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ETFC.OQ^J20 - E*TRADE FINANCIAL Corporation Business Update and 2007 Guidance Revision Conference Call

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OVERVIEW:

ETFC reported that it is lowering its expected EPS range for 2007 to between $1.05-1.15 from the previous range of $1.53-1.67. For full-year 2007, ETFC expects to generate total net revenue of $2.3b and net income of $475m, at the midpoint of its revised range.

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PRESENTATION

Operator

Welcome to the E*TRADE FINANCIAL Corporation's business update and 2007 guidance revision 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 requirements. E*TRADE FINANCIAL cautions you that certain factors, including risk and uncertainties referred to in the 10-K's, 10-Q's and other reports periodically filed with the Securities and Exchange Commission could cause the Company's actual results to differ materially from those indicated by its projections for forward-looking statements. This call will present information as of September 17, 2007.

Please note that E*TRADE FINANCIAL disclaims any duty to update any forward-looking statements made in the presentation. In this call E*TRADE FINANCIAL may also discuss some non-GAAP financial measures talking about its performance. These measures will be reconciled to GAAP during the course of this call or in the Company's press release which can be found on its website at www.E*TRADE.com.

This call is being recorded. Replays of this call will be available via phone, webcast and podcast beginning at approximately 7:00 PM Eastern time today through 11:00 PM Eastern time on Monday, September 24. The call is being webcast live at www.E*TRADE.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; Robert Simmons, Chief Financial Officer, and Dennis Webb, Chief Investment Officer and President of Capital Markets. Mr. Caplan?

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

Thanks for joining us this afternoon, particularly on such short notice. Hopefully by now you have all had an opportunity to review the press release we put out about an hour ago. For this call we have also provided a presentation that we will reference to help us walk you through our plan and the forecasted changes to our financial results.

In addition to these slides, we have posted an updated version of the supplemental portfolio disclosure document that we originally provided back in mid-August. The updated document includes data through August 31, along with some additional disclosures that will help you better understand the pace and magnitude of the changes in the credit environment we have experienced over the past few weeks.

Since the Safe Harbor statement has already been read, I will start with slide four and provide some context with respect to the core franchise. First, over the past eight months, even as we have worked to navigate through this credit market, we have experienced tremendous growth and record performance in our core retail franchise. We have generated annualized growth in our target segment account of 25% over the past three quarters -- success far in excess of our internal expectations. This growth has driven outpaced results across all of our key performance metrics including trading, margin, cash and assets from our retail customers.

In July trading activity was the strongest in at least five years. That activity and strong account growth largely continued into August, which is typically the slowest month of the year for both. In addition, the operational successes we have achieved in our core retail franchise have been recognized by leading financial media publications like Smart Money and Money Magazine where we received top accolades for both bank and brokerage services.

With a focus on retail liabilities and maintaining substantial excess liquidity sources, our balance sheet remains strong, in excess of regulatory well capitalized levels and positioned to absorb continued disruptions in the marketplace and within our portfolio. While there is no doubt that the impact from the macro credit environment will be significant to our results in the immediate term, it is important to recognize that the core franchise remains strong and well-positioned for growth as we navigate through the current credit cycle.

The strategic plan that we are outlining today is formulated to accomplish three primary goals. The first is to accelerate our transition to a retail-driven balance sheet structure. The second is to simplify and streamline the business by exiting and/or restructuring certain noncore operations and sharpening the focus on the retail franchise to improve operating margins. And third to increase the Company's return on equity by positioning the business where slower balance sheet growth translates into higher free cash flow which can be used for share or debt repurchase.

With respect to the balance sheet structure, we will accelerate our plans to increase its retail composition by holding the size of the balance sheet relatively unchanged through at least 2008.

On the liability side, we will use growth in customer cash to replace wholesale funding. On the asset side, we will allow home equity loans, consumer loans and securities to prepay, pay down or mature, replacing them with prime first lien mortgages and customer margin debt. This mix shift in assets and liabilities should help improve net interest spread over time.

In addition, the better overall performance and higher underlying collateral levels of first lien mortgages will reduce net charge-off levels and provision needs. Along with this mix shift, we are increasing our portfolio of composition targets to 80 to 85% of assets in whole loans and customer margins and 80 to 85% of liabilities in customer cash and deposits. Once we complete this transition, future growth in the balance sheet will be driven entirely from customer cash and credit as we continue to attract target segment customers and grow the core franchise.

With respect to simplifying and streamlining the business, we are exiting or restructuring certain noncore or underperforming businesses to better align our core operations with retail and improve the returns of the consolidated business.

In lending we are exiting our wholesale mortgage operations and repositioning the business to focus on direct retail originations. In brokerage we're taking steps to restructure the institutional business to allow us to focus on the areas that add benefit to or receive benefit from a connection with order flow generated by our retail customers.

The specifics of this restructuring are currently being worked through, and we will provide an update on our third-quarter conference call next month. We have embedded in our revised items restructuring and exit charges of approximately $32 million for these two businesses, the bulk of which will occur in the fourth quarter.

The changes we're making will slow our balance sheet growth and modify its composition and significantly reduce the capital demand, allowing for future growth with significantly less capital need.

I would like to spend some time now going through the components of our balance sheet to walk you through our thought process in sizing up the areas of risk or concern within both the whole loan and securities portfolio.

As of August 31, interest earning assets totaled $61 billion, including $40 billion in whole loans and $18 billion in securities. You will notice that these balances are all up slightly from June 30 levels, and this is the result of timing on trade settlements and prior purchase commitments. Going forward, we expect the total balance to remain at approximately this level or slightly lower.

On slide six you see the loan portfolio is comprised of roughly $30 billion in mortgages, $8 billion in margin debt and $2.7 billion in consumer loans. The consumer loan portfolio is in runoff mode, and delinquencies remain within the expected range. We are not anticipating any significant change in its performance, and we expect this portfolio to pay down and shrink at an annual pace of approximately 20% annually. Given existing reserves against this portfolio, we are not concerned about losses related to the consumer loans.

We are also not concerned about losses from margin debt as a result of the collateral levels against those loans. Where we are focusing our attention with respect to whole loans is the mortgage portfolio. In general, mortgage loan performance weakened through the first half of 2007, and the rate of deterioration increased further in August.

Nonperforming mortgage loans have increased by $72 million or 44% since June. To understand what this change will likely mean to our financial performance and ultimate loan-loss levels, we examined the characteristics of our delinquencies and nonperforming loans in the context of our entire balance sheet.

In our nonperforming loan balances, about 40% are first lien mortgages and about 60% are home equity. This is important given the significantly different loss characteristics between the two. In the first lien portfolio with average FICOs of 738 and loans to values of 69%, we have experienced annualized losses of between 1 and 2 basis points.

In addition, we are protected by private mortgage insurance on balances in excess of 80% of the property value at time of origination. As a result of these loss mitigation factors, charge-offs in our first lien portfolio remain relatively low, even with growth in nonperforming loans.

That said, given the changing credit environment, we assessed future loss expectations assuming higher delinquencies and default rates by stress testing the portfolio on a number of factors. Given our geographic dispersion, high FICOs, low LTVs and high owner occupancy levels, we expect that losses in our first lien portfolio will remain relatively low and continue to outperform industry comparables. To be prudent, we are increasing our allowance for loan losses against first lien mortgages to between 5 and 10 basis points from 2 basis points given the likelihood of continued market deterioration.

The second lien portfolio includes home equity lines of credit and installment loans and represents approximately 43% of our mortgage loan portfolio but 60% of the nonperforming loans. This is the portfolio that is driving the increase in loan losses. Annualized charge-offs in this portfolio have increased from approximately 19 basis points a year ago to 46 basis points in the second quarter and 87 basis points in July. While this change has significantly exceeded our previous expectation, the level is consistent with the performance of home equity portfolios across US savings institutions.

As a result of the new dynamics of the credit cycle and the trends we have seen in the past 30 and 60 days, we have increased our focus on additional factors within our loss expectations. Loan performance in the current credit environment has shown to be less correlated with the typical forecasting factors such as FICO. Adjusting for predictive criteria such as documentation type, occupancy type, CLTV and FICO factors, we have altered our expected loss levels.

In addition, we have traditionally assumed a 20% haircut to collateral value at the time of default, including foreclosure costs. For recently defaulted loans, we have observed that home values have depreciated by approximately 15% from original appraised values. Nonetheless, we are increasing the allowance levels against this portfolio and our revised guidance as a result of the pace and level of deterioration we have seen. Given the current market outlook for home depreciation for 2007 and 2008, we are adjusting our expectations to assume a 30% haircut to the original appraised values.

As a result, we are increasing the allowance for loan losses against our home equity portfolio to approximately $190 million in our revised guidance, taking the coverage ratio to approximately 100% of expected home equity nonperforming loans at year-end. In our adjustments we are assuming higher delinquencies and lower collateral values for the remainder of 2007 and throughout 2008.

Utilizing our enhanced model, we have run various scenario analyses against our entire loan portfolio to create a range of expected losses over the next 12 months. Consistent with our provision policy in our revised guidance, we are increasing the previously expected $70 million of provisions in the second half of 2007 by $25 million to match expected charge-offs and an additional $150 million to increase our allowance for loan losses based on 12 months of expected losses. This increases our coverage against first lien mortgages into the range of 5% to 10% from 5% in June, raises coverage against the home equity portfolio to approximately 100% from 51%, while allowing coverage in our seasoned and rolling off consumer loan portfolio to move to between 450 and 500% from 626%. All-in allowance for loan loss as a percent of nonperforming loans increases to roughly 75% from 45% in June.

Turning now to securities, our investment portfolio includes $18.2 billion of securities, $13 billion of which is AAA rated agency mortgage-backed securities. $2 billion is in corporate bonds, municipal bonds and agency preferred stock, and $3.3 billion is in asset-backed securities. Given the credit quality and underlying collateral of the mortgage-backed securities, we do not expect any material impairments from this portfolio. Similarly the corporate muni portfolio is also highly rated with solid collateral, and we also do not expect any significant impairments from these holdings.

What we are focused on for the potential impairment is the ABS portfolio. In general, prepayments have decreased and delinquencies have increased, causing us to change the future performance expectation for certain bonds. It is important to understand that within this $3.3 billion asset-backed security portfolio expected delinquencies and cash flow impairments differ significantly based on the performance of the underlying collateral. The prime residential first lien mortgage securities, which account for $2.2 billion of the $3.3 billion ABS balance, continue to perform as expected with very limited losses. With an average FICO of 732 and loan to value of 72%, we do not expect any significant impairments in this portfolio.

Contrary to expectations, this is also true with the bonds collateralized by subprime first lien residential mortgages. We have seen prepayment speed slow in this portfolio as underwriting guidelines have tightened significantly. Yet delinquencies in this portfolio of approximately 9% currently continue to trend meaningfully lower than the industry average of 20 to 25%. To date the rating agencies have not downgraded any of the bonds in our subprime portfolio, and we do not expect significant impairments in this portfolio in 2007. If credit trends worsened, we could see some slight erosion in these securities later in 2008.

Where we do see a higher risk of impairment is in the second lien and CDO securities. The second lien portfolio currently has $77 million that is rated BBB or below, of which $59 million that had originally been investment grade has been downgraded below investment grade. Aside from second liens, the remaining non-rated and below investment grade rated portfolio totaled $80 million.

Of this $54 million is in CDO bonds. Cash flow diversion triggers in these bonds could result in impairment depending on the degree of rating agency downgrades moving forward. Bonds rated AAA or higher in both the second lien and CDO categories are adequately supported by excess collateralization, and we don't expect material impairments in these bonds.

Similar to assessing risk in our whole loans, we ran various scenario analyses to stress test the performance of the securities portfolio. The scenarios range from holding current performance through the end of the year and improving in 2008 to continued deterioration across all categories throughout 2008, which resulted in a range of potential losses.

Our best assessment of these scenarios results in potential impairments of $100 million between now and year-end 2007. In 2008 we anticipate that we could see another 50 to $100 million in securities impairment, which would include some deterioration in the single-A rated second lien securities.

In conclusion, we have been thoughtful in our approach to assessing the performance of our loan and securities portfolios to make a best estimate of the impact of continued turbulence in the credit market. We remain cognizant of the fact that there is no clear indication of the ultimate magnitude and duration of this credit cycle. While we cannot control the macroenvironment, we can control the asset mix and growth of our balance sheet, and that is precisely what we're doing.

I will now turn the call over to Rob to walk through the detailed revisions to our guidance forecast.

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

Okay. Thanks, Mitch. I will first look at the revisions we're making today to our 2007 earnings outlook on a pre-tax basis and then in terms of earnings per share.

This year's results have been a mix of outperformance from continued account growth in our target segments and their subsequent engagement level offset by deterioration of the credit markets. The revisions we're making today to our guidance reflects prudent forecasting of potential loan losses and securities impairments as the credit cycle continues to evolve. The steps we are taking as a part of our strategic plan will position the business to generate higher return on equity and improved earnings quality over time.

In the immediate term, we're reducing our expected earnings for 2007 by $213 million after-tax or $325 million pre-tax with the intention of addressing the credit overhang and streamlining the business. Here is how the $325 million breaks out.

Relative to our previous guidance, we are increasing provisions for loan losses by $175 million for total provision in 2007 of $300 million. We expect to end the year with an allowance for loan losses of $225 million, consistent with our expectations for charge-offs over the next four quarters. We are building in potential securities impairments of $100 million in the second half of 2007.

We also see reduced earnings relative to previous guidance of approximately $18 million as a result of our initiative to alter the mix and growth in the balance sheet. We believe the lost economics and slower growth from keeping a flat balance sheet will be offset by freeing up more capital and generating higher valued earnings growth over time.

Lastly, we expect to realize total exit and restructuring related charges of approximately $32 million for the wholesale mortgage and institutional brokerage actions.

On a GAAP EPS basis, we are lowering our expected range for 2007 to between $1.05 and $1.15 from the previous range of $1.53 to $1.67. The midpoint moves to $1.10 from $1.60, down $0.50 from previous expectations. This is the net result of $0.27 of increased provision, $0.15 in potential impairments, $0.03 from reduced balance sheet growth and $0.05 in restructuring-related charges. On a full-year basis, we are now expecting to generate total net revenue of $2.3 billion and net income of $475 million at the midpoint of our revised range.

To put this in perspective, if we achieve this performance, 2007 will be the second best year in the Company's history, even with the increase in provision and projected impairments this year.

More importantly, on slides 17 you can see the Tier 1 and risk-based capital remain well above the regulatory thresholds for well capitalized status even as we absorb the outlined impairments.

As we look to 2008, we expect to hold the balance sheet roughly flat and accelerate our initiatives to move our balance sheet to 80 to 85% or more in retail assets and 80 to 85% or more funded by retail cash and deposits. We will accomplish this transition in an orderly fashion over time, allowing assets to roll off as they pay down or mature.

Second lien mortgage and securities will be replaced with first lien mortgage and customer margin debt. Growth in enterprise customer cash will be used to replace wholesale funding. By eliminating the wholesale component of the balance sheet and by focusing on optimizing spread more than balance sheet growth, we expect to free up over $500 million per year in internally generated cash that can be used for incremental share or debt repurchase. We believe this will help us improve return on equity as a firm and drive higher quality earnings growth. We would expect provision expense to be in the range of $150 million to $200 million in 2008 as we transition the balance sheet as planned. We expect provision expense to decline as we move into 2009 as a result of the composition of the balance sheet.

In terms of the securities portfolio, we would expect impairments on mortgage securities to be between $50 million and $100 million in 2008. Earnings growth in 2008 and beyond will be driven by the core retail franchise.

On this last slide, we show the differences between 2007 and expectations for 2008 for the three key areas for which we lowered our guidance today. In 2008 we expect $100 million less in total provision for loan losses than the 2007 level, while holding securities impairments equal to our expectations for the second half of 2007. The restructuring charges we have outlined are onetime in nature, and therefore, they would not be a continued headwind next year.

Based on the expectations for these three items and using the high-end of the projected range for provision expense and impairments, we see reduced headwinds in 2008 of approximately $132 million pre-tax. This is about $0.20 on a per share basis. Adding this to our $1.10 midpoint of our 2007 guidance produces an adjusted pro forma run-rate of $1.30 per share heading into 2008 assuming the more conservative scenario in the outlook. We would expect to grow off this base with continued success in attracting, retaining and migrating customers into our highest value target segments. We expect to provide our full guidance outlook for the next year in January, along with the release of our fourth-quarter results, and we will address the range of expectations for earnings and other growth metrics at that time.

Our core retail franchise of investing, trading, cash and lending customers remains strong. Our growth in target segment accounts remains robust. We will remain prudent in our assessment of credit risk as the environment evolves and continue to focus on our retail customers.

And with that, we would like to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Rich Repetto, Sandler O'Neill.

Rich Repetto - *Sandler O'Neill - Analyst*

I guess the first question is, I see how the run-rate comes up by $0.20 all things being equal. But if we keep -- how should we think about if the balance sheet is going to stay flat in a way, what is the growth on top of, say, you know, say that run-rate of 130,? How do we think about translate the target accounts into what the earnings power of the Company is?

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

Right. So we again will go into much more detail on that as we continue to go forward and as Rob said when we give guidance. But a great way to think about it at a high-level is you are right. You will not have the benefit of the earnings associated with the securities and the whole loans.

But an interesting way to think about this or the way that we're thinking about it is as follows. To the extent that you eliminate the securities and the wholesale borrowings, they are traditionally probably only making you 70 basis points in spread. And you will be left with a balance sheet which is comprised over time of first lien mortgages, margin as the asset class and customer cash and deposits. So you should see your spread widen. And you should see your spread over time begin to widen out materially, driving higher earnings.

So again, you would expect net interest income to grow in 2008 over 2007. It just won't grow as much as it would have had we also grown the balance sheet 30% with additional securities and whole loans. So that is one thing.

The other thing is, as Rob said, our view I guess conservatively is that we believe that by not continuing to grow the balance sheet, we are in a position that will free up significant access capital. This year we have deployed close to 7 or $800 million of capital into the balance sheet for capital purposes for growth. And in our minds, we would redeploy that capital for things like share repurchases, as well as debt buybacks which can be meaningfully accretive to earnings going forward as well.

Rich Repetto - *Sandler O'Neill - Analyst*

Understood. So is your goal on a long-term basis still 15 to 20% earnings growth?

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

Yes, absolutely. I mean as we look at the franchise over the long-term, our goal is to be in a place where we can continue to grow the topline revenue by 10 to 15 that we can move to a place where obviously we're growing EPS by 20%. As you know with respect to core ROE, we have been around 17, 16, 17, 18. We believe this will put us meaningfully over the 20 goal that we have been trying to achieve for sometime. And to be in a place where it also exiting and restructuring some of these businesses will help our operating margin to get it to 50%. So nothing has changed about our long-term goals, and the view is trying to connect that over these next couple of years to the growth in the retail franchise. And for the first time, I think we feel like we are in a place where the kind of growth we are seeing in acquisition of customers, particularly target customers, migration, retention; all of that and the engagement we're seeing with those customers across the cash, across the trading, across the assets and even credit is allowing us to be able to more directly connect the entire business to the retail franchise.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay. And then the last follow-up here, between June 30 or the first half and the end of August, things did -- the delinquencies and nonperformers did grow and accelerate. I'm just trying to see not only were they accelerated, but they continue to grow. I'm just trying to see, what are you seeing say in early September? I'm trying to get my arms around what you projected.

I know you have modeled more higher delinquencies, but are we at this point in September now where it is starting to trend -- you know, is it getting worse or better on your line that you projected?

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

Well, we're just getting all the remittances in for September, so it is too early to be able to comment on September. To your point we look at August, and we did a couple of things.

The first with respect to loan-loss around the loans, we basically said, okay, with respect to the model and I'm going to turn it over to Dennis in a minute, we believe that we are seeing some unusual correlations here with other components that would lead us to believe that FICO and LTV alone are not significant enough to make the judgments in terms of potential loan losses.

So one of the things we did is from April to September and beyond the rest of this year and frankly through all of 2008 assuming a $200 million of a loan-loss provision, we continue to assume a deteriorating credit environment. We assumed that the factor got worse, and we also assumed that the recoveries as we said here declined I think to 70% at the end of this year and, if I remember correctly, to about 60% by the end of next year.

So we are assuming in the guidance that we gave, first of all, for the next four quarters in taking up the provision, those sorts of metrics, and also as you then translate to all of next year and the final two quarters of next year, we are assuming that is getting worse.

With respect to the securities impairments again, we are not in a position to currently take $100 million in terms of what we are seeing. I think it is fair to say that we are currently in a place where you might see up to about $50 million in impairment given what we're seeing based on cash flows. I think given that we're trying to say that as we look at the rest of this year, we think it could be up to $100 million, meaning yet again another 50. And then again as we thought about next year, I think we gave the range of saying 50 on the low-end or 100 on the high-end. And again, that assumes that what we're currently seeing in terms of a trendline gets worse, i.e. you would assume the impairment moves up into all the way through the BBB's into the single-A's.

Dennis why don't you just add color?

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Let me just add a little color really on both sides, the investment portfolio as well as the whole loans. So just in terms of the home equity loans, essentially just to give everyone a little bit more color on some of the analysis that we did, we went back and looked at the delinquencies and the charge-offs from November all the way through May and June. And we came up with some regressions and essentially when you look at our allowance, we're making two adjustments. One is for the probability of default, and that represents about two-thirds of the increase. And then one-third represents an assumption around the recovery value that Mitch talked about.

So without going too far into the details, one of the things that we have learned over the past nine months and specifically in the last two months is that FICO really underestimates the probability of the default especially as you get to the higher LTV loans.

So for 70% CLTV and below, FICO has worked pretty well. As we get to the 80 to 90 and the 90 plus, we have seen that it has underestimated the probability of default anywhere from .5 times up to 3 times. The other things that we have seen is when you look at investment property, that is another area that has underperformed. We have about $500 million in investments. We have seen that be off by about a factor of 2. So -- I'm sorry, about 1.65 times. And then when we look at documentation types, stated income versus full documentation, again what we have seen is this FICO nonlinearity. For 700 and higher FICO, it is about 2 times. On the lower FICOs, it is about 4 times.

And so the probability of default is roughly two-thirds of the total increase. And Mitch alluded to the recovery value. Our previous estimates assume that we could recover about 80% of the original appraised value. Our current estimates now assume that it is about 70. What we have seen to date for the first part of the year is we have seen a recovery value of about $0.85 on the dollar with additional collection costs of about 8 to 10%.

Given the macroeconomic values and the people are now assuming home price depreciation of about 0 to 5%, we thought it was prudent to take that down to about 70% recovery going forward.

And then also just to talk a little bit about the numbers we roll out for 2008 of 150 to 200. The 150 basically assumes that we see more of what we're seeing today. The higher end of that range includes an increase of probability of default versus current trends plus a change in recovery value of 70 to 60. And so that explains most of the $50 million difference between the high and the low.

To give you a couple of sensitivities, we ran a number of different analyses. All things being equal changing the probability of default by 25% means expected losses of about $60 million over the following two years. When we look at recovery value, coincidentally that is also equal to about $60 million every two years for every 10% change in recovery value. And so that gives you some level of variance around the forecast.

When we look at the securities portfolio, we look really -- our recommendation is based on a bond by bond analyses. But essentially what you will see is that the expectations that we have given are consistent with market assumptions. And what I mean by that is for the Alt-A portfolio, we're looking at CPRs, assumed to be 10 to 12 CPR, so a significant slowing from where we have seen them to date. Constant default rates rising to 2% and a 30% severity. Again, that is worse than what we have seen. We have seen pre-pays of about 19 to 15 CPR. We have seen delinquencies in the 1.7% versus a 5%, and then we have seen severities of only 10 to 15%.

So again, in our estimate is assumed deterioration from what we have seen, but more like what the market is assuming going forward. For the subprime portfolio, again Mitch alluded to it, most analysts when they have looked at our portfolio of distributions assumed that we would have losses in our subprime portfolio. We have done a number of stress tests, and we do not see impairments in that book. Part of it is this election. The number I can point to the delinquencies in our book are about 9% versus an industry average of about 20 to 25%. And we also supported by excess collateralization, so we don't see any losses there.

Where we are really seeing a high risk of impairment is on our second lien bonds. And just to remind everyone, that is $172 million or roughly 1% of our investment portfolio. So it is a very small portfolio. But it is definitively getting hit hard. When we bought these bonds, we assumed lifetime cum losses of about 8% to 10%, and we are already seeing cum losses to date of 6% to 8%, and I believe the market assumption for that is closer to 25 or 35. So what we're seeing is 3 times the market expectation in losses. And so that book is specifically going to get hit hard and hit hard very quickly.

As we think about the 2008 guidance, given the deterioration in the market as Mitch pointed out, if those credit trends were to persist, we would start to see risk of impairment in those bonds over time as Alt-A subordinate bonds below the single-A starting getting hit. So again, all things being equal, the low range would be $50 million with continuing trends. 100 million would actually assumed worse impairments than what we're seeing today.

Operator

Matt Snowling, Friedman Billings Ramsey.

Matt Snowling - *Friedman Billings Ramsey - Analyst*

I'm just doing some quick math here and assuming you keep earning assets allowed at $60 billion and I'm just trying to get a retail funding say 80 or 85%, that is going to imply a deposit growth of 6 to $7 billion over the next six quarters or so.

I guess what I'm trying to get at, is that implying a slowdown in deposit growth? And it seems like more recently most of your growth is coming from the higher (inaudible). I was just wondering if that makes sense. The price of wholesale funding was another high-cost (inaudible).

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

I apologize. Half of it was sort of cutting out, so it was a little hard to hear you. Let me see if I can answer what I -- what the gist of the question was about growing the funding costs?

Matt Snowling - *Friedman Billings Ramsey - Analyst*

Well, yes, (technical difficulty)-- sorry, I'm coming up about 6 or $7 billion of August with funding that is going to replace wholesale funding. Is that correct?

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

Yes.

Matt Snowling - *Friedman Billings Ramsey - Analyst*

And you have been growing at about $2 billion or so a quarter in deposits. But does that imply you're expecting deposit growth to slow down or what is that?

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

No, I don't think that it necessarily would assume that, and I think your point is well taken. I think we will address that more as we go into guidance for next year.

But I think the way to think about it from a spread perspective as you know is that when you look at customer cash and deposits I believe on a blended basis, it is coming in right now at around 3.5%, 3.9% sort of in that range. And we would be replacing what is currently obviously wholesale borrowings, which are in the high-5s all the way up to 6s. So that is by way of example how we think about smaller balance sheet but beginning to widen out the spread.

Matt Snowling - *Friedman Billings Ramsey - Analyst*

Another question. Obviously you have about $20 billion of wholesale funding for the securities portfolio, and just given where the Fed is about to cut, is this the right time to unwind that portfolio when (inaudible) can pick up some spreads going forward?

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

Yes. Yes, so our view is that given where the Fed is, given even if the Fed cuts right, given where credit is, ultimately I think that the franchise will have more value over the long-term if the revenue and the earnings are generated 80 to 85% from customer cash and deposits and 80 to 85% from margin and retail mortgage. That is really where we think that you're going to get the highest value. Plus, that is what we're currently seeing.

So I mean if you look at what we have been able to experience so far year-to-date in growth in cash even over the last I guess 18 months and assume that we continue to invest in marketing, that we continue to try to engage the customer, we believe that's a very cost-effective way to grow the -- well, actually to replace wholesale borrowings with that form of cash and notwithstanding what will be potentially a Fed cut or series of Fed cuts.

Matt Snowling - *Friedman Billings Ramsey - Analyst*

All right. Are there any expenses associated with the wholesale mortgage business?

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

Are there any what, I'm sorry?

Matt Snowling - *Friedman Billings Ramsey - Analyst*

Expenses associated with the wholesale lending business?

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

Yes, there are and there is also revenue associated with the wholesale business. And so given where we are now I guess rather than getting into the specifics of it, we assumed that for purposes of next year we would just not have the recurring cost of the exit associated with the wholesale mortgage business.

Operator

Prashant Bhatia, Citigroup.

Prashant Bhatia - *Citigroup - Analyst*

If you tried to sell the $3 billion asset-backed portfolio in the open market, do you think losses there could approach $1 billion, or where do you think those losses would be?

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

Between 350 and $400 million.

Prashant Bhatia - *Citigroup - Analyst*

Okay. But your models right now are only telling you to write down about $100 million?

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

That is right given the cash flows. So it is the disconnect in the fact that there is basically no bid in the marketplace versus the fact that we are still receiving the full cash flows.

Prashant Bhatia - *Citigroup - Analyst*

Okay. So those markdowns then no chance in taking the mark to actually make it more appropriate with what you think the market values actually are right now?

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

I don't know that those are the market values. I think everybody is trying to understand what is the market value given that there is just no liquidity.

So why would we to our shareholders take a loss when, in fact, we are still continuing to receive cash flows on these bonds?

Prashant Bhatia - *Citigroup - Analyst*

Okay. But if you did mark down to market value I think the $400 million range you just mentioned --

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

350 to 4.

Prashant Bhatia - *Citigroup - Analyst*

350 to 4? That would put you below the well capitalized limit that you show as $200 million at the end of last quarter?

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

No, it would not. So you want to -- (multiple speakers)

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

And again, what I would say is that part of the problem with some of the accounting is that you're not marking to market all sides of the balance sheet. And so certainly we have seen spreads widen on the asset side. On all assets throughout the entire market other than treasuries, we have seen spreads widen.

If you were to do a similar exercise on the deposits, I think what you would find is that the value of the deposits have significantly increased in value. And so again I think it is important to look at the balance sheet holistically and look at what the net economics are both on the deposits and on the liabilities as well as the assets. And so given this current market, spreads have widened on nearly all assets. Probably wider than -- significantly wider than what we would call fair value because of the liquidity issues that have been brought to the forefront in the market.

Prashant Bhatia - *Citigroup - Analyst*

Okay. And that spread widening, what is the impact on -- I think last quarter you had disclosed 675 million in unrealized losses. What is that number now taking into account the spread widening?

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

I don't think we have it.

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

We do not have it available.

Prashant Bhatia - *Citigroup - Analyst*

But it is a bigger loss I guess with the spread widening?

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Yes, I would certainly assume so.

Prashant Bhatia - *Citigroup - Analyst*

Okay. So I guess I don't understand. I mean to your point on the 350 to 400 if you were to mark that down, I know you said you're not going to -- and then with the unrealized securities losses declining, are you actually growing? I guess you're still -- how do you end up being above well capitalized in that scenario?

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

Because given the current reserves that we're taking, as well as the impairments that we have modeled, we are still ending -- with the ending balance sheet, we're ending Tier 1 capital at a little over 6%, and we're ending risk-based capital at a little over 11%. About 11%.

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

And a couple of things that I would add to your question. The unrealized gain or loss that shows up in securities is really an opportunity cost, meaning that if you bought that asset today, you would get a wider price or a wider spread. So it is not really a loss of principal, if you will. So again, for anybody that purchased any asset in the past year, if spreads widened, it means that they could buy that asset today at a wider spread than what they would have previously. It still does not mean that you are not getting the spread you expected when you purchased it. So that is one piece.

The other piece is that again to the extent that you expect to get your principal back, any unrealized gain or loss will converge to zero as those bonds mature, and you get the repayment of the cash to be reinvested at the then current market rate. And so from the analysis, I don't think that is the right way to manage a balance sheet.

Prashant Bhatia - *Citigroup - Analyst*

Okay. And then just in terms of your board, how do they think about I guess the strategy going forward, and how do they think about potentially changing management compensation plans?

I think one part of your plan is really focused on EPS growth targets. Is there any chance they would put in an ROE target as well? How do you think about it as you take these charges? How does the board evaluate that?

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

I cannot answer the question yet because what is in place obviously now is the plan for 2007 and not for 2008 yet. That is something that we are working on now. That clearly obviously is something that is under discussion given the importance of ROE to us as we go forward and we think about the business.

Clearly I would say given the overall performance one of the messages that we have given obviously to our employee base is that we have continued to accrue added target bonus. The people who will be impacted with bonuses this year will be the senior managers, the people who are at the EVP in higher levels. And I would suspect that you would see obviously significantly lower levels of cash bonuses. And one of the things that we're actually working through right now is that many of us have our employment agreements that are rolling, and what we have been telling the board is that we're perfectly willing to sign up for another four or five years if they would like us, and in the process of doing that, we're absolutely willing to roll the dice with respect to equity, including performance, but equity because of where the equity currently trades and where we think it is going to go.

Prashant Bhatia - *Citigroup - Analyst*

Okay. So I mean I guess that is my point. As the board in the past has compensated on earnings growth --

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

No, it is not just earnings. It is earnings plus revenue plus a whole other set of factors, and that third set of factors relates to things like growth in customer target, service levels. I mean there are five or six other metrics that are all core to it.

Prashant Bhatia - *Citigroup - Analyst*

Okay and ROE is not one of those metrics?

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

ROE is one of the metrics that is looked at in connection with what you would call -- absolutely the Tier 3 brand of options.

Prashant Bhatia - *Citigroup - Analyst*

Okay. And just in general, can you help reconcile where the tangible equity fits in the Company? I think you've got about 3, 5 or over $3 billion in the bank, but the overall Company only has $1.8 billion of tangible equity. So where is that negative tangible equity sitting?

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

Well, if you look at where the -- if the question is where the intangibles are in the goodwill, the bulk of it is related to the brokerage side of the business. As we have got -- and we've got goodwill and intangibles from the recent acquisitions that we have done.

Prashant Bhatia - *Citigroup - Analyst*

Okay. So the bank basically -- now that you moved clearing onto the bank, the bank is getting the brokerage earnings, but the intangibles related to the brokerage are sitting outside the bank?

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

That is right.

Prashant Bhatia - *Citigroup - Analyst*

So I guess has that been part of the tool to enable you to lever up further, and is there a chance that the regulators would now look at clearing under your bank and potentially reverse that, or how does that work?

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

Well, first of all, clearing does not give you 100% of securities earnings. Okay? So there's only a part of the earnings that goes through clearing, which is why -- I mean you're trying to like divide bank and brokerage from retail and institutional. So it would not be fair to say that all of securities earnings goes through clearing and, therefore, through the bank.

What I can say is that when we put clearing under the bank, it obviously came with capital, and so it increased our capital ratios I think thereby making the OTS recognize that it was a source of strength, meaning that within the overall banking purview there was more capital.

Prashant Bhatia - *Citigroup - Analyst*

Okay. But none of that goodwill has moved to the bank I guess?

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

That is right.

Prashant Bhatia - *Citigroup - Analyst*

So is there a chance that they may look at this and potentially reverse this and create a situation where you have to deleverage the balance sheet?

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

No.

Operator

Mike Vinciquerra, BMO Capital Markets.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Just one question on the -- you were talking about the home equity portfolio, Mitch, in your opening remarks, and I think you mentioned that you got 100% coverage on nonperformers. I believe you said the number is $190 million. Did I get that right?

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

That is right.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

What is the difference? Just remind us the difference between nonperformers and delinquents because I think your total delinquents in home equity is 349 according to this report.

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

Right. So the difference is NPLs are between 90 and 180 days. After 180 days, you charge off. Delinquents and NPLs are a subset of delinquents, which go from 30 all the way to 180.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Thank you for that. How has the progression been from the early delinquency buckets into the later? I assume you have seen a much greater percentage of the earlier delinquencies moving into the 90 plus over the last several months?

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

We have with home equities. We have not with first lien positions. So, Dennis, do you want to --

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Yes, I mean I think that is exactly right. So it has been bouncing around, but as you can see in the NPLs we have seen it increase. Given the expectations that we have outlined, we would assume that that continues to increase.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Okay. Just one thing I want to go back to a question Rich asked at the beginning. We are talking about kind of earnings power looking out. When I look at your '08 assumptions and I know this is really preliminary on your part, but if we use the $1.30 and we look at your provision being 150 to 200, typically if we look historically, you have been looking at 50 to $100 million maybe on an annual basis and given the fact that your portfolio of quality will improve dramatically. That might not even be necessary, particularly if it's all first lien and margin.

Secondly, the 50 to $100 million in impairment presumably would go away, and again I'm talking like '09 under a more normal scenario. Your NIM should be much higher by the end of next year based on the changes you are making, and there may be some significant share repurchases. So even without considering business growth in the brokerage, I'm coming up with numbers that if you take $1.30 as the '08, you could be up $0.30, $0.40 without doing anything just because the portfolio kind of goes back to a normal level of losses and then we kind of build from there. Am I thinking about that wrong in terms of earnings power beyond next year?

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

No, that is exactly how we think about it. So conceptually -- well, I don't want to validate all of your numbers. Our view is that clearly I think given what we're seeing in the marketplace and we do not want to be contrarians and call the bottom. We are presuming that what you are seeing in the credit market both with respect to loans and with respect to securities will continue and, as you have seen from the ranges we have given, will continue aggressively through the latter half of this year and through all of next year.

I think we do believe by the time you get to '09 you are seeing things better on the macroeconomic sense side, and to your point, we have dramatically transformed our balance sheet by then. And we would hope to return to levels that you have seen us at historically with respect to charge-offs given a composition of first lien position mortgages as well as margin. So we totally agree with you.

The same thing would be true with securities impairments. Again, Dennis talked about why he thought it might look like 50 next year, what could result in 100. Again, you would certainly hope that by the time you get into '09 that that number is diminishing as well. And both of those things would put us in a position where we again get through the credit and we have headwinds -- tailwinds as opposed to headwinds going into '09.

Operator

Roger Freeman, Lehman Brothers.

Roger Freeman - *Lehman Brothers - Analyst*

I just wanted to see if you could clarify the assumption with respect to the delinquency rates going into 2008. You threw out a bunch of numbers there, but again just sort of following up on the last question, if you are at 2.78% in home equity delinquencies today, what effectively are you assuming into next year?

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

Okay. Let's do it, Dennis.

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Sure. So yes, again looking at delinquencies in aggregate, we would kind of see those delinquencies increase really now through most of 2008 if not all of 2008. But keep in mind it is on a declining balance.

So, as it relates to charge-offs, we would expect to see charge-offs in that 55 to $60 million range really from Q4 all the way through Q2 and then start to see declines Q3 and Q4 of next year. And so again, just to remind everyone of our policy, when a loan goes delinquent, it remains in delinquency for 180 days, and then it would be charged off at that point in time. And so we would continue to see an increase in delinquencies. That number would continue to grow. For a loan that went delinquent today, meaning September, that loan would be charged off in March or April of next year.

Roger Freeman - *Lehman Brothers - Analyst*

But I guess also the question would be, how are you thinking about the difference in both factors as well as recovery values next year in the range of 100 to $200 million?

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Yes, so again as I think I might have mentioned, what in the lower end, the 150 we're assuming delinquency rates consistent with what we have seen in the last 60 days. At the higher end, we're assuming increased delinquencies of about 25%. And then the recovery values, as Mitch outlined before, would go from 70 down to 60 in the 2008 number at the high-end, meaning the $200 million.

Roger Freeman - *Lehman Brothers - Analyst*

Okay. And how do the -- in the home equity portion, how do these delinquencies rates now compare to what you think are industry levels?

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

You know again you really have to break the portfolio into pieces. For stuff that we have seen below 80 CLTV, which is the majority of the portfolio, that is performing better than industry. As you look at the 80 plus or 80 to 90 and 90 plus, that is performing worse than industry.

So I think what you will see over time is a mix change, meaning the higher LTVs will decline, and you can kind of see that in some of the data that we presented in the portfolio disclosure. You are seeing those high LTVs start to amortize down.

Roger Freeman - *Lehman Brothers - Analyst*

Okay. I guess just having looked at some of the disclosure you provided around HELOC portfolio with respect to the documentation levels full versus stated income, I was surprised to see the 40% rate on stated income. It seemed -- relative to what you talked about most recently, it seemed like you had a very small portion of that in your portfolio.

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

Yes, well, this is a very conservative interpretation of stated document. So basically anything that is not the full documentation or the old document where what is included in the old document there is salary confirmation. So getting pay stubs as opposed to tax returns and the like, it is a higher percentage. Roughly 45%.

The other category, the other category something called preferred, again when we look at preferred just to talk a little bit about that since we have not spoken about it, that is typically something that is originated based on a long-term relationship. So someone that might have originated a first mortgage later came along and issued a second without doing all the paperwork just to emphasize that we're seeing delinquencies in that portfolio of about 57 basis points. So that is even out performing the full document by a factor of four times. About 2% delinquency for full documents versus 57 basis points for the preferred.

Roger Freeman - *Lehman Brothers - Analyst*

Okay.

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

And again, what you will see in the stated document again at the higher LTV levels, you are seeing worse than expected performance. At the lower LTV levels, you are seeing expected performance.

Roger Freeman - *Lehman Brothers - Analyst*

Got it. Lastly, on the access to financing, you are showing $13 billion of FHLB borrowing capacity now. That is up from $10 billion that you showed back in August. Can you talk to that?

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

That is correct.

Roger Freeman - *Lehman Brothers - Analyst*

How does that -- what causes that to change?

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

We actually even before this whole process had begun with the credit had applied to the FHLB given our balance sheet to be in a place where we could have borrowing capacity up to 40% of the asset size, and we were approved. And so, as a result of that, we have the ability to borrow up to this 13 or 14, and we have collateral pledged with them so it is available so we can draw down on it immediately.

Roger Freeman - *Lehman Brothers - Analyst*

Okay. And what do you have in terms of wholesale borrowing maturing over the next 30 to 60 days?

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

Typically that number runs about 6 to $7 billion. And again that is typically repo on the AAA agency collateral, so the Fannie's and the Freddie's. So we have seen no real impact in the ability to roll that over.

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

Everything that we have seen come up for roll since all of this started I guess maybe a month or six weeks ago, we have had no issue rolling it either on terms or pricing or anything that was not exactly favorable in what we expect.

Operator

William Tanona, Goldman Sachs.

William Tanona - *Goldman Sachs - Analyst*

If we go back to your 2005 Analyst Day, I think it was your '05 Analyst Day, you had mentioned and said that, hey listen, if we cannot grow this business 20% a year, we would sell this business. And as you think about kind of recalibrating earnings here and going to $1.10 to the mid point of the range and $1.30 for '08, you are far well below that. So I just kind of want to get your updated thoughts in terms of how you think about that in the overall context of your growth right now.

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

Happy to do it. So, first of all, $1.30 is not our guidance for next year. $1.30 just sets context from the $1.10 back to the $1.30 in terms of what are nonrecurring. That has nothing to do with any growth in the business. Right?

So we will give guidance as Rob said in January, and that guidance will -- all we were trying to do was say, off of the $1.10, we would not expect to see a certain amount of the loan loss provision. In other words, if I remember correctly, $1.30 still assumes $200 million in loan loss provisions and does assume a continuation of $100 million in securities impairments, but that is a differential from the 300 that we would be taking this year in '07, and it also presumes that we would not have the recurring charges associated with exiting the wholesale mortgage business and restructuring the institutional business. So that is how I believe we get from the $1.10 to the $1.30. Then it would be the question of growth.

So what does the balance sheet look like? What is the spread going to be given the change in the composition of the balance sheet, and what does that mean for growth to net interest income? What is the growth in the target segment customer? What sort of asset growth will we see? What sort of trading volume will we see, as well as what are we going to see in terms of margin being added, all of which would be accretive to those earnings numbers.

So again, I think one of the questions I was asked earlier on, is we believe that over the long-term we should continue and hold ourselves accountable to a growth rate of 15% and 20% in earnings. We have been doing that. Part of the issue is actually we have been exceeding that fairly significantly, both through acquisition as well as through the growth in the balance sheet. And, as I understand it, one of the criticisms has been why are you growing earnings in your balance sheet simply by buying securities and funding them with wholesale borrowings? Those are not high-value recurring earnings.

And so that is what we are attempting obviously to reduce here and put ourselves in a position where we can make the right investments to be able to in a place where we can continue to have those growth rates over the long-term and be able to do it with what we perceive to be higher quality recurring revenue and earnings.

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

And if you go back to the '05 Analyst Day as well, one of the things we talked about was driving a balance sheet that was funded 70 to 80% by retail. And if you look at our most recent quarters, we have been closer to 60%.

So that has been one goal we have not achieved, and we feel that really now is the time to work towards that goal and really go 80 to 85% retail funded because the growth is there. And if you go back to our last quarter, we talked about target segment growth in customers of 29% and 25% year-to-date. Those customers drive 75% of our revenues, and we are getting significant growth where it counts. That is where we want to focus this business, and that is more of what we want to talk to you about going forward.

William Tanona - *Goldman Sachs - Analyst*

Okay. Well, if I look at kind of past transactions in this industry and look at the price paid per account and look at your account base if you will, it looks like nobody is giving you any value whatsoever for the bank and if anything a negative value for that bank.

And so I know you guys worked really, really hard to try to get people to look at it as retail and institutional, but the reality is that nobody ever really looked at it that way. And it seems like you guys are starting to go back to kind of the core retail strategy if you will. So I want to get your thoughts in terms of any thoughts about breaking out the brokerage versus the banking once again just given what your kind of transition period is here back towards the retail?

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

Don't know. Way too early to say. But I think what you will see is the balance sheet -- right -- which is defined in your mind as the bank, being much more connected to retail. So allowing us to be in a position to replace the wholesale borrowings which clearly have a higher cost of funds with the growth in customer cash, which is coming I think as you know like 85 or 88 or 89% of that is coming from an investing customer or brokerage customer. So very little of the growth in customer cash and deposits comes from anybody other than an investing customer or brokerage customer. And then doing exactly the same thing when you move over to the asset side. Not allowing all the securities to pay down, but also given what we're seeing, I feel much more comfortable transitioning the balance sheet back to a place where it was I guess in the days of maybe -- the early days of the merger with E*TRADE or Telebank when it was really the combination of margin and first lien position mortgages which I think as you know have traditionally only had a couple basis points of charge-off.

So I think what we will do is we will be clearer and clearer about how much of the revenue and earnings is coming from this brokerage or investing customer.

William Tanona - *Goldman Sachs - Analyst*

Okay. And then I guess lastly in terms of management, I mean obviously I think it is a little bit of a disappointment here today. Any thoughts on what we should expect on the management front, whether it be additions or subtractions in the upcoming six-month period?

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

The only thing that you should probably expect differently is that we have a view that we are exiting the wholesale business in mortgage. And to the extent that we believe that we want retail and in the investing retail customer to drive the growth of the balance sheet through margin and through first lien, we believe that as we strengthen the retail mortgage franchise, that we will look for somebody at a senior level who will join our team and can be helpful to us.

The same could be said on the asset side. We think there is an opportunity now in the marketplace to try to also grow and enhance given what we're seeing with average balances that are coming in in the asset side from a target customer. It is in the $250,000 range I believe, $280,000 range. So as we are beginning to see that, is there somebody on the wealth management side or the asset gathering side that we would want to add to the team to strengthen it as well?

Operator

Michael Hecht, Banc of America Securities.

Michael Hecht - *Banc of America Securities - Analyst*

And we should come back to the balance sheet again and talk a little bit about how the shift to kind of core retail on your interest earning assets changes your sensitivity to interest rates and whether you will be more asset or liability sensitive going forward and what type of kind of interest rate environment is best for you at this point? I guess as part of that would impact a Fed easing would have and the impact I guess on the inversion that we are seeing at the short end of the curve, what that is having on you.

Dennis Webb - *E*TRADE FINANCIAL Corporation - Chief Investment Officer & President of Capital Markets*

So thanks for the question. So in terms of what environment is best for us, all else being equal we would prefer a positively sloped curve like most banks. However, as you have seen, we always hedge our interest rate risk down to a minimum or moderate risk category. And so the slope of the curve will help us, albeit limited, and I believe we gave some metrics last year in terms of what the sensitivity is to the income.

What is interesting about our model are the various sides of the balance sheet. The traditional brokerage balance sheet is asset sensitive, meaning you have margin balances that float with Fed Funds for the most part funded by free credits and sweeps that as we have talked about in the past have a duration of anywhere from one year to about three or four years.

So, as Mitch talked about, this increase in first mortgages which typically have a duration of four to five years will help balance that out. So on an ongoing basis, we would expect to have a very pretty tight natural hedge position between the sweeps and the free credits and the cash deposits really offset by the barbel of margin balances in mortgages. And so there will still be some hedging activity, but it will be a much more natural fit than we have seen in the past.

Michael Hecht - *Banc of America Securities - Analyst*

Okay. And you guys note that July and August retail trends have been pretty strong and seemed pretty pleased generally with retail engagement levels we are seeing recently. But it seems things have slowed quite a bit maybe 20% or so in September as we heard out of Schwab today. What impact do you think the pickup in volatility and just generally kind of choppier equity markets and (technical difficulty)-- retail trends the rest of the year?

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

Don't know, can't really comment. I mean I think to your point July and August have been very strong. I mean, we have not yet commented on September. Right? Obviously. I mean so we're not in a place where we would talk about what Schwab talked about today with the decline. But what we can say is I think our metrics will be out this coming Wednesday, and you will get a better sense of precisely what we have seen, the level of engagement. And I think we are even commenting within that at what we have seen in terms of the underlying behavior of the general buying in the marketplace by our customers.

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

And in general, as we always talk about the retail customer from an investing perspective is in pretty good shape. They have been well diversified. They have been again as we always talked about using options as hedging tools and sort of margin enhancing tools. So the customer is in good shape, and I think just as the rest of the market is waiting to seek what happens with the Fed tomorrow so is retail.

So I think you will get a good look at our August metrics on Wednesday, and I think we will all get a good idea of what the rest of the year looks like after the Fed makes up its mind tomorrow.

Michael Hecht - *Banc of America Securities - Analyst*

Okay, that is helpful. And then with perhaps even more focus kind of on the retail brokerage side, I mean any plans to get more aggressive on margin balance price or pricing seems to bolster growth on that side of the business like you guys have done on the deposit gathering side?

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

On the margin side, we are already one of the most competitive in the marketplace and really no need to consider any kind of changing there.

Michael Hecht - *Banc of America Securities - Analyst*

Okay. And then just -- I'm sorry.

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

(multiple speakers) -- and especially for our high-value customers and large users of margin. They have got the most competitive rates today. No need to improve them and no risk really of losing them either.

Michael Hecht - *Banc of America Securities - Analyst*

Got you. That is fair. And then just the last question, just to come back on the consolidation question, with overtures you guys have made to Ameritrade in the past and how vocal you have been on consolidation, how does today's repositioning affect your thinking here? I mean any more or less likely to pursue a combination here?

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

It does not change our thinking at all.

Operator

Matthew Fischer, Deutsche Bank.

Matthew Fischer - *Deutsche Bank - Analyst*

It must have been asked, but does this impact your high interest savings and checking offerings at all in terms of what you are offering clients in savings and checking?

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

No, no, it assumes everything that you have traditionally been seeing in terms of the kinds of products and the relative pricing levels.

Matthew Fischer - *Deutsche Bank - Analyst*

Okay. So you can improve the margin but still be aggressive?

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

Yes, significantly. I mean one of the issues that you are going to see I believe is that there is always some opportunity in disruption. So given the disruption in the credit markets, you're actually seeing spreads associated with extremely conservative first lien position mortgages at wider levels than you have probably seen them in five, three, four, five, I cannot remember how long. So on the asset side, you are seeing some benefit there.

On the liability side, again one of the points of criticism has always been one of your highest costs of borrowing is wholesale. Whether it is borrowing from the federal home loan bank or borrowing from the street on a reverse repurchase agreement because typically they are shorter duration, and you have to pay for hedging to extend them out, which is exactly what Dennis was addressing a moment ago in the question he was answering.

So I think we do believe over time we will be in a place where although we will not grow the balance sheet by replacing wholesale with customer cash and deposits and even by replacing the securities which do obviously have a much lower spread, but even the home equity lines of credit which typically have had a higher spread with first liens, there is the opportunity to continue to widen out our net interest spread over time.

Matthew Fischer - *Deutsche Bank - Analyst*

Thanks. And I guess lastly, just to clarify, your provisions in 2008, how should we think about -- are we frontloading them in the first half given the increase in delinquencies through the first half of '08? Or if spaced out evenly, how should we look at that?

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

I think as you think about 2008, again we're not yet giving guidance. But if you were to use the $200 million or the high-end number, I would say it would be slightly skewed to the first two quarters and then dropping in the latter half of the year given the mix change that you are seeing in our balance sheet.

Operator

Thank you. I will now turn the floor back over to Mr. Mitchell Caplan for any closing statements.

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

Great. Thanks, everybody, for the time, and I appreciate the attention attendance given the short notice. Thanks a lot.

Operator

Thank you. This concludes today's conference. You may now disconnect.
