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ETFC.OQ^J20 - Q3 2006 E*TRADE Financial Corp. Earnings Conference Call

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OVERVIEW:

ET generated 3Q06 earnings of $0.36 per share, excluding acquisition-related integration expenses and $0.35 on a GAAP basis. Total Opex in 3Q06, excluding corporate interest was $359m. During 3Q06, ET purchased approx. $35m of stock or roughly 1.5m shares at an avg. price of $22.79 per share. 2006 earnings is expected to be $1.45-1.50 excluding acquisition-related integration expenses. 2006 GAAP earnings is expected to be $1.40-1.45.

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PRESENTATION

Operator

Welcome to E*TRADE FINANCIAL Corporation's third quarter 2006 earnings conference call. [OPERATOR INSTRUCTIONS] I have been asked to begin this call with the following Safe Harbor statement. During this conference call, the Company will be sharing with you certain projections or other forward-looking statements regarding future events or its future performance. E*TRADE FINANCIAL cautions you that certain factors, including risks and uncertainties referred to in the 10-K's, 10-Q's and other reports it periodically files with the Securities and Exchange Commission could cause the Company's actual results to differ materially from those indicated by its projections or forward-looking statements.

This call will present information as much October 18, 2006. Please note that the Company disclaims any duty to update any forward-looking statements made in the presentation. In this call, E*TRADE FINANCIAL may also some discuss non-GAAP measures in talking about its performance, and you can find the reconciliation of those measures to GAAP in the Company's press release, which can be found on its website at www.etrade.com.

This call is being recorded. Replays of this call will be available via phone, webcast and by podcast beginning at approximately 7:00 p.m. eastern time today through 11 p.m. eastern time on Wednesday, November 1. The call is being webcast live at www.etrade.com. No other recordings or copies of this call are authorized or may be relied upon.

I will now turn the call over to Mitchell Caplan, Chief Executive Officer of E*TRADE FINANCIAL Corporation, who is joined by Jarrett Lilien, President and Chief Operating Officer, and Robert Simmons, Chief Financial Officer. Mr. Kaplan?

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Thanks, everyone, for joining us today. This past quarter E*TRADE FINANCIAL celebrated ten years as a public company. In 1996 we were a monoline online brokerage company that had 91,000 accounts and annual revenues of $52 million. Today we have matured into a diversified financial services institution, with over 4.4 million global retail customer accounts and annual revenues of approximately $2.5 billion.

From transforming the way people traded stocks a decade ago to helping redefine the broader financial services sector today, E*TRADE has emerged as an integrated, global growth franchise that provides a distinctive suite of financial solutions to the value-focused investor. Having built our entire model around an integrated, low-cost infrastructure, we are in a unique position to deliver the mass affluent investing customer a compelling value proposition across price and functionality and service. Our third quarter results illustrate the power of our transformed model, and demonstrate that the strategy of engaging with new and existing customers across multiple products serves both as a bridge over seasonality and is an avenue for future organic growth.

I am pleased to reported that we generated earnings of $0.36 per share, excluding acquisition-related integration expenses, and $0.35 on a GAAP basis. Included in these earnings are a number of unusual items creating some noise in our results, but which net to approximately zero in the aggregate. In a few minutes, Rob will discuss these items in detail. More importantly, however, embedded in these results is the success of our execution.

By offering customers the right products for the current environment, we grew our enterprise cash balances by $1.5 billion last quarter, our second highest level of cash growth ever. That increase allowed us to grow our balance sheet to a record $46.4 billion in average interest-earning assets. Those assets generated a record $343 million in net operating interest income after provision, up $8 million sequentially. This increase helped to offset the anticipated decrease in retail trading commission revenue.

While we always expect that certain trading activities will slow during the summer, the high quality recurring revenues generated by the spread on our growing customer cash and credit balances helped produce the strongest third quarter results in the Company's history. In reflecting on our competitive position, we believe we are at an inflection point for both accelerated growth and earnings expansion, as we invest in building a long term franchise. As we have said in the past, during the 2003 to 2004 time frame, we built a technology infrastructure to support a highly integrated product offering and global operations.

That integrated infrastructure has two significant benefits. First, it allows us to view our customer relationships on a holistic basis and manage the business accordingly. Second, it allows us to deliver the appropriate products and services more efficiently, and in the process generate higher incremental operating margins on each additional dollar of revenue.

By way of example. the E*TRADE complete investment account accomplishes exactly this, by offering high value, integrated financial solutions across trading, investing, banking and lending. The result has been broader customer engagement across all of our products., most notably evidenced in the organic enterprise cash growth of over $5 billion in the five quarters since the launch of complete, fueling efficient balance sheet growth.

During that period, net operating interest income after provision grew 75% and now represents almost 60% of our total net revenues. We are now positioned to expand our fee-based revenue contributors and broaden our geographic footprint with that full suite of products. By investing in these areas, we enhance our opportunity for organic growth domestically and extend our reach globally. As our competitors have largely abandoned their ambitions outside of the U.S., our international success also represents a key differentiator.

As we look at the size of the potential global market, we have identified a universe of nearly 80 million mass affluent households holding over $11 trillion of investable assets. In viewing our international prospects, we will continue to develop and distribute products and services based on a compelling value proposition comprised of the three pillars of price, functionality, and service. We plan to move forward thoughtfully, but aggressively on this expansion, as evidenced by our recent efforts to increase our holdings in IL & FS Investsmart in India.

This move opens the door to expand our operational partnership in that region, which we believe is crucial in navigating cultural and business differences. This partnership, through which we plan to provide local Indian investors access to both domestic and international markets and global

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customers with opportunities to invest in one of the world's most rapidly expanding economies, will serve as a prototype for continued expansion in other developing economies.

Our continued successful execution demonstrates that a model which delivers relevant, financial-driven, value-driven solutions to investing customers is a model that will thrive in a variety of macroeconomic conditions. More importantly, we believe the continued customer engagement that we are experiencing confirm our value-based products and our low-cost delivery channel are at an inflection point, as we expand our geographic footprint. As we move forward and celebrate more anniversaries, we will continue on our mission to deliver value to our shareholders by building on our successes and delivering timely value to our global investing-focused retail customer.

Now to provide further detail on how the quarter unfolded, I'd like the turn the call over to Jarrett.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

Thanks, Mitch. By keeping engagement with our existing global retail base and attracting new high-quality customers, we have created a franchise that delivers strong results. Across our trading, investing, banking and lending solutions we continue to see strong overall growth trends, signaling that our value proposition continues to resonate. Net revenue and net income were up 39% and 43% respectively year over year, as a result of both organic growth in our target customer segments and successful integration of Harris and Brown.

While the annualized growth rate of customer accounts in our retail business is trending at about 5%, the annualized growth rate of our high-value targeted segments is growing at about 30%. As a result, we continue to see increases in the quality of our overall customer base. Assets per customer, revenue per customer, segment income per customer and products per customer have all improved significantly.

Moving to our balance sheet, average interest earning assets increased by $2.3 billion or about 5% sequentially. Net operating interest income, after provision, grew 2.5% sequentially and was up 68% versus a year-ago period, fueled by growth in customer cash and credit. Our net interest spread decreased a modest five basis points to 286 basis points. This is within the range of our guidance for the second half of the year, and well below compression levels seen by others in the industry.

As we discussed last quarter, we believe that there was an opportunity to deepen customer engagement and attract new high-quality global customers by offering relevant value-based cash solutions. Important to our model, we believed that, from a rate volume perspective, the investment of a few basis points of spread to fund a larger interest-earning asset base would pay off, and it did. As Mitch noted, total enterprise cash increased by $1.5 billion this quarter.

But there's a more interesting story here. 72% of new deposit account openings and 80% of new account balances came from current investing customers. Nearly all of these investing customers increased their total assets with us, and almost half increased their total assets by over 20%. Even more compelling, the value of these customers was evident, not only in the increased asset levels but also in the significant out performance in trading, option volumes, commission revenue and margin balances as compared to the broader customer base.

Accordingly, we were able to not only grow net operating interest income, but to deepen relationships and engage new target customers, providing both current and future financial benefits. In the quarter, while average margin debt balances declined 5% as customers delevered, average mortgage and home equity loan balances increased 16%. Importantly, as we continue to build out our asset origination capability, we saw a 5% increase in retail mortgage-related lending originations and a 34% increase in those balances that we kept on our balance sheet. As always, we continue to adhere to our strict and conservative credit policy philosophy.

In trading, September DARTs increased 10% versus August, as we exited a period of seasonal softness and the market regained momentum. Overall, third quarter DARTs declined 18% versus the second quarter,, but were up 44% versus the third quarter of 2005, driven in large part by the successful integration of Harris and Brown. Anecdotally, the Harris and Brown customer trading activity suffered less of a seasonal decline than the broader customer base.

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Further, for these customers, assets are up 6.5%, and we have crossed $1.1 billion in deposit balances since closing. This performance shows the increased value of these customers, as we originally modeled no cross-sell benefit. Finally, we have achieved 102% of the original expense synergies as we exited the third quarter.

Within our trading solutions, options continue to be a growth area for to us, and now comprise 13% of domestic trading volumes. Looking abroad, while international DARTs were seasonally down 19% sequentially, they were up 28% year over year, an increase resulting entirely from organic growth, as we have yet to engage in any international consolidation. Retail average commission per trade decreased from $12.23 in the second quarter to $11.95.

This decrease was a function of the mix of customers, as Main Street customers traded less during the period, which resulted in a heavier weighting of active trader commissions. Given the seasonal pickup in the fourth quarter and the trends we saw in the month of September, we would expect to see average commissions return to a lever -- a level over $12.

During the quarter E*TRADE, like a number of our competitors, experienced a significant increase in losses resulting from fraud relating to identity theft. This has recently been highlighted by the media and has become a focus of the SEC and other regulatory agencies. In the quarter this resulted in an $18 million increase in fraud losses. As always, we continue to stand by our customers through our complete protection guarantee.

While our systems remain safe and secure, we continue to take steps to deter unauthorized activity in our customer's accounts and believe we have made appropriate technological and operational changes to significantly reduce the potential impact of these matters on an ongoing basis. We are working diligently with others in the industry, regulators and law enforcement officials to make appropriate changes and are confident that these combined efforts will help reduce this fraud.

Across our retail offerings, our investment in service has taken a firm hold throughout our business. We continue to invest in people and process to improve customer satisfaction. As a part of this effort, we have integrated our customer service, migrating to the former Harris and Brown customer service platforms and significantly increased a number of employees answering our customer's needs.

As proof points of the success of this service expansion, we have reduced average speeds of answer to less than 40 seconds generally and to less than 30 seconds for our target customers. Further, we have achieved an abandonment rate of 4% overall and 3% for our targeted segment.

Continuing the theme of organizational integration, we are confident we will soon obtain final written approval to move our clearing business under the bank. While this process has taken longer than expected, we have met all of the conditions for bank regulatory approval and anticipate receiving written approval within weeks. This approval will let us move forward with the final phases of our structural balance sheet integration. Again, the benefits of this structural change are three fold. One, more efficient capital allocation.

Two, a lower cost of funding, as we leverage brokerage cass -- cash to fund balance sheet growth and lower hedging costs, as we optimized the duration characteristics of the brokerage assets and liabilities. Once this new structure is finally implemented, we anticipate operational and economic efficiencies that will drive further opportunity for margin expansion, particularly once the yield curve returns to a more normalized slope. The specific future benefits to the model will be included in our 2007 guidance discussion in December. So, as you can see, the third quarter was a strong one for us from both a quantitative and qualitative standpoint. The model continues to resonate with customers, driving compelling growth and profitability.

And with that I'll turn the call over to Rob for the financial details of our results.

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Okay. Thanks, Jarrett. During the quarter our efforts in developing a model less affected by volatility in the markets really paid off. Let me walk you through a few of the highlights. Third quarter net revenue decreased 5% sequentially on retail commission seasonality ,but increased 39% against the comparable year-ago period. Net operating interest income, after provision, increased $8 million sequentially to a record $343 million, growing 68% year over year.

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As Jarrett noted, the increase in net operating interest income was the result of a larger balance sheet, while net interest spread declined modestly in a calculated effort to attract and deepen customer relationships. We will continue this calculated rate rate-volume approach, taking into account our success in new and existing customer engagements. We believe this will allow us to generate greater net operating interest income and non-interest income, providing a superior return on invested capital.

Provision for loan losses increased approximately $2.3 million sequentially on continued loan portfolio growth. Net charge-offs increased slightly to 17 basis points on seasoning of loans, up from 15 basis points in the prior quarter and down three basis points from the comparable period last year.

This low charge-off number continues to reflect the high credit quality and conservative mix of our portfolio. Commission revenue decreased $34 million sequentially, but grew $19 million year over year. Retail commissions represented a little over 17% of total net revenue this quarter, down sequentially from 21% in the second quarter. Gains on sales of loans and securities increased $4.9 million quarter over quarter and decreased $5.8 million versus a year ago.

On the expense side, our commitment to disciplined expense management and operational efficiency continued. Total operating expenses, excluding corporate interest, increased 2.3% sequentially to $359 million. This includes, however, the unusual items of $18 million in increased fraud and $17 million of restructuring, which I will discuss in a minute. Operating margin, excluding these items, was a solid 44%.

Compensation and benefits decreased $15 million sequentially to a 19% of revenues as a result of three factors. One, a decrease in variable compensation in our business, given lower sequential volumes. Two, a decrease in performance-based compensation, based on business unit performance. And, three, head count synergies resulting from integration and restructuring. We expect compensation and benefits to run at an annualized rate of approximately 19% to 20% of revenues on a going-forward basis.

As Mitch noted, included within our EPS numbers we had five unusual items this quarter that deserve some discussion. First, we exited some of our California offices as a part of a facilities consolidation. This resulted in restructuring charges of approximately $17 million for the quarter. We expect to take an additional restructuring charge of about $10 million in the fourth quarter, as we complete our facility consolidation.

Second, as Jarrett discussed earlier, the increase in fraud represented $18 million of the increase in the other expenses line item. Third, the market resurgence in September provided an opportunity for us to realize gains on certain of our corporate equity holdings. During the quarter, ISC's stock price had an interperiod high, and we opportunistically took approximately $14 million in gains this quarter above what we had planned. Fourth, as we closed the sale of E*TRADE Professional, we had a $5 million pretax equivalent gain in discontinued operations. And fifth, largely as a result of the favorable resolution of a tax issue related to pre-2000 earnings of a foreign subsidiary, we saw a $9.7 million discreet tax benefit. Taken in the aggregate, these five unusual items net to approximately zero within our GAAP EPS.

Market seasonality once again provided a good opportunity for us to create value under our share repurchase program. During the quarter we purchased in the open market approximately $35 million of stock, or roughly 1.5 million shares, at an average price of $22.79 per share. After this purchase we have approximately $97 million still available under our board-approved share repurchase program.

Including the affect of our share repurchases this quarter, our overall debt to equity continues to decline as modeled. Our leverage ending Q3 was 31%, down from 33% last quarter and 41% from the fourth quarter of 2005. We continued it look to deploy our capital against the projects with the best return. This past quarter we continued to invest in the growth of the Company, reduced our overall leverage and enhanced shareholder value through share repurchases.

Earlier this afternoon we announced a narrowing of our 2006 guidance range. Our previous guidance of $1.42 to $1.52, excluding acquisition-related integration expenses, has been narrowed to $1.45 to $1.50. Our previous GAAP guidance of $1.37 to $1.47 has been narrowed to $1.40 to $1.45. In summary, we are pleased with the Company's core performance during the third quarter and the market resurgence we have seen in the past weeks. Our focus continues to be on building an integrated, global franchise to deliver superior long-term shareholder value.

With that, operator, I would like to open the call to questions.

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QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS] Our first question is from Rich Repetto of Sandler O'Neill. Please go ahead.

Rich Repetto - *Sandler O'Neill - Analyst*

Hi, guys, how are you doing?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hi, Rich.

Rich Repetto - *Sandler O'Neill - Analyst*

The first question on the one-time items, because there is several, so I'm just trying to see the acquisition-related charges, that's nowhere -- that's still above and beyond the five items you talked about?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes. So in other words, what we did, Rich, is I think we tried to separate out what we thought the marketplace knew versus what they didn't know. So if you start -- we assumed and we'd always said that this year we'd have about $0.05 in integration-related expenses in connection with Harrison Brown, three in Q1, one in Q2 and one in Q3.

I think the consensus that's out there really sort of reflects $0.36 before that $0.01 of deal-related expenses or $0.35 GAAP, and so that's why we reported our numbers that way. Separate and apart from that, there were these five pieces of information, which I think the marketplace didn't know and we wanted to clearly sort of delineate, one of them, obviously, being the restructuring charge.

I guess to be clear, the purpose of the restructuring charge is we'd made up our mind, even a number of years ago, to begin to move more of our operations from the West Coast to the East Coast. And in the process of doing that and moving different parts of the business from an operational perspective over to the East Coast, we ended up with a significant amount of excess space in certain of our California facilities. And so, this was the quarter that we made the decision to exit those facilities entirely ,and that's when you see the restructuring charge associated with that.

Similarly, we had this experience of the additional fraud that was unexpected and again, I think we were pretty clear that we believe that we've made a significant number of operational changes and technology changes. We've seen that level of fraud in the last three weeks or so reduced to almost zero as a result of the changes we're making. But yet we're continuing to work with others in the industry who are experiencing some of the same problems, as well as the regulators and the SEC and the FBI and everybody else, because it appears to be sort of concerted rings in, at this point, eastern Europe and Thailand.

But we wanted to make it clear that that was an unusual item. And then offsetting those items were the one-time benefit we got from the tax, as a result of the Europe -- the foreign benefit from, I guess, 2002 or 2003, as well as the ISC shares that we sold for an additional gain over and above the $50 million or the $12.5 million a quarter we originally guided back in last December. We have left, I guess, as contemplated about $12.5 million, which we would anticipate exiting in Q4 of this year. And then finally the [disc op] benefit associated with the final sale of E*TRADE Pro. And I think, as Rob walked you through, all five of those end up netting to about a zero impact.

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Rich Repetto - *Sandler O'Neill - Analyst*

Okay. We can certainly go through more details after the call, but that helps, Mitch.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Good.

Rich Repetto - *Sandler O'Neill - Analyst*

I guess second question is what was on people's minds I guess last week, but the B of A, zero commission offering, you know, what have you seen, what have you learned and what do you think, I guess, since that occurred?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

A couple quick thoughts. The first is that I think the market missed it. I'm pretty convinced that the B of A offering wasn't really an offering against our business model or the business model of many of our direct competitors. I think the B of A offering was based entirely on their desire to try to grow deposit. I think many people recognize that growing deposits has been very difficult in these last couple of years, and that doing it cost effectively has been extremely difficult. And when you have a traditional brick and mortar franchise, you really only have a couple avenues in terms of growing deposits.

One, obviously, is to change your whole pricing strategy, impossible to do for their business model. Another one is to create a subsidiary, very much like Citi or HSBC direct did, and I guess they chose not to play in that game. They could continue to build out branches and spend the cost infrastructure, but ultimately I think they made the decision that, in exchange for $25,000 dollars at a very low interest rate, they would offer trading with no charge.

This is not free trading. All day long I would take $25,000 from our customers at 40 or 50 basis points of cost. I would clearly not characterize that as free. In fact, I would characterize that as extremely profitable. So when you look at the marketplace in which they're playing, I'm pretty convinced that they were really competing against their fellow brick and mortar brethren in the deposit-gathering arena.

It is why from our business model and, I guess, our perspective, we've always been of the belief that the customer you want is not a banking customer. It is why we told Telebank E*TRADE. It's you want to go after an investing-based customer, and you want the customer whose demographic and whose behavior base segmentation is about value. Somebody who says I understand that in exchange for traditional brick and mortar distribution, I go with nontraditional distribution and I get better value, and I get better value through pricing. I get better value through technological integration and innovation of products, and I get good value in service. And that's always been the customer that we're going after and that we've been able to penetrate and grow. It is not the customer who B of A is trying to attract.

So, when I look at it, my view is that they're neither going after the core customer that we're interested in nor can they afford to from their deposit pricing strategy and that, with respect to our customers who want to trade actively, not even remotely of interest. I mean I will tell you, we get about 25,000 calls a day into our system, so in the last -- I guess since Wednesday on that announcement we've had about 150,000 calls come through our system.

Of those 150,000 we've had about 160 that called about the B of A offer, and since then we've been tracking, and we have seen virtually no TOA's, no ACAT's, no movement as a result of that offer. Clearly we'll continue to monitor it, but my view is it's just -- it really isn't playing in our space, and we have, therefore, no interest, no desire, and have no intention of trying to competitively respond because we think it's unnecessary.

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Rich Repetto - *Sandler O'Neill - Analyst*

Understood. Someone was going to ask that question, so I might as well have asked it. Very last quick question, I just wanted to show Rob we're paying attention out here. It looks like in the -- on the second quarter, the retail client assets were restated downward, and specifically in the cash and money markets by about $600 million, if I got my numbers correct. Can you give me some color?

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Yes, absolutely. This quarter we had for the first time the technology through ADP to be able to kind of monitor our activity on a settlement-day basis as opposed to a trade-day basis. Looking at things on a settlement-day basis is much more conservative and accurate we have felt, and it's actually -- for everyone on the call, it's actually footnoted, actually, in the press release what we did.

Through the end of September, the end of the third quarter, there was about a cumulative $600 million difference between the trade-date numbers that was our previous methodology and settlement day, which is our new methodology. That's $600 million of cash that really we were not earning any economics on. It was just -- it was kind of there as a reporting type anomaly as a difference between trade date and settlement date.

So we -- as we looked at it, we just felt like moving to a more conservative methodology that better reflects the underlying economics made a lot of sense and so, again, this quarter was the first quarter that we had the technology to begin doing that. So there's no meaningful impact quarterly cash flows for this. It is just a kind of a one-time catch-up, and there's no economics to this. We took the opportunity with this technology to make this change this quarter, and going forward, we'll be consistent with that.

Rich Repetto - *Sandler O'Neill - Analyst*

On an apples-to-apples basis, I guess would customer cash still have grown by one point -- I guess it is an apples-to-apples basis. It would have --

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Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Yes, absolutely.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay. Thanks, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

What this was, Rich, as Rob ultimately explained it to me, was a one-time catch-up -- historical catch-up for all the years where we were reporting settlement trade date as opposed to settlement date.

Rich Repetto - *Sandler O'Neill - Analyst*

Yes, I just wanted to make -- let him make sure that he knows that we're looking at the old numbers, as well as the new numbers.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You got it.

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Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

I am impressed, Rich.

Rich Repetto - *Sandler O'Neill - Analyst*

Thanks, guys.

Operator

Thank you. Our next question is coming from Matt Snowling of Friedman Billings Ramsey. Please go ahead.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

Yes, hi, guys. I guess my ques --

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hi, Matt.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

Hi. My question's about moving the clearing over to the bank. Just wondering if you can quantify how much capital you expect to free up and maybe how long it takes to deploy that capital?

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Again, Matt, what I'd prefer to do is address it entirely in the call in December when we'll give earnings guidance. I think we were pretty clear in the script that we expect to receive approval literally at this point in a matter of a few weeks. or under a few weeks. And my guess is that we will be able to -- we've been preparing for it long enough that we'll be able to structurally make it happen in reasonably short order.

There are economic benefits associated with it, as we said, in connection with capital, in connection with hedging and in connection with lower cost to funds. But, again, the guidance for the rest of the year contemplates exactly what we know currently about the rest of the year, and we will be much more specific in the call in December on guidance as to the economic benefits for 2007 and beyond.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

I thought I would try, Mitch.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

I got you, Matt, but sorry.

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Matt Snowling - *Friedman BIllings Ramsey - Analyst*

Alright. Another quick question, then. On the balance sheet, you know, you obviously grew that pretty strongly during the quarter, about $2 billion or over $2 billion, I guess.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

And it looks like it's primarily funded with wholesale sources. I'm just wondering, is the thought or the hope to replace the wholesale funding over time with more deposits or is it just taking an opportunity put the assets on the book, even though it may have some impact on the spread, but it's just accretive, nonetheless.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

I don't know what you're saying, but we funded almost entirely with retail. So we funded on the liability side with about $1.5 billion of cash, and on the asset side we had virtually 100% growth in mortgage [whole] loans.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

Well, I was just looking at your average balance sheet, and the repos were up a billion.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, so that's on the liability side. We grew $2.4 billion. That's right. We funded about $1.5 billion of the $2.4 billion in growth with customer cash, which was the grow -- strongest growth we've had and second strongest growth ever we've had in customer cash. The difference we funded with wholesale borrowings, and we will, in fact, replace them in reasonably short order with customer cash that's coming in. But on top of that, one of the things that we experienced -- good question because it's a good point to make.

I think in the comments that Jarrett was going through, for the first time we are beginning to be as focused on the earnings power and, ultimately, where we go with spread and the contribution from both sides of the balance sheet. Traditionally, it has been the liability side or cash that has really driven the value, meaning that we've brought in $5 billion, I guess, in these last five quarters or so of customer cash. It's been very cost effective from a cost-to-funds perspective, from a duration perspective, and it is widened our spread. We have not really relied very much on the credit side of the balance sheet.

In the last probably six to nine months we've made some significant changes from an operational perspective around the origination, again, of credit products, so margin, mortgage, HELOC, things like that. And one of the things that's pretty -- I was pleased with in the quarter is that we were able to grow our mortgage originations quarter over quarter by 5%, obviously in a market where mortgage originations are declining elsewhere in the -- you know, generally speaking in the environment. And rather than originate mortgages which we had typically sold into the secondary market of our customers, we're now keeping the vast majority of them on balance sheet, and so you saw a significant increase on a percentage basis of the numbers. And s,o I was really quite pleased that what we actually did is we got out of mortgage-backed securities and replaced those mortgage-backed securities in the past quarter with mortgage whole loans and home equity lines of credit.

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Again, credit characteristics on average are sort of a 7.40 FICO score, LTV's on the firsts are at about 70%, LTV's on the HELOCs and seconds are about 77%, 78%. So I feel really good about the credit characteristics and, frankly, the ability to finally be in a place where we're starting to really originate again.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

Yes, let me give one other data point on that. If you look at the year-over-year numbers, a year ago deposits as a percentage of our interest-paying liabilities were about 53%. Today they're over 61%, so we've made some very nice progress towards improving the mix.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

And the aim is true as loans as a percentage of assets.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

Absolutely.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

I guess one quick question, then. In terms of the spread, how did it end the quarter?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Had how did it end the quarter? Rob is shaking his head. I was going to say favorably, but -- [LAUGHTER] Rob --

---

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

I don't think that helps.

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

We only have one spread metric.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Exactly. The spread metric that's -- Rob's looking at me -- is the one that we released in the quarter as 286.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

All right, guys..

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

But again, I think it's fair to say we guided for the second half of the year between 285 and 300. We're cognizant of that, and we also recognize that what we're really trying to do is take a look at, sort of, a rate volume analysis. Listen, Matt, one of the things that's pretty interesting, our thesis a long time ago and what we've been trying to determine is, when you look at spreads, spread is nothing more than a proxy for earnings growth and revenue growth, right?. I mean, it's just a metric when you multiply it times the balance sheet. So what you really should be thinking about is what actions can you take to generate significant expansion of earnings, and when you do that, can you do it as an acceptable return on invested capital?

So our theory for awhile has been, even if we see some spread compression, which is why we guided from last year -- I mean, last quarter, when we were at 289 to 285 to 300, because we knew that if we didn't grow the balance sheet as much, because we weren't engaging with customers as much, we'd have a higher spread. On the other hand, if we engaged with customers, there was a chance you would have a bigger balance sheet and see some spread compression. So the question was if you were willing to offer a bigger variety at appropriately priced products on the deposit side, or the liability side of the balance sheet, what else were you getting for those customer -- from those customers? Where else was it helping you within the overall income statement? Where were you seeing the economic benefit?

And one of the things that we've tracked is some of the metrics that Jarrett gave you, which were things like, as we looked at this growth and $1.5 billion in customer cash, we saw, you know, 80% of it in balances come from existing customers, from the investing-base customers. We saw all of them actually increase their balances, so it wasn't a question of moving within the system, they were actually -- there was net increases to their overall balances in the system. 50% of them increased their balances by more than 20%.

Then we went back and tracked it and said, okay, what else happened with those customers? When you look at that sample of customers, how did they perform on a DART basis? How did they perform with respect to options volume? How did they perform with respect to margin balances and commission revenue?

And I can tell you that when you look at them, if you recognize that the broader customer base was down 18%, we meaningfully out-performed with respect to DARTs, as in it was a positive number. The same sort of trend lines occurred across options, across commission revenue and across margin, so we recognize that these customers are, in fact, not only deepening their engagement as it relates to the balance sheet, they're also out performing with respect to the broader base of customers and a lot of the other drivers. And so this was always our thesis and it's why we intend to be very continue to be very focused on driving the relationship around these investing customers.

Matt Snowling - *Friedman BIllings Ramsey - Analyst*

Right. Understood. Thanks.

Operator

Thank you. Our next question is coming from Richard Herr of KBW. Please go ahead.

Richard Herr - *KBW - Analyst*

Hi, good afternoon.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Richard.

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Richard Herr - *KBW - Analyst*

Just quickly sort of spend a little time on the fraud here. I was just curious, do you have any insurance against this type of fraud or is this something you can't insure against?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Rob?

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

We have insure -- there is insurance out there which may or may not cover it.

Richard Herr - *KBW - Analyst*

Okay. So potentially you could have some degree of recovery in the coming quarters?

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Potentially.

Richard Herr - *KBW - Analyst*

Okay.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

I may -- and, Rob -- [LAUGHTER]

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

We'll keep you posted.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay. And did the --

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

It's a great question, Richard, but I think the more important --

Rich Repetto - *Sandler O'Neill - Analyst*

[multiple speakers] RSA password devices to your customers, does that aid at all in preventing this type of behavior?

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Rich Repetto - *Sandler O'Neill - Analyst*

Or is this a matter of not everybody has those yet or --?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

That's absolutely right. It's not everybody has them and when they have them, not everybody chooses to use them or use them consistently.

Rich Repetto - *Sandler O'Neill - Analyst*

Understood.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

But I suspect you're going to see -- I think that this thing is so widespread and it has such a significant impact on the industry at large, and you have so many players involved in this, not only from the Street, from Wall Street, but also, as I said, with respect to the SEC and the Secret Service and the FBI and everybody else, that I think you're going to end up seeing sort of structural changes in the industry, as well.

Rich Repetto - *Sandler O'Neill - Analyst*

That's helpful. On your spread, again, within your guidance range of 285 to 300, is that still a good range for Q4 or was that some of the thinking that brought down the top end of guidance?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Rob's looking at me because he's not going to let me -- as you know, I think as a policy we don't give quarterly guidance.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

We only give annual guidance. So I think that when we thought about the second half of the year, both Q3 and Q4, we did think about where we thought each of those metrics would be. So, again, at that point we were comfortable with a range for the second half of the year of 285 to 300, and we would continue to engage in rate volume. I think, as you look at the top end, mostly what's driving the decision around the top end was the decline in DARTs this quarter, so if you look at what is the new range imply, I think it implies anything from $0.37 to $0.42 in Q4, up from $0.36 in Q3.

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Rich Repetto - *Sandler O'Neill - Analyst*

That's helpful. On the rates, looking here the retail deposits was 2.67% up from 2.33. Is that just a matter of customers moving from money markets to more of a fixed-rate product like a CD, or is it just a matter of rates going up overall for --?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, fed's funds during that same period were up 35 basis points as a point of reference.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay, so that's --

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

So actually I think we did quite good.

Rich Repetto - *Sandler O'Neill - Analyst*

Sure, sure. And lastly on the gains, can you give us an update on how much you have left of soft bank gains and did you take any this quarter?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

We didn't take any soft bank gains. What we have left is really no longer soft bank but it's E*TRADE Japan. And Rob's looking at me and saying that, right now I think the only that we have said and have -- from a disclosure perspective is that we do -- would anticipate exiting, I think as we said at the be -- last December, we believe that we would sell virtually our entire stake in ISC during the course of this year, of 2006. I -- again as I said earlier, we have every belief that we will continue to execute on that strategy, and we originally guided to $50 million, because that's what the gain number was as of last December.

Fortunately, I guess, for us the market moved up. ISC stock moved up, so we've been able to extract actually more value out of the ISC shares than we thought. We have about $12.5 million in gains that would be available to us in Q4, and I think that's pretty much what we had modeled, again, originally at the first of the year, which was based on $50 million throughout all four quarters.

Rich Repetto - *Sandler O'Neill - Analyst*

That's helpful. Just one last quick question. How does October look, with all of this press about DOW 12,000?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You know, we never give specifics. September was up, I guess, 10%. In December we seem to be pleased with those numbers. I guess some of our competitors have reported and haven't been quite as strong, so that's a good sign for us. And I guess directionally it would be fair to say, as we always do, that if the market's up, usually volumes are up and everybody is benefiting from it. So we're going to move in the same direction as the rest of the market. I also think in Rob's prepared comments he did say that he was pleased with the reengagement in the market, so you take it for what it's worth.

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Rich Repetto - *Sandler O'Neill - Analyst*

Okay. Thank you very much.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from Mike Vinciquerra of Raymond James & Associates. Please go ahead.

Mike Vinciquerra - *Raymond James & Associates - Analyst*

Thanks. Good afternoon, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Mike.

Mike Vinciquerra - *Raymond James & Associates - Analyst*

Specifically on the income statement, one line item kind of caught my eye on the expense side, the clearing of -- for brokers costs down about 2.5% for the quarter, yet your retail trading and principle transaction revenue both down in the low to mid -- well, I guess 20% for retail, 28% for principle. What kept that particular line elevated on the expense side?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

If you remember, now that we've consolidated the business from a retail perspective between what you would think of as bank and brokerage, you do have an offset in clearing down because of volumes, but it also includes servicing, which means servicing of the whole loans, which as you grow your whole loan balance sheet is going to go up. So while you saw an 18% decline in DARTs, you also saw a $2.4 billion average increase in whole loans.

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Yes, this line item's not just correlated with trading volumes any more.

Mike Vinciquerra - *Raymond James & Associates - Analyst*

Okay, that makes sense. I have a question on your -- how you guys process your customer's trades. Historically you've done probably two-thirds of your trade processing internally or, I guess, executions internally, and it looks like on the Nasdaq side the last few quarters it has been dropping precipitously with you sending more trading volume out to Knight and Citadel, in particular. I don't know what the numbers are going to look look for Q3, but can you just talk about what your strategy has been there, what's going on, why we've seen the shift?

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes. I think it's fair to say that it really is stock specific. So if you look at our rate of internalization, it really has been sort of between 50 and 60/50 and 55% for as long as I can remember, and there's nothing that I'm seeing this quarter that is materially different. I think what is happening is that one of the things that we've done is we've actually been more disciplined about the stocks in which we are making a market, with the idea that we will get reciprocal flow because it we have less stocks and in deeper pools of liquidity, it's even better execution, which is really what it's all about for us.

And we would get reciprocal flow in those stocks and then in others where we feel we can't get the same level of depth, then we move those out to other market makers, Knight and otherwise. So I don't think there's anything that's happened. Jim?

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

Yes, the only thing I'll add there is just there was recently a publication that showed of the stocks that we do make a market in, we were actually ranked number one, based on overall speed and quality of execution. So I think, again, as we fine tune our market making model and continue to specialize, it's benefiting both our retail customers -- E*TRADE retail customers and others.

Mike Vinciquerra - *Raymond James & Associates - Analyst*

Makes sense. Thank you. And just the last thing is on the overseas operation, you guys are very excited, it seems, about the opportunity there. Your European business, or at least your international business was up stronger than the U.S., or stronger in the quarter, I guess.

I'm just curious what you see as the growth drivers there in your -- kind of your UK business and, I guess, in Germany with the new value proposition? And also you talked, I think in the past, about a complementary banking franchise potentially in some of these markets overseas to do what you're doing in the U.S. Can you talk about that a little?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

I'm happy to do it. We really are incredibly excited with international. And the reason why that's the case and why I think we didn't talk about it for so many years is because, I guess as you know, historically we came from a place of loss making to now a place where we're actually driving a significant amount of revenue and profits from our international operation.

But we truly did not want to get to a place where we begin to focus on international until we knew that the investment was not significant. And so what I mean by that is that we could look at a retail customer and deal with them across all of our products, so whether it was trading, which we were traditionally and have been traditionally doing for them in both -- the traditional locations of Europe and Asia, or whether it was moving into other asset-related products, mutual funds, banking, or lending, until we knew that our core platform effectively was transportable and transferable across the globe. So your incremental costs would be really de minimus and you could drop a significant amount to the bottom line.

So we feel as we're getting ready to enter into 2007 that we really are basically at that place. So as a result, you're right, we've gotten very focused on these other products, first in Europe and then secondly in Asia. In order to do that, we need to have a banking license. We will talk more about that as we give guidance for 2007 in December, but I think it's fair to say that we are well on our way with respect to a charter to deal with this in both our European operations and passporting throughout all of the EU countries, as well as in Asia.

At the same time, we've come to the understanding, the realization, the recognition that when you look at some of the emerging markets -- I guess I'd define those as India, China, and the Middle East -- that we are far better served participating in a partnership. So India, as I described on the call, is the perfect prototype. And as I look at Indiana, I'm really pleased with it, because we're looking at -- so far we've invested about $60 million or $65 million to date for our equity ownership. We have tendered for another 20% of the company, which would basically put us in a control

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position. If you look at the economics, though, our distribution back from the process out of India, we're generating somewhere around 14% or a 15% return and we also have all the upside associated with the future growth. So that model is one that we think is interesting.

I just came back from a three-week trip. I spent about a week in China and a week in India and then a number of days in Europe, and I suspect that we will obviously continue to deepen our strategy and our relationship in India, as evidenced by the tender. Ultimately, I think over the long-term, we have a real interest in mainland China in structuring a similar kind of relationship.

I mean part of that, Mike, is just -- I mean, last week I happened to be driving into the office and there was all this hoopla, as Jarrett says, around crossing the 300 million mark in terms of the population in the U.S. You go to China, it's 1.3 billion. You go to India, it's somewhere between 1.1 billion and 1.2 billion. And when you look at the power of the numbers -- I mean, we've had a website up for 5.5 months in China that's entirely educational only, with a small representative office in Shanghai, and we've had significantly over a million registered customers come up and sign on and register to the site in order to start getting informed and educated about investing in China.

So we see over the long-term that both of those countries have enormous power in the numbers. The goal for us was to make sure that we could enter in a way in which we would generate both a current return that was satisfactory to us, as well as have all of the option for future growth around them. So I guess we will clearly spend more time in December talking about the strategy from an international perspective and answering more of your questions about the banking charters in Europe and in Asia, and what it means for the growth of a global balance sheet.

Mike Vinciquerra - *Raymond James & Associates - Analyst*

Fantastic. Thanks, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from [William Penona] of Goldman Sachs. Please go ahead.

William Penona - *Goldman Sachs - Analyst*

Hey, good evening, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Bill.

William Penona - *Goldman Sachs - Analyst*

Just a question in terms of new accounts. Obviously you guys did pretty good on the lending accounts this time in terms of net new accounts, but you still seem to struggle on the investing accounts. I know you also talked about the fact that you guys had some success in terms of bringing assets from existing customers, but just want to get your thoughts in terms of how you might be able to kind of get things going again on a net new investing account side, as you think about the fact that you've already gotten through these acquisitions and now you've got to focus on growing that business from an organic standpoint?

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Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Actually I was really, really pleased with the account growth across the board this quarter. And if you look at the investing accounts -- and we talked about it in the script a little bit -- the success that you're seeing in those bank accounts, up 50% year over year, over 70% of those account openings were from existing investing customers. So what you're seeing is a great new account dynamic where the new accounts are representing a broadening and a deepening of current relationships. Growing the revenue per account, the assets per account, all the quality metrics are being driven by fantastic new account generation that's really starting with the investing customer. Also, as we've talked about, we're seeing in our targeted segment, the high-value segment a 30% annualized growth rate, and that really starts again with the investing customer. So you dig into the numbers, and it's a fantastic story all the way around.

William Penona - *Goldman Sachs - Analyst*

guess that -- I guess I'll repeat the question then, because both and you Mitch have mentioned that it starts with the investing accounts. And obviously I see the success that you have with generating the bank accounts, and we saw that this quarter, but what are we going to do to kind much jump start the investing accounts so we see some net new account growth on that front?

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Well, again, I think what Mitch and I talked about is it starts with the investing customer, and then you've got to look at what's going on in different parts of the -- in times of the market. The summer quarter is usually a pretty slow one, and you look at that growth, and still pretty good for a summer quarter, but really the story of the summer quarter were interest rates going up and investing customers -- especially we know for a fact our investing customers tended to be selling into market strength and basically diversifying their portfolios and going to a more defensive posture and more into cash product. So it really shows how the market -- or the model is working in a market where customers are being defensive, delevering, taking a little margin debt off the table, they want to go into a more defensive posture getting into cash product.

It is exactly what they did and our model benefits from it. So what I would expect is you'll continue -- as we go forward, we continue to take share from the traditional players on the investing side. Expect that to continue and in a different environment I think you'll see it differently. You could see less growth in banking-related accounts and more growth in the investing accounts. But I think the model, again, is working precisely the way it's supposed to given the environments that it's been faced with.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

And the one thing I would add, Bill, is I understand your point, meaning that one of the challenges -- you know, so when I look at it, top line growth in accounts broadly defined based off of $4.4 million is 4%, 6% a year. It's just too slow and that said, we are growing our core segment. So the ones that is really matter most to us -- and we define those based on revenue generation -- and that revenue generation comes from either transactional capacity, i.e. people who trade actively, are in the transacting space, or assets. So they come come to us and they engage with us either in mutual funds or cash or borrowing on credit. And as Jarrett said, we are growing all of those segments in combination at about 30% a year.

And that was the first proof point that we wanted. As we went through this model and began to segment, did we believe, as we spent more marketing dollars actively going after them, that we could see a significant growth in those accounts. And we can see it, A, from new customers. B, from current customers, right, meaning migration up from your Main Street. And you're not actually seeing that part of it in the numbers, because the numbers there you're seeing are just the absolute new accounts, as opposed to what we've been able to do with a core customer by getting them to be able to migrate up, as well as lowering both attrition and inactivity.

So this quarter one of the other things that pleased me is for the first time in a long time you saw the inactivity level down pretty significantly in a quarter where you otherwise might see inactivity go up. I mean, if one of the definitions around inactivity is trading, and you know it's seasonally

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slow in the summer and DARTs are down, you might actually -- and traditionally might very well expect to see inactivity go up, and we actually saw it decline. So a lot of this for us has been a proof point about the investment that we've made in marketing.

I think you know our marketing dollars are up significantly in '06 over '05. They were up significantly in '05 over '04. Long before -- we're going to test and learn, so before we just go out and spend -- you know, in our mind some of the our competitors have spent significantly more on marketing and not generated anything for it. So we're seeing pretty decent returns across the board for our marketing investment, and I think we will clearly take that into consideration as we look at '07 and beyond and try to build out the franchise.

William Penona - *Goldman Sachs - Analyst*

That's helpful. Thank you. I guess as you think about the marketing spend and you think about the Banc of America's coming out with that offering, clearly you guys going out -- you guys are unique in some of the online brokerage space by offering both the lending, banking and investment side of it. About about your thoughts in terms of turning the tides and going after the traditional banking model, considering that your rates are significantly better than the rates those banks are offering?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

I think that's exactly what we've always intended to do. The difference is we have zero interest in the traditional banking customer that has $800 or $900 in an account. You make all the money off that customer by literally paying them 20, 30 or 40 basis points, and you charge them fees for everything they do. That's the traditional banking model and it's why I sold Telebank.

I think it's much more interesting to recognize that embedded in some of the banking structures, brick and mortar, there are some investing-base customers, and to the extent that we have been able to gain share from any of these banks, it's only been, really, with the traditional investing-base customer. And your point is right. We have a competitive differentiator that is virtually impossible to match, given the cost infrastructure.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

That's backed up, too, by some of the stats we see in the business. When you look at quick transfer, which is that functionality where you push a button and move money into E*TRADE or out of E*TRADE, we still see a positive inflow of transfers in versus transfers out of anywhere between 2-to-1 and 3-to-2. But one of the biggest places that we net take cash is Banc of America and other traditional banks and other traditional players, and that's what we expect to continue to be the case with our value proposition.

William Penona - *Goldman Sachs - Analyst*

Great. Thanks for the color, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from Patrick Pinschmidt of Merrill Lynch. Please go ahead.

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Patrick Pinschmidt - *Merrill Lynch - Analyst*

Thanks, guys. Good evening.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Patrick.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

A couple quick questions. I guess the first point on margin debt balances. They were down 10% end of period. And just should we, kind of looking ahead to the fourth quarter here, expect this to balance seasonally and help by the positive market back drop?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

Okay. Okay. Great. And then the second question, on the restructuring charge for your West Coast operations -- I think $10 million you mentioned in the fourth quarter -- is that included in your guidance?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

It is.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

It is. Okay, great. And then, finally, on international, your running, I guess, about 14%, 15% of overall DARTs now. Given that you're sort of heightening the focus on Europe, you know, what do you think is a fair share there? What would you like to see? I realize the denominator would grow, but what do you think overall DARTs coming from the international -- ?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Let me answer it in a different way, if I may. We have challenged international that by 2010 they have to account for 30% of our overall revenue, whatever that revenue dollar amount is in 2010. And that has to come not only from DARTs but also from cash and credit relationships, so the traditional model.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

And would you expect the overseas customer relationship would have more of a transaction revenue bias versus the U.S. one?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Nope.

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Patrick Pinschmidt - *Merrill Lynch - Analyst*

Okay. Okay, great.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

When you look at the customer and the behavior, certainly in what you would look at as the traditional EU countries and, again, some of the more traditional Asian countries that we have been looking at, what we have basically seen is the behavior from a demographic perspective with mass affluent looks the same.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

But currently, though, your revenue generated in Europe and overseas is more transactional?

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

It is almost entirely transactional. We're not offering anything yet.

Patrick Pinschmidt - *Merrill Lynch - Analyst*

Okay, okay. Great. Thank you.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from Roger Freeman of Lehman Brothers. Please go ahead.

Roger Freeman - *Lehman Brothers - Analyst*

Hey, good evening.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Roger.

Roger Freeman - *Lehman Brothers - Analyst*

I guess with respect to the growth in cash balances during the quarter, what do you attribute that number growing at the second highest level to? Is it any particular marketing effort or increased rates? Obviously rates did go up because of fed hikes. What do you specifically point to?

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, I think it's a great question. You know, one of the things, I guess, that makes us feel great is, again, even though it is the second highest quarter, the highest quarter was $1.6 billion. We've had a couple other quarters right at a billion, so you're beginning to see sort of a trend line evolve, and what I believe is happening is two fold.

One is, as we're able to deepen the engagement with that investing customer, and we're making them better aware through marketing that we offer a whole suite of products, all of which have value, so we're so much more than what used to be an online trading business. They are recognizing that it's an interesting place to aggregate their cash and get real value for it. And that cash is not only their to-be invested cash, but it's also their fully-invested cash. Meaning they keep X% of their liquid net worth, we're finding somewhere between 15% and 18% in cash at all times, and clearly in situations like that, functionality matters, service matters, but rate matters. And because of our lower-cost infrastructure we have a competitive diffentiator.

I think as we have begun -- and Nick has done an excellent job from a marketing perspective to make our current customers and perspective customers much more aware -- it's made a big difference. We also happen to be playing to an audience at a time when it's interesting. This idea, you actually have seen an increase, meaning that traditionally you may only see 13% or 14% of liquid net worth in cash. It may have moved to 15, 16, 17, 18% in times like this, and it's also you're doing it in a place where there is, to your point, a little higher interest rate environment and fed funds have been moving up, and so you know you're sort of playing to the right audience at the right time with the right product.

Roger Freeman - *Lehman Brothers - Analyst*

Okay. And just as a [inaudible], you mentioned that you looked at these customers and found that they were more active on a number of fronts, trading, higher credit balances, et cetera, are these -- was their activity heightened during this quarter, as the cash balances increased or did this just identify those customers who have already been pretty active?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes and yes. So we did a bit of an aging and we also looked at the behavior specifically in quarter, and both of those statements are true.

Roger Freeman - *Lehman Brothers - Analyst*

Okay. And then, lastly, I guess on the lending side, can you talk about the impact of the loan optimizer has had? Obviously your mortgage balances were up. I know there's a component in there that ultimately you want to grow margin lending. That was down partly seasonally. When do you think that might kick in, getting people to use margin lending for things other than buying stock?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, I think we're just start to go get there. I mean, part of it was we had to get the operations in a place where it could work, and it could scale the way we needed to, and again generate the kind of op margins that we wanted to in that business. We feel pretty good about it from an operational perspective now, and I think you're beginning to see a lot of this growth as a result of the functionality around things like the optimizer.

You're seeing more and more of our customers begin to engage with it. I think that cash optimizer clearly was one of the key drivers in the $5 billion of deposit growth you've seen in these last five quarters that have all come organically. And our hope, certainly, and our expectation is you'll begin to see credit be the next play ground for us as we go into 2007.

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Roger Freeman - *Lehman Brothers - Analyst*

Okay. Thanks a lot.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from David Trone of Fox-Pitt Kelton. Please go ahead.

David Trone - *Fox-Pitt Kelton - Analyst*

Good evening.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, David.

David Trone - *Fox-Pitt Kelton - Analyst*

just thought it wouldn't be a fun call if we didn't bring up this B of A thing again, so let me just play the devil's advocate in one context. If I am an E*TRADE customer that trades a lot, why wouldn't I want to, you know, use E*TRADE for your great analytical tools, which I could free ride by keeping my account open, maybe even at worst case some modest funding in there, I then use B of A for free execution up to 30 times a month, and my only -- the only thing I really have to do on the interest rate side is open up a CD account, and they pay 5%, which is the same as pretty much everybody else, ING, direct, et al., I could avoid the transactional account issue. I know that's not going to apply to a lot of accounts, but they are pretty profitable types of people, why wouldn't I want to do that? What would stop me from doing that?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

How long have you got? Jarrett, go ahead.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

You have to go back to -- one of the key parts in there is what Dennis talked about earlier is that third-party analysis shows that we're number one in execution in the stocks that we trade, and that's really the biggest part of it. The example I've given a few times, if you're someone trading 1,000 shares and buying a $15 stock, you buy it with us at $15, you buy it somewhere else at $15.02. That just cost you $20. And so our sophisticated customers -- and that's what active traders are -- they're smart enough to know that you get what you pay for, and free means you're going to be sacrificing on execution quality. You're going to be sacrificing on functionality. A lot customers are using options in conjunction with their equity trades. You just don't get that at Banc of America, so especially active trader customers are not interested in this.

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Right. And I think, frankly, when B of A did their conference call and talked about it, they clearly stated that they had zero interest and zero belief that they were trying to go after the active trader. It just wasn't part of their market. I mean, it's interesting. I'll give you some quotes. You'll find this anecdotally interesting. e do dinner once a month with platinum customers and those customers are decent sized.

We do them in various cities across the country on the same night, and I asked for RM's to give me feedback when they discussed the B of A answer and said the custer -- here it was. Customer sent them in at last week platinum dinner, quote -- there is no free lunch, this is a gimmick. Second, B of A is bottom feeding. Third, B of A's brokerage and trading app is not their core competency. Next, why would I keep a portion of my none in a low yielding product. Third, trade -- four, trade execution concerns. Next, I trade in multiple accounts and the B of A offer is by customer and not account.

So all I can tell you is we have to watch it. We'd be foolish not to watch it, but in my mind, I hear you. Customers don't want to have to be forced into a CD to get 5% at some term. They want flexibility. They want their cash. They want to be able to move it.

They want a fair rate for the flexibility of the term that they're interested in, one that has significantly higher value than you're going to get in B of A. I mean, this is nonsense. There's no such thing as a free trade. I mean, the trade -- you know, no charge with $25,000 and look at B of A's typical average cost of funds.

David Trone - *Fox-Pitt Kelton - Analyst*

Yes, I guess you mentioned yourself that perhaps -- you didn't use the word desperate -- but to the extent that they're highly motivated to get deposit accounts and the cost of executing trade isn't that much, you know that, so regardless of their motivations, if it's a negative, if it steals some customers, it steals some customers. I guess it's a question of -- I think the one thing that resonates with me is the cost of the execution and the extent to which the guy that trades 20, 30 times a month recognizes that cost.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, but he recognizes much more the execution quality. That matters. I don't know, have you ever salt in focus groups with active traders?

David Trone - *Fox-Pitt Kelton - Analyst*

Well, yes, but you can cherry pick a lot of everything but the execution by just keeping your account open somewhere else.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

But you're executing through them.

David Trone - *Fox-Pitt Kelton - Analyst*

Right, right. So that's the key -- that's really the key issue.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You're getting inferior execution quality.

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David Trone - *Fox-Pitt Kelton - Analyst*

And to my point, you think that the type of person that trades 20, 30 times a month, they are savvy enough to know that.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Are you kidding? Absolutely.

David Trone - *Fox-Pitt Kelton - Analyst*

Okay.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

No, you should -- you know, one of the most common customer service calls in busy times are people who want to question -- the people that trade 20 or 30 times a month questioning every execution in a volatile market, and so I guarantee you they watch every penny.

David Trone - *Fox-Pitt Kelton - Analyst*

Okay, great. That's a good explanation. Thank you.

Operator

Thank you. Our next question is from Campbell Chaney of Sanders Morris. Please go ahead.

Campbell Chaney - *Sanders Morris - Analyst*

Hi, guys. I'll try and make this quick. Can you give us an idea of the mix in your loan portfolio? You did mention about credit. Where are you going to be pushing products through the system going forward? What's going to be your, let's say, flagship lending product?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You know what, it's a great question and it's hard to answer because I don't know if this makes sense to you, Campbell, but ,y experience is you can't push the product. You have to sell the product that the customer wants. So, if we end up in an environment where, for example, the fed actually starts to ease next year, I suspect you will see a significantly increased demand for first lien position mortgages.

If the fed doesn't and it stays flat, you may be in a place where a home equity line of credit or whatever is a product that's more interesting and more engaging. And then margin under any circumstances, I think one of the things that we've been trying to get customers to understand is it's nothing more than a collateralized loan/ And so if we can give them a fair value in terms of a cost and the underlying secure -- the underlying collateral is a security, why not let them borrow against that for lots of other things, particularly if it's a lower cost borrowing than that they might otherwise get. You know, credit card or something like that.

Campbell Chaney - *Sanders Morris - Analyst*

So primarily it's going to be those three products and it's going to be a mixture of those three? Okay.

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, very much so.

Campbell Chaney - *Sanders Morris - Analyst*

And then lastly, with the fall in the ten-year treasury during the quarter and your mortgage-backed securities portfolio, were you seeing accelerated applications that you had to take?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Not meaningful, mostly as a result of where we are in terms of the origination and premiums or discounts on our books, so, no.

Campbell Chaney - *Sanders Morris - Analyst*

Okay, so it really didn't have any impact on the margin?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

It really didn't.

Campbell Chaney - *Sanders Morris - Analyst*

Okay. Great. Thank you.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. Our next question is coming from Prashant Bhatia of Citigroup. Please go ahead.

Prashant Bhatia - *Citigroup - Analyst*

Hi.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Prashant.

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Prashant Bhatia - *Citigroup - Analyst*

Hi. Just real quick, $43 billion of gains this quarter, kind of $16 million above the line, 27 below and that's about $0.06. So I guess, one is how sustainable are these gains as we look twelve months out? And, two, what's the gain/loss position in both of the portfolios, maybe including the hedges that you have in place?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

So if I remember correctly, the above the line gains this quarter were -- what were they?

Prashant Bhatia - *Citigroup - Analyst*

$16 million?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

And I think we have guided anywhere consistently from $10 to $15 million, or something like that. That was -- that that's maybe five to 15, that sort of the -- five to 15 is what Dennis is shaking his head that we guided pretty consistently would be the range in any given quarter. And if you go back and you look historically, that's a pretty -- pretty good number. In fact, if you look at -- we're down dramatically over what those numbers were a year ago.

Prashant Bhatia - *Citigroup - Analyst*

Okay. What's the position in the portfolio where the gains are coming from including again the hedge gains and is losses?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Mostly they come from mortgage -- the sale of mortgage-backed securities and related.

Prashant Bhatia - *Citigroup - Analyst*

Right. I guess what's the balance? What's the net unrealized loss in that portfolio, or gain?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

We have a net unrealized gain in that portfolio, and we don't -- I don't know. I don't know.

Prashant Bhatia - *Citigroup - Analyst*

Okay.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Dennis is shaking his head. But I mean, that's not really where it comes from. Where it really comes from is the origination of mortgages in our retail business, which we believe are not mortgages that we would want to hold on balance sheet. And so we then sell them into the secondary market and generate a gain as a result of that.

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Prashant Bhatia - *Citigroup - Analyst*

Okay. And it's below the line gain?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes, the below the line gain I think we guided to $50 million this year, which was the sale of the ISC stock and, again, the point is that ISC appreciated in value throughout the year. We took advantage of that in selling it and generated additional gains, and our goal -- and I think what we've always said was by the end of the year we would be out of the ISC stock.

Prashant Bhatia - *Citigroup - Analyst*

Okay, and what's the position in that portfolio right now?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Again, I think I had said that we have a number of shares left in it. The gain in it is about $12.5 million and we would expect to take it in Q4.

Prashant Bhatia - *Citigroup - Analyst*

Okay, and after that that probably zeros out, then, going forward?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Yes.

Prashant Bhatia - *Citigroup - Analyst*

Okay. And then when you look at the net new assets this quarter, if you exclude the market benefit, what was that?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

About a billion dollars.

Prashant Bhatia - *Citigroup - Analyst*

A billion dollars. Okay. And then in terms of the loan growth, the $2.5 billion, how much that loan growth is purchased versus originated yourself?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You know what, I have to go -- let me go to the numbers. The percentage of origination versus purchase is up dramatically, and so it's improved hugely, so let me wait and go ba -- I don't want to misstate it. Let me go back to the numbers and I'll give it to you when we do a follow-up call, if you like.

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Prashant Bhatia - *Citigroup - Analyst*

Okay, great. Thank you.

Operator

Thank you. We have reached our allocated time. Our final question comes from Michael Hecht with Banc of America.

Michael Hecht - *Banc of America - Analyst*

Hey, guys, how are you doing?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Hey, Michael.

Michael Hecht - *Banc of America - Analyst*

I just wanted to come back to the enterprise spread compression this quarter and how mix shift played a role there, because I know you already highlighted the mix of higher wholesale funding across repo and the FHLB advances, but I wanted to focus a little bit on the free credits, which are still about 20% of your cash balance and where you guys are still only paying about 1.25%.

Those continue to fall. They were down like 10% in the quarter and presumably shifting to higher yielding areas for clients, like CD's or money funds where they can earn 5% or more. With that differential in rates, won't that continued mix shift continue to challenge momentum in your spread?

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Go ahead, Rob.

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

For the quarter, sweep went from $10.5 billion to 10.4, down 1%.

Michael Hecht - *Banc of America - Analyst*

I was actually talking about free credit balances on the balance sheet of the broker-dealer.

Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Sorry, I thought you said sweep.

Michael Hecht - *Banc of America - Analyst*

And the average enterprise data went from 6.4 to 5.8.

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Robert Simmons - *E*TRADE FINANCIAL Corporation - CFO*

Yes, but free credits may have -- what you also have to understand is free credits may have moved over into sweep, and that sweep could be a net number and they could have moved into other transactional accounts, all of which have low balances. I guess more Importantly in the aggregate what you saw was fed funds were up about 35 basis points. I think we were up about 35 basis points on the asset side and about 40 basis points on the liability side.

Clearly we saw five basis points of compression as a result of the mix. But part of it was also -- if you look at the absolute numbers, part of it was that our wholesale funds went up in terms of costs pretty dramatically. As we would expect to see some potential spread compression as a result of a shift mix, we would also expect to see an offset to that, as we replace some of our wholesale borrowings with retail deposit and we would also, as we said this quarter, begin to see some benefits on the asset origination side, which can offset some of the that.

Jarrett Lilien - *E*TRADE FINANCIAL Corporation - President & COO*

The other thing is with the cash optimizer you're clearly showing rate-sensitive people that they can move and get better rates quite easily. And you do see some of the that going on in the free credit world, but what we're seeing is that people that do move to higher rate products end up bringing over additional assets from the outside. So there is some offset benefit there as well is that, yes, we're paying on average to that customer higher rate, but on a much bigger balance.

Michael Hecht - *Banc of America - Analyst*

Okay. Fair enough. Just wanted to also come back to the margin balance to the bank story, since it seems earlier this year you guys were kind of hinting it was going to happen during the summer and now it sounds more like a 2007 story, so I'm just wondering kind of what --

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

No, let me be clear. We would expect to receive approval within two weeks.

Michael Hecht - *Banc of America - Analyst*

Right. But by the time you get implementation and actually get some benefit to spread, it sounds more like an '07 story versus --

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

No. I think we might address the issue as being more of a Q4 issue, if we thought that the shape of the yield curve was steeper. But given that the shape of the yield curve is currently inverted, we have chosen not to address any of the benefits in Q4 and we will address them as we go into '07.

Michael Hecht - *Banc of America - Analyst*

Okay. Fair enough. And then just last question, on the asset gathering strategy on the RAA front -- I mean,I saw you guys closed on the retirement advisors deal, which is your third or fourth deal there -- just maybe remind us of the strategy there and how it seems to be going so far, and when you might be in a position to start breaking out fee revenues from that business, so we can monitor how it is going?

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Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

You know, our goal was to try to acquire -- I think to be at the end of this year at about, what was it? Six, I think, so we're now currently announced three. We have a couple in the pipeline, and I suspect that, if we believe that it's worth breaking out in '07, then we will, and if not, I guess we'll deal with it in '08, but either way we'll address it in December when we do the guidance call.

Michael Hecht - *Banc of America - Analyst*

Okay, sounds good. Thanks, guys.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

Absolutely.

Operator

Thank you. I will now turn the floor back to Mitchell Caplan for closing remarks.

Mitchell Caplan - *E*TRADE FINANCIAL Corporation - CEO*

That's it. Thanks everybody for joining and sorry the call took so long. See you next quarter.

Operator

Thank you. This concludes today's E*TRADE FINANCIAL Corporation third quarter 2006 earnings conference call. You may now disconnect your lines and have a wonderful day.

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