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E*TRADE Financial Corp. (ETFC)

Q2 2015 Earnings Call

CORPORATE PARTICIPANTS

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Chief Executive Officer & Director

Michael A. Pizzi
Executive Vice President and Chief Risk Officer

OTHER PARTICIPANTS

Richard H. Repetto
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Chris M. Harris
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Steven J. Chubak
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Daniel T. Fannon
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Bank of America Merrill Lynch

Brian B. Bedell
Deutsche Bank Securities, Inc.

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RBC Capital Markets LLC

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
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Paul Thomas Idzik
Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Core Activities

- While the retail trading environment was dampened by seasonality, the pace of our progress remained solid
- In core activities, we continue to demonstrate the resilience of E*TRADE's model, growing accounts and assets and hitting several notable milestones
- We delivered on our commitment to do more for our customers, rolling out a number of new or enhanced products and services, including an upgraded retirement center and our groundbreaking app to the Apple Watch
- We also further sharpened our focus, deciding to sunset our non-core Global Trading platform

Capital

- On the capital front, our risk profile extended its trend of steady improvement, while we continued to advance the ball for shareholders on the capital plan, navigating well the second annual DFAST process, distributing more than \$140mm to the parent, and completing the steps to move our Clearing broker from under the bank
- We also transitioned our finance leadership, welcoming a new CFO from within our executive ranks
- In summation, we had a lot going on, got a lot done, and started H2 in a position of real strength, focused on continuing to deliver for our customers and our owners

E*TRADE CLEARING

- Elaborating a bit on the capital story, we completed a number of important components of our plan, most notably were steps to move E*TRADE Clearing
- We completed the move on July 1, hitting the mark on our commitment to do so in the latter half of 2015
- More than a matter of stellar marksmanship, the team under Mr. Pizzi's aegis, devoted significant time and energy to ensuring the transition was a smooth one, including:
 - Determining funding and capitalization and completing the work to secure additional external lines of liquidity
 - Bringing the total to approximately \$900mm
 - And contributing \$150mm in capital from the bank
- We are pleased to have completed this

DODD-FRANK ACT STRESS TESTS

- We are now directing our focus towards what's next
- We also completed the second annual Dodd-Frank Act Stress Tests
- While not surprised, we are proud to say that our bank performed well under all stress scenarios, remaining above regulatory well-capitalized minimums by a healthy margin with bank Tier 1 leverage remaining above 10% even when stressed most stringently, and our risk weighted measures remaining at more than four times the regulatory minimums
- It's worth mentioning that the stress tests utilized a reporting data as of Q3 last year and our legacy risks have diminished significantly since then, including a reduction in total loans of more than 15%
- Overall, we are pleased with the results and feel good about the feedback we received from our regulators regarding our capabilities and methodology

CAPITAL USAGE

- Today, we are in a very respectable position when it comes to future capital usage
- Having knocked out some big-ticket items in the form of material reduction in debt and extracting once-trapped value from the bank through the brokerage moves, we march forward in determining our next capital initiatives
- Mr. Pizzi will provide you with more details on our current thinking in just a few moments

Executive Appointment

- Turning to our financials, I feel it's an appropriate time to formally introduce our new CFO, Michael Pizzi
- Mike took the CFO baton in mid-June after having been with the Company for more than a decade, latterly serving as our Chief Risk Officer, and before that serving a number of years as our treasurer
- Mike is a strong, proven leader, and his expertise, regulatory experience, and considerable intellectual firepower make him an ideal fit
- As you all get to know him, I'm sure you'll share my opinion and value the dialogue with him
- I'm also certain that under Mike's leadership, we will resolutely prosecute our capital plan, maintain strong oversight of our Finance function, and continue to execute on other important financial initiatives

EPS

- As for the quarter's results, we recorded earnings of \$72mm or \$0.25 per share
- This excludes \$220mm tax benefit related to the favorable outcome of an IRS audit
- The quarter also included some unique items within our compensation, FDIC, and other expense lines:
 - The first \$6mm in compensation related to the departure of former CFO
 - The second, \$9mm in other expenses related to a contract amendment with our former subsidiary, G1X
- In a nutshell, we renegotiated the order routing agreement with our partners at G1X to provide us with greater flexibility and optionality as part of our staunch commitment to deliver the best possible execution for our customers

FDIC Expense

- And last, our FDIC expense dropped sequentially by \$7mm
- This expense reflects the calculation of both quantitative and qualitative assessments of risk, including the composition of the balance sheet, and overlaying regulatory judgment
- We've indicated for some time that we expected our FDIC rate to ultimately reduce significantly, and that is exactly what happened in Q2
 - This is a strong testament to our progress de-risking, and improving our regulatory standing
- Going forward, we expect the FDIC rate will be approximately 8BPS on total assets, as opposed to the previous run rate of around 20BPS

Non-Core Global Trading Platform

- Before we get into metrics, I want to highlight a business decision made under the ministrations of Mr. Pizzi during the quarter, which is to discontinue our non-core global trading platform
- We found that it did not have the scale to justify the associated expense, capital, or energy

- The accounts we did have, while reasonable in absolute quantum, weren't actively used, particularly as customers can access much of the same international exposure through our core US trading platform
- Importantly, we do not expect a significant outflow of assets related to these accounts as most of the customers are simply consolidating their investments into other E*TRADE brokerage accounts
- We began the closure process in May and expect to complete it in early Q3
- In total, we expect to close approximately 24,000 accounts, of which 3,300 were recognized in Q2 with the vast majority expected in July
 - This decision allows us to focus these resources on core products and services for our customer base

Brokerage Metrics

- Our brokerage metrics reflect some seasonality as the quarter opens at the zenith of tax season in April and closes as we head into the lulls of summer trading
- DARTs of 149,000 were down 12% sequentially, with options representing a steady 23% of total activity
- As volatility rose sharply in H1 July amidst market turmoil in China and the melodrama in Greece, customer trading volumes have increased slightly, up 6% from June

Mobile

- Mobile continued to represent an increasingly important component of our trades reaching a record 14% this quarter, compared to 11% a year ago
- And underscoring the increasing trend of mobile adoption, roughly one-third of our unique logins during the quarter were through our mobile apps
- We have also seen positive traction with our most recent Apple Watch app, with already 5,000 downloads since it launched in April
- Margin balances remained healthy during the quarter, even as the equity markets cooled slightly
- We ended the quarter at \$8.1B, just shy of the prior quarter's record high

New Brokerage Accounts

- We reported net new brokerage accounts of 19,000 during the quarter with the metric reduced by two items: First, approximately 3,300 accounts related to global trading as I just mentioned; and second, circa 3,500 accounts due to escheatment, an outsized number compared to normal levels as it related to a more comprehensive process concluded in May
 - Excluding these two items, net new brokerage accounts would have been approximately 25,000, with a normalized attrition rate of 8.7%, consistent with the prior quarter
- Net new brokerage assets were \$900mm during the quarter, down considerably from Q1, largely a result of seasonality during tax season

Retirement Products and Services

- We have been diligent in our efforts to expand awareness of our retirement products and services
- As a testament to the team's hard work, these assets have grown by more than 50% in just three years and have represented about one-third of total net new brokerage assets over the past two years
- Furthermore, we continue to see stability in our managed assets, which ended the quarter at \$3.2B

- As part of our effort to continue growing this element of our customer relationships, we revamped the retirement experience on etrade.com, creating a cleaner, simpler design, with inviting content that helps customers engage and take charge
 - It offers interactive widgets customized to each account, demonstrating the benefits of disciplined saving and investing; an account wizard that helps direct customers to the retirement account that is right for them; and personalized check-lists and to-do lists for each stage of an investor's retirement planning

Platform Enhancements

- In addition to the new retirement experience, other noteworthy platform enhancements are as follows:
- On our active trader platform, E*TRADE Pro, we rolled out a robust new tutorial experience, new plug and play layouts to support the unique needs of traders, as well as improvements to several other customization features
- We also simplified watch-list management and charting options and added the ability to trade tax lots across equity and options positions
- On etrade.com, we made a number of improvements to our stock plan participant experience and enhanced our bill pay functionality
- You will continue to see enhancements and innovations as we strive to better serve our customers in the fashion they find most relevant to support taking charge of their financial health
- I encourage you to stay tuned

CLOSING REMARKS

- One last item before I turn the call over
- I'd like to take a brief moment to express my gratitude for the service of our former CFO
- Matthew Audette was a faithful steward of E*TRADE and its finances for over 16 years, helping to guide the company through some of our most challenging times
 - We wish him the best in his future endeavors in sunny Southern California

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

FINANCIAL HIGHLIGHTS

Tax Benefit and EPS

- We accomplished a lot during Q2 and we posted good results
- Excluding the \$220mm tax benefit, we recorded earnings of \$72mm or \$0.25 per share for the quarter, compared to \$85mm or \$0.29 per share in the prior quarter, which excluded \$73mm pre-tax charge related to our landmark corporate debt transaction
- It also compares to \$69mm or \$0.24 per share in the year-ago quarter
- To quickly elaborate on the tax benefit, it resulted from an IRS audit of prior years' tax returns
- So essentially, years ago we took a conservative position on the deductibility of certain tax losses and have been working with the IRS for some time to resolve this position
 - This tax benefit also resulted in an increase in our deferred tax asset, which ended the quarter at \$1.1B, further increasing the shield against the payment of future tax dollars

Net Revenues, Interest Income and Net Interest Spread

- Turning back to the top
- Total net revenues were \$445mm in the quarter, compared to \$456mm in the prior quarter and \$438mm in the year-ago quarter
- Net interest income of \$267mm was down \$4mm from the prior quarter, as net interest spread contracted 12BPS, partially offset by \$1.2B increase in average assets
- The average balance sheet growth was driven primarily by third party deposits which moved back on balance sheet in conjunction with our new Sweep platform
- Although spread contracted sequentially at 25OBPS, it was in line with our expectations as interest rates remained challenging in the quarter
- If we hold today's environment constant, our net interest spread would be in the low 240 basis point range in Q3

BALANCE SHEET

Commissions, Fees & Service Charges and Other Revenue

- Our balance sheet ended the quarter at \$47.1B, up approximately \$300mm from the prior quarter
- Commissions, fees and service charges, and other revenue in Q2 were \$167mm, down 5% from the prior quarter but up 2% from the year-ago quarter
- Average commission per trade of \$10.96 increased 2 cents from the prior quarter and \$0.24 from the year ago
 - The y-over-y increase was driven largely by the mix of stock plan and option trades

Fees and Service Charges Revenues

- Fees and service charges revenues of \$55mm increased from \$52mm in the prior quarter.
- This is a result of more favorable revenue on third party deposit relationships and seasonally higher proxy fees, partially offset by slightly lower order flow revenue
- As you may remember from last quarter, with the rollout of the new sweep platform, we determined it appropriate to reclassify the revenue generated from off-balance sheet deposits into fees and service charges from net interest income
- Net gains on loans and securities were \$11mm this quarter, compared to \$9mm in the prior quarter and just above our expectations of \$5mm to \$10mm
- We expect to remain near the high end of the range if rates remain low, as they have been in the past couple quarters

Operating Expenses

- We recorded \$309mm in operating expenses for the quarter, inclusive of severance and the expense related to the G1X contract amendment
- Excluding these two items, our expenses for the quarter would have been \$294mm, compared to \$300mm in the prior quarter and \$284mm a year ago
- For the full year 2015, we continue to expect expenses to be within our previous guidance range of a low to mid-single digit increase over 2014
 - This is inclusive of the two unique items in this quarter's numbers, along with the benefit to FDIC expense

Loan Portfolio, Net Charge-Offs and Provision Expense

- The loan portfolio ended the quarter at \$5.7B, down \$412mm or 7% from the prior quarter
- This welcome decline was driven by higher than average prepayments among our borrowers
- Net charge-offs of just \$3mm across all loans were at the lowest level since Q3 of 2001
- Provision expense was also \$3mm, down from \$5mm in the prior quarter, leaving our allowance unchanged at \$402mm

FACTORS IMPACTING PROVISION

- There are a few factors impacting provision this quarter:
- First, similar to how we previously reserved for high risk home equity loans nearing conversion, this quarter we established a lifetime reserve on a subset of higher-risk one to four family loans
- Second, we made some changes to our modeling practices, which triggered a re-evaluation of the loss emergence period on loans covered in the general reserve
- Based on our review of recent loan performance, current economic conditions and their impact on borrower behavior, we extended the loss emergence period from 12 to 18 months
 - These changes largely offset the positive impact of faster prepayments, improving credit quality, and lower-than-expected defaults on the balloon loans that matured during the quarter

HELOC Portfolio

- As of June 30, the balloon segment of the HELOC portfolio was approximately \$120mm with an average of \$20mm scheduled to mature over each of the next four quarters
- Over the next several quarters, we continue to expect provision to fall within a range of \$0mm to \$20mm per quarter
- However, we are entering a period of increasing HELOC conversions, driving potentially greater volatility in future provision
- As our HELOC portfolio converts to amortizing loans, it takes a month or two following the event to get meaningful performance data, and we don't yet have that for the 2015 subset
- I expect we will have more data by Q4, and at that time will be able to provide clearer insight into the provision expense for 2016

Capital Plan

- Turning now to the capital plan
- It feels good to have the Clearing broker move behind us
- The entity was already capitalized well in excess of regulatory requirements
- However, we had to take steps to prudently bolster the position to meet funding requirements under aggressive stress scenarios. The \$150mm of capital moved from the bank addresses the permanent working capital position, and the roughly \$900mm in external lines meaningfully enhances the liquidity position
 - We anticipate these lines will cost us approximately \$3-5mm annually, depending on usage

Leverage Ratio, Dividend and Net Income

- As for our capital position, the bank's Tier 1 leverage ratio ended the quarter at 9.8%

- Pro forma for the move of the Clearing broker, it would have declined by approximately 50BPS, implying \$113mm of capital in excess of our targeted 9.0% leverage ratio
- The bank's net income for the quarter was \$114mm, which includes \$20mm from the Clearing broker
- We will seek approval to dividend the full amount to the parent in the current quarter
- In addition, the introducing broker generated \$30mm of capital during the quarter
 - And we intend to move that amount to the parent in the coming weeks

Corporate Cash and Debt Reduction

- Corporate cash ended the quarter at \$406mm, an increase of \$148mm from the prior quarter and well above our target of maintaining \$100mm
- Now, with debt reduction and the broker moves behind us, we are entering the next evolution of capital planning, no longer with pressing needs, but rather a host of strategic opportunities to evaluate, and I'm proud to be running point on these initiatives
- Each comes with a number of considerations, but I want to give you some context as to how we think about them: Balance sheet growth continues to be an attractive use of capital

New Sweep Platform and Composition

- And with our new sweep platform, we have the ability to operate close to the \$50B threshold
- In terms of composition, we are ever mindful of the possibility to accelerate the runoff of legacy funding and investments, including extinguishing wholesale funding obligations, disposing of the loan portfolio, and paying down trust preferred securities

Wholesale Funding

- With respect to the wholesale funding, we ended the quarter with \$4.5B of issuance obligations with \$315mm set to expire in H2
- While it is presently our intention to continue issuing those obligations, their termination would create capacity to onboard deposits, recasting our liability structure to be predominantly core-funded and low cost
 - However, doing so would also result in a loss of approximately \$420mm pre-tax

Other Funding

- In terms of other funding, we could redeem all \$433mm of trust preferred securities, of which the final 25% currently included in Tier 1 capital will be phased out in Q1 of 2016
- However there is a handful of reasons we are not overly anxious to do so at the moment, including the fairly modest associated cost of these notes
- As for the loan portfolio, there continues to be a mismatch between what they are worth to us and what they might sell for in the secondary market
 - So while we intend to continue to hold them on our books, as the size continues to shrink and we work our way through the conversions, the gap could meaningfully narrow and our strategy could change
- With respect to other uses, we continue to prudently invest in the business while being mindful of any unique future opportunities
 - This of course includes taking advantage of the scalability of our core brokerage platform through acquisition, or expanding our product and service offerings

Dividends, Share Buybacks and Capital Utilization

- And lastly, regarding dividends and share buybacks, while squarely on our radar until we achieve investment grade status, we remain restricted by covenants within our corporate debt
- The bottom line is that we are in a strong position when it comes to capital utilization opportunities
- Having deployed a significant amount to reduce our corporate debt, we intend to continue evaluating the best path forward, and will update you when appropriate

SUMMARY

- To summarize, we are in a position that we haven't been in for quite some time from a financial and capital standpoint and it's our goal to take advantage of this stance by continuing to provide value to our customers and shareholders
- On a personal note, I am excited to take on this new opportunity as CFO of such a tremendous company under the focused leadership of Mr. Idzik, and look forward to working with many of you

QUESTION AND ANSWER SECTION

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

Mike. I guess the first question – Mike, thanks for going through the capital initiatives. And but we have built – we've built a significant – your cash at – corporate cash at \$406mm, would we expect you to implement something in the quarter? We've been looking at these, the different alternatives for the last couple quarters. So would we expect some implementation in Q3?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Well, I think it's important to note with regard to ending cash across all the entities, not just corporate cash, that we took a fairly conservative position with regard to the movement of the Clearing broker and held more cash across all entities during that move and the complexity of that move.

As we were sizing the capital amounts that we wanted to move from the bank into the clear, the \$150mm that we talked about, we thought it prudent to hold more cash really at multiple levels. As far as capital utilization, we continue to study the alternatives and when we have something really to come back with we will. There's a lot of complexity and nuances to these. I did talk a little bit about the debt covenants and other items. We continue to work through those.

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

And I guess the one follow-up I would have and this goes right – speaks to your last answer. When – you've made real solid progress on the regulatory front, moving the clearing, the stress test impact, the FDIC premiums down significantly. And I know part of the process of looking at the wholesale funding was working with the regulators there. So I guess the question is – and you've also got the MOU removed at the OCC. So any additional – can you give us an update on the – what do you call it, correspondence with the regulators? Any update on the MOU with Fed and how you're working with the – I guess, on the wholesale funding conversation with them?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, Rich, taking that envelope at data points, you got a very perspicacious question so I'll answer it directly. We were of course delighted in Q1 to have the progress we've made, trying to run our business in a much better controlled and managed way recognized by the OCC in lifting their MOU. And I'm absolutely pleased to report that in Q2 we saw the same activity by the Federal Reserve Bank. And our MOU has been lifted by the Fed in Q2, and I couldn't be prouder as a team.

The discussions we have with our supervisors are, what I'd say close and continuous. And there's nothing we have talked to the individuals on this call about that we haven't had the opportunity and benefit of having conversations with our regulatory supervisors. So you can rest assured if we're talking about it on this call that we have had productive conversations with our regulators as well.

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

And can I just briefly follow. So the MOU from the Fed was lifted as well. Could you just briefly go through? I know I'm taking up too much time, but what the impact is of that? What that allows you to do?

Paul Thomas Idzik

Chief Executive Officer & Director

A

The impact of that as you noted of course is somewhat reflected in our FDIC premia. But what it really does, it just moves on a different – on a little different footing with the regulators in terms of either how quickly they might allow us to move and do certain things – we're just on a more stable regulatory footing and are having more discussions about the future of the firm and what we might do as opposed to the remediation that we were required to do at the MOU.

So if you will, Rich, we're more on the front foot in discussions with the regulators on shaping the future of the firm and what we want to do to grow the firm and do what we can to create value for our owners. And that dialogue shifted that way as opposed to still dealing with remediation. I mean, there's – just to be clear, Rich, we're not taking our foot off the gas on trying to continue to improve our regulatory standing in terms of what we're driving here and as well as the close conversations we have with the regulators helping shape how we build this firm better.

Chris M. Harris

Wells Fargo Securities LLC

Q

Another question on capital. Mike, if I heard you correctly, I think you guys are intending to dividend the full amount of excess capital at the bank up into the parent in the current quarter now that Clearing is separated. And I'm just wondering if you do that does that prevent you from potentially growing the bank balance sheet if you wanted to?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

You heard correctly. It's not the amount of excess capital; it's the amount of prior period earnings, which at the bank level was \$114mm. We do intend to apply to dividend that to the parent company. Certainly, giving our capital target of 9%, having more capital would allow us to grow the balance sheet. So moving that capital up to the parent does create the possibility of less growth to the balance sheet vs. more parent capital available. And

those are some of the things that we evaluate in terms of the positioning of the bank balance sheet vs. the corporate cash position and the capital alternatives that we are studying.

Chris M. Harris

Wells Fargo Securities LLC

Q

I see. Okay. And if you could maybe help us out with just reviewing really quickly what the covenants are with your data as it relates to stock buybacks? Are you completely prevented from doing them at this point or are there certain thresholds or triggers that have to be met in order to be able to buy back stock here?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes. Each debt instrument outstanding has slightly different covenants. But the most restrictive of them right now would put a limit of about \$100mm on buybacks. Now if that one was not in place, we would then fall to an earnings basket on the remaining items, which would be different by debt instrument. Without getting into the nuances or specifics we're talking, it's probably about a few hundred million dollars.

Chris M. Harris

Wells Fargo Securities LLC

Q

And that's in totality – \$100mm in totality or is that an annual number or...?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

That's the totality that it would grow and scale with earnings. Now I do want to add one important point. The covenants will go away if we reach investment grade status. So we took that into account when we sized the amount of debt outstanding and we pursued quantitative metrics consistent with an investment grade rating.

Obviously the assessment of the qualitative side of that is with the rating agencies and we hope that they conclude their work soon. But I'm sure they're looking for some degree of suitability of those metrics.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Mike, I appreciate all the color that you provided on the capital side. I was hoping to dig in a bit further, first relating to Chris's question. Are there explicit actions that you need to undertake based on the dialogue that you've had with the rating agencies thus far in order to obtain that investment grade status?

Is it going to actually require a portfolio sale or is it simply sufficient comfort with the current earnings trajectory that it can be sustained? I just want to have a better understanding of that, given the significant capital that you have and the share repurchase considerations.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes, I think it's more of the latter. In terms of the quantitative metrics on what we have achieved in terms of the debt profile and debt serviceability, we believe sets us at the quantitative level for investment grade.

From what they are looking at I think more, I think the important progress that we're talking about today in terms of what we have achieved with our regulators, the decline in expenses from the FDIC are all going to be very

important items in that assessment. But I think at this point I would say it's a qualitative assessment and it's sustaining the performance.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Okay. Thanks. And then maybe just on the topic of the – potential for a loan portfolio sale, obviously it will be dependent on the economics ultimately, but just thinking about the expense benefit that would be raised, clearly the FDIC assessment fee would go lower from 11BPS to the target potentially of 8BPS over time. You also have the lower servicing costs. Can you help us think through what additional cost benefits would be realized maybe in terms of risk management and resources allocated there, once the portfolio sale is in fact completed?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes, I think first just to clarify on the FDIC. The reduction in expense for this – in the quarter that we are reporting occurred intra quarter. So the run rate going forward will be about – just about 8BPS. What that means is the benefit on a full quarter basis is in the \$10mm to \$11mm range. Now, turning directly to the loan portfolio, sales of loan portfolio would cause a bit further of relief, but not really a material amount in terms of FDIC premiums.

So in Other Expenses you are really getting into – you're getting into head count and you are getting into some degree of professional services that we have deployed around the portfolio and certain other contracts for modeling and other items. We've never really broken those out. I'm not really going to break them out today, but it's a modest level of overall expense.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Okay. Thanks. And then just one quick follow-up for me regarding the FDIC fee rate. So the eight basis points is where you're running at currently. Is there any potential to drive that even lower, or is that lever been effectively exhausted?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

I would say it's effectively where it's going to be. The effective methodology, if you review it, does look at capital ratios. It does look at asset quality. Certainly parts of our – the remaining loan portfolio are still calculated in that methodology. But the items that we're talking about are going to move it in a very small way.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

Just going back to your comments on potentially using capital for balance sheet growth, can you give us an update on the amount of deposits you have off-balance sheet that you think you could bring back on?

And then I guess logistically speaking, if the \$50B capital is raised, how quick could you think you can bring them back on balance sheet?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, first of all, Conor, welcome to the call. First time you're running point for your firm.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes, in terms of the total amount of off-balance sheet deposits, there is about \$10B that's off-balance sheet. In terms of what we could bring back, it's about \$10B up to \$15B. Some of it can be brought back very quickly because it's already in a sweep deposit program, other a bit slower because it's sitting – it's in a money fund program, but all of that can be brought back. So over time, the amount's about \$10B and relative to the speed at which it can be deployed, it can be brought back fairly quickly.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

Thanks. That's helpful. And thanks for the well wishes. And on the securities deal, I think they declined a little more than I think I and a couple or two were expecting this quarter just given what happened with rates. Was there a change in your investment strategy or duration for the securities you guys are buying this quarter?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

No, there's not really a change in the composition of security, because the main driver there is prepayment activity, is an increase in prepayment speeds. Even though rates in Q2 are a little higher, prepayment speeds as you know lag from prior period rate effects. So the low rates we felt in Q1 drove a bit of a speed increase on the portfolio in Q2, and so the primary factor, it actually just amortization on the portfolio.

Conor B. Fitzgerald

Goldman Sachs & Co.

Q

And then the wash, we're pretty happy about that.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes. I think overall we're pretty happy.

Daniel T. Fannon

Jefferies LLC

Q

Just a question on the potential P&L impact if any around the global trading closure that you announced. As we think about modeling, is there any other line items that will be impacted by that?

Paul Thomas Idzik

Chief Executive Officer & Director

A

This is actually something that Mr. Pizzi started while he was in his Chief Credit Officer role. So he's been looking at this for a while. Mike?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes. The global trading business, really as we looked at it, starting from more of a strategic risk review as Risk Officer, now really seeing at the completion as Financial Officer is really a non-core business.

To give us some idea of trading volumes, it was 0.1% of all trades in the year 2014. So it's not a meaningful amount of overall trades. The product would have required some additional technology investment. It also was capital and efficient in terms of the capital exposures at the Clearing broker-dealer.

And given the need to reinvest, given the capital and efficiency, given that it didn't provide much in terms of revenue or trading, we thought it best to shut it down. And most importantly, I think to add is that the evolution of the market since the product was introduced gives customers the ability to really have these positions and exposures in their regular E*TRADE account, making the product really unnecessary. So really the growth potential of the product is really quite limited.

Paul Thomas Idzik

Chief Executive Officer & Director

A

And actually the much clearer tax positioning as a result as well for the customer.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes.

Daniel T. Fannon

Jefferies LLC

Q

Got it. And then I guess just a question on the provision. And I get your guidance and we are, but you continue to come in well below that as we did further into the amortization period. And so I'm wondering is – it seems as if even that while it's small in terms of where we are, the data you're seeing continues to be positive. So I guess if there's any other quantitative or qualitative comments you can make about your outlook for the credit of that – of the portfolio? And I'm thinking about it on a longer term basis.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Sure. The priority where we have some data to look at was really around the small portion of portfolio that's in balloons. That we can – we'd say is performing better than our original expectation. Around the larger portion of the portfolio and the end of draw, we really don't have much data yet. We said that of the 2015 end of draw risk population we would not really have that data until the back half of the year.

And so really, we really just start to see now a pickup in the amount of loans coming to that. So – and really, with looking at that we need to see the event occur; we need to see a population of data move through the delinquency chain before we can really reach any sort of assessment as to the accuracy of our model. We feel that we've captured the risk adequately and are very happy with the modeling approach that we've taken. But until we have that data, we're not going to know really significantly one way or another.

Christian Bolu

Credit Suisse Securities (USA) LLC (Broker)

Q

Just another question on credit provisions. Just on the 1-4 book specifically, provisions have been taken up there over the last few quarters. Feels like this quarter's spike up was more of a one-off – more one-time cleanup. So should we expect provisions in that specific book to maybe tick down from here or how should we think about those trends?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Yes. So this quarter, the provision in 1-4 family was directly affected by what I talked about in the prepared remarks. We took a special reserve on that population of high risk 1-4 family loans, so loans that we've identified as a pool of heightened risk. So that's additive to the allowance balance for the 1-4 family.

Also, the increase in the emergence period from 12 to 18 months will increase that allowance balance as more loans are now in the emergence period. And you are right to think that those two steps are really one-time items as the portfolio is static and in runoff mode. So from there that – as loans move through the period, they'll move out of that – they'll move out of the allowance balance.

Christian Bolu

Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. So just to be clear, if I look back through 2013, you released provisions there et cetera to tick back up from Q4 last year. But you're saying at this point, probably expect it to kind of go back down?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Well, I think I have to – so I would put it this way; if you just sort of assume all things equal on a declining portfolio, yes. But it will obviously be driven by entry-level delinquency, by underlying LTV, by changes in severity, so in any given period it could go up or down.

Christian Bolu

Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. That's understood. And just another follow-up question also on the securities yield. Just remind us what kind of reinvestment yields you're getting on your AFS and held-to-maturity books?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Yes. The marginal reinvestment rate right now is between about 150BPS and 200BPS; bounce around a little bit with rates during the quarter, but that's about where we've been averaging.

Christian Bolu

Credit Suisse Securities (USA) LLC (Broker)

Q

That's great. Thank you. And then on the off-balance sheet deposits, specifically the money market funds, just provide us an update in terms of the process of I think system changes, of customer notifications, how long that would take? Maybe any timeline you can provide there would be helpful.

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, for some of the money market funds of course that's a very specific choice by the customers. They could be in tax-advantaged product. How long it takes to essentially repaper those? That could take several months, maybe across two or three quarters actually to get that done.

Michael R. Carrier

Bank of America Merrill Lynch

Q

Just Mike, one question on the net interest spread outlook. So I guess you gave some of the reinvestment rates. When I put that together with the wholesale runoff and then the loan runoff, just wanted to get a sense in this like the current rate backdrop. Do you have sort of a range of like a floor and a ceiling where you guys can manage it with the current hedging strategy in place?

I know longer-term there's a lot of factors that will factor into it depending on what you do with the capital. But just wanted to get some sense, given the decline we saw and then some of your comments on the prepayments?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

Well, as I highlighted before, the decline that you see in the period from securities is really driven by an increase in prepayments. And that's really driven by some of the much lower rate levels we saw in Q1.

So looking at that overall level of volatility, that will go up and down as we see activity in prepayments move. Looking – in terms of spread, we think that the 240 basis point range really holds for – as we said in the prepared remarks, given the marginal reinvestment rate and given where other items in our business are now.

Obviously, growth in the margin book can significantly impact overall spread as well as the stock loan book. Those two are going to be more volatile in terms of the equity markets, but right now we expect them to hold up quite well.

Michael R. Carrier

Bank of America Merrill Lynch

Q

Okay. Got it. And then just as a follow-up, on the expense guide – and you say, low to mid single-digits. Just wanted to make sure, when you look at 2014, just because last year there were some items or charges during the year, just wanted to get maybe the base that's off. I think from how we're calculating it might put it around this level for the remainder of the year. But I just want to make sure we're using a good starting base.

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

I think it's – if you are talking about some of the larger special charges, obviously those will come out. It's the operating expense number that you can see for the full year there. I think it's around \$300mm or so per quarter I think is probably the right range of overall expense in terms of the low to mid single-digit number.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Maybe just to go back to the expense. Maybe just thinking about it from a run rate perspective, you are down to about \$295mm ex the one-timers and then the FDIC expense going down to \$290mm and then the other expense was a little elevated aside from that. So what would be the driver to bring that expense level up above \$290mm for the next two quarters?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Well, I think as we talked about the past, we've made a number of investments. Some of the investments – you heard me talk about in terms of risk on the last call. While we don't expect those – expenses there to go up, we have been making additional investments across the company in terms of technology and resiliency and now

beginning to make some more investments around customer experience and other items. Those are certainly the drivers of our overall expense picture from here.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Okay. So it's incremental to what's in the run rate right now?

Paul Thomas Idzik

Chief Executive Officer & Director

A

That's correct.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Right. Okay. And then maybe come back to capital, on the wholesale pay down, the loss of – the \$420mm loss obviously and considering – I think you were working on some tax sharing agreements. There were some complications in that analysis.

Just to get I guess a better sense of how attractive you think that is, it looks to me like it would be the most accretive use of capital. I guess what is the biggest holdback from doing that?

Paul Thomas Idzik

Chief Executive Officer & Director

A

Yes, I think when you look at the yield table you are calling it out quite correctly. It's very expensive liabilities. The marginal rate of reinvestment is quite low.

And you can look at just the absolute portfolio yields. So the accretion that you are highlighting there, we're well aware of that. Right now it is our intention to continue to issue the debt obligations to determine the issuance requirement, but we continue to study this. We have to take very carefully the absolute usage of capital from a Tier 1 regulatory capital perspective and be quite thoughtful about the usage of that \$420mm of capital to take that charge.

Brian B. Bedell

Deutsche Bank Securities, Inc.

Q

Okay, great. That's helpful. And then maybe just last on the – running the balance sheet closer to \$50B, looks like you do have some more room to do that in the near-term and this would be one I guess easy use of excess capital. But going back to the comment about the dividending the capital up from the bank to parent, the \$114mm that you mentioned, does that preclude you from running the balance sheet closer to \$50B in the near-term?

Paul Thomas Idzik

Chief Executive Officer & Director

A

The amount of excess capital that we have net of the Clearing broker move would put the ratio at about 9.3. Our target is nine, so there is some excess there. There is also capital generated within the period. So the dividend of the \$114mm of earnings does – would increase the capacity of the balance sheet if we left it within the bank. We think it's the right thing at this time to continue dividending the earnings of the bank up to the parent company. If we make a change there, we will discuss it and let you know.

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

Q

Okay. And maybe just lastly just on the NIM guidance and the 240s, is that entirely due to the securities book within your guidance or are there other significant factors in that guidance?

Paul Thomas Idzik*Chief Executive Officer & Director*

A

It's largely the securities book. We have seen a bit of compression in overall margin yield in terms of that book as well and there has been a small amount of compression in loan yields from the prepayment effect on the loan portfolio as well. So it's factoring all of that in into what the spread guidance is.

Bulent Ozcan*RBC Capital Markets LLC*

Q

Just a quick question maybe on the stress testing. It seems like you've been very successful; you've passed with flying colors. And my thinking would be that the regulators are very happy with you – with the progress that you've achieved.

So in terms of maybe crossing the \$50B threshold, what needs to be done to get over the threshold? What kind of investments do you still need to make, if any, as opposed to kind of waiting for regulatory changes that might or might not happen?

Michael A. Pizzi*Executive Vice President and Chief Risk Officer*

A

We're pretty convinced right now that we have a menu of opportunities to use capital that are attractive to our owners. And the \$50mm threshold is not one of the areas that are on our near-term menu.

Bulent Ozcan*RBC Capital Markets LLC*

Q

I see. Maybe on the NIM, so if you were to address the legacy issues and deal with the loan book, what will be the impact on NIM? I haven't run the numbers, but maybe you could just give us an update based on where we are today and the 240BPS NIM that you basically expected for Q3, if you have any changes there in rates? Have you kind of run the numbers? I was just want to get a sense of how attractive it is.

Michael A. Pizzi*Executive Vice President and Chief Risk Officer*

A

Would you clarify that question?

Bulent Ozcan*RBC Capital Markets LLC*

Q

Yes. So my – like my understanding was that the loan books, if you [indiscernible] (50:51) the loan books you also have to – that – if you want to get rid of the wholesale filing, you also need to deal with the loan books or kind of reduce your loan books. And I'm trying to get a sense of what the impact on your overall net interest margins would be.

Michael A. Pizzi*Executive Vice President and Chief Risk Officer*

A

Yes. I think if you look at the yield table, you can see the effect of yield to the loan portfolio. We've given sort of the marginal reinvestment rate of \$150mm to \$200mm. A good estimate might be to take the midpoint of that range. But of course a lot will matter here in terms of the value you realize on a sale, the capital impact in terms of modeling that.

So I think – rough numbers, you can get pretty close, but there's a lot of – there's a lot that has to be worked through in the specifics of any transaction. Obviously, as we said before, we intend to hold the portfolio. We feel that the value we can achieve is below – the value that we can achieve in a sale is below the value of holding it. But that could potentially change as market conditions continue to change.

Bulent Ozcan

RBC Capital Markets LLC

Q

I see. And maybe final one on the net interest – or net income at the bank, it was \$114mm this quarter, up from \$92mm. Was anything unusual there, or should we kind of think about that as a run rate and what might be dividend up to the holding company?

Michael A. Pizzi

Executive Vice President and Chief Risk Officer

A

No, you should not think of that as the run rate. That includes a portion of the tax settlement that went through the bank

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