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ETFC.OQ^J20 - Q2 2003 E*TRADE Group, Inc. Earnings Conference Call

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OVERVIEW:

During 2Q03, ET experienced highly favorable market conditions and For the first time in over two years, investors returned to the equity markets, driving a significant increase in brokerage transaction volume. Reported 2Q03 net income of $13m or GAAP EPS of $0.03. Q&A Focus: Guidance, DART, loans, etc.

CORPORATE PARTICIPANTS

Mitchell Caplan *E*Trade Group Incorporated - CEO*

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Arlen Gelbard *E*Trade Bank - Chief Banking Officer & President*

CONFERENCE CALL PARTICIPANTS

Michael Vinciquerra *Analyst - Raymond James & Associates*

Richard Repetto *Analyst - Putnam Lovell Securities*

Colin Clark *Analyst - Merrill Lynch*

Charlotte Chamberlain *Analyst - Jeffries & Company*

David Marsh *Analyst - Friedman, Billings, Ramsey*

Justin Hughes *Analyst - Jefferies & Co.*

Nick Spar *Analyst - Shefel & Co.*

PRESENTATION

Operator

Welcome to the Second Quarter 2003 Conference Call for E*Trade Group Incorporated. At this time, all participants have been placed on a listen-only mode. Following the presentation, the floor will be open for questions. I've been asked to begin this call with E*Trade Group, Incorporated, Safe Harbor Statements. 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 Group 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 for those indicated by its projections or forward-looking statements. In this call, E*Trade Group will discuss some non-GAAP measures in talking about its performance, and you can find a reconciliation of those measures to GAAP in the company's press release, which can be found on its Web site.

This call is being taped. The recording will be available by telephone beginning at approximately 7:00 p.m. eastern time today through midnight eastern time July 31st. The call is also being webcast at www.eTrade.com. No other tape recordings of this call or copies of the taping are authorized or may be relied upon. I will now turn the call over to Mitchell Caplan, CEO of E*Trade Group, Incorporated, who is joined by Jarrett Lilien, President and COO, and Leonard Purkis, CFO.

Mr. Caplan?

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

Thanks, everybody, for joining us this afternoon. Q2 2003 can be summarized in three words. Validation, innovation and discipline. In our first quarter earnings call, I spoke at some length about the philosophy that has guided E*Trade financial for over 20 years. Our goal has always been and remains to leverage innovative technology to provide superior financial products and services to our customers. During our second quarter, we experienced highly favorable market conditions. Interest rates remained low, fueling continued lending activity, and for the first time in over two years, investors returned to the equity markets, driving a significant increase in brokerage transaction volume.

Our diversified model enabled us to capitalize on these conditions. Our adherence to the core tenants of value and innovation helped us to transform opportunity into reward, and our disciplined management style produced changes that will help make us more efficient in future quarters. I'm pleased to announce that in Q2 2003, we produced GAAP earnings of 3 cents per share, which does include a charge of $76 million in restructuring and other exit charges as discussed on last quarter's earnings call.

On an ongoing basis, earnings per share equaled 14 cents. Included in our ongoing earnings is a $7 million or 1 cent per share reserve taken in connection with possible remaining exposure in the MJK Securities litigation. Exclusive of the MJK litigation reserve, operating earnings equaled 15 cents, and our strong quarterly earnings allowed us to increase the bonus accrual for employees by an additional 1 cent per share.

In both our banking and brokerage segments, our commitment to efficiency and technological advantages helped produce excellent ongoing operating margins and income, and in both of our segments, we delivered pioneering products that have increased our market share, volume, and customer satisfaction.

We've often said there are efficient brokerage platform transforms incremental trade into bottom line results. During the second quarter, transactions increased 41% from the prior quarter. This increase drove a 5-cent improvement in brokerage earnings per share from quarter to quarter. The positive impact of increased trading activity can be seen throughout our reported brokerage revenue lines, including commissions, principal transaction and net interest income. And the increased activity in the equity markets this quarter that benefited our retail business also produced positive results in our institutional trading and market-making businesses. These improvements illustrate the upside power of our brokerage business. Innovations have strengthened our active trader value proposition. During the quarter, we grew our market share in this category and our active traders showed a 42% increase in trading activity over last quarter. Our Power of 9 campaign continues to resonate well, particularly with the implementation of aggressive pricing on options trading and margin rates. And we expect continued market share growth as we launch new products and improve functionality in the second half of the year.

Today we announced the addition of Jack Sander to our team. Jack brings to the company over 20 years of experience as former Chairman of the Chicago Mercantile Exchange. Drawing on this experience, Jack will help us to roll out new trading capabilities and E-minis, our electronically traded index futures to our customers in the coming months. Our value proposition for Main Street investors is also resonating as well. Our Main Street customer trading activity increased 40% quarter-over-quarter. We gained share over traditional competitors in part because we believe that in these uncertain economic times, customers seek value and performance, which they've been able to find at E*Trade Financial.

Today we announce our plans to bring the same value and innovation that we brought to equity investing, banking, and lending to the mutual fund industry and investing. Working in cooperation with mutual fund families and regulatory agencies, and within applicable regulatory standards, we intend to rebate 50% of the 12B1 and shareholder service fees that we receive from the fund companies directly to our fund customers. By leveraging technology as our differentiator, we can take advantage of the increased scale we expect to create as a result of this initiative. We believe this program will accomplish three important objectives, including reducing the impact of fees incurred by fund shareholders, enhancing the attractiveness of fund investing, and increasing the number and average asset size of accounts at E*Trade Financial.

We plan to implement this initiative later this year. In banking, we remained focused on maximizing the benefit of the low interest rate environment by offering excellent lending products, competitive pricing, and exceptional service. At the same time, we are also preparing for a rising interest rate environment, and we continue our ongoing effort to widen net interest spreads while carefully managing credit risk. We approach widening net interest spread by prudently diversifying our asset portfolio and by growing transactional accounts to reduce costs of funding. We recently completed the purchase of $400 million in high FICO auto loans with a weighted average score of 754, and the acquisition of $100 million of high credit quality credit card assets with a weighted average FICO score of 705. In addition, we continue to grow transactional accounts.

During the quarter, we launched several important product enhancements. A dramatically improved Web site, a total guarantee on the safety and privacy of our online banking services, and a quick transfer feature that enables customers to seamlessly move funds between E*Trade accounts and between E*Trade and other financial institutions. These enhancements helped drive deposit growth of $139 million during the quarter to over $9 billion in deposits. Transactional accounts grew by $102 million during the period and represent 52% of our total deposit base. In Q2 03, as in Q1, continued strength of the mortgage market propelled prepayments to very high levels, driving down asset yields on our mortgage-related assets. Consequently, net interest spread for the quarter equal to 144 basis points, an 8 basis point decline over last quarter. So although we are pleased with our spread widening initiatives, results were dampened by the effect of continued prepayment. Importantly, though, the pressure on net interest spreads was again more than offset by record performance in our mortgage business.

Our mortgage business hit yet another milestone by originating a record $2.9 billion in loans during the quarter. As a result, the $4 million improvement in pre-tax income generated by the increase in mortgage production this quarter more than offset the $3 million decrease in net interest income resulting from the 8 basis point decline in net interest spread. Further, we are closing the quarter with a pipeline of $1.7 billion in locked loans, an increase of 42% over the pipeline of $1.2 billion at the end of our first quarter. While we are certainly pleased with these results, we are preparing for rising interest rates by increasing purchase money production to protect against an eventual dissipation of refinancing volume.

To this end, we introduced our mortgage on the move program last month. Mortgage on the Move is the industry's first widely available portable mortgage product for purchase money customers. It is yet another example of E*Trade Financial as a customer Champion and innovator. We are pleased with the overwhelming media and customer response the product has received. We also continue to grow our consumer finance business. Our RV and marine business produced loan volumes of $398 million during the quarter. In addition, we launched quick transfer functionality between home equities and deposits, enabling our customers to move their money seamlessly between accounts, and we have continued to build out our auto and credit card offerings. As interest rates rise, mortgage volumes will decline. We are confident, however, in our ability to offset the related revenue and income reduction.

In a rising interest rate environment, we have a greater ability to widen interest rate spread. Put simply, the diversification inherent in our banking model protects us as interest rates rise. While the past quarter was a successful one for both of our business segments, we continue to approach our operations with rigor and discipline. To this end, we have taken a restructuring charge of $76 million this quarter. Of this amount, $14 million was in cash-related charges. We are pleased to report that we are ahead of schedule on these initiatives. Second quarter charges included closure of our New York center, elimination of unprofitable product offerings such as stock baskets, E*Trade Financial advisor and Personal Money Management, and closure of 43 E*Trade Financial target zones.

As mentioned in last quarter's earnings call, we intend to take an additional charge of approximately $45 million in the third quarter. During Q3, we expect to complete our restructuring that will include closure of our banking operations in Denmark, discontinuation of local market equity trading operations in Hong Kong, and consolidation within our Menlo Park, Rancho Cordova and New York facilities. Through these and additional steps, we expect to generate between $45 and $50 million in annual savings, beginning in the second half of this year. From 1998 to 2000, the online brokerage industry experienced unprecedented growth in the number of accounts opened.

During the past three years, declining equity values and diminishing levels of trading activity by retail investors resulted in the accumulation of accounts of de minimis value. We believe that such accounts, while of potential value, should be distinguished from those of current actual value. There are approximately 1 million of these accounts. Accordingly, effective this quarter, we have placed these accounts on inactive status. By doing so, we no longer incur operational costs to service inactive accounts, and thereby further reduce operating expenses. Consistent with this action, we are modifying our definition of an active account to include accounts with a balance of at least $25 or that have Traded within the last six months. Although these accounts will no longer be reported as active, customers will be able to easily reactivate these accounts at a time of their choosing.

We continue to remain focused on revenue growth by expanding our relationship management program, which has already improved customer service and increased cross-sell, and we are committed to further enhancing our existing customers' experience and to creating and offering new and innovative products and services.

During the remainder of the year, we will be launching improvements to many of our core products and deploying new value-added products. Before Len reviews the numbers, let me address just a few important issues. We have made significant progress this quarter toward successfully resolving the MJK situation. As previously announced, we have settled the Fiserv litigation and have obtained third-party reimbursements covering that liability completely. The Wedbush and Nomura matters remain outstanding, and we continue to vigorously defend ourselves in these matters. We believe, however, that between the third-party reimbursements that we have negotiated and the $7 million in legal reserves we booked this quarter, we have appropriate reserves to cover possible exposure in these matters.

Finally, in an ongoing effort to improve transparency in our business, we now show substantially more detailed information about our brokerage and banking operations in our quarterly press releases. Additionally, you will find new information around asset balances, account growth and account attrition, and as a prelude to our transition to natural account expense reporting beginning in 2004, you will also note our breakout of compensation and benefits expense in our corporate metric Section.

Going forward, we also intend to provide monthly reports on key business drivers. Beginning in August, we will provide monthly daily average revenue Trades or darts, margin debt balances, equity shares Traded in our market making business, mortgage, and consumer loans funded, as well as account growth, active account, and total assets for both brokerage and banking. We believe that through increased disclosure and transparency, we can continue to improve investors' understanding of the company and demonstrate the strength of our business model. We believe that we are on the right path here. That our core tenants are sound, our model effective, and our approach rigorous, and we want people to see clearly what gives us the confidence that we have in our business and in our future. Now to Len.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Thanks, Mitch. First the financial highlights. Cash and equivalents for the quarter totaled $882 million. Free cash totaled $452 million this quarter, a $50 million increase over our first quarter. Free cash as we define it is a metric used by management in measuring business performance and represents cash held at the parent and excess regulatory capital of bank and brokerage. At the bank, net charge offs fell to $7 million this quarter, down from $8.8 million last quarter. Overall net charge offs as a percentage of average held for investment loans declined from 65 basis points to 49 basis points, driven by an improvement in our consumer finance portfolio net charge offs. Our allowance for loan losses grew by 12% from $29.2 million to $32.7 million quarter-over-quarter, as we provisioned in excess of our net charge offs. Our reserves now represent 140% of total non-performing loans, and that's a 21% increase over last quarter. As a percentage of ending health for investment loans, the reserve remained flat with first quarter with 52 basis points.

Our commitment to strong credit is manifest in the credit quality of our borrowed as measured by weighted average FICO scores. Specifically, FICO scores for a total loan portfolio average 730, up slightly from 729 last quarter, but our mortgage and consumer portfolios averaging 725 and 732 respectively. E*Trade Bank also remains well capitalized, as defined by the office of (inaudible) provision with tier 1 and risk-based capital ratios of 5.94% and 11.8% compared to 5.9% and 12.2% (inaudible). Finally, as you will see in our expanded metrics table, we now offer a darts metric, which includes professional, domestic, and international revenue Trades. This metric differs from our daily average transaction metric, which we report for the last time this quarter in that our transaction metric included both revenue and non-revenue trade executions while excluding professional and other commission-based revenue Trades. Although there's absolutely no economic impact with this change, we believe this improvement offers a more comparable commission for trade measure. With this and the other additional metrics provided, we feel investors have the tools necessary to understand the business and the drivers that affect our top and bottom lines.

Next, our revenues. Total net revenues for our second quarter totaled $381 million, an 18% improvement over last quarter, and a 21% improvement over same quarter last year. Increasing revenues quarter-over-quarter and year-over-year is a result of growth in both brokerage and banking revenues. Brokerage revenue for the quarter totaled $223 million, a 26% increase from last quarter, and a 4% increase from same quarter last year. This increase is the result of a significant growth in trading activity during the quarter in both our retail and market-making businesses, improving commission revenue by 41% and principal transaction revenues by 39%.

Banking revenue for the second quarter totaled $158 million, up 9% over last quarter, and up 57% over same quarter last year. This increase is related to the growth in both gain on sale of originated loans from our direct to retail mortgage and consumer finance origination businesses, and gain on sale of loans held for sale and securities from our correspondent mortgage business and partially offset by a decline in net interest income. The decline in net interest income comes as a result of accelerated prepayments in our mortgage portfolio, reducing our net interest spread over the quarter.

Now, for the expenses. On the expense side, we saw a 21% and a 31% increase in general and administrative expense quarter-over-quarter and year-over-year same quarter respectively. This increase is largely attributable to the $7 million MJK litigation reserve. We kept cost of services largely in check this quarter, seeing only a 9% increase over last quarter on an 18% increase in net revenues over the same period. The $15 million increase over the quarter is largely related to compensation of benefits, more specifically, bonus accrual and variable compensation driven by the mortgage and market-making activity. In selling and marketing expense, we saw an 8% increase quarter-over-quarter and a 5% decline year-over-year, same quarter.

Half of the increase was related to variable costs associated with our institutional business, and the other half of the increase was in support of our highly targeted marketing campaigns. Their effective marketing campaigns like the Power of 9 supporting our strong value proposition, we believe we have again this quarter gained market share in online trading. The operating leverage in our brokerage business is particularly apparent on a segment basis. Brokerage operating expenses totaled $259 million this quarter, including $68 million in restructuring and other asset charges and $7 million in MJK litigation reserves. Excluding these charges, our brokerage operating costs totaled $183 million, only a 9% increase over last quarter and a 26% growth in brokerage revenue.

Importantly, we are also able to control operating costs in banking, limiting the total increase to 15%, including $7.7 million in restructuring and other exit charges. Net of restructuring charges, bank-operating costs grew by 9%, in line with an equivalent growth in revenue. After non-operating income and expense, as you will note in the non-operating (inaudible) section of our P&L. It is clear to $22 million net gain on investments. At the end of last quarter, E*Trade Group held a 36% ownership interest in E*Trade Japan, which was accounted for under the equity method. On June 2nd, 2003, E*Trade Japan merged with Softbank Investment Corporation to form a new entity called SBI. Upon closing the merger, E*Trade Group owned 19.8% of SBI. We have determined that we no longer exercise significant -- or control over the new entity and it should, therefore, account for our investment in SBI under the cost method. (inaudible) equity security. In accordance with GAAP, we have recognized $29.5 million gain on investment based on the fair value of the SBI shares we received as of the merger date. The fair market value of our interest in SBI based on yesterday's closing price on the Tokyo Stock Exchange is $255 million against a book basis of $84 million. This investment is part of a multi-step process to maximize shareholder value.

In summary, the company reported second quarter net income of $13 million or GAAP earnings per share of 3 cents, which again includes $76 million in facility restructuring and other exit charges and $22 million in net gains on investments. Net income from ongoing operations totaled $50 million or 14 cents per share for ongoing operations. A reconciliation of the 4-cent quarter-to-quarter sequential increase to earnings per share from ongoing operations is as follows. First E*Trade actions increased 34,000 this quarter, driving increased earnings of 3.5 cents in our retail trading segment. Additionally, we gained an incremental penny and a half from our institutional and market-making businesses. Secondly, strong banking results generated an additional penny from bank. Thirdly, in total, incremental contribution from banking and brokerage was 6 cents per share. Netted against these results is a two-cent adjustment of the MJK litigation reserve and bonus accrual. For guidance in light of our performance this quarter and the accelerated benefit, we expect to see from our restructuring, we are raising our guidance for the year to between 52 and 57 cents per share from ongoing operations.

On a recorded basis, the equivalent will be earnings per share of 22 to 27 cents including restructuring charges. The incremental revenue from increased trading activity we experienced this quarter dropped largely to the bottom line and demonstrated the leverage in our model. The combination of this leverage and the benefits of our restructuring plans were the drivers behind increasing our guidance for the year, but there obviously remains uncertainty about the economic recovery that could impact results. We are pleased to note as a result of continued strength of the markets, our DARTs for the first 15 days of July equaled 138,000. That's up 18% over quarter 2. The leverage of our model is validated in our results, and we have confidence in our ability to manage the uncertainties of the economy. With that, we'll now open this call up to answer your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. The floor is now open for questions. If you have a question, please press the number 1 followed by 4 on your touchtone phone. If at any point your question is answered, you may remove yourself from the queue by pressing the # key. Please limit yourself to one question and one follow-up. We do ask while you pose your question that you pick up your handset to provide optimum sound quality. Thank you.

Our first question is coming from Michael Vinciquerra of Raymond James & Associates.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Thank you. Good afternoon. First question is just a clarification for Len. I just want to make sure, the $22 million gain is considered a non-operating item and, therefore, it is not part of your operating earnings of 14 cents for the quarter, is that correct?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

That's correct.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Ok. And then second of all, I just want to get a feeling from Mitch, obviously you're going through some significant cost savings right now and it seemed like the exercises are going to produce better results for the second half. How much of the improvement in your guidance, number one, is coming from the acceleration of the cost savings you're going to realize, and additionally, are there any other opportunities you see for cost savings beyond what you currently have planned maybe for the next 12 to 18 months, or is this pretty much going to take you to where you want to be?

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

A couple things. First of all, Mike, as you look out at the second half of the year, Jarrett, as you know, has been driving the restructuring initiative, and he has us a bit ahead of plan as we talked about. So we'd expect to see somewhere in the neighborhood of 3 to 3.5 cents improvement in the next two quarters in our earnings as a result of the restructuring charge. And then once we enter into next year, you would expect to see about a full 2 cents per quarter or 8 cents a year. And that's in connection just with the restructuring charge. What it does more interestingly, I know we've talked for forever about where is break-even as you look at your brokerage business, and I think you and I have talked consistently about a break-even for the brokerage segment at around 63,000 transactions and now 63,000 DARTs a day. As a result of the restructuring charge, what we are now at is about 50,000, so as long as we are doing 50,000 DARTs a day, we are in a position that we are at break-even for our entire brokerage segment, and also is you see each additional 10,000 DARTs again, we will earn about 1.5 cents to the bottom line as we talked about and validated this quarter through the model. So that's the first part of your question. The second is, there are a host of other initiatives that are also in place independently of the restructuring charge that Jarrett's driving around technology and otherwise that we will continue to apprise you of as we go through quarter by quarter in terms of cost savings.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Ok. Thank you. I'll jump back in line.

Operator

Thank you. Our next question is coming from Richard Repetto of Putnam Lovell Securities.

Richard Repetto - *Analyst - Putnam Lovell Securities*

Hi, guys. Congrats on a nice quarter.

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

Thanks, Rich.

Richard Repetto - *Analyst - Putnam Lovell Securities*

First a follow-up question on the guidance. The 52 to 57, and you back out 24, you get 32 to 33 for the second half of the year, and I assume that your 3 to 3.5 cents savings is for the second half, that's not per quarter.

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

That's correct.

Richard Repetto - *Analyst - Putnam Lovell Securities*

So you obviously have a positive outlook, you know, from a 14-cent second quarter here that EPS is going to incrementally increase with even a potential slowdown in trading here in the summer. So what's driving the optimism, I guess?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Rich, it's Len. I think to the upper end of the guidance there are three things we really looked at as driving it. One is the current -- and we're talking about current July market conditions continued through the rest of the year. Secondly, the mortgage business volume is maintained through the end of the year and there's no major growth as we enter the third quarter, but we do have a pipeline of 1.7 billion, and the third part is the restructured benefits kicking in, in the second half for the 3.5 cents. So the low end of the range where we were looking at that is a magnitude of selloff in both transactions and the mortgage volume.

Richard Repetto - *Analyst - Putnam Lovell Securities*

Ok. And then my one follow-up would be, now you've went to a new classification on the Trades from transactions to daily average revenue Trades. To some number around a little bit less than 30,000, it looks like free Trades or Trades that (inaudible) accounted for as revenue Trades before. Could you explain what that was in the prior quarter? You reported 82,000 Trades last quarter. Now if you back out from the accounting, from what you reported here, it seems like we can did account for about 55,000 of that as revenue Trades, if you look at what you've disclosed. So what's the gap here? Trades given as promotion or mutual fund Trades or what?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

I think you got a couple things in there, Rich. One is before we were -- as we've always done, we were reporting on transactions, and some transactions don't have revenue or didn't have revenue attached to them, so we also, though, at the same time didn't include revenue Trades from the professional segment, and as we committed to everybody, everything is under review these days, and our goal is to come out with more metrics and more clarity in our metrics, and we felt that going to where we've gotten to now with DARTs was just a better apples to apples comparison, so you and the rest of the investor community can really compare us to our competition, which as you know is something we're inviting everybody to do. So hopefully that explains it, but as you'll see, it comes out pretty much the same number.

Richard Repetto - *Analyst - Putnam Lovell Securities*

But the trades that weren't revenue trades last quarter, they were free trades given as promotion or ?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

No, not free Trades. It's just if you were to come in and do a trade and it took you two executions, that was two transactions. Whereas that was one revenue trade.

Richard Repetto - *Analyst - Putnam Lovell Securities*

Ok. I'll get back in the queue as well.

Operator

Our next question is coming from Colin Clark of Merrill Lynch.

Colin Clark - *Analyst - Merrill Lynch*

Hello, everyone. Can you hear me?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Absolutely.

Colin Clark - *Analyst - Merrill Lynch*

Great quarter.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Thank Colin.

Colin Clark - *Analyst - Merrill Lynch*

I'm trying to get a better sense of your strategy to drive higher bank net interest income particularly if rates stay low and mortgage revenues decline as refi activity declines. You mentioned your current spread is 144 basis points. It's been under pressure the last couple quarters, and you previously had a spread target range of 160 to 190 in '03. Just interested in your thoughts on is that range achievable in the current environment, especially if the rates stay low?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Let me start and then have Lene sort of follow up. What I would tell you is as we just looked at guidance at a very high level, again, we're looking at the guidance for the company as a whole and we're breaking it down by segment between bank and brokerage. So what I think you can expect to see within the banking group is that to the extent that you still have extraordinary performance in your mortgage business, what will be driving it particularly to the extent that it's driven by refinancing and not purchase money mortgage, as you well know, is the low interest rates and that will generate prepayments which is going to continue to put pressure on spread. Our goal has always been to be in a position where in either direction, you had a dollar for dollar offset, so that as mortgage was stronger, you were at least making the same or more in the mortgage earnings that you were losing in spread which is what happened this quarter, you know, we outperformed to the tune of about $1 million. When interest rates begin to rise, what you would expect to see is refinancing dissipate and our spread begin to widen and then you would look for, again, the opposite, which is that spread begins to compensate and outperform what's happening with respect to your mortgage business. (inaudible), I would tell you we are continuing to make efforts to widen spreads. We're doing it by looking at this asset diversification, we're doing it very slowly in order not to take what we perceive to be any significant credit risk, and we at the same time are looking to continue to lower our cost of funds with respect to our transaction costs. So you continue to take two steps forward with respect to spread widening, but inevitably, as long as the mortgage business is this strong, it's going to impact you on spread compression, and I think in order for us to get to our stated goal as you've said of 160 or 200, you will only get there when you begin to see some dissipation in the results of what you're seeing in the mortgage business.

Colin Clark - *Analyst - Merrill Lynch*

Ultimately, you know it's focused on credit quality that we've said over and over again, which will be the strongest limiting factor in terms of the speed in which we get the 200 basis points. We're confident that we're going to get there, and we keep taking (inaudible) that are moving us in the positive direction. The issue really is just in terms of optics and final reported numbers is that the positive direction is being mapped by the negative brought on by the prepayments. You know, so for example, as we diversify into a greater level of consumer finance assets, we're helping our spread, we're improving them, we're constantly looking from a balance sheet optimization point of view as to what to do.

Leonard Purkis When you have the prepayments going the other way, it hurts you, so for example, when we were talking at the end of -- when we talked at the end of last quarter's call and everyone was expecting to see a 20 basis point improvement based on the Janus acquisition and instead we improved 12 basis points, it was because we went backward 8 by virtue of the prepayments on the mortgage side. So it's something that as we focus on credit, we just do things slowly and methodically, and one of the things that we've done is right (inaudible) at the end of the month, we took our first step into the credit cards when we bought a portfolio of just under $100 million to increase spread. Now, again, focusing on the credit quality, you know, were very high FICO scores. So it's very consistent with our overall strategy. It's just a question of time.

Colin Clark - *Analyst - Merrill Lynch*

Ok. So if refinancing -- or if prepays slow, you know, let's fast forward a couple of quarters, and prepays slow significantly but rates stay relatively flat, does that make it challenging to drive your spreads higher, or do you have some plans in place in that type of scenario?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

We do have plans in place. We do a lot of scenario planning. It's not something that we're going to discuss now, but we do look at it in the very different interest rate environment.

Colin Clark - *Analyst - Merrill Lynch*

Ok. Great. I'll get back in the queue. Thanks.

Operator

Thank you. Our next question is coming from Charlotte Chamberlain of Jeffries & Company.

Charlotte Chamberlain - *Analyst - Jeffries & Company*

Hi. I was wondering, are you planning to put out some historical numbers on DART so that we can build a database to better forecast based on the (inaudible) that you're planning to give this out monthly?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

I suspect that you look at it where we are (inaudible) they are historical backing up for 6 or 8 quarters, so it's in what we've already released.

Charlotte Chamberlain - *Analyst - Jeffries & Company*

So you're not going back a couple of years or anything like that so we could kind of track it during the bubble as well?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

No. I think it's been over the last - we think we've got it over the last six quarters.

Charlotte Chamberlain - *Analyst - Jeffries & Company*

Ok. And then also can you give us an idea of what proportion of your mortgages were fixed rate versus arms over this last quarter?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Yeah. We are now in a position where -- you're talking about originated or on balance sheet?

Charlotte Chamberlain - *Analyst - Jeffries & Company*

Originated. And which ones you keep.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

So let's talk about what we keep first because I think that's what's relevant, which is what's on balance sheet. We're now at a position where on balance sheet, we're at about 50% fixed and with 50% variable. However, on an incremental basis over the last quarter or two quarters, we have been probably about 95% variable in terms of what we've added to our balance sheet. So we have strategically moved away from fixed and added almost exclusively variable on an incremental basis.

Charlotte Chamberlain - *Analyst - Jeffries & Company*

And originations, what would be the breakdown?

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

The breakdown is in this absolutely low interest rate environment, it's been consistently above 90% in terms of fixed rates.

Charlotte Chamberlain - *Analyst - Jeffries & Company*

Ok. Thanks.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Sure.

Operator

As a reminder, if you do have a question or comment, you may press 1 followed by 4 on your touchtone phones. Our next question is coming from David Marsh of Friedman, Billings, Ramsey.

David Marsh - *Analyst - Friedman, Billings, Ramsey*

Hi, guys. This is a pretty good quarter here. Couple of questions. The cash portion of the charge that you expect to take in the next quarter, do you have an estimate as what that will be?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

This past quarter, the charge, we took about a $76 million restructuring charge, and I think we said it was about 13 or 14 in cash. Next quarter, it will be again somewhere between $12 and $14 million in cash.

David Marsh - *Analyst - Friedman, Billings, Ramsey*

Ok. And on the portfolio of loans that you recently acquired, about 500 million total loans, what do you expect that to do for your net interest margin going into the third quarter?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

A guess would be -- again, now you aren't looking at me because you want me to be careful, but the expectation is you'd hope it would widen your spread by 3 or 4 basis points, and it will. It will move us in that direction. Ultimately, where our spread will come out at the end of next quarter again will be driven by what's happening in the market refinancing business.

David Marsh - *Analyst - Friedman, Billings, Ramsey*

If yields -- if you'll indulge me one more follow had been-up, if yields were to stay around about where they are right now, do you have any sense of how much you could grow NIM in the third quarter?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

If yields were to stay where they are right now, you would hope that you can continue to expand them 10 or 12 basis points. But I think that would depend entirely again upon what was happening in terms of the refinancing market. For the moment, as we've looked at the first 15 days of July again, it's interesting that we've seen transactions as strong as we've seen them and DARTs up 18% over last quarter for these first 15 days. Same is true on the fixed income side, we have actually seen a little bit of the slowing in the prepayment, which I think will be helpful, and I think really we have to wait to see what happens is in terms of the mortgage business and the volume there.

David Marsh - *Analyst - Friedman, Billings, Ramsey*

Ok. Thanks.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Sure.

Operator

Thank you. Our next question is coming from Justin Hughes of (inaudible).

Justin Hughes - *Analyst - Jefferies & Co.*

Question for Jarrett primarily. First of all, congratulations on the quarter. Excellent execution.

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

Thank you.

Justin Hughes - *Analyst - Jefferies & Co.*

I was wondering, on the professional segment, you're showing it on revenue per trade basis, but isn't that still priced on a per-share basis?

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

Yeah, part of the business is based on per-share, and part is, -- the short answer is we've got it split on where some of it goes. Some of it is within DARTs, and the rest is in --where is that now? Principal commissions.

Justin Hughes - *Analyst - Jefferies & Co.*

Ok. If somebody executes a trade and you charge like 1.5 cents per share, that is still showing up as a DART, and then a commission, so we're backing into something of a revenue per trade, correct?

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

That's right.

Justin Hughes - *Analyst - Jefferies & Co.*

Ok. Second of all, it seems like pricing is getting more and more competitive in that professional segment. Some people are going as low as a half a penny per share from some releases last week. I just am wondering, how competitive is that segment, and are you getting pricing pressure?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Well, that segment has been -- this is Len. That segment has been competitive for quite a while now. Particular pressure was on it as customers started to retreat from it in a weak market. We've actually seen a pretty significant pickup in volumes there and seen it strengthen a bit, so we're not overly concerned at this point. We think that we've got our cost structure right to price aggressively and very competitively in that business and intend to continue to grow market share there as well.

Justin Hughes - *Analyst - Jefferies & Co.*

It does look like you grew some market share is compared to the trade station numbers yesterday. Is that what your numbers are telling you as well?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Yeah, and again, in keeping with the kind of things that we're saying moving into July, we feel very good about that entire space.

Justin Hughes - *Analyst - Jefferies & Co.*

Ok.

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

Part of it, Justin, I think you know this from having discussed this with them in the past. We wanted to clean that whole process up before we started including it in DART, because I think what you're really getting at is that we had a series of people or investors who were trading through us with respect to Tradescape, and our view was it was too competitive and not profitable, and so we have eliminated them from trading with us, and as a result, you know, you've seen some volatility in the transactions or DARTs coming from that group, but we're confident that now where we are, there's less pricing pressure and there will be more consistent growth in terms of quarter to quarter as you look at that segment.

Justin Hughes - *Analyst - Jefferies & Co.*

Thank you.

Operator

Thank you. Our next question is coming from Nick Spar (inaudible) & Company.

Nick Spar - *Analyst - Shefel & Co.*

Hi, guys. Wonderful quarter. Question on cost-cutting. What round do you think you're in right now? You mentioned earlier on the call that obviously you're getting about $50 million this quarter. Have you put sort of a -- or have a goal for next year? Maybe give us some color on what items you think have the most fat to cut?

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

We haven't really talked about next year yet so I'd rather hold back on that. But what I can tell you is, I think the most interesting way to look at it isn't necessarily fair to cut. Its that we are continuing to try to do things with respect to our back office operations and using technology to lower the cost of that process. So there are a couple ways in which we can look at that. The first is on the brokerage side of the house, we are about 80% of the way through the process of ensuring that we are on one platform across our entire brokerage segment. And, you know, so there's still more to do there in terms of lowering our cost. The next step is to be able to have the bank in that same exact position, and they're probably about 60%. So as we for example have added other businesses like our consumer finance business around marine and RV in Southern California, you want to integrate that and get that on one platform. The goal as we get through that and enter into 2004 would be in a position of trying to put all of that together on one global platform, which again we believe could add some significant cost savings, but probably the most important thing is, once

Jarrett and I and the team are through next quarter with respect to this last restructuring charge, we have no more charges contemplated after that, and it is entirely based on just continuing to look for these efficiencies through operations by leveraging technology.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

And just adding a little bit too because the question has sort of been asked twice the same way, are there more efficiencies out there after this, and as Mitch said, you know, there's nothing that we see out there that's going to require a charge after this, but there are more efficiencies to get in the business, and we are doing some things in our back office, we're doing some things with technology. We're really putting together a lot of the operations between bank and broker, and there are other efficiencies that we've got on our agenda to find in the business and realize.

Nick Spar - *Analyst - Shefel & Co.*

Ok. Can you sort of you know, have you put a price target or a guess on you know once you've got one global platform, the efficiency, the (inaudible) you get from that?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

No, we'll get that as we start to look at next year.

Nick Spar - *Analyst - Shefel & Co.*

All right. Thank you.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Absolutely.

Operator

Our next question is a follow-up from Richard Repetto from Putnam Lovell.

Richard Repetto - *Analyst - Putnam Lovell Securities*

Hi guys, first of all I want to correct myself if you that second half guidance is 28 to 33 if you would back out you know the 24 from the beginning. So the follow-up question, though, on this new mortgage on the move, I just want to see, can you give us a little bit more color? I know it's gotten a lot of publicity and a lot of attention out there, but can you give us some quantitative on the results that you've seen?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

It's Len. It's too early to tell. I will give you a couple of bits of information, though, that I think you'll be happy with and we're very happy with. You know first of all, when we first did this, things like call volumes at the mortgage company increased by like 300%. Lead volume went up by 350%. And what we have found over time is, over the six weeks that it's been since we've launched this product, is there's been an incredible amount of interest in the product. But it's one of those because it's a purchase money product, it's something that takes longer time to ramp up. It's not like you make a decision and you close it. What I can tell you is that, you know, our daily prequalification letters for purchases, which is something that someone does when they're going out to buy a house, you know all of a sudden as a result went up by 75%. We're seeing really huge increases throughout the mortgage company, and even if the product does okay, we've had the benefit of putting the mortgage company on the map. I mean, in this six-week period of time, we've had 500 media touches. I mean, this is being talked about in all circles, not only within other banks, but within bankers associations in the secondary market, we've had meetings with Fannie and Freddie and the bond market association talking about development of a secondary market, so it's still in its infancy, but we're really amazed by the pickup that we've felt in the mortgage company from it.

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

Another thing to look at, Rich, it's interesting, I was talking to Matt Gearie (ph) who, as you know, runs the whole mortgage business and (inaudible) direct retail market recognitions.

Matt's comment to me was we are just now beginning to see the impact of the mortgage on the move product in the last five or six days, because since Greenspan has been speaking and you see rates beginning to back up a little for the first time, you see the locks coming through because people recognize the value. So they're saying this may be the time when interest rates are going to start to rise and the value of this product is really relevant to me as opposed to thinking that mortgages will be declining. So it will be interesting to see the sort of volume that we experience in the next 10 or 12 or 15 days based on this volatility we've been seeing around rates in the marketplace. So, you know, a little bit more to come. The other thing which is interesting is a side note that Len really is touching on is that if you look at the drivers of profitability of the mortgage business, it's margins, and our margins have been pretty consistent in terms of what we're making on the sale of our direct to retail mortgage business, and the other is the cost of driving that business and as a result of the mortgage on the move, we've been in position where the PR has been so great that our cost of marketing to drive that volume had dropped significantly in the last 30 days and is helping drive some of the profitability at the mortgage company. So there's been sort of a side benefit, which Len is touching on that I don't think we expected to see when we began this process.

Richard Repetto - *Analyst - Putnam Lovell Securities*

Super. Thanks, guys.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Sure.

Operator

Thank you. Our next question is a follow-up from Michael Vinciquerra of Raymond James.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Thank you. Two things. This is for Len on that portfolios that you bought, can you give us a little more detail on the credit card side? How is it structured? Did you simply buy some securities on the credit card side? Do you own the accounts, are you servicing those, that type of thing?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

We actually bought the accounts. We can't disclose by virtue of our agreement who we bought them from. They're very high credit quality. They're a portfolio with just under $100 million, where we made sure we scrubbed through the entire thing that there are zero delinquencies upon our purchase. The weighted average FICO of the balances themselves are 705. The weighted average FICO of the accounts themselves, believe it or not, are 740, so as we develop the balances in these accounts which, what you're going to see is the weighted average FICOs go up, and these are customers that we own. We bought them from a company that there was no other connection to the customer other than these accounts, so that we own the customer, and it's perfectly consistent with what we've been trying to do as a company, which is, you know, develop customers and then cross-sell them. So this is, you know, our first floor -- in a bigger sense. In addition, we are not doing the servicing on these. They're being serviced by the largest credit card servicer.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Ok. And I find it interesting, though, that the FICOs on these loans, which is a completely unscoored, is lower than all your secured loans in the auto and RV, but that's apaintly you're comfortable with the credit quality, so I'll take your word on that one.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

Yes.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

Last question is just for Lou on the market-making side, improvement in revenue capture in the period, I'm just curious, it looks like some of it must have come from the shift away from the bulletin board shares where you probably get much lower revenue capture if Knight's indication this afternoon was correct. Is that what's going on, or is there any other thing you see that could improve your revenue capture in market-making business in the future.

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

It's actually a couple of things. Clearly with the reengagement of the retail investor in the second quarter, we have seen additional volume, we've seen some additional volatility in the core stocks that we trade, the big listed and other over the counter names, so we would have had some lift as a result of that alone, but then you see that we report as well now the percentage of bulletin board stocks that we trade, and you're absolutely correct, as that mix changes, we get lift from that as well. I can't attribute really what percentage of the lift came from each one of these respectively, but they were both important. Bulletin boards are really a very small fraction of the revenue capture we get on larger listed over the counter stocks.

Michael Vinciquerra - *Analyst - Raymond James & Associates*

All right. Thank you.

Operator

Thank you. And our final question will be coming from Colin Clark of Merrill Lynch.

Colin Clark - *Analyst - Merrill Lynch*

Hi, guys. From what I understand, E*Trade's mortgage business has been -- has a fairly variable cost structure. I think that head count is somewhere around 500 employees, maybe more. Hypothetically, if mortgage revenues were to drop in half let's say by the first quarter of next year, how much and how fast could you reduce the mortgage cost base to offset that revenue decline?

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

So let me give you a couple data points. The first is, the actual head count now is about 700, and if you look at in the realms of information that we are now providing you about the business from both a banking and brokerage and corporate side, you'll see one of the big areas of growth for us I think around head count is also considered in temporary and consultant or whatever. That really isn't consultant. It's really temporary help, and it is hiring exactly that, staffing up for the mortgage business. So that we are in a position of having that real variability. And, you know, Rob Bernaby (ph) and his team have been preparing for about 18 months, for a while, for about 18 months or longer for this inevitable period which is coming. It just hasn't come yet. And so they have plans in place, and they track exactly what's happening based on interest rates and staff up or down right now based on what's going on in the marketplace and their expectation would be to take the variable expenses which are probably 80% of their operating costs, and the more that we put their back office on the rest of the company, the more it becomes variable and just drop it based on the volume we're experiencing in the mortgage business.

Mitchell Caplan - *E*Trade Group Incorporated - CEO*

I'd sort of add to that too, you know, we've had a good learning experience on the brokerage side where we've seen things be very hot, you know, through 2002 and then cool off quite a bit, and we've been able to stay in front of that and actually grow profits in a period of declining margins. We're applying that learning to the mortgage company and already we spend a lot of time with the mortgage companies figuring out and contemplating what are the steps that we're going to take when things cool down so we are ahead of the game. And one of the things Len has touched on already, but one of the focuses is that shift from the refi to purchase money options, which is a part of the market that we're expecting to see continue to be pretty good, even as interest rates increase, and you and a product like mortgage on the move is, you know, a good example of something that we're already doing to prepare for that next part of the cycle.

Leonard Purkis - *E*Trade Group Incorporated - CFO*

And just one last thing is that we're also able to move, as interest rates rise and the main first mortgage markets slow down because of refis, that's also a time when typically you'd expect to see home equity loans ib increase, so that we can simply move certain groups of people from the first mortgage desk over to the home equity desk. In addition, we'll be co-locating the mortgage business with the Janus boat and RV business later in the year, and when we do that, there will also be some natural synergies between the companies that when things slow down, we can move people over from one part of the business to the other.

Colin Clark - *Analyst - Merrill Lynch*

Great. Then just one follow-up to that. What percent of your origination business is purchase versus refi at present?

Leonard Purkis - *E*Trade Group Incorporated - CFO*

It's been about consistently and remains about 10% refi -- 10% purchase. I'm sorry. Right now. But I will tell you that even though it's been consistently around 10%, our purchase volume generated by the mortgage company almost doubled in quarter 2 over quarter 1. So that's part of our strategy to ramp that part of the business up. It's masked in terms of percentage just because the volume is to great, but in terms of the absolute numbers, they're definitely moving the way we'd like to see them.

Colin Clark - *Analyst - Merrill Lynch*

Ok. Great. Thanks.

Jarrett Lilien - *E*Trade Group Incorporated - President and COO*

That's it, everybody. Thanks so much for participating.

Operator

Thank you, ladies and gentlemen. This concludes the second quarter 2003 Conference Call for E*Trade Group, Incorporated. Please disconnect your lines at this time, and have a nice day.
