21-Oct-2014

E*TRADE Financial Corp. (ETFC)

Q3 2014 Earnings Call
CORPORATE PARTICIPANTS

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Chief Executive Officer & Director

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

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Chris J. Allen  
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Devin P. Ryan  
JMP Securities LLC

Joel Michael Jeffrey  
Keefe, Bruyette & Woods, Inc.

Kenneth W. Hill  
Barclays Capital, Inc.

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Jefferies LLC

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Wells Fargo Securities LLC

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Deutsche Bank Securities, Inc.
MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP FINANCIAL MEASURES

- During the call, the company may also discuss non-GAAP financial measures
- For a reconciliation of such non-GAAP measures to the comparable GAAP figures and for a discussion of additional risks and uncertainties that may affect the future results of E*TRADE Financial, please refer to our earnings release furnished with Form 8-K and our 10-Ks, 10-Qs and other documents the company has filed with the SEC

Paul Thomas Idzik
Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Performance

- We posted solid results for Q3 2014 and continue to make progress internally, further strengthening our business across all frames
- During what is typically a seasonally slow period trading held steady and margin balances reached record highs
- Meanwhile, we enhanced the value of our franchise in terms of accounts and assets, as we are seeing the early benefits from our investments in the business, including our new marketing approach

Capital Plan

- As a result of the team’s continued efforts in executing on our capital plan, we made our fifth consecutive quarterly distribution from the Bank to the parent this past quarter, bringing us to $400mm in cumulative dividends since Q3 of 2013
- Given this, we are now in a strong place to put this capital to work
- Our first area of focus is on debt reduction, where we anticipate taking action soon
  - We will, of course, keep you updated on this topic, but I am quite proud of what we’ve accomplished to bring us to this position

Risk Profile

- With respect to the firm’s overall risk profile, Enterprise Risk Management continues to have an increasingly important seat at the table, as it has become so deeply engrained in the operating culture of my colleagues that it’s now an area of real strength and pride for the firm
- Likewise, we continue to evolve to a greatly simplified and improved balance sheet composition
  - To that end, and specific to credit risk, our legacy loan portfolio continued its well-directed march downwards, declining by $350mm to end the quarter at $6.7B
• If John Philip Sousa were still alive, he would have found it irresistible to pen the ETFC Balance Sheet March

CUSTOMER EXPERIENCE

• Next, with respect to our focus, we continue to invest in our business to enhance the customer experience and strengthen our foundation, seeing meaningful strides on both fronts during the quarter, all with the elevated rigor, testing and control that is the cadence of the team
• In terms of enhancing the customer experience, we remain focused on digital channels, and made a number of improvements to our product offering during the quarter
• In mobile, we launched our new app simultaneously with the launch of iOS 8, with first-to-market functionality relative to peers, and also launched an app for the Amazon Fire phone

Bond Resource Center

• On the website, to pick from a long list, we revamped our Bond Resource Center with updated tools and solutions, and are in the process of deploying a new navigation framework for customers
• We also made a number of enhancements in adding new functionality to our active trader platform, most prominently, a more fulsome integration of FX training
• And finally, as we evolve our offering suite to meet customers increasingly on their own terms, we launched a browser-based training solution, enabling real-time monitoring and execution while investors are traveling outside the walls of their own digital properties
• As we introduce these front-of-house enhancements, we are simultaneously investing in stronger technology capabilities and more efficient operating procedures to ensure we are maintaining E*TRADE as a robust home for our customers’ financial matters

Q3 RESULTS

Earnings

• Turning to our financial results, we recorded earnings of $0.29 for the quarter on net income of $86mm
• Earnings included an income tax benefit of around $0.03, provision expense at the bottom of our expected range, and a sequentially flat net interest spread due largely to a robust performance in margin receivables and securities lending

Trading Activity

• Now, in terms of brokerage metrics, trading activity was solid in what is typically a seasonally slow period, as DARTs of 153,000 were down just 1% from the prior quarter and up 6% from the prior year
• October is continuing this trend with month-to-date trade ups (sic) [trades up] another 12% from September, as volatility has picked up significantly over the past several weeks
• Options represented 23% of our Q3 trades, generally consistent with where they’ve been over the past couple of years

Mobile Platform

• Our mobile platforms remain a celebrated and important part of our offering as mobile DARTs represented more than 11% of our total this quarter, continuing the trend of increased adoption and nicely above the 8% we saw for all of last year
Customer margin receivables reached new highs during the quarter, with average balances increasing $300mm to $7.6B, and exiting the quarter at $8.1B.
   o We continue to see some yield compression as margin utilization again shifted towards higher balance accounts

We also continued our solid account and asset growth with YTD net new brokerage accounts of 128,000, already eclipsing full year totals for each of the past five years

We added 24,000 net new brokerage accounts in the quarter, down from 33,000 in the prior quarter as our attrition rate ticked up slightly to 9.1% consistent with seasonal trends seen in Q3

YTD, our attrition rate is a solid 8.5%

Net New Brokerage Assets

Net new brokerage assets were a healthy $2.3B in the quarter, up from $1B in the prior quarter, which reflected seasonality around tax time in April

Within customer assets, we ended Q3 with nearly $3B of managed assets, up about $1B from a year ago
   o These fee-based products continue to be an area of focus for us as we work to do more for our customers in response to their needs and to diversify our revenue stream

Corporate Services Business

Our Corporate Services business continues to prove strategically important as a steady generator of roughly a third of our gross new accounts

We are committed to providing a best-in-class offering for employers and their plan participants and we’re quite gratified to receive external validation for our hard work with a number one rating for client satisfaction and loyalty by Group Five in their annual Stock Plan Administration Study, the largest of its kind and considered a respected authority for the stock plan industry
   o This is the third consecutive year our platform, Equity Edge Online, has won this distinction

As we canter towards year-end, I’m proud of what we’ve accomplished and where we stand

Our resolute focus on our customers is apparent in the metrics and we remain dedicated to executing on our plans to invest in and grow the business in an incisive and deliberate manner

Our regulatory dialogue is one with which we are quite pleased and which will continue to get the thoughtful attention it deserves

Further, our unwavering commitment to reducing risk is quite visibly paying dividends

Matthew J. Audette
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Risk Profile

From my standpoint, this was an outstanding quarter for us and another one of clear progress in terms of improving our risk profile, honing our focus on the core business, and demonstrating solid execution toward our capital goals, achieving an additional dividend from the Bank and positioning us to take actions on our corporate debt when the time is right
Net Income and Tax Rate

- So to start with our results, we reported third quarter net income of $86mm or $0.29 per share, up from net income of $69mm or $0.24 per share in Q2, and net income of $47mm or $0.16 per share in the year-ago quarter
- Our results benefited from an effective tax rate of 31% this quarter
  - This was the result of an $8mm or $0.03 benefit that primarily related to the settlement of the state tax audit
  - Absent this benefit, our tax rate would have been 38%

Net Revenue

- Net revenues of $440mm were up from $438mm in the prior quarter and $417mm in the year-ago quarter
- Revenue included net interest income of $269mm, essentially flat with the prior quarter as both net interest spread and our average assets were relatively unchanged
- Our spread remained elevated in Q3 and declined just one basis point as the benefit from the performance of margin and stock loan offset the impact of higher prepayment speeds on the securities portfolio and reduced yield on the loan portfolio, which had a one-time benefit in Q2 related to the sale of modified loans
- With respect to our spread going forward, the biggest drivers of near-term fluctuations will again be margin and stock loan
  - So if we hold those levels constant from where we ended Q3, our spread next quarter would be in the low-to-mid 2.50%

Interest Rate Environment

- One additional point on the interest rate environment
- Last week, we saw some of the most remarkable volatility in interest rates since the crisis
- While rates have largely recovered from the lows last week, if those low rates return, our spread would be biased downward going forward
- Given how much our spread is being driven by margin and stock loan, combined with our philosophy of taking minimal interest rate risk, I would not expect this downward pressure to be meaningful, especially in the near term
- But I think it’s important to highlight that if interest rates move at the extremes we saw last week and remain there, we would certainly be impacted
- Our balance sheet ended the quarter at $45.8B, flat with the prior quarter as customer cash decreased, while wholesale funding ticked up slightly by $175mm
  - This increase in wholesale funding related to large amounts of customer activity near quarter-end, and we expect this to roll off next quarter

Commissions, Fees and Service Charges

- Commissions, fees and service charges, and other revenue in Q3 were $163mm, up slightly from the prior quarter and up 7% from the year-ago quarter
- Average commission per trade of $11.05 increased $0.33 from the prior quarter but was down $0.10 from the year-ago period
- The sequential increase was primarily driven by options trading
Fees and service charges revenues of $45mm included $22mm of payment for order flow, flat with the prior quarter
Net gains on loans and securities were $8mm this quarter, up slightly from $7mm in Q2, which primarily related to the sale of TDRs

Operating Expenses

- Our operating expenses for the quarter were $277mm, down from $284mm in the prior quarter
- Marketing expense was the primary driver of the decline, as we pulled back our spending during the summer
  - This was partially offset by an increase in compensation, which reflects the impact of hiring in H1, along with higher incentive compensation
- For next quarter, we expect expenses to be closer to Q2 levels, which includes a sequential increase in marketing, in line with our expectations for a full year increase of 10%
- And compensation will be biased downward from Q3 as it contain the impact of some severance and incentive comp

Loan Portfolio

- The loan portfolio ended the quarter at $6.7B, down $350mm from the prior quarter
- Paydowns were again the driver, as charge-offs were minimal at just $10mm
  - We expect quarterly runoff in the range of 4% to 5% over the next few quarters
- Provision for loan losses was also $10mm, down from $12mm in the previous quarter and at the bottom of our expected range
- Our allowance for loan losses ended the quarter at $401mm, unchanged from the prior quarter
  - While the total balance was stable, the allocations continue to shift to home equity portfolio which will continue to drive the majority of credit costs

Home Equity Book

- Meanwhile, the overall health of the portfolio continued to improve, as the average CLTV for the home equity portfolio improved to 92% from 94% and the average LTV for the 1-4 family portfolio improved to 79% from 81% in the prior quarter
- Over the past few years, we’ve seen a significant increase in home prices, which has been a meaningful tailwind to the performance of our portfolio, with the most dramatic improvements to the performance of the 1-4 book
- And while the home equity book has also been a clear beneficiary of this trend, the vast majority of those loans, at slightly over $2B, are HELOCs which have yet to reach their amortization period, a credit event, which we expect will drive increased losses

Home Equity Provision

- Our home equity provision was $29mm this quarter, which included additional reserves related to a planned loan transfer, from a servicer that is exiting the third party home-equity servicing business
  - While we have conducted many transfers in the past, this one is unique for us as it relates exclusively to home equity loans, which can prove more challenging when transferred
- Excluding that charge, home equity provision would have been just above $20mm, which is consistent with the previous quarter and broadly in line with our expectations for next quarter
Meanwhile, the 1-4 family portfolio reserve declined by $17mm related to lower loss severities
  o But we now have an allowance of $27mm against these loans, leaving very little room to continue reducing this balance

HELOCs

• Now, with the vast majority of remaining risk being in the home equity portfolio, we expect future provision expense to be concentrated in that category
• So while we continue to feel comfortable with the diminishing level of risk in the overall portfolio, we do expect provision to migrate up over the next two years as we navigate through the vast majority of our HELOCs entering their amortization period, with expectations to trend towards the higher end of our $10mm to $30mm quarterly range
• As a reminder, losses associated with HELOCs converting to amortizing payments are incredibly difficult to predict
  o However, with each quarter that passes, we’re able to gather more information on the actual performance of these loans, giving us the ability to apply an increasing level of precision over time

Capital

• Turning now to capital
• Over the near-term, we continue to focus squarely on debt reduction as a first order of business
• As we discussed last quarter, based on our current thinking and analysis, we believe $1B is the right amount of debt for us over the long term

CASH LEVELS

• Through the capital flexibility we’ve achieved, we’ve been able to upstream $400mm in dividends to the parent over the past five quarters
• This has brought our parent cash levels above $600mm
• Given our desire to maintain at least two years of debt service coverage, which is $220mm today, we believe we are in a position to reduce our debt in the near term by approximately $400mm
  o It has been a long road to get to this position and I am incredibly excited to be working through the plans and tactics to reduce our debt

PLANS

• As we work to finalize our plans, we are focused on a few things:
  o First, addressing what is most economical
  o Second, improving our maturity profile
  o And finally, remaining mindful of the current and forecasted rate environment for refinance transactions
• Again, we are working on our plans, and hope to finalize them soon
• One final point on the capital plan
• Our objective remains to manage to a lower Bank Tier 1 leverage ratio, of 9.0% by year-end, with continued annual reductions to a target of 8.0% in 2016
  o While we cannot predict the timing or likelihood of the regulatory approval required to do so, it is our objective and we are focused on it
• We hope to have more to share with you by our next earnings call on this topic
QUESTION AND ANSWER SECTION

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

So the first question I have is, you’ve been seeing some really nice acceleration of your net new account growth, but your net new asset growth is actually lagging behind that a little bit, and it looks to me that 2014 is on pace to be your slowest year for net new asset growth since probably around 2008. So I was curious if you can explain kind of what leads to that lag between the really strong net new account growth and the slower net new asset growth, and then probably more importantly talk about what you think you can do to accelerate that net new asset growth from here?

Paul Thomas Idzik
Chief Executive Officer & Director

Well, Patrick, I’d be careful not to draw any conclusions and draw a trend line from one quarter. Part of what contributed to that difference in ratio, if you will, if you think about it as a ratio, was ETCS had a slightly lower quarter as a result of some variety of actions with some of our larger clients, and since a third of our net new accounts come from ETCS that has an impact on our numbers. But what I’m excited by is not only the growth in accounts, again doing a fantastic job YTD relative to full years in prior periods, and getting those accounts in, and then we’ve also demonstrating how well we’re gathering greater shares of their wallet. I think we’re getting the job done quite well.

I didn’t hear the second part of your question, Patrick. You broke up a bit.

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

Yes, sorry. So the question was so you’re seeing the really nice growth rate in your new accounts, but the growth rate in the net new assets has been lagging that a little bit. So I’m just curious is there a reason why the net new asset growth has been a little bit slower, and kind of what specifically you think you can do to try to reaccelerate that a little bit?

Paul Thomas Idzik
Chief Executive Officer & Director

Well, in the second part in terms of reaccelerating, again we look carefully at the quarter and understand the impact of some perturbations caused by changes in what happened within the corporate sector of ETCS. But the change in approach to marketing to be not only focused more on prospects and their unique requirements, but spending much more time understanding existing customer needs, and marketing and making ourselves available to existing customers has demonstrated in increased wallet share. So we feel good about migrating those net new accounts to larger and larger relationships over time, again, on our customers’ own terms. Does that get your question answered?

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

Yes, thank you. And then my follow-up question would be probably for Matt. So you talked about the growth in the sec lending business, those being a big driver for the net interest spread kind of coming in where it did. Is there something structurally changed at this point with securities lending that this is kind of the new run rate?
Because it’s not just you guys. It’s Schwab. Ameritrade’s had strength with this, too. Is there something going on that has just made this a sustainably better business for you?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Well, Patrick, I think a couple of things. One, keep in mind, the stock lending business in general is going to trend with the margin lending business, right. So the more margin you have, the more stock there is to loan out. So I think as margin has grown, there’s more stock loan to be had. The nature of the stock loan business is definitely going to be more volatile from an earnings standpoint, right. When there are certain stocks that are hard to borrow, you earn a lot on those stocks, and that can go away in an instant. So I think the nature of the business is a little bit more volatile. To answer the question, no, I don’t think there’s anything structurally. I just think it points to one of the many different revenue streams that really comes from our business. It’s not just commissions. It’s interest, which includes margin and stock loan. There’s fee income. There’s a lot of different things, and I think we’re just highlighting one that’s performing quite well right now.

Patrick J. O’Shaughnessy  
Raymond James & Associates, Inc.

Got you. Appreciate it. Thanks, guys.

Paul Thomas Idzik  
Chief Executive Officer & Director

Hey, Patrick. I have one for you.

Patrick J. O’Shaughnessy  
Raymond James & Associates, Inc.

Yes, sir?

Paul Thomas Idzik  
Chief Executive Officer & Director

What do you think of the call last weekend?

Patrick J. O’Shaughnessy  
Raymond James & Associates, Inc.

I think that it was not pass interference.

Paul Thomas Idzik  
Chief Executive Officer & Director

You’re a good man, Patrick.

Chris J. Allen  
Evercore Partners (Securities)

Just wanted to follow-up, I guess, quickly on the sec borrowed stock lending topic. I mean, judging by the color you’ve given in terms of looking into Q4 so far, fair to say that obviously the margin balance has ended the period at a high level, the stock lending business continued at a fairly high level even with the volatility we’ve had so far to start the quarter?
Matthew J. Audette  
*Chief Financial Officer & Executive Vice President*

Well, I’d just say, directionally on margin and stock loan, they have pulled back a bit, not dramatically, pulled back a bit into October.

Chris J. Allen  
*Evercore Partners (Securities)*

Got it. Okay. And then just on compensation, I was wondering if you could give us any color in terms of the impact of incentive comp this quarter and on severance? And it looks like you guys continued hiring through Q3, so I’m just wondering kind of is the full run-rate of the hiring you’ve done this year in the compensation numbers going forward?

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

Yeah. So just looking at the sequential increase q-over-q, the incentive comp was the biggest driver of that. We reached some – as the financial results have been quite good this year, we hit some performance thresholds during the quarter. So you’ve got nine months’ worth of that incentive compensation in Q3. So that’s the primary reason why I would expect that to be biased down next quarter. That was a big driver.

I think the hires that we made, if you look at just the pure headcount in H1, especially in Q2, a lot of that hiring was done in the month of June or at the end of the quarter. So that was the big reason for the increase in Q3. I don’t see that same effect in a big way in Q3. So I think it’s really the incentive compensation, the severance that we certainly are not sitting here today having any of that assumed into Q4. That happens when it happens. So the incentive accruals are going to be the big drivers going forward.

Alexander V. Blostein  
*Goldman Sachs & Co.*

So I was hoping to spend a little bit of time on the HELOCs. I guess, Matt, if you guys could provide a little more granularity on the resets as we approach 2015. And obviously, we know the amount that’s resetting. But any sense of what’s the minimum payment today vs. what it’s going to be vs. kind of what people are paying today, just to kind of give us a sense of the actual net shock to the sort of the monthly payments?

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

Sure, Alex. So not much has changed there, all right. I can give you directional comments. The absolute size of these loans are relatively small, numbers you probably know, roughly $75,000 per loan. So the total payments they’re making today are relatively small. So the payment increases we’re talking about are a few hundred dollars a month, right. It’s not dramatic. It’s dramatic, of course, if you can’t afford $300 or a few hundred dollars a month, but it’s relatively small. I think what we’ve seen so far on the ones that have converted is consistent with what we’ve said the past couple of quarters, which is the population is still relatively small. Another three months have gone by. We like what we see in the category. There’s not a big dramatic credit event here, but it’s a small population. So we ground ourselves in that. But that’s what we’ve seen so far.
Got it. And then from, staying on HELOCs for a second, in the prepayments that we’ve seen, obviously continuously going up in dollar terms and now seeing it in percentage terms as well. Is there a wide kind of distribution between the years where these HELOCs amortizing and what they’re prepaying? Or do you think it’s kind of evenly spread? So if somebody’s starting to amortize in 2015 vs. somebody who’s amortizing in 2016, there’s not a huge divergence in what the excess payment these people are making right now?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah, there’s no dramatic difference, Alex. I think the primary point there is that our people are making voluntary prepayments. Whether they’re refinancing out or they’re just making small curtailments, the balances continue to get smaller. The biggest bucket remains in 2016 at around $1B, but there’s nothing to infer about as we get closer to it that the voluntary payments are spiking in a big way in 2015. There’s nothing dramatic to highlight there. I just think the broad point that they continue to pay down is the important one.

Richard H. Repetto  
Sandler O’Neill & Partners LP

Yeah. Hi. My question first is for Matt, the pugnacious guy that he is. The NIM – the funding rate on the FHLB advances dropped by 49BPS. Just trying to see, I don’t think you made it – spoke to that in the prepared comments. Was there anything going on there when balances were pretty much the same?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah. Rich, I did not address that in the prepared comments. It’s a good question. So a lot of the wholesale funding is a mix to both the FHLB advances and the repos, our mix of wholesale funding combined with hedges, a lot of which we have terminated. So there’s a lot of expense amortizing against those, and there’s just simply an old hedge where it reached its amortization term and then it rolled off, meaning you would expect to see a similar rate on that line going forward.

Richard H. Repetto  
Sandler O’Neill & Partners LP

Okay. And then just one follow-up on the home equity guidance that you’ve given. So if things didn’t meaningfully change or change, are we just getting out of some precision on – are we just being conservative when we’re guiding to sort of towards the high end of the provision because of the amortization?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah, Rich, so I think – and keep in mind, I’m giving our overall views over the next couple of years. So where we sit today, right, the home equity provision has been pretty consistent in the $20mm roughly a quarter range, and that’s how we see it in the near term. We just want to make sure that we highlight, we actually get into the meat, into the heart of these amortizations in 2015 and 2016. Everything else being equal, you would think it would migrate up from where it is now, right. So that starts to put us into the higher end of the range on the home equity side. And then you add to that that the reserves on the 1-4 side are now down to such a small balance that that natural offset that we’ve seen for the past couple of quarters, that’s landed provision down in the $10 million-ish range, that’s not going to be there, so it’s really just highlighting that. There’s no new information that we’re really using to highlight that. I think it’s just really highlighting the natural trends that we’ve seen over the last couple of quarters and how they would play out over the next couple of years.
Okay. And then one last thing for Paul. It seems like it was going around the industry, there’s a lot of talk about these online advisory firms that – robo advisors, as they refer to them, and when you look at what you’re trying to do, Paul, grow sort of change the complexion of the P&L, more fee-based with managed accounts, and your focus on the new branding on Type B and digital people are very comfortable dealing in a digital world, it would seem like a perfect blend in your strategy. So I was just trying to see, have you looked at this? What are the plans? Is it a build or a buy, if you do think it’s something you’ll get into, as far as online advice?

Thanks, Rich. While the term robo-advisors has been relatively new and certainly received significant airtime lately, it’s actually something that’s been core to our offering for quite some time. Our model, as you know, is focused on empowering self-directed investors and traders through digital technology and supported by professional advice when they seek it, our education tools and guidance. So we’ve always been focused on online tools that deliver advice, help customers determine allocations, help them make better decisions, and we’ve had an online advisor tool for quite some time that is quite part of our offering to customers and is completely free to use. So these type of tools are part of our DNA. It’s something we continue to refine every day as we go to deliver for our customers, our tool works across investing styles and doesn’t try and direct someone to a particularly pre-canned idea of what’s right for them. And the true self-directed investor can get a truly customized portfolio, mapping to their needs for as little as the cost of placing the trades, which is to put themselves in position with the portfolio. So, we feel that we’ve been in this business for a while and I guess my regret is I didn’t coin the phrase robo-advisor and charge a penny for every time it appears in print.

You’d get a high evaluation if you did for that tool. Anyway, that’s all I had. Thanks.

So, the first question I had actually relates to yield curve expectations. There appears to be a growing consensus among many of the market participants that we speak with that if and when the Fed begins to hike rates, that we could actually experience more of a flattening yield curve vs. a parallel shift. And I was hoping you could maybe just speak to how we should think about that potential earnings impact if that scenario plays out, with of course the all-important caveat that the evolving composition of your balance sheet could certainly alter the future forecasting there?

Sure. I think, one, our view is on the long-term spread potential of our balance sheet as 300BPS have been our reviews for quite some time. And I think the thing to keep in mind in that commentary is where we make our money. We make our money on the deposit side, right? So raising money cheaper than it would cost us to go borrow it. We’re not making our money on taking interest rate risk and moving up the curve. So I think I feel comfortable where we’re headed on the interest rate side and getting those 300BPS. As a general statement, right, the flatter the yield curve, the harder it is to make money, right. There’s no getting around that. But we don’t get caught up in the short-term movements or speculation on where the curve is going to go. We know we’ve got a
great business model that will generate a lot of net interest income today and more as rates go up. So we’ll just keep focused on running the business.

Steven J. Chubak  
Nomura Securities International, Inc.

Okay. Thanks. I just have one follow up relating to the provision guidance. Matt, it sounded as though you believe that it’s going to stay at the higher end of the range for the next couple of years and I suppose where I’m struggling a little bit is trying to reconcile the guidance which seems overly conservative in the context of where your reserves are today and the loss experience that you’ve had and relative to even with the net charge-off or the step off in charge offs that you could experience given that your loss coverage is so elevated. I suppose I’m just trying to understand exactly how to think about the allowance for loan loss reserves in that trajectory even with the step up in the provision given that you’re already been preparing for this for such a long time?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah. So I’d say a couple of things. First and foremost, a lot of the guidance starts with when you look at the 1-4 family reserves, right? We are down to $27mm, right? I don’t think it’s a stretch to say that the – and just using this quarter as an example. Provision was reduced $16mm simply from the 1-4 family bucket. That is, we are at the near end of that continuing. So then you move over to, okay, what is the reasonable estimate where home equity is going? We’re sitting here at Q3 2014, the vast majority of amortizations are ahead of us, right? They’re not behind us, they’re ahead of us. So I think the natural assumption that that number would be biased up slightly is a fair one. But I think the caveat that I would have, that I had in the prepared remarks and I would have now, is this stuff is incredibly difficult to predict. So I’m answering a very specific question, but this stuff is hard to predict.

We’ve never had the scenario we’re having right now where loans are going to hit the amortization period and have gone through a period of declining home prices for so long even though they’ve recovered significantly recently. No one’s ever gone through this before. But all that being said, I think it’s reasonable to assume that provision would go up slightly, that the 1-4 family releases are going to stop, and that’s what gets us to thinking, we’ll be at the higher end of the range. Keep in mind, I’m talking about over the next two years, right? I’m not talking about next quarter, right. Next quarter we’re biased to a level closer to where we were this quarter, but again, biased up a little bit because of that 1-4 family issue. So hopefully that gives you context to our thinking.

Michael R. Carrier  
Bank of America Merrill Lynch

Hey, Matt, just on the net interest spread outlook, so you gave some color on Q4. Just when you’re thinking about 2015, assuming that the margin balances hold in this level, your securities lending can continue, just based on where the rate outlook is and maybe keep it at a 2.50% ten-year, but then just the roll-off of the loan portfolio. Are you still thinking like a 2.40% range for next year? Or has that shifted?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah. So, Mike, we’ll give 2015 views and guidance on the next call. I mean, I think the thing to keep in mind is just at the margin levels and stock loan earnings levels that we’re at right now, those are really big drivers, especially looking at the last couple of quarters, right? The movement in that has meaningfully moved spread from what we expected just given those moves. So we’ll have our thoughts on 2015 next quarter. For now I’ve just got what I said about Q4.
Michael R. Carrier  
Bank of America Merrill Lynch

Okay. And then just as a follow-up. So in terms of the capital deployment, you guys have been real clear on the debt pay-down. I guess, longer-term, if you think that there is more opportunity to move some of those deposits back on balance sheet, like what are the hurdles in terms of getting past that $50B, like in terms of whether it’s cost systems, just what would it take for you guys to do two to three years out to get there?

Paul Thomas Idzik  
Chief Executive Officer & Director

We talked about this the last call and it turned into an analysts feeding frenzy and dogs breakfast. So, Matt’s been pretty clear about our priorities in the near term. Number one is, taking a bite out of our debt load. And as we start to reassess our priorities, we’ll be happy to start communicating to you guys when we get there. But I’m not entering in this debate again, because you guys went into a bit of a feeding frenzy with not a lot of content last time. So that’s it on this topic.

Devin P. Ryan  
JMP Securities LLC

Well that just took one of my questions off the table.

Paul Thomas Idzik  
Chief Executive Officer & Director

Yeah, hey, I’m happy about that.

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Hey Devin, don’t ask about 50, buddy. Don’t do it.

Devin P. Ryan  
JMP Securities LLC

I won’t. But, just a quick follow-up here maybe on the net interest spread question. So, cash flow hedges have obviously limited, I think, some of your downside from falling rates in recent years. And so, just trying to understand that dynamic a little bit better, and how you guys use the interest rate hedges? Are they constantly rolling on and off? Or is there more of a maturity schedule there, so we could maybe think about there is some point in the future where you lose some of the benefit. Just trying to think about the dynamics since you guys are very dynamic around managing your balance sheet?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Yeah. So the interest rate risk philosophy, Devin, hasn’t changed, which is, we look to run at minimal levels of interest rate risk. Now the balance sheet content we had in the past, right, the place that we chose to put those interest rate derivatives and manage that risk, a lot of that was on the wholesale book. So you see that specifically rolling off in those line items. But that hasn’t changed our interest rate risk philosophy, right? So we continue to focus on minimal risk. You can do that in a bunch of different ways in the types of securities that you buy, the duration of the securities that you buy. So there’s lots of different ways to do that, and that hasn’t changed.
Got it. Okay, great. And then just maybe lastly with respect to data tracking, and you guys seem to be very data driven, at least since Paul and Navtej joined. Just around some of the metrics that are important, whether it be funding rates. I mean can you give any update on progress on funding rates? I think you’re up to 58% at least last time we spoke from 50%. I mean where some of the kind of important data on the brokerage side, can you give any update on where those metrics are trending?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President  
Yeah, Devin.

Paul Thomas Idzik  
Chief Executive Officer & Director  
We’re looking for that data, yeah.

Matthew J. Audette  
Chief Financial Officer & Executive Vice President  
Yeah. I don’t see any, nothing to add there, Devin. I think the metric you’re referring to is the increase funding rate on our new online application. I think we’re still pleased with that. I don’t think we have an update on what that data is today. But we’re happy with the performance. It’s one of the things driving the new account metrics that we talked through, the new asset metrics we talked through. But we don’t have a specific update on that.

Devin P. Ryan  
JMP Securities LLC  
Okay. More like the stock [indiscernible] (39:17)

Paul Thomas Idzik  
Chief Executive Officer & Director  
Devin, that’s a really good question. We’ll try and bring some of that next quarter. That’s a very solid question. The reason I’m struggling is we were looking at that earlier today, and for some reason, we just don’t have those numbers in-hand right now. But we’ll make sure we cover that next update.

Joel Michael Jeffrey  
Keefe, Bruyette & Woods, Inc.  
Most of my questions were asked and answered. Just a quick one though. Can you talk a little bit about how the sort of typical activity of one of your mobile clients might compare to a more sort of average client? It does look like the DARTs coming from mobile was pretty consistent with last quarter. But I think we’ve heard from some of your competitors that they tend to be a bit more active.

Paul Thomas Idzik  
Chief Executive Officer & Director  
I’d say, first of all, we’re pleased with the engagement we have with so many of our customers across multiple platforms. And it’s one of the reasons why we’re not just investing in one place in which we reach our customers, but all of them, including our branches and our call centers. But to answer your question, our individuals or clients who use our mobile app to trade tend to be a bit better-heeled. They trade more often, and they’re amongst
our most engaged customers in terms of using the full spread and depth of our capabilities and what we offer at E*TRADE. So we’re quite excited when we start to see people use our mobile apps to a fuller extent because they tend to turn out to be better customers over time.

Joel Michael Jeffrey  
Keefe, Bruyette & Woods, Inc.

But there’s nothing you could give us to say that they potentially trade one more time a month or anything along those lines?

Paul Thomas Idzik  
Chief Executive Officer & Director

I don’t think – that’s not something we would typically share.

Kenneth W. Hill  
Barclays Capital, Inc.

Just had a quick question on the advisor franchise there, so you’ve got about, I think a little bit over 300 financial advisors, I’m wondering if you’re seeing a little bit more demand in the current environment right now and if you have any plans to really step that up, particularly if we enter a more volatile environment here.

Paul Thomas Idzik  
Chief Executive Officer & Director

We’ve been working quite hard to improve the tools and training of our financial advisors, as well as the type of branch atmosphere we’d like across the country. Our intent is to not only continue to invest in the tools to support our financial advisors so they can support our customers better, but we are in the process of trying to add well-skilled, client-focused advisors and hope to reporting higher numbers of advisors over the next several quarters.

Kenneth W. Hill  
Barclays Capital, Inc.

Okay. The other question I had, I guess in the current environment we tend to hear a lot about cyber security and a lot of attacks and even potential breaches on data. Wondering if you could speak to how that’s impacted your business and maybe what activities you guys are taking or – and also potentially, I guess, any additional costs you might see longer term because of increased scrutiny around that area?

Paul Thomas Idzik  
Chief Executive Officer & Director

Yeah. Well, we don’t break out our expenses in that level of granularity, I think it’s safe to say we are spending more both in terms of hardware, software, and highly skilled technology engineers to keep track of what’s happening 24/7 in our environment. We’re increasingly and to a level of paranoia around cyber security, protecting our customers’ personal account information is our top priority. And we are continuously investing in this area. Additionally, I think it’s important we work with government institutions and also collaborate with others in the financial services industry to share information so that we can continue to keep our skill set sharp. It’s a never-ending battle out there on this front. And just can’t let our guard down. And our customers expect us to stay sharp on this and we are, indeed, trying to do so.

Daniel T. Fannon  
Jefferies LLC
Just one for me, I guess, in terms of your balance sheet and the data, how would you characterize the debt markets today for potential refinancings for E*TRADE?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

Well, Dan, they are incredibly volatile, especially on the high yield market where we would issue. If you just go back week, week and a half ago, things got so volatile there were very few people doing anything. If you went to the few weeks prior to that, the markets were incredibly good. And sitting here today, they’ve absolutely firmed up a bit. So hopefully take from those comments that we monitor them closely. And I think we’d be in a position whenever it made sense to do to, to make a judgment when it made sense to do something vs. not.

Chris M. Harris  
Wells Fargo Securities LLC

Couple quick ones on the expenses, Matt, you talked about the downside risk to NIM if rates really stay depressed for a while. Just wondering what kind of flexibility you guys might have on the expense side of the ledger. I know you recently upped the expenses a little bit to invest for growth. Could any of that be on the table if we had really low rates for a long while? Or might you not want to sacrifice growth just for the sake of offsetting pressure on the NIM?

Paul Thomas Idzik  
Chief Executive Officer & Director

We’d absolutely look at our expense position if we had a prolonged period of slowdown. We’re pretty happy with how we’re investing both in terms of where and our approach to it. And let me give an example, we’ve done a pretty thorough job of trying to make as much of our investment profile not only subject to some pretty rigorous screens inside, but as bite-sized as possible so that it’s more flexible and more able to be steered one way or the other in the future. At the same time, you can appreciate that once you’ve started the project, one of the toughest things to do is stop it mid-stream because the shareholders really don’t benefit from that initial spend if it’s a well-purposed, business-oriented, customer-facing, or regulatory topic. So we’re staying on top of it, and of course we have some flexibility and we’ll continue to monitor it in the future. But again, as I said on a different topic, we want to make sure we don’t overly respond to a swing one quarter one way or the other.

Chris M. Harris  
Wells Fargo Securities LLC

That makes perfect sense. And I’m sure you guys said it and I missed the number, what’s the operating expense guidance for next quarter?

Matthew J. Audette  
Chief Financial Officer & Executive Vice President

So closer to Q2 levels, right? So low to mid $280s million.

Brian B. Bedell  
Deutsche Bank Securities, Inc.

Just a quick question for Matt and then another follow up. Just on the NIM outlook again for Q4, I just was unclear whether that includes the current rate back drop. And then, I think you mentioned obviously if we got to those extreme levels, is that meaning that like 1.95% ten-year at the extreme levels that would be the more material pressure on to them?
Matthew J. Audette  
*Chief Financial Officer & Executive Vice President*

So, in the short term, Brian, there’s, the big drivers are going to be margin and stock loan, right? Even the volatility in interest rates on an individual quarter basis, right, with margin stock loan driving such a large piece of our spread combined with our philosophy and taking minimal interest rate risk, there wouldn’t be any dramatic short-term movements, right? You’d have to have a serious movement in interest rates to see that. So my comments were more that margin and stock alone are going to drive things. And if we do return to the extreme low levels of rates we saw last week for a long time, that would impact us over the long-term but not much in the short term.

Brian B. Bedell  
*Deutsche Bank Securities, Inc.*

Right. Right. And then just on the level of margin and stock loan for your – that’s implied in your fourth quarter guidance, is that more of the trend that you’re seeing now in October? Or more of Q3 levels?

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

Yeah, no. More third quarter, I’m giving you more comments on where if we held where we exited Q3, that’s what Q4 would look like.

Brian B. Bedell  
*Deutsche Bank Securities, Inc.*

Got it. Okay. And then just on the capital, as opposed to the questions on the use of the capital, just more about the plan with the fed in terms of stepping down to the 9% and the 8.5% and the 8.0%. I guess how should we – should we be modeling this over the 3-year period? Or should we be thinking that as you have a leverage ratio that’s likely going to be 10.5% or better next quarter that we should be managing that down to 9% in terms of our expectation of dividending that cash up to the parent which would imply a good at least $300mm, $400mm or more instead of the $75mm. Or should we just be thinking about this over say a 3-year period?

Paul Thomas Idzik  
*Chief Executive Officer & Director*

We – let me try this one, Matt – we’ve been sending messages around this for quite some time and the inference to you should be that we’ve not really changed our intentions. We, in the near term we plan to continue requesting $75mm per quarter. In the meantime, we’re focused on taking down our leverage ratio to our targeted 9% by year-end. We feel very good about our regulatory relationships. We have active, and quite frankly, constructive dialogues with our regulators, but can’t predict the timing or certainty of achieving exactly that objective of 9%. And we hope to provide more by our next earnings call, not only on the use of the capital, but how we’re doing on this ratio. So I hope that lets you know that we’re not taking the eye off the ball on this one and that we continue to have that as a goal for 2014.

Brian B. Bedell  
*Deutsche Bank Securities, Inc.*

Right. So is it just in getting down to that 9% that would imply a much higher dividend, $75mm. Do I have that correct? Or can you have both the $75mm and the 9%?
Paul Thomas Idzik  
Chief Executive Officer & Director  

That, your math is absolutely correct.

Brian B. Bedell  
Deutsche Bank Securities, Inc.  

Okay.

Matthew J. Audette  
Chief Financial Officer & Executive Vice President  

Brian, it would absolutely be much higher. But I don’t know if at the last point there you’re saying you get down to 9% and do $75mm. It is -- if we are successful in the objectives that Paul I think highlighted quite well, there would be an amount of capital much larger than $75mm that would come out to get you down, right. Sitting here at our balance sheet ties today at 10.4%, right, that’s $500mm or so to get you down to 9%, right, so it would be, if successful, a much bigger number.