

E TRADE FINANCIAL CORP
Form 10-Q
August 06, 2018
Table of Contents

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

FORM 10-Q

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

For the quarterly period ended June 30, 2018

Commission File Number 1-11921

ETRADE Financial Corporation
(Exact Name of Registrant as Specified in its Charter)

Delaware 94-2844166
(State or other jurisdiction (I.R.S. Employer
of incorporation or organization) Identification Number)
11 Times Square, 32nd Floor, New York, New York 10036
(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 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth 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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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, 2018, there were 259,675,020 shares of common stock outstanding.

Table of Contents

E*TRADE FINANCIAL CORPORATION

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended June 30, 2018

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

	<u>Forward-Looking Statements</u>	<u>1</u>
Item 1.	<u>Condensed Consolidated Financial Statements (Unaudited)</u>	<u>42</u>
	<u>Condensed Consolidated Statement of Income</u>	<u>43</u>
	<u>Condensed Consolidated Statement of Comprehensive Income</u>	<u>44</u>
	<u>Condensed Consolidated Balance Sheet</u>	<u>45</u>
	<u>Condensed Consolidated Statement of Shareholders' Equity</u>	<u>46</u>
	<u>Condensed Consolidated Statement of Cash Flows</u>	<u>47</u>
	<u>Notes to the Condensed Consolidated Financial Statements (Unaudited)</u>	<u>49</u>
	<u>Note 1—Organization, Basis of Presentation and Summary of Significant Accounting Policies</u>	<u>49</u>
	<u>Note 2—Business Acquisition</u>	<u>53</u>
	<u>Note 3—Net Revenue</u>	<u>55</u>
	<u>Note 4—Fair Value Disclosures</u>	<u>57</u>
	<u>Note 5—Offsetting Assets and Liabilities</u>	<u>66</u>
	<u>Note 6—Available-for-Sale and Held-to-Maturity Securities</u>	<u>68</u>
	<u>Note 7—Loans Receivable, Net</u>	<u>71</u>
	<u>Note 8—Derivative Instruments and Hedging Activities</u>	<u>80</u>
	<u>Note 9—Deposits</u>	<u>83</u>
	<u>Note 10—Other Borrowings</u>	<u>83</u>
	<u>Note 11—Corporate Debt</u>	<u>84</u>
	<u>Note 12—Shareholders' Equity</u>	<u>85</u>
	<u>Note 13—Earnings Per Share</u>	<u>88</u>
	<u>Note 14—Regulatory Requirements</u>	<u>89</u>
	<u>Note 15—Commitments, Contingencies and Other Regulatory Matters</u>	<u>91</u>
	<u>Note 16—Subsequent Event</u>	<u>94</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)</u>	<u>3</u>
	<u>Overview</u>	<u>3</u>
	<u>Earnings Overview</u>	<u>15</u>
	<u>Balance Sheet Overview</u>	<u>23</u>
	<u>Liquidity and Capital Resources</u>	<u>28</u>
	<u>Risk Management</u>	<u>34</u>
	<u>Concentrations of Credit Risk</u>	<u>34</u>
	<u>Summary of Critical Accounting Policies and Estimates</u>	<u>35</u>
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>36</u>
	<u>Key Terms</u>	<u>38</u>
Item 4.	<u>Controls and Procedures</u>	<u>95</u>
Part II	OTHER INFORMATION	
Item 1.	<u>Legal Proceedings</u>	<u>96</u>
Item 1A.	<u>Risk Factors</u>	<u>96</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>96</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>97</u>
Item 4.	<u>Mine Safety Disclosure</u>	<u>97</u>
Item 5.	<u>Other Information</u>	<u>97</u>
Item 6.	<u>Exhibits</u>	<u>97</u>
	<u>Signatures</u>	<u>98</u>

Table of Contents

Unless otherwise indicated, references to "the Company," "we," "us," "our," "E*TRADE" and "E*TRADE Financial" mean E*TRADE Financial Corporation and its subsidiaries, and references to the parent company mean E*TRADE Financial Corporation but not its subsidiaries.

E*TRADE, E*TRADE Financial, E*TRADE Bank, the Converging Arrows logo, OptionsHouse, Equity Edge Online, Trust Company of America, TCA by E*TRADE, and LibertyTM are trademarks or registered trademarks of E*TRADE Financial Corporation in the United States and in other countries. All other trademarks are the property of their respective owners.

E*TRADE Q2 2018 10-Q | Page ii

Table of Contents

PART I

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 discuss, among other things:

- our future plans, objectives, outlook, strategies, expectations and intentions relating to our business and future financial and operating results and the assumptions that underlie these matters and include statements regarding our proposed transaction with Capital One Financial Corporation (Capital One) and its benefits and timing,
- our capital plan initiatives and expected balance sheet size,
- the payment of dividends from our subsidiaries to our parent company,
- the management of our legacy mortgage and consumer loan portfolio,
- our ability to utilize deferred tax assets, the expected implementation and applicability of government regulation and our ability to comply with these regulations,
- our ability to maintain required regulatory capital ratios,
- continued repurchases of our common stock, payment of dividends on our preferred stock,
- our ability to meet upcoming debt obligations,
- the integration and related restructuring costs of past and any future acquisitions,
- the expected outcome of existing or new litigation,
- our ability to execute our business plans and manage risk,
- the potential decline of fees and service charges,
- future sources of revenue, expense and liquidity, and
- any other 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:

- the closing of the proposed transaction with Capital One may not occur or may be delayed and that the actual aggregate consideration paid in connection with the proposed transaction is still subject to final determination,
- changes in business, economic or political condition,
- performance, volume and volatility in the equity and capital markets,
- changes in interest rates or interest rate volatility,
- customer demand for financial products and services,
- our ability to continue to compete effectively and respond to aggressive price competition within our industry,
- cyber security threats, potential system disruptions and other security breaches or incidents,
- our ability to participate in consolidation opportunities in our industry, to complete consolidation transactions and to realize synergies or implement integration plans,
- our ability to service our corporate debt and, if necessary, to raise additional capital,
- changes in government regulation or actions by our regulators, including those that may result from the implementation and enforcement of regulatory reform legislation,
- our ability to move capital to our parent company from our subsidiaries,

Table of Contents

adverse developments in litigation,
our ability to manage our balance sheet growth, and
the timing, duration and costs associated with our stock repurchase program.

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. Investors should also consider the risks and uncertainties described elsewhere in this report, including under Part I. Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations and Part II. Item 1A. Risk Factors of this Quarterly Report and Part I. Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the Securities and Exchange Commission (SEC), which are incorporated herein by reference. The forward-looking statements contained in this report reflect our expectations only as of the date of this report. Investors should not place undue reliance on forward-looking statements, as we do not undertake to update or revise forward-looking statements, except as required by law.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (MD&A)

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, 2017.

OVERVIEW

Company Overview

E*TRADE is a financial services company that provides online brokerage and related products and services primarily to individual retail investors. Founded on the principle of innovation, we aim to enhance the financial independence of traders and investors through a powerful digital experience that includes tools and educational materials, supported by professional guidance, to help individual investors and traders meet both near- and long-term investing goals. We provide these services to customers through our digital platforms and network of industry-licensed customer service representatives and financial consultants, over the phone, by email and online via two national financial centers and in-person at 30 regional financial centers across the United States. We operate directly and through several subsidiaries, many of which are overseen by governmental and self-regulatory organizations. Our most important subsidiaries are described below:

E*TRADE Securities LLC (E*TRADE Securities) is a registered broker-dealer that clears and settles customer securities transactions.

E*TRADE Bank is a federally chartered savings bank that provides Federal Deposit Insurance Corporation (FDIC) insurance on qualifying amounts of customer deposits and provides other banking and cash management capabilities. E*TRADE Savings Bank, a subsidiary of E*TRADE Bank, is a federally chartered savings bank that provides FDIC insurance on qualifying amounts of customer deposits and custody solutions for registered investment advisors (RIAs) through Trust Company of America (TCA).

E*TRADE Financial Corporate Services is a provider of software and services for managing equity compensation plans to our corporate clients.

E*TRADE Futures LLC (E*TRADE Futures) is a registered non-clearing Futures Commission Merchant (FCM) that provides clearing and settlement services for customer futures transactions.

E*TRADE Capital Management, LLC (E*TRADE Capital Management) is an RIA that provides investment advisory services for our customers.

Table of Contents

Delivering a powerful digital offering for our customers is a core pillar of our business strategy and we believe our focus on being a digital leader in the financial services industry is a competitive advantage. Our hybrid delivery model is available through the following award-winning digital platforms:

Web

Our leading-edge sites for customers and our primary channel to interact with prospects

- Access to a broad range of trading solutions
- Actionable ideas and information
- Research and education for decision making

Mobile

Powerful trading applications for smartphones, tablets and watches

- Award-winning mobile apps
- Platforms to manage accounts on the move
- Stock and portfolio alerts

Active Trading Platforms

Powerful software and web-based trading solutions

- Sophisticated trading tools
- Idea generation and analysis
- Advanced portfolio and market tracking

Strategy

Our business strategy is centered on two key objectives: accelerating the growth of our core brokerage business to improve market share, and generating robust earnings growth and healthy returns on capital to deliver long-term value for our shareholders.

Accelerate Growth of Core Brokerage Business

Enhance overall customer experience

We are focused on delivering cutting-edge trading solutions while improving our market position in investing products. Through these offerings, we aim to continue growing our customer base while deepening engagement with our existing customers.

Capitalize on value of corporate services channel

Our corporate services channel is a strategically important driver of brokerage account and asset growth. We leverage our industry-leading position in corporate stock plan administration to improve client acquisition and engage with plan participants to bolster awareness of our full suite of offerings.

Table of Contents

Generate Robust Earnings Growth and Healthy Returns on Capital

Utilize balance sheet to enhance returns

We utilize our bank structure to effectively monetize brokerage relationships by investing stable, low-cost deposits primarily in agency mortgage-backed securities. Meanwhile, we continue to manage down the size and risk associated with our legacy mortgage and consumer loan portfolio.

Put capital to work for shareholders

As we continue to deliver on our capital plan initiatives, we are focused on generating and effectively deploying excess capital, including through our share repurchase program for the benefit of our shareholders.

Products and Services

We offer a broad range of products and services to our customers. Our core brokerage business is organized into four product areas: Trading, Investing, Corporate Services, and Advisor Services. Additionally, we offer banking and cash management capabilities, including deposit accounts insured by the FDIC, which are fully integrated into customer brokerage accounts. Among other features, customers have access to debit cards with ATM fee refunds, online and mobile bill pay, mobile check deposits, Apple Pay, and E*TRADE Line of Credit, a program which allows customers to borrow against the market value of securities pledged as collateral.

Trading

The Company delivers automated trade order placement and execution services, offering our customers a full range of investment vehicles, including US equities, exchange-traded funds (ETFs), options, bonds, futures, American depositary receipts (ADRs) and non-proprietary mutual funds. Margin accounts are also available to qualifying customers, enabling them to borrow against their securities. We help customers plan and execute margin trades through robust margin solutions, including calculators and requirement lookup and analysis tools. The Company also offers a fully paid lending program, which allows our customers to be compensated for lending certain securities in their account.

The Company markets trading products and services to self-directed investors and active traders. Products and services are delivered through web, desktop and mobile digital channels. Trading and investing tools are supported by guidance, including fixed income, options and futures specialists available on-call for customers. Other tools and resources include independent research and analytics, live and on-demand education, market commentary, and strategies, trading ideas and screeners for major asset classes.

Investing

The Company endeavors to help investors build wealth and address their long-term investing needs. Products and services include individual retirement accounts (IRAs), including Roth IRAs, and a suite of managed products and asset allocation models. These include our Core Portfolios, Blend Portfolios, Dedicated Portfolios, and Fixed Income Portfolios. Investors are provided a full suite of digital tools across the Company's web and mobile channels to address their investing needs. These include planning and allocation tools, education and editorial content.

The Company also offers guidance through a team of licensed financial consultants and Chartered Retirement Planning CounselorsSM at our 30 regional financial centers across the country. Guidance is also accessible through our two national financial centers by phone, email and online channels. Customers can receive complimentary portfolio reviews and personalized investment recommendations.

Table of Contents

Corporate Services

The Company provides stock plan administration services for both public and private companies. Through our industry-leading platform, Equity Edge Online, the Company offers management of employee stock option plans, employee stock purchase plans and restricted stock plans with fully-automated stock plan administration. Accounting, reporting and scenario modeling tools are also available. The integrated stock plan solutions include multi-currency settlement and delivery, disbursement in various currencies and streamlined tax calculation. Additionally, corporate clients are offered 10b5-1 plan design and implementation and SEC filing assistance. The Company's digital platforms allow participants in corporate client stock plans to view and manage their holdings. Participants have access to education tools, restricted stock sales support and dedicated stock plan service representatives. Our Corporate Services channel is an important driver of brokerage account and asset growth, serving as an introductory channel to the Company, with approximately 1.7 million individual stock plan accounts. Our corporate clients represent approximately 20% of S&P 500 companies and over 50% of publicly traded U.S. technology companies.

Advisor Services

As a result of the acquisition of TCA, which was completed on April 9, 2018, the Company has expanded its ability to provide technology solutions and custody services to independent RIAs. Liberty, our proprietary technology platform, includes sophisticated modeling, rebalancing, reporting and practice management capabilities that are fully customizable for the RIA. We expect our Advisor Services channel to provide access to a growing segment of our industry and help bolster the Company's ability to attract and retain customers in need of specialized and sophisticated customer service engagement.

For additional information about our business see Part I. Item 1. Business in the Annual Report on Form 10-K for the year ended December 31, 2017.

Financial Performance

Our net revenue is generated primarily from net interest income, commissions and fees and service charges.

Net interest income is largely impacted by the size of our balance sheet, our balance sheet mix, and average yields on our assets and liabilities. Net interest income is driven primarily from interest earned on investment securities, margin receivables, and our legacy loan portfolio, less interest incurred on interest-bearing liabilities, including deposits, customer payables, corporate debt and other borrowings.

Commissions revenue is generated by customer trades and is largely impacted by trade volume, trade type, and commission rates.

Fees and service charges revenue is mainly impacted by order flow revenue, fees earned on off-balance sheet customer cash and other assets, advisor management and custody fees, and mutual fund service fees.

Our net revenue is offset by non-interest expenses, the largest of which are compensation and benefits and advertising and market development.

Table of Contents

Significant Events in the Second Quarter of 2018

Completed Trust Company of America acquisition

On April 9, 2018, we completed the acquisition of TCA for a cash purchase price of \$275 million. The acquisition is expected to benefit the Company as the RIA portion of our industry is growing and the Company expects to leverage the E*TRADE brand to accelerate growth. For additional information, see Note 2—Business Acquisition.

Issued \$420 million of Senior Notes to redeem Trust Preferred Securities

In June 2018, we issued \$420 million of 4.50% Senior Notes due 2028 (Senior Notes) with the intention of using the net proceeds from the sale of the Senior Notes to redeem trust preferred securities (TRUPs) issued by ETB Holdings, Inc. (ETB Holdings), the parent company of E*TRADE Bank. We substantially completed the redemption of TRUPs in July 2018 and expect to redeem the remaining outstanding TRUPs during the third quarter of 2018. For additional information, see Note 16—Subsequent Event.

Repurchased 3.0 million shares of our common stock

We continued to execute on our share repurchase program, under which the Board of Directors has authorized the repurchase of up to \$1 billion of shares of our common stock. During the second quarter of 2018, the Company repurchased 3.0 million shares of common stock at an average price of \$62.51, for a total of \$188 million. As of June 30, 2018, we have repurchased 14.2 million shares of common stock at an average price of \$48.64, for a total of \$690 million since we began repurchasing shares under this authorization in the third quarter of 2017. As of August 2, 2018, we have subsequently repurchased an additional 2.3 million shares of common stock at an average price of \$60.80.

Table of Contents

Key Performance Metrics

Management monitors a number of customer activity and corporate metrics to evaluate the Company's performance. The most significant of these are displayed below along