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E*TRADE Financial Corp. (ETFC)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Paul Thomas Idzik
Chief Executive Officer & Director

BUSINESS OVERVIEW

- We had a productive quarter marked by a number of accomplishments on both customer facing and financial fronts
- We launched one of our most compelling offerings in recent history
- We generated healthy levels of capital while marching forward on our capital deployment initiatives
    - And the investments made to strengthen our platforms and infrastructure again proved their worth as we handled the flurry of Brexit-inspired customer activity without getting on to a sticky wicket
- Meanwhile on an industry level, we deftly managed the challenges of the revenue environment while progressing our work related to the Department of Labor Fiduciary Standards

Q2 OPERATING RESULTS

Net Income

- Starting with our results, we reported net income of $133mm or $0.48 per share for the quarter

- We again had a sizable benefit to the provision line led by a solid loan performance and outsized recoveries
- These recoveries are a phenomenon which is difficult to predict but can dramatically impact a portfolio as seasoned as ours

Customer Activity

- On the customer activity front, metrics remain healthy largely reflecting seasonality relative to the prior quarter
- Trading activity declined throughout the period, but experienced a spike surrounding the courageous UK vote to leave the European Union, when our customers took advantage of the dip in the equity markets to the tune of $1.1B in net buying during a single trading day, the highest on record
  - The significant attention we placed on strengthening our infrastructure over the past several years enabled our platforms to handle these elevated volumes with room to spare

DARTs and Margin Balances

- For the entire quarter, a record 17% of DARTs were executed via mobile platforms
- In July to date, DARTs are currently tracking down 1% from June
- Margin balances, which had slowly edged down throughout Q1, ended Q2 up at $6.8B
  - The majority of the $0.5B increase was a Brexit-bolstered spike, so the quarter's average was lower at $6.5B
- In July to date, balances have tapered to $6.4B

New Account Addition

- We added 23,000 net new accounts in Q2, down from Q1's solid 45,000 adjusted new accounts and last year's 25,000
- Our attrition rate of 8.3% remained encouraging for the quarter
- While an increase from a near record adjusted 7.3% in the prior quarter, it decreased from an adjusted 8.7% a year ago
- We also attracted $1.6B in net new brokerage assets, reflecting our strongest Q2 in several years, but down sequentially on typical tax-related outflows in April
- We made meaningful enhancements to the customer experience this quarter

Adaptive Portfolio

- On the product front, Adaptive Portfolio, our robo-solution, is the most important new product launch in some time
- While still very early days from our June launch, we are pleased with adoption thus far, having amassed more than $100mm of assets under management in the program, including legacy managed account balances converted upon launch
- The offering stands out in a few ways:
  - First, it provides our customers the option of combining active and passive management, a new concept for the auto investing space, which has traditionally relied on passive only portfolios
  - Second, it falls between our pure digital and managed account solutions, delivering a best-in-class digital experience combined with access to financial consultants when customers have questions or want to discuss the portfolio selected by the online tool

  - Third, at circa 1%, the low cash allocation means customers' money is being put to work for them through their investments, while keeping just enough cash to rebalance and service the portfolio as necessary
  - And last, consistent with our unbiased approach to providing our customers with the solutions right for their own needs, we have no proprietary products within our model portfolios. So the investments available to customers are selected to be the best for each particular portfolio construction and not just the best that happen to carry our name
- Importantly, the solution serves longer term retirement investing and savings dollars, so it is an important component of our ongoing efforts to increase share of wallet among our existing customer base
- Additionally, we've found that as customers and prospects are navigating the Adaptive Portfolio experience they are also looking at our other offerings, leading to increased activity and self-directed account openings
- Transitioning over to our corporate services channel, we are in the midst of rolling out a completely redesigned stock plan participant experience

Equity Edge Online

- We've long had an edge in this business because of our top rated platform, Equity Edge Online
  - However, over the past three years, we've been acutely focused on further improving both the B2B and B2C elements of this channel
- This rollout presents plan participants with a more streamlined, intuitive and engaging experience

Stock Plan Benefits

- We always strive to surprise and delight our customers, but when it comes to the stock plan participant, getting the digital experience right is essential
- We understand deeply that these participants are not your typical investor, often joining us with financial knowledge less developed than what we find with mainstream E*TRADE customers
- Further, stock plan benefits are inherently complicated
  - So the more we can do to educate and engage these participants, the more they may value this component of their compensation and thus appropriately value their employer for providing it
- This is no small responsibility, and one we take extremely seriously

Recognition

- In terms of industry accolades, we were recognized by Kiplinger's this quarter in their biennial review of online brokers, earning high marks in tools and ease of use as well as first place for mobile, a platform which is increasingly important to our customers and where we frequently stand out from the crowd

Expenses

- Expenses for the quarter were $295mm, down $17mm from Q1, primarily due to seasonality and advertising, driving our adjusted operating margin, which excludes provision, to 38% from 34%
- In the face of a progressively challenging interest rate environment, we remain committed to keeping our expenses appropriately sized and continue to expect a 37% adjusted operating margin for the full year, barring exogenous factors

Capital Deployment

- On the capital front, we continue to execute on both of our deployment initiatives, putting $151mm to work repurchasing our common stock, ending the quarter nearly two-thirds the way through our $800mm program, and continuing to grow the balance sheet, ending the quarter at $49.2B, closely approaching our target of $49.5B
    - And for what's next, we continue to dedicate a lot of time and energy to this question, considering share repurchase beyond our current program, evaluating growth or enrichment through acquisition and examining balance sheet growth beyond our current target
- Regarding that final point, we've been very clear that in order to justify the compliance cost and achieve appropriate returns on capital, we need some combination of higher interest rates and a more sizeable quantum of deposits to allow us to pounce confidently over the $50B threshold
- Today with interest rates unlike at a rise in the near-term and our current level of available off-balance sheet deposits at about $2B, we've planned to asymptotically dance below the NIFTY 50 line as crossing would equate to more of a tiptoe than a pounce
- However, with industry form making money market fund to suboptimal sweep vehicle for customers, the team is working to convert approximately $4B or substantially all of our money market funds into our Cash Sweep Program, thus increasing our potential balance sheet size to above $55B
- While there are still boxes to check, we already have regulatory approval and we intent to complete this conversion in September
    - With that move, we anticipate crossing $50B in H1 next year
- Mr. Pizzi will provide an update on the particulars and the costs to conduct the Pizzi pounce

DOL Fiduciary Standards

- Moving on to the DOL Fiduciary Standards, we made significant headway this quarter working through this overreaching rule, which has proved rather Proustian in nature and shrouded with ambiguity
- I'm pleased to report that we completed much of the analysis and are moving on to implementation
    - This was no small task and commend the internal teams that worked so diligently to get us where we are
- We do anticipate additional costs as we work through the implementation phase including those related to third-party assistance from industry experts and counsel, digital enhancements to adopt the rule in our platform and increased legal and compliance costs
- Importantly, we are well-positioned to be fully compliant within the DOL stated implementation days and these expenses are included within our target operating margin for the year

Governance Update

- And now, a note on governance
- A couple of weeks ago, we further strengthened our board with the addition of Kevin Kabat
- Kevin's extensive background and financial services rounds up our board, which now stands at 12 members
- Kevin spent more than 30 years in the industry including the last eight years as CEO of Fifth Third Bancorp
    - In addition, he has experience on a number of boards both public companies and charitable organizations
- We are fortunate to benefit from his insights, particularly as we position the company to cross $50B

Summary

- So, in summary, it's been a solid first-half of the year and while I'm pleased with where we stand, we have plenty to accomplish in capital deployment, growth, expense management, and our primary mandate, which is to serve the retail investors
- On all fronts, I'm excited about what's in store for the remainder of this year

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

P&L RESULTS

Net Income

- For the quarter, we reported net income of $133mm or $0.48 per share
- This compares to adjusted net income of $123mm $0.43 per share in the prior quarter, which excludes the $31mm income tax benefit
    - It also compares to adjusted net income of $72mm or $0.25 per share in the year ago quarter, which excludes $220mm income tax benefit

Revenues

- Revenues for the quarter were $474mm, up $2mm from the prior quarter largely related to higher yields on customer assets held by third parties and up $45mm from the year ago quarterly largely attributable to the benefits from our wholesale funding termination and the Fed rate hike

Net Interest Income and Margins

- Net interest income was $286mm for the quarter down $1mm from the prior quarter as a 17 basis point reduction in net interest margin was mostly offset by $2.5B larger average balance sheet
- Our net interest margin of 264BPS decreased as we put money to work, growing our balance sheet in unspectacular rate environment and as average margin balances contracted
- The rate environment is certainly impacting us with our average reinvestment rate now in the range of 150 to 175BPS
- We continue to expect our full-year net interest margin to be 260 to 265BPS with the back half of the year in the mid-250s
    - This also assumes no change in the fed funds rate and that margin balances remain constant with their current level

Commissions Revenue

- Commissions, fees, and service charges and other revenues were $178mm, up $3mm from the prior quarter and up $11mm vs. the year ago quarter
- Compared to Q1, commissions revenue decreased $1mm as lower trading activity was offset by higher average commission per trade, which increased $0.18 to $10.82 driven by a higher course of stock plan customer trades and more auctions contracts per trade
- Relative to the year ago quarter, commissions revenue increased $3mm on higher trading activity partially offset by $0.14 decline in the average commission related to a higher mix of active traders

Fees and Service Charges Revenue

- Fees and service charges revenue increased relative to both the prior quarter and the year ago quarter, primarily attributable to higher reorg fees and higher yield on customer assets held by third parties
    - This quarter the average yield on those assets was 41BPS, up 11BPS from Q1
- As Paul mentioned, we expect to convert approximately $4B of money market funds into our Cash Sweep Program in September

Securities and Other Gains

- Securities and other gains were $10mm, flat with the prior quarter
- For the full year, we expect gains to be near the high-end of our $30mm to $40mm range
- Non-interest expense for the quarter was $295mm, down $17mm sequentially with the biggest driver being a seasonal decline in marketing
- Expenses were about $7mm below our expectations due to a further pull back in marketing in response to the environment and a small benefit running though communication expense

Adjusted Operating Margin

- Our adjusted operating margin for the quarter was 38%, up from 34% in Q1 as revenues rose slightly and expenses decrease significantly
- Our commitment to manage to an operating margin requires us to govern our expense base closely and while our operating margin improved, there is much more work to do as our revenue continues to face environmental headwinds from low interest rates
- With the rationale expense structure already in place and a discipline to marketing spend, we are committed to regularly reviewing productivity where output can be achieved with leaner resources
    - While this effort is ongoing, the current revenue environment makes our commitment to respond all the more important, and we are steadfast in supporting our operating margin target of 37% for the year

Provision Benefit

- Moving onto the provision line, we recorded a benefit of $35mm for the quarter, once again better than expected
- Net charge-offs were positive at $6mm of recoveries, contributed to the $29mm reduction and the allowance of $293mm while the overall portfolio reduced by $300mm or 6% ending the quarter at $4.4B
- Recoveries continued to be a significant factor propelling provision benefit
- As we have said in the past, recoveries in the recapture of previously charged off loans are exceptionally difficult to predict and can meaningfully swing our results
    - We also continue to benefit from better than expected performance of high risk loans that have been reserved for the full life of loan

HELOC Conversions

- This quarter, we had a relatively small amount of HELOC conversions at just over $50mm
- Overall, the performance of conversions remains consistent with an average default rate of approximately 12%, about twice that of a non-converting loan
- At this point, about $0.7B or 45% of the HELOC portfolio has yet to convert

- Nearly all of those occur over the next three quarters, with a fairly even distribution across each
  - So, while we are pleased with the performance of HELOC conversions to-date, we have a sizeable amount left to convert and we do expect losses to increase as a result
- We believe we are adequately reserved for the losses and thus expect provision to be zero through the remainder of the year, with a caveat many of the variables I just covered can have a meaningful impact on the provision result

Capital Mix

- Moving onto capital, we distributed $190mm up to the parent during the quarter, comprising the following:
  - $85mm from the bank, which is below Q1 net income of $108mm, as we utilized capital to fund balance sheet growth
  - And $102mm from the brokers, comprising $27mm from the introducing broker and $75mm from the clearing broker
- In Q3, we expect total dividend for to the parent of roughly $125mm, which includes $40mm from the bank, again below current quarter bank net income of $106mm, as we will use capital in Q3 for balance sheet growth; $57mm from the introducing broker and $28mm from the clearing broker
- As with last quarter's move, capital is being released from the clearer as its needs have reduced
- We are currently in the process of merging our two broker dealers, so starting in Q4, we will have a single brokerage entity to distribute capital to the parent
- Without going into too much detail, the entities were separated about 15 years ago for operational reasons that are no longer relevant
  - The combined entity will streamline our organizational structure and regulatory oversight
- In terms of capital, we expect future distributions to be consistent with that historically distributed out of the introducing broker

Capital Generation

- So, on to capital generation
- We ended the quarter with strong measures at the both the bank and parent
- The bank's leverage ratio ended the quarter at 8.2%, above our current 8% target
- Keep in mind that we intend to seek approval to lower this target to 7.5% early next year
- At the parent, we ended the quarter with a Tier 1 leverage ratio of 7.5%, above our minimum of 7%, and the other metric by which we measure available capital, corporate cash, ended the quarter at $523mm, well above our minimum of $100mm or two years of debt service coverage
  - So, we are in a strong position to continue deploying capital
- We remained active on that front in the quarter, repurchasing $151mm of our common stock and growing the balance sheet by $1.3B
- We have now completed more than $500mm of our $800mm share repurchase program, having repurchased 5.9mm shares during the quarter and 20.6mm over the course of the entire program at an average price of $24.34

Balance Sheet Growth

- On balance sheet growth, we ended the quarter at $49.2B, just shy of our current target of $49.5B of consolidated assets
- To expand on Paul's comments regarding our plans to exceed $50B in H1 next year, after converting the money market funds to our sweep program in September, on a pro forma basis, we have approximately

$6B of deposits readily available to bring on balance sheet, assuming no organic growth between now and then

- That amount puts crossing $50B squarely within economic reach

Capital Perspective

- From a capital perspective, we anticipate funding this growth through earnings and a lower bank Tier 1 leverage threshold
- There are a host of reporting changes and filing requirements we will enjoy with our increased size, all of which we are currently digging through
- We will provide updates on these on future calls
- With respect to incurring the expenses related to crossing, it is still too early to assign precision to timing
- However, our rough estimates assume $50mm related to the build-out, with around $5mm incurred in H2 this year and the remainder evenly spent in 2017 and 2018, and the running cost of approximately $15mm per year will start to occur in 2017 with a full run rate in 2018
  - Needless to say, with the right amount of deposits at our disposal, the returns are quite compelling and we are excited to unshackle our growth

QUESTION AND ANSWER SECTION

Richard Henry Repetto
Sandler O'Neill & Partners LP

Q

A question on the SIFI strategy, you laid out a good amount of the detail. I guess the question is, first, what's the incremental margin, at least currently, that you'd expect to get on the $6B of, I guess, new sweep deposits? And then, I know there is still a lot of talk about potentially with a new administration bumping up that SIFI limit, what would be the plan if it got increased to, I don't know, well into $100mm or above?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

[ph] I don't know (22:06) the incremental margin. At today's yield curve, the marginal investment rate's about 150 to 175BPS. So, that would be a rough proxy of the investment yield. So, we wouldn't expect to do anything with these deposits and the deposits we currently have. We're paying about 1 basis point interest, around roughly 8BPS or so to the FDIC. You can net all that down and you can get sort of what the incremental net interest margin that the deposit will provide. Against that, though is obviously the expenses that we have to take, which we just talked about in terms of timing.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Rich, with regard to the second part of your question, after Mr. Pizzi and I finished the bottle of champagne, we'd be able to unravel some of the infrastructure we had to put in place to support these deposits, and if it took place right at the beginning of the year, we wouldn't have to wait to build up the additional deposits. We'd bring them all immediately on balance sheet.

Richard Henry Repetto
Sandler O'Neill & Partners LP

Q

Got it. Okay. That's helpful. And I guess just one follow-up, on the NIM. With this current interest rate environment, any further updates on what you are – what we'd expect in the NIM over the next couple of quarters?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah, we...

Paul Thomas Idzik
Chief Executive Officer & Director

A

Michael, would you answer that?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Sure. We were 281 in Q1. We're 264. We're still holding guidance for the year that we originally gave, but that really puts us in the – in sort of the mid-250s over the rest of the year.

Steven J. Chubak
Nomura Securities International, Inc.

Q

So, Mike, I appreciate all the detail on the different puts and takes supporting the decision to pursue the Pizzi pounce. However, the crossover is highly sensitive to reinvestment rate assumptions. And I'm just wondering given the range you've giving in terms of reinvestment yield, if you stay at the lower end of that range, at 150BPS does that impact at all the timing of your decision?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Not really. I mean, in that range of 150 to 175BPS. I mean, I think we have to have some confidence that we're not going to continually go lower than what we've seen here post Brexit, is hopefully – is going go to hold the sort of the lower range in yields. If we're within that range, I mean, you can do the math at a 7.5% capital hold with that really equates to as a spread and what incremental return that's generating on the marginal capital. We feel that's a pretty reasonable use of capital at that level and that's the right decision to begin the work and to beginning incurring the cost to support levels greater than $50B.

Steven J. Chubak
Nomura Securities International, Inc.

Q

All right. And are you assuming a 7% capital target, longer term target vs. the current level that you're imagining to today?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

We're at 8% right now for the bank. We are 7%, minimum of 7% for the consolidated company. The only item that we have sort of in the immediate sites is really to try and get the bank to a level of 7.5% early next year and beyond that, we'll have to see.

Steven J. Chubak
Nomura Securities International, Inc.

Q

Got it. And you alluded to M&A opportunities in the past. I'm wondering whether the decision to cross the SIFI threshold actually impedes your ability to do any acquisitions? And on the flip side, did that actually create any obstacles for a potential bidder if someone comes with an offer that's actually attractive enough?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Steven, I could see how that might cause you to furrow your brows and come up with that. But we believe if the deal would come along that was attractive to our shareholders ,we would – it would be attractive to finance as well. And so, we don't think of one vs. the other. Putting things on the balance sheet is good long-term attractive growth, good for our shareholders. If we were to find an acquisition that was attractive, that we thought was good for the shareholders, we'd do that. And no, I don't believe either of these things we're talking about will make us less attractive to a potential acquirer.

Steven J. Chubak
Nomura Securities International, Inc.

Q

Thanks. And just last one for me. And Mike, it's a bit of technical one on the balance sheet, but looking beyond 2016, one of the questions we're getting most often is, if we're to assume a static yield curve and just looking at the maturity schedule of your securities book and assuming a steady pace of loan run off, what will be your reasonable expectation for NIM compression beyond 2016, recognizing that there are going to be some reinvestment headwinds, all else equal?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah. I mean, you can take a look at the securities yields, right, and compare them to kind of where we are at the margin, which is that 150 to 175. Now keep in mind that's on a fairly depressed yield curve as we ended the quarter, that was 175 to 200 in the prior period. So, hopefully we get some degree of normalization off these post Brexit lows, but if we don't, I mean you can model it over the average life of the securities portfolio to be becoming down in line with the life of the portfolio that we're going to recycle into the marginal rate on the securities book, keeping in mind that both stock lending and margin will continue to support higher spreads than just what the security is generating on the margin.

Conor Fitzgerald
Goldman Sachs & Co.

Q

So, it looks like the Tier-1 leverage at the HoldCo has kind of become your [ph] binding concern (27:50) And I think I heard your comments that you'll fund the growth to $55B through retained earnings partly. I guess can you just help us understand how we should think about the pace of the buyback over the next couple of quarters, considering the growth you're thinking about?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, as you can see the amount of corporate cash we have available today and the near – the buffer we have over 7% today is almost enough to complete the buyback program. Given the timing to say sort of H1 next year to break $50B, with the bank possibly moving down from 8% to 7.5%, we can fund the organic or balance some of that organic balance sheet, roughly about half, with the decline in the ratio at the bank. The rest will have become through retained earnings at the bank, and then that will support also the capital ratio at the parent level. So, we have the ability to complete the current buyback program and still break through $50B in the timing, if we were able to achieve the assumptions within our capital plan.

Conor Fitzgerald
Goldman Sachs & Co.

Q

Got it. That's helpful. Thanks. And then, not to beat a dead horse, but just to make sure I've got the moving pieces right on the $50B, going over $50B. Once I factor in kind of the lost money market fees, if the NIM is at the low end or below the 150 range you're talking about, factoring in the lack of the kind of foreground opportunity cost from our buyback, the return seemed I guess marginal would be the word I would use. Can you just talk about, again, maybe going back to Steven's question, just how sensitive you guys are to that reinvestment rate?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, I mean, yeah, if you start to go materially below the 150 to 175 range, you start talking about maybe 1% gross, so netting the money fund yield off that, it starts to become much more of a wash overall. And I think you're right in sort of pointing out that if you get below that range, the math starts to go the other way. But so long as we're within that range, we're comfortable that this is the current use of capital.

Conor Fitzgerald
Goldman Sachs & Co.

Q

Got it. And then just the last one is the technical one. The yield on the loans are a little better than I think, at least I had thought. Is 4% – I guess, can you give a little color on what drove the improvement q-over-q at spec, and is 4% ...

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah, it's lags on the LIBOR resets in the ARM portfolio starting to come through, and then really just the billing cycle on some of the home equities from the end of the year just catching up, so overall that's what's driving it on the quarter.

Conor Fitzgerald
Goldman Sachs & Co.

Q

Got it, so this Q2 is not a bad proxy for the rest of the year?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

There's still LIBOR resets to come, right. Some of these loans are 12-month resets. So depending on the timing of their cycle, there may be some additional drift up, but it's going to be small at this point.

Chris M. Harris
Wells Fargo Securities LLC

Q

Thanks, guys. Maybe want to ask a different question about the efficiencies review that's kind of undergoing. Maybe if you guys can talk to us a little bit about what areas you guys are focused on and what you actually think might be a range of expenses that you'd be targeting if the environment continues to remain pretty challenged here in the interest rate environment.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah, sure. It's a bit too early to tell on range, but it's a lot of the things where we have. Obviously, we've done a lot of investing over the past in our technology and our enterprise risk management and compliance, in the corporate infrastructure and business and other facing initiatives. Whenever you come through a period of investment like that, it's time to take stock and review just to make sure we're being as efficient and possible with how we grew and put ourselves together. So overall, it's a review of our corporate and management structure, that really leads out anything that's customer facing from a sales and service perspective.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. And one quick one on the loan portfolio – excuse me, the securities portfolio, following upon the prior questions, trying to gauge the sensitivity to reinvestment rates. How many years until the legacy securities portfolio fully rolls off?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

The legacy loan portfolio?

Chris M. Harris
Wells Fargo Securities LLC

Q

Not the loans, I mean the securities portfolio. Sorry, I misspoke.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

The securities portfolio is not a legacy portfolio. There's nothing legacy in it at this point. It's largely just the reinvestment of our agency securities book. So there are higher yields in there that are from past investments in higher rate cycles. But it's in line really with the average life of our liability duration, which we put in sort of the kind of high 3s, mid 4s area.

Devin P. Ryan
JMP Securities LLC

Q

Maybe just another one here on the [ph] PG pounce (34:51) above $50B. Obviously, higher kind of more rigorous regulatory requirements as that occurs. I'm just curious, are you guys pretty comfortable at this point that you'll still be able to work capital ratios down over time after crossing or is that something that you're still working through the that implications on? I just want to – can you give some sense there?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Devin, I think we've been clear on these calls in the past that we think we should be operating closer to 7%. But we worked closely with our supervisors and laid our capital plans and continued to improve our enterprise risk management, and those are the things that get us in a position where we feel comfortable asking and to-date, I think we've got that timing in activity right and we're going to continue to pursue it that way.

And to be clear, even if we are not given permission to progress down the road, we've have – we're going to continue to work with our supervisors to make sure we are improving what we are doing in enterprise risk management compliance et cetera because that's just good business.

Devin P. Ryan
JMP Securities LLC

Q

Yeah. Okay. That's helpful. Full-time employees increased 3% in the quarter, overall headcount up 5%, I know there was a bunch of consultants in there. Is that growth with the DOL or the [ph] PG pounce (34:15) or something else that's driving the head count?

Paul Thomas Idzik
Chief Executive Officer & Director

A

About a third of that is customer facing people and I'm proud to say we have now over 300 FCs because we've had a real initiative to drive that number up. And the remainder really fall into to two categories, one is sort of project related, specific activity related and so we expect to see those numbers come off a bit going forward, and we have some summer interns on board as well that are in the numbers. And by the way, we're going to change the name in future quarters from consultants to contingents, because they're really more contingent workers helping on things like IT et cetera.

Devin P. Ryan
JMP Securities LLC

Q

Got it. Okay. Great. And then a last one on some of the normalization, maybe we're seeing in the securities lending yields. I mean, is that just a function of kind of where demand is for hard to borrows? I'm just curious from a modeling perspective, whether that could tick back up or this seems like a pretty good level.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

You hit it right. It's the amount of hard to borrows. It's what's hard to borrow and the levels that we're getting on it and it continues to fluctuate.

Devin P. Ryan
JMP Securities LLC

Q

Got – I mean, did that change at all post Brexit? It seemed like maybe that could have improved but I'm curious if there's any color there.

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

It's been volatile with the markets, is probably the best way to describe it. It's too early to tell where it's going to end up at.

Daniel Thomas Fannon
Jefferies LLC

Q

Thanks. I guess, first question is on the provision outlook. Just curious as to what your assumption is for recoveries, if it continues? I think the last couple of quarters you've highlighted that as being the positive. Are you assuming that continues, or there's some improvement in recoveries or are you not – just curious about…

Paul Thomas Idzik
Chief Executive Officer & Director

A

Dan, as I said in our prepared remarks, it's a phenomenon that's very difficult to predict. These are recoveries from loans that were pretty much written off and forgotten and we were surprised to see some money come back on them. So our provision estimates going forward don't assume any recoveries, nor are we quite frankly allowed to assume any recoveries in the model.

Daniel Thomas Fannon
Jefferies LLC

Q

Got it. And then, Mike, you mentioned a small benefit in the communications line for expenses. Can you just quantify that? Are there any other kind of one-time things in this quarter that you would point out?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

I'd just say a good run rate for communications is about $22mm. It's related to a couple of items that were related to data charges that came through last year. And it's just – it's reversing in the current period.

Daniel Thomas Fannon
Jefferies LLC

Q

Got it. And then just lastly, in terms of the expenses and the outlook. The $5mm you highlighted with the threshold – going over the threshold for H2, that's inclusive of the guidance, of your margin guidance still for the year?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Yeah. Consider the $5mm in our current operating margin guidance.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

So, just maybe to go back on the decision to go over $50B. How do you think about that in conjunction with re-upping the stock buyback program beyond $800mm? Are they mutually exclusive or do you feel you can do both?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, I mean, if you think about it this way, if we're successful in getting from 8% to 7.5% that's going to be about $180mm of capital free up, that will support about $2.4B of balance sheet or so. You need about roughly the same amount to get to the amount of balance sheet we're talking about. So, you can do the math in terms of total capital generation that we're putting up. There's still going to be some excess capital. So, what we do with that capital, we'll have to see, but there is room to continue buybacks at some level.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

Okay. Okay. That's helpful. And then just on the operating margin target of 37%, I know you're not giving guidance [ph] today (38:25) for 2017, but would you assume you'd be able to maintain that even with the extra spend on the going over $50B?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, going over $50B is going to generate incremental revenue. We're doing a lot of that work right now, because we got to get some of the precision on the timing of that spend. So it's too early for me to give you an overall operating margin target. But as we work through our planning process, specifically our budget and capital planning process, we'll have more to update you on at Q3 and Q4 calls.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

Okay. Great. Thanks. And maybe just one last one on the broader banking strategy, Paul, that's great you get Kevin on board. Maybe if you can talk a little bit about how you're envisioning either making retail customers more aware of your current banking capabilities or expanding them and then maybe just include that with any update on your thoughts about your priorities for acquisitions if you were to do them.

Paul Thomas Idzik
Chief Executive Officer & Director

A

Yeah. Our priorities for acquisitions have remained consistent with when we started chatting with you all. I mean, number one, on the hit parade would be finding brokerage opportunities to help add to our scale in our core business. The second would defined opportunities to do the same in our corporate services business or lines that would be tangential to that corporate services business to the stock plan administration business.

And finally are things that we think about that are attractive in the banking space without any credit exposure with things such as payments is the one that most often comes to mind when we think about this because there is some interesting things happening in the fintech space, but that's what we're thinking about.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

Okay. And just for the retail bank offering, is there a plan to you negate broader advertising or sort of campaign cushion make people aware of that, and we put...

Paul Thomas Idzik
Chief Executive Officer & Director

A

We really have the banking product line for the convenience of our customers. And so, that's the reason we have it. We occasionally think about doing JVs with other parties to potentially supplement some of those products, but again staying away from many any credit exposure.

Michael Roger Carrier
Bank of America Merrill Lynch

Q

Hi. Thanks guys. Paul, just on the banking strategy. You mentioned the two, I think, that you guys were focused on in terms of making that leap with both rates and obviously the growth being able to surpass that $50B. So when I think about the rates or whatever they are, but on the surpassing the $50B, you had that chunk that you can bring over, I just want to confirm the plan is like Q1 2017. Now I guess more importantly just longer term, when you think about the growth rate in that business for what you're doing whether it's in the stock plan business, what you're doing with the robo, just the core business, and maybe just given the restrictions over the past couple of years, it's hard for us to see like what the cash growth has been, but any color on what you think, the firm is able to generate over the longer term given the investment that you have made?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, I think if I understand your question correctly, overall we are going to have this large amount or $6B that we are going to convert. Organic growth continues to grow with every account as the FDIC in short product is the marginal cash product for every – just about every customer today. So, whether they're coming from stock plan or whether they are coming from organic channels, we continue to grow that cash. With roughly about 17% of an account in the form of cash, cash will grow as we grow the total number of accounts. Cash does move quarter-to-quarter and it does move up and down, but overall it's been a growing trend as we grow our business.

Michael Roger Carrier
Bank of America Merrill Lynch

Q

Okay. That's helpful. Yeah, I was just trying to get at, given that strategy, is there anything when you think about the net new asset growth, Paul, you mentioned this 300 FCs. Obviously, you've been focused on trying to continue to grow the net new assets, but just the cash angle, if there was anything that was more focused there? And then I guess just last one, just on the robo offering. There's a lot out there on kind of the pure plays, your competitors, the big waterhouses. So just how are you differentiating and probably more importantly how are you marketing and what do you think in terms of your current customer base adapting vs. bringing in new customers, particularly related to the DOL because there might be some market dislocation there?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Mike, first of all, we're differentiating the product mainly in three ways. One, it's the only product out there that offers both active and just passive management for the client to choose which one they want. Secondly, with only 1% cash requirement, putting more of each dollar of investment to work for our customers, meaning that's a very nice value proposition. And third, unlike people who work at Bank of America or anyone else on this call, many of our customers do need help with their accounts and what's happening in tax season. And so rather than some of the pure plays, we're also there from them when they want to call us and talk about what's happening.

Interestingly, as we've started this product, which was sadly lacking from our families of products, we're seeing people come, look at the site, and in addition to looking at the robo finding out that they're also opening sometimes in conjunction with or sometimes instead of opening a self- directed account. So, anything we can do to get new customers and existing customers to really think about what's the right way to position their portfolio we think is just an important service to provide. It's going to pay off well for us in the future.

Kenneth Hill
Barclays Capital, Inc.

Q

I just wanted to follow up on that last one with adaptive portfolios. I mean, you just cover it a little bit about how you're thinking about the customers coming in. But as the customer progresses through the lifecycle and evolves with the product, do you guys have anything in place right now which may alert you or might be a scream which says this customer be more open to a financial consultant relationship or getting more broader advise longer term, and what do you think that could do for some of the other products over time?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Well, Mr. Hill, we do have those indications and the team is on top of those. So clearly, you don't have an account with us because you would have gotten called knowing your net worth. But we're happy when we get them in the hands of an FC because once they reach a certain level, the FCs who are able to grow that book to be five times more productive than a completely unFC'ed account.

Kenneth Hill
Barclays Capital, Inc.

Q

Okay. Just one follow-up too, on the $100mm, I think you said you had in there before and you said that was seeded with some of the legacy assets. How much of that was made up of legacy, and how much has just been new people come into the platform?

Paul Thomas Idzik
Chief Executive Officer & Director

A

Legacy is about 60% of that. Remember, we launched in June and so 40% new.

Chris Allen
The Buckingham Research Group, Inc.

Q

Just a couple of quick ones. Just on the fees and service charges you mentioned reorg fees as a driver as well as higher rates there. Anything to think about going forward in terms of normalization of reorg rates and then obviously you would be pointing out the deposit – the balance sheet deposit, just wondering like anything like EBIT was maybe one-time impact to the reorg in this quarter?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Sure. Reorg was worth about $1.4mm, and it was really related to a couple of key transactions in the market. Obviously, those are pretty hard to forecast, so as transactions come that have fees for the M&A reorganization, that will bounce around a bit.

Chris Allen
The Buckingham Research Group, Inc.

Q

Got it. And then just on the pre-tax margin guidance, I'm thinking about kind of expense run rates. Given the NIM outlook you've given us and thinking about lower trading revenues just in terms of – from a seasonal perspective, which seems kind of implied that we're going to see a little bit higher expenses, although I'm trying to envision how that's possible just with the environment, putting aside the $5mm, any color there?

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

A

Well, I mean, you do have a lower spread coming from the old curve, but you'll have a full quarter benefit of the larger balance sheet on an average basis coming into the next quarter. So, overall with where we are on expenses, where we're tracking with balance sheet, what the environment is like, obviously DARTs can go up and down. We still feel pretty confident in the 37%.