capital plan, with a particular focus on the Tier 1 leverage ratio at E\*TRADE Bank;
- generate capital sufficient to meet our operating needs at both our bank and our parent company;
- assess and manage interest rate risk; and
- maintain disciplined expense control and improved operational efficiency.

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Management monitors a number of metrics in evaluating the Company's performance. The most significant of these are shown in the table and discussed in the text below:

	Three Months Ended September 30,		Variance	Nine Months Ended September 30,		Variance
	2014	2013	2014 vs. 2013	2014	2013	2014 vs. 2013
<b>Customer Activity Metrics:</b>						
Daily average revenue trades ("DARTs")	153,494	145,150	6 %	168,526	147,777	14 %
Average commission per trade	\$ 11.05	\$ 11.15	(1)%	\$ 10.79	\$ 11.18	(3)%
Margin receivables (dollars in billions)	\$ 8.1	\$ 6.2	31 %	\$ 8.1	\$ 6.2	31 %
End of period brokerage accounts	3,126,476	2,975,842	5 %	3,126,476	2,975,842	5 %
Net new brokerage accounts	23,510	13,111	79 %	128,417	72,651	77 %
Annualized brokerage account attrition rate	9.1%	9.0%	*	8.5%	8.7%	*
Customer assets (dollars in billions)	\$ 281.7	\$ 240.6	17 %	\$ 281.7	\$ 240.6	17 %
Net new brokerage assets (dollars in billions)	\$ 2.3	\$ 2.4	(4)%	\$ 7.4	\$ 7.2	3 %
Brokerage related cash (dollars in billions)	\$ 40.4	\$ 38.2	6 %	\$ 40.4	\$ 38.2	6 %
<b>Company Financial Metrics:</b>						
Corporate cash (dollars in millions)	\$ 610	\$ 373	64 %	\$ 610	\$ 373	64 %
E*TRADE Financial Tier 1 leverage ratio	7.7%	6.6%	1.1 %	7.7%	6.6%	1.1 %
E*TRADE Financial Tier 1 common ratio	16.1%	12.9%	3.2 %	16.1%	12.9%	3.2 %
E*TRADE Bank Tier 1 leverage ratio	10.4%	9.5%	0.9 %	10.4%	9.5%	0.9 %
Special mention loan delinquencies (dollars in millions)	\$ 159	\$ 278	(43)%	\$ 159	\$ 278	(43)%
Allowance for loan losses (dollars in millions)	\$ 401	\$ 459	(13)%	\$ 401	\$ 459	(13)%
Enterprise net interest spread	2.54%	2.30%	0.24 %	2.52%	2.32%	0.20 %
Enterprise interest-earning assets (average dollars in billions)	\$ 41.3	\$ 40.8	1 %	\$ 41.6	\$ 40.6	2 %

\* Percentage not meaningful.

*Customer Activity Metrics*

- DARTs are the predominant driver of commissions revenue from our customers.
- Average commission per trade is an indicator of changes in our customer mix, product mix and/or product pricing.
- Margin receivables represent credit extended to customers to finance their purchases of securities by borrowing against securities they own and are a key driver of net operating interest income.
- End of period brokerage accounts, net new brokerage accounts and brokerage account attrition rate are indicators of our ability to attract and retain brokerage customers. The brokerage account attrition rate is calculated by dividing attriting brokerage accounts, which are gross new brokerage accounts less net new brokerage accounts, by total brokerage accounts at the previous period end. This rate is presented on an annualized basis.
- Changes in customer assets are an indicator of the value of our relationship with the customer. An increase in customer assets generally indicates that the use of our products and services by existing and new customers is expanding. Changes in this metric are also driven by changes in the valuations of our customers' underlying securities.

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- Net new brokerage assets are total inflows to all new and existing brokerage accounts less total outflows from all closed and existing brokerage accounts and are a general indicator of the use of our products and services by new and existing brokerage customers.
- Brokerage related cash is an indicator of the level of engagement with our brokerage customers and is a key driver of net operating interest income.

### *Company Financial Metrics*

- Corporate cash is an indicator of the liquidity at the parent company. It is the primary source of capital above and beyond the capital deployed in our regulated subsidiaries. See Liquidity and Capital Resources for a reconciliation of this non-GAAP measure to the comparable GAAP measure.
- E\*TRADE Financial Tier 1 leverage ratio is Tier 1 capital divided by average total assets for leverage capital purposes for the parent company. E\*TRADE Financial Tier 1 common ratio is Tier 1 capital less elements of Tier 1 capital that are not in the form of common equity, such as trust preferred securities, divided by total risk-weighted assets for the holding company. The Tier 1 leverage and Tier 1 common ratios are non-GAAP measures as the parent company is not yet held to these regulatory capital requirements and are indications of E\*TRADE Financial's capital adequacy. See Liquidity and Capital Resources for a reconciliation of these non-GAAP measures to the comparable GAAP measures.
- E\*TRADE Bank Tier 1 leverage ratio is Tier 1 capital divided by adjusted total assets for E\*TRADE Bank and is an indication of E\*TRADE Bank's capital adequacy.
- Special mention loan delinquencies are loans 30-89 days past due and are an indicator of the expected trend for charge-offs in future periods as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge-off.
- Allowance for loan losses is an estimate of probable losses inherent in the loan portfolio as of the balance sheet date and is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date as well as the forecasted losses, including economic concessions to borrowers, over the estimated remaining life of loans modified as troubled debt restructurings ("TDR").
- Enterprise interest-earning assets, in conjunction with our enterprise net interest spread, are indicators of our ability to generate net operating interest income.

### *Significant Events in the Third Quarter of 2014*

#### *\$75 Million Dividend Issued from E\*TRADE Bank to the Parent Company*

- We received approval from our regulators for a \$75 million dividend from E\*TRADE Bank to the parent company, totaling \$400 million in dividends over the last five quarters, continuing to reflect significant progress on our capital plan.

#### *Enhancements to Our Trading and Investing Products and Services*

- We launched several mobile enhancements, including a new iPhone® application for iOS 8, with touch ID fingerprint authentication, and a home screen widget containing market and watch list information, as well as an app for the Amazon Fire Phone.
- We made improvements to our website, including revamping the Fixed Income Solutions Center with updated tools and resources.
- We enhanced and added more functionality to our active trader platform, most prominently a more fulsome integration of FX trading.
- We evolved our offering suite through launching browser-based trading, enabling real-time monitoring and execution.

#### *Market Recognition*

- Our corporate services business was rated #1 for client satisfaction and loyalty for the third consecutive year by Group Five, an independent consulting and research firm, in their 2014 Stock Plan Administration Study Industry Report.

## EARNINGS OVERVIEW

We generated net income of \$86 million and \$252 million, or \$0.29 and \$0.86 per diluted share, on total net revenue of \$440 million and \$1.4 billion for the three and nine months ended September 30, 2014, respectively. Net operating interest income increased 12% to \$269 million and 11% to \$805 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013, which were driven primarily by the size and mix of the balance sheet as well as increases in net interest spread. Commissions, fees and service charges and other revenue increased 7% to \$163 million and 13% to \$508 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013, which were driven primarily by increased order flow revenue and advisor management fees, in addition to increased trading activity.

Provision for loan losses decreased 73% to \$10 million and 79% to \$26 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The decreases were driven primarily by improving economic conditions, as evidenced by the lower levels of delinquent loans in the one- to four-family and home equity loan portfolios, lower net charge-offs, home price improvement and loan portfolio run-off. Total operating expenses increased 2% to \$277 million for the three months ended September 30, 2014 compared to the same period in 2013, primarily due to an increase in compensation and benefits expense. Total operating expenses decreased 13% to \$851 million for the nine months ended September 30, 2014, compared to the same period in 2013 driven primarily by \$142 million in impairment of goodwill that was recognized in the second quarter of 2013 which increased operating expenses for the same period in 2013.

The following sections describe in detail the changes in key operating factors and other changes and events that affected net revenue, provision for loan losses, operating expense, other income (expense) and income tax expense.

### Revenue

The components of revenue and the resulting variances are as follows (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Net operating interest income	\$ 269	\$ 241	\$ 28	12 %	\$ 805	\$ 725	\$ 80	11 %
Commissions	108	103	5	5 %	341	310	31	10 %
Fees and service charges	45	40	5	13 %	138	113	25	22 %
Principal transactions	—	13	(13)	*	10	56	(46)	(82)%
Gains on loans and securities, net	8	12	(4)	(33)%	30	49	(19)	(39)%
Net impairment	—	(1)	1	*	—	(3)	3	*
Other revenues	10	9	1	11 %	29	27	2	7 %
Total non-interest income	171	176	(5)	(3)%	548	552	(4)	(1)%
Total net revenue	\$ 440	\$ 417	\$ 23	6 %	\$ 1,353	\$ 1,277	\$ 76	6 %

\* Percentage not meaningful.

### Net Operating Interest Income

Net operating interest income increased 12% to \$269 million and 11% to \$805 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Net operating interest income is earned primarily through investing deposits and customer payables in enterprise interest-earning assets, which include: available-for-sale securities, held-to-maturity securities, margin receivables and real estate loans.

The following table presents enterprise average balance sheet data and enterprise income and expense data for our operations, as well as the related net interest spread, yields and rates and have been prepared on the basis required by the SEC's Industry Guide 3, "Statistical Disclosure by Bank Holding Companies" (dollars in millions):

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Three Months Ended September 30,

	2014			2013		
	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost
<b>Enterprise interest-earning assets:</b>						
Loans(1)	\$ 6,871	\$ 70	4.05%	\$ 9,288	\$ 96	4.15%
Available-for-sale securities	12,595	70	2.23%	13,011	69	2.11%
Held-to-maturity securities	11,366	81	2.84%	9,853	65	2.62%
Margin receivables	7,645	67	3.47%	5,938	56	3.75%
Cash and equivalents	1,316	—	0.15%	1,544	1	0.20%
Segregated cash	904	—	0.06%	517	—	0.09%
Securities borrowed and other	649	28	16.89%	661	12	7.08%
Total enterprise interest-earning assets	41,346	316	3.04%	40,812	299	2.92%
Non-operating interest-earning and non-interest earning assets(2)	4,523			4,312		
Total assets	\$ 45,869			\$ 45,124		
<b>Enterprise interest-bearing liabilities:</b>						
Deposits	\$ 25,068	2	0.03%	\$ 25,804	4	0.05%
Customer payables	6,624	2	0.13%	5,548	2	0.15%
Securities sold under agreements to repurchase	3,753	30	3.07%	4,446	37	3.29%
Federal Home Loan Bank ("FHLB") advances and other borrowings	1,290	16	4.75%	1,292	17	5.20%
Securities loaned and other	1,634	—	0.03%	874	—	0.01%
Total enterprise interest-bearing liabilities	38,369	50	0.50%	37,964	60	0.62%
Non-operating interest-bearing and non-interest bearing liabilities(3)	2,270			2,383		
Total liabilities	40,639			40,347		
Total shareholders' equity	5,230			4,777		
Total liabilities and shareholders' equity	\$ 45,869			\$ 45,124		
<b>Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread</b>	<b>\$ 2,977</b>	<b>\$ 266</b>	<b>2.54%</b>	<b>\$ 2,848</b>	<b>\$ 239</b>	<b>2.30%</b>
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.57%			2.34%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			107.76%			107.50%
Return on average:						
Total assets			0.75%			0.42%
Total shareholders' equity			6.59%			3.97%
Average equity to average total assets			11.40%			10.59%

Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):

	Three Months Ended September 30,	
	2014	2013
Enterprise net interest income	\$ 266	\$ 239
Taxable equivalent interest adjustment	(1)	(1)
Customer assets held by third parties(4)	4	3
Net operating interest income	\$ 269	\$ 241

- (1) Nonaccrual loans are included in the average loan balances. Interest payments received on nonaccrual loans are recognized on a cash basis in operating interest income until it is doubtful that full payment will be collected, at which point payments are applied to principal.
- (2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.
- (3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.
- (4) Includes revenue earned on average customer assets of \$14.6 billion and \$12.0 billion for the three months ended September 30, 2014 and 2013, respectively, held by third parties outside the Company, including money market funds and sweep deposit accounts at unaffiliated financial institutions. Fees earned on the customer assets are based on the federal funds rate plus a negotiated spread or other contractual arrangement with the third party institutions.

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	Nine Months Ended September 30,					
	2014			2013		
	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost
<b>Enterprise interest-earning assets:</b>						
Loans <sup>(1)</sup>	\$ 7,556	\$ 231	4.07%	\$ 9,828	\$ 305	4.14%
Available-for-sale securities	12,940	221	2.28%	12,800	200	2.08%
Held-to-maturity securities	11,075	240	2.88%	9,709	184	2.52%
Margin receivables	7,307	194	3.56%	5,761	164	3.82%
Cash and equivalents	1,258	1	0.15%	1,501	3	0.21%
Segregated cash	847	1	0.09%	382	—	0.10%
Securities borrowed and other	633	66	13.84%	644	38	7.89%
Total enterprise interest-earning assets	41,616	954	3.06%	40,625	894	2.94%
Non-operating interest-earning and non-interest earning assets <sup>(2)</sup>	4,331			4,715		
Total assets	\$ 45,947			\$ 45,340		
<b>Enterprise interest-bearing liabilities:</b>						
Deposits	\$ 25,331	6	0.03%	\$ 26,113	10	0.05%
Customer payables	6,416	7	0.15%	5,302	6	0.14%
Securities sold under agreements to repurchase	4,071	95	3.07%	4,455	111	3.29%
Federal Home Loan Bank ("FHLB") advances and other borrowings	1,285	50	5.09%	1,280	51	5.27%
Securities loaned and other	1,457	—	0.03%	827	—	0.01%
Total enterprise interest-bearing liabilities	38,560	158	0.54%	37,977	178	0.62%
Non-operating interest-bearing and non-interest bearing liabilities <sup>(3)</sup>	2,285			2,490		
Total liabilities	40,845			40,467		
Total shareholders' equity	5,102			4,873		
Total liabilities and shareholders' equity	\$ 45,947			\$ 45,340		
<b>Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread</b>	<b>\$ 3,056</b>	<b>\$ 796</b>	<b>2.52%</b>	<b>\$ 2,648</b>	<b>\$ 716</b>	<b>2.32%</b>
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.55%			2.35%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			107.93%			106.97%
Return on average:						
Total assets			0.73%			0.08%
Total shareholders' equity			6.58%			0.77%
Average equity to average total assets			11.10%			10.75%

Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):

	Nine Months Ended September 30,	
	2014	2013
Enterprise net interest income	\$ 796	\$ 716
Taxable equivalent interest adjustment	(1)	(1)
Customer assets held by third parties <sup>(4)</sup>	10	10
Net operating interest income	\$ 805	\$ 725

- (1) Nonaccrual loans are included in the average loan balances. Interest payments received on nonaccrual loans are recognized on a cash basis in operating interest income until it is doubtful that full payment will be collected, at which point payments are applied to principal.
- (2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.
- (3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.
- (4) Includes revenue earned on average customer assets of \$14.2 billion and \$10.9 billion for the nine months ended September 30, 2014 and 2013, respectively, held by third parties outside the Company, including money market funds and sweep deposit accounts at unaffiliated financial

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institutions. Fees earned on the customer assets are based on the federal funds rate plus a negotiated spread or other contractual arrangement with the third party institutions.

The fluctuation in enterprise interest-earning assets is driven primarily by changes in enterprise interest-bearing liabilities, specifically deposits and customer payables. Average enterprise interest-earning assets increased 1% to \$41.3 billion and 2% to \$41.6 billion for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases in average enterprise interest-earning assets were primarily a result of increases in average held-to-maturity securities and margin receivables, which were partially offset by decreases in average loans compared to the same periods in 2013.

Average enterprise interest-bearing liabilities increased 1% to \$38.4 billion and 2% to \$38.6 billion for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases in average enterprise interest-bearing liabilities were primarily due to increases in average customer payables and securities loaned and other, partially offset by decreases in average deposits and securities sold under agreements to repurchase.

As part of our strategy to strengthen our overall financial and franchise position, we have been focused on improving our capital ratios by reducing risk and deleveraging the balance sheet. Our deleveraging strategy included transferring customer deposits to third party institutions. At September 30, 2014, \$14.8 billion of our customers' assets were held at third party institutions, including third party banks and money market funds. Approximately 71% of these off-balance sheet assets resulted from our deleveraging efforts. We estimate the impact of our deleveraging efforts on net operating interest income to be approximately 135 basis points based on the estimated current re-investment rates on these assets, less approximately 30 basis points of cost associated with holding these assets on our balance sheet, primarily FDIC insurance premiums. While we may take some tactical actions in future periods, we consider this deleveraging initiative to be complete.

Enterprise net interest spread increased by 24 basis points and 20 basis points to 2.54% and 2.52% for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Enterprise net interest spread is driven by changes in average balances and average interest rates earned or paid on those balances. During the three and nine months ended September 30, 2014, the increases in enterprise net interest spread were driven primarily by the growth in margin receivables and securities loaned coupled with higher yields on the securities lending business, and lower wholesale borrowing costs due to a decrease in securities sold under agreements to repurchase. These increases were partially offset by the decrease in loans and lower rates earned on margin receivables. Enterprise net interest spread may further fluctuate based on the size and mix of the balance sheet, as well as the impact from the level of interest rates.

### **Commissions**

Commissions revenue increased 5% to \$108 million and 10% to \$341 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The main factors that affect commissions are DARTs, average commission per trade and the number of trading days.

DART volume increased 6% to 153,494 and 14% to 168,526 for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Option-related DARTs as a percentage of total DARTs represented 23% and 22% of trading volume for the three and nine months ended September 30, 2014, respectively, compared to 24% for both the same periods in 2013.

Average commission per trade decreased 1% to \$11.05 and 3% to \$10.79 for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Average commission per trade is impacted by customer mix and the different commission rates on various trade types (e.g. equities, options, fixed income, stock plan, exchange-traded funds, mutual funds, forex and cross border). Accordingly, changes in the mix of trade types will impact average commission per trade.

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**Fees and Service Charges**

Fees and service charges increased 13% to \$45 million and 22% to \$138 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The table below shows the components of fees and service charges and the resulting variances (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Order flow revenue	\$ 22	\$ 19	\$ 3	16 %	\$ 69	\$ 52	\$ 17	33 %
Mutual fund service fees	6	5	1	20 %	17	16	1	6 %
Advisor management fees	6	3	3	100 %	17	9	8	89 %
Foreign exchange revenue	4	4	—	0 %	12	11	1	9 %
Reorganization fees	1	3	(2)	(67)%	5	6	(1)	(17)%
Other fees and service charges	6	6	—	0 %	18	19	(1)	(5)%
<b>Total fees and service charges</b>	<b>\$ 45</b>	<b>\$ 40</b>	<b>\$ 5</b>	<b>13 %</b>	<b>\$ 138</b>	<b>\$ 113</b>	<b>\$ 25</b>	<b>22 %</b>

The increases in fees and services charges for the three and nine months ended September 30, 2014, compared to the same periods in 2013, were driven primarily by increased order flow revenue as a result of increased trading volumes and as E\*TRADE Securities began routing all of its order flow to third parties following the sale of G1 Execution Services, LLC which was completed on February 10, 2014. In addition, advisor management fees increased, driven by assets in managed accounts within our retirement, investing and savings products, which were \$3.0 billion at September 30, 2014, compared to \$2.1 billion at September 30, 2013.

**Principal Transactions**

Principal transactions decreased 82% to \$10 million for the nine months ended September 30, 2014 compared to the same period in 2013. There was no principal transactions revenue for the three months ended September 30, 2014. Principal transactions were derived from our market making business in which we acted as a market-maker for our brokerage customers' orders as well as orders from third party customers. On February 10, 2014, we completed the sale of the market making business to an affiliate of Susquehanna International Group, LLP ("Susquehanna") and no longer generate principal transactions revenue.

**Gains on Loans and Securities, Net**

Gains on loans and securities, net decreased 33% to \$8 million and 39% to \$30 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The table below shows the activity and resulting variances (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Gains (losses) on loans, net	\$ (3)	\$ (1)	\$ (2)	200 %	\$ 4	\$ (1)	\$ 5	*
Gains on available-for-sale securities, net	12	16	(4)	(25)%	34	50	(16)	(32)%
Hedge ineffectiveness	(1)	(3)	2	(67)%	(8)	—	(8)	*
Gains on securities, net	11	13	(2)	(15)%	26	50	(24)	(48)%
<b>Gains on loans and securities, net</b>	<b>\$ 8</b>	<b>\$ 12</b>	<b>\$ (4)</b>	<b>(33)%</b>	<b>\$ 30</b>	<b>\$ 49</b>	<b>\$ (19)</b>	<b>(39)%</b>

\* Percentage not meaningful.

Gains on loans and securities, net for the nine months ended September 30, 2014 included a \$7 million gain recognized on the sale of one- to four-family loans modified as TDRs during the second quarter of 2014, and a \$6 million gain recognized on the sale of our remaining \$17 million in amortized cost of available-for-sale non-agency CMOs in the first quarter of 2014.

**Provision for Loan Losses**

Provision for loan losses decreased 73% to \$10 million and 79% to \$26 million for the three and nine months ended

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September 30, 2014, respectively, compared to the same periods in 2013. The decrease in provision for loan losses was driven primarily by improving economic conditions, as evidenced by the lower levels of delinquent loans in the one- to four-family and home equity loan portfolios, lower net charge-offs, home price improvement and loan portfolio run-off for the nine months ended September 30, 2014. Provision for loan losses also included \$11 million and \$13 million of benefits recognized from settlements with third party mortgage originators during the nine months ended September 30, 2014 and 2013, respectively. The timing and magnitude of the provision for loan losses is affected by many factors and we anticipate variability from quarter to quarter, particularly as home equity lines of credit begin converting to amortizing loans.

**Operating Expense**

The components of operating expense and the resulting variances are as follows (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Compensation and benefits	\$ 108	\$ 88	\$ 20	23 %	\$ 305	\$ 270	\$ 35	13 %
Advertising and market development	21	21	—	0 %	88	81	7	9 %
Clearing and servicing	21	31	(10)	(32)%	72	94	(22)	(23)%
FDIC insurance premiums	18	25	(7)	(28)%	61	79	(18)	(23)%
Professional services	27	23	4	17 %	79	59	20	34 %
Occupancy and equipment	22	17	5	29 %	59	53	6	11 %
Communications	17	16	1	6 %	53	53	—	0 %
Depreciation and amortization	19	22	(3)	(14)%	60	68	(8)	(12)%
Amortization of other intangibles	5	6	(1)	(17)%	16	18	(2)	(11)%
Impairment of goodwill	—	—	—	*	—	142	(142)	*
Facility restructuring and other exit activities	2	6	(4)	(67)%	6	23	(17)	(74)%
Other operating expenses	17	16	1	6 %	52	40	12	30 %
<b>Total operating expense</b>	<b>\$ 277</b>	<b>\$ 271</b>	<b>\$ 6</b>	<b>2 %</b>	<b>\$ 851</b>	<b>\$ 980</b>	<b>\$ (129)</b>	<b>(13)%</b>

\* Percentage not meaningful.

**Compensation and Benefits**

Compensation and benefits increased 23% to \$108 million and 13% to \$305 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increase resulted primarily from increased salaries expense due to increased headcount and increased incentive compensation when compared to the same periods in 2013.

**Clearing and Servicing**

Clearing and servicing decreased 32% to \$21 million and 23% to \$72 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The decrease resulted primarily from a decrease in clearing fees as a result of the sale of the market making business which was partially offset by costs associated with an increase in trading volumes, when compared to the same periods in 2013. Additionally, servicing fees decreased when compared to the same periods in 2013 as the loan portfolio continues to run off.

**FDIC Insurance Premiums**

FDIC insurance premiums decreased 28% to \$18 million and 23% to \$61 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The decrease for the nine months ended September 30, 2014 was due to the sale of \$0.8 billion of our one- to four-family loans modified as TDRs during the second quarter of 2014 as well as continued improvement and quality of our balance sheet, improving capital ratios and overall risk profile when compared to the same periods in 2013. TDRs are considered underperforming assets and are assessed at a higher rate in the FDIC insurance calculation. We expect sustained savings as a result of the sale, and as we continue to improve the quality of the balance sheet and capital ratios in future periods.

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*Professional Services*

Professional services increased 17% to \$27 million and 34% to \$79 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013, primarily driven by professional services engagements focused on improving the customer experience and overall product offering, as well as our continued enterprise risk management build-out.

*Impairment of Goodwill*

Impairment of goodwill was \$142 million for the nine months ended September 30, 2013. This impairment represented the entire amount of goodwill associated with the market making business, which was sold in the first quarter of 2014. There were no similar charges during the nine months ended September 30, 2014.

*Facility Restructuring and Other Exit Activities*

Facility restructuring and other exit activities were \$2 million and \$6 million for the three and nine months ended September 30, 2014, respectively, compared to \$6 million and \$23 million for the same periods in 2013. The costs in 2014 were driven by severance costs incurred primarily related to our exit of the market making business and were partially offset by the \$4 million gain on the sale of that business, which was completed on February 10, 2014. The costs in 2013 were driven primarily by severance costs incurred as part of the expense reduction initiatives in the prior periods.

*Other Operating Expenses*

Other operating expenses increased 6% to \$17 million and 30% to \$52 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases were driven primarily by increased expenses related to real estate owned compared to the same periods in 2013. In addition, a legal accrual reversal of \$3 million in the second quarter of 2013 offset the other operating expenses for the nine months ended September 30, 2013.

*Other Income (Expense)*

Other income (expense) decreased 3% to \$28 million and increased 17% to \$95 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013 as shown in the following table (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Corporate interest expense	\$ (29)	\$ (29)	\$ —	0 %	\$ (86)	\$ (86)	\$ —	0 %
Losses on early extinguishment of debt	—	—	—	*	(12)	—	(12)	*
Equity in income of investments and other	1	—	1	*	3	5	(2)	(40)%
Total other income (expense)	\$ (28)	\$ (29)	\$ 1	(3)%	\$ (95)	\$ (81)	\$ (14)	17 %

\* Percentage not meaningful.

Total other income (expense) primarily consisted of corporate interest expense of \$29 million for both the three months ended September 30, 2014 and 2013 and \$86 million for both the nine months ended September 30, 2014 and 2013. In addition, during the nine months ended September 30, 2014 we recognized \$12 million of losses on early extinguishment of debt as a result of the early extinguishment of \$100 million in repurchase agreements.

*Income Tax Expense*

Income tax expense was \$39 million and \$129 million for the three and nine months ended September 30, 2014, respectively, compared to income tax expense of \$33 million and \$62 million for the same periods in 2013. The effective tax rate was 31% and 34% for the three and nine months ended September 30, 2014, respectively, compared to 41% and 69% for the same periods in 2013. Income tax expense for the three and nine months ended September 30, 2014 included \$8 million of benefit primarily related to the settlement of a state tax audit. Income tax expense for the nine months ended September 30, 2014 also included \$5 million of benefit related to a recent change to the New York state tax code and its impact on state deferred taxes. Excluding the impact of the recent change to the New York state tax code and the settlement of the state tax audit, our effective tax rate for the three and nine months ended September 30, 2014 would have been 38% and 37%, respectively calculated in the following table (dollars in millions):

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	For the Three Months Ended September 30, 2014			For the Nine Months Ended September 30, 2014		
	Pre-tax Income	Tax Expense (Benefit)	Tax Rate	Pre-tax Income	Tax Expense (Benefit)	Tax Rate
Taxes and tax rate before the impact of the change in New York state tax code and settlement of a state tax audit	\$ 125	\$ 47	38%	\$ 381	\$ 142	37%
Impact of the change in the New York State tax code	—	—		—	(5)	
Impact primarily related to the settlement of a state tax audit	—	(8)		—	(8)	
Income taxes and tax rate as reported	<u>\$ 125</u>	<u>\$ 39</u>	31%	<u>\$ 381</u>	<u>\$ 129</u>	34%

At the end of June 2013, we decided to exit the market making business, and as a result recorded \$142 million in goodwill impairment during the nine months ended September 30, 2013. The \$142 million goodwill impairment charge associated with the market making business was non-deductible for tax purposes. In addition, the overall state apportionment increased significantly as a result of the exit of the market making business and we expected our state taxable income to increase in future periods. We expected to utilize net operating losses in California; therefore we recognized a tax benefit of \$26 million during the nine months ended September 30, 2013, the majority of which consisted of releasing valuation allowances for net operating losses, research and development credits and revaluation of other deferred tax assets relating to California. Without the exit of the market making business, the effective tax rate for the nine months ended September 30, 2013 would have been 38%, calculated in the following table (dollars in millions):

	For the Nine Months Ended September 30, 2013		
	Pre-tax Income	Tax Expense	Tax Rate
Taxes and tax rate before impact of exit of market making business	\$ 232	\$ 88	38%
Impact of exit of market making business:			
Goodwill impairment charge	(142)	—	
State apportionment change	—	(26)	
Income taxes and tax rate as reported	<u>\$ 90</u>	<u>\$ 62</u>	69%

*Valuation Allowance*

We are required to establish a valuation allowance for deferred tax assets and record a corresponding charge to income tax expense if it is determined, based on evaluation of available evidence at the time the determination is made, that it is more likely than not that some or all of the deferred tax assets will not be realized. If we were to conclude that a valuation allowance was required, the resulting loss could have a material adverse effect on our financial condition and results of operations. As of September 30, 2014, we did not establish a valuation allowance against our federal deferred tax assets as we believe that it is more likely than not that all of these assets will be realized. Slightly less than half of our existing federal deferred tax assets are not related to net operating losses and therefore, have no expiration date. We expect to utilize the majority of our existing federal deferred tax assets within the next five years.

**SEGMENT RESULTS REVIEW**

We report operating results in two segments: 1) trading and investing; and 2) balance sheet management. Trading and investing includes retail brokerage products and services; investor-focused banking products; and corporate services. Balance sheet management includes the management of asset allocation; loans previously originated by the Company or purchased from third parties; deposits and customer payables; and credit, liquidity and interest rate risk for the Company as described in the Risk Management section. Costs associated with certain functions that are centrally-managed are separately reported in a corporate/other category. For more information on our segments, see Note 14—Segment Information in Item 1. Consolidated Financial Statements (Unaudited).

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**Trading and Investing**

The following table summarizes trading and investing financial information and key customer activity metrics as of and for the three and nine months ended September 30, 2014 and 2013 (dollars in millions, except for key metrics):

	Three Months Ended September 30,		Variance		Nine Months Ended September 30,		Variance	
	2014	2013	2014 vs. 2013		2014	2013	2014 vs. 2013	
			Amount	%			Amount	%
Net operating interest income	\$ 165	\$ 134	\$ 31	23 %	\$ 459	\$ 401	\$ 58	14 %
Commissions	108	103	5	5 %	341	310	31	10 %
Fees and service charges	45	39	6	15 %	137	111	26	23 %
Principal transactions	—	13	(13)	*	10	56	(46)	(82)%
Other revenues	9	8	1	13 %	25	24	1	4 %
Total net revenue	327	297	30	10 %	972	902	70	8 %
Total operating expense	183	171	12	7 %	574	688	(114)	(17)%
Trading and investing income	\$ 144	\$ 126	\$ 18	14 %	\$ 398	\$ 214	\$ 184	86 %
Key Customer Activity Metrics:								
DARTs	153,494	145,150	8,344	6 %	168,526	147,777	20,749	14 %
Average commission per trade	\$ 11.05	\$ 11.15	\$ (0.10)	(1)%	\$ 10.79	\$ 11.18	\$ (0.39)	(3)%
Margin receivables (dollars in billions)	\$ 8.1	\$ 6.2	\$ 1.9	31 %	\$ 8.1	\$ 6.2	\$ 1.9	31 %
End of period brokerage accounts	3,126,476	2,975,842	150,634	5 %	3,126,476	2,975,842	150,634	5 %
Net new brokerage accounts	23,510	13,111	10,399	79 %	128,417	72,651	55,766	77 %
Annualized brokerage account attrition rate	9.1%	9.0%	0.1%	*	8.5%	8.7%	(0.2)%	*
Customer assets (dollars in billions)	\$ 281.7	\$ 240.6	\$ 41.1	17 %	\$ 281.7	\$ 240.6	\$ 41.1	17 %
Net new brokerage assets (dollars in billions)	\$ 2.3	\$ 2.4	\$ (0.1)	(4)%	\$ 7.4	\$ 7.2	\$ 0.2	3 %
Brokerage related cash (dollars in billions)	\$ 40.4	\$ 38.2	\$ 2.2	6 %	\$ 40.4	\$ 38.2	\$ 2.2	6 %

\* Percentage not meaningful.

The trading and investing segment offers products and services to individual retail investors, generating revenue from these customer relationships and from corporate services activities. This segment currently generates four main sources of revenue: net operating interest income; commissions; fees and service charges; and other revenues. Net operating interest income is generated primarily from margin receivables and from a deposit transfer pricing arrangement with the balance sheet management segment. The balance sheet management segment utilizes deposits and customer payables and compensates the trading and investing segment via a market-based transfer pricing arrangement. This compensation is reflected in segment results as operating interest income for the trading and investing segment and operating interest expense for the balance sheet management segment, and is eliminated in consolidation. Other revenues include results from providing software and services for managing equity compensation plans from corporate customers, as we ultimately service retail investors through these corporate relationships.

Trading and investing income increased 14% to \$144 million and 86% to \$398 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. We continued to generate net new brokerage accounts, ending the third quarter of 2014 with 3.1 million accounts. Brokerage related cash, which is one of our most profitable sources of funding, increased by \$2.2 billion to \$40.4 billion when compared to the same period in 2013.

Trading and investing, net operating interest income increased 23% to \$165 million and 14% to \$459 million for the three and nine months ended September 30, 2014, respectively, driven primarily by the growth in margin receivables coupled with higher yields on securities borrowed balances when compared to the same periods in 2013.

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Trading and investing commissions revenue increased 5% to \$108 million and 10% to \$341 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases were primarily due to increases in DARTs of 6% to 153,494 and 14% to 168,526 for the three and nine months ended September 30, 2014, respectively, partially offset by decreases in average commission per trade of 1% to \$11.05 and 3% to \$10.79, compared to the same periods in 2013.

Trading and investing fees and service charges increased 15% to \$45 million and 23% to \$137 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases in fees and services charges were driven primarily by increased order flow revenue as a result of increased trading volumes and as E\*TRADE Securities began routing all of its order flow to third parties following the sale of G1 Execution Services, LLC which was completed on February 10, 2014. In addition, advisor management fees increased driven by assets in managed accounts within our retirement, investing and savings products, which were \$3.0 billion at September 30, 2014, compared to \$2.1 billion at September 30, 2013.

Trading and investing principal transactions decreased 82% to \$10 million for the nine months ended September 30, 2014 compared to the same period in 2013. There was no principal transactions revenue for the three months ended September 30, 2014. Principal transactions were derived from our market making business in which we acted as a market-maker for our brokerage customers' orders as well as orders from third party customers. On February 10, 2014, we completed the sale of the market making business to an affiliate of Susquehanna and no longer generate principal transactions revenue.

Trading and investing operating expense increased 7% to \$183 million and decreased 17% to \$574 million for the three and nine months ended September 30, 2014 compared to the same periods in 2013. The increase for the three months ended September 30, 2014, was driven by increased compensation and benefits primarily as a result of increased incentive compensation, and increased professional services expense as a result of our focus on improving the customer experience and overall product offering. The decrease for the nine months ended September 30, 2014, compared to the same period in 2013 was driven by higher operating expenses in the prior period as a result of \$142 million in impairment of goodwill associated with the market making business, which was recognized in the second quarter of 2013.

As of September 30, 2014, we had approximately 3.1 million brokerage accounts, 1.3 million stock plan accounts and 0.4 million banking accounts. For the three months ended September 30, 2014 and 2013, our brokerage products contributed 79% and 78%, respectively, and our banking products contributed 21% and 22%, respectively, of total trading and investing net revenue. For the nine months ended September 30, 2014 and 2013, our brokerage products contributed 80% and 78%, respectively, and our banking products contributed 20% and 22%, respectively, of total trading and investing net revenue.

**Balance Sheet Management**

The following table summarizes balance sheet management financial information and key financial metrics as of and for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Net operating interest income	\$ 104	\$ 107	\$ (3)	(3)%	\$ 346	\$ 324	\$ 22	7%
Fees and service charges	—	1	(1)	*	1	2	(1)	(50)%
Gains on loans and securities, net	8	12	(4)	(33)%	30	49	(19)	(39)%
Net impairment	—	(1)	1	*	—	(3)	3	*
Other revenues	1	1	—	0%	4	3	1	33%
Total net revenue	113	120	(7)	(6)%	381	375	6	2%
Provision for loan losses	10	37	(27)	(73)%	26	126	(100)	(79)%
Total operating expense	36	43	(7)	(16)%	113	135	(22)	(16)%
Balance sheet management income	\$ 67	\$ 40	\$ 27	68%	\$ 242	\$ 114	\$ 128	112%
Key Financial Metrics:								
Special mention loan delinquencies	\$ 159	\$ 278	\$ (119)	(43)%	\$ 159	\$ 278	\$ (119)	(43)%
Allowance for loan losses	\$ 401	\$ 459	\$ (58)	(13)%	\$ 401	\$ 459	\$ (58)	(13)%

\* Percentage not meaningful.

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The balance sheet management segment generates revenue from managing loans previously originated by the Company or purchased from third parties, as well as utilizing deposits and customer payables to generate additional net operating interest income. The balance sheet management segment utilizes deposits and customer payables from the trading and investing segment, wholesale borrowings and proceeds from loan pay-downs to invest in available-for-sale and held-to-maturity securities. Net operating interest income is generated from interest earned on available-for-sale and held-to-maturity securities and loans receivable, net of interest paid on wholesale borrowings and on a deposit transfer pricing arrangement with the trading and investing segment. The balance sheet management segment utilizes deposits and customer payables and compensates the trading and investing segment via a market-based transfer pricing arrangement. This compensation is reflected in segment results as operating interest income for the trading and investing segment and operating interest expense for the balance sheet management segment and is eliminated in consolidation.

The balance sheet management segment income increased 68% to \$67 million and 112% to \$242 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases in balance sheet management income were primarily due to decreases in provision for loan losses of 73% to \$10 million and 79% to \$26 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013.

The balance sheet management net operating interest income decreased 3% to \$104 million and increased 7% to \$346 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The decrease for the three months ended September 30, 2014 was driven by the decrease in interest earned on the loan portfolio as it continues to pay down, partially offset by an increase in interest earned on our securities portfolio, compared to the same period in 2013. The increase for the nine months ended September 30, 2014 was driven by the growth in average balances and increased yields of our securities portfolio, which more than offset the decrease in the interest earned on the loan portfolio, compared to the same period in 2013.

Gains on loans and securities, net decreased 33% to \$8 million and 39% to \$30 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Gains on loans and securities, net for the nine months ended September 30, 2014 included a \$7 million gain on the sale of one- to four-family loans modified as TDRs during the second quarter of 2014, and a \$6 million gain recognized on the sale of our remaining \$17 million in amortized cost of available-for-sale non-agency CMOs in the first quarter of 2014.

Provision for loan losses decreased 73% to \$10 million and 79% to \$26 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The decreases in provision for loan losses were driven primarily by improving economic conditions, as evidenced by the lower levels of delinquent loans in the one- to four-family and home equity loan portfolios, lower net charge-offs, home price improvement and loan portfolio run-off. The timing and magnitude of the provision for loan losses is affected by many factors and we anticipate variability from quarter to quarter, particularly as home equity lines of credit begin converting to amortizing loans.

Total balance sheet management operating expense decreased 16% for both the three and nine months ended September 30, 2014 to \$36 million and to \$113 million, respectively, compared to the same periods in 2013. The decrease in operating expense for the three and nine months ended September 30, 2014 resulted primarily from lower FDIC insurance premiums and reduced servicing expenses due to lower loan balances, partially offset by increased expense related to real estate owned when compared to the same periods in 2013.

### ***Corporate/Other***

The following table summarizes corporate/other financial information for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

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	Three Months Ended		Variance		Nine Months Ended		Variance	
	September 30,		2014 vs. 2013		September 30,		2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Total net revenue	\$ —	\$ —	\$ —	*	\$ —	\$ —	\$ —	*
Compensation and benefits	32	25	7	28 %	83	68	15	22 %
Professional services	10	13	(3)	(23)%	34	31	3	10 %
Occupancy and equipment	4	2	2	100 %	11	5	6	120 %
Communications	—	—	—	*	1	1	—	0 %
Depreciation and amortization	4	4	—	0 %	13	12	1	8 %
Facility restructuring and other exit activities	2	6	(4)	(67)%	6	23	(17)	(74)%
Other operating expenses	6	7	(1)	(14)%	16	17	(1)	(6)%
Total operating expense	58	57	1	2 %	164	157	7	4 %
Operating loss	(58)	(57)	(1)	2 %	(164)	(157)	(7)	4 %
Total other income (expense)	(28)	(29)	1	(3)%	(95)	(81)	(14)	17 %
Corporate/other loss	\$ (86)	\$ (86)	\$ —	0 %	\$ (259)	\$ (238)	\$ (21)	9 %

\* Percentage not meaningful.

The corporate/other category includes costs that are centrally-managed, technology related costs incurred to support centrally-managed functions, restructuring and other exit activities, corporate debt and corporate investments.

The corporate/other loss before income taxes was \$86 million and \$259 million for the three and nine months ended September 30, 2014, respectively, compared to \$86 million and \$238 million for the same periods in 2013.

The operating loss increased 2% to \$58 million and 4% to \$164 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The increases during the three and nine months ended September 30, 2014 were primarily due to increased compensation and benefits, and occupancy and equipment partially offset by lower facility restructuring and other exit activities. The increase in compensation and benefits for the three and nine months ended September 30, 2014 compared to the same periods in 2013 resulted primarily from increased salaries expense. Facility restructuring and other exit activities for the three and nine months ended September 30, 2014 were driven by severance costs incurred primarily related to our exit of the market making business. These costs were partially offset by the \$4 million gain on the sale of that business, which was completed on February 10, 2014.

Total other income (expense) primarily consisted of corporate interest expense of \$29 million for both the three months ended September 30, 2014 and 2013 and \$86 million for both the nine months ended September 30, 2014 and 2013. In addition, during the nine months ended September 30, 2014 we recognized \$12 million of losses on early extinguishment of debt as a result of the early extinguishment of \$100 million in repurchase agreements.

**BALANCE SHEET OVERVIEW**

The following table sets forth the significant components of the consolidated balance sheet (dollars in millions):

	September 30, 2014	December 31, 2013	Variance 2014 vs. 2013	
			Amount	%
<b>Assets:</b>				
Cash and equivalents	\$ 1,809	\$ 1,838	\$ (29)	(2)%
Segregated cash	608	1,066	(458)	(43)%
Securities <sup>(1)</sup>	24,363	23,773	590	2 %
Margin receivables	8,117	6,353	1,764	28 %
Loans receivable, net	6,302	8,123	(1,821)	(22)%
Investment in FHLB stock	77	61	16	26 %
Other <sup>(2)</sup>	4,543	5,066	(523)	(10)%
<b>Total assets</b>	<b>\$ 45,819</b>	<b>\$ 46,280</b>	<b>\$ (461)</b>	<b>(1)%</b>
<b>Liabilities and shareholders' equity:</b>				
Deposits	\$ 24,927	\$ 25,971	\$ (1,044)	(4)%
Wholesale borrowings <sup>(3)</sup>	5,211	5,822	(611)	(10)%
Customer payables	6,526	6,310	216	3 %
Corporate debt	1,771	1,768	3	0 %
Other liabilities	2,110	1,553	557	36 %
<b>Total liabilities</b>	<b>40,545</b>	<b>41,424</b>	<b>(879)</b>	<b>(2)%</b>
<b>Shareholders' equity</b>	<b>5,274</b>	<b>4,856</b>	<b>418</b>	<b>9 %</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 45,819</b>	<b>\$ 46,280</b>	<b>\$ (461)</b>	<b>(1)%</b>

(1) Includes balance sheet line items available-for-sale and held-to-maturity securities.

(2) Includes balance sheet line items property and equipment, net, goodwill, other intangibles, net and other assets.

(3) Includes balance sheet line items securities sold under agreements to repurchase and FHLB advances and other borrowings.

**Segregated Cash**

Segregated cash decreased by \$458 million to \$608 million during the nine months ended September 30, 2014. The level of cash required to be segregated under federal or other regulations, or segregated cash, is driven largely by customer cash and securities lending balances we hold as a liability in excess of the amount of margin receivables and securities borrowed balances we hold as an asset. The excess represents customer cash that we are required by our regulators to segregate for the exclusive benefit of our brokerage customers.

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**Securities**

Available-for-sale and held-to-maturity securities are summarized as follows (dollars in millions):

	September 30, 2014	December 31, 2013	Variance 2014 vs. 2013	
			Amount	%
Available-for-sale securities:				
Debt securities:				
Residential mortgage-backed securities:				
Agency mortgage-backed securities and CMOs	\$ 11,235	\$ 12,236	\$ (1,001)	(8)%
Non-agency CMOs	—	14	(14)	(100)%
Total residential mortgage-backed securities	11,235	12,250	(1,015)	(8)%
Other debt securities	1,249	1,342	(93)	(7)%
Total debt securities	12,484	13,592	(1,108)	(8)%
Publicly traded equity securities <sup>(1)</sup>	32	—	32	*
Total available-for-sale securities	\$ 12,516	\$ 13,592	\$ (1,076)	(8)%
Held-to-maturity securities:				
Agency residential mortgage-backed securities and CMOs	\$ 9,489	\$ 8,359	\$ 1,130	14 %
Other debt securities	2,358	1,822	536	29 %
Total held-to-maturity securities	\$ 11,847	\$ 10,181	\$ 1,666	16 %
Total securities	\$ 24,363	\$ 23,773	\$ 590	2 %

\* Percentage not meaningful.

(1) Publicly traded equity securities consisted of investments in a mutual fund related to the Community Reinvestment Act.

Securities represented 53% and 51% of total assets at September 30, 2014 and December 31, 2013, respectively. We classify securities as available-for-sale or held-to-maturity based on our investment strategy and management's assessment of our intent and ability to hold the securities until maturity. The decrease in available-for-sale securities during the nine months ended September 30, 2014 was primarily due to net sales and principal paydowns on agency mortgage-backed securities and CMOs. Additionally, we sold \$17 million in amortized cost of available-for-sale non-agency CMOs during the first quarter of 2014 as part of our continued focus to reduce legacy risks. The increase in held-to-maturity securities was a result of the purchase of agency mortgage-backed securities and CMOs and agency debt securities included in other debt securities.

**Loans Receivable, Net**

Loans receivable, net are summarized as follows (dollars in millions):

	September 30, 2014	December 31, 2013	Variance 2014 vs. 2013	
			Amount	%
One- to four-family	\$ 3,196	\$ 4,475	\$ (1,279)	(29)%
Home equity	2,991	3,454	(463)	(13)%
Consumer and other	488	602	(114)	(19)%
Unamortized premiums, net	28	45	(17)	(38)%
Allowance for loan losses	(401)	(453)	52	(11)%
Total loans receivable, net	\$ 6,302	\$ 8,123	\$ (1,821)	(22)%

Loans receivable, net decreased 22% to \$6.3 billion at September 30, 2014 from \$8.1 billion at December 31, 2013. We are continuing our strategy of reducing balance sheet risk by allowing the loan portfolio to pay down, which we plan to do for the foreseeable future. Additionally, we sold \$0.8 billion of our one- to four-family loans modified as TDRs. These loans were transferred to held-for-sale at March 31, 2014 and sold during the second quarter of 2014. As a result of this transaction, we recorded a charge-off of \$42 million related to these one- to four-family loans which drove the majority of the decrease in the allowance for loan losses during the nine months ended September 30, 2014.

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**Other Assets**

Other assets are summarized as follows (dollars in millions):

	September 30,		December 31,		Variance	
	2014	2013	2013	2014	2014 vs. 2013	
					Amount	%
Property and equipment, net	\$ 240	\$ 237	\$ 237	\$ 240	\$ 3	1 %
Goodwill	1,792	1,792	1,792	1,792	—	— %
Other intangibles	199	216	216	199	(17)	(8)%
Other assets:						
Deferred tax assets, net	1,018	1,239	1,239	1,018	(221)	(18)%
Deposits paid for securities borrowed	461	536	536	461	(75)	(14)%
Held-for-sale assets	—	177	177	—	(177)	(100)%
Other	833	869	869	833	(36)	(4)%
<b>Total other assets</b>	<b>\$ 4,543</b>	<b>\$ 5,066</b>	<b>\$ 5,066</b>	<b>\$ 4,543</b>	<b>\$ (523)</b>	<b>(10)%</b>

Total other assets decreased 10% to \$4.5 billion due primarily to decreases in deferred tax assets, deposits paid for securities borrowed and due to the disposition of held-for-sale assets related to our market making business during the nine months ended September 30, 2014. At December 31, 2013, held-for-sale assets were reported in the other assets line item on the consolidated balance sheet, which consisted primarily of \$105 million of trading securities and \$21 million of other intangibles, net. We completed the sale of the market making business on February 10, 2014. See Note 2—Disposition in Item 1. Consolidated Financial Statements (Unaudited) for additional information on the market making business.

**Deposits**

Deposits are summarized as follows (dollars in millions):

	September 30,		December 31,		Variance	
	2014	2013	2013	2014	2014 vs. 2013	
					Amount	%
Sweep deposits	\$ 19,098	\$ 19,592	\$ 19,592	\$ 19,098	\$ (494)	(3)%
Complete savings deposits	3,859	4,303	4,303	3,859	(444)	(10)%
Checking deposits	1,068	1,098	1,098	1,068	(30)	(3)%
Other money market and savings deposits	850	914	914	850	(64)	(7)%
Time deposits	52	64	64	52	(12)	(19)%
<b>Total deposits</b>	<b>\$ 24,927</b>	<b>\$ 25,971</b>	<b>\$ 25,971</b>	<b>\$ 24,927</b>	<b>\$ (1,044)</b>	<b>(4)%</b>

Deposits represented 61% and 63% of total liabilities at September 30, 2014 and December 31, 2013, respectively. At September 30, 2014, 90% of our customer deposits were covered by FDIC insurance. Deposits provide the benefit of lower interest costs compared with wholesale funding alternatives.

The majority of the deposits balance, specifically sweep deposits, is included in brokerage related cash and reported as a customer activity metric of \$40.4 billion and \$39.7 billion at September 30, 2014 and December 31, 2013, respectively. The total brokerage related cash balance is summarized as follows (dollars in millions):

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	September 30, 2014	December 31, 2013	Variance	
			2014 vs. 2013	
			Amount	%
Deposits	\$ 24,927	\$ 25,971	\$ (1,044)	(4)%
Less: bank related cash <sup>(1)</sup>	(5,829)	(6,379)	550	(9)%
Customer payables	6,526	6,310	216	3 %
Customer assets held by third parties <sup>(2)</sup>	14,822	13,783	1,039	8 %
Total brokerage related cash <sup>(3)</sup>	\$ 40,446	\$ 39,685	\$ 761	2 %

(1) Bank related cash includes complete savings deposits, checking deposits, other money market and savings deposits and time deposits.

(2) Customer assets held by third parties are not reflected on our consolidated balance sheet and are not immediately available for liquidity purposes. However, we maintain the ability to bring the majority of these customer assets back on the balance sheet with appropriate notification to the third parties.

(3) Increases in brokerage related cash generally indicate that the use of our products and services by existing and new brokerage customers is expanding.

As part of our strategy to strengthen our overall financial and franchise position we have been focused on improving our capital ratios by reducing risk and deleveraging the balance sheet. Our deleveraging strategy included transferring customer deposits to third party institutions. At September 30, 2014, our customers held \$14.8 billion of assets at third party institutions, including third party banks and money market funds. Approximately 71% of these off-balance sheet assets resulted from our deleveraging efforts. While we may take some tactical actions in future periods, we consider our deleveraging initiatives to be complete.

Customer assets held by third parties included \$4.5 billion and \$4.4 billion of customer sweep deposits at both September 30, 2014 and December 31, 2013, respectively in the extended insurance sweep deposit account program ("ESDA") that we have in place for brokerage customers. At September 30, 2014, the ESDA program utilized E\*TRADE Bank in combination with six additional third party program banks to allow certain customers the ability to insure at least \$1,250,000 of the cash they hold in the ESDA. In addition, customer assets held by third parties at September 30, 2014 and December 31, 2013 included \$10.3 billion and \$9.4 billion, respectively, held in third party money market funds in which our customers can elect to participate.

#### Wholesale Borrowings

Wholesale borrowings, which consist of securities sold under agreements to repurchase and FHLB advances and other borrowings, are summarized as follows (dollars in millions):

	September 30, 2014	December 31, 2013	Variance	
			2014 vs. 2013	
			Amount	%
Securities sold under agreements to repurchase	\$ 3,917	\$ 4,543	\$ (626)	(14)%
FHLB advances	866	851	15	2 %
Total securities sold under agreements to repurchase and FHLB advances	4,783	5,394	(611)	(11)%
Subordinated debentures	428	428	—	0 %
Total wholesale borrowings	\$ 5,211	\$ 5,822	\$ (611)	(10)%

Wholesale borrowings represented 13% and 14% of total liabilities at September 30, 2014 and December 31, 2013, respectively. Securities sold under agreements to repurchase and FHLB advances are the primary wholesale funding sources of the Bank. During the nine months ended September 30, 2014, total wholesale borrowings decreased by \$611 million primarily due to the scheduled expiration of \$600 million of securities sold under agreements to repurchase during the second quarter of 2014. We also terminated \$100 million of securities sold under agreements to repurchase during the first quarter of 2014, which resulted in a \$12 million loss on early extinguishment of debt. This decrease was partially offset by the effect of large amounts of customer net buying activity at the end of September 2014, which was temporarily funded with wholesale borrowings.

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**Corporate Debt**

Corporate debt by type is shown as follows (dollars in millions):

	Face Value	Discount	Net
<b>September 30, 2014</b>			
Interest-bearing notes:			
6 3/4% Notes, due 2016	\$ 435	\$ (3)	\$ 432
6% Notes, due 2017	505	(3)	502
6 3/8% Notes, due 2019	800	(5)	795
Total interest-bearing notes	1,740	(11)	1,729
Non-interest-bearing debt:			
0% Convertible debentures, due 2019	42	—	42
Total corporate debt	\$ 1,782	\$ (11)	\$ 1,771
<b>December 31, 2013</b>			
Interest-bearing notes:			
6 3/4% Notes, due 2016	\$ 435	\$ (4)	\$ 431
6% Notes, due 2017	505	(4)	501
6 3/8% Notes, due 2019	800	(6)	794
Total interest-bearing notes	1,740	(14)	1,726
Non-interest-bearing debt:			
0% Convertible debentures, due 2019	42	—	42
Total corporate debt	\$ 1,782	\$ (14)	\$ 1,768

**Other Liabilities**

Other liabilities increased 36% to \$2.1 billion due primarily to an increase of \$0.8 billion to \$1.8 billion in deposits received for securities loaned at September 30, 2014.

**Shareholders' Equity**

The activity in shareholders' equity during the nine months ended September 30, 2014 is summarized as follows (dollars in millions):

	Common Stock / Additional Paid-In Capital	Accumulated Deficit / Other Comprehensive Loss	Total
Beginning balance, December 31, 2013	\$ 7,331	\$ (2,475)	\$ 4,856
Net income	—	252	252
Net change from available-for-sale securities	—	122	122
Net change from cash flow hedging instruments	—	32	32
Other <sup>(1)</sup>	12	—	12
Ending balance, September 30, 2014	\$ 7,343	\$ (2,069)	\$ 5,274

(1) Other includes conversions of convertible debentures and share-based compensation.

**LIQUIDITY AND CAPITAL RESOURCES**

We have established liquidity and capital policies to support the successful execution of our business strategies, while ensuring ongoing and sufficient liquidity through the business cycle. We believe liquidity is of critical importance to the Company and especially important within E\*TRADE Bank. The objective of our policies is to ensure that we can meet our corporate and banking liquidity needs under both normal operating conditions and under periods of stress in the financial markets.

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Our corporate liquidity needs are primarily driven by the amount of principal and interest due on our corporate debt as well as any capital needs at E\*TRADE Bank. Our banking liquidity needs are driven primarily by the level and volatility of our customer activity. Management maintains a set of liquidity sources and monitors certain business trends and market metrics closely in an effort to ensure we have sufficient liquidity and to avoid dependence on other more expensive sources of funding.

Management believes the following sources of liquidity are of critical importance in maintaining ample funding for liquidity needs: corporate cash, bank cash, deposits and unused FHLB borrowing capacity. Management believes that within deposits, sweep deposits are of particular importance as they are the most stable source of liquidity for E\*TRADE Bank when compared to non-sweep deposits. While in recent periods we have transferred customer sweep deposits to third party banks that participate in our ESDA program, we maintain the ability to bring the majority of these off-balance sheet deposits back to E\*TRADE Bank with appropriate notification to the third party program banks. In addition, certain customer payables and sweep deposits were transferred to third party money market funds. At September 30, 2014, we had \$4.5 billion and \$10.3 billion of customer deposits at third party banks and third party money market funds, respectively. We continually assess our liquidity position with respect to our ESDA program with the third party banks, and maintain additional sources of liquidity outside of deposits through other programs that are available to us. Refer to Other Sources of Liquidity within this section for additional information on those programs.

Capital is generated primarily through the business operations of the trading and investing and balance sheet management segments, which are primarily contained within E\*TRADE Bank; therefore, we believe a key indicator of the capital generated or used in our business operations is the level of regulatory capital in E\*TRADE Bank. At September 30, 2014, E\*TRADE Bank's Tier 1 leverage ratio was 10.4%, an increase from 9.5% at December 31, 2013. We have been focused on improving the Tier 1 leverage ratio at E\*TRADE Bank through continued earnings and deleveraging the balance sheet by a reduction in wholesale borrowings, retail deposits and customer payables. While we may take some tactical actions in future periods, we consider our deleveraging initiatives to be complete within E\*TRADE Bank. We are now focused on continuing to generate capital through earnings.

We submitted an initial capital plan to the OCC and Federal Reserve during the second quarter of 2012. The plan included: our five-year business strategy; forecasts of our business results and capital ratios; capital distribution plans in current and adverse operating conditions; and internally developed stress tests. During the third quarter of 2012, we received initial feedback from our regulators on this plan and we believe that key elements of this plan, specifically reducing risk, deleveraging the balance sheet and the development of an enterprise risk management function, are critical. We submitted an updated capital plan to the OCC and Federal Reserve in February 2013, which included the key elements outlined in the initial plan as well as the progress made during 2012 on those key elements. We believe we have made important progress on our capital plan, as evidenced by the \$400 million in dividends that our regulators approved from E\*TRADE Bank, including \$225 million during the nine months ended September 30, 2014 and \$175 million during 2013. We plan to request a similar dividend each quarter over the near term up to the level of E\*TRADE Bank's net income from the previous quarter, while continuing an active and ongoing dialogue with our regulators to ensure our execution of the plan is consistent with their expectations.

### **Consolidated Cash and Equivalents**

The consolidated cash and equivalents balance decreased by \$29 million to \$1.8 billion at September 30, 2014 when compared to December 31, 2013. The majority of this balance is cash held in regulated subsidiaries, primarily the Bank, outlined as follows (dollars in millions):

	September 30, 2014	December 31, 2013	September 30, 2013
Corporate cash	\$ 610	\$ 415	\$ 373
Bank cash <sup>(1)</sup>	1,175	1,402	1,401
International brokerage and other cash	24	21	22
Total consolidated cash and equivalents	<u>\$ 1,809</u>	<u>\$ 1,838</u>	<u>\$ 1,796</u>

(1) Bank cash included \$691 million, \$507 million and \$453 million of cash at September 30, 2014, December 31, 2013 and September 30, 2013, respectively, held by E\*TRADE Clearing LLC and E\*TRADE Securities LLC, which are broker-dealer subsidiaries of E\*TRADE Bank.

Corporate cash is the primary source of liquidity at the parent company. We define corporate cash as cash held at the parent company as well as cash held in certain subsidiaries that can distribute cash to the parent company without any regulatory approval. We believe corporate cash is a useful measure of the parent company's liquidity as it is the primary source of capital above and beyond the capital deployed in our regulated subsidiaries. Corporate cash can fluctuate in any given quarter and is impacted primarily by tax settlements, approval and timing of subsidiary dividends, debt service costs and other overhead cost sharing arrangements. Corporate cash ended the third quarter of 2014 at \$610 million, which included the \$76 million cash proceeds from the sale of the market making business in the first quarter of 2014 and the \$225 million in dividends from E\*TRADE Bank to the parent company during the nine months ended September 30, 2014. We target corporate cash to be

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at least two times our scheduled annual debt service payments and corporate debt with scheduled maturities coming due in the next 12 months. Currently we do not have any corporate debt with scheduled maturities in the next 12 months. As such, our target is approximately \$220 million, or two times our annual debt service.

From the level of corporate cash at September 30, 2014 we would expect the balance to grow assuming we receive regulatory approval for ongoing dividends along with the fact that the parent company had \$323 million in net deferred tax assets, which will ultimately become sources of corporate cash as the parent's subsidiaries reimburse the parent for the use of its deferred tax assets. However, with corporate cash at \$610 million, well above our target at September 30, 2014, we believe we are in a position to reduce our debt in the near term by approximately \$400 million, subject to market conditions.

### ***Liquidity Available from Subsidiaries***

Liquidity available to us from our subsidiaries is limited by regulatory requirements. In addition, neither E\*TRADE Bank nor its subsidiaries may pay dividends to the parent company without approval from its regulators. Loans by E\*TRADE Bank to the parent company and its other non-bank subsidiaries are subject to various quantitative, arm's length, collateralization and other requirements.

E\*TRADE Bank is subject to capital requirements determined by its primary regulators. At September 30, 2014 and December 31, 2013, E\*TRADE Bank had \$2.3 billion and \$1.9 billion, respectively, of capital in excess of the amount needed to meet the regulatory minimum Tier 1 leverage ratio required to be considered "well capitalized."

Our broker-dealer subsidiaries are subject to capital requirements determined by their respective regulators. At September 30, 2014 and December 31, 2013, all of our brokerage subsidiaries met their minimum net capital requirements. Our broker-dealer subsidiaries had excess net capital of \$1.0 billion at September 30, 2014, an increase of \$152 million from \$873 million at December 31, 2013. The excess net capital of the broker-dealer subsidiaries at September 30, 2014 included \$597 million and \$411 million of excess net capital at E\*TRADE Clearing LLC and E\*TRADE Securities LLC, respectively, which are subsidiaries of E\*TRADE Bank and these amounts are also included in the excess capital of E\*TRADE Bank.

### ***Financial Regulatory Reform Legislation and Basel III Framework***

The Dodd-Frank Act requires all companies, including savings and loan holding companies, that directly or indirectly control an insured depository institution to serve as a source of strength for the institution. The implementation of holding company capital requirements for Tier 1 leverage, Tier 1 risk-based capital and total risk-based capital ratios will impact us as the parent company was not previously subject to regulatory capital requirements. These requirements will become effective for us on January 1, 2015, subject to a phase-in period for certain requirements over several years, as further explained below. Additionally, we monitor our Tier 1 common ratio, which has no mandated minimum or "well capitalized" standard. The Tier 1 common ratio is defined as Tier 1 capital, less elements of Tier 1 capital that are not in the form of common equity, such as trust preferred securities, divided by total risk-weighted assets. We believe these capital ratios are an important measure of capital strength and accordingly we manage our capital against the current capital ratios that apply to bank holding companies in preparation for the application of these requirements.

The Tier 1 leverage, Tier 1 risk-based capital, total risk-based capital and Tier 1 common ratios are non-GAAP measures as the parent company is not yet held to the Tier 1 leverage, Tier 1 risk-based capital and total risk-based capital regulatory capital requirements and as the Tier 1 common ratio is not a regulatory capital ratio. The Tier 1 leverage, Tier 1 risk-based capital, total risk-based capital and Tier 1 common ratios are calculated as follows (dollars in millions):

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	September 30, 2014	December 31, 2013	September 30, 2013
Shareholders' equity	\$ 5,274	\$ 4,856	\$ 4,829
Deduct:			
Losses in other comprehensive income on available-for-sale debt securities and cash flow hedges, net of tax	(304)	(459)	(426)
Goodwill and other intangible assets, net of deferred tax liabilities	1,609	1,654	1,681
Disallowed servicing assets and deferred tax assets	1,063	1,185	1,223
Tier 1 common	2,906	2,476	2,351
Add:			
Qualifying restricted core capital elements (TRUPs) <sup>(1)</sup>	433	433	433
Tier 1 capital	3,339	2,909	2,784
Add:			
Allowable allowance for loan losses	228	228	231
Total capital	\$ 3,567	\$ 3,137	\$ 3,015
Total average assets	\$ 45,869	\$ 46,038	\$ 45,123
Deduct:			
Goodwill and other intangible assets, net of deferred tax liabilities	1,609	1,654	1,681
Disallowed servicing assets and deferred tax assets	1,063	1,185	1,223
Average total assets for leverage capital purposes	\$ 43,197	\$ 43,199	\$ 42,219
Total risk-weighted assets <sup>(2)</sup>	\$ 18,070	\$ 17,992	\$ 18,200
Tier 1 leverage ratio (Tier 1 capital / Average total assets for leverage capital purposes)	7.7%	6.7%	6.6%
Tier 1 capital / Total risk-weighted assets	18.5%	16.2%	15.3%
Total capital / Total risk-weighted assets	19.7%	17.4%	16.6%
Tier 1 common ratio (Tier 1 common / Total risk-weighted assets)	16.1%	13.8%	12.9%

(1) The Company included 100% of its trust preferred securities ("TRUPs") in E\*TRADE Financial's Tier 1 capital, as the final ruling issued in July 2013 by the regulatory agencies has the phase-out of TRUPs beginning January 1, 2015 for the Company. If the TRUPs phase-out had been implemented, E\*TRADE Financial's Tier 1 leverage ratio would have been 6.8% at September 30, 2014.

(2) Under the regulatory guidelines for risk-based capital, on-balance sheet assets and credit equivalent amounts of derivatives and off-balance sheet items are assigned to one of several broad risk categories according to the obligor or, if relevant, the guarantor or the nature of any collateral. The aggregate dollar amount in each risk category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are aggregated for determining total risk-weighted assets.

At September 30, 2014, our Tier 1 leverage ratio was approximately 7.7% compared to the minimum ratio required to be "well capitalized" of 5%, the Tier 1 risk-based capital ratio was approximately 18.5% compared to the minimum ratio required to be "well capitalized" of 6%, and the total risk-based capital ratio was approximately 19.7% compared to the minimum ratio required to be "well capitalized" of 10%. Our Tier 1 common ratio was 16.1% at September 30, 2014.

In July 2013, the U.S. Federal banking agencies finalized a rule to implement Basel III in the U.S., a framework for the calculation and components of a banking organization's regulatory capital and for calculating a banking organization's risk-weighted assets. Among other things, the Basel III rule raises the minimum thresholds for required capital ratios and revises certain aspects of the definitions and elements of the capital that can be used to satisfy these required minimum ratios. While the rule became effective on January 1, 2014 for certain large banking organizations, most U.S. banking organizations, including the Company and E\*TRADE Bank, have until January 1, 2015 to begin complying with this new framework, with the fully phased-in Basel III capital ratios becoming effective in 2019. We expect to be compliant with the Basel III framework, as it is phased in.

We believe the most relevant element of the final rule to us relate to the risk-weighting of margin receivables, which will qualify for 0% risk-weighting. We believe this change will have a favorable impact on our current capital ratios. In addition, the final rule gives the option for a one-time permanent election for the inclusion or exclusion in the calculation of Common Tier 1 capital of unrealized gains (losses) on all available-for-sale debt securities; we currently intend to elect to exclude unrealized gains (losses).

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On September 9, 2014, U.S. Federal banking agencies issued an inter-agency final rule that implements a quantitative liquidity coverage ratio ("LCR") that is generally consistent with, and in some respects stricter than, the international LCR standard established by the Basel Committee on Banking Supervision. The purpose of the LCR is to require certain financial institutions to hold minimum amounts of high-quality, liquid assets against projected net cash outflows over a 30-day period of stressed conditions. While the LCR does not apply to companies with less than \$50 billion in assets, including the Company, we believe we would be compliant with the LCR standards set out in the final rule.

### ***Stress Testing***

On October 9, 2012, the U.S. Federal banking agencies, including the OCC and the Federal Reserve, issued final rules implementing provisions of the Dodd-Frank Act that require banking organizations with total consolidated assets of more than \$10 billion but less than \$50 billion to conduct annual company-run stress tests, report the results to their primary federal regulator and the Federal Reserve and publish a summary of the results. Under the rules, stress tests must be conducted using certain scenarios (baseline, adverse and severely adverse), which the OCC and Federal Reserve will publish by November 15 of each year.

Under the OCC stress test regulations, E\*TRADE Bank is required to conduct stress-testing using the prescribed stress-testing methodologies. The final OCC regulations required E\*TRADE Bank to conduct its first stress test using financial statement data as of September 30, 2013, and submit the results prior to March 31, 2014. The results of the first official test will not be public information for banking organizations with total consolidated assets of more than \$10 billion but less than \$50 billion. E\*TRADE Bank, which is under \$50 billion, submitted the results of its first stress test prior to March 31, 2014, as required. In the second quarter of 2014 we received feedback from the OCC on our stress test submission. While the details of our results are not public, we can share the high level result that we remained well above the regulatory well-capitalized levels for all capital ratios across all scenarios and we were satisfied with the feedback around our stress testing process, approach and methodologies. E\*TRADE Bank will be required to publish summary results of its annual stress test between June 15 and June 30 each year, beginning with its second annual stress test in 2015.

Under the final Federal Reserve regulations, the Company will be required to conduct its first stress test using financial statement data as of September 30, 2016, and it will be required to report the results of its first stress test to the Federal Reserve on or before March 31, 2017, and to disclose a summary of its first stress test results between June 15 and June 30, 2017.

### ***Other Sources of Liquidity***

We also maintain uncommitted lines of credit with unaffiliated banks to finance margin lending, with available balances subject to approval when utilized. At September 30, 2014, there were no outstanding balances.

We rely on borrowed funds, from sources such as securities sold under agreements to repurchase and FHLB advances, to provide liquidity for E\*TRADE Bank. Our ability to borrow these funds is dependent upon the continued availability of funding in the wholesale borrowings market. In addition, we can borrow from the Federal Reserve Bank's discount window to meet short-term liquidity requirements, although it is not viewed as a primary source of funding. At September 30, 2014, E\*TRADE Bank had approximately \$2.8 billion and \$1.0 billion in additional collateralized borrowing capacity with the FHLB and the Federal Reserve Bank, respectively. We also have the ability to generate liquidity in the form of additional deposits by raising the yield on our customer deposit account products.

### ***Off-Balance Sheet Arrangements***

We enter into various off-balance-sheet arrangements in the ordinary course of business, primarily to meet the needs of our customers and to reduce our own exposure to interest rate risk. These arrangements include firm commitments to extend credit and letters of credit. Additionally, we enter into guarantees and other similar arrangements as part of transactions in the ordinary course of business. For additional information on each of these arrangements, see Item 1. Consolidated Financial Statements (Unaudited).

## **RISK MANAGEMENT**

As a financial services company, our business exposes us to certain risks. The identification, mitigation and management of existing and potential risks are key to effective enterprise risk management. There are certain risks that are inherent to our business (e.g. execution of transactions) whereas other risks will present themselves through the conduct of that business. We seek to monitor and manage our significant risk exposures through a set of board approved limits as well as Key Risk Indicators ("KRIs") or metrics. We have in place a governance framework that regularly reports metrics, major risks and exposures to senior management and the Board of Directors. During 2014, we have and will continue to enhance our risk management culture and capabilities.

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We developed a Board-approved Risk Appetite Statement ("RAS") which was disseminated to employees and specifies the significant risks we are exposed to and our tolerance of those risks. As described in the RAS, our business exposes us to the following eight major categories of risk:

- *Credit Risk*—the risk of loss arising from the inability or failure of a borrower or counterparty to meet its credit obligations.
- *Interest Rate Risk*—the risk of loss of income or value of future income due to changes in interest rates arising from the Company's balance sheet position. This includes convexity risk, which arises from optionality in the balance sheet, related to prepayments in mortgage assets.
- *Liquidity Risk*—the potential inability to meet contractual and contingent financial obligations either on- or off-balance sheet, as they come due.
- *Market Risk*—the risk that asset values or income streams will be adversely affected by changes in market prices.
- *Operational Risk*—the risk of loss due to failure of people, processes and systems, or damage to physical assets caused by unexpected events.
- *Strategic Risk*—sometimes called business risk, is the risk of loss of market size, market share or margin in any business.
- *Reputational Risk*—the potential that negative perceptions regarding our conduct or business practices will adversely affect valuation, profitability, operations or customer base or require costly litigation or other measures.
- *Legal, Regulatory and Compliance Risk*—the current and prospective risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, internal policies, and procedures, or ethical standards.

For additional information about our interest rate risk, see Item 3. Quantitative and Qualitative Disclosures about Market Risk. For additional information on liquidity risk, see Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources. Market risk, operational risk, strategic risk, reputational risk and legal, regulatory and compliance risk and the management of risk are more fully described in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2013. We are also subject to other risks that could impact our business, financial condition, results of operations or cash flows in future periods. See Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2013.

### ***Credit Risk Management***

Credit risk is the risk of loss arising from the inability or failure of a borrower or counterparty to meet its credit obligations. We are exposed to credit risk in the following areas:

- We hold credit risk exposure in our loan portfolio. We are not currently originating or purchasing loans, and we are continuing our strategy of reducing balance sheet risk by allowing the loan portfolio to pay down.
- We extend margin loans to our brokerage customers which exposes us to the risk of credit losses in the event we cannot liquidate collateral during significant market movements.
- We engage in financial transactions with counterparties which expose us to credit losses in the event a counterparty cannot meet its obligations. These financial transactions include our invested cash, securities lending, repurchase and reverse repurchase agreements and derivatives contracts, as well as the settlement of trades.

Credit risk is monitored by our Credit Committee, whose objective is to evaluate current and expected credit performance of the Company's loans, investments, borrowers and counterparties relative to market conditions and the probable impact on the Company's financial performance. The Credit Committee establishes credit risk guidelines in accordance with the Company's strategic objectives and existing policies. The Credit Committee reviews investment and lending activities involving credit risk to ensure consistency with those established guidelines. These reviews involve an analysis of portfolio balances, delinquencies, losses, recoveries, default management and collateral liquidation performance, as well as any credit risk mitigation efforts relating to the portfolios. In addition, the Credit Committee reviews and approves credit related counterparties engaged in financial transactions with the Company.

### *Loss Mitigation on the Loan Portfolio*

Our credit risk operations team focuses on the mitigation of potential losses in the loan portfolio. Through a variety of strategies, including voluntary line closures, automatically freezing lines on all delinquent accounts, and freezing lines on loans with materially reduced home equity, we have reduced our exposure to open home equity lines from a high of over \$7 billion in 2007 to \$184 million at September 30, 2014.

We have a loan modification program that focuses on the mitigation of potential losses in the loan portfolio. We consider modifications in which we make an economic concession to a borrower experiencing financial difficulty a TDR. During the nine months ended September 30, 2014 and 2013, we modified \$17 million and \$72 million, respectively, of one- to four-family loans and \$11 million and \$14 million, respectively, of home equity loans, in which the modification was considered a TDR. In order to significantly reduce risk on the legacy loan portfolio, we sold \$0.8 billion of our one- to four-family loans modified as TDRs during the second quarter of 2014.

In addition, we process minor modifications on a number of loans through traditional collections actions taken in the normal course of servicing delinquent accounts. These actions typically result in an insignificant delay in the timing of payments; therefore, we do not consider such activities to be economic concessions to the borrowers. At September 30, 2014 and December 31, 2013, we had \$27 million and \$32 million, respectively, of mortgage loans with a minor modification that was not considered a TDR. Approximately 7% of these loans were classified as nonperforming at both September 30, 2014 and December 31, 2013.

To reduce vendor oversight and regulatory risk, we have an initiative to assess our servicing relationships and, where appropriate, consolidate loan servicing or transfer certain mortgage loans to servicers that specialize in managing troubled assets. We completed a servicer transfer of \$246 million of mortgage loans as a result of this initiative during the first quarter of 2014. At September 30, 2014, \$2.2 billion of our mortgage loans were held at servicers that specialize in managing troubled assets. We believe this initiative has improved and will continue to improve the credit performance in future periods of the loans transferred compared to the expected credit performance of these same loans if they had not been transferred.

We continue to review the mortgage loan portfolio in order to identify loans to be repurchased by the originator. Our review is primarily focused on identifying loans with violations of transaction representations and warranties or material misrepresentation on the part of the seller. Any loans identified with these deficiencies are submitted to the original seller for repurchase. During the nine months ended September 30, 2014 and 2013, we agreed to settlements with third-party mortgage originators specific to loans sold to us by those originators. One-time payments were agreed upon to satisfy in full all pending and future requests with those specific originators. We applied the full amount of payments of \$11 million and \$13 million for the nine months ended September 30, 2014 and 2013, respectively, as recoveries to the allowance for loan losses, resulting in a corresponding reduction to net charge-offs as well as our provision for loan losses. Approximately \$23 million of loans were repurchased by or settled with the original sellers during the nine months ended September 30, 2014, for a total of \$456 million of loans that were repurchased, including global settlements, since we actively started reviewing our purchased loan portfolio beginning in 2008. While we may continue to pursue loans to be repurchased by or settled with the original sellers, we consider this effort to be substantially complete.

## **CONCENTRATIONS OF CREDIT RISK**

### *Loans*

One- to four-family loans include interest-only loans for a five to ten year period, followed by an amortizing period ranging from 20 to 25 years. At September 30, 2014, 42% of our one- to four-family portfolio were not yet amortizing. However, during the trailing twelve months ended September 30, 2014, based on the unpaid principal balance before charge-offs, approximately 15% of these borrowers made voluntary annual principal payments of at least \$2,500 and slightly over a third of those borrowers made voluntary annual principal payments of at least \$10,000.

The home equity loan portfolio is primarily second lien loans on residential real estate properties, which have a higher level of credit risk than first lien mortgage loans. Approximately 15% of the home equity loan portfolio was in the first lien position and we held both the first and second lien positions in less than 1% of the home equity loan portfolio at September 30, 2014. The home equity loan portfolio consisted of approximately 20% of home equity installment loans and approximately 80% of home equity lines of credit at September 30, 2014.

Home equity installment loans are primarily fixed rate and fixed term, fully amortizing loans that do not offer the option of an interest-only payment. The majority of home equity lines of credit convert to amortizing loans at the end of the draw period, which typically ranges from five to ten years. Approximately 8% of this portfolio will require the borrowers to repay the loan in full at the end of the draw period, commonly referred to as "balloon loans." At September 30, 2014, 86% of the home equity line of credit portfolio had not converted from the interest-only draw period and had not begun amortizing. However, during the trailing twelve months ended September 30, 2014, approximately 40% of our borrowers made voluntary

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annual principal payments of at least \$500 on their home equity lines of credit and slightly under half of those borrowers reduced their principal balance by at least \$2,500.

The following table outlines when one- to four-family and home equity lines of credit convert to amortizing by percentage of the one- to four-family and home equity line of credit portfolios, respectively, at September 30, 2014:

<u>Period of Conversion to Amortizing Loan</u>	<u>% of One- to Four-Family Portfolio</u>	<u>% of Home Equity Line of Credit Portfolio</u>
Already amortizing	58%	14%
Through December 31, 2014	0%	3%
Year ending December 31, 2015	4%	27%
Year ending December 31, 2016	16%	43%
Year ending December 31, 2017	22%	13%

We track and review factors to predict and monitor credit risk in the mortgage loan portfolio on an ongoing basis. These factors include: loan type, estimated current loan-to-value ("LTV")/combined loan-to-value ("CLTV") ratios, delinquency history, documentation type, borrowers' current credit scores, housing prices, loan vintage and geographic location of the property. In economic conditions in which housing prices generally appreciate, we believe that loan type, LTV/CLTV ratios, documentation type and credit scores are the key factors in determining future loan performance. In a housing market with declining home prices and less credit available for refinance, we believe the LTV/CLTV ratio becomes a more important factor in predicting and monitoring credit risk. Credit scores and LTV/CLTV are updated on at least a quarterly basis. For the consumer and other loan portfolio, we track and review delinquency status to predict and monitor credit risk on at least a quarterly basis.

The following tables show the distribution of the mortgage loan portfolios by credit risk factor (dollars in millions):

<u>Current LTV/CLTV(1)</u>	<u>One- to Four-Family</u>		<u>Home Equity</u>	
	<u>September 30, 2014</u>	<u>December 31, 2013</u>	<u>September 30, 2014</u>	<u>December 31, 2013</u>
<=80%	\$ 1,826	\$ 1,912	\$ 1,132	\$ 1,142
80%-100%	841	1,365	813	866
100%-120%	333	711	584	736
>120%	196	487	462	710
Total mortgage loans receivable	\$ 3,196	\$ 4,475	\$ 2,991	\$ 3,454
Average estimated current LTV/CLTV (2)	79%	90%	92%	98%
Average LTV/CLTV at loan origination (3)	71%	72%	80%	80%

- (1) Current CLTV calculations for home equity loans are based on the maximum available line for home equity lines of credit and outstanding principal balance for home equity installment loans. For home equity loans in the second lien position, the original balance of the first lien loan at origination date and updated valuations on the property underlying the loan are used to calculate CLTV. Current property values are updated on a quarterly basis using the most recent property value data available to us. For properties in which we did not have an updated valuation, we utilized home price indices to estimate the current property value.
- (2) The average estimated current LTV/CLTV ratio reflects the outstanding balance at the balance sheet date and the maximum available line for home equity lines of credit, divided by the estimated current value of the underlying property.
- (3) Average LTV/CLTV at loan origination calculations are based on LTV/CLTV at time of purchase for one- to four-family purchased loans and undrawn balances for home equity loans.

<u>Documentation Type</u>	<u>One- to Four-Family</u>		<u>Home Equity</u>	
	<u>September 30, 2014</u>	<u>December 31, 2013</u>	<u>September 30, 2014</u>	<u>December 31, 2013</u>
Full documentation	\$ 1,404	\$ 1,847	\$ 1,531	\$ 1,769
Low/no documentation	1,792	2,628	1,460	1,685
Total mortgage loans receivable	\$ 3,196	\$ 4,475	\$ 2,991	\$ 3,454

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<u>Current FICO (1)</u>	<u>One- to Four-Family</u>		<u>Home Equity</u>	
	<u>September 30, 2014</u>	<u>December 31, 2013</u>	<u>September 30, 2014</u>	<u>December 31, 2013</u>
≥720	\$ 1,827	\$ 2,252	\$ 1,578	\$ 1,811
719 - 700	318	436	304	343
699 - 680	253	366	255	293
679 - 660	196	296	204	245
659 - 620	253	404	273	310
<620	349	721	377	452
Total mortgage loans receivable	<u>\$ 3,196</u>	<u>\$ 4,475</u>	<u>\$ 2,991</u>	<u>\$ 3,454</u>

(1) FICO scores are updated on a quarterly basis; however, at September 30, 2014 and December 31, 2013, there were some loans for which the updated FICO scores were not available. The current FICO distribution at September 30, 2014 included the most recent FICO scores where available, otherwise the original FICO score was used, for approximately \$74 million and \$4 million of one- to four-family and home equity loans, respectively. The current FICO distribution at December 31, 2013 included original FICO scores for approximately \$95 million and \$10 million of one- to four-family and home equity loans, respectively.

<u>Vintage Year</u>	<u>One- to Four-Family</u>		<u>Home Equity</u>	
	<u>September 30, 2014</u>	<u>December 31, 2013</u>	<u>September 30, 2014</u>	<u>December 31, 2013</u>
2003 and prior	\$ 115	\$ 146	\$ 118	\$ 151
2004	330	423	212	274
2005	651	869	808	933
2006	1,233	1,775	1,440	1,630
2007	866	1,260	406	458
2008	1	2	7	8
Total mortgage loans receivable	<u>\$ 3,196</u>	<u>\$ 4,475</u>	<u>\$ 2,991</u>	<u>\$ 3,454</u>
Average age of mortgage loans receivable (years)	8.5	7.7	8.6	7.9

<u>Geographic Location</u>	<u>One- to Four-Family</u>		<u>Home Equity</u>	
	<u>September 30, 2014</u>	<u>December 31, 2013</u>	<u>September 30, 2014</u>	<u>December 31, 2013</u>
California	\$ 1,416	\$ 2,111	\$ 932	\$ 1,083
Florida	227	300	215	247
New York	220	301	233	259
Virginia	163	206	139	158
Other states	1,170	1,557	1,472	1,707
Total mortgage loans receivable	<u>\$ 3,196</u>	<u>\$ 4,475</u>	<u>\$ 2,991</u>	<u>\$ 3,454</u>

Approximately 38% and 40% of the Company's mortgage loans receivable were concentrated in California at September 30, 2014 and December 31, 2013, respectively. No other state had concentrations of mortgage loans that represented 10% or more of the Company's mortgage loans receivable at September 30, 2014 and December 31, 2013.

*Allowance for Loan Losses*

The allowance for loan losses is management's estimate of probable losses inherent in the loan portfolio at the balance sheet date. The estimate of the allowance for loan losses is based on a variety of quantitative and qualitative factors, including the composition and quality of the portfolio; delinquency levels and trends; current and historical charge-off and loss experience; our historical loss mitigation experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate; the overall availability of housing credit; and general economic conditions. The allowance for loan losses is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date as well as the forecasted losses, including economic concessions to borrowers, over the estimated remaining life of loans modified as TDRs. The general allowance for loan losses also included a qualitative component to account for a variety of factors that present additional uncertainty that may not be fully considered in the quantitative loss model but are factors we believe may impact the level of credit losses.

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The following table presents the allowance for loan losses by loan portfolio (dollars in millions):

	One- to Four-Family		Home Equity		Consumer and Other		Total	
	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013
General reserve:								
Quantitative component	\$ 9	\$ 34	\$ 278	\$ 212	\$ 11	\$ 21	\$ 298	\$ 267
Qualitative component	9	8	23	50	3	4	35	62
Specific valuation allowance	9	60	59	64	—	—	68	124
Total allowance for loan losses	\$ 27	\$ 102	\$ 360	\$ 326	\$ 14	\$ 25	\$ 401	\$ 453
Allowance as a % of loans receivable(1)	0.8%	2.3%	12.0%	9.4%	2.9%	4.1%	6.0%	5.3%

(1) Allowance as a percentage of loans receivable is calculated based on the gross loans receivable for each respective category.

The one- to four-family allowance for loan losses decreased 74% to \$27 million at September 30, 2014 from \$102 million at December 31, 2013. This decline was primarily a result of the sale of \$0.8 billion of our one- to four-family loans modified as TDRs during the second quarter of 2014. As a result of this transaction, we recorded a charge-off of \$42 million related to these one- to four-family loans which had been previously recorded as part of the specific valuation allowance and drove the majority of the decrease in the allowance for loan losses during the nine months ended September 30, 2014.

The home equity allowance for loan losses increased 10% to \$360 million at September 30, 2014 from \$326 million at December 31, 2013, inclusive of the migration of certain estimated losses previously captured in the qualitative component into the quantitative component. As of September 30, 2014, we enhanced our quantitative allowance methodology to identify higher risk home equity lines of credit and extend the period of management's forecasted loan losses captured within the general allowance to include the total probable loss on a subset of these higher risk loans. This enhancement drove the migration of estimated losses previously captured on these loans from the qualitative component to the quantitative component of the general allowance, and drove the majority of the provision for loan losses within the home equity portfolio during the nine months ended September 30, 2014.

*Troubled Debt Restructurings*

TDRs include two categories of loans: (1) loan modifications completed under our programs that involve granting an economic concession to a borrower experiencing financial difficulty, and (2) loans for which we received bankruptcy notification. The following table shows total TDRs by category at September 30, 2014 and December 31, 2013 (dollars in millions):

	Loans Modified as TDRs <sup>(1)</sup>	Bankruptcy Loans	Total TDRs
<b>September 30, 2014</b>			
One- to four-family	\$ 184	\$ 133	\$ 317
Home equity	173	48	221
Total	\$ 357	\$ 181	\$ 538
<b>December 31, 2013</b>			
One- to four-family	\$ 1,036	\$ 136	\$ 1,172
Home equity	188	53	241
Total	\$ 1,224	\$ 189	\$ 1,413

(1) Includes loans modified as TDRs that also had received a bankruptcy notification of \$41 million and \$252 million at September 30, 2014 and December 31, 2013, respectively.

Total TDRs decreased \$875 million during the nine months ended September 30, 2014 primarily due to the sale of \$0.8 billion of our one- to four-family loans modified as TDRs in the second quarter of 2014. See the Allowance for Loan Losses section above for additional information on this transaction.

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The following table shows total TDRs by delinquency category at September 30, 2014 and December 31, 2013 (dollars in millions):

	TDRs Current	TDRs 30-89 Days Delinquent	TDRs 90-179 Days Delinquent	TDRs 180+ Days Delinquent	Total Recorded Investment in TDRs
<b>September 30, 2014</b>					
One- to four-family	\$ 236	\$ 28	\$ 5	\$ 48	\$ 317
Home equity	183	12	7	19	221
Total	\$ 419	\$ 40	\$ 12	\$ 67	\$ 538
<b>December 31, 2013</b>					
One- to four-family	\$ 901	\$ 102	\$ 44	\$ 125	\$ 1,172
Home equity	198	17	7	19	241
Total	\$ 1,099	\$ 119	\$ 51	\$ 144	\$ 1,413

TDRs on accrual status, which are current and have made six or more consecutive payments, were \$249 million and \$950 million at September 30, 2014 and December 31, 2013, respectively.

*Troubled Debt Restructurings – Loan Modifications*

We believe the distinction between loans modified as TDRs and total TDRs, which include bankruptcy loans, is important. Our loan modification programs focus on the mitigation of potential losses through making an economic concession to a borrower, whereas with loans for which we have received bankruptcy notification we have not taken any loss mitigation actions. The following table shows loans modified as TDRs by delinquency category at September 30, 2014 and December 31, 2013 (dollars in millions):

	Modifications Current	Modifications 30-89 Days Delinquent	Modifications 90-179 Days Delinquent	Modifications 180+ Days Delinquent	Total Recorded Investment in Modifications
<b>September 30, 2014</b>					
One- to four-family	\$ 155	\$ 17	\$ 1	\$ 11	\$ 184
Home equity	149	9	5	10	173
Total	\$ 304	\$ 26	\$ 6	\$ 21	\$ 357
<b>December 31, 2013</b>					
One- to four-family	\$ 817	\$ 92	\$ 39	\$ 88	\$ 1,036
Home equity	162	13	4	9	188
Total	\$ 979	\$ 105	\$ 43	\$ 97	\$ 1,224

The following table shows loans modified as TDRs and the specific valuation allowance by loan portfolio as well as the percentage of total expected losses at September 30, 2014 and December 31, 2013 (dollars in millions):

	Recorded Investment in Modifications before Charge-offs	Charge-offs	Recorded Investment in Modifications	Specific Valuation Allowance	Net Investment in Modifications	Specific Valuation Allowance as a % of Modifications	Total Expected Losses
<b>September 30, 2014</b>							
One- to four-family	\$ 229	\$ (45)	\$ 184	\$ (9)	\$ 175	5%	24%
Home equity	313	(140)	173	(59)	114	34%	64%
Total	\$ 542	\$ (185)	\$ 357	\$ (68)	\$ 289	19%	47%
<b>December 31, 2013</b>							
One- to four-family	\$ 1,354	\$ (318)	\$ 1,036	\$ (60)	\$ 976	6%	28%
Home equity	338	(150)	188	(64)	124	34%	63%
Total	\$ 1,692	\$ (468)	\$ 1,224	\$ (124)	\$ 1,100	10%	35%

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The recorded investment in loans modified as TDRs includes the charge-offs related to certain loans that were written down to the estimated current value of the underlying property less estimated selling costs. These charge-offs were recorded on modified loans that were delinquent in excess of 180 days, in bankruptcy, or when certain characteristics of the loan, including CLTV, borrower's credit and type of modification, cast substantial doubt on the borrower's ability to repay the loan. Included in allowance for loan losses was a specific valuation allowance of \$68 million and \$124 million that was established for loans modified as TDRs at September 30, 2014 and December 31, 2013, respectively. The specific valuation allowance for these individually impaired loans represents the forecasted losses over the remaining life of the loan, including the economic concession to the borrower.

The total expected loss on loans modified as TDRs includes both the previously recorded charge-offs and the specific valuation allowance. Total expected losses on loans modified as TDRs increased from 35% at December 31, 2013 to 47% at September 30, 2014, primarily due to the sale of \$0.8 billion of our one- to four-family loans modified as TDRs. See the Allowance for Loan Losses section above for additional information on this transaction.

*Net Charge-offs*

The following table provides an analysis of the allowance for loan losses and net charge-offs for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Charge-offs	Recoveries <sup>(1)</sup>	Net Charge-Offs	% of Average Loans (Annualized)
<b>Three Months Ended September 30, 2014</b>				
One- to four-family	\$ (1)	\$ —	\$ (1)	0.03%
Home equity	(13)	7	(6)	0.86%
Consumer and Other	(4)	1	(3)	2.84%
Total	<u>\$ (18)</u>	<u>\$ 8</u>	<u>\$ (10)</u>	0.62%
<b>Three Months Ended September 30, 2013</b>				
One- to four-family	\$ (7)	\$ —	\$ (7)	0.55%
Home equity	(29)	9	(20)	2.13%
Consumer and Other	(5)	3	(2)	1.67%
Total	<u>\$ (41)</u>	<u>\$ 12</u>	<u>\$ (29)</u>	1.27%
<b>Nine Months Ended September 30, 2014</b>				
One- to four-family	\$ (44)	\$ 11	\$ (33)	1.20%
Home equity	(54)	18	(36)	1.50%
Consumer and Other	(13)	4	(9)	2.05%
Total	<u>\$ (111)</u>	<u>\$ 33</u>	<u>\$ (78)</u>	1.39%
<b>Nine Months Ended September 30, 2013</b>				
One- to four-family	\$ (37)	\$ 14	\$ (23)	0.58%
Home equity	(132)	26	(106)	3.58%
Consumer and Other	(29)	10	(19)	3.42%
Total	<u>\$ (198)</u>	<u>\$ 50</u>	<u>\$ (148)</u>	2.01%

(1) Recoveries include the impact of mortgage originator settlements.

Loan losses are recognized when, based on management's estimate, it is probable that a loss has been incurred. The charge-off policy for both one- to four-family and home equity loans is to assess the value of the property when the loan has been delinquent for 180 days or has received bankruptcy notification, regardless of whether or not the property is in foreclosure, and charge-off the amount of the loan balance in excess of the estimated current value of the underlying property less estimated selling costs. Modified loans considered TDRs are charged-off when they are identified as collateral dependent based on certain terms of the modification, which includes assigning a higher level of risk to loans in which the LTV or CLTV is greater than 110% or 125%, respectively, a borrower's credit score is less than 600 and certain types of modifications, such

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as interest-only payments. Consumer loans are charged-off when the loan has been 120 days delinquent or when it is determined that collection is not probable.

Net charge-offs for the three and nine months ended September 30, 2014 compared to the same periods in 2013 decreased by \$19 million and \$70 million, respectively. As discussed above, as a result of our sale of one- to four-family loans modified as TDRs during the second quarter of 2014, we recorded a charge-off of \$42 million for these loans during the nine months ended September 30, 2014. Additionally, net charge-offs for the nine months ended September 30, 2014 and 2013 included \$11 million and \$13 million of benefit recorded from settlements with third party mortgage originators, respectively. The timing and magnitude of charge-offs are affected by many factors and we anticipate variability from quarter to quarter, particularly as home equity lines of credit begin converting to amortizing loans.

*Delinquent Loans*

We believe the distinction between loans delinquent 90 to 179 days and loans delinquent 180 days and greater is important as loans delinquent 180 days and greater have been written down to their expected recovery value, whereas loans delinquent 90 to 179 days have not (unless they are in process of bankruptcy or are modifications that have substantial doubt as to the borrower's ability to repay the loan). We believe loans delinquent 90 to 179 days are an important measure because these loans are expected to drive the vast majority of future charge-offs. Additional charge-offs on loans delinquent 180 days and greater are possible if home prices decline beyond current expectations, but we do not anticipate these charge-offs to be significant, particularly when compared to the expected charge-offs on loans delinquent 90 to 179 days. We expect the balances of one- to four-family loans delinquent 180 days and greater to decline over time; however, we expect the balances to remain at high levels in the near term due to the extensive amount of time it takes to foreclose on a property in the current real estate market. The following table shows the comparative data for loans delinquent 90 to 179 days (dollars in millions):

	September 30, 2014	December 31, 2013
One- to four-family	\$ 22	\$ 70
Home equity	27	36
Consumer and other loans	2	3
Total loans delinquent 90-179 days	\$ 51	\$ 109
Loans delinquent 90-179 days as a percentage of gross loans receivable	0.8%	1.3%

During the nine months ended September 30, 2014, loans delinquent 90 to 179 days decreased by \$58 million to \$51 million, driven primarily by the sale of our one- to four-family loans modified as TDRs.

In addition, we monitor loans in which a borrower's current credit history casts doubt on their ability to repay a loan. We classify loans as special mention when they are between 30 and 89 days past due. The following table shows the comparative data for special mention loans (dollars in millions):

	September 30, 2014	December 31, 2013
One- to four-family	\$ 95	\$ 190
Home equity	56	69
Consumer and other loans	8	12
Total special mention loans	\$ 159	\$ 271
Special mention loans receivable as a percentage of gross loans receivable	2.4%	3.2%

The trend in special mention loan balances is generally indicative of the expected trend for charge-offs in future periods, as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge-off. One- to four-family loans are generally secured in a first lien position by real estate assets, reducing the potential loss when compared to an unsecured loan. Home equity loans are generally secured by real estate assets; however, the majority of these loans are secured in a second lien position, which substantially increases the potential loss when compared to a first lien position. The loss severity of our second lien home equity loans was approximately 93% at September 30, 2014.

During the nine months ended September 30, 2014, special mention loans decreased by \$112 million to \$159 million and are down 85% from their peak of \$1.0 billion at December 31, 2008. This decrease was largely due to the sale of our one- to four-family loans modified as TDRs in the second quarter of 2014. While the level of special mention loans can fluctuate significantly in any given period, we believe the continued decrease is an encouraging sign regarding the future credit performance of the mortgage loan portfolio.

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*Nonperforming Assets*

We classify loans as nonperforming when they are no longer accruing interest, which includes loans that are 90 days and greater past due, TDRs that are on nonaccrual status for all classes of loans and certain performing junior liens that have a delinquent senior lien. The following table shows the comparative data for nonperforming loans and assets (dollars in millions):

	September 30, 2014	December 31, 2013
One- to four-family	301	526
Home equity	172	164
Consumer and other	2	3
Total nonperforming loans receivable	475	693
Real estate owned and other repossessed assets, net	39	53
Total nonperforming assets, net	\$ 514	\$ 746
Nonperforming loans receivable as a percentage of gross loans receivable	7.1%	8.1%
One- to four-family allowance for loan losses as a percentage of one- to four-family nonperforming loans receivable	8.9%	19.5%
Home equity allowance for loan losses as a percentage of home equity nonperforming loans receivable	209.2%	198.3%
Consumer and other allowance for loan losses as a percentage of consumer and other nonperforming loans receivable	795.5%	868.3%
Total allowance for loan losses as a percentage of total nonperforming loans receivable	84.4%	65.4%

During the nine months ended September 30, 2014, nonperforming assets, net decreased \$232 million to \$514 million when compared to December 31, 2013. The decrease in the one- to four-family nonperforming loans receivable during the nine months ended September 30, 2014 was primarily due to the sale of \$0.8 billion of our one- to four-family loans modified as TDRs, which included \$377 million of nonperforming loans. The decrease in nonperforming loans receivable was partially offset by an increase in nonperforming TDRs that had been charged-off due to bankruptcy notification. In February 2014, the OCC issued clarifying guidance related to consumer debt discharged in Chapter 7 bankruptcy proceedings. As a result of the clarifying guidance, beginning the first quarter of 2014 these bankruptcy loans remain on nonaccrual status regardless of payment history. This change did not have a material impact on our statement of financial condition, results of operations or cash flows. Prior to this change, we had \$238 million of bankruptcy loans as performing loans at December 31, 2013.

*Securities*

We focus primarily on security type and credit rating to monitor credit risk in our securities portfolios. We consider securities backed by the U.S. government or its agencies to have low credit risk as the long-term debt rating of the U.S. government is AA+ by Standard & Poor ("S&P") and AAA by Moody's and Fitch at September 30, 2014. At September 30, 2014, the amortized cost of these securities accounted for over 99% of our total securities portfolio. We review the remaining debt securities that were not backed by the U.S. government or its agencies according to their credit ratings from S&P, Moody's and Fitch where available. At September 30, 2014, all municipal bonds and corporate bonds were rated investment grade (defined as a rating equivalent to a Moody's rating of "Baa3" or higher, or a S&P or Fitch rating of "BBB-" or higher).

Certain non-agency CMOs were other-than-temporarily impaired as a result of the deterioration in the expected credit performance of the underlying loans in those specific securities. During the nine months ended September 30, 2014, we sold our remaining \$17 million in amortized cost of the available-for-sale non-agency CMOs as part of our continued focus to reduce legacy risks.

**SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with GAAP. Note 1—Organization, Basis of Presentation and Summary of Significant Accounting Policies of Part II. Item 8. Financial Statements and Supplementary Data in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 contains a summary of our significant accounting policies, many of which require the use of estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented. We believe that of our significant accounting policies, the following are critical because they are based on estimates and assumptions that require complex and subjective judgments by management: allowance for loan losses; valuation of goodwill and other intangible assets; estimates of effective tax rates, deferred taxes and

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valuation allowance; classification and valuation of certain investments; accounting for derivative instruments; and fair value measurements. Changes in these estimates or assumptions could materially impact our financial condition and results of operations, and actual results could differ from our estimates. We updated our accounting policy for the allowance for loan losses as of and for the period ended September 30, 2014 to reflect significant changes in management's estimates and assumptions. Our remaining critical accounting policies are more fully described in Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations—Summary of Critical Accounting Policies and Estimates in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

### ***Allowance for Loan Losses***

#### *Description*

The allowance for loan losses is management's estimate of probable losses inherent in the loan portfolio as of the balance sheet date. In determining the adequacy of the allowance, we perform periodic evaluations of the loan portfolio and loss forecasting assumptions. As of September 30, 2014, the allowance for loan losses was \$401 million on \$6.7 billion of total loans receivable designated as held-for-investment.

#### *Judgments*

Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. We evaluate the adequacy of the allowance for loan losses by loan portfolio segment: one- to four-family, home equity and consumer and other. The estimate of the allowance for loan losses is based on a variety of quantitative and qualitative factors, including:

- the composition and quality of the portfolio;
- delinquency levels and trends;
- current and historical charge-off and loss experience;
- our historical loss mitigation experience;
- the condition of the real estate market and geographic concentrations within the loan portfolio;
- the interest rate climate;
- the overall availability of housing credit; and
- general economic conditions.

The allowance for loan losses is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date as well as the forecasted losses, including economic concessions to borrowers, over the estimated remaining life of loans modified as TDRs.

For loans that are not TDRs, we established a general allowance. The one- to four-family and home equity loan portfolios represented 48% and 45%, respectively, of total loans receivable as of September 30, 2014. The one- to four-family and home equity loan portfolios are separated into risk segments based on key risk factors, which include but are not limited to loan type, delinquency history, documentation type, LTV/CLTV ratio and borrowers' credit scores. Both current CLTV and FICO scores are among the factors utilized to categorize the risk associated with mortgage loans and assign a probability assumption of future default. We utilize historical mortgage loan performance data to develop the forecast of delinquency and default for these risk segments. The general allowance for loan losses also included a qualitative component to account for a variety of factors that present additional uncertainty that may not be fully considered in the quantitative loss model but are factors we believe may impact the level of credit losses. We utilize a qualitative factor framework whereby, on a quarterly basis, management assesses the risk associated with three main factors. These factors are: external factors, such as changes in the macro-economic, legal and regulatory environment; internal factors, such as procedural changes and reliance on third parties; and portfolio specific factors, such as the impact on borrowers' monthly payments from one- to four-family loans converting from interest only to amortizing. The uncertainty related to these factors may expand overtime, temporarily increasing the qualitative component in advance of the more precise identification of these probable losses being captured within the general allowance.

The total qualitative component was \$35 million and \$62 million as of September 30, 2014 and December 31, 2013, respectively. The qualitative component for the one- to four-family and home equity loan portfolios was 11% and 24% of the quantitative component of the general allowance for loan losses at September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014, we enhanced our quantitative allowance methodology to identify higher risk home equity lines of credit and extend the period of management's forecasted loan losses captured within the general allowance to include the total probable loss on a subset of these higher risk loans. This enhancement drove the migration of estimated losses previously captured on these loans from the qualitative component to the quantitative component of the general allowance, and drove the majority of the provision for loan losses within the home equity portfolio during the nine months ended September 30, 2014.

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The consumer and other loan portfolio is separated into risk segments by product and delinquency status. We utilize historical performance data and historical recovery rates on collateral liquidation to forecast delinquency and loss at the product level. The consumer and other loan portfolio represented 7% of total loans receivable as of September 30, 2014. The qualitative component for the consumer and other loan portfolio was 32% and 21% of the quantitative component of the general allowance at September 30, 2014 and December 31, 2013, respectively.

For modified loans accounted for as TDRs that are valued using the discounted cash flow model, we established a specific allowance. The specific allowance for TDRs factors in the historical default rate of an individual loan before being modified as a TDR in the discounted cash flow analysis in order to determine that specific loan's expected impairment. Specifically, a loan that has a more severe delinquency history prior to modification will have a higher future default rate in the discounted cash flow analysis than a loan that was not as severely delinquent. For both of the one- to four-family and home equity loan portfolio segments, the pre-modification delinquency status, the borrower's current credit score and other credit bureau attributes, in addition to each loan's individual default experience and credit characteristics, are incorporated into the calculation of the specific allowance. A specific allowance is established to the extent that the recorded investment exceeds the discounted cash flows of a TDR with a corresponding charge to provision for loan losses. The specific allowance for these individually impaired loans represents the forecasted losses over the estimated remaining life of the loan, including the economic concession to the borrower.

### *Effects if Actual Results Differ*

Historic volatility in the credit markets has substantially increased the complexity and uncertainty involved in estimating the losses inherent in the loan portfolio. In the current market it is difficult to estimate how potential changes in the quantitative and qualitative factors, including the impact of home equity lines of credit converting from interest only to amortizing loans or requiring borrowers to repay the loan in full at the end of the draw period, might impact the allowance for loan losses. If our underlying assumptions and judgments prove to be inaccurate, the allowance for loan losses could be insufficient to cover actual losses. We may be required under such circumstances to further increase the provision for loan losses, which could have an adverse effect on the regulatory capital position and results of operations in future periods.

During the normal course of conducting examinations, our banking regulators, the OCC and Federal Reserve, continue to review our business and practices. This process is dynamic and ongoing and we cannot be certain that additional changes or actions will not result from their continuing review.

## **GLOSSARY OF TERMS**

*Active accounts*—Accounts with a balance of \$25 or more or a trade in the last six months.

*Active customers*—Customers that have an account with a balance of \$25 or more or a trade in the last six months.

*Active trader*—The customer group that includes those who execute 30 or more trades per quarter.

*Adjusted total assets*—E\*TRADE Bank-only assets composed of total assets plus/(less) unrealized losses (gains) on available-for-sale securities, less disallowed deferred tax assets, goodwill and certain other intangible assets.

*Agency*—U.S. Government sponsored enterprises and federal agencies, such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, the Small Business Administration and the Federal Home Loan Bank.

*ALCO*—Asset Liability Committee.

*AML*—Anti-Money Laundering.

*APIC*—Additional paid-in capital.

*Average commission per trade*—Total trading and investing segment commissions revenue divided by total number of revenue trades.

*Average equity to average total assets*—Average total shareholders' equity divided by average total assets.

*Bank*—ETB Holdings, Inc. ("ETBH"), the entity that is our bank holding company and parent to E\*TRADE Bank.

*Basis point*—One one-hundredth of a percentage point.

*BCBS*—International Basel Committee on Banking Supervision.

*BOLI*—Bank-Owned Life Insurance.

*Brokerage account attrition rate*—Attriting brokerage accounts, which are gross new brokerage accounts less net new brokerage accounts, divided by total brokerage accounts at the previous period end.

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*Brokerage related cash*—Customer sweep deposits, customer payables and money market balances, including those held by third parties.

*CAMELS rating*—A U.S. supervisory rating of a bank's overall condition. The components of the rating consist of Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk.

*Cash flow hedge*—A derivative instrument designated in a hedging relationship that mitigates exposure to variability in expected future cash flows attributable to a particular risk.

*CFPB*—Consumer Financial Protection Bureau.

*CFTC*—Commodity Futures Trading Commission.

*Charge-off*—The result of removing a loan or portion of a loan from an entity's balance sheet because the loan is considered to be uncollectible.

*CLTV*—Combined loan-to-value.

*CMOs*—Collateralized mortgage obligations.

*Consumer loans*—Loans that are secured by real personal property, such as recreational vehicles.

*Corporate cash*—Cash held at the parent company as well as cash held in certain subsidiaries that can distribute cash to the parent company without any regulatory approval.

*Customer assets*—Market value of all customer assets held by the Company including security holdings, deposits and customer payables, as well as customer assets held by third parties and vested unexercised options.

*Daily average revenue trades ("DARTs")*—Total revenue trades in a period divided by the number of trading days during that period.

*Derivative*—A financial instrument or other contract, the price of which is directly dependent upon the value of one or more underlying securities, interest rates or any agreed upon pricing index. Derivatives cover a wide assortment of financial contracts, including forward contracts, options and swaps.

*DIF*—Depositors Insurance Fund.

*Economic Value of Equity ("EVE")*—The present value of expected cash inflows from existing assets, minus the present value of expected cash outflows from existing liabilities, plus the expected cash inflows and outflows from existing derivatives and forward commitments. This calculation is performed for E\*TRADE Bank.

*Enterprise interest-bearing liabilities*—Liabilities such as customer deposits, repurchase agreements, FHLB advances and other borrowings, certain customer credit balances and securities loaned programs on which the Company pays interest; excludes customer money market balances held by third parties.

*Enterprise interest-earning assets*—Assets such as loans, available-for-sale securities, held-to-maturity securities, margin receivables, trading securities, securities borrowed balances and cash and investments required to be segregated under regulatory guidelines that earn interest for the Company.

*Enterprise net interest income*—The taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense and interest earned on customer cash held by third parties.

*Enterprise net interest margin*—The enterprise net operating interest income divided by total enterprise interest-earning assets.

*Enterprise net interest spread*—The taxable equivalent rate earned on average enterprise interest-earning assets less the rate paid on average enterprise interest-bearing liabilities, excluding corporate interest-earning assets and liabilities and customer cash held by third parties.

*ESDA*—Extended insurance sweep deposit accounts.

*Exchange-traded funds ("ETFs")*—A fund that invests in a group of securities and trades like an individual stock on an exchange.

*Fair value*—The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

*Fair value hedge*—A derivative instrument designated in a hedging relationship that mitigates exposure to changes in the fair value of a recognized asset or liability or a firm commitment.

*Fannie Mae*—Federal National Mortgage Association.

*FASB*—Financial Accounting Standards Board.

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*FDIC*—Federal Deposit Insurance Corporation.

*Federal Reserve*—Board of Governors of the Federal Reserve System.

*FHLB*—Federal Home Loan Bank.

*FICO*—Fair Isaac Credit Organization.

*FINRA*—Financial Industry Regulatory Authority.

*Fixed charge coverage ratio*—Net income before taxes, depreciation and amortization and corporate interest expense divided by corporate interest expense. This ratio indicates the Company's ability to satisfy fixed financing expenses.

*Forex*—A type of trade that involves buying one currency while simultaneously selling another. Currencies are traded in pairs consisting of a "base currency" and a "quote currency."

*Freddie Mac*—Federal Home Loan Mortgage Corporation.

*Generally Accepted Accounting Principles ("GAAP")*—Accounting principles generally accepted in the United States of America.

*Ginnie Mae*—Government National Mortgage Association.

*Gross loans receivable*—Includes unpaid principal balances and premiums (discounts).

*Interest rate cap*—An option contract that puts an upper limit on a floating exchange rate. The writer of the cap has to pay the holder of the cap the difference between the floating rate and the upper limit when that upper limit is breached. There is usually a premium paid by the buyer of such a contract.

*Interest rate floor*—An option contract that puts a lower limit on a floating exchange rate. The writer of the floor has to pay the holder of the floor the difference between the floating rate and the lower limit when that lower limit is breached. There is usually a premium paid by the buyer of such a contract.

*Interest rate swaps*—Contracts that are entered into primarily as an asset/liability management strategy to reduce interest rate risk. Interest rate swap contracts are exchanges of interest rate payments, such as fixed-rate payments for floating-rate payments, based on notional principal amounts.

*LCR*—Liquidity Coverage Ratio.

*LIBOR*—London Interbank Offered Rate. LIBOR is the interest rate at which banks borrow funds from other banks in the London wholesale money market (or interbank market).

*LTV*—Loan-to-value.

*NASDAQ*—National Association of Securities Dealers Automated Quotations.

*Net new customer asset flows*—The total inflows to all new and existing customer accounts less total outflows from all closed and existing customer accounts, excluding the effects of market movements in the value of customer assets.

*NFA*—National Futures Association.

*NOLs*—Net operating losses.

*Nonperforming assets*—Assets that do not earn income, including those originally acquired to earn income (nonperforming loans) and those not intended to earn income (real estate owned). Loans are classified as nonperforming when they are no longer accruing interest, which includes loans that are 90 days and greater past due, TDRs that are on nonaccrual status for all classes of loans and certain junior liens that have a delinquent senior lien.

*Notional amount*—The specified dollar amount underlying a derivative on which the calculated payments are based.

*NYSE*—New York Stock Exchange.

*OCC*—Office of the Comptroller of the Currency.

*Operating margin*—Income before other income (expense), income tax expense and discontinued operations, if applicable.

*Options*—Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to either purchase or sell the associated financial instrument at a set price during a period or at a specified date in the future.

*OTTI*—Other-than-temporary impairment.

*OTS*—Office of Thrift Supervision.

*PII*—Personally Identifiable Information.

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*Real estate owned and other repossessed assets*—Ownership or physical possession of real property by the Company, generally acquired as a result of foreclosure or repossession.

*Recovery*—Cash proceeds received on a loan that had been previously charged off.

*Repurchase agreement*—An agreement giving the seller of an asset the right or obligation to buy back the same or similar securities at a specified price on a given date. These agreements are generally collateralized by mortgage-backed or investment-grade securities.

*Return on average total assets*—Annualized net income divided by average assets.

*Return on average total shareholders' equity*—Annualized net income divided by average shareholders' equity.

*Risk-weighted assets*—Primarily computed by the assignment of specific risk-weightings assigned by the regulators to assets and off-balance sheet instruments for capital adequacy calculations.

*S&P*—Standard & Poor's.

*SEC*—U.S. Securities and Exchange Commission.

*Special mention loans*—Loans where a borrower's current credit history casts doubt on their ability to repay a loan. Loans are classified as special mention when loans are between 30 and 89 days past due.

*Stock plan trades*—Trades that originate from our corporate services business, which provides software and services to assist corporate customers in managing their equity compensation plans. The trades typically occur when an employee of a corporate customer exercises a stock option or sells restricted stock.

*Sweep deposit accounts*—Accounts with the functionality to transfer brokerage cash balances to and from a FDIC insured account at the banking subsidiaries.

*Taxable equivalent interest adjustment*—The operating interest income earned on certain assets is completely or partially exempt from federal and/or state income tax. These tax-exempt instruments typically yield lower returns than a taxable investment. To provide more meaningful comparison of yields and margins for all interest-earning assets, the interest income earned on tax exempt assets is increased to make it fully equivalent to interest income on other taxable investments. This adjustment is done for the analytic purposes in the net enterprise interest income/spread calculation and is not made on the consolidated statement of income, as that is not permitted under GAAP.

*Tier 1 capital*—Adjusted equity capital used in the calculation of capital adequacy ratios. Tier 1 capital equals: total shareholders' equity, plus/(less) unrealized losses (gains) on available-for-sale securities and cash flow hedges and qualifying restricted core capital elements, less disallowed servicing and deferred tax assets, goodwill and certain other intangible assets.

*Troubled Debt Restructuring ("TDR")*—A loan modification that involves granting an economic concession to a borrower who is experiencing financial difficulty, and loans that have been charged-off due to bankruptcy notification.

*Wholesale borrowings*—Borrowings that consist of securities sold under agreements to repurchase and FHLB advances and other borrowings.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion about market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2013 and as updated in this report.

#### ***Interest Rate Risk***

Our exposure to interest rate risk is related primarily to interest-earning assets and interest-bearing liabilities, all of which are held for non-trading purposes. The management of interest rate risk is essential to profitability. The primary objective of the management of interest rate risk is to control exposure to interest rates within the Board-approved limits, as outlined in the scenario analysis below, and with limited exposure to earnings volatility resulting from interest rate fluctuations. Our general strategies to manage interest rate risk include balancing variable-rate and fixed-rate assets and liabilities and utilizing derivatives in a way that reduces overall exposure to changes in interest rates. Exposure to interest rate risk requires management to make complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

- Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.

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- The yield curve may steepen, flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.
- Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to interest rate risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At September 30, 2014, 91% of our total assets were enterprise interest-earning assets.

At September 30, 2014, approximately 59% of total assets were residential real estate loans and available-for-sale and held-to-maturity mortgage-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

When real estate loans prepay, unamortized premiums and/or discounts are written off. Depending on the timing of the prepayment, these write-offs may impact anticipated yields. The ALCO reviews estimates of the impact of changing market rates on prepayments. This information is incorporated into our interest rate risk management strategy.

Our liability structure consists of two central sources of funding: deposits and wholesale borrowings. Cash provided to us through deposits is the primary source of funding. Key deposit products include sweep accounts, complete savings accounts and other money market and savings accounts. Wholesale borrowings include securities sold under agreements to repurchase and FHLB advances. Other sources of funding include customer payables, which is customer cash contained within our broker-dealers, and corporate debt issued by the parent company.

Deposit accounts and customer payables tend to be less rate-sensitive than wholesale borrowings. Agreements to repurchase securities and the majority of FHLB advances re-price as agreements reset. Sweep accounts, complete savings accounts and other money market and savings accounts re-price at management's discretion. Corporate debt has fixed rates.

### ***Derivative Instruments***

We use derivative instruments to help manage interest rate risk. Interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments between two parties based on a contractual underlying notional amount, but do not involve the exchange of the underlying notional amounts. Option products are utilized primarily to decrease the market value changes resulting from the prepayment dynamics of the mortgage portfolio, as well as to protect against increases in funding costs. The types of options employed include Cap Options ("Caps"), Floor Options ("Floors"), "Payor Swaptions" and "Receiver Swaptions". Caps mitigate the market risk associated with increases in interest rates while Floors mitigate the risk associated with decreases in market interest rates. Similarly, Payor and Receiver Swaptions mitigate the market risk associated with the respective increases and decreases in interest rates. See derivative instruments discussion in Note 8—Accounting for Derivative Instruments and Hedging Activities in Item 1. Consolidated Financial Statements (Unaudited).

### ***Scenario Analysis***

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the Economic Value of Equity ("EVE") approach, the present value of all existing interest-earning assets, interest-bearing liabilities, derivatives and forward commitments are estimated and then combined to produce an EVE figure. The approach values only the current balance sheet in which the most significant assumptions are the prepayment rates of the loan portfolio and mortgage-backed securities and the repricing of deposits. This approach does not incorporate assumptions related to business growth, or liquidation and re-investment of instruments. This approach provides an indicator of future earnings and capital levels because changes in EVE indicate the anticipated change in the value of future cash flows. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 basis points. The change in EVE amounts fluctuate based on the parallel shifts in interest rates primarily due to the change in timing of cash flows in the Company's residential loan and mortgage-backed securities portfolios. Expected prepayment rates on residential mortgage loans and mortgage-backed securities increase as interest rates decline. In a rising interest rate environment, expected prepayment rates decrease.

The EVE method is used at the E\*TRADE Bank level and not for the Company. The ALCO monitors E\*TRADE Bank's interest rate risk position. E\*TRADE Bank had nearly 100% of enterprise interest-earning assets at both September 30, 2014 and December 31, 2013 and held 99% of enterprise interest-bearing liabilities at both September 30, 2014 and December 31, 2013. The sensitivity of EVE at September 30, 2014 and December 31, 2013 and the limits established by E\*TRADE Bank's Board of Directors are listed below (dollars in millions):

Change in EVE

Parallel Change in Interest Rates (basis points) <sup>(1)</sup>	September 30, 2014		December 31, 2013		Board Limit
	Amount	Percentage <sup>(2)</sup>	Amount	Percentage <sup>(2)</sup>	
+300	\$ (611)	(11.4)%	\$ (573)	(12.2)%	(25)%
+200	\$ (355)	(6.6)%	\$ (355)	(7.6)%	(15)%
+100	\$ (135)	(2.5)%	\$ (150)	(3.2)%	(7)%
-100	\$ (15)	(0.3)%	\$ (39)	(0.8)%	(7)%

(1) On September 30, 2014 and December 31, 2013, the yield for the three-month treasury bill was 0.02% and 0.07%, respectively. As a result, the requirements of the EVE model were temporarily modified, resulting in the removal of the minus 200 and 300 basis points scenarios for the periods ended September 30, 2014 and December 31, 2013.

(2) The percentage change represents the amount of change in EVE divided by the base EVE as calculated in the current interest rate environment.

We actively manage interest rate risk positions. As interest rates change, we will adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The Company compares the parallel shift in interest rate changes in EVE to the established board limits in order to assess the Company's interest rate risk on a monthly basis. In the event that the percentage change in EVE exceeds the board limits, E\*TRADE Bank's Chief Risk Officer, Chief Financial Officer and Treasurer must all be promptly notified in writing and decide upon a plan of remediation. In addition, E\*TRADE Bank's Board of Directors must be promptly notified of the exception and the planned resolution.

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**PART I—FINANCIAL INFORMATION**

**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INCOME**

**(In millions, except share data and per share amounts)**

**(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Revenue:</b>				
Operating interest income	\$ 319	\$ 301	\$ 963	\$ 903
Operating interest expense	(50)	(60)	(158)	(178)
Net operating interest income	269	241	805	725
Commissions	108	103	341	310
Fees and service charges	45	40	138	113
Principal transactions	—	13	10	56
Gains on loans and securities, net	8	12	30	49
Other-than-temporary impairment ("OTTI")	—	—	—	(1)
Less: noncredit portion of OTTI recognized into (out of) other comprehensive income (loss) (before tax)	—	(1)	—	(2)
Net impairment	—	(1)	—	(3)
Other revenues	10	9	29	27
Total non-interest income	171	176	548	552
Total net revenue	440	417	1,353	1,277
Provision for loan losses	10	37	26	126
<b>Operating expense:</b>				
Compensation and benefits	108	88	305	270
Advertising and market development	21	21	88	81
Clearing and servicing	21	31	72	94
FDIC insurance premiums	18	25	61	79
Professional services	27	23	79	59
Occupancy and equipment	22	17	59	53
Communications	17	16	53	53
Depreciation and amortization	19	22	60	68
Amortization of other intangibles	5	6	16	18
Impairment of goodwill	—	—	—	142
Facility restructuring and other exit activities	2	6	6	23
Other operating expenses	17	16	52	40
Total operating expense	277	271	851	980
Income before other income (expense) and income tax expense	153	109	476	171
<b>Other income (expense):</b>				
Corporate interest expense	(29)	(29)	(86)	(86)
Losses on early extinguishment of debt	—	—	(12)	—
Equity in income of investments and other	1	—	3	5
Total other income (expense)	(28)	(29)	(95)	(81)
Income before income tax expense	125	80	381	90
Income tax expense	39	33	129	62
Net income	\$ 86	\$ 47	\$ 252	\$ 28
Basic earnings per share	\$ 0.30	\$ 0.17	\$ 0.87	\$ 0.10
Diluted earnings per share	\$ 0.29	\$ 0.16	\$ 0.86	\$ 0.10
<b>Shares used in computation of per share data:</b>				
Basic (in thousands)	288,843	287,111	288,536	286,882
Diluted (in thousands)	294,119	292,630	293,968	292,249

See accompanying notes to consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)**  
(In millions)  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$ 86	\$ 47	\$ 252	\$ 28
Other comprehensive income (loss)				
Available-for-sale securities:				
OTTI, net <sup>(1)</sup>	—	—	—	—
Noncredit portion of OTTI reclassification (into) out of other comprehensive income, net <sup>(2)</sup>	—	—	—	1
Unrealized gains (losses), net <sup>(3)</sup>	(20)	19	143	(202)
Reclassification into earnings, net <sup>(4)</sup>	(7)	(10)	(21)	(31)
Net change from available-for-sale securities	(27)	9	122	(232)
Cash flow hedging instruments:				
Unrealized gains (losses), net <sup>(5)</sup>	5	(11)	(27)	57
Reclassification into earnings, net <sup>(6)</sup>	18	21	59	64
Net change from cash flow hedging instruments	23	10	32	121
Other comprehensive income (loss)	(4)	19	154	(111)
Comprehensive income (loss)	\$ 82	\$ 66	\$ 406	\$ (83)

- (1) Amounts are net of benefit from income taxes of \$0 for both the three and nine months ended September 30, 2014, compared to benefit from income taxes of less than \$1 million for both the three and nine months ended September 30, 2013.
- (2) Amounts are net of benefit from income taxes of \$0 for both the three and nine months ended September 30, 2014, compared to benefit from income taxes of less than \$1 million for both the three and nine months ended September 30, 2013.
- (3) Amounts are net of benefit from income taxes of \$13 million and provision for \$86 million for the three and nine months ended September 30, 2014, respectively, compared to provision for income taxes of \$12 million and benefit from \$120 million for the three and nine months ended September 30, 2013, respectively.
- (4) Amounts are net of provision for income taxes of \$5 million and \$13 million for the three and nine months ended September 30, 2014, respectively, compared to provision for income taxes of \$6 million and \$19 million for the three and nine months ended September 30, 2013, respectively.
- (5) Amounts are net of provision for income taxes of \$2 million and benefit from \$21 million for the three and nine months ended September 30, 2014, respectively, compared to benefit from income taxes of \$8 million and provision for \$27 million for the three and nine months ended September 30, 2013, respectively.
- (6) Amounts are net of benefit from income taxes of \$12 million and \$38 million for the three and nine months ended September 30, 2014, respectively, compared to benefit from income taxes of \$14 million and \$38 million for the three and nine months ended September 30, 2013, respectively.

See accompanying notes to the consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
(In millions, except share data)  
(Unaudited)

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
<b><u>ASSETS</u></b>		
Cash and equivalents	\$ 1,809	\$ 1,838
Cash required to be segregated under federal or other regulations	608	1,066
Available-for-sale securities	12,516	13,592
Held-to-maturity securities (fair value of \$11,943 and \$10,092 at September 30, 2014 and December 31, 2013, respectively)	11,847	10,181
Margin receivables	8,117	6,353
Loans receivable, net (net of allowance for loan losses of \$401 and \$453 at September 30, 2014 and December 31, 2013, respectively)	6,302	8,123
Investment in FHLB stock	77	61
Property and equipment, net	240	237
Goodwill	1,792	1,792
Other intangibles, net	199	216
Other assets	2,312	2,821
Total assets	<u>\$ 45,819</u>	<u>\$ 46,280</u>
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
<b>Liabilities:</b>		
Deposits	\$ 24,927	\$ 25,971
Securities sold under agreements to repurchase	3,917	4,543
Customer payables	6,526	6,310
FHLB advances and other borrowings	1,294	1,279
Corporate debt	1,771	1,768
Other liabilities	2,110	1,553
Total liabilities	<u>40,545</u>	<u>41,424</u>
Commitments and contingencies (see Note 13)		
<b>Shareholders' equity:</b>		
Common stock, \$0.01 par value, shares authorized: 400,000,000 at September 30, 2014 and December 31, 2013; shares issued and outstanding: 288,812,764 and 287,357,001 at September 30, 2014 and December 31, 2013, respectively	3	3
Additional paid-in-capital ("APIC")	7,340	7,328
Accumulated deficit	(1,770)	(2,022)
Accumulated other comprehensive loss	(299)	(453)
Total shareholders' equity	<u>5,274</u>	<u>4,856</u>
Total liabilities and shareholders' equity	<u>\$ 45,819</u>	<u>\$ 46,280</u>

See accompanying notes to the consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
(In millions)  
(Unaudited)

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Shares	Amount				
<b>Balance, December 31, 2013</b>	287	\$ 3	\$ 7,328	\$ (2,022)	\$ (453)	\$ 4,856
Net income	—	—	—	252	—	252
Other comprehensive income	—	—	—	—	154	154
Conversion of convertible debentures	—	—	1	—	—	1
Exercise of stock options and related tax effects	1	—	6	—	—	6
Issuance of restricted stock, net of forfeitures and retirements to pay taxes	1	—	(13)	—	—	(13)
Share-based compensation	—	—	18	—	—	18
<b>Balance at September 30, 2014</b>	<b>289</b>	<b>\$ 3</b>	<b>\$ 7,340</b>	<b>\$ (1,770)</b>	<b>\$ (299)</b>	<b>\$ 5,274</b>

  

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Shares	Amount				
<b>Balance, December 31, 2012</b>	286	\$ 3	\$ 7,319	\$ (2,108)	\$ (310)	\$ 4,904
Net income	—	—	—	28	—	28
Other comprehensive loss	—	—	—	—	(111)	(111)
Exercise of stock options and related tax effects	—	—	(6)	—	—	(6)
Issuance of restricted stock, net of forfeitures and retirements to pay taxes	1	—	(6)	—	—	(6)
Share-based compensation	—	—	20	—	—	20
<b>Balance at September 30, 2013</b>	<b>287</b>	<b>\$ 3</b>	<b>\$ 7,327</b>	<b>\$ (2,080)</b>	<b>\$ (421)</b>	<b>\$ 4,829</b>

See accompanying notes to the consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
(In millions)  
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
<b>Cash flows from operating activities:</b>		
Net income	\$ 252	\$ 28
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	26	126
Depreciation and amortization (including discount amortization and accretion)	245	311
Net impairment and gains on loans and securities, net	(30)	(46)
Impairment of goodwill	—	142
Equity in income of investments and other	(3)	(5)
Share-based compensation	18	20
Deferred taxes	128	60
Other	(2)	2
Net effect of changes in assets and liabilities:		
Decrease (increase) in cash required to be segregated under federal or other regulations	458	(361)
Increase in margin receivables	(1,764)	(385)
Increase in customer payables	216	865
(Increase) decrease in other assets	(84)	260
Increase (decrease) in other liabilities	908	(129)
Net cash provided by operating activities	368	888
<b>Cash flows from investing activities:</b>		
Purchases of available-for-sale securities	(1,346)	(5,433)
Proceeds from sales, maturities of and principal payments on available-for-sale securities	2,592	5,190
Purchases of held-to-maturity securities	(2,437)	(2,032)
Proceeds from maturities of and principal payments on held-to-maturity securities	829	1,579
Proceeds from sale of loans	802	—
Net decrease in loans receivable	973	1,316
Capital expenditures for property and equipment	(62)	(31)
Proceeds from sale of G1 Execution Services, Inc.	76	—
Cash transferred on sale of G1 Execution Services, Inc.	(9)	—
Proceeds from sale of real estate owned and repossessed assets	27	53
Net cash flow from derivatives hedging assets	(6)	11
Other	(15)	6
Net cash provided by investing activities	1,424	659

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS—(Continued)**  
(In millions)  
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
<b>Cash flows from financing activities:</b>		
Net decrease in deposits	\$ (1,044)	\$ (2,523)
Net decrease in securities sold under agreements to repurchase	(626)	(5)
Advances from FHLB	560	1,010
Payments on advances from FHLB	(560)	(1,010)
Net cash flow from derivatives hedging liabilities	(156)	4
Other	5	11
Net cash used in financing activities	(1,821)	(2,513)
Decrease in cash and equivalents	(29)	(966)
Cash and equivalents, beginning of period	1,838	2,762
Cash and equivalents, end of period	\$ 1,809	\$ 1,796
<b>Supplemental disclosures:</b>		
Cash paid for interest	\$ 179	\$ 180
(Refund received) cash paid for income taxes	\$ (2)	\$ 3
<b>Non-cash investing and financing activities:</b>		
Transfers of loans held-for-investment to loans held-for-sale	\$ 795	\$ 41
Transfers from loans to other real estate owned and repossessed assets	\$ 40	\$ 59
Transfers from other real estate owned and repossessed assets to loans	\$ 16	\$ —
Conversion of convertible debentures to common stock	\$ 1	\$ —
Reclassification of market making business assets and liabilities to business held-for-sale	\$ —	\$ 79

See accompanying notes to the consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1—ORGANIZATION, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization**—E\*TRADE Financial Corporation is a financial services company that provides brokerage and related products and services primarily to individual retail investors under the brand "E\*TRADE Financial." The Company also provides investor-focused banking products, primarily sweep deposits and savings products, to retail investors.

On February 10, 2014, the Company completed the sale of its subsidiary G1 Execution Services, LLC, a registered broker-dealer and market maker, to an affiliate of Susquehanna International Group, LLP. The sale generated cash proceeds of \$76 million.

**Basis of Presentation**—The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries as determined under the voting interest model. Entities in which the Company has the ability to exercise significant influence but in which the Company does not possess control are generally accounted for by the equity method. Entities in which the Company does not have the ability to exercise significant influence are generally carried at cost. However, investments in marketable equity securities where the Company does not have the ability to exercise significant influence over the entities are accounted for as available-for-sale securities. The Company also evaluates its initial and continuing involvement with certain entities to determine if the Company is required to consolidate the entities under the variable interest entity ("VIE") model. This evaluation is based on a qualitative assessment of whether the Company has both: 1) the power to direct activities that most significantly impact the economic performance of the VIE; and 2) the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

The Company's consolidated financial statements are prepared in accordance with GAAP. Intercompany accounts and transactions are eliminated in consolidation. Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. These consolidated financial statements reflect all adjustments, which are all normal and recurring in nature, necessary to present fairly the financial position, results of operations and cash flows for the periods presented.

At the end of June 2013, the Company decided to exit its market making business, G1 Execution Services, LLC, and reclassified the assets and liabilities of the market making business to held-for-sale. The assets and liabilities of the market making business are presented in the other assets and other liabilities line items, respectively, at December 31, 2013 on the consolidated balance sheet. The sale of the market making business was completed on February 10, 2014. For additional information on the market making business, see Note 2—Disposition.

The Company reports corporate interest expense separately from operating interest expense. The Company believes reporting these items separately provides a clearer picture of the financial performance of the Company's operations than would a presentation that combined these two items. Operating interest expense is generated from the operations of the Company. Corporate debt, which is the primary source of corporate interest expense, has been issued primarily in connection with recapitalization transactions and past acquisitions.

Similarly, the Company reports gains on sales of investments, net separately from gains on loans and securities, net. The Company believes reporting these two items separately provides a clearer picture of the financial performance of the Company's operations than would a presentation that combined these two items. Gains on loans and securities, net are the result of activities in the Company's operations, namely its balance sheet management segment. Gains on sales of investments, net relate to investments of the Company at the corporate level and are not related to the ongoing business of the Company's operating subsidiaries. Gains on sales of investments, net are reported in the equity in income of investments and other line item on the consolidated statement of income.

These consolidated financial statements should be read in conjunction with the Annual Report on Form 10-K for the year ended December 31, 2013.

**Use of Estimates**—Preparing the Company's consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented. Actual results could differ from management's estimates. Certain significant accounting policies are critical because they are based on estimates and assumptions that require complex and subjective judgments by management. Changes in these estimates or assumptions could materially impact the Company's financial condition and results of operations. Material estimates in which management believes changes could reasonably occur include: allowance for loan losses; valuation of goodwill and other intangible assets; estimates of effective tax rates, deferred taxes and valuation allowance; classification and valuation of certain investments; accounting for derivative instruments; and fair value measurements.

**Financial Statement Descriptions and Related Accounting Policies**

**Available-for-Sale Securities**—Available-for-sale securities consist primarily of debt securities and also include equity securities. Securities classified as available-for-sale are carried at fair value, with the unrealized gains and losses reflected as a component of accumulated other comprehensive loss, net of tax. Realized and unrealized gains or losses on available-for-sale debt and equity securities are computed using the specific identification method. Interest earned on available-for-sale debt and equity securities is included in operating interest income. Amortization or accretion of premiums and discounts on available-for-sale debt securities are also recognized in operating interest income using the effective interest method over the contractual life of the security. Realized gains and losses on available-for-sale debt and equity securities, other than OTTI, are included in the gains on loans and securities, net line item. Available-for-sale securities that have an unrealized loss (impaired securities) are evaluated for OTTI at each balance sheet date.

**Margin Receivables**—The fair value of securities that the Company received as collateral in connection with margin receivables and securities borrowing activities, where the Company is permitted to sell or re-pledge the securities, was approximately \$11.3 billion and \$9.1 billion at September 30, 2014 and December 31, 2013, respectively. Of this amount, \$2.9 billion and \$1.9 billion had been pledged or sold in connection with securities loans, bank borrowings and deposits with clearing organizations as of September 30, 2014 and December 31, 2013, respectively.

**Nonperforming Loans**—The Company classifies loans as nonperforming when they are no longer accruing interest, which includes loans that are 90 days and greater past due, TDRs that are on nonaccrual status for all classes of loans and certain junior liens that have a delinquent senior lien. Interest previously accrued, but not collected, is reversed against current income when a loan is placed on nonaccrual status. Interest payments received on nonperforming loans are recognized on a cash basis in operating interest income until it is doubtful that full payment will be collected, at which point payments are applied to principal. The recognition of deferred fees or costs on originated loans and premiums or discounts on purchased loans in operating interest income is discontinued for nonperforming loans. Nonperforming loans, excluding TDRs and certain junior liens that have a delinquent senior lien, return to accrual status when the loan becomes less than 90 days past due. Loans modified as TDRs return to accrual status after six consecutive payments have been made in accordance with the modified terms. All bankruptcy loans remain on nonaccrual status regardless of the payment history.

Loan losses are recognized when, based on management's estimates, it is probable that a loss has been incurred. The Company's charge-off policy for both one- to four-family and home equity loans is to assess the value of the property when the loan has been delinquent for 180 days or it is in bankruptcy, regardless of whether or not the property is in foreclosure, and charge-off the amount of the loan balance in excess of the estimated current value of the underlying property less estimated selling costs. TDR loan modifications are charged-off when certain characteristics of the loan, including CLTV, borrower's credit and type of modification, cast substantial doubt on the borrower's ability to repay the loan. Closed-end consumer loans are charged-off when the loan has been delinquent for 120 days or when it is determined that collection is not probable.

**Allowance for Loan Losses**—The allowance for loan losses is management's estimate of probable losses inherent in the loan portfolio as of the balance sheet date. The allowance for loan losses is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date as well as the forecasted losses, including economic concessions to borrowers, over the estimated remaining life of loans modified as TDRs.

The Company's segments are one- to four-family, home equity and consumer and other. The estimate of the allowance for loan losses is based on a variety of quantitative and qualitative factors, including:

- the composition and quality of the portfolio;
- delinquency levels and trends;
- current and historical charge-off and loss experience;
- the Company's historical loss mitigation experience;
- the condition of the real estate market and geographic concentrations within the loan portfolio;
- the interest rate climate;
- the overall availability of housing credit; and
- general economic conditions.

For loans that are not TDRs, the Company established a general allowance. The one- to four-family and home equity loan portfolios represented 48% and 45%, respectively, of total loans receivable as of September 30, 2014. The one- to four-family and home equity loan portfolios are separated into risk segments based on key risk factors, which include but are not limited to loan type, delinquency history, documentation type, LTV/CLTV ratio and borrowers' credit scores. For home equity loans in the second lien position, the original balance of the first lien loan at origination date and updated valuations on the property underlying the loan are used to calculate CLTV. Both current CLTV and FICO scores are among the factors utilized to

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categorize the risk associated with mortgage loans and assign a probability assumption of future default. The Company utilizes historical mortgage loan performance data to develop the forecast of delinquency and default for these risk segments. The general allowance for loan losses also includes a qualitative component to account for a variety of factors that present additional uncertainty that may not be fully considered in the quantitative loss model but are factors the Company believes may impact the level of credit losses. The Company utilizes a qualitative factor framework whereby, on a quarterly basis, management assesses the risk associated with three main factors. These factors are: external factors, such as changes in the macroeconomic, legal and regulatory environment; internal factors, such as procedural changes and reliance on third parties; and portfolio specific factors, such as the impact on borrowers' monthly payments from one- to four-family loans converting from interest only to amortizing. The uncertainty related to these factors may expand over time, temporarily increasing the qualitative component in advance of the more precise identification of these probable losses being captured within the general allowance.

The total qualitative component was \$35 million and \$62 million as of September 30, 2014 and December 31, 2013, respectively. The qualitative component for the one- to four-family and home equity loan portfolios was 11% and 24% of the quantitative component of the general allowance for loan losses at September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014, we enhanced our quantitative allowance methodology to identify higher risk home equity lines of credit and extend the period of management's forecasted loan losses captured within the general allowance to include the total probable loss on a subset of these higher risk loans. This enhancement drove the migration of estimated losses previously captured on these loans from the qualitative component to the quantitative component of the general allowance, and drove the majority of the provision for loan losses within the home equity portfolio during the nine months ended September 30, 2014.

The consumer and other loan portfolio is separated into risk segments by product and delinquency status. The Company utilizes historical performance data and historical recovery rates on collateral liquidation to forecast delinquency and loss at the product level. The consumer and other loan portfolio represented 7% of total loans receivable as of September 30, 2014. The qualitative component for the consumer and other loan portfolio was 32% and 21% of the quantitative component of the general allowance at September 30, 2014 and December 31, 2013, respectively.

For modified loans accounted for as TDRs that are valued using the discounted cash flow model, the Company established a specific allowance. The specific allowance for TDRs factors in the historical default rate of an individual loan before being modified as a TDR in the discounted cash flow analysis in order to determine that specific loan's expected impairment. Specifically, a loan that has a more severe delinquency history prior to modification will have a higher future default rate in the discounted cash flow analysis than a loan that was not as severely delinquent. For both of the one- to four-family and home equity loan portfolio segments, the pre-modification delinquency status, the borrower's current credit score and other credit bureau attributes, in addition to each loan's individual default experience and credit characteristics, are incorporated into the calculation of the specific allowance. A specific allowance is established to the extent that the recorded investment exceeds the discounted cash flows of a TDR with a corresponding charge to provision for loan losses. The specific allowance for these individually impaired loans represents the forecasted losses over the estimated remaining life of the loan, including the economic concession to the borrower.

*Other-than-temporary Impairment ("OTTI")*—The Company considers OTTI for an available-for-sale or held-to-maturity debt security to have occurred if one of the following conditions are met: the Company intends to sell the impaired debt security; it is more likely than not that the Company will be required to sell the impaired debt security before recovery of the security's amortized cost basis; or the Company does not expect to recover the entire amortized cost basis of the security. The Company's evaluation of whether it intends to sell an impaired debt security considers whether management has decided to sell the security as of the balance sheet date. The Company's evaluation of whether it is more likely than not that the Company will be required to sell an impaired debt security before recovery of the security's amortized cost basis considers the likelihood of sales that involve legal, regulatory or operational requirements. For impaired debt securities that the Company does not intend to sell and it is not more likely than not that the Company will be required to sell before recovery of the security's amortized cost basis, the Company uses both qualitative and quantitative valuation measures to evaluate whether the Company expects to recover the entire amortized cost basis of the security. The Company considers all available information relevant to the collectability of the security, including credit enhancements, security structure, vintage, credit ratings and other relevant collateral characteristics.

If the Company intends to sell an impaired debt security or if it is more likely than not that the Company will be required to sell the impaired debt security before recovery of the security's amortized cost basis, the Company will recognize OTTI in earnings equal to the entire difference between the security's amortized cost basis and the security's fair value. If the Company does not intend to sell the impaired debt security and it is not more likely than not that the Company will be required to sell the impaired debt security before recovery of its amortized cost basis but the Company does not expect to recover the entire amortized cost basis of the security, the Company will separate OTTI into two components: 1) the amount related to credit loss, recognized in earnings; and 2) the noncredit portion of OTTI, recognized through other comprehensive income (loss).

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The Company considers OTTI for an available-for-sale equity security to have occurred if the decline in the security's fair value below its cost basis is deemed other than temporary based on evaluation of both qualitative and quantitative valuation measures. If the impairment of an available-for-sale equity security is determined to be other-than-temporary, the Company will recognize OTTI in earnings equal to the entire difference between the security's amortized cost basis and the security's fair value. If the Company intends to sell an impaired equity security and the Company does not expect to recover the entire cost basis of the security prior to the sale, the Company will recognize OTTI in the period the decision to sell is made.

**Real Estate Owned and Repossessed Assets**—Real estate owned and repossessed assets are included in the other assets line item in the consolidated balance sheet. Real estate owned represents real estate acquired through foreclosure and also includes those properties acquired through a deed in lieu of foreclosure or similar legal agreement. Both real estate owned and the repossessed assets are carried at the lower of carrying value or fair value, less estimated selling costs.

**New Accounting and Disclosure Guidance**—Below is the new accounting and disclosure guidance that relates to activities in which the Company is engaged.

### *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*

In July 2013, the FASB amended the presentation guidance on unrecognized tax benefits. The amended guidance requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except under certain circumstances. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The unrecognized tax benefit should also be presented in the financial statements as a liability if the tax law of the applicable jurisdiction does not require the Company to use, and the Company does not intend to use, the deferred tax asset to settle any additional income taxes. The amended presentation guidance became effective for annual and interim periods beginning on January 1, 2014 for the Company and was applied prospectively to unrecognized tax benefits existing at that date. The adoption of the amended presentation guidance did not have a material impact on the Company's financial condition, results of operations or cash flows.

### *Accounting for Investments in Qualified Affordable Housing Projects*

In January 2014, the FASB amended the accounting guidance for investments in qualified affordable housing projects. The amended accounting guidance permits reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, the Company would amortize the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognize the net investment performance in the consolidated statement of income (loss) as a component of income tax expense (benefit). The amended guidance will be effective for annual and interim periods beginning on January 1, 2015 for the Company and must be applied retrospectively. Early adoption is permitted. While the Company is currently evaluating the impact of the new accounting guidance, the adoption is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

### *Reclassification of Residential Real Estate Collateralized Mortgage Loans upon Foreclosure*

In January 2014, the FASB amended the accounting and disclosure guidance on reclassifications of residential real estate collateralized mortgage loans upon foreclosure ("ASU 2014-04"). The amended guidance clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amended disclosure guidance requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in mortgage loans collateralized by residential real estate property that are in the process of foreclosure. As early adoption was permitted, the Company early adopted the amended guidance as of January 1, 2014. The adoption of the amended accounting guidance did not have a material impact on the Company's financial condition, results of operations or cash flows.

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### *Presentation and Disclosure of Discontinued Operations*

In April 2014, the FASB amended the presentation and disclosure guidance on disposal transactions. The amended guidance raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The amended guidance will be effective for all disposals or classifications as held for sale that occur in annual and interim periods beginning on January 1, 2015 for the Company. Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. The adoption is not expected to have a material impact on the Company's current financial condition, results of operations or cash flows; however, it may impact the reporting of future disposals if and when they occur.

### *Revenue Recognition on Contracts with Customers*

In May 2014, the FASB amended the guidance on revenue recognition on contracts with customers. The new standard outlines a single comprehensive model for entities to apply in accounting for revenue arising from contracts with customers. The amended guidance will be effective for annual and interim periods beginning on January 1, 2017 for the Company and may be applied on either a full retrospective or modified retrospective basis. Early adoption is not permitted. While the Company is currently evaluating the impact of the new accounting guidance, the adoption is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

### *Accounting and Disclosures for Repurchase Agreements*

In June 2014, the FASB amended the accounting and disclosure guidance on repurchase agreements. The amended guidance requires entities to account for repurchase-to-maturity transactions as secured borrowings, eliminates accounting guidance on linked repurchase financing transactions, and expands the disclosure requirements related to transfers of financial assets accounted for as sales and as secured borrowings. The amended guidance will be effective for annual and interim periods beginning on January 1, 2015 for the Company and must be applied using a cumulative-effect approach as of the beginning of the period of adoption. Early adoption is not permitted. While the Company is currently evaluating the impact of the new accounting guidance, the adoption is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

### *Classification of Government-Guaranteed Mortgage Loans upon Foreclosure*

In August 2014, the FASB amended the accounting and disclosure guidance related to the classification of certain government-guaranteed mortgage loans upon foreclosure. The amended guidance requires entities to derecognize a mortgage loan and recognize a separate other receivable upon foreclosure if certain conditions are met. The separate other receivable is recorded based on the amount of principal and interest expected to be recovered under the guarantee. The amended guidance will be effective for annual and interim periods beginning on January 1, 2015 for the Company. Early adoption, including adoption in an interim period, is permitted but only for entities that have early adopted ASU 2014-04. The amended guidance may be applied on either a prospective or modified retrospective basis, consistent with the transition method elected to adopt ASU 2014-04. The adoption is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

### *Disclosures of Uncertainties about an Entity's Ability to Continue as a Going Concern*

In August 2014, the FASB amended the guidance related to an entity's evaluations and disclosures of going concern uncertainties. The new guidance requires management to perform interim and annual assessments of the entity's ability to continue as a going concern within one year of the date the financial statements are issued, and to provide certain disclosures if conditions or events raise substantial doubt about the entity's ability to continue as a going concern. The amended guidance will be effective for the Company for annual periods beginning on January 1, 2016 and for interim periods beginning on January 1, 2017. Early adoption is permitted. The adoption will not impact the Company's financial condition, results of operations or cash flows.

## **NOTE 2—DISPOSITION**

On February 10, 2014, the Company completed the sale of its market making business, G1 Execution Services, LLC, to an affiliate of Susquehanna for cash proceeds of \$76 million. The sale resulted in a gain of \$4 million which was recorded in the facility restructuring and other exit activities line item on the consolidated statement of income. The table below

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summarizes the carrying amounts of the major classes of assets and liabilities of the market making business at December 31, 2013 (dollars in millions):

	December 31, 2013 <sup>(1)</sup>
<b>Assets:</b>	
Cash and equivalents	\$ 11
Trading securities	105
Property and equipment, net	2
Other intangibles, net	21
Other assets	38
Total assets	<u>\$ 177</u>
<b>Liabilities:</b>	
Other liabilities	\$ 107
Total liabilities	<u>\$ 107</u>

<sup>(1)</sup>Assets and liabilities at December 31, 2013 were classified as held-for-sale and reflected in the other assets and other liabilities line items on the consolidated balance sheet respectively.

**NOTE 3—OPERATING INTEREST INCOME AND OPERATING INTEREST EXPENSE**

The following table shows the components of operating interest income and operating interest expense (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Operating interest income:</b>				
Loans	\$ 70	\$ 96	\$ 231	\$ 305
Available-for-sale securities	69	68	220	199
Held-to-maturity securities	81	65	240	184
Margin receivables	67	56	194	164
Securities borrowed and other	32	16	78	51
Total operating interest income	<u>319</u>	<u>301</u>	<u>963</u>	<u>903</u>
<b>Operating interest expense:</b>				
Securities sold under agreements to repurchase	(30)	(37)	(95)	(111)
FHLB advances and other borrowings	(16)	(17)	(50)	(51)
Deposits	(2)	(4)	(6)	(10)
Customer payables and other	(2)	(2)	(7)	(6)
Total operating interest expense	<u>(50)</u>	<u>(60)</u>	<u>(158)</u>	<u>(178)</u>
Net operating interest income	<u>\$ 269</u>	<u>\$ 241</u>	<u>\$ 805</u>	<u>\$ 725</u>

**NOTE 4—FAIR VALUE DISCLOSURES**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company may use various valuation approaches, including market, income and/or cost approaches. The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is a market-based measure considered from the perspective of a market participant. Accordingly, even when market assumptions are not readily available, the Company's own assumptions reflect those that market participants would use in pricing the asset or liability at the measurement date. The fair value measurement accounting guidance describes the following three levels used to classify fair value measurements:

- Level 1—Unadjusted quoted prices in active markets for identical assets or liabilities that are accessible by the Company.

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- Level 2—Quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3—Unobservable inputs that are significant to the fair value of the assets or liabilities.

The availability of observable inputs can vary and in certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to a fair value measurement requires judgment and consideration of factors specific to the asset or liability.

### ***Recurring Fair Value Measurement Techniques***

#### *U.S. Treasury Securities and Agency Debentures*

The fair value measurements of U.S. Treasury securities were classified as Level 1 of the fair value hierarchy as they were based on quoted market prices in active markets. The fair value measurements of agency debentures were classified as Level 2 of the fair value hierarchy as they were based on quoted market prices observable in the marketplace.

#### *Residential Mortgage-backed Securities*

The Company's residential mortgage-backed securities portfolio primarily comprised agency mortgage-backed securities and CMOs. Agency mortgage-backed securities and CMOs are guaranteed by U.S. government sponsored enterprises and federal agencies. The weighted average coupon rates for the available-for-sale residential mortgage-backed securities at September 30, 2014 are shown in the following table:

	<b>Weighted Average Coupon Rate</b>
Agency mortgage-backed securities	3.11%
Agency CMOs	3.12%

The fair value of agency mortgage-backed securities was determined using a market approach with quoted market prices, recent market transactions and spread data for similar instruments. The fair value of agency CMOs was determined using market and income approaches with the Company's own trading activities for identical or similar instruments. Agency mortgage-backed securities and CMOs were categorized in Level 2 of the fair value hierarchy.

#### *Other Debt Securities*

The fair value measurements of agency debt securities were determined using market and income approaches along with the Company's own trading activities for identical or similar instruments and were categorized in Level 2 of the fair value hierarchy.

The Company's municipal bonds are revenue bonds issued by state and other local government agencies. The valuation of corporate bonds is impacted by the credit worthiness of the corporate issuer. All of the Company's municipal bonds and corporate bonds were rated investment grade at September 30, 2014. These securities were valued using a market approach with pricing service valuations corroborated by recent market transactions for identical or similar bonds. Municipal bonds and corporate bonds were categorized in Level 2 of the fair value hierarchy.

#### *Publicly Traded Equity Securities*

The fair value measurements of the Company's publicly traded equity securities were classified as Level 1 of the fair value hierarchy as they were based on quoted market prices in active markets.

#### *Derivative Instruments*

Interest rate swap and option contracts were valued with an income approach using pricing models that are commonly used by the financial services industry. The market observable inputs used in the pricing models include the swap curve, the volatility surface, and prime or overnight indexed swap basis from a financial data provider. The Company does not consider these models to involve significant judgment on the part of management, and the Company corroborated the fair value measurements with counterparty valuations. The Company's derivative instruments were categorized in Level 2 of the fair value hierarchy. The consideration of credit risk, the Company's or the counterparty's, did not result in an adjustment to the valuation of its derivative instruments in the periods presented.

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### *Securities Owned and Securities Sold, Not Yet Purchased*

Securities transactions entered into by broker-dealer subsidiaries were included in trading securities as held-for-sale assets within other assets and securities sold, not yet purchased as held-for-sale liabilities in the Company's fair value disclosures at December 31, 2013. The Company's definition of actively traded is based on average daily volume and other market trading statistics. The majority of the Company's securities owned and securities sold, not yet purchased were categorized in Level 1 of the fair value hierarchy. The fair value of these securities was determined using listed or quoted market prices. The Company did not hold any of these securities at September 30, 2014.

### *Nonrecurring Fair Value Measurement Techniques*

Certain other assets are recorded at fair value on a nonrecurring basis: 1) one- to four-family and home equity loans in which the amount of the loan balance in excess of the estimated current value of the underlying property less estimated selling costs has been charged-off; and 2) real estate owned that is carried at the lower of the property's carrying value or fair value less estimated selling costs.

The Company evaluates and reviews assets that have been subject to fair value measurement requirements on a quarterly basis in accordance with policies and procedures that were designed to be in compliance with guidance from the Company's regulators. These policies and procedures govern the frequency of the review, the use of acceptable valuation methods, and the consideration of estimated selling costs.

### *Loans Receivable and Real Estate Owned*

Loans that have been delinquent for 180 days or that are in bankruptcy and certain TDR loan modifications are charged-off based on the estimated current value of the underlying property less estimated selling costs. Property valuations for these one- to four-family and home equity loans are based on the most recent "as is" property valuation data available, which may include appraisals, broker price opinions, automated valuation models or updated values using home price indices. Subsequent to the recording of an initial fair value measurement, these loans continue to be measured at fair value on a nonrecurring basis, utilizing the estimated value of the underlying property less estimated selling costs. These property valuations are updated on a monthly, quarterly or semi-annual basis depending on the type of valuation initially used. If the value of the underlying property has declined, an additional charge-off is recorded. If the value of the underlying property has increased, previously charged-off amounts are not reversed. If the valuation data obtained is significantly different from the valuation previously received, the Company reviews additional property valuation data to corroborate or update the valuation.

Property valuations for real estate owned are based on the lowest value of the most recent property valuation data available, which may include appraisals, listing prices or approved offer prices. Nonrecurring fair value measurements on one- to four-family and home equity loans and real estate owned were classified as Level 3 of the fair value hierarchy as the majority of the valuations included Level 3 inputs that were significant to the fair value.

The following table presents additional information about significant unobservable inputs used in the valuation of assets measured at fair value on a nonrecurring basis that were categorized in Level 3 of the fair value hierarchy at September 30, 2014:

	<u>Unobservable Inputs</u>	<u>Average</u>	<u>Range</u>
Loans receivable:			
One- to four-family	Appraised value	\$ 371,400	\$19,000-\$1,400,000
Home equity	Appraised value	\$ 277,600	\$7,000-\$1,070,000
Real estate owned	Appraised value	\$ 337,100	\$6,500-\$1,750,000

### *Goodwill*

At the end of the second quarter of 2013, the Company decided to exit the market making business, and as a result evaluated the total goodwill allocated to the market making reporting unit for impairment. The Company valued the market making business by using a combination of expected present value of future cash flows of the business, a form of the income approach, and prices of comparable businesses, a form of the market approach, with significant unobservable inputs. The Company valued the market making reporting unit using the expected sale structure of the market making business. As a result of the evaluation, it was determined that the entire carrying amount of goodwill allocated to the market making reporting unit was impaired, and the Company recognized \$142 million impairment of goodwill during the year ended December 31, 2013.

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**Recurring and Nonrecurring Fair Value Measurements**

Assets and liabilities measured at fair value at September 30, 2014 and December 31, 2013 are summarized in the following tables (dollars in millions):

	Level 1	Level 2	Level 3	Total Fair Value
<b>September 30, 2014:</b>				
<b>Recurring fair value measurements:</b>				
<b>Assets</b>				
Available-for-sale securities:				
Debt securities:				
Agency residential mortgage-backed securities and CMOs	\$ —	\$ 11,235	\$ —	\$ 11,235
Agency debentures	—	529	—	529
Agency debt securities	—	675	—	675
Municipal bonds	—	40	—	40
Corporate bonds	—	5	—	5
Total debt securities	—	12,484	—	12,484
Publicly traded equity securities	32	—	—	32
Total available-for-sale securities	32	12,484	—	12,516
Other assets:				
Derivative assets <sup>(1)</sup>	—	59	—	59
Deposits with clearing organizations <sup>(2)</sup>	97	—	—	97
Total other assets measured at fair value on a recurring basis	97	59	—	156
Total assets measured at fair value on a recurring basis <sup>(3)</sup>	\$ 129	\$ 12,543	\$ —	\$ 12,672
<b>Liabilities</b>				
Derivative liabilities <sup>(1)</sup>	\$ —	\$ 48	\$ —	\$ 48
Total liabilities measured at fair value on a recurring basis <sup>(3)</sup>	\$ —	\$ 48	\$ —	\$ 48
<b>Nonrecurring fair value measurements:</b>				
Loans receivable:				
One- to four-family	\$ —	\$ —	\$ 39	\$ 39
Home equity	—	—	26	26
Total loans receivable	—	—	65	65
Real estate owned	—	—	36	36
Total assets measured at fair value on a nonrecurring basis <sup>(4)</sup>	\$ —	\$ —	\$ 101	\$ 101

(1) All derivative assets and liabilities were interest rate contracts at September 30, 2014. Information related to derivative instruments is detailed in Note 8—Accounting for Derivative Instruments and Hedging Activities.

(2) Represents U.S. Treasury securities held by a broker-dealer subsidiary.

(3) Assets and liabilities measured at fair value on a recurring basis represented 28% and less than 1% of the Company's total assets and total liabilities, respectively, at September 30, 2014.

(4) Represents the fair value of assets prior to deducting estimated selling costs that were carried on the consolidated balance sheet at September 30, 2014, and for which a fair value measurement was recorded during the period.

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	Level 1	Level 2	Level 3 <sup>(1)</sup>	Total Fair Value
<b>December 31, 2013:</b>				
<b>Recurring fair value measurements:</b>				
<b>Assets</b>				
Available-for-sale securities:				
Debt securities:				
Residential mortgage-backed securities:				
Agency mortgage-backed securities and CMOs	\$ —	\$ 12,236	\$ —	\$ 12,236
Non-agency CMOs	—	—	14	14
Total residential mortgage-backed securities	—	12,236	14	12,250
Agency debentures	—	466	—	466
Agency debt securities	—	831	—	831
Municipal bonds	—	40	—	40
Corporate bonds	—	5	—	5
Total debt securities	—	13,578	14	13,592
Total available-for-sale securities	—	13,578	14	13,592
Other assets:				
Derivative assets <sup>(2)</sup>	—	107	—	107
Deposits with clearing organizations <sup>(3)</sup>	53	—	—	53
Held-for-sale assets—trading securities <sup>(4)</sup>	104	1	—	105
Total other assets measured at fair value on a recurring basis	157	108	—	265
Total assets measured at fair value on a recurring basis <sup>(5)</sup>	\$ 157	\$ 13,686	\$ 14	\$ 13,857
<b>Liabilities</b>				
Derivative liabilities <sup>(2)</sup>	\$ —	\$ 169	\$ —	\$ 169
Held-for-sale liabilities—securities sold, not yet purchased <sup>(4)</sup>	94	1	—	95
Total liabilities measured at fair value on a recurring basis <sup>(5)</sup>	\$ 94	\$ 170	\$ —	\$ 264
<b>Nonrecurring fair value measurements:</b>				
Loans receivable:				
One- to four-family	\$ —	\$ —	\$ 246	\$ 246
Home equity	—	—	46	46
Total loans receivable <sup>(6)</sup>	—	—	292	292
Real estate owned <sup>(6)</sup>	—	—	47	47
Total assets measured at fair value on a nonrecurring basis <sup>(7)</sup>	\$ —	\$ —	\$ 339	\$ 339

- (1) Instruments measured at fair value on a recurring basis categorized as Level 3 represented less than 1% of the Company's total assets and none of its total liabilities at December 31, 2013.
- (2) All derivative assets and liabilities were interest rate contracts at December 31, 2013. Information related to derivative instruments is detailed in Note 8—Accounting for Derivative Instruments and Hedging Activities.
- (3) Represents U.S. Treasury securities held by a broker-dealer subsidiary.
- (4) Assets and liabilities of the market making business were reclassified as held-for-sale and are presented in the other assets and other liabilities line items, respectively, on the consolidated balance sheet at December 31, 2013. Information related to the classification is detailed in Note 2—Disposition.
- (5) Assets and liabilities measured at fair value on a recurring basis represented 30% and 1% of the Company's total assets and total liabilities, respectively, at December 31, 2013.
- (6) Represents the fair value of assets prior to deducting estimated selling costs that were carried on the consolidated balance sheet at December 31, 2013, and for which a fair value measurement was recorded during the period.
- (7) Goodwill allocated to the market making reporting unit with a carrying amount of \$142 million was written down to zero during the year ended December 31, 2013 and categorized in Level 3 of the fair value hierarchy.

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The following table presents the gains and losses associated with the assets measured at fair value on a nonrecurring basis during the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
One- to four-family	\$ 2	\$ 10	\$ 9	\$ 34
Home equity	5	11	25	47
Total losses on loans receivable measured at fair value	\$ 7	\$ 21	\$ 34	\$ 81
(Gains) losses on real estate owned measured at fair value	\$ —	\$ (2)	\$ (1)	\$ —
Losses on goodwill measured at fair value	\$ —	\$ —	\$ —	\$ 142

*Transfers Between Levels 1 and 2*

For assets and liabilities measured at fair value on a recurring basis, the Company's transfers between levels of the fair value hierarchy are deemed to have occurred at the beginning of the reporting period on a quarterly basis. The Company had no material transfers between Level 1 and 2 during the three and nine months ended September 30, 2014 and 2013.

*Level 3 Rollforward for Recurring Fair Value Measurements*

Level 3 assets include instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. While the Company's fair value estimates of Level 3 instruments utilized observable inputs where available, the valuation included significant management judgment in determining the relevance and reliability of market information considered.

The following tables present additional information about Level 3 assets measured at fair value on a recurring basis for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Available-for-sale Securities			
	Non-agency CMOs			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Beginning of period	\$ —	\$ 14	\$ 14	\$ 49
Gains (losses) recognized in earnings <sup>(1)</sup>	—	(1)	6	(3)
Net gains recognized in other comprehensive income (loss) <sup>(2)</sup>	—	2	3	5
Sales	—	—	(23)	(35)
Settlements	—	(1)	—	(2)
End of period	\$ —	\$ 14	\$ —	\$ 14

(1) Gains and losses recognized in earnings are reported in the gains on loans and securities, net and net impairment line items on the consolidated statement of income.

(2) Net gains recognized in other comprehensive income (loss) are reported in the net change from available-for-sale securities line item.

**Fair Value of Financial Instruments Not Carried at Fair Value**

The following table summarizes the carrying values, fair values and fair value hierarchy level classification of financial instruments that are not carried at fair value on the consolidated balance sheet at September 30, 2014 and December 31, 2013 (dollars in millions):

	September 30, 2014				
	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
<b>Assets</b>					
Cash and equivalents	\$ 1,809	\$ 1,809	\$ —	\$ —	\$ 1,809
Cash required to be segregated under federal or other regulations	\$ 608	\$ 608	\$ —	\$ —	\$ 608
Held-to-maturity securities:					
Agency mortgage-backed securities and CMOs	\$ 9,489	\$ —	\$ 9,563	\$ —	\$ 9,563
Agency debentures	163	—	166	—	166
Agency debt securities	2,190	—	2,209	—	2,209
Other non-agency debt securities	5	—	—	5	5
Total held-to-maturity securities	<u>\$ 11,847</u>	<u>\$ —</u>	<u>\$ 11,938</u>	<u>\$ 5</u>	<u>\$ 11,943</u>
Margin receivables	\$ 8,117	\$ —	\$ 8,117	\$ —	\$ 8,117
Loans receivable, net:					
One- to four-family	\$ 3,183	\$ —	\$ —	\$ 2,851	\$ 2,851
Home equity	2,641	—	—	2,449	2,449
Consumer and other	478	—	—	479	479
Total loans receivable, net <sup>(1)</sup>	<u>\$ 6,302</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,779</u>	<u>\$ 5,779</u>
Investment in FHLB stock	\$ 77	\$ —	\$ —	\$ 77	\$ 77
Deposits paid for securities borrowed	\$ 461	\$ —	\$ 461	\$ —	\$ 461
<b>Liabilities</b>					
Deposits	\$ 24,927	\$ —	\$ 24,927	\$ —	\$ 24,927
Securities sold under agreements to repurchase	\$ 3,917	\$ —	\$ 3,928	\$ —	\$ 3,928
Customer payables	\$ 6,526	\$ —	\$ 6,526	\$ —	\$ 6,526
FHLB advances and other borrowings	\$ 1,294	\$ —	\$ 923	\$ 250	\$ 1,173
Corporate debt	\$ 1,771	\$ —	\$ 1,906	\$ —	\$ 1,906
Deposits received for securities loaned	\$ 1,812	\$ —	\$ 1,812	\$ —	\$ 1,812

(1) The carrying value of loans receivable, net includes the allowance for loan losses of \$401 million and loans that are valued at fair value on a nonrecurring basis at September 30, 2014.

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	December 31, 2013				
	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
<b>Assets</b>					
Cash and equivalents	\$ 1,838	\$ 1,838	\$ —	\$ —	\$ 1,838
Cash required to be segregated under federal or other regulations	\$ 1,066	\$ 1,066	\$ —	\$ —	\$ 1,066
Held-to-maturity securities:					
Agency mortgage-backed securities and CMOs	\$ 8,359	\$ —	\$ 8,293	\$ —	\$ 8,293
Agency debentures	164	—	168	—	168
Agency debt securities	1,658	—	1,631	—	1,631
Total held-to-maturity securities	\$ 10,181	\$ —	\$ 10,092	\$ —	\$ 10,092
Margin receivables	\$ 6,353	\$ —	\$ 6,353	\$ —	\$ 6,353
Loans receivable, net:					
One- to four-family	\$ 4,392	\$ —	\$ —	\$ 3,790	\$ 3,790
Home equity	3,148	—	—	2,822	2,822
Consumer and other	583	—	—	596	596
Total loans receivable, net <sup>(1)</sup>	\$ 8,123	\$ —	\$ —	\$ 7,208	\$ 7,208
Investment in FHLB stock	\$ 61	\$ —	\$ —	\$ 61	\$ 61
Deposits paid for securities borrowed	\$ 536	\$ —	\$ 536	\$ —	\$ 536
<b>Liabilities</b>					
Deposits	\$ 25,971	\$ —	\$ 25,971	\$ —	\$ 25,971
Securities sold under agreements to repurchase	\$ 4,543	\$ —	\$ 4,571	\$ —	\$ 4,571
Customer payables	\$ 6,310	\$ —	\$ 6,310	\$ —	\$ 6,310
FHLB advances and other borrowings	\$ 1,279	\$ —	\$ 924	\$ 225	\$ 1,149
Corporate debt	\$ 1,768	\$ —	\$ 1,951	\$ —	\$ 1,951
Deposits received for securities loaned	\$ 1,050	\$ —	\$ 1,050	\$ —	\$ 1,050

(1) The carrying value of loans receivable, net includes the allowance for loan losses of \$453 million and loans that are valued at fair value on a nonrecurring basis at December 31, 2013.

The fair value measurement techniques for financial instruments not carried at fair value on the consolidated balance sheet at September 30, 2014 and December 31, 2013 are summarized as follows:

*Cash and equivalents, cash required to be segregated under federal or other regulations, margin receivables, deposits paid for securities borrowed, customer payables and deposits received for securities loaned*—Fair value is estimated to be carrying value.

*Held-to-maturity securities*—The held-to-maturity securities portfolio included agency mortgage-backed securities and CMOs, agency debentures, agency debt securities, and other non-agency debt securities. The fair value of agency mortgage-backed securities is determined using market and income approaches with quoted market prices, recent market transactions and spread data for similar instruments. The fair value of agency CMOs and agency debt securities is determined using market and income approaches with the Company's own trading activities for identical or similar instruments. The fair value of agency debentures is based on quoted market prices that were derived from assumptions observable in the marketplace. Fair value of other non-agency debt securities is estimated to be carrying value.

*Loans receivable, net*—Fair value is estimated using a discounted cash flow model. Loans are differentiated based on their individual portfolio characteristics, such as product classification, loan category, pricing features and remaining maturity. Assumptions for expected losses, prepayments and discount rates are adjusted to reflect the individual characteristics of the loans, such as credit risk, coupon, term, and payment characteristics, as well as the secondary market conditions for these types of loans. There was limited or no observable market data for the home equity and one- to four-family loan portfolios, which indicates that the market for these types of loans is considered to be inactive. Given the limited market data, these fair value measurements cannot be determined with precision and changes in the underlying assumptions used, including discount rates, could significantly affect the results of current or future fair value estimates. In addition, the amount that would be realized in a

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forced liquidation, an actual sale or immediate settlement could be significantly lower than both the carrying value and the estimated fair value of the portfolio.

*Investment in FHLB stock*—FHLB stock is carried at cost, which is considered to be a reasonable estimate of fair value.

*Deposits*—Fair value is the amount payable on demand at the reporting date for sweep deposits, complete savings deposits, other money market and savings deposits and checking deposits. For certificates of deposit and brokered certificates of deposit, fair value is estimated by discounting future cash flows using discount factors derived from current observable rates implied for other similar instruments with similar remaining maturities.

*Securities sold under agreements to repurchase*—Fair value is determined by discounting future cash flows using discount factors derived from current observable rates implied for other similar instruments with similar remaining maturities.

*FHLB advances and other borrowings*—Fair value for FHLB advances is estimated by discounting future cash flows using discount factors derived from current observable rates implied for similar instruments with similar remaining maturities. For subordinated debentures, fair value is estimated by discounting future cash flows at the rate implied by dealer pricing quotes.

*Corporate debt*—Fair value is estimated using dealer pricing quotes. The fair value of the non-interest-bearing convertible debentures is directly correlated to the intrinsic value of the Company's underlying stock. As the price of the Company's stock increases relative to the conversion price, the fair value of the convertible debentures increases.

### **NOTE 5—OFFSETTING ASSETS AND LIABILITIES**

For financial statement purposes, the Company does not offset derivative instruments, repurchase agreements or securities borrowing and securities lending transactions. The Company's derivative instruments, repurchase agreements and securities borrowing and securities lending transactions are generally transacted under master agreements that are widely used by counterparties and that may allow for net settlements of payments in the normal course, as well as offsetting of all contracts with a given counterparty in the event of bankruptcy or default of one of the two parties to the transaction. The following table presents information about these transactions to enable the users of the Company's financial statements to evaluate the potential effect of rights of setoff between these recognized assets and recognized liabilities at September 30, 2014 and December 31, 2013 (dollars in millions):

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	Gross Amounts of Recognized Assets and Liabilities	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts Presented in the Consolidated Balance Sheet	Gross Amounts Not Offset in the Consolidated Balance Sheet		
				Financial Instruments	Collateral Received or Pledged (Including Cash)	Net Amount
<b>September 30, 2014</b>						
Assets:						
Deposits paid for securities borrowed <sup>(1)(5)</sup>	\$ 461	\$ —	\$ 461	\$ (242)	\$ (205)	\$ 14
Derivative assets <sup>(1)(3)</sup>	59	—	59	(18)	(6)	35
Total	\$ 520	\$ —	\$ 520	\$ (260)	\$ (211)	\$ 49
Liabilities:						
Repurchase agreements <sup>(4)</sup>	\$ 3,917	\$ —	\$ 3,917	\$ —	\$ (3,916)	\$ 1
Deposits received for securities loaned <sup>(2)(6)</sup>	1,812	—	1,812	(242)	(1,400)	170
Derivative liabilities <sup>(2)(3)</sup>	32	—	32	(18)	(14)	—
Total	\$ 5,761	\$ —	\$ 5,761	\$ (260)	\$ (5,330)	\$ 171
<b>December 31, 2013</b>						
Assets:						
Deposits paid for securities borrowed <sup>(1)(5)</sup>	\$ 536	\$ —	\$ 536	\$ (247)	\$ (282)	\$ 7
Derivative assets <sup>(1)(3)</sup>	92	—	92	(48)	(12)	32
Total	\$ 628	\$ —	\$ 628	\$ (295)	\$ (294)	\$ 39
Liabilities:						
Repurchase agreements <sup>(4)</sup>	\$ 4,543	\$ —	\$ 4,543	\$ —	\$ (4,537)	\$ 6
Deposits received for securities loaned <sup>(2)(6)</sup>	1,050	—	1,050	(247)	(740)	63
Derivative liabilities <sup>(2)(3)</sup>	168	—	168	(48)	(120)	—
Total	\$ 5,761	\$ —	\$ 5,761	\$ (295)	\$ (5,397)	\$ 69

(1) Net amounts presented in the consolidated balance sheet are reflected in the other assets line item.

(2) Net amounts presented in the consolidated balance sheet are reflected in the other liabilities line item.

(3) Excludes net accrued interest payable of \$10 million and \$19 million at September 30, 2014 and December 31, 2013, respectively.

(4) The Company pledges available-for-sale and held-to-maturity securities as collateral for amounts due on repurchase agreements and derivative liabilities. The collateral pledged included available-for-sale securities at fair value and held-to-maturity securities at amortized cost for both September 30, 2014 and December 31, 2013.

(5) Included in the gross amounts of deposits paid for securities borrowed was \$339 million and \$415 million at September 30, 2014 and December 31, 2013, respectively, transacted through a program with a clearing organization, which guarantees the return of cash to the Company. For presentation purposes, these amounts presented are based on the original counterparties to the Company's master securities loan agreements.

(6) Included in the gross amounts of deposits received for securities loaned was \$1.2 billion and \$682 million at September 30, 2014 and December 31, 2013, respectively, transacted through a program with a clearing organization, which guarantees the return of securities to the Company. For presentation purposes, these amounts presented are based on the original counterparties to the Company's master securities loan agreements.

Effective June 10, 2013, certain types of derivatives that the Company trades are subject to the Dodd-Frank Act clearing mandate and as a result, are subject to derivatives clearing agreements ("cleared derivatives contracts"). These cleared derivatives contracts enable clearing by a derivatives clearing organization through a clearing member. Under the contracts, the clearing member typically has a one-way right to offset all contracts in the event of the Company's default or bankruptcy. As such, the cleared derivatives contracts are not bilateral master netting agreements and do not allow for offsetting. At September 30, 2014 and December 31, 2013, the Company had less than \$1 million and \$15 million, respectively, in derivative assets of cleared derivatives contracts and \$16 million and \$1 million, respectively, in derivative liabilities of cleared derivatives contracts.

**NOTE 6—AVAILABLE-FOR-SALE AND HELD-TO-MATURITY SECURITIES**

The amortized cost and fair value of available-for-sale and held-to-maturity securities at September 30, 2014 and December 31, 2013 are shown in the following tables (dollars in millions):

	Amortized Cost	Gross Unrealized / Unrecognized Gains	Gross Unrealized / Unrecognized Losses	Fair Value
<b>September 30, 2014:</b>				
Available-for-sale securities:				
Debt securities:				
Agency residential mortgage-backed securities and CMOs	\$ 11,324	\$ 91	\$ (180)	\$ 11,235
Agency debentures	524	15	(10)	529
Agency debt securities	661	16	(2)	675
Municipal bonds	40	1	(1)	40
Corporate bonds	6	—	(1)	5
Total debt securities	12,555	123	(194)	12,484
Publicly traded equity securities <sup>(1)</sup>	32	—	—	32
Total available-for-sale securities	\$ 12,587	\$ 123	\$ (194)	\$ 12,516
Held-to-maturity securities:				
Agency residential mortgage-backed securities and CMOs	\$ 9,489	\$ 147	\$ (73)	\$ 9,563
Agency debentures	163	3	—	166
Agency debt securities	2,190	35	(16)	2,209
Other non-agency debt securities	5	—	—	5
Total held-to-maturity securities	\$ 11,847	\$ 185	\$ (89)	\$ 11,943
<b>December 31, 2013:</b>				
Available-for-sale securities:				
Debt securities:				
Residential mortgage-backed securities:				
Agency mortgage-backed securities and CMOs	\$ 12,505	\$ 66	\$ (335)	\$ 12,236
Non-agency CMOs	17	2	(5)	14
Total residential mortgage-backed securities	12,522	68	(340)	12,250
Agency debentures	520	—	(54)	466
Agency debt securities	832	8	(9)	831
Municipal bonds	42	—	(2)	40
Corporate bonds	6	—	(1)	5
Total debt securities	13,922	76	(406)	13,592
Total available-for-sale securities	\$ 13,922	\$ 76	\$ (406)	\$ 13,592
Held-to-maturity securities:				
Agency residential mortgage-backed securities and CMOs	\$ 8,359	\$ 99	\$ (165)	\$ 8,293
Agency debentures	164	4	—	168
Agency debt securities	1,658	13	(40)	1,631
Total held-to-maturity securities	\$ 10,181	\$ 116	\$ (205)	\$ 10,092

(1) Publicly traded equity securities consisted of investments in a mutual fund related to the Community Reinvestment Act.

**Contractual Maturities**

The contractual maturities of all available-for-sale and held-to-maturity debt securities at September 30, 2014 are shown below (dollars in millions):

	<u>Amortized Cost</u>	<u>Fair Value</u>
<b>Available-for-sale debt securities:</b>		
Due within one year	\$ 4	\$ 4
Due within one to five years	10	10
Due within five to ten years	898	896
Due after ten years	11,643	11,574
Total available-for-sale debt securities	<u>\$ 12,555</u>	<u>\$ 12,484</u>
<b>Held-to-maturity debt securities:</b>		
Due within one year	\$ 169	\$ 171
Due within one to five years	820	845
Due within five to ten years	2,902	2,955
Due after ten years	7,956	7,972
Total held-to-maturity debt securities	<u>\$ 11,847</u>	<u>\$ 11,943</u>

The Company pledged \$1.7 billion and \$2.1 billion at September 30, 2014 and December 31, 2013, respectively, of available-for-sale securities and \$3.3 billion and \$3.4 billion at September 30, 2014 and December 31, 2013, respectively, of held-to-maturity securities as collateral for repurchase agreements, derivatives and other purposes.

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**Investments with Unrealized or Unrecognized Losses**

The following tables show the fair value and unrealized or unrecognized losses on available-for-sale and held-to-maturity securities, aggregated by investment category, and the length of time that individual securities have been in a continuous unrealized or unrecognized loss position at September 30, 2014 and December 31, 2013 (dollars in millions):

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized / Unrecognized Losses	Fair Value	Unrealized / Unrecognized Losses	Fair Value	Unrealized / Unrecognized Losses
<b>September 30, 2014:</b>						
Available-for-sale securities:						
Debt securities:						
Agency residential mortgage-backed securities and CMOs	\$ 1,304	\$ (6)	\$ 4,930	\$ (174)	\$ 6,234	\$ (180)
Agency debentures	—	—	282	(10)	282	(10)
Agency debt securities	—	—	94	(2)	94	(2)
Municipal bonds	—	—	17	(1)	17	(1)
Corporate bonds	—	—	5	(1)	5	(1)
Publicly traded equity securities	32	—	—	—	32	—
Total temporarily impaired available-for-sale securities	\$ 1,336	\$ (6)	\$ 5,328	\$ (188)	\$ 6,664	\$ (194)
Held-to-maturity securities:						
Agency residential mortgage-backed securities and CMOs	\$ 796	\$ (3)	\$ 2,572	\$ (70)	\$ 3,368	\$ (73)
Agency debt securities	124	(1)	764	(15)	888	(16)
Total temporarily impaired held-to-maturity securities	\$ 920	\$ (4)	\$ 3,336	\$ (85)	\$ 4,256	\$ (89)
<b>December 31, 2013:</b>						
Available-for-sale securities:						
Debt securities:						
Agency mortgage-backed securities and CMOs	\$ 6,422	\$ (268)	\$ 1,266	\$ (67)	\$ 7,688	\$ (335)
Non-agency CMOs	—	—	11	(5)	11	(5)
Agency debentures	466	(54)	—	—	466	(54)
Agency debt securities	384	(9)	—	—	384	(9)
Municipal bonds	27	(2)	—	—	27	(2)
Corporate bonds	—	—	5	(1)	5	(1)
Total temporarily impaired available-for-sale securities	\$ 7,299	\$ (333)	\$ 1,282	\$ (73)	\$ 8,581	\$ (406)
Held-to-maturity securities:						
Agency residential mortgage-backed securities and CMOs	\$ 3,607	\$ (121)	\$ 891	\$ (44)	\$ 4,498	\$ (165)
Agency debt securities	1,153	(40)	—	—	1,153	(40)
Total temporarily impaired held-to-maturity securities	\$ 4,760	\$ (161)	\$ 891	\$ (44)	\$ 5,651	\$ (205)

The Company does not believe that any individual unrealized loss in the available-for-sale or unrecognized loss in the held-to-maturity portfolio as of September 30, 2014 represents a credit loss. The credit loss component is the difference between the security's amortized cost basis and the present value of its expected future cash flows, and is recognized in earnings. The noncredit loss component is the difference between the present value of its expected future cash flows and the fair value and is recognized through other comprehensive income (loss). The Company assessed whether it intends to sell, or

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whether it is more likely than not that the Company will be required to sell a security before recovery of its amortized cost basis. For debt securities that are considered other-than-temporarily impaired and that the Company does not intend to sell as of the balance sheet date and will not be required to sell prior to recovery of its amortized cost basis, the Company determines the amount of the impairment that is related to credit and the amount due to all other factors.

The majority of the unrealized or unrecognized losses on mortgage-backed securities are attributable to changes in interest rates and a re-pricing of risk in the market. Agency mortgage-backed securities and CMOs, agency debentures and agency debt securities are guaranteed by U.S. government sponsored enterprises and federal agencies. Municipal bonds and corporate bonds are evaluated by reviewing the credit-worthiness of the issuer and general market conditions. The Company does not intend to sell the debt securities in an unrealized or unrecognized loss position as of the balance sheet date and it is not more likely than not that the Company will be required to sell the debt securities before the anticipated recovery of its remaining amortized cost of the debt securities in an unrealized or unrecognized loss position at September 30, 2014.

The following table presents a roll forward for the three and nine months ended September 30, 2014 and 2013 of the credit loss component on debt securities held by the Company that had a noncredit loss recognized in other comprehensive income (loss) and had a credit loss recognized in earnings (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Credit loss balance, beginning of period	\$ 152	\$ 165	\$ 166	\$ 187
Additions:				
Subsequent credit impairment	—	1	—	3
Debt securities sold	—	—	(14)	(24)
Credit loss balance, end of period <sup>(1)</sup>	\$ 152	\$ 166	\$ 152	\$ 166

(1) The credit loss balance at September 30, 2014 and 2013 included \$123 million and \$121 million, respectively, of credit losses associated with debt securities that have been factored to zero, but the Company still holds legal title to these securities until maturity or until they are sold.

**Gains on Loans and Securities, Net**

The detailed components of the gains on loans and securities, net line item on the consolidated statement of income for the three and nine months ended September 30, 2014 and 2013 are as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Gains (losses) on loans, net	\$ (3)	\$ (1)	\$ 4	\$ (1)
Gains on securities, net:				
Gains on available-for-sale securities	12	16	34	58
Losses on available-for-sale securities	—	—	—	(8)
Hedge ineffectiveness	(1)	(3)	(8)	—
Gains on securities, net	11	13	26	50
Gains on loans and securities, net	\$ 8	\$ 12	\$ 30	\$ 49

During the nine months ended September 30, 2014, the Company recognized a pre-tax gain of \$7 million on the sale of \$0.8 billion of one- to four-family loans modified as TDRs. The Company also sold \$17 million in amortized cost of its available-for-sale non-agency CMOs for proceeds of approximately \$23 million, which resulted in a pre-tax gain of \$6 million. Similarly, during the nine months ended September 30, 2013, the Company sold \$231 million in amortized cost of its available-for-sale non-agency CMOs for proceeds of approximately \$227 million, which resulted in a pre-tax net loss of \$4 million.

**NOTE 7—LOANS RECEIVABLE, NET**

Loans receivable, net at September 30, 2014 and December 31, 2013 are summarized as follows (dollars in millions):

	September 30, 2014	December 31, 2013
One- to four-family	\$ 3,196	\$ 4,475
Home equity	2,991	3,454
Consumer and other	488	602
Total loans receivable	6,675	8,531
Unamortized premiums, net	28	45
Allowance for loan losses	(401)	(453)
Total loans receivable, net	\$ 6,302	\$ 8,123

During the nine months ended September 30, 2014, the Company sold \$0.8 billion of one- to four-family loans modified as TDRs.

At September 30, 2014, the Company pledged \$5.6 billion and \$0.3 billion of loans as collateral to the FHLB and Federal Reserve Bank, respectively. At December 31, 2013, the Company pledged \$6.8 billion and \$0.6 billion of loans as collateral to the FHLB and Federal Reserve Bank, respectively. Additionally, the Company's entire loans receivable portfolio was serviced by other companies at September 30, 2014 and December 31, 2013.

The following table represents the breakdown of the total recorded investment in loans receivable and allowance for loan losses by loans that have been collectively evaluated for impairment and those that have been individually evaluated for impairment at September 30, 2014 and December 31, 2013 (dollars in millions):

	Recorded Investment		Allowance for Loan Losses	
	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013
Loans collectively evaluated for impairment	\$ 6,165	\$ 7,163	\$ 333	\$ 329
Loans individually evaluated for impairment (TDRs)	538	1,413	68	124
Total	\$ 6,703	\$ 8,576	\$ 401	\$ 453

***Credit Quality and Concentrations of Credit Risk***

The Company tracks and reviews factors to predict and monitor credit risk in its mortgage loan portfolio on an ongoing basis. These factors include: loan type, estimated current LTV/CLTV ratios, delinquency history, documentation type, borrowers' current credit scores, housing prices, loan vintage and geographic location of the property. In economic conditions in which housing prices generally appreciate, the Company believes that loan type, LTV/CLTV ratios, documentation type and credit scores are the key factors in determining future loan performance. In a housing market with declining home prices and less credit available for refinance, the Company believes the LTV/CLTV ratio becomes a more important factor in predicting and monitoring credit risk. The factors are updated on at least a quarterly basis. The Company tracks and reviews delinquency status to predict and monitor credit risk in the consumer and other loan portfolio on at least a quarterly basis.

***Credit Quality***

The following tables show the distribution of the Company's mortgage loan portfolios by credit quality indicator at September 30, 2014 and December 31, 2013 (dollars in millions):

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<b>Current LTV/CLTV (1)</b>	<b>One- to Four-Family</b>		<b>Home Equity</b>	
	<b>September 30, 2014</b>	<b>December 31, 2013</b>	<b>September 30, 2014</b>	<b>December 31, 2013</b>
<=80%	\$ 1,826	\$ 1,912	\$ 1,132	\$ 1,142
80%-100%	841	1,365	813	866
100%-120%	333	711	584	736
>120%	196	487	462	710
<b>Total mortgage loans receivable</b>	<b>\$ 3,196</b>	<b>\$ 4,475</b>	<b>\$ 2,991</b>	<b>\$ 3,454</b>
Average estimated current LTV/CLTV (2)	79%	90%	92%	98%
Average LTV/CLTV at loan origination (3)	71%	72%	80%	80%

- (1) Current CLTV calculations for home equity loans are based on the maximum available line for home equity lines of credit and outstanding principal balance for home equity installment loans. For home equity loans in the second lien position, the original balance of the first lien loan at origination date and updated valuations on the property underlying the loan are used to calculate CLTV. Current property values are updated on a quarterly basis using the most recent property value data available to the Company. For properties in which the Company did not have an updated valuation, home price indices were utilized to estimate the current property value.
- (2) The average estimated current LTV/CLTV ratio reflects the outstanding balance at the balance sheet date and the maximum available line for home equity lines of credit, divided by the estimated current value of the underlying property.
- (3) Average LTV/CLTV at loan origination calculations are based on LTV/CLTV at time of purchase for one- to four-family purchased loans and undrawn balances for home equity loans.

<b>Documentation Type</b>	<b>One- to Four-Family</b>		<b>Home Equity</b>	
	<b>September 30, 2014</b>	<b>December 31, 2013</b>	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Full documentation	\$ 1,404	\$ 1,847	\$ 1,531	\$ 1,769
Low/no documentation	1,792	2,628	1,460	1,685
<b>Total mortgage loans receivable</b>	<b>\$ 3,196</b>	<b>\$ 4,475</b>	<b>\$ 2,991</b>	<b>\$ 3,454</b>

<b>Current FICO (1)</b>	<b>One- to Four-Family</b>		<b>Home Equity</b>	
	<b>September 30, 2014</b>	<b>December 31, 2013</b>	<b>September 30, 2014</b>	<b>December 31, 2013</b>
>=720	\$ 1,827	\$ 2,252	\$ 1,578	\$ 1,811
719 - 700	318	436	304	343
699 - 680	253	366	255	293
679 - 660	196	296	204	245
659 - 620	253	404	273	310
<620	349	721	377	452
<b>Total mortgage loans receivable</b>	<b>\$ 3,196</b>	<b>\$ 4,475</b>	<b>\$ 2,991</b>	<b>\$ 3,454</b>

- (1) FICO scores are updated on a quarterly basis; however, at September 30, 2014 and December 31, 2013, there were some loans for which the updated FICO scores were not available. The current FICO distribution at September 30, 2014 included the most recent FICO scores where available, otherwise the original FICO score was used, for approximately \$74 million and \$4 million of one- to four-family and home equity loans, respectively. The current FICO distribution at December 31, 2013 included original FICO scores for approximately \$95 million and \$10 million of one- to four-family and home equity loans, respectively.

*Concentrations of Credit Risk*

One- to four-family loans include interest-only loans for a five to ten year period, followed by an amortizing period ranging from 20 to 25 years. At September 30, 2014, 42% of the Company's one- to four-family portfolio were not yet amortizing. However, during the trailing twelve months ended September 30, 2014, based on the unpaid principal balance before charge-offs, approximately 15% of these borrowers made voluntary annual principal payments of at least \$2,500 and slightly over a third of those borrowers made voluntary annual principal payments of at least \$10,000.

The home equity loan portfolio is primarily second lien loans on residential real estate properties, which have a higher level of credit risk than first lien mortgage loans. Approximately 15% of the home equity portfolio was in the first lien position and the Company holds both the first and second lien positions in less than 1% of the home equity loan portfolio at September 30, 2014. The home equity loan portfolio consists of approximately 20% of home equity installment loans and approximately 80% of home equity lines of credit at September 30, 2014.

Home equity installment loans are primarily fixed rate and fixed term, fully amortizing loans that do not offer the option of an interest-only payment. The majority of home equity lines of credit convert to amortizing loans at the end of the

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draw period, which typically ranges from five to ten years. Approximately 8% of this portfolio will require the borrowers to repay the loan in full at the end of the draw period. At September 30, 2014, 86% of the home equity line of credit portfolio had not converted from the interest-only draw period and had not begun amortizing. However, during the trailing twelve months ended September 30, 2014, approximately 40% of the Company's borrowers made voluntary annual principal payments of at least \$500 on their home equity lines of credit and slightly under half of those borrowers reduced their principal balance by at least \$2,500.

The following table outlines when one- to four-family and home equity lines of credit convert to amortizing by percentage of the one- to four-family portfolio and home equity line of credit portfolios, respectively, at September 30, 2014:

<b>Period of Conversion to Amortizing Loan</b>	<b>% of One- to Four-Family Portfolio</b>	<b>% of Home Equity Line of Credit Portfolio</b>
Already amortizing	58%	14%
Through December 31, 2014	0%	3%
Year ending December 31, 2015	4%	27%
Year ending December 31, 2016	16%	43%
Year ending December 31, 2017	22%	13%

Approximately 38% and 40% of the Company's mortgage loans receivable were concentrated in California at September 30, 2014 and December 31, 2013, respectively. No other state had concentrations of mortgage loans that represented 10% or more of the Company's mortgage loans receivable at September 30, 2014 and December 31, 2013.

**Delinquent Loans**

The following table shows total loans receivable by delinquency category at September 30, 2014 and December 31, 2013 (dollars in millions):

	<b>Current</b>	<b>30-89 Days Delinquent</b>	<b>90-179 Days Delinquent</b>	<b>180+ Days Delinquent</b>	<b>Total</b>
<b>September 30, 2014</b>					
One- to four-family	\$ 2,943	\$ 95	\$ 22	\$ 136	\$ 3,196
Home equity	2,863	56	27	45	2,991
Consumer and other	478	8	2	—	488
Total loans receivable	<u>\$ 6,284</u>	<u>\$ 159</u>	<u>\$ 51</u>	<u>\$ 181</u>	<u>\$ 6,675</u>
<b>December 31, 2013</b>					
One- to four-family	\$ 3,988	\$ 190	\$ 70	\$ 227	\$ 4,475
Home equity	3,309	69	36	40	3,454
Consumer and other	587	12	3	—	602
Total loans receivable	<u>\$ 7,884</u>	<u>\$ 271</u>	<u>\$ 109</u>	<u>\$ 267</u>	<u>\$ 8,531</u>

**Nonperforming Loans**

The Company classifies loans as nonperforming when they are no longer accruing interest. Nonaccrual loans include loans that are 90 days and greater past due, TDRs that are on nonaccrual status for all classes of loans and certain junior liens that have a delinquent senior lien. The following table shows the comparative data for nonaccrual loans (dollars in millions):

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
One- to four-family	301	526
Home equity	172	164
Consumer and other	2	3
Total nonperforming loans receivable	<u>475</u>	<u>693</u>

Nonperforming loans decreased \$218 million to \$475 million at September 30, 2014 when compared to December 31, 2013. The decrease in the one- to four-family nonperforming loans receivable during the nine months ended September 30, 2014 was primarily due to the sale of one- to four-family loans modified as TDRs, which included \$377 million of nonperforming loans. The decrease in nonperforming loans receivable was partially offset by the increase in nonperforming TDRs that had been charged-off due to bankruptcy notification. In February 2014, the OCC issued clarifying guidance related

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to consumer debt discharged in Chapter 7 bankruptcy proceedings. As a result of the clarifying guidance, beginning the first quarter of 2014 these bankruptcy loans remain on nonaccrual status regardless of payment history. This change did not have a material impact on the statement of financial condition, results of operations or cash flows. Prior to this change, the Company had \$238 million of bankruptcy loans as performing loans at December 31, 2013.

**Real Estate Owned and Loans with Formal Foreclosure Proceedings in Process**

At September 30, 2014 and December 31, 2013, the Company held \$36 million and \$50 million, respectively, of real estate owned that were acquired through foreclosure and through a deed in lieu of foreclosure or similar legal agreement. The Company also held \$113 million and \$199 million of loans for which formal foreclosure proceedings were in process at September 30, 2014 and December 31, 2013, respectively.

**Allowance for Loan Losses**

The following table provides a roll forward by loan portfolio of the allowance for loan losses for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Three Months Ended September 30, 2014			
	One- to Four-Family	Home Equity	Consumer and Other	Total
Allowance for loan losses, beginning of period	\$ 44	\$ 337	\$ 20	\$ 401
Provision for loan losses	(16)	29	(3)	10
Charge-offs	(1)	(13)	(4)	(18)
Recoveries	—	7	1	8
Charge-offs, net	(1)	(6)	(3)	(10)
Allowance for loan losses, end of period	\$ 27	\$ 360	\$ 14	\$ 401
	Three Months Ended September 30, 2013			
	One- to Four-Family	Home Equity	Consumer and Other	Total
Allowance for loan losses, beginning of period	\$ 144	\$ 279	\$ 28	\$ 451
Provision for loan losses	(24)	60	1	37
Charge-offs	(7)	(29)	(5)	(41)
Recoveries	—	9	3	12
Charge-offs, net	(7)	(20)	(2)	(29)
Allowance for loan losses, end of period	\$ 113	\$ 319	\$ 27	\$ 459
	Nine Months Ended September 30, 2014			
	One- to Four-Family	Home Equity	Consumer and Other	Total
Allowance for loan losses, beginning of period	\$ 102	\$ 326	\$ 25	\$ 453
Provision for loan losses	(42)	70	(2)	26
Charge-offs	(44)	(54)	(13)	(111)
Recoveries	11	18	4	33
Charge-offs, net	(33)	(36)	(9)	(78)
Allowance for loan losses, end of period	\$ 27	\$ 360	\$ 14	\$ 401

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Nine Months Ended September 30, 2013

	One- to Four-Family	Home Equity	Consumer and Other	Total
Allowance for loan losses, beginning of period	\$ 184	\$ 257	\$ 40	\$ 481
Provision for loan losses	(48)	168	6	126
Charge-offs	(37)	(132)	(29)	(198)
Recoveries	14	26	10	50
Charge-offs, net	(23)	(106)	(19)	(148)
Allowance for loan losses, end of period	\$ 113	\$ 319	\$ 27	\$ 459

The general allowance for loan losses also included a qualitative component to account for a variety of factors that present additional uncertainty that may not be fully considered in the quantitative loss model but are factors the Company believes may impact the level of credit losses. The total qualitative component was \$35 million and \$62 million at September 30, 2014 and December 31, 2013, respectively.

Total allowance for loan losses decreased during the nine months ended September 30, 2014 primarily due to the sale of one- to four-family loans modified as TDRs. As a result of this sale, the Company recorded a charge-off related to one- to four-family loans of \$42 million which drove the majority of the decrease in the allowance for loan losses.

During the nine months ended September 30, 2014 and 2013, the Company agreed to settlements with third party mortgage originators specific to loans sold to the Company by those originators. One-time payments were agreed upon to satisfy in full all pending and future repurchase requests with those specific originators. The Company applied the full amount of payments of \$11 million and \$13 million for the nine months ended September 30, 2014 and 2013, respectively, as recoveries to the allowance for loan losses, resulting in a corresponding reduction to net charge-offs as well as provision for loan losses.

**Impaired Loans—Troubled Debt Restructurings**

TDRs include two categories of loans: (1) loan modifications completed under the Company's programs that involve granting an economic concession to a borrower experiencing financial difficulty, and (2) loans that have been charged off based on the estimated current value of the underlying property less estimated selling costs due to bankruptcy notification. Upon being classified as a TDR, such loan is categorized as an impaired loan and is considered impaired until maturity regardless of whether the borrower performs under the terms of the loan. Impairment on TDRs is measured on an individual basis.

The unpaid principal balance in one- to four-family TDRs was \$0.3 billion and \$1.2 billion at September 30, 2014 and December 31, 2013, respectively. For home equity loans, the recorded investment in TDRs represents the unpaid principal balance.

The following table shows a summary of the Company's recorded investment in TDRs that were on accrual and nonaccrual status, in addition to the recorded investment of TDRs at September 30, 2014 and December 31, 2013 (dollars in millions):

	Accrual TDRs(1)	Nonaccrual TDRs			Recorded Investment in TDRs
		Current(2)	30-89 Days Delinquent	90+ Days Delinquent	
<b>September 30, 2014</b>					
One- to four-family	\$ 121	\$ 115	\$ 28	\$ 53	\$ 317
Home equity	128	55	12	26	221
Total	\$ 249	\$ 170	\$ 40	\$ 79	\$ 538
<b>December 31, 2013</b>					
One- to four-family	\$ 774	\$ 127	\$ 102	\$ 169	\$ 1,172
Home equity	176	22	17	26	241
Total	\$ 950	\$ 149	\$ 119	\$ 195	\$ 1,413

(1) Represents loans modified as TDRs that are current and have made six or more consecutive payments.

(2) Represents loans modified as TDRs that are current but have not yet made six consecutive payments, bankruptcy loans and certain junior lien TDRs that have a delinquent senior lien.

The decrease in the one- to four-family TDRs was primarily due to the sale of \$0.8 billion of one- to four-family loans modified as TDRs during the nine months ended September 30, 2014.

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The following table shows the average recorded investment and interest income recognized both on a cash and accrual basis for the Company's TDRs during the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Average Recorded Investment		Interest Income Recognized	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2014	2013	2014	2013
One- to four-family	\$ 319	\$ 1,204	\$ 2	\$ 8
Home equity	223	256	5	5
Total	\$ 542	\$ 1,460	\$ 7	\$ 13

	Average Recorded Investment		Interest Income Recognized	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
One- to four-family	\$ 653	\$ 1,212	\$ 13	\$ 25
Home equity	230	267	14	15
Total	\$ 883	\$ 1,479	\$ 27	\$ 40

Included in the allowance for loan losses was a specific valuation allowance of \$68 million and \$124 million that was established for TDRs at September 30, 2014 and December 31, 2013, respectively. The specific allowance for these individually impaired loans represents the forecasted losses over the estimated remaining life of the loan, including the economic concession to the borrower. The following table shows detailed information related to the Company's TDRs at September 30, 2014 and December 31, 2013 (dollars in millions):

	September 30, 2014			December 31, 2013		
	Recorded Investment in TDRs	Specific Valuation Allowance	Net Investment in TDRs	Recorded Investment in TDRs	Specific Valuation Allowance	Net Investment in TDRs
With a recorded allowance:						
One- to four-family	\$ 89	\$ 9	\$ 80	\$ 403	\$ 60	\$ 343
Home equity	\$ 120	\$ 59	\$ 61	\$ 140	\$ 64	\$ 76
Without a recorded allowance: <sup>(1)</sup>						
One- to four-family	\$ 228	\$ —	\$ 228	\$ 769	\$ —	\$ 769
Home equity	\$ 101	\$ —	\$ 101	\$ 101	\$ —	\$ 101
Total:						
One- to four-family	\$ 317	\$ 9	\$ 308	\$ 1,172	\$ 60	\$ 1,112
Home equity	\$ 221	\$ 59	\$ 162	\$ 241	\$ 64	\$ 177

(1) Represents loans where the discounted cash flow analysis or collateral value is equal to or exceeds the recorded investment in the loan.

**Troubled Debt Restructurings — Loan Modifications**

The Company has loan modification programs that focus on the mitigation of potential losses in the one- to four-family and home equity mortgage loan portfolio. The Company currently does not have an active loan modification program for consumer and other loans. The various types of economic concessions that may be granted typically consist of interest rate reductions, maturity date extensions, principal forgiveness or a combination of these concessions. Trial modifications are classified immediately as TDRs and continue to be reported as delinquent until the successful completion of the trial period, which is typically 90 days. The loan then becomes a permanent modification reported as current but remains on nonaccrual status until six consecutive payments have been made.

The vast majority of the Company's loans modified as TDRs include an interest rate reduction in combination with another type of concession. The Company prioritizes the interest rate reduction modifications in combination with the following modification categories: principal forgiven, principal deferred and re-age/extension/capitalization of accrued interest. Each class is mutually exclusive in that if a modification had an interest rate reduction with principal forgiven and an extension, the modification would only be presented in the principal forgiven column in the table below. The following tables provide the number of loans, post-modification balances immediately after being modified by major class, and the financial impact of modifications during the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

Three Months Ended September 30, 2014

	Number of Loans	Interest Rate Reduction					Total
		Principal Forgiven	Principal Deferred	Re-age/ Extension/ Interest Capitalization	Other with Interest Rate Reduction	Other	
One- to four-family	15	\$ —	\$ —	\$ 4	\$ —	\$ 1	\$ 5
Home equity	39	—	—	—	—	2	2
Total	54	\$ —	\$ —	\$ 4	\$ —	\$ 3	\$ 7

Three Months Ended September 30, 2013

	Number of Loans	Interest Rate Reduction					Total
		Principal Forgiven	Principal Deferred	Re-age/ Extension/ Interest Capitalization	Other with Interest Rate Reduction	Other	
One- to four-family	94	\$ 4	\$ 1	\$ 20	\$ 2	\$ 6	\$ 33
Home equity	48	—	—	2	1	1	4
Total	142	\$ 4	\$ 1	\$ 22	\$ 3	\$ 7	\$ 37

Nine Months Ended September 30, 2014

	Number of Loans	Interest Rate Reduction					Total
		Principal Forgiven	Principal Deferred	Re-age/ Extension/ Interest Capitalization	Other with Interest Rate Reduction	Other	
One- to four-family	52	\$ 1	\$ —	\$ 9	\$ 2	\$ 5	\$ 17
Home equity	153	—	—	3	2	6	11
Total	205	\$ 1	\$ —	\$ 12	\$ 4	\$ 11	\$ 28

Nine Months Ended September 30, 2013

	Number of Loans	Interest Rate Reduction					Total
		Principal Forgiven	Principal Deferred	Re-age/ Extension/ Interest Capitalization	Other with Interest Rate Reduction	Other	
One- to four-family	269	\$ 16	\$ 5	\$ 62	\$ 4	\$ 14	\$ 101
Home equity	200	—	—	5	7	5	17
Total	469	\$ 16	\$ 5	\$ 67	\$ 11	\$ 19	\$ 118

Three Months Ended September 30,

	2014			2013		
	Financial Impact			Financial Impact		
	Principal Forgiven	Pre-Modification Weighted Average Interest Rate	Post-Modification Weighted Average Interest Rate	Principal Forgiven	Pre-Modification Weighted Average Interest Rate	Post-Modification Weighted Average Interest Rate
One- to four-family	\$ —	5.8%	2.3%	\$ 2	5.1%	2.3%
Home equity	—	5.7%	2.5%	—	5.0%	2.4%
Total	\$ —			\$ 2		

Nine Months Ended September 30,

	2014			2013		
	Financial Impact			Financial Impact		
	Principal Forgiven	Pre-Modification Weighted Average Interest Rate	Post-Modification Weighted Average Interest Rate	Principal Forgiven	Pre-Modification Weighted Average Interest Rate	Post-Modification Weighted Average Interest Rate
One- to four-family	\$ —	5.2%	2.6%	\$ 6	5.2%	2.3%
Home equity	—	5.4%	2.4%	—	4.5%	1.9%
Total	\$ —			\$ 6		

The Company considers modifications that become 30 days past due to have experienced a payment default. The following table shows the recorded investment in modifications that experienced a payment default within 12 months after the modification for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

Three Months Ended September 30,

	2014		2013	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
	One- to four-family <sup>(1)</sup>	1	\$ —	38
Home equity <sup>(2)</sup>	19	1	20	1
Total	20	\$ 1	58	\$ 15

Nine Months Ended September 30,

	2014		2013	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
	One- to four-family <sup>(1)</sup>	22	\$ 8	111
Home equity <sup>(2)</sup>	40	2	56	2
Total	62	\$ 10	167	\$ 45

(1) For the three and nine months ended September 30, 2014, no recorded investment and \$1 million of the recorded investment in one- to four-family loans that had a payment default in the trailing 12 months was classified as current, compared to \$4 million and \$12 million for the three and nine months ended September 30, 2013, respectively.

(2) For the three and nine months ended September 30, 2014, less than \$1 million and \$1 million of the recorded investment in home equity loans that had a payment default in the trailing 12 months was classified as current, compared to less than \$1 million and \$1 million for both the three and nine months ended September 30, 2013, respectively.

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The delinquency status is the primary measure the Company uses to evaluate the performance of loans modified as TDRs. The following table shows the loans modified as TDRs by delinquency category at September 30, 2014 and December 31, 2013 (dollars in millions):

	Modifications Current	Modifications 30-89 Days Delinquent	Modifications 90-179 Days Delinquent	Modifications 180+ Days Delinquent	Recorded Investment in Modifications
<b>September 30, 2014</b>					
One- to four-family	\$ 155	\$ 17	\$ 1	\$ 11	\$ 184
Home equity	149	9	5	10	173
Total	\$ 304	\$ 26	\$ 6	\$ 21	\$ 357
<b>December 31, 2013</b>					
One- to four-family	\$ 817	\$ 92	\$ 39	\$ 88	\$ 1,036
Home equity	162	13	4	9	188
Total	\$ 979	\$ 105	\$ 43	\$ 97	\$ 1,224

The decrease in the one- to four-family TDRs was primarily due to the sale of \$0.8 billion of our one- to four-family loans modified as TDRs during the nine months ended September 30, 2014.

**NOTE 8—ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company enters into derivative transactions primarily to protect against interest rate risk on the value of certain assets, liabilities and future cash flows. Cash flow hedges, which include a combination of interest rate swaps and purchased options, including caps and floors, are used primarily to reduce the variability of future cash flows associated with existing variable-rate assets and liabilities and forecasted issuances of liabilities. Fair value hedges, which include interest rate swaps, are used to offset exposure to changes in value of certain fixed-rate assets and liabilities. Each derivative is recorded on the consolidated balance sheet at fair value as a freestanding asset or liability. The following table summarizes the fair value amounts of derivatives designated as hedging instruments reported in the consolidated balance sheet at September 30, 2014 and December 31, 2013 (dollars in millions):

	Notional	Fair Value		Net(3)
		Asset(1)	Liability(2)	
<b>September 30, 2014</b>				
Interest rate contracts:				
Cash flow hedges:				
Pay-fixed rate swaps	\$ 1,075	\$ 9	\$ (32)	\$ (23)
Purchased options	1,325	26	—	26
Total cash flow hedges	2,400	35	(32)	3
Fair value hedges:				
Pay-fixed rate swaps	1,453	24	(16)	8
Total derivatives designated as hedging instruments(4)	\$ 3,853	\$ 59	\$ (48)	\$ 11
<b>December 31, 2013</b>				
Interest rate contracts:				
Cash flow hedges:				
Pay-fixed rate swaps	\$ 2,480	\$ 19	\$ (168)	\$ (149)
Purchased options	825	8	—	8
Total cash flow hedges	3,305	27	(168)	(141)
Fair value hedges:				
Pay-fixed rate swaps	1,614	80	(1)	79
Total derivatives designated as hedging instruments(4)	\$ 4,919	\$ 107	\$ (169)	\$ (62)

- (1) Reflected in the other assets line item on the consolidated balance sheet.
- (2) Reflected in the other liabilities line item on the consolidated balance sheet.
- (3) Represents derivative assets net of derivative liabilities for disclosure purposes only.
- (4) All derivatives were designated as hedging instruments at September 30, 2014 and December 31, 2013.

**Cash Flow Hedges**

The effective portion of changes in fair value of the derivative instruments that hedge cash flows is reported as a component of accumulated other comprehensive loss, net of tax in the consolidated balance sheet, for both active and discontinued hedges. Amounts are included in net operating interest income as a yield adjustment in the same period the hedged forecasted transaction affects earnings. The ineffective portion of changes in fair value of the derivative instrument, which is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of a hypothetical derivative which is created to match the exact terms of the underlying instruments being hedged, is reported in the gains on loans and securities, net line item in the consolidated statement of income.

If it becomes probable that a hedged forecasted transaction will not occur, amounts included in accumulated other comprehensive loss related to the specific hedging instruments would be immediately reclassified into the gains on loans and securities, net line item in the consolidated statement of income. If hedge accounting is discontinued because a derivative instrument is sold, terminated or otherwise de-designated, amounts included in accumulated other comprehensive loss related to the specific hedging instrument continue to be reported in accumulated other comprehensive loss until the forecasted transaction affects earnings.

The future issuances of liabilities, including repurchase agreements, are largely dependent on the market demand and liquidity in the wholesale borrowings market. At September 30, 2014, the Company believes the forecasted issuance of all debt in cash flow hedge relationships is probable. However, unexpected changes in market conditions in future periods could impact the ability to issue this debt. The Company believes the forecasted issuance of debt in the form of repurchase agreements is most susceptible to an unexpected change in market conditions.

The following table summarizes the effect of interest rate contracts designated and qualifying as hedging instruments in cash flow hedges on accumulated other comprehensive loss and on the consolidated statement of income for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Gains (losses) on derivatives recognized in OCI (effective portion), net of tax	\$ 5	\$ (11)	\$ (27)	\$ 57
Losses reclassified from AOCI into earnings (effective portion), net of tax	\$ (18)	\$ (21)	\$ (59)	\$ (64)
Cash flow hedge ineffectiveness gains (losses) <sup>(1)</sup>	\$ (1)	\$ —	\$ (1)	\$ 1

(1) The cash flow hedge ineffectiveness is reflected in the gains on loans and securities, net line item on the consolidated statement of income.

During the upcoming twelve months, the Company expects to include a pre-tax amount of approximately \$105 million of net unrealized losses that are currently reflected in accumulated other comprehensive loss in net operating interest income as a yield adjustment in the same periods in which the related hedged items affect earnings. The maximum length of time over which transactions are hedged is 8 years.

The following table shows the balance in accumulated other comprehensive loss attributable to active and discontinued cash flow hedges at September 30, 2014 and December 31, 2013 (dollars in millions):

	September 30, 2014	December 31, 2013
Accumulated other comprehensive loss balance (net of tax) related to:		
Discontinued cash flow hedges	\$ (233)	\$ (201)
Active cash flow hedges	(33)	(97)
Total cash flow hedges	\$ (266)	\$ (298)

The following table shows the balance in accumulated other comprehensive loss attributable to cash flow hedges by type of hedged item at September 30, 2014 and December 31, 2013 (dollars in millions):

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	September 30, 2014	December 31, 2013
Repurchase agreements	\$ (344)	\$ (379)
FHLB advances	(85)	(99)
Total balance of cash flow hedges, before tax	(429)	(478)
Tax benefit	163	180
Total balance of cash flow hedges, net of tax	<u>\$ (266)</u>	<u>\$ (298)</u>

**Fair Value Hedges**

Fair value hedges are accounted for by recording the fair value of the derivative instrument and the fair value of the asset or liability being hedged on the consolidated balance sheet. Changes in the fair value of both the derivatives and the underlying assets or liabilities are recognized in the gains on loans and securities, net line item in the consolidated statement of income. To the extent that the hedge is ineffective, the changes in the fair values will not offset and the difference, or hedge ineffectiveness, is reflected in the gains on loans and securities, net line item in the consolidated statement of income.

Hedge accounting is discontinued for fair value hedges if a derivative instrument is sold, terminated or otherwise de-designated. If fair value hedge accounting is discontinued, the previously hedged item is no longer adjusted for changes in fair value through the consolidated statement of income and the cumulative net gain or loss on the hedged asset or liability at the time of de-designation is amortized to interest income or interest expense using the effective interest method over the expected remaining life of the hedged item. Changes in the fair value of the derivative instruments after de-designation of fair value hedge accounting are recorded in the gains on loans and securities, net line item in the consolidated statement of income.

The following table summarizes the effect of interest rate contracts designated and qualifying as hedging instruments in fair value hedges and related hedged items on the consolidated statement of income for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Three Months Ended September 30,					
	2014			2013		
	Hedging Instrument	Hedged Item	Hedge Ineffectiveness <sup>(1)</sup>	Hedging Instrument	Hedged Item	Hedge Ineffectiveness <sup>(1)</sup>
Agency debentures	\$ (2)	\$ 2	\$ —	\$ 3	\$ (5)	\$ (2)
Agency mortgage-backed securities	—	—	—	(7)	6	(1)
Total gains (losses) included in earnings	<u>\$ (2)</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ (4)</u>	<u>\$ 1</u>	<u>\$ (3)</u>

	Nine Months Ended September 30,					
	2014			2013		
	Hedging Instrument	Hedged Item	Hedge Ineffectiveness <sup>(1)</sup>	Hedging Instrument	Hedged Item	Hedge Ineffectiveness <sup>(1)</sup>
Agency debentures	\$ (59)	\$ 52	\$ (7)	\$ 48	\$ (48)	\$ —
Agency mortgage-backed securities	(17)	17	—	21	(22)	(1)
Total gains (losses) included in earnings	<u>\$ (76)</u>	<u>\$ 69</u>	<u>\$ (7)</u>	<u>\$ 69</u>	<u>\$ (70)</u>	<u>\$ (1)</u>

(1) Reflected in the gains on loans and securities, net line item on the consolidated statement of income.

**NOTE 9—SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND FHLB ADVANCES AND OTHER BORROWINGS**

Securities sold under agreements to repurchase, FHLB advances and other borrowings at September 30, 2014 and December 31, 2013 are shown in the following table (dollars in millions):

	FHLB Advances and Other Borrowings			Total	Weighted Average Interest Rate
	Repurchase Agreements <sup>(1)</sup>	FHLB Advances	Other		
Due within one year	\$ 3,267	\$ 270	\$ —	\$ 3,537	0.34%
Due between one and two years	250	250	—	500	0.43%
Due between two and three years	400	400	—	800	0.78%
Thereafter	—	—	428	428	2.92%
Subtotal	3,917	920	428	5,265	0.63%
Fair value hedge adjustments	—	23	—	23	
Deferred costs	—	(77)	—	(77)	
Total other borrowings at September 30, 2014	\$ 3,917	\$ 866	\$ 428	\$ 5,211	0.63%
Total other borrowings at December 31, 2013	\$ 4,543	\$ 851	\$ 428	\$ 5,822	0.72%

(1) The maximum amount at any month end for repurchase agreements was \$4.9 billion and \$4.6 billion for nine months ended September 30, 2014 and the year ended December 31, 2013, respectively.

**Securities Sold Under Agreements to Repurchase**

During the nine months ended September 30, 2014, the decrease in securities sold under agreements to repurchase was primarily due to the scheduled expiration of \$600 million. In addition, the Company paid down in advance of maturity \$100 million of its fixed-rate repurchase agreements for which losses on early extinguishment of debt of \$12 million were recorded in the consolidated statement of income.

**NOTE 10—ACCUMULATED OTHER COMPREHENSIVE LOSS**

The following tables present after-tax changes in each component of accumulated other comprehensive loss for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

	Available-for-sale Securities	Cash Flow Hedging Instruments	Foreign Currency Translation	Total
Beginning balance, June 30, 2014	\$ (11)	\$ (289)	\$ 5	\$ (295)
Other comprehensive income (loss) before reclassifications	(20)	5	—	(15)
Amounts reclassified from accumulated other comprehensive loss	(7)	18	—	11
Net change	(27)	23	—	(4)
Ending balance, September 30, 2014	\$ (38)	\$ (266)	\$ 5	\$ (299)

	Available-for-sale Securities	Cash Flow Hedging Instruments	Foreign Currency Translation	Total
Beginning balance, June 30, 2013	\$ (104)	\$ (341)	\$ 5	\$ (440)
Other comprehensive income (loss) before reclassifications	19	(11)	—	8
Amounts reclassified from accumulated other comprehensive loss	(10)	21	—	11
Net change	9	10	—	19
Ending balance, September 30, 2013	\$ (95)	\$ (331)	\$ 5	\$ (421)

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	Available-for-sale Securities	Cash Flow Hedging Instruments	Foreign Currency Translation	Total
Beginning balance, December 31, 2013	\$ (160)	\$ (298)	\$ 5	\$ (453)
Other comprehensive income (loss) before reclassifications	143	(27)	—	116
Amounts reclassified from accumulated other comprehensive loss	(21)	59	—	38
Net change	122	32	—	154
Ending balance, September 30, 2014	\$ (38)	\$ (266)	\$ 5	\$ (299)

	Available-for-sale Securities	Cash Flow Hedging Instruments	Foreign Currency Translation	Total
Beginning balance, December 31, 2012	\$ 137	\$ (452)	\$ 5	\$ (310)
Other comprehensive income (loss) before reclassifications	(201)	57	—	(144)
Amounts reclassified from accumulated other comprehensive loss	(31)	64	—	33
Net change	(232)	121	—	(111)
Ending balance, September 30, 2013	\$ (95)	\$ (331)	\$ 5	\$ (421)

The following table presents the income statement line items impacted by reclassifications out of accumulated other comprehensive loss for the three and nine months ended September 30, 2014 and 2013 (dollars in millions):

Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss				Affected Line Items in the Consolidated Statement of Income
	Three Months Ended September 30,		Nine Months Ended September 30,		
	2014	2013	2014	2013	
Available-for-sale securities:					
	\$ 12	\$ 16	\$ 34	\$ 50	Gains on loans and securities, net
	(5)	(6)	(13)	(19)	Tax expense
	\$ 7	\$ 10	\$ 21	\$ 31	Reclassification into earnings, net
Cash flow hedging instruments:					
	\$ —	\$ 2	\$ —	\$ 7	Operating interest income
	(30)	(37)	(97)	(109)	Operating interest expense
	(30)	(35)	(97)	(102)	Reclassification into earnings, before tax
	12	14	38	38	Tax expense
	\$ (18)	\$ (21)	\$ (59)	\$ (64)	Reclassification into earnings, net

**NOTE 11—EARNINGS PER SHARE**

The following table presents a reconciliation of basic and diluted earnings per share (in millions, except share data and per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Basic:</b>				
Net income	\$ 86	\$ 47	\$ 252	\$ 28
Basic weighted-average shares outstanding (in thousands)	288,843	287,111	288,536	286,882
Basic earnings per share	\$ 0.30	\$ 0.17	\$ 0.87	\$ 0.10
<b>Diluted:</b>				
Net income	\$ 86	\$ 47	\$ 252	\$ 28
Basic weighted-average shares outstanding (in thousands)	288,843	287,111	288,536	286,882
Effect of dilutive securities:				
Weighted-average convertible debentures (in thousands)	4,066	4,125	4,071	4,125
Weighted-average options and restricted stock issued to employees (in thousands)	1,210	1,394	1,361	1,242
Diluted weighted-average shares outstanding (in thousands)	294,119	292,630	293,968	292,249
Diluted earnings per share	\$ 0.29	\$ 0.16	\$ 0.86	\$ 0.10

For the three months ended September 30, 2014 and 2013, the Company excluded 0.4 million and 1.2 million shares, respectively of stock options and restricted stock awards and units from the calculations of diluted earnings per share as the effect would have been anti-dilutive. For the nine months ended September 30, 2014 and 2013, the Company excluded 0.5 million and 1.8 million shares, respectively of stock options and restricted stock awards and units from the calculations of diluted earnings per share as the effect would have been anti-dilutive.

**NOTE 12—REGULATORY REQUIREMENTS*****Registered Broker-Dealers***

The Company's largest U.S. broker-dealer subsidiaries are subject to the Uniform Net Capital Rule (the "Rule") under the Securities Exchange Act of 1934 administered by the SEC and FINRA, which requires the maintenance of minimum net capital. The minimum net capital requirements can be met under either the Aggregate Indebtedness method or the Alternative method. Under the Aggregate Indebtedness method, a broker-dealer is required to maintain minimum net capital of the greater of 6<sup>2</sup>/<sub>3</sub>% of its aggregate indebtedness, as defined, or a minimum dollar amount. Under the Alternative method, a broker-dealer is required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions. The method used depends on the individual U.S. broker-dealer subsidiary. The Company's other broker-dealers, including its international broker-dealer subsidiaries located in Europe and Asia, are subject to capital requirements determined by their respective regulators.

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At September 30, 2014 and December 31, 2013, all of the Company's broker-dealer subsidiaries met minimum net capital requirements. The tables below summarize the minimum excess capital requirements for the Company's broker-dealer subsidiaries at September 30, 2014 and December 31, 2013 (dollars in millions):

	Required Net Capital	Net Capital	Excess Net Capital
<b>September 30, 2014:</b>			
E*TRADE Clearing LLC <sup>(1)</sup>	\$ 175	\$ 772	\$ 597
E*TRADE Securities LLC <sup>(1)</sup>	—	411	411
Other broker-dealers	1	18	17
Total	\$ 176	\$ 1,201	\$ 1,025
<b>December 31, 2013:</b>			
E*TRADE Clearing LLC <sup>(1)</sup>	\$ 144	\$ 715	\$ 571
E*TRADE Securities LLC <sup>(1)</sup>	—	261	261
G1 Execution Services, LLC <sup>(2)</sup>	1	22	21
Other broker-dealers	2	22	20
Total	\$ 147	\$ 1,020	\$ 873

(1) Elected to use the Alternative method to compute net capital. The net capital requirement was \$250,000 for E\*TRADE Securities LLC for both periods presented.

(2) Elected to use the Aggregate Indebtedness method to compute net capital. G1 Execution Services, LLC is the Company's market maker and was held-for-sale at December 31, 2013. The sale of G1 Execution Services, LLC was completed on February 10, 2014.

**Banking**

E\*TRADE Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on E\*TRADE Bank's financial condition and results of operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, E\*TRADE Bank must meet specific capital guidelines that involve quantitative measures of E\*TRADE Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. In addition, E\*TRADE Bank may not pay dividends to the parent company without approval from its regulators and any loans by E\*TRADE Bank to the parent company and its other non-bank subsidiaries are subject to various quantitative, arm's length, collateralization and other requirements. E\*TRADE Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require E\*TRADE Bank to meet minimum total capital, Tier 1 capital and Tier 1 leverage ratios. As shown in the table below, at both September 30, 2014 and December 31, 2013, E\*TRADE Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. However, events beyond management's control, such as deterioration in credit markets, could adversely affect future earnings and E\*TRADE Bank's ability to meet future capital requirements and ability to pay dividends to the parent company. E\*TRADE Bank's actual and required capital amounts and ratios at September 30, 2014 and December 31, 2013 are presented in the table below (dollars in millions):

	Actual		Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions		Excess Capital
	Amount	Ratio	Amount	Ratio	
<b>September 30, 2014:</b>					
Total capital	\$ 4,667	25.87%	\$ 1,804	10.00%	\$ 2,863
Tier 1 capital	\$ 4,439	24.61%	\$ 1,082	6.00%	\$ 3,357
Tier 1 leverage	\$ 4,439	10.40%	\$ 2,134	5.00%	\$ 2,305
<b>December 31, 2013:</b>					
Total capital	\$ 4,331	24.25%	\$ 1,786	10.00%	\$ 2,545
Tier 1 capital	\$ 4,105	22.98%	\$ 1,072	6.00%	\$ 3,033
Tier 1 leverage	\$ 4,105	9.51%	\$ 2,158	5.00%	\$ 1,947

**NOTE 13—COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS**

***Legal Matters***

***Litigation Matters***

On October 27, 2000, Ajaxo, Inc. ("Ajaxo") filed a complaint in the Superior Court for the State of California, County of Santa Clara. Ajaxo sought damages and certain non-monetary relief for the Company's alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology that Ajaxo offered the Company as well as damages and other relief against the Company for their alleged misappropriation of Ajaxo's trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for \$1 million for breach of the Ajaxo non-disclosure agreement. Although the jury found in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets, the trial court subsequently denied Ajaxo's requests for additional damages and relief. On December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury's previous finding in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets. Although the Company paid Ajaxo the full amount due on the above-described judgment, the case was remanded back to the trial court, and on May 30, 2008, a jury returned a verdict in favor of the Company denying all claims raised and demands for damages against the Company. Following the trial court's entry of judgment in favor of the Company on September 5, 2008, Ajaxo filed post-trial motions for vacating this entry of judgment and requesting a new trial. The trial court denied these motions. On December 2, 2008, Ajaxo filed a notice of appeal with the Court of Appeal of the State of California for the Sixth District. On August 30, 2010, the Court of Appeal affirmed the trial court's verdict in part and reversed the verdict in part, remanding the case. The Company petitioned the Supreme Court of California for review of the Court of Appeal decision. On December 16, 2010, the California Supreme Court denied the Company's petition for review and remanded for further proceedings to the trial court. The testimonial phase of the third trial in this matter concluded on June 12, 2012. By order dated May 28, 2014, the Court determined to conduct a second phase of this bench trial to allow Ajaxo to attempt to prove entitlement to additional royalties. Phase two of the trial is scheduled to commence December 8, 2014. The Company will continue to defend itself vigorously.

On May 16, 2011, Droplets Inc., the holder of two patents pertaining to user interface servers, filed a complaint in the U.S. District Court for the Eastern District of Texas against E\*TRADE Financial Corporation, E\*TRADE Securities LLC, E\*TRADE Bank and multiple other unaffiliated financial services firms. Plaintiff contends that the defendants engaged in patent infringement under federal law. Plaintiff seeks unspecified damages and an injunction against future infringements, plus royalties, costs, interest and attorneys' fees. On September 30, 2011, the Company and several co-defendants filed a motion to transfer the case to the Southern District of New York. Venue discovery occurred throughout December 2011. On January 1, 2012, a new judge was assigned to the case. On March 28, 2012, a change of venue was granted and the case was transferred to the United States District Court for the Southern District of New York. The Company filed its answer and counterclaim on June 13, 2012 and plaintiff moved to dismiss the counterclaim. The Company filed a motion for summary judgment. Plaintiffs sought to change venue back to the Eastern District of Texas on the theory that this case is one of several matters that should be consolidated in a single multi-district litigation. On December 12, 2012, the Multidistrict Litigation Panel denied the transfer of this action to Texas. By opinion dated April 4, 2013, the Court denied defendants' motion for summary judgment and plaintiff's motion to dismiss the counterclaims. The Court issued its order on claim construction on October 22, 2013, and by order dated January 28, 2014, the Court adopted the defendants' proposed claims construction. On March 25, 2014, the Court granted plaintiff leave to amend its complaint to add a newly-issued patent, but stayed all litigation pertaining to that patent until a covered business method review could be heard by the Patent and Trademark Appeals Board. The defendants filed petitions for covered business method patent reviews with the Patent and Trademark Appeals Board on May 12, 2014. Motions for summary judgment were filed in the U.S. District Court in August 2014 and the parties await the decision. The Company will continue to defend itself vigorously in this matter, both in the District Court and at the U.S. Patent and Trademark Office.

Several cases have been filed nationwide involving the April 2007 leveraged buyout ("LBO") of the Tribune Company ("Tribune") by Sam Zell, and the subsequent bankruptcy of Tribune. In *William Niese et al. v. A.G. Edwards et al.*, in Superior Court of Delaware, New Castle County, former Tribune employees and retirees claimed that Tribune was actually insolvent at the time of the LBO and that the LBO constituted a fraudulent transaction that depleted the plaintiffs' retirement plans, rendering them worthless. E\*TRADE Clearing LLC, along with numerous other financial institutions, is a named defendant in this case. One of the defendants removed the action to federal district court in Delaware on July 1, 2011. In *Deutsche Bank Trust Company Americas et al. v. Adaly Opportunity Fund et al.*, filed in the Supreme Court of New York, New York County on June 3, 2011, the Trustees of certain notes issued by Tribune allege wrongdoing in connection with the LBO. In particular the Trustees claim that the LBO constituted a constructive fraudulent transfer under various state laws. G1 Execution Services, LLC (formerly known as E\*TRADE Capital Markets, LLC), along with numerous other financial institutions, is a named defendant in this case. In *Deutsche Bank et al. v. Ohlson et al.*, filed in the U.S. District Court for the Northern District of Illinois, noteholders of Tribune asserted claims of constructive fraud and G1 Execution Services, LLC is a named defendant in

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this case. Under the agreement governing the sale of G1 Execution Services, LLC to Susquehanna, the Company remains responsible for any resulting actions taken against G1 Execution Services, LLC as a result of such investigation. In *EGI-TRB LLC et al. v. ABN-AMRO et al.*, filed in the Circuit Court of Cook County Illinois, creditors of Tribune assert fraudulent conveyance claims against multiple shareholder defendants and E\*TRADE Clearing LLC is a named defendant in this case. These cases have been consolidated into a multi-district litigation. The Company's time to answer or otherwise respond to the complaints has been stayed pending further orders of the Court. On September 18, 2013, the Court entered the Fifth Amended Complaint. On September 23, 2013, the Court granted the defendants' motion to dismiss the individual creditors' complaint. The individual creditors filed a notice of appeal. The steering committees for plaintiffs and defendants have submitted a joint plan for the next phase of litigation. The next phase of the action will involve individual motions to dismiss. On April 22, 2014, the Court issued its protocols for dismissal motions for those defendants who were "mere conduits" who facilitated the transactions at issue. The motion to dismiss Count I of the Fifth Amended Complaint for failure to state a cause of action was fully briefed on July 2, 2014, and the parties await decision on that motion. The Company will defend itself vigorously in these matters.

On April 30, 2013, a putative class action was filed by John Scranton, on behalf of himself and a class of persons similarly situated, against E\*TRADE Financial Corporation and E\*TRADE Securities LLC in the Superior Court of California, County of Santa Clara, pursuant to the California procedures for a private Attorney General action. The Complaint alleged that the Company misrepresented through its website that it would always automatically exercise options that were in-the-money by \$0.01 or more on expiration date. Plaintiffs allege violations of the California Unfair Competition Law, the California Consumer Remedies Act, fraud, misrepresentation, negligent misrepresentation and breach of fiduciary duty. The case has been deemed complex within the meaning of the California Rules of Court, and a case management conference was held on September 13, 2013. The Company's demurrer and motion to strike the complaint were granted by order dated December 20, 2013. The Court granted leave to amend the complaint. A second amended complaint was filed on January 31, 2014. On March 11, 2014, the Company moved to strike and for a demurrer to the second amended complaint. On October 20, 2014, the Court sustained the Company's demurrer, dismissing four counts of the second amended complaint with prejudice and two counts without prejudice. The plaintiffs have until November 10, 2014 to file a third amended complaint. The Company will continue to defend itself vigorously in this matter.

On April 18, 2014, a putative class action was filed by the City of Providence, Rhode Island against forty-one high frequency trading firms, stock exchanges, market-makers, and other broker-dealers, including the Company, in the U.S. District Court for the Southern District of New York. The Complaint alleges that the high frequency trading firms, certain broker-dealers managing dark pools, and the exchanges manipulated the U.S. Securities markets, and that numerous market-makers and broker-dealers participated in that manipulation by doing business with the high frequency traders. As to the Company, the Complaint alleges violation of Sections 10(b) and 20(a) of the Exchange Act. On May 2, 2014, a similar putative class action was filed by American European Insurance Company against forty-two high frequency trading firms, stock exchanges, market-makers, and other broker-dealers, including the Company, in the U.S. District Court for the Southern District of New York. The action filed by American European Insurance Company made allegations substantially similar to the allegations in the City of Providence complaint. On June 13, 2014, a putative class action was filed by James J. Flynn and Dominic Morelli against twenty-six firms including the Company in the United States District Court for the Southern District of New York. The Flynn Complaint made allegations substantially similar to the allegations in the City of Providence Complaint. While there can be no assurances, based on the advice of the Company's external legal counsel, the Company believes that the claims against it have no merit and the Company will ultimately prevail. The consolidated amended complaint does not identify the Company as a defendant or make any allegations regarding the Company. The Company will defend itself vigorously in these matters.

In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business. In each pending matter, the Company contests liability or the amount of claimed damages. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, the Company is unable to reasonably estimate a range of possible losses on its remaining outstanding legal proceedings; however, the Company believes any losses would not be reasonably likely to have a material adverse effect on the consolidated financial condition or results of operations of the Company.

An unfavorable outcome in any matter could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company's favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

### *Regulatory Matters*

The securities, futures, foreign currency and banking industries are subject to extensive regulation under federal, state and applicable international laws. From time to time, the Company has been threatened with or named as a defendant in

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lawsuits, arbitrations and administrative claims involving securities, banking and other matters. The Company is also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators, such as the SEC, FINRA, CFTC, NFA or OCC by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers or disciplinary action being taken against the Company or its employees by regulators. Any such claims or disciplinary actions that are decided against the Company could have a material impact on the financial results of the Company or any of its subsidiaries.

During 2012, the Company completed a review of order handling practices and pricing for order flow between E\*TRADE Securities LLC and G1 Execution Services, LLC. The Company has implemented changes to its practices and procedures that were recommended during the review. Banking regulators and federal securities regulators were regularly updated during the course of the review and may initiate investigations into the Company's historical practices which could subject it to monetary penalties and cease-and-desist orders, which could also prompt claims by customers of E\*TRADE Securities LLC. Any of these actions could materially and adversely affect the Company's broker-dealer businesses. On July 11, 2013, FINRA notified E\*TRADE Securities LLC and G1 Execution Services, LLC that it is conducting an examination of both firms' routing practices. The Company is cooperating fully with FINRA in this examination. Under the agreement governing the sale of G1 Execution Services, LLC to Susquehanna, the Company remains responsible for any resulting actions taken against G1 Execution Services, LLC as a result of such investigation.

In October 2014, E\*TRADE Securities LLC and G1 Execution Services, LLC reached a settlement with the SEC in connection with effecting the sale of certain "penny stock" securities on behalf of three former customers without an applicable exemption from the registration provisions of the federal securities laws during the period 2007 to 2011. Without admitting or denying the SEC's findings, E\*TRADE Securities LLC and G1 Execution Services, LLC entered into a settlement pursuant to which they agreed to be censured and consented to an order of the SEC requiring them to cease and desist from committing or causing future violations of the registration provisions of the Securities Act of 1933. Pursuant to the settlement agreement, E\*TRADE Securities LLC and G1 Execution Services, LLC agreed to pay approximately \$1.6 million in disgorgement and prejudgment interest on commissions and a \$1 million penalty. This matter was previously reserved for.

### *Insurance*

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company's ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

### *Estimated Liabilities*

For all legal matters, an estimated liability is established in accordance with the loss contingencies accounting guidance. Once established, the estimated liability is adjusted based on available information when an event occurs requiring an adjustment.

### *Commitments*

In the normal course of business, the Company makes various commitments to extend credit and incur contingent liabilities that are not reflected in the consolidated balance sheet. Significant changes in the economy or interest rates may influence the impact that these commitments and contingencies have on the Company in the future.

### *Other Investments*

The Company has investments in small business investment companies, community development financial institutions, affordable housing tax credit partnerships and other limited partnerships. The Company had \$33 million in unfunded commitments with respect to these investments at September 30, 2014.

### *Unused Lines of Credit and Certificates of Deposit*

At September 30, 2014, the Company had approximately \$37 million of certificates of deposit scheduled to mature in less than one year and \$184 million of unfunded commitments to extend credit.

### *Guarantees*

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In prior periods when the Company sold loans, the Company provided guarantees to investors purchasing mortgage loans, which are considered standard representations and warranties within the mortgage industry. The primary guarantees are that: the mortgage and the mortgage note have been duly executed and each is the legal, valid and binding obligation of the Company, enforceable in accordance with its terms; the mortgage has been duly acknowledged and recorded and is valid; and the mortgage and the mortgage note are not subject to any right of rescission, set-off, counterclaim or defense, including, without limitation, the defense of usury, and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto. The Company is responsible for the guarantees on loans sold. If these claims prove to be untrue, the investor can require the Company to repurchase the loan and return all loan purchase and servicing release premiums. Management does not believe the potential liability exposure will have a material impact on the Company's results of operations, cash flows or financial condition due to the nature of the standard representations and warranties, which have resulted in a minimal amount of loan repurchases.

Prior to 2008, ETBH raised capital through the formation of trusts, which sold trust preferred securities in the capital markets. The capital securities must be redeemed in whole at the due date, which is generally 30 years after issuance. Each trust issued trust preferred securities at par, with a liquidation amount of \$1,000 per capital security. The trusts used the proceeds from the sale of issuances to purchase subordinated debentures issued by ETBH.

During the 30-year period prior to the redemption of the trust preferred securities, ETBH guarantees the accrued and unpaid distributions on these securities, as well as the redemption price of the securities and certain costs that may be incurred in liquidating, terminating or dissolving the trusts (all of which would otherwise be payable by the trusts). At September 30, 2014, management estimated that the maximum potential liability under this arrangement, including the current carrying value of the trusts, was equal to approximately \$436 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

**NOTE 14—SEGMENT INFORMATION**

The Company reports its operating results in two segments, based on the manner in which its chief operating decision maker evaluates financial performance and makes resource allocation decisions: 1) trading and investing; and 2) balance sheet management. Trading and investing includes retail brokerage products and services; investor-focused banking products; and corporate services. Balance sheet management includes the management of asset allocation; loans previously originated by the Company or purchased from third parties; deposits and customer payables; and credit, liquidity and interest rate risk. The balance sheet management segment utilizes deposits and customer payables and compensates the trading and investing segment via a market-based transfer pricing arrangement, which is eliminated in consolidation.

The Company does not allocate costs associated with certain functions that are centrally-managed to its operating segments. These costs are separately reported in a corporate/other category, along with technology related costs incurred to support centrally-managed functions; restructuring and other exit activities; and corporate debt and corporate investments.

The Company evaluates the performance of its segments based on the segment's income (loss) before income taxes. Financial information for the Company's reportable segments is presented in the following tables (dollars in millions):

	<b>Three Months Ended September 30, 2014</b>			
	<b>Trading and Investing</b>	<b>Balance Sheet Management</b>	<b>Corporate/ Other</b>	<b>Total</b>
Net operating interest income	\$ 165	\$ 104	\$ —	\$ 269
Total non-interest income	162	9	—	171
Total net revenue	327	113	—	440
Provision for loan losses	—	10	—	10
Total operating expense	183	36	58	277
Income (loss) before other income (expense) and income taxes	144	67	(58)	153
Total other income (expense)	—	—	(28)	(28)
Income (loss) before income taxes	\$ 144	\$ 67	\$ (86)	\$ 125
Income tax expense				39
Net income				<u>\$ 86</u>

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	Three Months Ended September 30, 2013			
	Trading and Investing	Balance Sheet Management	Corporate/ Other	Total
Net operating interest income	\$ 134	\$ 107	\$ —	\$ 241
Total non-interest income	163	13	—	176
Total net revenue	297	120	—	417
Provision for loan losses	—	37	—	37
Total operating expense	171	43	57	271
Income (loss) before other income (expense) and income taxes	126	40	(57)	109
Total other income (expense)	—	—	(29)	(29)
Income (loss) before income taxes	\$ 126	\$ 40	\$ (86)	80
Income tax expense				33
Net income				<u>\$ 47</u>

	Nine Months Ended September 30, 2014			
	Trading and Investing	Balance Sheet Management	Corporate/ Other	Total
Net operating interest income	\$ 459	\$ 346	\$ —	\$ 805
Total non-interest income	513	35	—	548
Total net revenue	972	381	—	1,353
Provision for loan losses	—	26	—	26
Total operating expense	574	113	164	851
Income (loss) before other income (expense) and income taxes	398	242	(164)	476
Total other income (expense)	—	—	(95)	(95)
Income (loss) before income taxes	\$ 398	\$ 242	\$ (259)	381
Income tax expense				129
Net income				<u>\$ 252</u>

	Nine Months Ended September 30, 2013			
	Trading and Investing	Balance Sheet Management	Corporate/ Other	Total
Net operating interest income	\$ 401	\$ 324	\$ —	\$ 725
Total non-interest income	501	51	—	552
Total net revenue	902	375	—	1,277
Provision for loan losses	—	126	—	126
Total operating expense	688	135	157	980
Income (loss) before other income (expense) and income taxes	214	114	(157)	171
Total other income (expense)	—	—	(81)	(81)
Income (loss) before income taxes	\$ 214	\$ 114	\$ (238)	90
Income tax expense				62
Net income				<u>\$ 28</u>

*Segment Assets*

	Trading and Investing	Balance Sheet Management	Corporate/ Other	Total
As of September 30, 2014	\$ 11,989	\$ 33,070	\$ 760	\$ 45,819
As of December 31, 2013	\$ 10,820	\$ 34,784	\$ 676	\$ 46,280

#### **NOTE 15—SUBSEQUENT EVENT**

On October 31, 2014, the Company executed a sale-leaseback transaction on its office located in Alpharetta, Georgia. The Company now leases a total of forty-five properties, as this was its only owned office prior to the transaction. The Company recorded the sales proceeds of approximately \$56 million as a financing obligation and the related assets continue to be included in the property and equipment, net line item on the consolidated balance sheet.

#### **ITEM 4. CONTROLS AND PROCEDURES**

- (a) Based on an evaluation under the supervision and with the participation of our management, our Chief Executive Officer and our Chief Financial Officer have concluded that the Company's disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 ("Exchange Act"), were effective as of the end of the period covered by this report to provide reasonable assurance that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.
- (b) There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2014, identified in connection with management's evaluation required by paragraph (d) of Exchange Act Rules 13a-15 and 15d-15, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### **PART II—OTHER INFORMATION**

##### **ITEM 1. LEGAL PROCEEDINGS**

On October 27, 2000, Ajaxo, Inc. ("Ajaxo") filed a complaint in the Superior Court for the State of California, County of Santa Clara. Ajaxo sought damages and certain non-monetary relief for the Company's alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology that Ajaxo offered the Company as well as damages and other relief against the Company for their alleged misappropriation of Ajaxo's trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for \$1 million for breach of the Ajaxo non-disclosure agreement. Although the jury found in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets, the trial court subsequently denied Ajaxo's requests for additional damages and relief. On December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury's previous finding in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets. Although the Company paid Ajaxo the full amount due on the above-described judgment, the case was remanded back to the trial court, and on May 30, 2008, a jury returned a verdict in favor of the Company denying all claims raised and demands for damages against the Company. Following the trial court's entry of judgment in favor of the Company on September 5, 2008, Ajaxo filed post-trial motions for vacating this entry of judgment and requesting a new trial. The trial court denied these motions. On December 2, 2008, Ajaxo filed a notice of appeal with the Court of Appeal of the State of California for the Sixth District. On August 30, 2010, the Court of Appeal affirmed the trial court's verdict in part and reversed the verdict in part, remanding the case. The Company petitioned the Supreme Court of California for review of the Court of Appeal decision. On December 16, 2010, the California Supreme Court denied the Company's petition for review and remanded for further proceedings to the trial court. The testimonial phase of the third trial in this matter concluded on June 12, 2012. By order dated May 28, 2014, the Court determined to conduct a second phase of this bench trial to allow Ajaxo to attempt to prove entitlement to additional royalties. Phase two of the trial is scheduled to commence December 8, 2014. The Company will continue to defend itself vigorously.

On May 16, 2011, Droplets Inc., the holder of two patents pertaining to user interface servers, filed a complaint in the U.S. District Court for the Eastern District of Texas against E\*TRADE Financial Corporation, E\*TRADE Securities LLC, E\*TRADE Bank and multiple other unaffiliated financial services firms. Plaintiff contends that the defendants engaged in patent infringement under federal law. Plaintiff seeks unspecified damages and an injunction against future infringements, plus royalties, costs, interest and attorneys' fees. On September 30, 2011, the Company and several co-defendants filed a motion to transfer the case to the Southern District of New York. Venue discovery occurred throughout December 2011. On January 1, 2012, a new judge was assigned to the case. On March 28, 2012, a change of venue was granted and the case was transferred to

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the United States District Court for the Southern District of New York. The Company filed its answer and counterclaim on June 13, 2012 and plaintiff moved to dismiss the counterclaim. The Company filed a motion for summary judgment. Plaintiffs sought to change venue back to the Eastern District of Texas on the theory that this case is one of several matters that should be consolidated in a single multi-district litigation. On December 12, 2012, the Multidistrict Litigation Panel denied the transfer of this action to Texas. By opinion dated April 4, 2013, the Court denied defendants' motion for summary judgment and plaintiff's motion to dismiss the counterclaims. The Court issued its order on claim construction on October 22, 2013, and by order dated January 28, 2014, the Court adopted the defendants' proposed claims construction. On March 25, 2014, the Court granted plaintiff leave to amend its complaint to add a newly-issued patent, but stayed all litigation pertaining to that patent until a covered business method review could be heard by the Patent and Trademark Appeals Board. The defendants filed petitions for covered business method patent reviews with the Patent and Trademark Appeals Board on May 12, 2014. Motions for summary judgment were filed in the U.S. District Court in August 2014 and the parties await the decision. The Company will continue to defend itself vigorously in this matter, both in the District Court and at the U.S. Patent and Trademark Office.

Several cases have been filed nationwide involving the April 2007 leveraged buyout ("LBO") of the Tribune Company ("Tribune") by Sam Zell, and the subsequent bankruptcy of Tribune. In *William Niese et al. v. A.G. Edwards et al.*, in Superior Court of Delaware, New Castle County, former Tribune employees and retirees claimed that Tribune was actually insolvent at the time of the LBO and that the LBO constituted a fraudulent transaction that depleted the plaintiffs' retirement plans, rendering them worthless. E\*TRADE Clearing LLC, along with numerous other financial institutions, is a named defendant in this case. One of the defendants removed the action to federal district court in Delaware on July 1, 2011. In *Deutsche Bank Trust Company Americas et al. v. Adaly Opportunity Fund et al.*, filed in the Supreme Court of New York, New York County on June 3, 2011, the Trustees of certain notes issued by Tribune allege wrongdoing in connection with the LBO. In particular the Trustees claim that the LBO constituted a constructive fraudulent transfer under various state laws. G1 Execution Services, LLC (formerly known as E\*TRADE Capital Markets, LLC), along with numerous other financial institutions, is a named defendant in this case. In *Deutsche Bank et al. v. Ohlson et al.*, filed in the U.S. District Court for the Northern District of Illinois, noteholders of Tribune asserted claims of constructive fraud and G1 Execution Services, LLC is a named defendant in this case. Under the agreement governing the sale of G1 Execution Services, LLC to Susquehanna, the Company remains responsible for any resulting actions taken against G1 Execution Services, LLC as a result of such investigation. In *EGI-TRB LLC et al. v. ABN-AMRO et al.*, filed in the Circuit Court of Cook County Illinois, creditors of Tribune assert fraudulent conveyance claims against multiple shareholder defendants and E\*TRADE Clearing LLC is a named defendant in this case. These cases have been consolidated into a multi-district litigation. The Company's time to answer or otherwise respond to the complaints has been stayed pending further orders of the Court. On September 18, 2013, the Court entered the Fifth Amended Complaint. On September 23, 2013, the Court granted the defendants' motion to dismiss the individual creditors' complaint. The individual creditors filed a notice of appeal. The steering committees for plaintiffs and defendants have submitted a joint plan for the next phase of litigation. The next phase of the action will involve individual motions to dismiss. On April 22, 2014, the Court issued its protocols for dismissal motions for those defendants who were "mere conduits" who facilitated the transactions at issue. The motion to dismiss Count I of the Fifth Amended Complaint for failure to state a cause of action was fully briefed on July 2, 2014, and the parties await decision on that motion. The Company will defend itself vigorously in these matters.

During 2012, the Company completed a review of order handling practices and pricing for order flow between E\*TRADE Securities LLC and G1 Execution Services, LLC. The Company has implemented changes to its practices and procedures that were recommended during the review. Banking regulators and federal securities regulators were regularly updated during the course of the review and may initiate investigations into the Company's historical practices which could subject it to monetary penalties and cease-and-desist orders, which could also prompt claims by customers of E\*TRADE Securities LLC. Any of these actions could materially and adversely affect the Company's broker-dealer businesses. On July 11, 2013, FINRA notified E\*TRADE Securities LLC and G1 Execution Services, LLC that it is conducting an examination of both firms' routing practices. The Company is cooperating fully with FINRA in this examination. Under the agreement governing the sale of G1 Execution Services, LLC to Susquehanna, the Company remains responsible for any resulting actions taken against G1 Execution Services, LLC as a result of such investigation.

On April 30, 2013, a putative class action was filed by John Scranton, on behalf of himself and a class of persons similarly situated, against E\*TRADE Financial Corporation and E\*TRADE Securities LLC in the Superior Court of California, County of Santa Clara, pursuant to the California procedures for a private Attorney General action. The Complaint alleged that the Company misrepresented through its website that it would always automatically exercise options that were in-the-money by \$0.01 or more on expiration date. Plaintiffs allege violations of the California Unfair Competition Law, the California Consumer Remedies Act, fraud, misrepresentation, negligent misrepresentation and breach of fiduciary duty. The case has been deemed complex within the meaning of the California Rules of Court, and a case management conference was held on September 13, 2013. The Company's demurrer and motion to strike the complaint were granted by order dated December 20, 2013. The Court granted leave to amend the complaint. A second amended complaint was filed on January 31, 2014. On March 11, 2014, the Company moved to strike and for a demurrer to the second amended complaint. On October 20, 2014, the Court

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sustained the Company's demurrer, dismissing four counts of the second amended complaint with prejudice and two counts without prejudice. The plaintiffs have until November 10, 2014 to file a third amended complaint. The Company will continue to defend itself vigorously in this matter.

On April 18, 2014, a putative class action was filed by the City of Providence, Rhode Island against forty-one high frequency trading firms, stock exchanges, market-makers, and other broker-dealers, including the Company, in the U.S. District Court for the Southern District of New York. The Complaint alleges that the high frequency trading firms, certain broker-dealers managing dark pools, and the exchanges manipulated the U.S. Securities markets, and that numerous market-makers and broker-dealers participated in that manipulation by doing business with the high frequency traders. As to the Company, the Complaint alleges violation of Sections 10(b) and 20(a) of the Exchange Act. On May 2, 2014, a similar putative class action was filed by American European Insurance Company against forty-two high frequency trading firms, stock exchanges, market-makers, and other broker-dealers, including the Company, in the U.S. District Court for the Southern District of New York. The action filed by American European Insurance Company made allegations substantially similar to the allegations in the City of Providence complaint. On June 13, 2014, a putative class action was filed by James J. Flynn and Dominic Morelli against twenty-six firms including the Company in the United States District Court for the Southern District of New York. The Flynn Complaint made allegations substantially similar to the allegations in the City of Providence Complaint. While there can be no assurances, based on the advice of the Company's external legal counsel, the Company believes that the claims against it have no merit and the Company will ultimately prevail. The consolidated amended complaint does not identify the Company as a defendant or make any allegations regarding the Company. The Company will defend itself vigorously in these matters.

In October 2014, E\*TRADE Securities LLC and G1 Execution Services, LLC reached a settlement with the SEC in connection with effecting the sale of certain "penny stock" securities on behalf of three former customers without an applicable exemption from the registration provisions of the federal securities laws during the period 2007 to 2011. Without admitting or denying the SEC's findings, E\*TRADE Securities LLC and G1 Execution Services, LLC entered into a settlement pursuant to which they agreed to be censured and consented to an order of the SEC requiring them to cease and desist from committing or causing future violations of the registration provisions of the Securities Act of 1933. Pursuant to the settlement agreement, E\*TRADE Securities LLC and G1 Execution Services, LLC agreed to pay approximately \$1.6 million in disgorgement and prejudgment interest on commissions and a \$1 million penalty. This matter was previously reserved for.

In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business. In each pending matter, the Company contests liability or the amount of claimed damages. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, the Company is unable to reasonably estimate a range of possible losses on its remaining outstanding legal proceedings; however, the Company believes any losses would not be reasonably likely to have a material adverse effect on the consolidated financial condition or results of operations of the Company.

An unfavorable outcome in any matter could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company's favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company's ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

### **ITEM 1A. RISK FACTORS**

There have been no material changes in the Company's risk factors from those disclosed in its Annual Report on Form 10-K for the year ended December 31, 2013.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

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**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b><u>Exhibit Number</u></b>	<b><u>Description</u></b>
*31.1	Certification—Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification—Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification—Section 906 of the Sarbanes-Oxley Act of 2002
*101.INS	XBRL Instance Document
*101.SCH	XBRL Taxonomy Extension Schema Document
*101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
*101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herein.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: November 4, 2014

E\*TRADE Financial Corporation  
(Registrant)

By

/s/ PAUL T. IDZIK

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**Paul T. Idzik**  
*Chief Executive Officer*  
*(Principal Executive Officer)*

By

/s/ MATTHEW J. AUDETTE

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**Matthew J. Audette**  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*



**CERTIFICATION PURSUANT TO RULE 13a-14(a)/15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Matthew J. Audette, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of E\*TRADE Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 4, 2014

E\*TRADE Financial Corporation  
(Registrant)

By \_\_\_\_\_ /s/ MATTHEW J. AUDETTE  
Matthew J. Audette  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The certification set forth below is being submitted in connection with this Quarterly Report on Form 10-Q of E\*TRADE Financial Corporation (the "Quarterly Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

Paul T. Idzik, the Chief Executive Officer and Matthew J. Audette, the Chief Financial Officer of E\*TRADE Financial Corporation, each certifies that, to the best of their knowledge:

1. the Quarterly Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and
2. the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of E\*TRADE Financial Corporation.

Dated: November 4, 2014

*/s/* PAUL T. IDZIK

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Paul T. Idzik  
*Chief Executive Officer*  
*(Principal Executive Officer)*

*/s/* MATTHEW J. AUDETTE

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Matthew J. Audette  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

