E TRADE FINANCIAL Corp
Form 10-Q
August 05, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2014 or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission File Number 1-11921

E*TRADE Financial Corporation
(Exact Name of Registrant as Specified in its Charter)

Delaware	94-2844166
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1271 Avenue of the Americas, 14th Floor, New York, New York 10020
(Address of principal executive offices and Zip Code)
(646) 521-4300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of July 31, 2014, there were 288,718,428 shares of common stock outstanding.

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E*TRADE FINANCIAL CORPORATION
FORM 10-Q QUARTERLY REPORT
For the Quarter Ended June 30, 2014
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Unless otherwise indicated, references to "the Company," "we," "us," "our" and "E*TRADE" mean E*TRADE Financial Corporation and its subsidiaries.

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions based on certain assumptions and include any statement that is not historical in nature. These statements may be identified by the use of words such as "assume," "expect," "believe," "may," "will," "should," "anticipate," "intend," "plan," "estimate," "continue" and similar expressions. We caution that actual results could differ materially from those discussed in these forward-looking statements. Important factors that could contribute to our actual results differing materially from any forward-looking statements include, but are not limited to, those discussed under Part 1. Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q; and Part 1. Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC, which are incorporated herein by reference. By their nature forward-looking statements are not guarantees of future performance or results and are subject to risks, uncertainties and assumptions that are difficult to predict or quantify. Actual future results may vary materially from expectations expressed or implied in this report or any of our prior communications. The forward-looking statements contained in this report reflect our expectations only as of the date of this report. You should not place undue reliance on forward-looking statements, as we do not undertake to update or revise forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made, except as required by law.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial statements and the related notes that appear elsewhere in this document and with the Annual Report on Form 10-K for the year ended December 31, 2013.

GLOSSARY OF TERMS

In analyzing and discussing our business, we utilize certain metrics, ratios and other terms that are defined in the Glossary of Terms, which is located at the end of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

OVERVIEW

Strategy

Our business strategy is centered on two core objectives: accelerating the growth of our core brokerage business to improve market share, and strengthening our overall financial and franchise position.

Accelerate Growth of Core Brokerage Business

- Enhance digital and offline customer experience.

We are focused on maintaining our competitive position in trading, margin lending and cash management, while expanding our customer share of wallet in retirement, investing and savings. Through these offerings, we aim to continue acquiring new customers while deepening engagement with both new and existing ones.

- Capitalize on value of corporate services business.

This includes leveraging our industry-leading position to improve client acquisition, and bolstering awareness among plan participants of our full suite of offerings. This channel is a strategically important driver of brokerage account growth for us.

- Maximize value of deposits through the Company's bank.

Our brokerage business generates a significant amount of deposits, which we monetize through the bank by investing primarily in low-risk, agency mortgage-backed securities.

Strengthen Overall Financial and Franchise Position

- Manage down legacy investments and mitigate credit losses.

We continue to manage down the size and risks associated with our legacy loan portfolio, while mitigating credit losses where possible.

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- Execute on our capital plan.

The core components of our capital plan include bolstering our capital levels through earnings and de-risking and building out best-in-class enterprise risk management capabilities. A key goal of this plan is to distribute capital from the bank to the parent.

Key Factors Affecting Financial Performance

Our financial performance is affected by a number of factors outside of our control, including:

- customer demand for financial products and services;
- weakness or strength of the residential real estate and credit markets;
- performance, volume and volatility of the equity and capital markets;
- customer perception of the financial strength of our franchise;
- market demand and liquidity in the secondary market for mortgage loans and securities;
- market demand and liquidity in the wholesale borrowings market, including securities sold under agreements to repurchase;
- the level and volatility of interest rates;
- our ability to obtain regulatory approval to move capital from our bank to our parent company; and
- changes to the rules and regulations governing the financial services industry.

In addition to the items noted above, our success in the future will depend upon, among other things, our ability to:

- have continued success in the acquisition, growth and retention of brokerage customers;
- generate meaningful growth in our retirement, investing and savings customer products;
- enhance our risk management capabilities;
- reduce credit costs;
- achieve the capital ratios stated in our capital plan, with a particular focus on the Tier 1 leverage ratio at E*TRADE Bank;
- generate capital sufficient to meet our operating needs at both our bank and our parent company;
- assess and manage interest rate risk; and
- maintain disciplined expense control and improved operational efficiency.

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Management monitors a number of metrics in evaluating the Company’s performance. The most significant of these are shown in the table and discussed in the text below:

	Three Months Ended June 30,		Variance	Six Months Ended June 30,		Variance
	2014	2013	2014 vs. 2013	2014	2013	2014 vs. 2013
Customer Activity Metrics:						
Daily average revenue trades ("DARTs")	155,194	149,670	4 %	176,224	149,122	18 %
Average commission per trade	$10.72	$11.10	(3)%	$10.68	$11.20	(5)%
Margin receivables (dollars in billions)	$7.3	$6.0	22 %	$7.3	$6.0	22 %
End of period brokerage accounts	3,102,966	2,962,731	5 %	3,102,966	2,962,731	5 %
Net new brokerage accounts	33,005	29,506	12 %	104,907	59,540	76 %
Annualized brokerage account attrition rate	8.6 %	8.4 %	*	8.0 %	8.5 %	*
Customer assets (dollars in billions)	$280.9	$220.1	28 %	$280.9	$220.1	28 %
Net new brokerage assets (dollars in billions)	$1.0	$1.7	(41)%	$5.1	$4.8	6 %
Brokerage related cash (dollars in billions)	$40.0	$35.6	12 %	$40.0	$35.6	12 %
Company Financial Metrics:						
Corporate cash (dollars in millions)	$570	$251	127 %	$570	$251	127 %
E*TRADE Financial Tier 1 leverage ratio	7.5 %	6.4 %	1.1 %	7.5 %	6.4 %	1.1 %
E*TRADE Financial Tier 1 common ratio	15.8 %	12.2 %	3.6 %	15.8 %	12.2 %	3.6 %
E*TRADE Bank Tier 1 leverage ratio	10.2 %	9.5 %	0.7 %	10.2 %	9.5 %	0.7 %
Special mention loan delinquencies (dollars in millions)	$155	$269	(42)%	$155	$269	(42)%
Allowance for loan losses (dollars in millions)	$401	$451	(11)%	$401	$451	(11)%
Enterprise net interest spread	2.55 %	2.35 %	0.20 %	2.51 %	2.33 %	0.18 %
Enterprise interest-earning assets (average dollars in billions)	$41.4	$40.2	3 %	$41.8	$40.5	3 %

* Percentage not meaningful.

Customer Activity Metrics

- DARTs are the predominant driver of commissions revenue from our customers.
- Average commission per trade is an indicator of changes in our customer mix, product mix and/or product pricing.
- Margin receivables represent credit extended to customers to finance their purchases of securities by borrowing against securities they own and are a key driver of net operating interest income.
- End of period brokerage accounts, net new brokerage accounts and brokerage account attrition rate are indicators of our ability to attract and retain brokerage customers. The brokerage account attrition rate is calculated by dividing attriting brokerage accounts, which are gross new brokerage accounts less net new brokerage accounts, by total

brokerage accounts at the previous period end. This rate is presented on an annualized basis.

- Changes in customer assets are an indicator of the value of our relationship with the customer. An increase in customer assets generally indicates that the use of our products and services by existing and new customers is expanding. Changes in this metric are also driven by changes in the valuations of our customers' underlying securities.

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- Net new brokerage assets are total inflows to all new and existing brokerage accounts less total outflows from all closed and existing brokerage accounts and are a general indicator of the use of our products and services by new and existing brokerage customers.
- Brokerage related cash is an indicator of the level of engagement with our brokerage customers and is a key driver of net operating interest income.

Company Financial Metrics

- Corporate cash is an indicator of the liquidity at the parent company. It is the primary source of capital above and beyond the capital deployed in our regulated subsidiaries. See Liquidity and Capital Resources for a reconciliation of this non-GAAP measure to the comparable GAAP measure.
- E*TRADE Financial Tier 1 leverage ratio is Tier 1 capital divided by average total assets for leverage capital purposes for the parent company. E*TRADE Financial Tier 1 common ratio is Tier 1 capital less elements of Tier 1 capital that are not in the form of common equity, such as trust preferred securities, divided by total risk-weighted assets for the holding company. The Tier 1 leverage and Tier 1 common ratios are non-GAAP measures as the parent company is not yet held to these regulatory capital requirements and are indications of E*TRADE Financial’s capital adequacy. See Liquidity and Capital Resources for a reconciliation of these non-GAAP measures to the comparable GAAP measures.
- E*TRADE Bank Tier 1 leverage ratio is Tier 1 capital divided by adjusted total assets for E*TRADE Bank and is an indication of E*TRADE Bank’s capital adequacy.
- Special mention loan delinquencies are loans 30-89 days past due and are an indicator of the expected trend for charge-offs in future periods as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge-off.
- Allowance for loan losses is an estimate of probable losses inherent in the loan portfolio as of the balance sheet date and is typically equal to management’s forecast of loan losses in the twelve months following the balance sheet date as well as the forecasted losses, including economic concessions to borrowers, over the estimated remaining life of loans modified as troubled debt restructurings ("TDR").
- Enterprise interest-earning assets, in conjunction with our enterprise net interest spread, are indicators of our ability to generate net operating interest income.

Significant Events in the Second Quarter of 2014

Completed the Sale of TDRs

- On April 22, 2014, we completed the sale of one- to four-family loans modified as TDRs. The sale generated cash proceeds of $0.8 billion and we recognized a net gain of approximately $7 million on the sale.

$75 Million Dividend Issued from E*TRADE Bank to the Parent Company

- We received approval from our regulators for a $75 million dividend from E*TRADE Bank to the parent company, totaling $325 million in dividends over the last four quarters, continuing to reflect significant progress on our long-term capital plan.

Completed First Official Stress Test under Dodd-Frank Act

- We submitted our first official stress test prior to March 31, 2014 as required under the Dodd-Frank Act, and received feedback from the OCC on our submission in the second quarter of 2014. While the details of our results are not public, we can share the high level result that we remained well above the regulatory well-capitalized levels for all capital ratios across all scenarios and we were satisfied with the feedback around our stress testing process, approach and methodologies.

EARNINGS OVERVIEW

We generated net income of $69 million and $166 million, or $0.24 and $0.56 per diluted share, on total net revenue of $438 million and $913 million for the three and six months ended June 30, 2014, respectively. Net operating interest income increased 11% to $270 million and $536 million for both the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013, which were driven primarily by the size and mix of the balance sheet as well as increases in net

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interest spread. Commissions, fees and service charges and other revenue increased 3% to $161 million and 16% to $345 million for the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013, which were driven primarily by increased order flow revenue for both periods, in addition to increased trading activity during the six months ended June 30, 2014.

Provision for loan losses decreased 74% to $12 million and 82% to $16 million for the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013. The decreases were driven primarily by improving economic conditions, as evidenced by the lower levels of delinquent loans in the one- to four-family and home equity loan portfolios, lower net charge-offs, home price improvement and loan portfolio run-off. Total operating expenses decreased 31% to $284 million and 19% to $574 million for the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013. The decreases for the three and six months ended June 30, 2014 were driven primarily by $142 million in impairment of goodwill that was recognized in the second quarter of 2013 which increased operating expenses for the same periods in 2013.

The following sections describe in detail the changes in key operating factors and other changes and events that affected net revenue, provision for loan losses, operating expense, other income (expense) and income tax expense.

Revenue

The components of revenue and the resulting variances are as follows (dollars in millions):

	Three Months Ended June 30,		Variance 2014 vs. 2013		Six Months Ended June 30,		Variance 2014 vs. 2013	
	2014	2013	Amount	%	2014	2013	Amount	%
Net operating interest income	$270	$243	$27	11 %	$536	$484	$52	11 %
Commissions	105	106	(1)	(1)%	233	207	26	13 %
Fees and service charges	46	41	5	12 %	93	73	20	27 %
Principal transactions	—	21	(21)	*	10	43	(33)	(77)%
Gains on loans and securities, net	7	21	(14)	(67)%	22	37	(15)	(41)%
Net impairment	—	(1)	1	*	—	(2)	2	*
Other revenues	10	9	1	11 %	19	18	1	6 %
Total non-interest income	168	197	(29)	(15)%	377	376	1	0 %
Total net revenue	$438	$440	$(2)	(0)%	$913	$860	$53	6 %

* Percentage not meaningful.

Net Operating Interest Income

Net operating interest income increased 11% to $270 million and $536 million for both the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013. Net operating interest income is earned primarily through investing deposits and customer payables in enterprise interest-earning assets, which include: available-for-sale securities, held-to-maturity securities, margin receivables and real estate loans.

The following table presents enterprise average balance sheet data and enterprise income and expense data for our operations, as well as the related net interest spread, yields and rates and have been prepared on the basis required by the SEC’s Industry Guide 3, "Statistical Disclosure by Bank Holding Companies" (dollars in millions):

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	Three Months Ended June 30,			2013		
	2014					
	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost
Enterprise interest-earning assets:						
Loans[1]	$7,416	$77	4.18 %	$9,811	$102	4.17 %
Available-for-sale securities	12,742	72	2.28 %	12,399	67	2.16 %
Held-to-maturity securities	11,298	82	2.91 %	9,770	61	2.51 %
Margin receivables	7,330	65	3.56 %	5,675	54	3.81 %
Cash and equivalents	1,310	1	0.15 %	1,365	1	0.21 %
Segregated cash	799	1	0.10 %	468	—	0.10 %
Securities borrowed and other	500	21	16.43 %	678	13	7.95 %
Total enterprise interest-earning assets	41,395	319	3.08 %	40,166	298	2.97 %
Non-operating interest-earning and non-interest earning assets[2]	4,203			4,752		
Total assets	$45,598			$44,918		
Enterprise interest-bearing liabilities:						
Deposits	$25,239	2	0.03 %	$25,598	3	0.05 %
Customer payables	6,250	3	0.16 %	5,293	2	0.14 %
Securities sold under agreements to repurchase	4,010	30	2.98 %	4,465	37	3.28 %
Federal Home Loan Bank ("FHLB") advances and other borrowings	1,285	17	5.24 %	1,287	17	5.26 %
Securities loaned and other	1,506	—	0.03 %	856	—	0.02 %
Total enterprise interest-bearing liabilities	38,290	52	0.53 %	37,499	59	0.62 %
Non-operating interest-bearing and non-interest bearing liabilities[3]	2,187			2,487		
Total liabilities	40,477			39,986		
Total shareholders' equity	5,121			4,932		
Total liabilities and shareholders' equity	$45,598			$44,918		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread	$3,105	$267	2.55 %	$2,667	$239	2.35 %
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.58 %			2.38 %
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			108.11 %			107.11 %
Return on average:						
Total assets			0.61 %			(0.48)%
Total shareholders' equity			5.40 %			(4.40)%
Average equity to average total assets			11.23 %			10.98 %

Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):

	Three Months Ended June 30,	
	2014	2013
Enterprise net interest income	$267	$239
Customer assets held by third parties[4]	3	4

Net operating interest income	$270	$243

(1) Nonaccrual loans are included in the average loan balances. Interest payments received on nonaccrual loans are recognized on a cash basis in operating interest income until it is doubtful that full payment will be collected, at which point payments are applied to principal.

(2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.

(3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.

(4) Includes revenue earned on average customer assets of $14.1 billion and $11.2 billion for the three months ended June 30, 2014 and 2013, respectively, held by third parties outside the Company, including money market funds and sweep deposit accounts at unaffiliated financial institutions. Fees earned on the customer assets are based on the federal funds rate plus a negotiated spread or other contractual arrangement with the third party institutions.

	Six Months Ended June 30, 2014			2013		
	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost
Enterprise interest-earning assets:						
Loans[1]	$7,904	$161	4.08 %	$10,103	$209	4.13 %
Available-for-sale securities	13,115	151	2.30 %	12,691	131	2.06 %
Held-to-maturity securities	10,927	159	2.91 %	9,636	119	2.48 %
Margin receivables	7,134	127	3.60 %	5,671	108	3.85 %
Cash and equivalents	1,229	1	0.15 %	1,478	2	0.21 %
Segregated cash	818	1	0.10 %	314	—	0.10 %
Securities borrowed and other	626	38	12.24 %	636	26	8.33 %
Total enterprise interest-earning assets	41,753	638	3.06 %	40,529	595	2.95 %
Non-operating interest-earning and non-interest earning assets[2]	4,235			4,923		
Total assets	$45,988			$45,452		
Enterprise interest-bearing liabilities:						
Deposits	$25,465	4	0.03 %	$26,270	6	0.05 %
Customer payables	6,310	5	0.16 %	5,177	4	0.14 %
Securities sold under agreements to repurchase	4,232	65	3.06 %	4,459	74	3.29 %
Federal Home Loan Bank ("FHLB") advances and other borrowings	1,283	34	5.26 %	1,274	34	5.31 %
Securities loaned and other	1,367	—	0.04 %	803	—	0.01 %
Total enterprise interest-bearing liabilities	38,657	108	0.55 %	37,983	118	0.62 %
Non-operating interest-bearing and non-interest bearing liabilities[3]	2,292			2,544		
Total liabilities	40,949			40,527		
Total shareholders’ equity	5,039			4,925		
Total liabilities and shareholders’ equity	$45,988			$45,452		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread	$3,096	$530	2.51 %	$2,546	$477	2.33 %
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.54 %			2.36 %
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			108.01 %			106.70 %
Return on average:						
Total assets			0.72 %			(0.08)%
Total shareholders' equity			6.58 %			(0.77)%
Average equity to average total assets			10.96 %			10.84 %

Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):

	Six Months Ended June 30, 2014	2013
Enterprise net interest income	$530	$477
Customer assets held by third parties[4]	6	7

Net operating interest income	$536	$484

(1) Nonaccrual loans are included in the average loan balances. Interest payments received on nonaccrual loans are recognized on a cash basis in operating interest income until it is doubtful that full payment will be collected, at which point payments are applied to principal.

(2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.

(3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.

(4) Includes revenue earned on average customer assets of $14.1 billion and $10.4 billion for the six months ended June 30, 2014 and 2013, respectively, held by third parties outside the Company, including money market funds and sweep deposit accounts at unaffiliated financial institutions. Fees earned on the customer assets are based on the federal funds rate plus a negotiated spread or other contractual arrangement with the third party institutions.