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E*TRADE Financial Corp. (ETFC)

Q1 2016 Earnings Call

CORPORATE PARTICIPANTS

Paul Thomas Idzik
Chief Executive Officer & Director

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

Richard H. Repetto
Sandler O'Neill & Partners LP

Conor Fitzgerald
Goldman Sachs & Co.

Christopher M. Harris
Wells Fargo Securities LLC

Steven J. Chubak
Nomura Securities International, Inc.

Daniel Thomas Fannon
Jefferies LLC

Devin P. Ryan
JMP Securities LLC

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)

Brian B. Bedell
Deutsche Bank Securities, Inc.

Michael Roger Carrier
Bank of America/Merrill Lynch

MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP FINANCIAL MEASURES

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

Paul Thomas Idzik
Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Performance

- We kicked off the year with solid play by all our lines, as we posted strong results, continued to roll out enhancements to our customer offering, and deployed a considerable quantum of capital to shareholders
- Amidst a market environment characterized by trepidation and unease, we posted respectable growth in the business as our customers remained relatively active
- Our results again benefited from the dwindling size and better-than-expected performance of our legacy loan portfolio, and we made significant progress on our premeditated march toward $50B balance sheet
- Meanwhile, we began managing the bank to a lower Tier 1 leverage ratio, distributed a considerable amount of capital to the parent, and continued to put capital to work for our owners

Net Income, Customer Activity and DARTs

- Starting with our results
- We reported net income of $153mm, or $0.53 per share for the quarter
- On the metrics, customer activity increased sequentially, a trend that is typical in Q1
- We also traditionally expect an uptick in activity from our corporate services customers in Q1
  - And that trend was less pronounced, attributable to the underperformance of the market
- Options contributed a steady 23% of total DARTs
- Additionally, the portion of trades executed via mobile platforms held steady at 16%
- In April to date, DARTs are tracking down 1% from March

Bleak Opening and Margin Balances

- In terms of sentiment, Q1 presented a bleak opening for our customers as the markets kicked off January with one of the worst starts in history
- Confidence in activity improved through the quarter, and by March end, it seemed the Cimmerian curtain had lifted
- The sum total of this quarter's activity was solid, with our customers being net buyers of $1.2B of securities, while exhibiting some purposeful de-risking behavior
- Margin balances were dialed back by slightly over $1B with balances averaging $6.7B and ending the period at $6.3B
- In April to-date, balances are flat where they ended the quarter

Net New Brokerage Accounts

- Meanwhile, we continued to post solid growth
- Excluding the impact of shuttering our Hong Kong and Singapore operations, we added 45,000 net new brokerage accounts during the quarter, while our adjusted attrition rate improved to 7.3%, both of which represent our best quarterly marks in two years
- We added $2.9B of net new brokerage assets during the quarter, healthy for Q1, but down from $3.5B a year ago primarily due to lower activity from our stock plan customers
- Our focus on retirement, investing, and savings is present in this metric as one-quarter of these flows were into retirement accounts
- Q1's results also included $0.10 per share income tax benefit, and some important changes to our reporting and segments

- And Mr. Pizzi will elegantly walk you through each of those
- There is one element I will highlight, however, which is the impact of these changes on our operating margin calculation, reducing it by about 2 percentage points, making our equivalent target 37% for this year

Provision for Loan Losses and Adjusted Operating Margin

- Also, you'll find that we present this metric both straight up, and adjusted, which excludes provision for loan losses this quarter, the latter being the measure to which we manage our spending
- While we are ever-mindful of the impact that provision can have on our bottom line and our capital, we don't view it as a key factor governing our investments in the business
  - That said, a large benefit is not a license to spend, nor would we ignore any meaningful charges
- And with that context out of the way, we posted an adjusted operating margin of 34% in Q1, below our full year target of 37%, yet broadly in line with our expectations given the timing of balance sheet growth and seasonality in comp and advertising

Loan Portfolio

- The performance of the loan portfolio exceeded our expectations, and our results included a net benefit in the charge-off line, a first for the company
- We continue to benefit from recoveries, along with better-than-expected performance of HELOC conversions, which we are now more than halfway through
  - This diminishing portfolio ended the quarter at just $4.7B

Capital

- On to capital, where we delivered some remarkable numbers and progress this quarter, across each stage of the capital lifecycle: generation, distribution, and deployment
- Talking about our generation of capital, we've done a lot, both from an earnings stand point as well as through lower capital thresholds
- The progress we've made acutely reflects our improved financial position and regulatory progress, which are proof positive of all the work the entire team has done on the enterprise risk management front, the enhancements we've made to our operations and leadership team, as well as the continued and marked improvement to our overall risk profile
- Concordant with our much improved stature is the freedom we've earned to internally distribute the capital we generate, continuing to benefit from improved flexibility at the bank and companywide

Target Leverage Ratio

- This quarter we distributed a hefty $400mm to the parent, well above our typical contribution
- This included capital from the bank, both formed through earnings, and liberated through the 100BPS drop in our target leverage ratio, and capital from our brokers, from the earnings of our introducing broker and the extraction of excess capital from our dealing broker
- One related element of note: while we achieved a reduction in our bank leverage ratio to 8%, well ahead of our original plan, we have our sights set on continued improvement to our capital efficiency there, and aim to manage closer to 7.5% in early 2017
  - This, of course, is our aspiration, and would require regulatory approval

Capital Deployment

- On capital deployment, we exceeded $350mm in cumulative share repurchases during the quarter, putting us nearly halfway through our current authorization, just a few months after embarking on the program
- While market dislocations during the quarter presented us with opportunities to be aggressive buyers of our stock, we aim to continue buybacks at a more modest pace, with an eye on completing the current $800mm program by year-end
- We are devotees of buybacks, as they allow us to return capital to shareholders efficiently and with low risk

BALANCE SHEET

- With regard to additional capital deployment, we're progressing on growing our balance sheet to $49.5B, adding $2.5B during the period
- We intend to reach our target size this quarter
- In exploring other avenues to put capital to work, we continue to focus on growth, with acquisition as one method to achieve that goal
- This quarter, we sharpened our focus, and I'd like to walk through our current thinking

Scaled Acquisitions

- We believe scaled acquisitions in the brokerage space make the most sense
- We also look for opportunities to bolster our capabilities through acquisition and consideration of our retirement, investing and savings vertical, as well as our corporate services channel
  - However, we continually evaluate build vs. buy on this front
- Specific to acquisitions in the banking space, our areas of focus include innovative financial technology within custody and payment services; and trust and wealth management offerings, to the extent we find a logical fit in support of our current strategy
- Now, we certainly understand there has been significant investor interest around acquisitions that could result in credit exposure, and I'd like to summarize our present thinking on this

CREDIT EXPOSURE

- To the extent we would consider taking on credit exposure through acquisition, it would have to exceed a substantially higher hurdle for returns, to ensure the benefits and associated risks would truly be worthy of our owners' capital and management's time
- To make this point very clear, we will not explore acquisitions in a traditional banking model unless it is overwhelmingly compelling for shareholders
- We have come too far as a company to go round the bend by assuming unwarranted risk through an injudicious acquisition
- We also continue to evaluate other options for capital deployment, including share repurchases beyond our current program, and balance sheet growth beyond $50B
- Mr. Pizzi will provide color on how we measure these options

Enhancements and Rollouts

- With respect to enhancements and rollouts, Q1 was a busy quarter

- To cover a few of the highlights
- We continued to expand our industry-leading mobile offerings as we incorporated customer feedback to increase customization capabilities on the mobile dashboard
- As mobile continues to become a channel for long-term investors as much as for active traders, we also introduced a mobile retirement center, helping customers plan their retirement savings with a calculator tool, and easily open an IRA or rollover an existing 401(k) account

Income Estimator Tool

- On our website, we upgraded our income estimator tool, which now provides an improved logic that can be applied to securities within a watch list and can seamlessly send any stock, ETF, or mutual fund through for execution
- Most recently, we rolled out a new dashboard in E*TRADE Pro, creating a home base for our most active traders to track the markets, manage their portfolios, and much more, in a consolidated manner
- We have a pipeline of great tools, features, and new experiences in store for our customers this year
    - So stay tuned
    - I look forward to sharing more with you

Awards Season

- We've just emerged from our industry's awards season with an ample assortment of accolades, receiving high marks from Barron's and NerdWallet, nine best-in-class distinctions from StockBrokers.com, which includes earning the number one mobile app, three Gold awards from Corporate Insight, and an honoree designation from the Webby Awards

Regulation

- Our industry also witnessed one of the more impactful pieces of overreaching regulation seen in recent history
- The Department of Labor's ruling on the applicability of the Fiduciary Standard
- First, I want to state unequivocally that we support efforts to advance the best interests of retail investors, and will work within the new regulatory guidelines to continue to deliver guidance on our customers' terms, and provide services that help investors take control of their financial health
- We're also pleased that the DoL heeded many of the industry's concerns regarding the initial draft, delivering a final rule that is less burdensome than originally proposed
    - We believe as a matter of principle that all who serve the retail investor should be held to the highest standards when it comes to working in their best interest
- At the same time, we believe this pursuit must be balanced against ensuring investors continue to have seamless access to investment support, and the greatest variety of financial choices at their disposal, to help them trade, invest, and save
- We're still working through the ruling's significance, but are confident it'll have minimal impact on our ability to properly serve our customers

Leadership

- On the leadership front, I'm very pleased to welcome an addition to our executive suite, as we concluded our comprehensive search for a new Chief Risk Officer earlier this month, appointing Ms. Ellen Koebler to the post

- With a risk management career spanning nearly two decades at a handful of large and complex financial institutions, Ellen brings considerable fire power to this crucial function and to our Executive Committee
  - As Ellen comes on board, our unassailable Acting CRO and the original architect of E*TRADE's Risk organization, Mr. Paul Brandow, has graciously agreed to stay on in an advisory capacity to me and the entire executive management team
  - I'm happy to know we'll continue to benefit from his sage perspective and consummate insight

CLOSING REMARKS

- In closing, as I think about 2016, we have a lot of exciting things in the works on the customer experience front, and we'll continue to ruthlessly pursue the best path forward on capital deployment
- I look forward to keeping you apprised

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Adjusted Net Income

- For the quarter, we reported adjusted net income of $122mm or $0.43 per share
- This excludes $31mm, or $0.10 per share tax benefit related to the release of a valuation allowance against state deferred tax assets
- Our results compare to $89mm or $0.30 per share in the prior quarter
  - It also compares to adjusted net income of $85mm or $0.29 per share in the year-ago quarter, which excludes the loss on early extinguishment of corporate debt

Realignment

- Before I delve into the details of our income statement, I'd like to review the changes we made to our reporting this quarter
- For those of you following along, these changes are laid out graphically in our quarterly financial supplement on about.etrade.com under the quarterly earnings section
- There, you will also find realigned financials going back through 2014
- I'll refer to those during this call
- We consolidated our business segments and realigned both our income statement and yield table, all of which are reflective of how we currently manage the business

Segment Reporting

- As for the specifics, beginning with segment reporting, we collapsed our operating segments and are now presenting only consolidated financial results
- With the vast majority of our legacy costs in the rearview mirror, and the management of our balance sheet now focused solely on maximizing the value of customer deposits, we thought it was the right time to wave goodbye to the balance sheet management segment as well as the corporate category

Corporate Interest Expense

- We also realigned our income statement, moving our below-the-line items into revenue and expenses
- Most notable among those changes is that corporate interest expense is now included in net interest income
- Additionally, other income and expense was moved into the gains and losses on securities and other revenue line
- And losses on early extinguishment of debt are now included within the non-interest expense section
- Taking a deeper dive into net interest income, we are now reporting net interest margin, as opposed to spread
- After all, most of you already call it NIM

Revenue and Net Interest Income

- Now onto the result
- Revenue for the quarter were $472mm, up from $439mm in the prior quarter attributable to higher net interest income as both net interest margin and balance sheet size increased sequentially, and up from $441mm in the year-ago quarter as a result of the termination of wholesale borrowings, the Fed rate hike, and the corporate debt reduction and refinance
- Net interest income of $287mm improved $17mm from the prior quarter driven by a 7 basis point improvement in the net interest margin on $1.4B larger average interest earning balance sheet

Net Interest Margin

- Our net interest margin of 281 BPS increased as a result of the full quarter impact of the Fed rate hike coupled with slower prepayment speeds on the securities portfolio, but was partially offset by lower margin balances
- Because we guided to spread on our last call, I'll tell you that based on our prior reporting, our spread for the quarter would have been 294BPS
- Meaning, we significantly outperformed our expectations of high 270BPS
- As for our expectations for the full year, holding the Fed Funds rate constant, and doing the same to margin balances, we expect our net interest margin for the full year to be in the 260BPS to 265BPS range
    - Adjusted for the reporting changes, this is consistent with our previous guidance
- Note that our significant outperformance in Q1 is offsetting our expectation for NIM to contract in the remainder of the year
- For Q2 specifically, we expect it to land in the mid-260BPS

Commissions, Fees and Service Charges

- Commissions, fees and service charges, and other revenues were $175mm, up $15mm from the prior quarter and down just modestly vs. the year-ago quarter
- Two main factors contributed to the fluctuations

CUSTOMER ACTIVITY

- First, customer activity increased 12% vs
- Q4, but decreased 3% vs. the year-ago period

- And second, improved rates on off-balance sheet cash helped drive increases in fees and service charges relative to both periods
- On the latter, the average rate earned on off-balance sheet cash was 30 BPS in Q1, up 17 BPS from Q4 as a result of the full quarter impact of the December rate hike
  - Keep in mind, this is a gross number
  - So net of the fees paid to our third party platform administrator, we earned 24 BPS on average in the period

AVERAGE COMMISSION PER TRADE

- Average commission per trade of $10.64 declined $0.02 from the prior quarter and $0.30 from the year-ago quarter
- The y-over-y decline was driven by a lower contribution from stock plan customer trades and fewer options contracts per trade
- Securities and other gains were $10mm, flat with the prior quarter
- For the full year, we expect gains to be in the $30mm to $40mm range

Non-Interest Expense

- Non-interest expense for the quarter was $312mm, up $7mm from the prior quarter, which included $14mm in non-recurring charges
- Excluding those items, the $21mm sequential increase was driven primarily by compensation and benefits, which reflect the full quarter impact of the hires we made in Q4 as well as seasonality related to compensation
- We remain highly attuned to the operating environment, and the impact it has on how we manage our expenses

Adjusted Operating Margin and Net Charge-Offs

- As Paul mentioned, for the quarter, our adjusted operating margin was 34%
- Our target for the year remains 37%, the equivalent of 39% prior to our reporting changes
- For Q2 specifically, we expect expenses to decrease approximately $10mm sequentially, primarily related to lower marketing spend
- Provision for the quarter was a benefit of $34mm, needless to say, better than we expected
- Net charge-offs were also positive at $3mm of recoveries, resulting in $31mm reduction in the allowance to $322mm
- Meanwhile, the overall portfolio itself reduced by $284mm, or 6%, to $4.7B
- In addition to the positive impact of recoveries, our provision benefit also reflected better-than-expected performance of converted HELOCs that were previously classified as high risk and had been reserved for using the full life of loan loss expectation
  - This includes balloon loans, of which there are just $25mm remaining, the vast majority of which will convert in the current quarter
- In total, we had $213mm of HELOCs convert to amortizing loans during Q1, which puts us more than halfway through the conversions

Performance

- Performance in Q1 was consistent with the observations we discussed last quarter where the default rate of the converting loan is about twice that of the non-converting loan, at approximately 12%
- So while we have been pleasantly surprised by performance to-date, please keep in mind that we have a sizeable pipeline of conversions through Q1 of next year
- For this reason, we expect our provision to be approximately zero, with the caveat that recoveries o f a greater than expected magnitude could again result in a provision benefit

Tax Benefit

- One final note on the P&L regarding the tax benefit we recorded this quarter
- With the move of our broker dealers behind us, we took a hard look at our organizational alignment and found an opportunity to reinstate the tax treatment of our broker dealers prior to moving them under the bank
- The tax election resulted in a release of valuation allowance against the associated state deferred tax assets
- We are always looking for ways to deliver for shareholders and were pleased to uncover additional value in this pursuit

Capital

- Moving on to capital, we distributed nearly $400mm up to the parent during the quarter, comprising the following. $248mm from the bank, which included $97mm from the prior quarter's net income, and $151mm as a result of our reduced bank leverage ratio; and $148mm from the brokers, which included $24mm of excess capital generation at the introducing broker, as well as $124mm from the clearing broker

Dividends

- In Q2, we expect total dividends to the parent of approximately $190mm from the bank and brokers
- Starting with the bank, since balance sheet growth consumes bank capital and directly impacts our leverage ratio, in Q2, we will request an $85mm dividend to the parent, which is below the prior quarter bank net income of $108mm
- From the introducing broker, we anticipate $27mm to the parent, as part of the standard quarterly distribution
- And from the clearing broker, we plan to move $75mm
- We continually assess the capital position of the entity, and based on the business environment, we may periodically move surplus capital

Capital Deployment Initiatives

- We remain in the midst of two capital deployment initiatives, balance sheet growth and share repurchases
- On the former, we expect to reach our targeted balance sheet size by the end of the current quarter
    - At that point, based on Q1 deposits, we would have $2B in off-balance sheet deposits available to onboard

Cost

- With respect to the cost of exceeding $50B, we completed additional work during the quarter, and our initial estimate remains intact, which is $50mm over two years related to the build-out, with an annual recurring component of roughly $15mm
- So to justify these expenses, along with the capital required to be held against the assets, we need some combination of higher rates and an abundance of customer cash
- So for the time being, we plan to hold steady under the $50B mark

Share Repurchases

- On share repurchases, as Paul highlighted, we are nearly halfway through the $800mm program, having picked up nearly 15mm shares at an average price of $23.81
- To elaborate on our internal parameters regarding utilizing capital for repurchases, while corporate cash is a clear measure of our dry powder, we are also mindful of our consolidated Tier 1 leverage ratio
    - Which we manage to a floor of 7.0%, meaning we would not utilize capital to the extent it would put us below this level
- We ended the quarter with corporate cash of $482mm and consolidated Tier 1 leverage of 7.8%, which provides the ability to make substantial progress on our program

QUESTION AND ANSWER SECTION

Richard H. Repetto
Sandler O'Neill & Partners LP

Q

The checking line definitely contributed here with the provision. I'm just trying to see – you don't expect it to contribute like it did. And is the performance that you're seeing there, I know we still got half the amortization portfolio to go, but are we still – it just feels like we're conservative given the last couple of quarters and the amount of reversals we've seen in that line.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Mike is going to talk to it in more detail. But Rich, our models and what we have set aside goes through a tremendous amount of scrutiny, not only from our own people, but from our accountancy firm and also from our regulators. So, I just think we just need to keep that in context as we think about it. But Mike, I know you have stuff to add here.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah, Rich, I would keep in mind that as we move through time, we're moving into later vintage loans, with the loans this year being really converting 2006 vintage, next year would be 2007. So, the remaining 50% is of vintages that are largely thought to be of lower quality. So that may help put this in perspective a little bit.

The other point I would call-out is, while we did have $3mm of recoveries through the charge-off line, they are not coming from the current loan population. And so that elevated recovery number that we see that's really been really very influential in the last few quarters is very difficult to forecast on a go-forward basis. And that's what contributes to coming out where we are on the current allowance.

Richard H. Repetto
Sandler O'Neill & Partners LP Q

Got it. Okay, helpful. Thank you. And then just – I'm going to ask about interest rate sensitivity, and we looked at the presentation and it's hard to compare given the new – the adjustments to the NII. But is there incremental – like the spread in your presentation is wider. Has anything changed in regards to interest rate sensitivity?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President A

Very little change in regards to interest rate sensitivity. What I will say is given the movement in margin and the movements in cash, and you'll see a higher amount of segregated cash. Those are the items that are directly influencing the small change in the delta in net interest income that you see.

Richard H. Repetto
Sandler O'Neill & Partners LP Q

Got it. Okay. And then I guess my last question is on, great quarter, it seem like you beat on every revenue line, but margin loans did drop, it appears a little bit more than peers. Anything going on – I know you mentioned Paul deleveraging of the consumer, but can you give us some more color on I guess it was – I think 15% quarter-to-quarter?

Paul Thomas Idzik
Chief Executive Officer & Director A

Yeah. Rich, if you go back in history, you will see that while margin balances were building up, ours were building a little faster. And as our customer base decided to derisk, they derisked a little faster and a little more steeply than the competition. So I think it's just a question of the makeup of the relative customer books.

Conor Fitzgerald
Goldman Sachs & Co. Q

Paul, I just want to go back to your comments on I think managing the business to be adjusted pre-tax margin. So excluding the reserve release, I think on the last quarter call, you kind of left the door open for maybe you're reinvesting reserve release if they were stronger than you expected back in the business. Should we kind of interpret your comments today as reserve release is totally divorced from your expenses?

Paul Thomas Idzik
Chief Executive Officer & Director A

No. I think what we said is we don't see it as a license to just spend it without regard to our other targets and other obligations we have both to our owners and other things we're trying to accomplish. So that's what we're trying to point to as well as saying if we have worse than expected charges that we would try and still keep to our target. So that's I think what you're hearing us talk about, Conor, is just trying to continue to be as disciplined as we can in managing for the type of results that we think our owners deserve.

Conor Fitzgerald
Goldman Sachs & Co. Q

Got it. Okay.

Paul Thomas Idzik
Chief Executive Officer & Director A

If we thought we could put some additional cash to work wisely, we'd be happy to tell you about that.

Conor Fitzgerald
Goldman Sachs & Co.

Q

Got it. And then again on the buyback, I appreciate the comments around the timing and the 7% floor. But if you were to get kind of more aggressive, is it more in your mind you just want to be more deliberate from here on out or are you kind of trying to maybe respond to share price movements when you think about kind of the pace and the timing. Is it more steady or are you going to try to be a little more dynamic?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, I think you saw an acceleration in the quarter that was definitely in response to the market. I think we will remain as dynamic as we can be within the confines of our capital and corporate cash to respond to the overall market environment. But as we said on the call, we see finishing this really within the year really one quarter ahead of the authorization timing.

Christopher M. Harris
Wells Fargo Securities LLC

Q

Just wanted to come back to the NIM for a second, the 290-basis points-or-so that you talked about – 294BPS, I guess, it was for the quarter. What was it that happened that really surprised on the upside. Was it the flow through on rates, the Fed rate hike being a little bit stronger than maybe you guys had anticipated? Is that what drove a lot of it? Just trying to square that relative to the original guidance?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, the Fed rate hike did drive some of it but that was contemplated within the guidance. The main driver of outperformance vs. the guidance really had to do with lower than expected pre – substantially lower than expected prepayment fees on the securities portfolio. And then you will see that even though the margin balance declined, the rate is up more than what the Fed – more than what the Fed would suggest, meaning the balances that left were at a much lower rate than the average for the portfolio.

Christopher M. Harris
Wells Fargo Securities LLC

Q

Got you. Okay. I was going to ask a question on the margin loan, so that's good. All right. Ameritrade, on their call, they talked a little bit about some expenses for DOL. Any thoughts there guys whether you've kind of taken a look at that? I mean, I know we've really just gotten the final ruling out, but anything you could help us there as far as perhaps magnitude or anything qualitatively as well?

Paul Thomas Idzik
Chief Executive Officer & Director

A

I didn't listen to the TD Ameritrade call. But we anticipate being on the meet at our DOL obligations within the target guidance we've given for operating margin. As we've gone through and seen what's occurring out of the regs, we feel our model stands up very well with us not having proprietary product, us having compensation practices that are close to what's desired as it is. And so we're pretty confident we're going to be able to continue to try and drive towards our target operating margin.

Steven J. Chubak
Nomura Securities International, Inc.

Q

I figure will kick it off with a question on capital ratios. You noted that you intend to request an incremental 50 basis point reduction in your targeted bank leverage to 7.5% next year. I just wanted to get a sense as whether 7% is a reasonable end game target that you guys are still contemplating, which from your remarks is consistent with what you're managing to at the parent today?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Steven, we do see others in the industry have a target – have a 7% handle. And when Mike and I wistfully look across the horizon as the sunsets, our eyes do twinkle thinking about the ability to get down to 7%. We think it's probably a reasonable aspiration we have. And we'll just continue doing what we have been doing in terms of improving our risk profile, taking regulatory guidance seriously, working hard to keep strengthening our enterprise risk management. And with all those things and with the close supervision of our regulators, we're hopeful that we'll be able to get down more towards where we see other competitors in a reasonable period of time.

Steven J. Chubak
Nomura Securities International, Inc.

Q

Understood. Well, thinking about that pro forma balance sheet always brings a twinkle in your eye, I know in the past, you had spoken about some potential benefits linked to a portfolio sales and recognizing there's some different puts and takes. But given the favorable credit performance we've seen and now that you're halfway through, the amortizing HELOCs, is that still an attractive avenue worth pursuing? And does the secondary market actually accommodate that at the moment?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, right now, we still think that holding those assets is in our shareholders' best interest. We, of course, continue to take soundings in the market, and if we felt a better solution would be to sell those to other people. We would certainly do so. And you have my phone number and if you want to buy them, Steven, you just give us a call and we'll talk about it at some point.

Steven J. Chubak
Nomura Securities International, Inc.

Q

Unfortunately I don't think I have deep enough pockets, Paul, but thank you for the offer. And maybe just one more quick one for me. I was hoping you can just give an update on any plans you might have to extinguish the $400 mm or so troughs just given that the securities as of the end of this year now fully disallowed from Tier 1 capital?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yes, Steven, if we look at the securities, they remain reasonably attractive from a debt spread perspective in terms of issuance. So we view them as really just liabilities at this point. To the extent that because they are somewhat illiquid, we see secondary trading in them, if someone's looking to move them, we will from time to time participate there as they can be purchased at a discount, but we have no intent to exercise the regulatory call.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Steven, that's an order of magnitude less than the loan. So we also take a call from you on the troughs.

Daniel Thomas Fannon
Jefferies LLC

Q

I appreciate the additional color around the M&A strategy in the outlook. I guess, if you could give us some additional commentary maybe around just the current environment. There was some activity in the market and the industry this quarter. I guess, how would you characterize the opportunity set in terms of pricing or actual available properties today?

Paul Thomas Idzik
Chief Executive Officer & Director

A

You guys are as aware as – I mean, more aware than almost anyone else regarding what kind of things might fit into each of those categories. But I'll take this opportunity to say that neither Michael nor I, nor our board is going to have us overpay for any property. And I think that's about all we need to say.

Daniel Thomas Fannon
Jefferies LLC

Q

Okay. And I guess, Mike, a question on NIM, the guidance going to next quarter, margin balances are down, but I think in the previous answer to a question, you highlighted that the rates are up. So just curious as to kind of the outlook and the decline, I guess roughly 15-basis points-or-so q-over-q and the drivers of that?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah. I mean, we're anticipating some normalization in the overall security speeds from the very low level that they were in Q1 the year. That's going to be the primary driver of the decline in securities yield that we're expecting to get to the guidance range for next quarter and for the full year.

Devin P. Ryan
JMP Securities LLC

Q

Maybe just a follow-up here on just DOL considerations, definitely appreciate you guys don't anticipate big implications around the ability to provide services for clients. But I'm just trying to think in the near-term, are there any considerations that you guys are thinking about? I'm not sure if we see a slowdown in rollover activity just for some period as the final rule is being digested, or maybe – or even on the positive side, some evidence that more money is moving towards self-directed just as it's falling through the cracks of the brokerage firms on the retail side. I'm just curious if there's any other considerations we're not talking about?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, I think there's a whole host of – irrespective of what firm you are, there's a host of internal operational factors that all of us across the industry are going to have to deal with, even if it's just how you script telephone conversations regarding IRAs. So there is definitely work to be done. And I'm convinced our team is going to be able to do that. I think that this is just another indication that E*TRADE's model within the self-directed industry is going to hold up pretty well and has the right secular trends supporting its continued growth. We see continued movement to digital, continued movement to self-directed. We think those things show up well for what we're trying to do.

Devin P. Ryan
JMP Securities LLC

Q

Okay. Got it. That's helpful. And then just following-up here on M&A thoughts, another hypothetical, but just curious how you guys would think about the utilization of stock in a deal? Obviously, it's pulled back here a little bit in recent months, but if you're thinking about anything on the brokerage or bank side, how would you think about that? Or just the things that we're kind of talking about or even thinking about, just not of the size that stock would even be necessary?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Devin, it's just really hard to talk about theoreticals, and I don't want to sound like former government officials. But it's really difficult to just comment about theoreticals. So, if we had anything to talk about, we'll be really clear and explain our rational, how we decided to fund it or anything, but we – it's just difficult to talk theoretically.

Devin P. Ryan
JMP Securities LLC

Q

Got it. Okay. No, that's fair enough. And just last on the NIM, just follow-up here again. On reinvestment rates, where are you guys seeing them right now on the securities portfolio as you're building it out a little bit further and as some are rolling off? And within that outlook, what is implied in sec lending? Just curious where you see that with the lower margin balances.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Reinvestment rate is about 175 basis point to 200 basis point range. We've been pretty much in that range over the quarter. We're seeing a lot of volatility in rates, but also seeing a lot of volatility in agency spread. So, even on the days where rates moved pretty low, we were still able to purchase at some attractive overall spread levels.

Within securities lending, securities lending did move down with margin, although it's going to ebb and flow both with the size of the margin book as well as the amount of hard to borrows within the book. So, even with the size of the book coming down, you can still see that we did fairly well overall in securities lending this quarter. And I think as the market more normalizes, we'll see the hard to borrow activity pick back up again.

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)

Q

Mike. I have a question unfortunately on M&A. I hear you loud and clear on the high bar to take on credit risk. So, just curious, first of all, what kind of returns you would need to take on [ph] said (41:49) credit risk?

And then more broadly, what is the strategic rationale of even considering any current credit risk? I don't know, do you believe you have some sort of competitive edge on evaluating credit, or is there some other kind of strategic rationale that I'm missing?

Paul Thomas Idzik
Chief Executive Officer & Director

A

I think, Christian, I think we talked about some of this in some of the public comments we made at some of the conferences. Some of the areas we would look that have wealth management and other areas within that fall within a banking space may come with some credit assets. The return hurdle we're going to apply to any credit asset is going to be well in excess of our cost of capital in terms of putting the appropriate valuation on those businesses, given they come with considerable risk. They are therefore tangential really in overall strategic fit to something that, they come along with something that has a much broader strategic fit.

Christian Bolu
Credit Suisse Securities (USA) LLC (Broker)
Q

Okay. Got it. And then, pardon if I missed this one in the prepared remarks, but do you have an estimate for the impact of increased FDIC rates in the back half?

Paul Thomas Idzik
Chief Executive Officer & Director
A

If the FDIC raises its threshold amount in Q3, which our sources lead us to believe they will, it's going to be about $1mm per quarter in increased assessment.

Brian B. Bedell
Deutsche Bank Securities, Inc.
Q

Paul, maybe just talk a little bit more about the DOL and your IRA rollover business. Retirement assets I think are close to $50B; I guess, first of all, how much of that is in IRAs? And then more strategically, with the DOL rules, how does that impact the stock plan administration business and the strategy of converting those users over to your platform?

Paul Thomas Idzik
Chief Executive Officer & Director
A

We don't break out what portion of retirement assets are IRA vs. other. With regard to stock plan business, it shouldn't impact our opportunities of continuing to make those participants great customers of E*TRADE. And in fact may give us some opportunities to have some discussions along the way they may not be getting as well served by some other providers as a result of this.

Brian B. Bedell
Deutsche Bank Securities, Inc.
Q

You view it as an opportunity essentially more than something that could be burdensome?

Paul Thomas Idzik
Chief Executive Officer & Director
A

Well, it's definitely burdensome, but I think it's an opportunity for our model relative to others.

Brian B. Bedell
Deutsche Bank Securities, Inc.
Q

Okay. Okay, great. And then just in longer term plan of accelerating organic growth, can you talk a little bit about, from the acquisition side, I guess from a capability perspective, what do you think you need to accelerate that client organic growth. What types of – is it largely wealth management or do you feel you need more technology like a robo-advisory capability?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, we already do have a robo-advisory capability, we've had it for some time. We have a new version coming out later this year and something I look forward to talking more about on a subsequent call. I'd say, there's several fronts for us on this accelerating organic growth.

One, is you will have seen us do some significant hiring over the last year. And that's primarily across hiring more financial consultants, also it has to do with adding along with the account growth, additional customer service people that we're providing the service, and adding some professionals into the corporate services participant experience area where some of our nascent efforts there are actually turning up very nicely.

The second is we interact with every one of our customers digitally, and you're seeing us do things to continue to improve our edge in mobile, and to make our overall web experience and mobile experience the type of experience that makes people want to engage more fulsomely with us and with improving their financial health. So it's a bit of doing a lot of little things better and continuing down the path.

Brian B. Bedell
Deutsche Bank Securities, Inc.

Q

And just lastly on the – how do you feel your transactional banking capabilities are now. And again, is that something that looks attractive from an acquisition perspective again to cross-sell to your customers and accelerate their organic growth?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, one of the things we are as we said in the prepared comments looking at is more along if you think about the excitement that's taking place in the payments space across some of the Fintech areas, are the type of things that we are starting to look at analytically with regard to that's something we should build, something we want to consider acquiring. But there are definitely ways we can improve some of the capabilities of our banking and banking like activities.

Michael Roger Carrier
Bank of America/Merrill Lynch

Q

Mike just a quick one, just on the commission rate, I think you mentioned that the activity in the corporate area was a bit lighter in Q1. Have you seen some of that improve with stability in the markets? And would you expect some improvement kind of going into Q2, which is maybe less seasonal than what's typical?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, I can tell you over the course of the quarter, we saw less initial activity in the early months and it did pick-up a little bit in the later months, but not meaningful enough to have an effect on the commission per trade being down $0.02 from Q4. But if you look back to last year, you'll see that typically there's a pretty powerful effect on commission per trade that we didn't see directly come directly through this quarter. Whether we see some of that come through this quarter or not, I think we're going to have to wait and see how things progress.

Michael Roger Carrier
Bank of America/Merrill Lynch

Q

Okay. Thanks. And then Paul just one quick one on the M&A or the growth side, I think on one hand when you look at getting through or growing to the $50B, you mentioned in a different rate environment maybe if the cash generation was stronger, then you would potentially pursue that. Just wanted to get your sense of what environment that might be?

And then on the strategic side, it seems like there's a ton going on in financials and the tech area, Fintech. On one hand, it seems like that's the pricier area, but on the other hand, it's obviously where the industry is going. And so I just wanted to get your thoughts on how quickly can you build something vs. having to acquire something and vice versa? Is there a lot of demand out there for a financial services company for – on the tech side – tech firms looking for financial service firms to kind of grow in that space?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Let me try and take those in turn. I'd say, the jumping over the $50B mark is impacted by two things. I mean, clearly, you want to have a quantum of cash that makes it worth your while to earn on that cash because the costs are the same whether you're at $51B or $61B.

And the rate environment obviously makes it easier to jump more quickly just do the math. With regard to looking at Fintech opportunities, I think the question for us continues to be how quickly can we deploy something ac ross our customer base and would it bring incremental revenues, would it strengthen the customer tie with our company.

And so we're continuing to look. I do think the valuations make certain deals difficult. And so, we have evaluate that, but speed to market is important. And I'm not all that familiar, I presume some of you guys would be more familiar than I am with a lot of Fintech firms looking at actually acquiring something that's going to get them nicely regulated to the degree, in fact, I don't think they can even possibly imagine. So that would be my way of looking at it