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E*TRADE Financial Corp. (ETFC)

Q4 2015 Earnings Call

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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

Opening Remarks

- As always, it is a pleasure to share my thoughts with you
- Later, Mr. Pizzi will dissect the quarter, but first I'd like spend some time reflecting on what has been by all accounts a banner year at E*TRADE
- An adjusted net income of $340mm or $1.17 per share represents the company's strongest financial performance in nearly a decade
    - It is the product of exceptional efforts by our colleagues across the organization

Risk Profile

- We've come so far as a company to bolster our financial and competitive positions, and in the hall of accomplishments, the 2015 display case houses some of our most celebrated and hard-earned trophies
- During the year, our risk profile exhibited a step function improvement as the continued reduction in legacy assets was marked by two consecutive quarters of lowering reserves while our demonstration of enhanced enterprise risk controls among other things help solidify our regulatory standing
    - We embarked upon four major capital deployment actions emblematic of our improved position and greater flexibility
- And most importantly, we focused on the customer experience, bringing several digital enhancements and offerings to market while further sharpening our focus through the discontinuation of non-core businesses

Debt

- I'll start with our financial position
- Faced with tremendous opportunity, my colleagues rose to the challenge exceeding even our own demanding expectations
- To provide a highlight reel of our triumphs, we kicked off 2015 announcing regulatory approval to reduce our bank's Tier 1 leverage ratio by 50BPS to a level of 9%
- Reduced and refinanced our corporate debt to our target level of $1B at a blended average coupon of 5%, the lowest in company history

Capital

- Simplified our operating structure by extracting our broker dealer subsidiaries from the bank, which now serve as a more efficient source of capital for the parent
- Distributed more than $800mm of excess capital to the parent
- Terminated costly legacy funding sources from our balance sheet, markedly improving its profile and returns while creating capacity to fuel growth with the core customer deposits
- And began the process of growing the balance sheet to our target of circa $49.5B
    - Put in place and began executing on an $800mm share repurchase program
- And finally, announced yet another approval to reduce our targeted bank leverage ratio in early 2016, this time by 100BPS to 8%, a full year ahead of expectations

Accomplishments

- Our accomplishments numbered large and were significant in scope
- And we ended the year in a bountifully stronger position than we began it and, frankly, better and stronger than the company has been in more than a decade
- Notably, our progress and resulting position were recognized by our regulators and rating agencies across a few dimensions
- First, the MOUs at both the bank and parent were lifted early in the year
- Next, reflective of our much improved risk profile and regulatory standing, our FDIC insurance rates were cut by more than half

Balance Sheet

- And finally, we've received investment grade credit ratings for the first time in the company history, following seven notches of cumulative upgrades from our two covering agencies during the year with a BBB designation from S&P in August and Moody's following suite in December
    - While it is more than a pleasure to look back on these achievements, make no mistake that we are acutely focused on what is next, marked by our unwavering commitment to be faithful stewards of shareholder capital
- To that end, we are currently in the midst of executing two important initiatives
- First, we are steadily marching towards our target balance sheet size of $49.5B, which we expect to achieve in Q2

Share Repurchasing

- Second, we are actively executing on our $800mm share repurchase program announced in November
- Through year-end, we have purchased $50mm, and at January to-date, we have put another $26mm to work
- Meanwhile, we continue to evaluate other possibilities for capital deployment
- Beyond making prudent investments in the business, chief among these possibilities are potential acquisitions
- I've mentioned that we think of these in three broad categories, of which two continued to rise to the top of the list
    - Those are scale acquisitions in the brokerage business and opportunities to better capitalize on our customer deposits through banking

Banking

- On the brokerage side, we have superior platforms and systems in place and utilizing the scale inherent therein is attractive
- On banking, we see value in optimizing our low cost stable deposits through a more traditional approach
    - While an abundance of small and medium-sized opportunities exist in these areas, we are staying highly objective with an eye on delivering compelling returns on capital, ensuring our customers will be well served and remaining close to our digital ethos
- As we examine specific opportunities, management and our board pass each through a robust filter, ensuring our heightened standards for risk, our demonstrated commitment to creating value for shareholders and our regulatory standing are at the forefront of any decisions

Growth and Capital Deployment

- Irrespective of acquisitions, as we think about both growth and capital deployment, we have started the work on sizing the implications of exceeding $50B in assets
- While I remain hopeful that logic rears its noble head and that certain regulations might change, we take a more pragmatic approach to managing our business
- Accordingly, I charged Mr. Pizzi and team with understanding all elements of crossing this threshold, from systems to reporting to personnel and, most relevant for your purposes, costs
- While there's still a lot of analysis to do and the numbers will be refined, initial estimates suggest about $50mm over two years related to getting in shape with an additional recurring component of approximately $15mm annually
- Keep in mind that not all of these costs, specifically those related to initial build-out, would have immediate P&L impact
  - Mr. Pizzi will cover more on that later

Costs

- These costs are certainly not insignificant and as we noted on numerous occasions, tiptoeing over the $50B line won't benefit our owners, particularly in the current rate environment
- However, with cost and benefits were clearly defined, we will be able to make an informed decision considering rates, growth, and return on capital
- So we are spending a healthy amount of time working through this exercise
- For the avoidance of any doubt, our intent for the foreseeable future is to manage our balance sheet to our stated target and not cross [ph] into the (08:00) land of $50B.

INVESTMENTS

- While on the topic of expenses, the team has completed the budgeting work for 2016, and I would like to give some color on how we are thinking about spend going forward
- We have made a lot of important investments in the business over the past few years, in particular, fortifying the company's risk and control framework in line with our enhanced expectations, bolstering our foundation through improvements to systems and infrastructure and, finally, upgrading talent

Expense Structure

- With much of the foundational work complete, we have really just begun to shift our dollars to chip away at delivering enhancements truly geared towards improving our competitive position
- Today, with this more rational expense structure, we are transitioning the way we think and talk about overall spending to be more directly aligned with the revenue environment, meaning operating margin
- On this measure for 2016, we expect it to be 39%
- There is substantial upside in a more normalized rate environment where our target should move to the mid-40%s range
  - While Mr. Pizzi will share additional thoughts on expenses in the coming quarter, I wanted to accentuate our revamped approach on the matter

Business Metrics

- Turning to our business metrics, customer activity rates slowed amidst global and macroeconomic uncertainty during the year with DARTs of 155,000, down 8% from 2014
- Q4 continued a trend of moderation as DARTs of 147,000 were down 6% from Q3
- 4Options during the quarter were stable at 24% of total DARTs consistent with our full year mix

DARTS

- In January to-date, we've seen uptick in trading activity amidst volatile markets and in line with seasonal patterns
- Through yesterday, DARTs are tracking up 26% from December
- Despite uncertainty in the markets, our customers showed confidence when they acted as they were net buyers of $6.8B of securities during the year and maintained relatively healthy margin balances throughout, ending the year at $7.4B
- For the quarter, margin balances averaged $7.5B, down from $8B last quarter
- Recently, we've seen a decline to about $7B
- Despite the macroeconomic morass, our core franchise also continued its steady growth adding 13,000 net new brokerage accounts during Q4, bringing the full year total to 96,000 after we adjust for unique items

Adjusted Attrition Rate

- Our adjusted attrition rate for the quarter of 8.2% improved from 9.3% in the prior quarter
- That brings our full year adjusted attrition rate to 8.9% in line with 2014 in a range that we think is healthy given our business model
- We brought in $2.8B of net new brokerage assets during the quarter which was up from $2.1B in Q3
    - o That brings our full year total to $9.3B representing a 3.8% growth rate
- Importantly, approximately one third of those net new assets were flows into retirement accounts

Retirement Assets

- Retirement, investing and savings continue to represent a key component of our future growth
- Both our challenge and our opportunity is to better engage our customers to broaden their awareness and showcase our capabilities as a provider of investment solutions for both the near and long-term focused
- We ended the year with $48B in retirement assets with our 880,000 retirement accounts, both of which increased modestly during the year
    - o We also have $3.2B of assets in managed accounts, which we think compliments this component of our business quite nicely

Stock Plan Administration Business

- Another tremendous area of opportunity for us is our stock plan administration business
- We continued to invest in this business during the year and completed the transition of clients on to our award-winning Equity Edge Online platform
- During the year, we added 144,000 net new accounts in this business and ended the year with 1.4mm plan participants

Digital Storefront and Core Platform

- Turnings to the enhancements we've made to our digital storefront and core platforms, leading with etrade.com, we launched a new welcome page for prospective customers to better deliver our value proposition the moment a window shopper steps into the store
- While it is in the early days we have seen an improvement in the funding rate for new accounts directed to this page, which is up over 2.5 percentage points compared to our prior experience

NEW RETIREMENT CENTER

- Once in the door, all customers were met with several overhauled sections of our site including a revamped account overview page
  - Our new retirement center which provides a simpler interface and inviting content to help customers engage, take charge and keep their goals on track
  - Our new tax center, which brings more efficiency and ease to a process that is notoriously stressful and convoluted

TipRanks

- And finally, this morning, we announced the introduction of TipRanks to our platform
- In listening to customers, we heard a strong need for help navigating the scores of public content across social and financial channels
- The tool which presents analyst sentiment on individual stocks in an ultra clear way takes a unique algorithm-based approach to analyzing and aggregating recommendations from more than 3,700 sell side analysts and 4,500 financial bloggers

Active Trader Platform

- Turning to our active trader platform, E*TRADE Pro, we made a number of upgrades to further equip retail investors with professional grade tools
- The big ticket items include a new Options Analyzer which simplifies very complex strategies
- In addition to our new streamlined design, the revamped tool enables traders to build multiple option strategies, run through various strike and date scenarios, customize graphing features, and more seamlessly submit any strategy for trading
- And our new Margin Analyzer, which provides greater clarity by way of a new detailed overview of buying power, displaying real time requirements for each position in the customers' portfolio

DARTS

- Lastly is mobile, which continues to become a more prevalent component of our offering as mobile DARTs were a record 14% of total DARTs in 2015 and 15% in Q4
- Customers seek an experience that rivals the desktop in terms of power and depth and this year, we delivered robust enhancements to further empower customers on the go

Market Conditions

- Some of the more noteworthy features we added this year include conditional orders to help customers more nimbly seize opportunities based on different market conditions, multi-leg options to execute complex strategies, a bespoke mutual fund trading experience [indiscernible] (14:12) that embraces the unique form factor, and several new technologies available on Apple products including home screen support on iOS, Apple Pay, and of course, our Apple Watch app, where we're the only broker among our peers to offer account level data

Digital Offerings

- When it comes to the prowess of our digital offerings, we received significant third party recognition this year, including earning four out of five stars overall at Barron's 2015 broker review, three first place awards, along with five best-in-class ratings in StockBrokers.com 2015 review
- And for the fourth year running, Equity Edge Online was rated number one for client satisfaction and loyalty by Group Five

SUMMARY

- So, in summary, 2015 was a great year for E*TRADE
- We're very proud of the accomplish we made, but recognize there is more to do to drive growth in the metrics and I know we can do better
- So, as we turn the page to a new year, I'm enthusiastic about the many initiatives we have underway to enhance our offering and grow our franchise, all while keeping focused on continuing to deliver value for shareholders
- I am eager to share our progress along the way and I am confident 2016 will be another great year for E*TRADE

Michael A. Pizzi
Chief Financial Officer

Q4 RESULTS

Earnings

- I'll start with our results
- For the quarter, we reported earnings of $89mm or $0.30 per share
- That compares to $98mm or $0.33 per share in the prior quarter after excluding the impact of the wholesale funding transaction
- It also compares to adjusted net income of $78mm or $0.26 per share in the year ago quarter, after excluding early extinguishment of corporate debt
- The quarter also included an elevated tax rate of 43%, largely related to the impact of our wholesale funding transaction on the full year's pre-tax income and the associated impact on non-deductible items
    - We expected to return to a more normalized 38% to 40% range in 2016

Revenue and Net Interest Income

- Revenues were $454mm, up from an adjusted $443mm in the prior quarter, attributable to higher net interest spread, but down from $461mm in the year ago quarter as a result of lower customer activity
- Net interest income of $285mm, improved $22mm from the prior quarter, driven by a healthy 30 basis point improvement in spread, primarily related to the elimination of expensive wholesale funding, partially offset by $1B lower average balance sheet, again the result of the wholesale elimination

Fed Funds Rate

- Spread for the quarter was 288BPS, above the high 270s range we discussed in the last call, as a result of better margin loan yields, coupled with meaningfully slower prepayment speeds within our securities portfolio
- As for 2016 spread, holding the Fed funds rate constant and doing the same for our most erratic variables relative to where they ended the year, margin, stock lending, and prepayments fees, we expect our spread for the year to be in the 270 to 275 basis point range, with Q1 in the high 270s
- I would note that with margin relative to where it ended the year, there is some downside

Commissions, Fees and Service Charge

- Commissions, fees, and service charges, and other revenues were $160mm, down $10mm from the prior quarter and down $16mm vs. the year ago quarter, largely attributable to a decline in trading activity relative to both periods
- Average commission per trade of $10.66 declined $0.21 from the prior quarter and $0.18 from the year ago quarter
- The sequential decrease was driven by a higher mix of active traders and fewer contracts per option trade
- The y-over-y decline was also driven by a higher mix of active traders
- Securities gains were $9mm, compared with an adjusted $10mm in the prior quarter
- For the full year, we expect gains to be in the $30mm to $40mm range, though any given quarter could vary

Expenses

- Expenses for the quarter were $305mm, up $12mm from the prior quarter, influenced by a couple of unique items
    - First, we had $6mm of executive severance within the restructuring line
    - Second, we had an $8mm, one-time third-party contract charge in the communications line
        - Excluding those two items, expenses were $291mm

Revenue and Investments

- Looking ahead, we are truly shifting our framework to be more aligned with the revenue environment and that is evident in the investments we are making going forward
- These investments are ones that will have a more direct impact on the growth in our business
- As for the most significant drivers of the current year's expense guidance, which is predicated on an operating margin of 39%, they are the following

Head Count

- First, the impact of adding talent
- We grew head count in 2015 and we'll have the full year run rate of those additions as well as continued hiring throughout 2016
- In 2015, many of the hires we made related to foundational enhancements and improvements to project management
- In 2016, many of the hires we make will be related to business growth

- In conjunction with this, we expect consultant head count to decline, which is captured in professional services

Marketing Spend

- Second, we plan to increase our marketing spend in the high single-digit percentage range during the year
- We maintain flexibility here and will be mindful of what market conditions warrant
- And last, the impact of our reduced FDIC insurance premiums
- We had a drop in our assessment rate mid-2015 and will recognize the full benefit of that in 2016
  - We expect this expense to be approximately $6mm per quarter, with $49.5B balance sheet

Operating Expenses

- So those are the pieces that will impact the full year
- More specifically for Q1, we expect operating expenses to be around $310mm, which includes a sequential uptick in marketing spend
  - That combined with a smaller balance sheet we'll have in Q1 relative to the rest of the year, will cause our op margin for the quarter to be below our full year guidance
- And to be clear on our operating margin guidance, the metric is aligned with that which we report in our key performance metrics and is the percentage we make on revenue after provision and operating expenses, meaning it excludes corporate interest expense, and other below the line items
- We view this metric as an important measure of how we are managing the business

Loan Portfolio

- Moving on to the loan portfolio
- It ended the year at $5B, down 6% during the quarter, and down 22% for the full year
- The allowance reduced yet again as we continue to see positive portfolio relative to our expectations, ending the quarter at $353mm, $23mm decline from the prior quarter
  - This translated into a benefit to provision for loan losses of $23mm, as net charge-offs were zero

HELOCs

- With respect to HELOCs, we began 2015 with $600mm of HELOCs scheduled to convert to amortizing payments or mature during the year
- We managed through the first significant volume of conversions and maturities, and we now have a sizable sample of converted loan performance, to measure against our original expectations
- We enter 2016 armed with even more data to forecast the performance of the future conversions, and maturities
  - This year, we have about $800mm of our total $2.1B of home equity loans, of which $1.7B are HELOCs scheduled to do so

MORTGAGE LOAN CHARGE-OFF

- So here's what I would emphasize on the topic
- In the month a HELOC converts from an interest-only to an amortizing payment, we observe a significant increase in the rate of new 30-day delinquencies would ultimately result in the default rate approximately twice that of the non-converting population

- Translating that into actual loss terms, the 24-month benchmark default rate on non-converting loans has been about 6% while those that have converted are closer to 12%
- Furthermore, the charge-off occurs approximately six months to nine months after the conversion event when the loan reaches 180 days past two consistent with our standard accounting process for mortgage loan charge-offs

CLTVs

- And finally, our loss estimates incorporate our assumption on loans converting in 2016 are generally a poor credit quality than the average converted loans to date, as national housing values peaked in 2006 when most of them were originated, translating to higher CLTVs and less equity in the properties today
- These conversions and their performance are the single largest factor impacting our loss modeling and, while expect charge-offs to increase in 2016, we are comfortable with our current level of reserves and continue to expect provision expense for the year to be near zero

Capital

- Moving on to capital, we announced four major capital deployment actions in 2015 and we are in the midst of executing on two of them, balance sheet growth and share repurchases
- On balance sheet growth, we expect to reach our targeted balance sheet size in Q2
- At that point, on a pro forma basis, we would be left with about $70B of off-balance sheet deposits
- Before assuming any level of growth in the business, $2B of these deposits could be brought on the balance sheet at our direction
    - So taking this into account and again before assuming any level of customer cash growth, we have the ability to cross $50B organically

Assets and Non-Recurring Expenses

- To expand on Paul's comments regarding the work underway to size the impact of expenses of crossing $50B in assets, first, we would have the upfront non-recurring expenses to implement the qualitative requirements associated with crossing the threshold
- More specifically, those are tied to requirements scripted under Dodd-Frank, namely CCAR, the liquidity coverage ratio, and resolution planning
- Within the rough initial estimate of $50mm, we're doing much work to determine what the final number will be and what portion of that would actually flow through the P&L vs. how much will be capitalized
    - This does not include any additional FDIC costs, which will be incurred at a rate relatively in line with our cost today

Head Count

- With respect to the $15mm estimate of recurring annual expenses, that would be predominantly associated with additional head count in various legal compliance, and financial roles
- But while we work through these calculations, it is important to note that we will only cross the $50B threshold, if doing so presents compelling returns

Share Repurchasing

- Lastly, with respect to corporate cash, we ended the quarter with $447mm, up $15mm from the prior quarter as the $50mm dividend from E*TRADE Securities was offset by the usage of $50mm to repurchase shares
- As a reminder, we intend to resume quarterly dividends from the bank to the parent in Q1, and in light of our reduced Tier 1 leverage threshold to 8% at the bank this quarter, we intend to request dividends in excess of its $97mm of Q4 net income

QUESTION AND ANSWER SECTION

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

I guess my first question is a follow-up to the SIFI sort of research that you've done on the cost. And when you talk about a compelling return, I just wanted to get a little bit more color what you'd sort of categorize as a compelling return? And then, it looks like you would still have $2B in sweep or off-balance sheet deposits you could add. So, that would give you some growth, but where could you see growth coming from on the deposit side to actually get that compelling return on the SIFI cost?

Michael A. Pizzi
Chief Financial Officer

A

A couple things I would point out there, Rich. One, the $2B doesn't assume any growth in cash. That's really where we – what the calculations would be if we ran them as of 12/31. Continuing to – if you look at our customer cash balances over time in a trend, you'll see that over time that they have been growing. So, we would expect that number to grow with our business as we grow accounts and grow customers.

The $2B that you have there, if you think about what we give as our reinvestment rate of essentially 175BPS or so, you can use that to estimate the revenue that's available on that $2B. When we think of returns, we're not really just talking about a dollar return or margin, but we have to put equity against that balance sheet. So, what we're really talking about is a compelling ROE to grow the balance sheet through $50B, taking into account those costs.

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

Okay. That's helpful. And I guess – I'm sure that you're still working through a lot of the cost here. But, anyway, I guess my follow-up question would be – this may not be as relevant today, but interest rate sensitivity and it seems like the other e-brokers get specific in regards to how they would be impacted by rate hikes, whether they happen, whether it is as likely now as before. But with the wholesale funding cleanup, are you able to give us, a better idea of the interest rate sensitivity for E*TRADE?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. In the past with the various movements on the balance sheet, one, you can see the wholesale funding but even the changes in the composition and cost of corporate debt, the paydowns in the loan portfolio, the deleveraging project to bring our balance sheet down to get to a target capital ratio, and then the sort of re-leveraging or bringing the balance sheet back up in size that we're doing now, we have shied away from giving that guidance. We are at a point now where we are completing some work, and I would say stay tuned because we're going to be coming – we'll be coming with more fulsome disclosures around our interest rate sensitivity.

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

Okay. And maybe I will sneak one in for Paul, if I could. On the M&A, Paul, we hear a lot that there was an article about a broker, private broker up for sale. Any of the properties out there, as far as scale properties, do you find particularly interesting?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Rich, it's always good to hear from you. And I find lots of things interesting but you can't possibly expect me to answer that question.

Steven J. Chubak
Nomura Securities International, Inc.

Q

So I appreciate all the detail you guys provided on the incremental expense associated with crossing, I guess, what you called the nifty land of $50B threshold so just sticking with, I guess, your classification. But if we were to take that 175 basis point spread on that newly deployed client cash, I'm just trying to get sense as to how long it would take to actually cross the threshold organically where the economic benefits would intuitively make sense?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Steven, we, as Michael has said, we've been doing a lot of analysis and furrowing our brows a bit about what's the right way to talk about this. But as Mike said, we could go over today originally. Mike, I don't know if you want to add anything to that because it's difficult to forecast the way exactly Steven is describing it, particularly given the impact if there's a potential rate rise or potential...

Michael A. Pizzi
Chief Financial Officer

A

Yeah. I mean, I think, you're thinking about it in the correct way. As rates move higher, the spread earned on that balance sheet will be larger. So, we will need less balance to earn that compelling return. At a lower rate environment, we're going to need more balance. Look at sort of the relative earnings on that relative to a reasonable equity cost and, therefore, return on equity that you want to achieve as a target and I think you can back into a number.

Steven J. Chubak
Nomura Securities International, Inc.

Q

All right. Okay. That's helpful. And maybe again switching over back to the NIM discussion, just wanted to get a sense as to given the guidance where you indicated a rebasing presumably in the asset yield side, If you can give some additional detail in terms of what assumptions are being made in certain items, particularly those that are more volatile like stock lending, but also in terms of securities yields and the pro forma return?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. The guidance we gave holds some of those volatile components constant. So we are holding the margin balance constant at a rate that's level there. We are holding stock loan contribution constant throughout that calculation. And then, essentially running a constant balance sheet at $49.5B to give you that spread guidance in the 270 to 275 basis point range. It also assumes no additional movements in federal funds.

Steven J. Chubak
Nomura Securities International, Inc.

Q

Okay. And just one final one from me. With the FDIC expense guidance update that you provided, does that contemplate the step up in fees that's expected later in the year?

Michael A. Pizzi
Chief Financial Officer

A

The run rate expense guidance does not include any step up in fees. The step up in fees is out there as an issue. We expect it to have to get closure sometime in 2016. We've incorporated it into our planning and therefore it is incorporated into the operating margin guidance that we've given you. But the run rate because we don't know the form that charge is going to take, it could be a one-time charge, it could be an ongoing assessment, it can actually be an element of both. Because of that, we have not factored it into the dollar guidance, but we have taken it into the consideration in the calculation of the operating margin.

Conor B. Fitzgerald
Goldman Sachs & Co.

Q

Just -- you guys have been pretty aggressive with the share repurchase early. I just want to understand kind of your appetite for maybe using a chunk of your authorization sooner rather than later, just given what's happening with the markets and kind of your stock specifically YTD.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Conor, as you can will expect and Mr. Pizzi will talk more about this in a bit, we're subject to the same quiet period requirements as a corporation as we would as an individual, and so that has had some issues with regards to what we can or can't do with accelerating or decelerating during this period of time, but Mike, do you want to...

Michael A. Pizzi
Chief Financial Officer

A

Yeah. I think as you probably understand, we're operating under a plan, and that's we're going to drop the amount that we've done thus far this year as we entered the quiet period late in December. With that, that's been a consistent amount of purchase. With the movement in prices and the volatility of the market, it's an item of active discussion between Paul and I as to what the appropriate set of actions will be when we exit this period in a couple of days.

Conor B. Fitzgerald
Goldman Sachs & Co.

Q

That's helpful. And then, I think you were one in the first to raise margin lending rates after the Fed hike. I'm just wondering if could give a little color on what you're seeing in the early innings in terms of your success in passing through that higher rate, just trying to get a sense, just given kind of competition has been relatively strong on margin lending balances?

Michael A. Pizzi
Chief Financial Officer
A

From what I understand most of our major competitors have now passed through that increase, some delayed it a little bit, and we're not really seeing much in the way of any movement really. But it's been largely passed through.

Conor B. Fitzgerald
Goldman Sachs & Co.
Q

That's helpful. And then if I could just sneak in one last one, that 1.75% number you quoted, that's net of the money market fee revenue you lost, and then just one more you could – what do you kind of think your cost of capital is on a low risk? Why was revenue stream like this? That should be helpful. Thanks.

Michael A. Pizzi
Chief Financial Officer
A

The 1.75% is the marginal rate of reinvestment. So in terms of where we are effectively buying duration matched securities in today's market, please keep in mind, yields have been exceptionally volatile, as have spreads, so that number is bouncing around. We could think of it is as a range of about 1.75% to 2% right now. We haven't historically disclosed our cost of equity, but it's actually fairly straightforward calculation from a CAPM model so in terms of where we're coming out, but I think from that you're going to get around the 10%-ish type of range cost.

Conor B. Fitzgerald
Goldman Sachs & Co.
Q

Okay. And sorry, so the 1.75% million is the spread revenue, but you do money market fee revenue in the other revenue line?

Michael A. Pizzi
Chief Financial Officer
A

Yeah. So if you move deposits back on balance sheet, and you are buying in the 1.75% to 2% range, you are giving up the fees that you are earning on the off-balance sheet portion.

Conor B. Fitzgerald
Goldman Sachs & Co.
Q

And I'm sorry, what's that in today's rate environment?

Michael A. Pizzi
Chief Financial Officer
A

It's about 23BPS.

Michael Roger Carrier
Bank of America Merrill Lynch
Q

Hey, Mike. Just on the expense outlook, so, I know you just mentioned on Q1 $310mm, it seems like that's a pretty decent bump up even with advertising from like the adjusted number that I think is around $290mm in this quarter. So just wanted to see, what's driving that? I know you mentioned advertising, maybe seasonal comp, but is there anything else that gets the lift in Q1?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. If you back and look, you'll see the comp event is always the highest in Q1, that is really related to all of the tax items and resets that go on. So that will be occurring as well as the ramp up in marketing, and then some of the full year head count really continuing, but that's really more for the full year, not just for Q1.

Michael Roger Carrier
Bank of America Merrill Lynch

Q

Okay. And then just in terms of going over the $50B, you guys gave the cost, I'm just curious when you think about like getting positioned for that transition, if you determine that it makes sense. Like, what's like the timeline in terms of getting prepared? Is there any additional hiring, any additional system costs, meaning is it something that you guys have been planning as you've been kind of revamping the infrastructure, that it wouldn't take that long, or are you still thinking it will take a few quarters to be building that out?

Michael A. Pizzi
Chief Financial Officer

A

Look, I think that, one, I'd say there's really no decision to cross at this point. We are working on a plan, but a plan is not a decision point. But I think at some point, yes, with the growth in cash, it will become a more and more likely decision, but at what point that is is a little bit off into the future.

How the rules work, some of the CCAR rules, you have five quarters to come into compliance with. So, that gives you an operating window of time, but obviously you want to have a very detailed and well thought out plan put in place before you start down that road because you have a fixed window to get it in place. Other rules actually kick in, this is the heightened expectation rules, they kick in day one when you cross 50. So, that work has to be done almost immediately, but some of that's a bit more structural and a bit easier to put in place.

So, as we step back from it, you don't have – it's not going to take a full two years in terms of the expense period to go over 50, but there is going to be a period of ramp up time as you're building out the plan and as you're beginning on the execution of the first phases of the plan, particularly personnel to get some of this work done.

Christopher M. Harris
Wells Fargo Securities LLC

Q

Another clearly really strong quarter in credit. And I appreciate your comments about expectations on default rates and the HELOC book, but I'm just trying to square that with what you guys are actually reporting. This is the third consecutive quarter of no charge-offs in the HELOC portfolio. So, it seems like you guys are running way, way better than that. So, help us maybe bridge the loss experiences you're kind of reporting now vs. where you think they potentially might be going?

Michael A. Pizzi
Chief Financial Officer

A

I could probably give you a little bit of color on that. I think the gross charge-offs for the period were $21mm that will be coming out in our 10-K when we file it and we are seeing an elevated level of recoveries that are driving the net charge-off number to zero. We expect that recovery stream to continue somewhat, but it has been exceptionally strong, and we are coming up on increased conversion balances. So that really squares to how we get to the loss modeling that supports the $353mm allowance.

Christopher M. Harris
Wells Fargo Securities LLC

Q

Okay. All right. That makes sense then. And then the commentary around acquisitions, would you guys consider acquiring a bank that had credit risk? Is that part of the potential candidates that you're considering?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Chris, we're considering a number of things across three dimensions, right, which we've talked about on a couple of calls now. Let's remember the reason we brought this up is because we were in [ph] purdah (40:19) for a period of time and couldn't entertain these at all. So as the music's changed here, we wanted to make sure that we were very clear with the Street, with the sell side, with our investors that we're now in a different spot and we can entertain these things.

As we said today, two of those three categories have emerged as having more potential attractive opportunities and I say potential. One is certainly trying to find ways to add scale in the brokerage business because the operating leverage is so attractive. The second is in banking, finding a way to monetize the value of our customer deposits to a greater degree than we do today. And that would imply acquiring an institution that has strong capabilities in traditional intermediary activities.

Kenneth W. Hill
Barclays Capital, Inc.

Q

I know you've talked a lot about acquisitions here, but during the quarter, I think you guys announced an expansion of your relationship with Jefferies giving clients access to munis you had a relationship in place on IPOs for at least a year now. So are there any other in demand products that could maybe be satisfied through more of a kind of partnership than anything else?

Paul Thomas Idzik
Chief Executive Officer & Director

A

That's a good question, Ken. We look at partnerships all the time. We recently got involved with a partnership in our back office that we think not only provides customers a better service level, but provides us better economics. So we look at those all the time, particularly as people produced new products. And if you think about the introduction of TipRanks today, that's very much of partnership and that's providing some additional valued educational and investing knowledge to our customers through a partnership. So we think about those all the time.

Kenneth W. Hill
Barclays Capital, Inc.

Q

Okay. And then just modeling question here for the commission. I know you guys dropped quite a bit and a lot of the peers kind of stabilized on a little bit higher. And I know you mentioned some of the higher percentage of active traders this quarter. Is there anything different that you're seeing from the customer base? Are you guys targeting a higher group of active traders and making it easier for them to trade out a discounted rate that might be kind of driving that lower over time and should we expect to stabilize some?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Ken, we're clearly continuing to invest in, for example, E*TRADE Pro, which unquestionably signals the fact that we are absolutely committed to serving the needs of those valued customers and much of what we're introducing on the mobile devices is also aimed at serving that viable client base because they like to stay in touch and like to be able to take action when they want to take action.

So, our dedication to that area is very important. Our modeling on that metric that you just described is influenced by a number of factors and including the impact of our corporate services business and a change in buying behavior somewhat in Q4 as people repositioned and a few more mutual fund type purchases as opposed to just straight DARTs, straight equity trades. So, there's a number of moving factors, Ken.

Kenneth W. Hill
Barclays Capital, Inc.

Q

Okay. Thanks for taking my questions.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Of course.

Michael A. Pizzi
Chief Financial Officer

A

If I could just make one correction to an earlier comment to Conor's question. I gave the gross revenue number on the off-balance sheet, the off-balance sheet sweep deposits. There are fees paid in that arrangement. So, when I gave the number of 23 BPS, we're actually in the 10 to 15 basis point range because we have to pay the administrator fees, so it's not quite as high as that. We also expect that to go up with the full quarter now of post the Federal Reserve increase into the 25 to 30 basis point range.

Devin P. Ryan
JMP Securities LLC

Q

Just a question here on excess liquidity. If this market volatility persists, does that change your view at all around the 2 times debt service cushion? I know you're well above that now but just trying to think about what's truly excess. And also you're now being at the 8% Tier 1 leverage capital plan objective. That's great. Should we think about that as an ending point or is there still a goal to maybe move that lower overtime?

Paul Thomas Idzik
Chief Executive Officer & Director

A

I'll take the second first. Well, Devin, we just got permission to take it down to 8% so you'll forgive us for wanting to catch our breath a bit, and I appreciate your impatience but I'm going to catch our breath a bit. We do think as the loan portfolio continues to cure, that there is some more opportunity to take that down to a level towards the 7% handle.

But that's something that we want to carefully work through with our regulators and make sure that all the right people are comfortable before we even start entertaining that idea. The dust has just begun to settle on the trophy of getting that done. So we're going to be patient and approach it in the same careful way we did in getting down to 8%. And then Mike is going to take the other question.

Michael A. Pizzi
Chief Financial Officer

A

Yeah. On the 2 times debt service, please keep in mind that the 2 times debt service is actually a covenant in our revolver at this point in time. So we will not go below the $100mm number. We view corporate cash as an ultimate resource of liquidity, if we needed to use it between our legal entities and is also a source of capital. So therefore, we're not going to operate at a thinner margin than that 2 times level.

Devin P. Ryan
JMP Securities LLC

Q

Okay. Great. Helpful. And then just with respect to the SEC lending, the balances bounce around quite a bit, revenues tend to be less volatile there. So just, within the NIM guidance with that line specifically, should we just think about the revenue level being relatively constant with where it's been or just – how should we think about that dynamic?

Michael A. Pizzi
Chief Financial Officer

A

Well, within the NIM guidance, we are keeping it constant. Now, constant doesn't mean the constant yield there. It means it's a constant overall contribution. Keep in mind that the hard to borrow component that is essentially the rebate earned on the stock lending is put up to the borrowing line and the borrowing balance is driven by customer activity. So there is going to be a lot of volatility in the yield that's posted there. But from a dollar perspective, we expect it to be relatively flat.

Devin P. Ryan
JMP Securities LLC

Q

Okay. Great. And then just finally to be clear here, the operating margin expectation of 39%, that includes provision. I'm assuming I know that there is not much expected this year, but just want to make sure that that objective includes provision.

Michael A. Pizzi
Chief Financial Officer

A

That includes provision, and our guidance on provision for the year is zero.

Brian B. Bedell
Deutsche Bank Securities, Inc.

Q

Maybe just to add on to that question on the 39% op margin with the provision, should the provision vary greatly in either direction, do you view that as something that would change that operating margin or would you use that as sort of contributing to that 39% target either way?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, as you'd expect, we have to react to that when it occurs. If provisions come in above what we anticipate, we'll have to look where we may be able to reduce other costs. Those numbers come in big and chunky though so our ability to move the other number is not quite the flexibility we might have otherwise. And if it comes in better, we'll again take a look and see. We've often times on these calls said we like to flex our marketing budget, and when times are good, invest in driving future customer growth and, when times are bad, being as responsible as we can. So that's a bit something we have to handle day-to-day as we see what happens.

Brian B. Bedell
Deutsche Bank Securities, Inc.

Q

That's great color. And then maybe just lastly repo in the acquisition spectrum, I guess actually a question both for you and Mike. Mike, if you can talk a little bit about the financial metrics or hurdles for deals that you might be following in terms of either accretion timeline or ROE? And then maybe Paul, how do you feel about the RIA business? It's one big area that you're not in and I could see that scaling via your capabilities. Thanks.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Why don't you take the metrics one first?

Michael A. Pizzi
Chief Financial Officer

A

Sure. I mean, anything we're looking at is going to have to have an extremely compelling return in terms of the investment that we are making in terms of either ROE or its return on invested capital. We would also expect accretion commensurate to the deal size and the risk in the deal. So we would expect higher metrics for deals that are going to be – that have higher complexity or higher risk to them in terms of what we can achieve. I guess the only sort of thing I would carve out of that is probably anything that's around a capability or product. We haven't talked much about that. They would largely be on the smaller side, but any larger amount use of capital is going to have to have an extremely compelling return profile and accretion.

Paul Thomas Idzik
Chief Executive Officer & Director

A

On RIA, we've been pretty consistent in our thinking on this, which is not really all that intrigued by that opportunity right now for two main reasons. One, we really want to see how the Department of Labor regulations that I alluded might turn out. That could have quite a significant impact in that business. And secondly, if you're going to go into that business, I believe you need to enter that business with scale. And so that would also make us think twice about that. And so for right now, that's not quite at the top of our mind.

Brian B. Bedell
Deutsche Bank Securities, Inc.

Q

Okay. That's a great color. Thank you.

Paul Thomas Idzik
Chief Executive Officer & Director

A

I think we'll take – what do we have, two more, maybe we'll take? Two more calls, please, Edison.

Andrew Del Medico
Autonomous Research LLP

Q

Just a follow-up on the potential for bank M&A. You've done a great job of de-risking the balance sheet over the past several years. So what's changed in your thinking that will make you want to kind of get back in and add more credit risk now?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, let me just repeat that we've talked about potential acquisitions, thinking about potential acquisitions across three fronts. And I think considering the type of credit risk that we have been managing over the past several years, and how it came on the books is not exactly what I would consider traditional banking business.

Andrew Del Medico
Autonomous Research LLP

Q

Okay. I guess when you evaluate a potential bank acquisition, I guess what loan channels and some assets would you really be looking at there?

Paul Thomas Idzik
Chief Executive Officer & Director

A

I think we want to look at – when we think about things, we think about things that are going to complement our existing business, our business model, how we go about things, the type of customers we have, will it have any resonance even with the E*TRADE Corporate Services business. And so those are the type of applications of our thinking and the direction we're taking.

Rob Rutschow
CLSA Americas LLC

Q

First question on expenses, it looks like your head count was up by about 100, a little over 100 this quarter. So does the guidance for 2016, for the 39% pre-tax, assume that you're going to see a ramp up in head count expense and does that mean you would see some offsets elsewhere in the expense categories?

Michael A. Pizzi
Chief Financial Officer

A

The guidance included our projected head count. But it's not – the head count projection is not – the continued growth rate is going to slow from what it has been. So you don't necessarily – you're not necessarily going to see offsets. The hiring in Q4 is very much around staffing up just for the tax season and financial season that we enter this time of year.

Rob Rutschow
CLSA Americas LLC

Q

Okay. And one more question on the possible – possibly going above $50B. In terms of the deposits that you would want to bring on, are there any impediments to that? Do you have to change any customer agreements to bring those on balance sheet? And what would you anticipate the earning asset level to be if you were to bring on that additional $2B in deposits?

Michael A. Pizzi
Chief Financial Officer

A

Well, we're working through that, I mean. right now, in terms of the actual conversions that are underway. You'll notice that assets that are in off-balance sheet came down as we brought some on our balance sheet. We have additional conversions that are going to occur this quarter and that's going to be a live process bringing us to our target level of $49.5B by sometime in Q2.

The additional $2B amount is really part of the same process. If we wanted to bring it on, we could. The remaining amount for various reasons, it's either in money funds that the customer has chosen to be on a tax exempt product, it is money above the FDIC insurance threshold. So to be insured, it has to be held at a different bank. Therefore, it cannot be brought back onto our balance sheet. So of that seven, five of it cannot be brought back, two can be brought back. That's what we gave in the prepared remarks. And then as we grow accounts and grow our business over time, we expect that two to grow.