

E TRADE FINANCIAL CORP
Form 10-Q
August 04, 2010
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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, 2010

or

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

Commission File Number 1-11921

E*TRADE Financial Corporation

(Exact Name of Registrant as Specified in its Charter)

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Delaware
(State or Other Jurisdiction of

94-2844166
(I.R.S. Employer

Incorporation or Organization)

Identification Number)

135 East 57th Street, New York, New York 10022

(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 ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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 ☒ 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 ☒

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 ☒

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

As of August 2, 2010, there were 220,722,632 shares of common stock outstanding.

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E*TRADE FINANCIAL CORPORATION

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended June 30, 2010

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*Unless otherwise indicated, references to the Company, we, us, our and E*TRADE mean E*TRADE Financial Corporation or its subsidiaries.*

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements involving risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as expect, may, anticipate, intend, plan and similar expressions. Our actual results could differ materially from those discussed in these forward-looking statements, and we caution that we do not undertake to update these statements. Factors that could contribute to our actual results differing from any forward-looking statements include those discussed under Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report. The cautionary statements made in this report should be read as being applicable to all forward-looking statements wherever they appear in this report. Important factors that may cause actual results to differ materially from any forward-looking statements are set forth in our 2009 Form 10-K filed with the Securities and Exchange Commission (SEC) under the heading Risk Factors.

We further caution that there may be risks associated with owning our securities other than those discussed in such filings.

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

This information is set forth immediately following Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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.

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 core business is our trading and investing customer franchise. Our strategy is to profitably grow this business by focusing on two primary groups of customers: traders and long-term investors. We believe our trading customers, particularly our active traders, are the foundation of our brokerage business and we are focused on maintaining our competitive position with this customer group. Our long-term investing customer group is less developed when compared to our trading customers and represents our largest opportunity for future growth.

We believe our focus on certain key factors will enable us to execute our strategy of profitably growing our trading and investing business. These key factors include the development of innovative online trading and long-term investing products and services, a concerted effort to deliver superior customer service, creative and cost-effective marketing and sales, and expense discipline. In addition, we continue to invest significantly for long-term growth so that we remain competitive among the largest online brokers.

Our strategy also includes an intense focus on mitigating the credit losses inherent in our loan portfolio. In addition, we are focused on our overall capital structure as evidenced by the recapitalization transactions

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executed in the second and third quarters of 2009. We believe these transactions significantly improved our capital structure and better positioned the Company for future growth.

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;

the weakness or strength of the residential real estate and credit markets;

the 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; 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:

continuing our success in the acquisition, growth and retention of trading customers;

our ability to generate meaningful growth in the long-term investing customer group;

our ability to assess and manage credit risk;

our ability to generate capital sufficient to meet our operating needs, particularly a level sufficient to offset loan losses;

our ability to assess and manage interest rate risk; and

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:

	As of or For the Three Months Ended June 30,			Variance	As of or For the Six Months Ended June 30,			Variance
	2010	2009		2010 vs. 2009	2010	2009		2010 vs. 2009
Customer Activity Metrics: ⁽¹⁾								
Daily average revenue trades (DARTs)	170,283	202,578		(16)%	162,916	189,209		(14)%
Average commission per trade	\$ 11.05	\$ 11.27		(2)%	\$ 11.21	\$ 11.14		1%
Margin receivables (dollars in billions)	\$ 4.8	\$ 3.1		55%	\$ 4.8	\$ 3.1		55%
End of period brokerage accounts	2,649,500	2,626,793		1%	2,649,500	2,626,793		1%
Net new brokerage accounts	17,523	51,598		*	19,421	110,987		*
Customer assets (dollars in billions)	\$ 143.8	\$ 127.5		13%	\$ 143.8	\$ 127.5		13%
Net new brokerage assets (dollars in billions)	\$ 2.1	\$ 2.3		*	\$ 4.3	\$ 4.6		*
Brokerage related cash (dollars in billions)	\$ 20.7	\$ 17.7		17%	\$ 20.7	\$ 17.7		17%
Company Financial Metrics:								
Corporate cash (dollars in millions)	\$ 481.1	\$ 527.0		(9)%	\$ 481.1	\$ 527.0		(9)%
E*TRADE Bank excess risk-based capital (dollars in millions)	\$ 1,008.4	\$ 910.9		11%	\$ 1,008.4	\$ 910.9		11%
Special mention loan delinquencies (dollars in millions)	\$ 660.3	\$ 859.7		(23)%	\$ 660.3	\$ 859.7		(23)%
Allowance for loan losses (dollars in millions)	\$ 1,102.9	\$ 1,218.9		(10)%	\$ 1,102.9	\$ 1,218.9		(10)%
Enterprise net interest spread	2.89%	2.91%		(0.02)%	2.93%	2.63%		0.30%
Enterprise interest-earning assets (average in billions)	\$ 41.0	\$ 45.2		(9)%	\$ 41.7	\$ 45.0		(7)%

* Percentage not meaningful.

(1) The prior periods presented have been updated to exclude international local brokerage activity.

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. As a result, this metric is impacted by the mix between our customer groups.

Margin receivables represent credit extended to customers and non-customers to finance their purchases of securities by borrowing against securities they currently own. Margin receivables are a key driver of net operating interest income.

End of period brokerage accounts and net new brokerage accounts are indicators of our ability to attract and retain trading and investing customers.

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.

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 existing and new brokerage customers.

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Customer cash and deposits, particularly our brokerage related cash, are an indicator of a deepening engagement with our customers and are 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 also a source of cash that can be deployed in our regulated subsidiaries.

E*TRADE Bank excess risk-based capital is the excess capital that E*TRADE Bank has compared to the regulatory minimum to be considered well-capitalized and is an indicator of E*TRADE Bank's ability to absorb future loan losses. It is also a potential source of additional corporate cash as this capital, if requested by us and approved by our regulators, could be sent as a dividend or otherwise distributed up to the parent company.

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 the losses inherent in our loan portfolio as of the balance sheet date and is typically equal to the expected charge-offs in our loan portfolio over the next twelve months as well as the estimated charge-offs, including economic concessions to borrowers, over the estimated remaining life of loans modified in troubled debt restructurings.

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 2010**Enhancements to Our Trading and Investing Products and Services*

An open applications programming interface (Open API) for third-party and independent software developers was made available to active traders. These customers can now have access to technical information and documentation, reference guides, and other resources to help network external applications and programs with our active trader platform.

Completion of 1-for-10 Reverse Stock Split

In June 2010, we completed a 1-for-10 reverse stock split. All prior periods presented have been adjusted to reflect the impact of this reverse stock split, including basic and diluted weighted-average shares and shares issued and outstanding.

Summary Financial Results (dollars in millions, except per share amounts)

	Three Months Ended June 30,		Variance	Six Months Ended June 30,		Variance
	2010	2009	2010 vs. 2009	2010	2009	2010 vs. 2009
Net operating interest income	\$ 302.0	\$ 339.6	(11)%	\$ 622.4	\$ 618.2	1%
Commissions	\$ 119.6	\$ 154.1	(22)%	\$ 232.8	\$ 279.7	(17)%
Fees and services charges	\$ 35.2	\$ 47.9	(27)%	\$ 77.4	\$ 94.7	(18)%
Principal transactions	\$ 28.7	\$ 22.7	26%	\$ 54.9	\$ 40.3	36%
Total net revenue	\$ 534.0	\$ 620.9	(14)%	\$ 1,070.5	\$ 1,118.2	(4)%
Provision for loan losses	\$ 165.7	\$ 404.5	(59)%	\$ 433.6	\$ 858.5	(49)%

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Operating margin	\$ 92.7	\$ (112.8)	*	\$ 65.9	\$ (363.4)	*
Net income (loss)	\$ 35.1	\$ (143.2)	*	\$ (12.8)	\$ (375.9)	*
Diluted earnings (loss) per share	\$ 0.12	\$ (2.16)	*	\$ (0.06)	\$ (6.11)	*

* Percentage not meaningful.

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During the three and six months ended June 30, 2010, we generated net income of \$35.1 million and incurred a net loss of \$12.8 million, respectively. Our net income for the three months ended June 30, 2010 primarily resulted from income before income taxes of \$203.3 million in our trading and investing segment, which was offset by \$165.7 million in provision for loan losses reported in our balance sheet management segment. Our net loss for the six months ended June 30, 2010 was due primarily to income before income taxes of \$389.1 million in our trading and investing segment, which was more than offset by \$433.6 million in provision for loan losses reported in our balance sheet management segment. Although we expect provision for loan losses to continue at elevated levels in future periods, the level of provision for loan losses has declined for seven consecutive quarters. While we cannot state with certainty that this trend will continue, we believe it is a positive indicator that our loan portfolio has continued to improve.

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

Revenue

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

	Three Months		Variance		Six Months Ended		Variance	
	Ended				June 30,			
	2010	2009	2010 vs. 2009		2010	2009	2010 vs. 2009	
			Amount	%			Amount	%
Net operating interest income	\$ 302.0	\$ 339.6	\$ (37.6)	(11)%	\$ 622.4	\$ 618.2	\$ 4.2	1%
Commissions	119.6	154.1	(34.5)	(22)%	232.8	279.7	(46.9)	(17)%
Fees and service charges	35.2	47.9	(12.7)	(27)%	77.4	94.7	(17.3)	(18)%
Principal transactions	28.7	22.7	6.0	26%	54.9	40.3	14.6	36%
Gains on loans and securities, net	48.9	73.2	(24.3)	(33)%	78.0	108.5	(30.5)	(28)%
Net impairment	(12.2)	(29.7)	17.5	*	(20.8)	(48.5)	27.7	*
Other revenues	11.8	13.1	(1.3)	(10)%	25.8	25.3	0.5	2%
Total non-interest income	232.0	281.3	(49.3)	(18)%	448.1	500.0	(51.9)	(10)%
Total net revenue	\$ 534.0	\$ 620.9	\$ (86.9)	(14)%	\$ 1,070.5	\$ 1,118.2	\$ (47.7)	(4)%

* Percentage not meaningful.

Total net revenue decreased 14% to \$534.0 million and 4% to \$1.1 billion for the three and six months ended June 30, 2010, respectively, compared to the same periods in 2009. This was driven by lower commissions, fees and service charges and gains on loans and securities, net, which was slightly offset by a decrease in net impairment. Additionally, the decrease for the three months ended June 30, 2010 was driven by lower net operating interest income compared to the same period in 2009.

Net Operating Interest Income

Net operating interest income decreased 11% to \$302.0 million and increased slightly to \$622.4 million for the three and six months ended June 30, 2010, respectively, compared to the same periods in 2009. Net operating interest income is earned primarily through investing customer cash and deposits in interest-earning assets, which include: margin receivables, real estate loans, mortgage-backed securities and investment securities. The decrease in net operating interest income for the three months ended June 30, 2010 was due primarily to decreases in our enterprise interest-earning assets, specifically loans and available-for-sale mortgage-backed securities. The slight increase for the six months ended June 30, 2010 was driven by lower yields on our enterprise interest-bearing liabilities, specifically deposits, which was mostly offset by a decrease in our enterprise interest-earning assets.

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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 has been prepared on the basis required by the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* (dollars in millions):

	Three Months Ended June 30,					
	Average Balance	2010 Operating Interest Inc./Exp.	Average Yield/ Cost	Average Balance	2009 Operating Interest Inc./Exp.	Average Yield/ Cost
Enterprise interest-earning assets:						
Loans ⁽¹⁾	\$ 18,844.0	\$ 225.3	4.78%	\$ 23,889.8	\$ 292.5	4.90%
Margin receivables	4,479.4	50.0	4.47%	2,771.7	31.4	4.55%
Available-for-sale mortgage-backed securities	8,826.4	70.6	3.20%	11,795.2	127.6	4.32%
Available-for-sale investment securities	3,725.3	23.6	2.53%	253.5	3.3	5.15%
Held-to-maturity securities	135.1	1.3	3.74%			
Trading securities	1.4	0.0	5.68%	23.6	0.5	8.47%
Cash and equivalents ⁽²⁾	4,317.7	2.5	0.23%	5,790.9	4.7	0.33%
Stock borrow and other	661.0	6.6	3.99%	681.2	21.6	12.73%
Total enterprise interest-earning assets	40,990.3	379.9	3.71%	45,205.9	481.6	4.27%
Non-operating interest-earning assets ⁽³⁾	4,273.5			3,775.5		
Total assets	\$ 45,263.8			\$ 48,981.4		
Enterprise interest-bearing liabilities:						
Retail deposits	\$ 24,118.0	14.7	0.24%	\$ 27,061.9	50.6	0.75%
Brokered certificates of deposit	116.1	1.5	5.18%	214.3	2.9	5.39%
Customer payables	4,660.2	1.7	0.14%	4,503.4	2.1	0.19%
Securities sold under agreements to repurchase	6,332.6	30.7	1.92%	6,856.2	51.4	2.96%
Federal Home Loan Bank (FHLB) advances and other borrowings	2,747.2	30.8	4.43%	3,644.7	38.4	4.17%
Stock loan and other	599.5	0.4	0.28%	501.0	0.5	0.41%
Total enterprise interest-bearing liabilities	38,573.6	79.8	0.82%	42,781.5	145.9	1.36%
Non-operating interest-bearing liabilities ⁽⁴⁾	2,704.2			3,602.2		
Total liabilities	41,277.8			46,383.7		
Total shareholders' equity	3,986.0			2,597.7		
Total liabilities and shareholders' equity	\$ 45,263.8			\$ 48,981.4		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread						
	\$ 2,416.7	\$ 300.1	2.89%	\$ 2,424.4	\$ 335.7	2.91%
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.93%			2.97%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			106.27%			105.67%
Return on average:						
Total assets			0.31%			(1.17)%
Total shareholders' equity			3.52%			(22.06)%
Average equity to average total assets			8.81%			5.30%
Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):						

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	Three Months Ended June 30,	
	2010	2009
Enterprise net interest income ⁽⁵⁾	\$ 300.1	\$ 335.7
Taxable equivalent interest adjustment	(0.3)	(0.7)
Customer cash held by third parties and other ⁽⁶⁾	2.2	4.6
Net operating interest income	\$ 302.0	\$ 339.6

(1) Nonaccrual loans are included in the respective average loan balances. Income on such nonaccrual loans is recognized on a cash basis.

(2) Includes segregated cash balances.

(3) Non-operating 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.

(4) Non-operating 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.

(5) Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.

(6) Includes interest earned on average customer assets of \$3.1 billion and \$2.8 billion for the three months ended June 30, 2010 and 2009, respectively, held by parties outside E*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

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	Six Months Ended June 30,					
	Average Balance	2010 Operating Interest Inc./Exp.	Average Yield/ Cost	Average Balance	2009 Operating Interest Inc./Exp.	Average Yield/ Cost
Enterprise interest-earning assets:						
Loans ⁽¹⁾	\$ 19,383.3	\$ 466.9	4.82%	\$ 24,483.3	\$ 605.8	4.95%
Margin receivables	4,247.9	94.7	4.49%	2,761.4	58.3	4.26%
Available-for-sale mortgage-backed securities	9,257.2	152.5	3.29%	11,486.0	253.3	4.41%
Available-for-sale investment securities	3,875.7	51.3	2.65%	190.2	5.3	5.57%
Held-to-maturity securities	67.9	1.3	3.71%			
Trading securities	1.7	0.1	6.14%	29.5	1.2	7.93%
Cash and equivalents ⁽²⁾	4,168.1	4.8	0.23%	5,368.0	10.5	0.39%
Stock borrow and other	672.5	13.6	4.08%	635.9	29.7	9.42%
Total enterprise interest-earning assets	41,674.3	785.2	3.77%	44,954.3	964.1	4.30%
Non-operating interest-earning assets ⁽³⁾	4,260.7			3,808.1		
Total assets	\$ 45,935.0			\$ 48,762.4		
Enterprise interest-bearing liabilities:						
Retail deposits	\$ 24,467.8	33.1	0.27%	\$ 26,720.7	144.1	1.09%
Brokered certificates of deposit	118.0	3.0	5.11%	253.8	6.4	5.13%
Customer payables	4,917.3	3.6	0.15%	4,141.0	4.9	0.24%
Securities sold under agreements to repurchase	6,352.2	65.5	2.05%	6,974.8	112.5	3.21%
Federal Home Loan Bank (FHLB) advances and other borrowings	2,754.2	60.2	4.35%	3,910.2	84.5	4.30%
Stock loan and other	609.4	0.9	0.30%	462.1	1.4	0.60%