E TRADE FINANCIAL CORP
Form 10-Q
May 10, 2007
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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 March 31, 2007

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)

Delaware	**94-2844166**
(State or other jurisdiction of	**(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 x No ¨

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

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨

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 May 4, 2007, there were 426,865,051 shares of common stock outstanding.

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E*TRADE FINANCIAL CORPORATION

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended March 31, 2007

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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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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.

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 2006 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.

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 strategy centers on strengthening and growing our retail business and leveraging that growth in our institutional business. We strive to further develop our retail business by acquiring, retaining and expanding our relationships with global retail customers. We offer our retail and institutional customers a suite of investing, trading, banking and lending products. We plan to grow these relationships organically by using technology to deliver an attractive combination of product, service and price to the value-driven mass affluent customer. We also intend to grow, where appropriate, through targeted acquisitions which leverage our existing business platform and through further expansion into certain international markets.

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;
- competitors pricing on financial products and services;
- interest rates and the shape of the interest rate yield curve; and

the performance, volume and volatility of the equity and capital markets.

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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 customers;
- deepening customer acceptance of our investing, trading, banking and lending products;
- disciplined expense control and improved operational efficiency;
- maintaining strong overall asset quality; and
- prudent risk and capital management.

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:

	At or For the Three Months Ended March 31, 2007	At or For the Three Months Ended March 31, 2006	Variance 2007 vs. 2006
Customer Activity Metrics:			
Retail client assets (dollars in billions)	$ 200.5	$ 192.0	4 %
Customer cash and deposits (dollars in billions)	$ 36.0	$ 29.8	21 %
U.S. daily average revenue trades	141,238	159,199	(11)%
International daily average revenue trades	28,798	21,960	31 %
Total daily average revenue trades	170,036	181,159	(6)%
Average commission per trade	$ 11.89	$ 12.10	(2)%
Company Financial Metrics:			
Net revenue growth(1)	8%	43%	(35)%
Enterprise net interest spread (basis points)	274	286	(4)%
Enterprise interest-earning assets (average in billions)	$ 52.9	$ 41.3	28 %
Operating margin (%)	42%	41%	1 %
Compensation and benefits as a % of revenue	19%	19%	(0)%

(1) Revenue growth is the difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

Customer Activity Metrics

- Retail client assets are an indicator of the value of our relationship with the customer. An increase in retail client 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.

Customer cash and deposits are an indicator of a deepening engagement with our customers and are key drivers of net operating interest income.

Daily average revenue trades (DARTs) are the predominant driver of commission revenue from our retail customers.

Average commission per trade is impacted by the mix between our retail domestic and international businesses and the mix between active traders, mass affluent and main street customers. This metric is an indicator of changes in our customer mix, product mix and/or product pricing.

Company Financial Metrics

Net revenue growth is an indicator of our overall financial well-being and our ability to execute on our strategy. When coupled with operating margin, the two provide information about the general success of our business.

Enterprise net interest spread is a broad indicator of our ability to generate net operating interest income.

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Enterprise interest-earning assets, in conjunction with our enterprise net interest spread, are indicators of our ability to generate net operating interest income.

Operating margin is an indicator of the profitability of our operations.

Compensation and benefits as a percentage of revenue is an indicator of our productivity. This ratio coupled with operating margin is an indictor of our efficiency.

Significant Events in the First Quarter of 2007

Launch of Global Trading Platform Pilot Program

We launched our Global Trading Platform pilot program, which provides the ability to buy, sell and hold foreign equities in local currencies to investors who seek liquidity and diversity in their portfolios. Under the pilot program, certain of our U.S. customers now have access to foreign stocks and currencies in six major international markets: Canada, France, Germany, Hong Kong, Japan and the United Kingdom.

Introduction of the Max-Rate Checking Account

E*TRADE Bank introduced a Max-Rate Checking Account which features an annual percentage yield up to 3.25%, unlimited check writing and free online bill pay, among other benefits.

Summary Financial Results

Income Statement Highlights for the Three Months Ended March 31, 2007 (dollars in millions, except per share amounts)

	Three Months Ended March 31,		Variance
	2007	2006	2007 vs. 2006
Total net revenue	$ 645.0	$ 598.3	8%
Net operating interest income after provision for loan losses	$ 369.4	$ 314.6	17%
Operating margin	$ 270.6	$ 243.8	11%
Net income	$ 169.4	$ 142.5	19%
Diluted net earnings per share	$ 0.39	$ 0.33	18%
Operating margin (%)	42%	41%	1%

During the first quarter of 2007, despite volatility in the global equity markets and increased pressure on the domestic real estate market, we continued to strengthen our operating and financial performance. Total net revenue and net income increased 8% and 19%, respectively, when compared to the corresponding period in the prior year. We believe the investments we have made in marketing, operations and service are driving organic growth in customer cash and deposits and margin receivables, which are the primary drivers of our increase in net income. We were able to achieve this growth while increasing our operating margin to 42% in the first quarter of 2007 from 41% when compared to the same period in the prior year. We believe this growth in operating margin reflects increasing efficiencies in our operations and control over our operating expenses.

Net operating interest income after provision for loan losses increased 17% to $369.4 million for the three months ended March 31, 2007, compared with the same period in 2006. Net operating interest income benefited from increases in customer cash and deposits, which increased $6.2 billion compared to the same period in 2006. The increase in customer cash and deposits resulted from organic growth, primarily in our new Complete Savings Account, which was launched at the end of 2006. This new product has driven measurable growth in cash from new and existing customers. In addition, customers who utilized this new product tended to engage more broadly with our other products and services.

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Balance Sheet Highlights (dollars in billions)

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Total assets	$ 60.1	$ 53.7	12%
Total average enterprise interest-earning assets[(1) (2)]	$ 52.9	$ 49.6	7%
Average loans, net and margin receivables as a percentage of enterprise interest-earning assets[(1) (2)]	66%	65%	1%
Average retail deposits and customer payables as a percentage of enterprise interest-bearing liabilities[(1) (2)]	62%	62%	0%

(1) The table data on average enterprise interest-earning assets, loans, net and margin receivables, retail deposits and customer payables has been prepared on the basis required by the SEC s Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* .

(2) Percentages calculated reflect data for the three months ended March 31, 2007 and December 31, 2006.

The increase in total assets was attributable primarily to increases of $3.3 billion in loans receivable, net and $2.5 billion in available-for-sale mortgage-backed and investment securities. The increase in loans receivable, net was due principally to growth in our real estate loan portfolio. We continue to focus our efforts on growing our residential mortgage loan portfolios, primarily one- to four-family loans, and allowing our consumer loan portfolio to decline. Average enterprise interest-earning assets increased by $11.5 billion in the first three months of 2007 compared to the same period in 2006, which was related primarily to the increase in average loans, net and margin receivables.

Retail deposits and customer payables were $32.1 billion, up 8% or $2.4 billion during the first three months of 2007. Retail deposits and customer payables are two of our lowest cost sources of funding and are important contributors to our net operating interest income growth. The increase during the period was due primarily to growth in the Complete Savings Account.

EARNINGS OVERVIEW

Net income increased 19% to $169.4 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was a result of strong growth in interest-earning assets, which are funded primarily by retail deposits and customer payables. In addition, we were able to achieve this growth while increasing our operating margin to 42% in the first quarter of 2007 from 41% when compared to the same period in the prior year. We believe this growth in operating margin is reflective of increasing efficiencies in our operations.

We report corporate interest income and corporate interest expense separately from operating interest income and operating interest expense. We believe reporting these two items separately provides a clearer picture of the financial performance of our operations than would a presentation that combined these two items. Our operating interest income and operating interest expense is generated from the operations of the Company and is a broad indicator of our success in our banking, lending and balance sheet management businesses. Our corporate debt, which is the primary source of our corporate interest expense, has been used primarily to finance acquisitions, such as Harris*direct* and BrownCo, and generally has not been downstreamed to any of our operating subsidiaries.

Similarly, we report gain on sales and impairment of investments separately from gain on sales of loans and securities, net. We believe reporting these two items separately provides a clearer picture of the financial performance of our operations than would a presentation that combined these two items. Gain on sales of loans and securities, net are the result of activities in our operations, namely our lending and balance sheet management businesses. Gain on sales and impairment of investments relates to historical equity investments of the Company at the corporate level and are not related to the ongoing business of our operating subsidiaries.

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The following sections describe in detail the changes in key operating factors and other changes and events that have affected our consolidated net revenue, expense excluding interest, other income (expense) and income tax expense.

Revenue

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

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	Variance 2007 vs. 2006 Amount	Variance 2007 vs. 2006 %
Revenue:				
Operating interest income	$ 829,795	$ 594,294	$ 235,501	40 %
Operating interest expense	(439,209)	(269,505)	(169,704)	63 %
Net operating interest income	390,586	324,789	65,797	20 %
Provision for loan losses	(21,186)	(10,197)	(10,989)	108 %
Net operating interest income after provision for loan losses	369,400	314,592	54,808	17 %
Commission	158,993	175,869	(16,876)	(10)%
Fees and service charges	59,498	57,862	1,636	3 %
Principal transactions	30,082	30,692	(610)	(2)%
Gain on sales of loans and securities, net	17,375	11,628	5,747	49 %
Other revenue	9,650	7,706	1,944	25 %
Total non-interest income	275,598	283,757	(8,159)	(3)%
Total net revenue	$ 644,998	$ 598,349	$ 46,649	8 %

Net operating interest income after provision for loan losses continues to be our largest source of revenue and now represents 57% of total net revenue for the three months ended March 31, 2007. This reflects our focus on retaining retail customer cash and deposits and retail credit balances. Net operating interest income is earned primarily through holding credit balances, which includes margin, real estate and consumer loans, and by holding customer cash and deposits, which are a low cost source of funding. The table below presents each revenue component as a percentage of total net revenue.

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	Variance 2007 vs. 2006
Revenue:			
Net operating interest income after provision for loan losses	57%	53%	4 %
Commission[(1)]	25	29	(4)%
Fees and service charges	9	10	(1)%
Principal transactions	5	5	0 %
Gain on sales of loans and securities, net	3	2	1 %
Other revenue	1	1	0 %
Total net revenue	100%	100%	%

(1) Retail commission revenue represented 19% and 23% of total net revenue for the three months ended March 31, 2007 and 2006, respectively. Institutional commission revenue represented 6% and 7% of total net revenue for the three months ended March 31, 2007 and

2006, respectively.

Net Operating Interest Income After Provision for Loan Losses

Net operating interest income after provision for loan losses increased 17% to $369.4 million for the three months ended March 31, 2007, compared to the same period in 2006. The increase in net operating interest income was due primarily to growth in enterprise interest-earning assets, specifically loans, net. Average loans, net as a percentage of average enterprise interest-earning assets increased 6% to 53% for the three months ended March 31, 2007 compared to the same period in 2006.

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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 thousands):

	Three Months Ended March 31, 2007			2006		
	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	Operating Interest Inc./Exp.	Average Yield/Cost
Enterprise interest-earning assets:						
Loans, net	$ 28,093,409	$ 451,399	6.43%	$ 19,571,064	$ 281,270	5.75%
Margin receivables	6,787,828	123,986	7.41%	6,477,585	104,904	6.57%
Mortgage-backed and related available-for-sale securities	12,040,109	157,967	5.25%	10,555,616	125,504	4.76%
Available-for-sale investment securities	3,901,434	63,496	6.52%	2,519,826	37,389	5.94%
Trading securities	119,779	3,269	10.92%	138,660	2,648	7.64%
Cash and cash equivalents(1)	1,358,120	15,930	4.76%	1,549,180	15,899	4.16%
Stock borrow and other	570,805	10,051	7.14%	530,629	7,730	5.91%
Total enterprise interest-earning assets	52,871,484	826,098	6.27%	41,342,560	575,344	5.56%
Non-operating interest-earning assets(2)	4,422,167			4,915,704		
Total assets	$ 57,293,651			$ 46,258,264		
Enterprise interest-bearing liabilities:						
Retail deposits	$ 24,696,611	177,329	2.91%	$ 18,120,089	90,505	2.03%
Brokered certificates of deposit	466,559	5,659	4.92%	420,600	4,113	3.97%
Customer payables	6,380,411	20,479	1.30%	6,759,733	16,373	0.98%
Repurchase agreements and other borrowings	12,137,872	159,031	5.24%	9,855,018	111,520	4.53%
Federal Home Loan Bank (FHLB) advances	4,996,389	62,852	5.03%	3,054,111	32,539	4.26%
Stock loan and other	1,349,305	12,515	3.76%	669,753	4,197	2.54%
Total enterprise interest-bearing liabilities	50,027,147	437,865	3.53%	38,879,304	259,247	2.70%
Non-operating interest-bearing liabilities(3)	3,016,712			3,918,572		
Total liabilities	53,043,859			42,797,876		
Total shareholders equity	4,249,792			3,460,388		
	$ 57,293,651			$ 46,258,264		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread	$ 2,844,337	$ 388,233	2.74%	$ 2,463,256	$ 316,097	2.86%
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.94%			3.06%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			105.69%			106.34%
Return on average:						
Total assets			1.18%			1.23%
Total shareholders equity			15.95%			16.47%
Average equity to average total assets			7.42%			7.48%

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

Three Months Ended March 31, 2007	2006

Enterprise net interest income[4]	$ 388,233	$ 316,097
Taxable equivalent interest adjustment	(7,320)	(3,392)
Stock conduit, net[5]	9	262
Customer cash held by third parties[6]	9,664	11,822
Net operating interest income	$ 390,586	$ 324,789

(1) Includes segregated cash balances.

(2) 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.

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

(4) 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.

(5) Net operating interest income earned on average stock conduit assets of $2.7 million and $824.0 million for the quarters ended March 31, 2007 and 2006, respectively.

(6) Includes interest earned on average customer assets of $3.9 billion and $3.6 billion for the quarters ended March 31, 2007 and 2006, respectively, held by parties outside E*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

Average enterprise interest-earning assets increased 28% to $52.9 billion for the three months ended March 31, 2007 compared to the same period in 2006. Average loans, net and margin receivables grew 44% to $28.1 billion and 5% to $6.8 billion, respectively, for the three months ended March 31, 2007 compared to the same period in 2006. Average loans, net grew as a result of our focus on growing mortgage loan products.

Average enterprise interest-bearing liabilities increased 29% to $50.0 billion for the three months ended March 31, 2007 compared to the same period in 2006. The increase in average enterprise interest-bearing liabilities was primarily in low-cost customer deposits. Average retail deposits increased 36% to $24.7 billion for the three months ended March 31, 2007 compared to the same period in 2006. Increases in average retail deposits were driven by growth in the Complete Savings Account.

Enterprise net interest spread decreased by 12 basis points to 2.74% for the three months ended March 31, 2007 compared to the same period in 2006. This minor decrease was primarily the result of the challenging interest rate environment in which the yield curve continues to remain relatively flat to inverted.

Provision for Loan Losses

Provision for loan losses increased 108% to $21.2 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in the provision for loan losses was related primarily to the growth in our mortgage loan portfolio and the increase in delinquent loans during the period. While our credit standards have remained strong, we anticipate upward trends in delinquencies and charge-offs compared to 2006 as a result of the continued seasoning of our mortgage loan portfolio and the current instability in the overall consumer credit market. The provision for loan losses is expected to increase in future periods consistent with the seasoning of the portfolio. Further deterioration in the consumer credit market could drive an increase in the provision for loan losses above the amounts recorded during the first quarter of 2007.

Commission

Retail and institutional commission revenue decreased 10% to $159.0 million for the three months ended March 31, 2007 compared to the same period in 2006. The primary factors that affect our commission revenue are DARTs and average commission per trade, which is impacted by both trade types and the mix between our domestic and international businesses. Each business has a different pricing structure, unique to its customer base and local market practices, and as a result, a change in the relative number of executed trades in these businesses impacts average commission per trade. Each business also has different trade types (e.g. equities, options, fixed income, exchange-traded funds, contract for difference and mutual funds) that can have different commission rates. As a result, changes in the mix of trade types within either of these businesses may impact average commission per trade.

DARTs decreased 6% to 170,036 for the three months ended March 31, 2007 compared to the same period in 2006. Our U.S. DART volume decreased 11% from 2006, driven by changing market conditions and decreased trading activities. Our international DARTs grew by 31% compared to 2006, driven entirely by organic growth. Our international operations continue to be a strong growth contributor within our retail trading business, and we believe that over time they will become a significant component of our entire business. In addition, option-related DARTs further increased as a percentage of our total U.S. DARTs and now represent 14% of U.S. trading volume versus 12% a year ago.

Average commission per trade decreased 2% to $11.89 for the three months ended March 31, 2007 compared to 2006. The decrease was primarily a function of the mix of customers. Main Street Investors, who generally have a higher commission per trade, traded less during the period which resulted in a heavier weighting of Active Traders, who generally have a lower commission per trade.

Fees and Service Charges

During the period ended March, 31, 2007, the Company re-defined the line item Service charges and fees by reclassifying certain fee-like revenue items formerly reported in Other revenue into the Service charges and fees line item, now called Fees and service charges. The fee-like revenue streams moved include payment for order flow, foreign currency margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue.

Fees and service charges increased 3% to $59.5 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was due to an increase in our advisor management fees, partially offset by a decrease in account maintenance fees. We expect our account maintenance fee income to continue to decline over time as we have fewer customers who are subject to the fee; however, we expect our advisory management fee income, which is not currently a significant portion of fees and service charges, to increase over time as we focus on growing this product.

Principal Transactions

Principal transactions decreased 2% to $30.1 million for the three months ended March 31, 2007, compared to the same period in 2006. The decrease in principal transactions resulted from lower trading volumes and market volatility which were compounded by a decrease in the average revenue earned per trade. Our principal transactions revenue is influenced by overall trading volumes, the number of stocks for which we act as a market maker, the trading volumes of those specific stocks and the performance of our proprietary trading activities.

Gain on Sales of Loans and Securities, Net

Gain on sales of loans and securities, net increased 49% to $17.4 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands):

	Three Months Ended March 31,		Variance 2007 vs. 2006	
	2007	2006	Amount	%
Gain on sales of originated loans	$ 1,915	$ 3,318	$ (1,403)	(42)%
Loss on sales of loans held-for-sale, net	(1,662)	(689)	(973)	141 %
Gain on sales of loans, net	253	2,629	(2,376)	(90)%
Gain on sales of securities, net	17,122	8,999	8,123	90 %
Gain on sales of loans and securities, net	$ 17,375	$ 11,628	$ 5,747	49 %

The increase in the total gain on sales of loans and securities, net during the three months ended March 31, 2007 was due primarily to an increase in gain on sales of securities, partially offset by the decrease in gain on sales of originated loans compared to the same period in 2006. Retail mortgage loan origination volumes decreased during the comparable periods and we retained a greater number of originated mortgage loans on the balance sheet to drive growth in net operating interest income. The increase in gain on sales of securities, net resulted from higher security sales volumes for the three months ended March 31, 2007 compared to same period in 2006.

Other Revenue

Other revenue increased 25% to $9.7 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in other revenue was due to an increase in software consulting fees from our Corporate Services business.

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Expense Excluding Interest

The components of expense excluding interest and the resulting variances are as follows (dollars in thousands):

	Three Months Ended March 31,		Variance 2007 vs. 2006	
	2007	2006	Amount	%
Compensation and benefits	$ 123,782	$ 115,988	$ 7,794	7 %
Clearing and servicing	67,252	63,288	3,964	6 %
Advertising and marketing development	45,592	34,781	10,811	31 %
Communications	26,156	31,408	(5,252)	(17)%
Professional services	24,985	27,755	(2,770)	(10)%
Depreciation and amortization	19,383	18,789	594	3 %
Occupancy and equipment	23,579	20,504	3,075	15 %
Amortization of other intangibles	10,268	11,332	(1,064)	(9)%
Facility restructuring and other exit activities	733	(253)	986	*
Other	32,675	31,005	1,670	5 %
Total expense excluding interest	$ 374,405	$ 354,597	$ 19,808	6 %

* Percentage not meaningful

Expense excluding interest increased 6% to $374.4 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in expense excluding interest was driven primarily by an increase in marketing initiatives and increased compensation and benefits expense.

Compensation and Benefits

Compensation and benefits increased 7% to $123.8 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase resulted primarily from increased variable and incentive compensation expense. These increases in compensation are in line with the growth and performance of our business and our focus on enhancing customer service with additional representatives. We believe compensation and benefits as a percentage of revenue is a measure of our efficiency and the most relevant metric to assess this expense. This ratio was 19% for both the three month periods ending March 31, 2007 and 2006.

Clearing and Servicing

Clearing and servicing expense increased 6% to $67.3 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase is due to higher loan balances during the period, which resulted in higher servicing costs.

Advertising and Market Development

Advertising and market development expense increased 31% to $45.6 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase is a result of expanded efforts to promote our products and services to the value-driven mass affluent customer.

Communications

Communications expense decreased 17% to $26.2 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease is due to higher expenses in 2006 associated with communications to our newly acquired customers from Harris*direct* and BrownCo. In addition, variable expenses such as quote services and trade confirmations decreased with our decrease in trading volume.

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Professional Services

Professional services decreased 10% to $25.0 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease is due primarily to higher third party support services in 2006, including technology and transitional service agreements, associated with our integrations of Harris*direct* and BrownCo in 2006.

Occupancy and Equipment

Occupancy and equipment increased 15% to $23.6 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase is due primarily to new or expanded customer service centers.

Other Income (Expense)

Other income (expense) decreased from an expense of $22.1 million to an expense of $8.2 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands):

	Three Months Ended March 31,		Variance 2007 vs. 2006	
	2007	2006	Amount	%
Other income (expense):				
Corporate interest income	$ 1,705	$ 1,961	$ (256)	(13)%
Corporate interest expense	(37,791)	(40,508)	2,717	(7)%
Gain on sales and impairment of investments	19,756	17,616	2,140	12 %
Loss on early extinguishment of debt		(135)	135	*
Equity in income (loss) of investments and venture funds	8,095	(1,007)	9,102	*
Total other expense	$ (8,235)	$ (22,073)	$ 13,838	*

* Percentage not meaningful

Total other expense for the three months ended March 31, 2007 primarily consisted of corporate interest expense resulting from the funding of the Harris*direct* and BrownCo acquisitions beginning in late 2005. Offsetting corporate interest expense was $19.8 million in gain on sales and impairment of investments, which resulted from the sale of our investment in E*TRADE Australia during the first quarter of 2007. Also offsetting corporate interest expense was $8.1 million in income from equity method investments and venture funds for the three months ended March 31, 2007.

Income Tax Expense

Income tax expense from continuing operations increased 18% to $92.9 million during the three months ended March 31, 2007 compared to the same period in 2006. The increase in income tax expense was related to the increase in pre-tax income over the comparable period. Our effective tax rates for the three months ended March 31, 2007 and 2006 were 35.4% and 35.5%, respectively.

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SEGMENT RESULTS REVIEW

Retail

Retail segment income decreased 3% to $171.5 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands, except for key metrics):

	Three Months Ended March 31,		Variance 2007 vs. 2006	
	2007	2006	Amount	%
Retail segment income:				
Net operating interest income after provision for loan losses	$ 227,481	$ 205,920	$ 21,561	10 %
Commission	123,305	135,864	(12,559)	(9)%
Fees and service charges	54,203	53,344	859	2 %
Gain on sales of loans and securities, net	4,911	8,727	(3,816)	(44)%
Other revenue	9,751	9,299	452	5 %
Net segment revenue	419,651	413,154	6,497	2 %
Total segment expense	248,193	235,820	12,373	5 %
Total retail segment income	$ 171,458	$ 177,334	$ (5,876)	(3)%
Key Metrics:				
Retail client assets (dollars in billions)	$ 200.5	$ 192.0	$ 8.5	4 %
Customer cash and deposits (dollars in billions)	$ 36.0	$ 29.8	$ 6.2	21 %
U.S. DARTS	141,238	159,199	(17,961)	(11)%
International DARTS	28,798	21,960	6,838	31 %
DARTs	170,036	181,159	(11,123)	(6)%
Average commission per trade	$ 11.89	$ 12.10	$ (0.21)	(2)%
Average margin debt (dollars in billions)	$ 6.9	$ 6.6	$ 0.3	5 %

Our retail segment generates revenue from investing, trading, banking and lending relationships with retail customers. These relationships essentially drive five sources of revenue including net operating interest income; commission; fees and service charges; gain on sales of loans and securities, net; and other revenue. Other revenue includes results from our stock plan administration products and services, as we ultimately service retail customers through these corporate relationships. Our geographically dispersed retail accounts grew 5% during the three months ended March 31, 2007 compared to the same period in 2006. We believe this growth is a result of the investments we have made in marketing, operations and service. As of March 31, 2007, we had approximately 3.6 million active investing and trading accounts and 0.9 million active deposit and lending accounts.

The slight decline in retail segment income during the first quarter of 2007 was the result of lower commission revenue and higher marketing spend offset by growth in net operating interest income.

Retail net operating interest income after provision for loan losses increased 10% to $227.5 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was driven by growth in customer cash and deposits, which generally translate into a lower cost of funds. The growth in customer cash and deposits of $6.2 billion was largely the result of the growth in the Complete Savings Account.

Retail commission revenue decreased 9% to $123.3 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease in commission revenue was primarily the result of lower trading volumes in the overall domestic equity market. Slightly offsetting this decline was an increase in our international commissions where DARTs increased 31% from 21,960 to 28,798 for the three months ended March 31, 2007 compared to the same period in 2006.

Retail segment expense increased $12.4 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase related primarily to our increased marketing spend as we expanded efforts to promote our products and services to the value-driven mass affluent customer.

Institutional

Institutional segment income increased 49% to $99.1 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands, except for key metrics):

	Three Months Ended March 31,		Variance 2007 vs. 2006	
	2007	2006	Amount	%
Institutional segment income:				
Net operating interest income after provision for loan losses	$ 141,919	$ 108,672	$ 33,247	31 %
Commission	35,688	40,005	(4,317)	(11)%
Fees and service charges	7,475	6,791	684	10 %
Principal transactions	30,082	30,692	(610)	(2)%
Gain on sales of loans and securities, net	12,464	2,901	9,563	330 %
Other revenue	41	111	(70)	(63)%
Net segment revenue	227,669	189,172	38,497	20 %
Total segment expense	128,534	122,754	5,780	5 %
Total institutional segment income	$ 99,135	$ 66,418	$ 32,717	49 %
Key Metrics:				
Total nonperforming loans receivable as a % of total gross loans receivable	0.39%	0.21%	*	0.18 %
Average revenue capture per 1,000 equity shares	$ 0.576	$ 0.277	$ 0.299	108 %

* Percentage not meaningful

Our institutional segment generates earnings from balance sheet management activities, market-making and global execution and settlement services. Balance sheet management activities include purchasing loan receivables from the retail segment as well as third parties, and leveraging these loans and retail customer cash and deposit relationships to generate additional net operating interest income. Retail trading order flow is leveraged by the institutional segment to generate additional revenue for the Company.

Net operating interest income after provision for loan losses increased 31% to $141.9 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase primarily was a result of growth in interest-earning assets, which are funded primarily by retail customer cash and deposit balances. These customer balances were kept on-balance sheet as a low-cost source of funding and then utilized by the institutional segment either to purchase interest-earning assets or pay down wholesale liabilities.

Institutional commissions decreased 11% to $35.7 million for the three months ended March 31, 2007 compared to the same period in 2006. This decrease was due to lower trading volumes during the first quarter of 2007 compared to the same period in 2006. We provide institutional customers with global execution and settlement services, as well as worldwide access to research provided by third parties, in exchange for commissions based on negotiated rates, which differ by customer.

Gain on sales of loans and securities, net increased approximately $9.6 million for the three months ended March 31, 2007 compared to the same period in 2006. We evaluate our portfolio of securities available-for-sale

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in light of changing market conditions and where appropriate, take steps intended to optimize our overall economic position. Based on this evaluation, we decided to sell certain securities, which resulted in a gain on sales of loans and securities, net of $12.5 million for the three months ended March 31, 2007.

Total institutional segment expense increased 5% to $128.5 million for the three months ended March 31, 2007 compared to the same period in 2006 and was predominantly related to an increase in professional services and occupancy and equipment expenses.

BALANCE SHEET OVERVIEW

The following table sets forth the significant components of our consolidated balance sheet (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Assets:			
Cash and equivalents[1]	$ 1,605,984	$ 1,493,856	8 %
Trading securities	151,046	178,600	(15)%
Available-for-sale mortgage-backed and investment securities	16,458,481	13,921,983	18 %
Loans held-for-sale	193,385	283,496	(32)%
Margin receivables	6,947,535	6,828,448	2 %
Loans receivable, net	29,671,642	26,372,697	13 %
Other assets [2]	5,107,009	4,660,223	10 %
Total assets	$ 60,135,082	$ 53,739,303	12 %
Liabilities and shareholders equity:			
Deposits	$ 26,256,619	$ 24,071,012	9 %
Securities sold under agreements to repurchase	12,125,686	9,792,422	24 %
Customer payables	6,311,657	6,182,672	2 %
Other borrowings	6,560,501	5,323,962	23 %
Corporate debt[3]	1,843,207	1,842,169	0 %
Accounts payable, accrued and other liabilities	2,686,386	2,330,696	15 %
Total liabilities	55,784,056	49,542,933	13 %
Shareholders equity	4,351,026	4,196,370	4 %
Total liabilities and shareholders equity	$ 60,135,082	$ 53,739,303	12 %

(1) Includes balance sheet line items cash and equivalents and cash and investments required to be segregated under Federal or other regulations.

(2) Includes balance sheet line items property and equipment, net, goodwill, other intangibles, net and other assets.

(3) Includes balance sheet line items senior notes and mandatory convertible notes.

During the period, we re-presented our balance sheet to report margin receivables and customer payables directly on the face of the balance sheet. The remaining components of brokerage receivables and brokerage payables are now reported in the Other assets and Accounts payable, accrued and other liabilities line items, respectively.

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The margin receivables balance is a component of the margin debt balance, which is reported as a key retail metric of $7.0 billion for both March 31, 2007 and 2006. The total margin debt balance is summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006
Margin receivables	$ 6,947,535	$ 6,828,448
Margin held by third parties and other	84,609	174,652
Margin debt	$ 7,032,144	$ 7,003,100

The increase in total assets was primarily the result of growth in available-for-sale mortgage-backed and investment securities and loans receivable, net. The growth in available-for-sale mortgage-backed and investment securities was driven primarily by growth in mortgage-backed securities. The growth in loans receivable, net was the result of our continued focus on growing our residential mortgage loan portfolios, including one- to four-family mortgages and home equity loans.

The increase in total liabilities primarily was attributable to the increase in deposits and securities sold under agreements to repurchase. The $2.2 billion increase in deposits was due primarily to the growth in the Complete Savings Account. The increase in securities sold under agreements to repurchase contributed to the growth of the loans receivable, net.

Loans Receivable, Net

Loans receivable, net are summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Real estate loans:			
One- to four-family	$ 13,360,842	$ 10,870,214	23 %
Home equity lines of credit (HELOC), Home equity installment loans (HEIL) and other	12,759,680	11,809,008	8 %
Consumer and other loans:			
Recreational vehicle	2,182,334	2,292,356	(5)%
Marine	621,368	651,764	(5)%
Commercial	233,301	219,008	7 %
Credit card	109,559	128,583	(15)%
Automobile	56,849	77,533	(27)%
Other	2,940	3,706	(21)%
Unamortized premiums, net	412,758	388,153	6 %
Allowance for loan losses	(67,989)	(67,628)	1 %
Total loans receivable, net	$ 29,671,642	$ 26,372,697	13 %

Loans receivable, net increased 13% to $29.7 billion at March 31, 2007 from $26.4 billion at December 31, 2006. We continue to focus on our growth in real estate loans while allowing our consumer loans to decline. We anticipate that our mortgage portfolio will continue to increase over time, and we believe this will improve our credit risk profile. We anticipate that recreational vehicle and marine loan balances will continue to decline over time due to our sale of Consumer Finance Corporation in 2005, and automobile loans will continue to decline due to our exit of the automobile origination business in 2004.

In recent months, there has been considerable attention in the financial and business media regarding rising delinquencies and default rates in the sub-prime[(1)] lending market. As a general matter, we do not originate or

(1) Defined as borrowers with FICO scores less than 620 at the time of origination.

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purchase sub-prime loans to hold on our balance sheet; however, in the normal course of purchasing large pools of mortgage loans, we invariably end up acquiring a de minimis amount of these loans. As of March 31, 2007, sub-prime loans represented less than one-fifth of one percent of our total loan portfolio.

During the first quarter of 2007, we entered into a credit default swap (CDS) on $4.0 billion of our first-lien residential mortgage loan portfolio. A CDS provides, for a fee, an assumption by a third party of a portion of the credit risk related to the underlying loans. The CDS we entered into provides protection for losses in excess of 10 basis points, but not to exceed approximately 75 basis points. In addition, our regulatory risk-weighted assets were reduced as a result of this transaction because we transferred a portion of our credit risk to an unaffiliated third party.

Allowance for Loan Losses

The allowance for loan losses is management s estimate of credit losses inherent in our loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of factors, including the composition and quality of the portfolio; delinquency levels and trends; probable expected losses for the next twelve months; current and historical charge-off and loss experience; current industry charge-off and loss experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate as it affects adjustable-rate loans; and general economic conditions. Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. In general, we believe the allowance for loan losses should be equal to at least twelve months of probable projected losses for all loan types. We believe this level is representative of probable losses inherent in the loan portfolio at the balance sheet date.

In determining the allowance for loan losses, we allocate a portion of the allowance to various loan products based on an analysis of individual loans and pools of loans. However, the entire allowance is available to absorb credit losses inherent in the total loan portfolio as of the balance sheet date.

The following table presents the allowance for loan losses by major loan category (dollars in thousands):

	Consumer & Other		Real Estate		Total	
	Allowance	Allowance as % of Consumer and Other Loans Receivable	Allowance	Allowance as % of Real Estate Loans Receivable	Allowance	Allowance as % of Total Loans Receivable
March 31, 2007	$ 23,863	0.73%	$ 44,126	0.17%	$ 67,989	0.23%
December 31, 2006	$ 28,197	0.82%	$ 39,431	0.17%	$ 67,628	0.26%

The following table provides an analysis of the allowance for loan losses for the three months ended March 31, 2007 and 2006 (dollars in thousands):

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Allowance for loan losses, beginning of period	$ 67,628	$ 63,286
Provision for loan losses	21,186	10,197
Charge-offs	(26,444)	(14,859)
Recoveries	5,619	5,885
Net charge-offs	(20,825)	(8,974)
Allowance for loan losses, end of period	$ 67,989	$ 64,509

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Losses are recognized when it is probable that a loss will be incurred. Our policy is to charge off closed-end consumer loans when the loan is 120 days delinquent or when we determine that collection is not probable. For first-lien mortgages, a charge-off is recognized when we foreclose on the property. For revolving loans, our policy is to charge off loans when collection is not probable or the loan has been delinquent for 180 days.

During the three months ended March 31, 2007, the allowance for loan losses increased by $0.4 million from the level at December 31, 2006. The allowance increased by $4.7 million related to the growth of the real estate portfolio. Offsetting this increase was a decrease in the allowance for loan losses of $4.3 million related to the decline in the size of the consumer loan portfolio.

Net charge-offs for the three months ended March 31, 2007 compared to the same period in 2006 increased by $11.9 million. The overall increase was primarily due to higher net charge-offs on real estate loans. The increase in real estate loan charge-offs was due to the growth of the portfolio. Annualized net charge-offs as a percentage of average loans receivable, net were 0.30% at March 31, 2007 compared to 0.22% at December 31, 2006.

Nonperforming Assets

We classify loans as nonperforming when full and timely collection of interest or principal becomes uncertain or when they are 90 days past due. The following table shows the comparative data for nonperforming loans and assets (dollars in thousands):

	March 31, 2007	December 31, 2006
Real estate loans	$ 110,544	$ 66,435
Consumer and other loans	5,955	8,906
Total nonperforming loans, net	116,499	75,341
Real estate owned (REO) and other repossessed assets, net	19,808	12,904
Total nonperforming assets, net	$ 136,307	$ 88,245
Total nonperforming loans receivable as a percentage of total gross loans receivable	0.39%	0.28%
Total allowance for loan losses as a percentage of total nonperforming loans receivable	58.68%	90.52%

We expect nonperforming loan levels to fluctuate over time due to portfolio growth, portfolio seasoning and resolution through collections, sales or charge-offs. The performance of any loan can be affected by external factors, such as economic conditions or factors particular to the borrower.

During the three months ended March 31, 2007, our nonperforming assets, net increased $48.1 million from $88.2 million at December 31, 2006. The increase was attributed to an increase in nonperforming real estate loans and REO and other repossessed assets, net of $51.0 million, offset by a decrease in nonperforming consumer and other loans of $2.9 million. These trends are primarily the result of our targeted growth in real estate loans as well as the seasoning of the real estate loan acquisitions made in prior periods.

The allowance as a percentage of total nonperforming loans receivable, net decreased from 91% at December 31, 2006 to 59% at March 31, 2007. Our total loan portfolio has shifted towards a larger concentration of mortgage loans, where the risk of loss is generally less than the risk of loss on a consumer loan. As such, the total allowance as a percentage of nonperforming assets decreased.

In addition to nonperforming assets in the table above, we monitor loans where a borrower s past credit history casts doubt on their ability to repay a loan (Special Mention loans). Special Mention loans represented $357.3 million, or 1%, and $261.5 million, or 1%, of the total loan portfolio at March 31, 2007 and December 31, 2006, respectively, and are generally secured by real estate assets, reducing the potential loss should they become nonperforming. These loans are actively monitored, continue to accrue interest and remain a component of the loans receivable balance. The increase in Special Mention loans was due primarily to an

increase in the 30-day delinquency category of mortgage loans. We expect migration from this category to more serious delinquency classifications to increase over time consistent with the current consumer credit environment; however, we do not expect this migration to be significant.

Available-for-Sale Mortgage-Backed and Investment Securities

Available-for-sale securities are summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Mortgage-backed securities:			
Backed by U.S. government sponsored and Federal agencies	$ 10,377,478	$ 9,109,307	14 %
Collateralized mortgage obligations and other	1,830,916	1,108,385	65 %
Total mortgage-backed securities	12,208,394	10,217,692	19 %
Investment securities:			
Asset-backed securities	2,608,003	2,161,728	21 %
Publicly traded equity securities:			
Preferred stock	380,236	458,674	(17)%
Corporate investments	37,515	24,139	55 %
FHLB stock	296,170	244,212	21 %
Other	928,163	815,538	14 %
Total investment securities	4,250,087	3,704,291	15 %
Total available-for-sale securities	$ 16,458,481	$ 13,921,983	18 %

Available-for-sale securities represented 27% and 26% of total assets at March 31, 2007 and December 31, 2006, respectively. Available-for-sale securities increased 18% to $16.5 billion at March 31, 2007 compared to December 31, 2006, due primarily to the growth in our asset-backed securities portfolio. We evaluate our available-for-sale securities in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall position. Based on this evaluation, we decided to grow the mortgage-backed and asset-backed securities portfolios, which resulted in an increase of $2.4 billion in these portfolios during the three months ended March 31, 2007.

As interest rates increase, the fair value of fixed-rate available-for-sale securities decreases and vice versa. The fair value of the portfolio will be adversely impacted in the future if long-term interest rates continue to rise. Net unrealized gains and losses in available-for-sale securities are included in shareholders equity as accumulated other comprehensive income or loss, net of tax.

Deposits

Deposits are summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Sweep deposit accounts	$ 10,803,331	$ 10,837,124	(0)%
Money market and savings accounts	9,879,772	7,634,241	29 %
Certificates of deposit[(1)]	4,738,123	4,737,253	0 %
Brokered certificates of deposit[(2)]	447,403	483,777	(8)%
Checking accounts	387,990	378,617	2 %

Total deposits	$ 26,256,619	$ 24,071,012	9 %

(1) Represents retail certificates of deposit including retail brokered certificates of deposit.
(2) Represents institutional certificates of deposit.

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Deposits represented 47% and 49% of total liabilities at March 31, 2007 and December 31, 2006, respectively. Deposits increased $2.2 billion to $26.3 billion at March 31, 2007 compared to December 31, 2006, driven by a $2.2 billion increase in money market and savings accounts.

The increase in deposits is primarily the result of the growth in our Complete Savings Account. This new product has driven measurable growth in cash from new and existing customers. Deposits generally provide us the benefit of lower interest costs, compared with wholesale funding alternatives.

The deposits balance is a component of the total customer cash and deposits balance reported as a customer activity metric of $36.0 billion for the three months ended March 31, 2007. The total customer cash and deposits balance is summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Deposits	$ 26,256,619	$ 24,071,012	9 %
Less: brokered certificates of deposit	(447,403)	(483,777)	(8)%
Deposits excluding brokered certificates of deposit	25,809,216	23,587,235	9 %
Customer payables	6,311,657	6,182,672	2 %
Customer cash balances held by third parties and other	3,914,037	3,819,860	2 %
Total customer cash and deposits	$ 36,034,910	$ 33,589,767	7 %

Securities Sold Under Agreements to Repurchase and Other Borrowings

Securities sold under agreements to repurchase and other borrowings are summarized as follows (dollars in thousands):

	March 31, 2007	December 31, 2006	Variance 2007 vs. 2006
Securities sold under agreements to repurchase	$ 12,125,686	$ 9,792,422	24%
FHLB advances	$ 6,023,124	$ 4,865,466	24%
Subordinated debentures	425,522	385,502	10%
Other	111,855	72,994	53%
Total other borrowings	$ 6,560,501	$ 5,323,962	23%

Securities sold under agreements to repurchase increased by 24% at March 31, 2007 compared to December 31, 2006. Securities sold under agreements to repurchase coupled with FHLB advances are the primary wholesale funding sources of the Bank. The Bank used these wholesale sources along with deposit growth to fund the increase in loans receivable. Other borrowings represented 12% and 11% of total liabilities at March 31, 2007 and December 31, 2006, respectively. The increase of $1.2 billion during the three months ended March 31, 2007 was due primarily to an increase in FHLB advances. We actively manage our funding sources and determine the optimal mix based on pricing, liquidity and capacity during each period.

LIQUIDITY AND CAPITAL RESOURCES

Our liquidity and capital resources enable us to fund our operating activities, finance acquisitions and grow our assets. Cash flows are derived from our operations in the retail and institutional segments and our capital market activities. The segment cash flows provide capital to fund growth in our regulated subsidiaries. The Company s cash and equivalents balance increased to $1.2 billion for the period ended March 31, 2007.

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Corporate Debt

Our current senior debt ratings are Ba2 (positive outlook) by Moody s Investor Service, BB- (stable) by Standard & Poor s and BB (high) by Dominion Bond Rating Service (DBRS). The Company s long-term deposit ratings are Baa3 (positive outlook) by Moody s Investor Service, BB+ (stable) by Standard & Poor s and BBB (low) by DBRS. A significant change in these ratings may impact the rate and availability of future borrowings.

Liquidity Available from Subsidiaries

Liquidity available to the Company from its subsidiaries, other than Converging Arrows, Inc. (Converging Arrows), is limited by regulatory requirements. Converging Arrows is a subsidiary of the parent company. At March 31, 2007, Converging Arrows had $125.7 million of cash and investment securities available as a source of liquidity for the parent company. Converging Arrows is not restricted in its dealings with the parent company and may transfer funds to the parent company without regulatory approval. In addition to Converging Arrows, brokerage and banking subsidiaries may provide liquidity to the parent; however, they are restricted by regulatory guidelines.

E*TRADE Bank is prohibited by regulations from lending to the parent company. At March 31, 2007, E*TRADE Bank had approximately $179.9 million of capital available for dividend declaration without regulatory approval while still maintaining well capitalized status. E*TRADE Bank is also required by Office of Thrift Supervision (OTS) regulations to maintain tangible capital of at least 1.50% of tangible assets. E*TRADE Bank satisfied this requirement at March 31, 2007 and December 31, 2006.

Brokerage subsidiaries are required to maintain net capital equal to the greater of $250,000 or 2% of aggregate debit balances arising from customer transactions. At March 31, 2007 and December 31, 2006, all of our brokerage subsidiaries met their minimum net capital requirements. The Company s broker-dealer subsidiaries had excess net capital of $695.6 million at March 31, 2007.

Other Sources of Liquidity

We maintain committed and uncommitted financing facilities with banks totaling $250.0 million to meet corporate liquidity needs and $576.0 million to meet margin lending needs. There were no outstanding balances, and the full $826.0 million was available under these lines at March 31, 2007 and December 31, 2006.

We rely on borrowed funds, such as FHLB advances and securities sold under agreements to repurchase, to provide liquidity for the Bank. At March 31, 2007, the Bank had approximately $10.5 billion in additional borrowing capacity.

Other Liquidity Matters

We currently anticipate that our available cash resources and credit will be sufficient to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced products and services, respond to competitive pressures, acquire businesses or technologies or take advantage of unanticipated opportunities.

SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon the financial results of the Company. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: allowance for loan losses and uncollectible margin loans; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rate; deferred taxes and valuation allowances; and valuation of goodwill and other intangibles. These are more fully described in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2006.

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GLOSSARY OF TERMS

Active Trader The customer segment that includes those who execute 30 or more trades per quarter.

Adjusted total assets Bank-only assets composed of total assets plus/(less) unrealized losses (gains) on available-for-sale securities, less deferred tax assets, goodwill and certain other intangible assets.

Average commission per trade Total retail segment commission revenue divided by total number of retail trades.

Average equity to average total assets Average total shareholders equity divided by average total assets.

Bank ETB Holdings, Inc. (ETBH), the entity that is our bank holding company and parent to E*TRADE Bank and ETGAM.

Basis point One one-hundredth of a percentage point.

Cash flow hedge A financial derivative instrument designated in a hedging relationship that mitigates exposure to variability in expected future cash flows attributable to a particular risk.

Charge-off The result of removing a loan or portion of a loan from an entity s balance sheet because the loan is considered to be uncollectible.

Compensation and benefits as a percentage of revenue Total compensation and benefits expense divided by total net revenue.

Contract for difference (CFDs) A derivative based on an underlying stock or index that covers the difference between the nominal value at the opening of a trade and at the close of a trade. A CFD is researched and traded in the same manner as a stock.

Corporate investments Primarily equity investments held at the parent company level that are not related to the ongoing business of the Company s operating subsidiaries.

Customer cash and deposits Customer cash, deposits, customer payables and money market balances, including those held by third parties.

Daily average revenue trades (DARTs) Total revenue trades in a period divided by the number of trading days during that period.

Derivative A financial instrument or other contract the price of which is directly dependent upon the value of one or more underlying securities, interest rates or any agreed upon pricing index. Derivatives cover a wide assortment of financial contracts, including forward contracts, options and swaps.

*E*TRADE Complete* An integrated investing, trading, banking and lending product that allows customers to manage their relationships with the Company through one account. E*TRADE Complete helps customers optimize cash and credit by utilizing tools designed to inform them of whether or not they are receiving the most appropriate rates for their cash and paying the most appropriate rates for credit.

Enterprise interest-bearing liabilities Liabilities such as customer deposits, repurchase agreements, other borrowings and advances from the FHLB, certain customer credit balances and stock loan programs on which the Company pays interest; excludes customer money market balances held by third parties.

Enterprise interest-earning assets Consists of the primary interest-earning assets of the Company and includes: loans receivable, mortgage-backed and available-for-sale securities, margin receivables, stock borrow balances, and cash required to be segregated under regulatory guidelines that earn interest for the Company.

Enterprise net interest income The 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.

Enterprise net interest spread The taxable equivalent rate earned on average enterprise interest-earning assets less the rate paid on average enterprise interest-bearing liabilities, excluding corporate interest-earning assets and liabilities, stock conduit and cash held by third parties.

Exchange-traded funds A fund that invests in a group of securities and trades like an individual stock on an exchange.

Fair value hedge A financial derivative instrument designated in a hedging relationship that mitigates exposure to changes in the fair value of a recognized asset or liability or a firm commitment.

GAAP Accounting principles generally accepted in the United States of America.

Interest rate cap An options contract that puts an upper limit on a floating exchange rate. The writer of the cap has to pay the holder of the cap the difference between the floating rate and the upper limit when that upper limit is breached. There is usually a premium paid by the buyer of such a contract.

Interest rate floor An options contract that puts a lower limit on a floating exchange rate. The writer of the floor has to pay the holder of the floor the difference between the floating rate and the lower limit when that lower limit is breached. There is usually a premium paid by the buyer of such a contract.

Interest rate swaps Contracts that are entered into primarily as an asset/liability management strategy to reduce interest rate risk. Interest rate swap contacts are exchanges of interest rate payments, such as fixed-rate payments for floating-rate payments, based on notional principal amounts.

Main Street Investor The customer segment that includes those who execute less than 30 trades per quarter and hold less than $50,000 in assets in combined retail accounts.

Margin debt The extension of credit to brokerage customers of the Company, on and off balance sheet, where the loan is secured with securities owned by the customer.

Mass Affluent The customer segment that includes those who hold $50,000 or more in assets in combined retail accounts.

Net Present Value of Equity (NPVE) The present value of expected cash inflows from existing assets, minus the present value of expected cash outflows from existing liabilities, plus the expected cash inflows and outflows from existing derivatives and forward commitments. This calculation is performed for E*TRADE Bank.

Nonperforming assets Assets that do not earn income, including those originally acquired to earn income (delinquent loans) and those not intended to earn income (REO). Loans are classified as nonperforming when full and timely collection of interest and principal becomes uncertain or when the loans are 90 days past due.

Notional amount The specified dollar amount underlying a derivative on which the calculated payments are based.

Operating expenses Total expense excluding interest, as shown on the Company s consolidated statement of income.

Operating margin Income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change.

Operating margin (%) Percentage of net revenue that goes to income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change. It is calculated by dividing our income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change by our total net revenue.

Options Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to either purchase or sell the associated financial instrument at a set price during a period or at a specified date in the future.

Organic Business related to new and existing customers as opposed to acquisitions.

Principal transactions Transactions that primarily consist of revenue from market-making activities.

Real-estate owned repossessed assets (REO) Ownership of real property by the Company, generally acquired as a result of foreclosure.

Repurchase agreement An agreement giving the seller of an asset the right or obligation to buy back the same or similar securities at a specified price on a given date. These agreements are generally collateralized by mortgage-backed or investment-grade securities.

Retail deposits Balances of retail customer cash held at the Bank; excludes brokered certificates of deposit.

Retail client assets Market value of all client assets held by the Company including security holdings, customer cash and deposits and vested unexercised options.

Return on average total assets Annualized net income from continuing operations divided by average assets.

Return on average total shareholders equity Annualized net income from continuing operations divided by average shareholders equity.

Revenue growth The difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

Risk-weighted assets Primarily computed by the assignment of specific risk-weightings assigned by the OTS to assets and off-balance sheet instruments for capital adequacy calculations. This calculation is for E*TRADE Bank only.

Stock conduit The borrowing of shares from a Broker-Dealer and subsequently lending the same shares to another Broker-Dealer netting a fee.

Sweep deposit accounts Accounts with the functionality to transfer brokerage cash balances to and from an FDIC-insured money market account at the Bank.

Taxable equivalent interest adjustment The operating interest income earned on certain assets is completely or partially exempt from federal and/or state income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable investment. To provide more meaningful comparison of yields and margins for all interest-earning assets, the interest income earned on tax exempt assets is increased to make it fully equivalent to interest income on other taxable investments. This adjustment is done for the analytic purposes in the net enterprise interest income/spread calculation and is not made on the consolidated statement of income, as that is not permitted under GAAP.

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Tier 1 Capital Adjusted equity capital used in the calculation of capital adequacy ratios at E*TRADE Bank as required by the OTS. Tier 1 capital equals: total shareholder s equity at E*TRADE Bank, plus/(less) unrealized losses (gains) on available-for-sale securities and cash flow hedges, less deferred tax assets, goodwill and certain other intangible assets.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 and as updated in this report. Market risk is our exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Our exposure to interest rate risk is primarily related to interest-earning assets and interest-bearing liabilities.

Interest Rate Risk

The management of interest rate risk is essential to profitability. Interest rate risk is our exposure to changes in interest rates. In general, we manage our interest rate risk by balancing variable-rate and fixed-rate assets, liabilities and we utilize derivatives in a way that reduces our overall exposure to changes in interest rates. In recent years, we have managed our interest rate risk to achieve a minimum to moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Exposure to interest rate risk requires management to make complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

- Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.
- The yield curve may flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.
- Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At March 31, 2007, 92% of our total assets were operating interest-earning assets.

At March 31, 2007, approximately 68% of our total assets were residential mortgages and available-for-sale mortgage-backed and asset-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

Our current strategy is to retain more originated mortgage loans on the balance sheet. When mortgage loans prepay, mortgage origination costs are written off. Depending on the timing of the prepayment, the write-offs of mortgage origination costs may result in lower than anticipated yields. E*TRADE Bank s Asset Liability Committee (ALCO) reviews estimates of the impact of changing market rates on loan production volumes and prepayments. This information is incorporated into our interest rate risk management strategy.

We held $151.0 million in trading securities as of March 31, 2007. These securities and the associated interest rate risk are not material to the Company s financial position, results of operations, or cash flows.

Our liability structure consists of transactional deposit relationships, such as savings and money market accounts; certificates of deposit; securities sold under agreements to repurchase; customer payables; wholesale collateralized borrowings from the FHLB and other entities; and long term notes. Our transactional deposit accounts and customer payables tend to be less rate-sensitive than wholesale borrowings. Agreements to repurchase securities and money market accounts re-price as interest rates change. Certificates of deposit re-price over time depending on maturities. FHLB advances and long-term notes generally have fixed rates.

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Derivative Financial Instruments

We use derivative financial instruments to help manage our interest rate risk. Interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments between two parties based on a contractual underlying notional amount, but do not involve the exchange of the underlying notional amounts. Option products are utilized primarily to decrease the market value changes resulting from the prepayment dynamics of the mortgage portfolio, as well as to protect against increases in funding costs. The types of options employed include Cap Options (Caps) and Floor Options (Floors), Payor Swaptions and Receiver Swaptions. Caps mitigate the market risk associated with increases in interes rates while Floors mitigate the risk associated with decreases in market interest rates. Similarly, Payor and Receiver Swaptions mitigate the market risk associated with the respective increases and decreases in interest rates. See derivative financial instruments discussion at Note 7 Accounting for Derivative Financial Instruments and Hedging Activities in Item 1. Consolidated Financial Statements.

For mortgage loans intended to be sold, Interest Rate Lock Commitments (IRLCs) are considered derivatives with changes in fair value recorded in earnings. IRLCs are commitments issued to borrowers that lock in an interest rate now for a loan closing in one to three months. These locks, initially recorded with a fair value of zero, will fluctuate in value during the lock period as market interest rates change. See mortgage banking activities discussion at Note 7 Accounting for Derivative Financial Instruments and Hedging Activities in Item 1. Consolidated Financial Statements.

Scenario Analysis

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the Net Present Value of Equity (NPVE) approach, the present value of all existing assets, liabilities, derivatives and forward commitments are estimated and then combined to produce a NPVE figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 and 200 basis points. The NPVE method is used at the E*TRADE Bank level and not for the Company. During the period ended March 31, 2007, E*TRADE Clearing LLC (ETC) became a wholly-owned operating subsidiary of E*TRADE Bank.

E*TRADE Bank has 96% and 81% of our operating interest-earning assets at March 31, 2007 and December 31, 2006, respectively, and holds 97% and 79% of our operating interest-bearing liabilities at March 31, 2007 and December 31, 2006, respectively. The sensitivity of NPVE at March 31, 2007 and December 31, 2006 and the limits established by E*TRADE Bank s Board of Directors are listed below (dollars in thousands):

Parallel Change in	Change in NPVE				
	March 31, 2007[(1)]		December 31, 2006		
Interest Rates (bps)	Amount	Percentage	Amount	Percentage	Board Limit
+300	$ (532,716)	(14)%	$ (52,325)	(2)%	(55)%
+200	$ (326,507)	(8)%	$ (32,680)	(1)%	(30)%
+100	$ (137,224)	(4)%	$ (15,303)	(1)%	(20)%
-100	$ (106,368)	(3)%	$ (159,618)	(6)%	(20)%
-200	$ (519,518)	(13)%	$ (560,142)	(20)%	(30)%

(1) Amounts and percentages include ETC.

Under criteria published by the OTS, E*TRADE Bank s overall interest rate risk exposure at March 31, 2007 was characterized as minimum. We actively manage our interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The ALCO monitors E*TRADE Bank s interest rate risk position.

Other Market Risk

Equity Security Risk

Equity securities risk is the risk of potential loss from investing in public and private equity securities including foreign currency exchange risk. We hold equity securities for investment purposes and in trading securities for market-making purposes. The foreign currency exchange risk associated with these investments is not material to the Company. For investment purposes, we currently hold publicly traded equity securities, in which we had gross unrealized gains of $24.5 million as of March 31, 2007. As each security s market price fluctuates, we are exposed to risk of a loss with respect to these unrealized gains. See publicly traded equity securities discussion at Note 5 Available-for-Sale Mortgage-Backed and Investment Securities in Item 1. Consolidated Financial Statements.

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PART I FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INCOME

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31, 2007	2006
Revenue:		
Operating interest income	$ 829,795	$ 594,294
Operating interest expense	(439,209)	(269,505)
Net operating interest income	390,586	324,789
Provision for loan losses	(21,186)	(10,197)
Net operating interest income after provision for loan losses	369,400	314,592
Commission	158,993	175,869
Fees and service charges	59,498	57,862
Principal transactions	30,082	30,692
Gain on sales of loans and securities, net	17,375	11,628
Other revenue	9,650	7,706
Total non-interest income	275,598	283,757
Total net revenue	644,998	598,349
Expense excluding interest:		
Compensation and benefits	123,782	115,988
Clearing and servicing	67,252	63,288
Advertising and market development	45,592	34,781
Communications	26,156	31,408
Professional services	24,985	27,755
Depreciation and amortization	19,383	18,789
Occupancy and equipment	23,579	20,504
Amortization of other intangibles	10,268	11,332
Facility restructuring and other exit activities	733	(253)
Other	32,675	31,005
Total expense excluding interest	374,405	354,597
Income before other income (expense), income taxes and discontinued operations	270,593	243,752
Other income (expense):		
Corporate interest income	1,705	1,961
Corporate interest expense	(37,791)	(40,508)
Gain on sales and impairment of investments	19,756	17,616
Loss on early extinguishment of debt		(135)
Equity in income (loss) of investments and venture funds	8,095	(1,007)

Total other expense	(8,235)	(22,073)
Income before income taxes and discontinued operations	262,358	221,679
Income tax expense	92,948	78,695
Net income from continuing operations	169,410	142,984
Loss from discontinued operations, net of tax		(513)
Net income	$ 169,410	$ 142,471
Basic earnings per share from continuing operations	$ 0.40	$ 0.34
Basic earnings (loss) per share from discontinued operations		(0.00)
Basic net earnings per share	$ 0.40	$ 0.34
Diluted earnings per share from continuing operations	$ 0.39	$ 0.33
Diluted earnings (loss) per share from discontinued operations		(0.00)
Diluted net earnings per share	$ 0.39	$ 0.33
Shares used in computation of per share data:		
Basic	423,786	414,679
Diluted	437,535	432,302

See accompanying notes to consolidated financial statements

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(In thousands, except share amounts)

(Unaudited)

	March 31, 2007	December 31, 2006
ASSETS		
Cash and equivalents	$ 1,194,981	