

E TRADE FINANCIAL CORP  
Form 10-Q  
August 04, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

*(Mark One)*

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

For the Quarterly Period Ended June 30, 2011

or

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

Commission File Number 1-11921

**E\*TRADE Financial Corporation**

(Exact Name of Registrant as Specified in its Charter)

Delaware  
(State or Other Jurisdiction)

94-2844166  
(I.R.S. Employer)

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

of Incorporation or Organization)

Identification Number)

1271 Avenue of the Americas, 14<sup>th</sup> Floor, New York, New York 10020

(Address of Principal Executive Offices and Zip Code)

(646) 521-4300

(Registrant's Telephone Number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of August 1, 2011, there were 285,213,819 shares of common stock outstanding.

**Table of Contents**

**E\*TRADE FINANCIAL CORPORATION**

**FORM 10-Q QUARTERLY REPORT**

**For the Quarter Ended June 30, 2011**

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

|   |    |
|---|----|
| <b><u>Item 1. Consolidated Financial Statements (Unaudited)</u></b>   | 3  |
| <u>Consolidated Statement of Income (Loss)</u>  | 44 |
| <u>Consolidated Balance Sheet</u>   | 45 |
| <u>Consolidated Statement of Comprehensive Income</u>   | 46 |
| <u>Consolidated Statement of Shareholders' Equity</u>   | 47 |
| <u>Consolidated Statement of Cash Flows</u>   | 48 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u>   | 50 |
| <u>Note 1. Organization, Basis of Presentation and Summary of Significant Accounting Policies</u>           | 50 |
| <u>Note 2. Operating Interest Income and Operating Interest Expense</u>                                     | 53 |
| <u>Note 3. Fair Value Disclosures</u>   | 53 |
| <u>Note 4. Available-for-Sale and Held-to-Maturity Securities</u>   | 62 |
| <u>Note 5. Loans, Net</u>   | 66 |
| <u>Note 6. Accounting for Derivative Instruments and Hedging Activities</u>                                 | 72 |
| <u>Note 7. Deposits</u>   | 75 |
| <u>Note 8. Securities Sold Under Agreements to Repurchase and FHLB Advances and Other Borrowings</u>        | 75 |
| <u>Note 9. Corporate Debt</u>   | 76 |
| <u>Note 10. Shareholders' Equity</u>  | 77 |
| <u>Note 11. Earnings (Loss) per Share</u>   | 78 |
| <u>Note 12. Regulatory Requirements</u>   | 78 |
| <u>Note 13. Commitments, Contingencies and Other Regulatory Matters</u>                                     | 80 |
| <u>Note 14. Segment Information</u>   | 85 |
| <u>Note 15. Subsequent Event</u>  | 87 |
| <b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b> | 3  |
| <u>Overview</u>   | 3  |
| <u>Earnings Overview</u>  | 7  |
| <u>Segment Results Review</u>   | 14 |
| <u>Balance Sheet Overview</u>   | 18 |
| <u>Liquidity and Capital Resources</u>  | 22 |
| <u>Risk Management</u>  | 26 |
| <u>Concentrations of Credit Risk</u>  | 27 |
| <u>Summary of Critical Accounting Policies and Estimates</u>  | 36 |
| <u>Glossary of Terms</u>  | 37 |
| <b><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></b>                            | 42 |
| <b><u>Item 4. Controls and Procedures</u></b>   | 87 |
| <b>PART II OTHER INFORMATION</b>  |    |
| <b><u>Item 1. Legal Proceedings</u></b>   | 87 |
| <b><u>Item 1A. Risk Factors</u></b>   | 91 |
| <b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>                           | 91 |
| <b><u>Item 3. Defaults Upon Senior Securities</u></b>   | 91 |
| <b><u>Item 5. Other Information</u></b>   | 91 |
| <b><u>Item 6. Exhibits</u></b>  | 92 |
| <b><u>Signatures</u></b>  | 93 |

*Unless otherwise indicated, references to the Company, we, us, our and E\*TRADE mean E\*TRADE Financial Corporation or its subsidiaries.*

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

E\*TRADE, E\*TRADE Financial, E\*TRADE Bank, Equity Edge, OptionsLink and the Converging Arrows logo are registered trademarks of E\*TRADE Financial Corporation in the United States and in other countries.

## **Table of Contents**

### **FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements involving risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as expect, may, anticipate, intend, plan and similar expressions. Our actual results could differ materially from those discussed in these forward-looking statements, and we caution that we do not undertake to update these statements. Factors that could contribute to our actual results differing from any forward-looking statements include those discussed under Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission (SEC). The cautionary statements made in this report should be read as being applicable to all forward-looking statements wherever they appear in this report. We further caution that there may be risks associated with owning our securities other than those discussed in such filings. Important factors that may cause actual results to differ materially from any forward-looking statements are set forth in Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2010, and as updated in this report.

### **ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

This information is set forth immediately following Item 3. Quantitative and Qualitative Disclosures about Market Risk.

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the consolidated financial statements and the related notes that appear elsewhere in this document.*

### **GLOSSARY OF TERMS**

In analyzing and discussing our business, we utilize certain metrics, ratios and other terms that are defined in the Glossary of Terms, which is located at the end of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **OVERVIEW**

#### *Strategy*

Our core business is our trading and investing customer franchise. Building on the strengths of this franchise, our growth strategy is focused on four areas: retail brokerage, corporate services and market making, wealth management, and banking.

Our retail brokerage business is our foundation. We believe a focus on these key factors will position us for future growth in this business: growing our sales force with a focus on long-term investing, optimizing our marketing spend, continuing to develop innovative products and services and minimizing account attrition.

Our corporate services and market making businesses enhance our strategy by allowing us to realize additional economic benefit from our retail brokerage business. Our corporate services business is a leading provider of software and services for managing equity compensation plans and is an important source of new retail brokerage accounts. Our market making business allows us to increase the economic benefit on the order flow from the retail brokerage business as well as generate additional revenues through external order flow.

We also plan to expand our wealth management offerings. Our vision is to provide wealth management services that are enabled by innovative technology and supported by guidance from professionals when needed.

**Table of Contents**

Our retail brokerage business generates a significant amount of customer cash and we plan to continue to utilize our bank to optimize the value of these customer deposits.

Our strategy also includes an intense focus on mitigating the credit losses in our legacy loan portfolio and maintaining disciplined expense management. We remain focused on strengthening our overall capital structure and positioning the Company for future growth.

***Key Factors Affecting Financial Performance***

Our financial performance is affected by a number of factors outside of our control, including:

customer demand for financial products and services;

weakness or strength of the residential real estate and credit markets;

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

customer perception of the financial strength of our franchise;

market demand and liquidity in the secondary market for mortgage loans and securities;

market demand and liquidity in the wholesale borrowings market, including securities sold under agreements to repurchase;

our ability to obtain regulatory approval to move capital from our bank to our parent company; and

changes to the rules and regulations governing the financial services industry.

In addition to the items noted above, our success in the future will depend upon, among other things:

continuing our success in the acquisition, growth and retention of trading customers;

our ability to generate meaningful growth in the long-term investing customer group;

our ability to assess and manage credit risk;

our ability to generate capital sufficient to meet our operating needs, particularly a level sufficient to offset loan losses;

our ability to assess and manage interest rate risk; and

disciplined expense control and improved operational efficiency.

**Table of Contents**

Management monitors a number of metrics in evaluating the Company's performance. The most significant of these are shown in the table and discussed in the text below:

|  | As of or For the<br>Three Months Ended<br>June 30, |            |                           | As of or For the<br>Six Months Ended June 30, |            |                           |
|--|--|------------|---------------------------|---|------------|---------------------------|
|  | 2011   | 2010       | Variance<br>2011 vs. 2010 | 2011  | 2010       | Variance<br>2011 vs. 2010 |
| <b>Customer Activity Metrics:</b>                            |  |            |                           |   |            |                           |
| Daily average revenue trades ( DARTs )                       | 147,908  | 170,283    | (13)%                     | 162,476                                       | 162,916    | (0)%                      |
| Average commission per trade                                 | \$ 11.14   | \$ 11.05   | 1%                        | \$ 11.24                                      | \$ 11.21   | 0%                        |
| Margin receivables (dollars in billions)                     | \$ 5.7   | \$ 4.8     | 19%                       | \$ 5.7  | \$ 4.8     | 19%                       |
| End of period brokerage accounts                             | 2,759,773  | 2,649,500  | 4%                        | 2,759,773                                     | 2,649,500  | 4%                        |
| Net new brokerage accounts                                   | 24,950   | 17,523     | *                         | 75,462  | 19,421     | *                         |
| Customer assets (dollars in billions)                        | \$ 185.6   | \$ 143.8   | 29%                       | \$ 185.6                                      | \$ 143.8   | 29%                       |
| Net new brokerage assets (dollars in billions)               | \$ 1.5   | \$ 2.1     | *                         | \$ 5.4  | \$ 4.3     | *                         |
| Brokerage related cash (dollars in billions)                 | \$ 26.3  | \$ 20.7    | 27%                       | \$ 26.3                                       | \$ 20.7    | 27%                       |
| <b>Company Financial Metrics:</b>                            |  |            |                           |   |            |                           |
| Corporate cash (dollars in millions)                         | \$ 423.7   | \$ 481.1   | (12)%                     | \$ 423.7                                      | \$ 481.1   | (12)%                     |
| E*TRADE Bank excess risk-based capital (dollars in millions) | \$ 1,390.0   | \$ 1,008.4 | 38%                       | \$ 1,390.0                                    | \$ 1,008.4 | 38%                       |
| Special mention loan delinquencies (dollars in millions)     | \$ 461.3   | \$ 660.3   | (30)%                     | \$ 461.3                                      | \$ 660.3   | (30)%                     |
| Allowance for loan losses (dollars in millions)              | \$ 878.6   | \$ 1,102.9 | (20)%                     | \$ 878.6                                      | \$ 1,102.9 | (20)%                     |
| Enterprise net interest spread                               | 2.89%  | 2.89%      | 0.00%                     | 2.87%   | 2.93%      | (0.06)%                   |
| Enterprise interest-earning assets (average in billions)     | \$ 42.9  | \$ 41.0    | 5%                        | \$ 42.8                                       | \$ 41.7    | 3%                        |

\* Percentage not meaningful.

**Customer Activity Metrics**

DARTs are the predominant driver of commissions revenue from our customers.

Average commission per trade is an indicator of changes in our customer mix, product mix and/or product pricing.

Margin receivables represent credit extended to customers and non-customers to finance their purchases of securities by borrowing against securities they currently own. Margin receivables are a key driver of net operating interest income.

End of period brokerage accounts and net new brokerage accounts are indicators of our ability to attract and retain brokerage customers.

Changes in customer assets are an indicator of the value of our relationship with the customer. An increase in customer assets generally indicates that the use of our products and services by existing and new customers is expanding. Changes in this metric are also driven by changes in the valuations of our customers' underlying securities.





## **Table of Contents**

Net new brokerage assets are total inflows to all new and existing brokerage accounts less total outflows from all closed and existing brokerage accounts and are a general indicator of the use of our products and services by existing and new brokerage customers.

Customer cash and deposits, particularly brokerage related cash, are an indicator of a deepening engagement with our customers and are a key driver of net operating interest income.

### *Company Financial Metrics*

Corporate cash is an indicator of the liquidity at the parent company. It is the primary source of capital above and beyond the capital deployed in our regulated subsidiaries.

E\*TRADE Bank excess risk-based capital is the capital that E\*TRADE Bank has in excess of the regulatory minimum to be considered well-capitalized and is an indicator of E\*TRADE Bank's ability to absorb future losses. It is also a potential source of additional corporate cash, as this capital, if requested by us and approved by our regulators, could be sent as a dividend or otherwise distributed to the parent company.

Special mention loan delinquencies are loans 30-89 days past due and are an indicator of the expected trend for charge-offs in future periods as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge-off.

Allowance for loan losses is an estimate of the losses inherent in our loan portfolio as of the balance sheet date and is typically equal to management's forecast of loan losses over the next twelve months as well as the estimated losses, including economic concessions to borrowers, over the estimated remaining life of loans modified in troubled debt restructurings. The general allowance for loan losses also includes a specific qualitative component to account for a variety of economic and operational factors that are not directly considered in the quantitative loss model, including the current level of unemployment and the limited historical charge-off and loss experience on modified loans, but are factors we believe may impact our level of credit losses.

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

### *Significant Events in the Second Quarter of 2011*

#### *Enhancements to Our Trading and Investing Products and Services*

We continued to grow our sales force in the second quarter, increasing our financial consultant team by 30% in the first half of the year, as we continued to focus on engagement with long-term and retirement investors, as well as corporate clients;

We introduced weekly options, expanded fixed income news and research offerings in the Bond Resource Center, and expanded the availability of personalization tools;

We provided E\*TRADE Securities' customers with access to the AIG public offering, advocating for retail investors to have access to initial public offerings and other offerings typically limited to institutional investors; and

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

We expanded our corporate services client base with more than 30 new client contracts and continued to execute our strategy to service both private and public companies as a foundation for future retail brokerage account growth.

### *Issuance and Extinguishment of Senior Notes*

During the quarter, we issued an aggregate principal amount of \$435 million in senior notes due May 2016 (  $\frac{6}{4}\%$  Notes ), and used the proceeds to redeem all of the outstanding  $7\frac{3}{8}\%$  Notes due September 2013, approximately \$415 million in aggregate principal amount, including paying the associated redemption premium, accrued interest and related fees and expenses.

**Table of Contents***Conversions of Convertible Debentures*

On April 29, 2011, Citadel sold 27.5 million shares of the Company's common stock through a secondary offering. As part of and following the offering, Citadel converted \$314.1 million in convertible debentures into 30.4 million shares of common stock. A total of \$325.1 million in convertible debentures were converted into 31.4 million shares of common stock during the quarter.

**EARNINGS OVERVIEW**

We generated net income of \$47.1 million and \$92.4 million, or \$0.16 and \$0.32 per share for the three and six months ended June 30, 2011, respectively. We reported total net revenue of \$517.6 million and \$1.1 billion for the three and six months ended June 30, 2011, respectively and provision for loan losses declined 38% and 49% to \$103.1 million and \$219.2 million, for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010.

Commissions, fees and service charges, principal transactions and other revenue decreased 11% to \$174.1 million and 4% to \$374.8 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010, which was driven primarily by a decline in trading activity during the comparable periods.

Total operating expenses increased 6% to \$290.9 million and 3% to \$588.9 million for the three and six months ended June 30, 2011, respectively, when compared to the same periods in 2010. This increase was driven primarily by an increase in advertising and market development expense and FDIC insurance premiums during the three and six months ended June 30, 2011.

The following sections describe in detail the changes in key operating factors and other changes and events that have affected net revenue, provision for loan losses, operating expense, other income (expense) and income tax expense (benefit).

**Revenue**

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

|                                    | Three Months |          | Variance      |       | Six Months Ended |            | Variance      |       |
|------------------------------------|--------------|----------|---------------|-------|------------------|------------|---------------|-------|
|                                    | Ended        |          | 2011 vs. 2010 |       | June 30,         |            | 2011 vs. 2010 |       |
|                                    | 2011         | 2010     | Amount        | %     | 2011             | 2010       | Amount        | %     |
| Net operating interest income      | \$ 315.4     | \$ 302.0 | \$ 13.4       | 4%    | \$ 625.1         | \$ 622.4   | \$ 2.7        | 0%    |
| Commissions                        | 103.8        | 119.6    | (15.8)        | (13)% | 228.3            | 232.8      | (4.5)         | (2)%  |
| Fees and service charges           | 36.6         | 35.2     | 1.4           | 4%    | 73.9             | 77.4       | (3.5)         | (5)%  |
| Principal transactions             | 23.8         | 28.7     | (4.9)         | (17)% | 53.3             | 54.9       | (1.6)         | (3)%  |
| Gains on loans and securities, net | 31.0         | 48.9     | (17.9)        | (37)% | 63.3             | 78.0       | (14.7)        | (19)% |
| Net impairment                     | (2.9)        | (12.2)   | 9.3           | (76)% | (8.9)            | (20.8)     | 11.9          | (57)% |
| Other revenues                     | 9.9          | 11.8     | (1.9)         | (16)% | 19.3             | 25.8       | (6.5)         | (25)% |
| Total non-interest income          | 202.2        | 232.0    | (29.8)        | (13)% | 429.2            | 448.1      | (18.9)        | (4)%  |
| Total net revenue                  | \$ 517.6     | \$ 534.0 | \$ (16.4)     | (3)%  | \$ 1,054.3       | \$ 1,070.5 | \$ (16.2)     | (2)%  |

Total net revenue decreased 3% to \$517.6 million and 2% to \$1.1 billion for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. This was driven primarily by lower gains on loans and securities, net and commissions, which were partially offset by an increase in net operating interest income and a decrease in net impairment.

*Net Operating Interest Income*

Net operating interest income increased 4% to \$315.4 million and increased slightly to \$625.1 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. Net operating interest income is earned primarily through investing customer

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

cash and deposits in interest-earning assets, which include: margin receivables, real estate loans, available-for-sale securities and held-to-maturity securities.

**Table of Contents**

The following table presents enterprise average balance sheet data and enterprise income and expense data for our operations, as well as the related net interest spread, yields and rates and has been prepared on the basis required by the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* (dollars in millions):

|  | Three Months Ended June 30, |  |                           |                    |  |                           |
|--|-----------------------------|--|---------------------------|--------------------|--|---------------------------|
|  | Average<br>Balance          | 2011<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/<br>Cost | Average<br>Balance | 2010<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/<br>Cost |
| <b>Enterprise interest-earning assets:</b>   |                             |  |                           |                    |  |                           |
| Loans <sup>(1)</sup>   | \$ 15,030.0                 | \$ 181.0                                   | 4.82%                     | \$ 18,844.0        | \$ 225.3                                   | 4.78%                     |
| Margin receivables   | 5,732.5                     | 58.7                                       | 4.11%                     | 4,479.4            | 50.0                                       | 4.47%                     |
| Available-for-sale securities  | 15,428.2                    | 107.0                                      | 2.78%                     | 12,551.7           | 94.2                                       | 3.00%                     |
| Held-to-maturity securities  | 3,950.3                     | 32.9                                       | 3.34%                     | 135.1              | 1.3  | 3.74%                     |
| Cash and equivalents   | 1,489.2                     | 0.8  | 0.20%                     | 3,390.4            | 1.9  | 0.23%                     |
| Segregated cash and investments  | 638.6                       | 0.2  | 0.09%                     | 927.3              | 0.6  | 0.24%                     |
| Securities borrowed and other  | 639.2                       | 12.5                                       | 7.84%                     | 662.4              | 6.6  | 4.00%                     |
| Total enterprise interest-earning assets   | 42,908.0                    | 393.1                                      | 3.67%                     | 40,990.3           | 379.9                                      | 3.71%                     |
| Non-operating interest-earning and non-interest earning assets <sup>(2)</sup>  | 4,290.5                     |  |                           | 4,273.5            |  |                           |
| Total assets   | \$ 47,198.5                 |  |                           | \$ 45,263.8        |  |                           |
| <b>Enterprise interest-bearing liabilities:</b>  |                             |  |                           |                    |  |                           |
| Retail deposits  | \$ 26,042.5                 | 11.1                                       | 0.17%                     | \$ 24,118.0        | 14.7                                       | 0.24%                     |
| Brokered certificates of deposit   | 49.0                        | 0.7  | 5.64%                     | 116.1              | 1.5  | 5.18%                     |
| Customer payables  | 5,489.3                     | 2.1  | 0.16%                     | 4,660.2            | 1.7  | 0.14%                     |
| Securities sold under agreements to repurchase   | 5,369.1                     | 38.0                                       | 2.80%                     | 6,332.6            | 30.7                                       | 1.92%                     |
| Federal Home Loan Bank ( FHLB ) advances and other borrowings  | 2,745.2                     | 26.9                                       | 3.89%                     | 2,747.2            | 30.8                                       | 4.43%                     |
| Securities loaned and other  | 655.2                       | 0.4  | 0.24%                     | 599.5              | 0.4  | 0.28%                     |
| Total enterprise interest-bearing liabilities  | 40,350.3                    | 79.2                                       | 0.78%                     | 38,573.6           | 79.8                                       | 0.82%                     |
| Non-operating interest-bearing and non-interest bearing liabilities <sup>(3)</sup>   | 2,208.5                     |  |                           | 2,704.2            |  |                           |
| Total liabilities  | 42,558.8                    |  |                           | 41,277.8           |  |                           |
| Total shareholders' equity   | 4,639.7                     |  |                           | 3,986.0            |  |                           |
| Total liabilities and shareholders' equity   | \$ 47,198.5                 |  |                           | \$ 45,263.8        |  |                           |
| <b>Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread</b> |                             |  |                           |                    |  |                           |
|  | \$ 2,557.7                  | \$ 313.9                                   | 2.89%                     | \$ 2,416.7         | \$ 300.1                                   | 2.89%                     |
| Enterprise net interest margin (net yield on enterprise interest-earning assets)   |                             |  | 2.93%                     |                    |  | 2.93%                     |
| Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities   |                             |  | 106.34%                   |                    |  | 106.27%                   |
| Return on average:   |                             |  |                           |                    |  |                           |
| Total assets   |                             |  | 0.40%                     |                    |  | 0.31%                     |
| Total shareholders' equity   |                             |  | 4.06%                     |                    |  | 3.52%                     |
| Average equity to average total assets   |                             |  | 9.83%                     |                    |  | 8.81%                     |
| Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):                             |                             |  |                           |                    |  |                           |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  | <b>Three Months Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2011</b>                            | <b>2010</b> |
| Enterprise net interest income                               | \$ 313.9                               | \$ 300.1    |
| Taxable equivalent interest adjustment                       | (0.3)                                  | (0.3)       |
| Customer cash held by third parties and other <sup>(4)</sup> | 1.8                                    | 2.2         |
| Net operating interest income                                | \$ 315.4                               | \$ 302.0    |

- (1) Nonaccrual loans are included in the respective average loan balances. Income on such nonaccrual loans is recognized on a cash basis.
- (2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.
- (3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.
- (4) Includes interest earned on average customer assets of \$3.7 billion and \$3.1 billion for the three months ended June 30, 2011 and 2010, respectively, held by parties outside the Company, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

**Table of Contents**

|  | Six Months Ended June 30, |  |                           |                                      |  |                           |
|--|---------------------------|--|---------------------------|--------------------------------------|--|---------------------------|
|  | Average<br>Balance        | 2011<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/<br>Cost | Average<br>Balance                   | 2010<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/<br>Cost |
| <b>Enterprise interest-earning assets:</b>   |                           |  |                           |                                      |  |                           |
| Loans <sup>(1)</sup>   | \$ 15,425.2               | \$ 367.3                                   | 4.76%                     | \$ 19,383.3                          | \$ 466.9                                   | 4.82%                     |
| Margin receivables   | 5,588.7                   | 115.0                                      | 4.15%                     | 4,247.9                              | 94.7                                       | 4.49%                     |
| Available-for-sale securities  | 15,589.6                  | 218.2                                      | 2.80%                     | 13,132.9                             | 203.8                                      | 3.10%                     |
| Held-to-maturity securities  | 3,238.4                   | 53.7                                       | 3.32%                     | 67.9                                 | 1.3  | 3.71%                     |
| Cash and equivalents   | 1,659.7                   | 1.7  | 0.20%                     | 2,913.5                              | 3.3  | 0.23%                     |
| Segregated cash and investments  | 682.7                     | 0.4  | 0.11%                     | 1,254.6                              | 1.5  | 0.24%                     |
| Securities borrowed and other  | 641.5                     | 22.3                                       | 7.00%                     | 674.2                                | 13.7                                       | 4.09%                     |
| Total enterprise interest-earning assets   | 42,825.8                  | 778.6                                      | 3.64%                     | 41,674.3                             | 785.2                                      | 3.77%                     |
| Non-operating interest-earning and non-interest earning assets <sup>(2)</sup>  | 4,381.0                   |  |                           | 4,260.7                              |  |                           |
| Total assets   | \$ 47,206.8               |  |                           | \$ 45,935.0                          |  |                           |
| <b>Enterprise interest-bearing liabilities:</b>  |                           |  |                           |                                      |  |                           |
| Retail deposits  | \$ 25,805.1               | 22.4                                       | 0.17%                     | \$ 24,467.8                          | 33.1                                       | 0.27%                     |
| Brokered certificates of deposit   | 59.6                      | 1.6  | 5.45%                     | 118.0                                | 3.0  | 5.11%                     |
| Customer payables  | 5,404.6                   | 4.0  | 0.15%                     | 4,917.3                              | 3.6  | 0.15%                     |
| Securities sold under agreements to repurchase   | 5,625.6                   | 76.0                                       | 2.69%                     | 6,352.2                              | 65.5                                       | 2.05%                     |
| Federal Home Loan Bank ( FHLB ) advances and other borrowings  | 2,748.7                   | 52.2                                       | 3.78%                     | 2,754.2                              | 60.2                                       | 4.35%                     |
| Securities loaned and other  | 670.0                     | 0.7  | 0.22%                     | 609.4                                | 0.9  | 0.30%                     |
| Total enterprise interest-bearing liabilities  | 40,313.6                  | 156.9                                      | 0.77%                     | 39,218.9                             | 166.3                                      | 0.84%                     |
| Non-operating interest-bearing and non-interest bearing liabilities <sup>(3)</sup>   | 2,497.3                   |  |                           | 2,819.3                              |  |                           |
| Total liabilities  | 42,810.9                  |  |                           | 42,038.2                             |  |                           |
| Total shareholders equity  | 4,395.9                   |  |                           | 3,896.8                              |  |                           |
| Total liabilities and shareholders equity  | \$ 47,206.8               |  |                           | \$ 45,935.0                          |  |                           |
| <b>Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread</b> |                           |  |                           |                                      |  |                           |
|  | \$ 2,512.2                | \$ 621.7                                   | 2.87%                     | \$ 2,455.4                           | \$ 618.9                                   | 2.93%                     |
| Enterprise net interest margin (net yield on enterprise interest-earning assets)   |                           |  | 2.90%                     |                                      |  | 2.97%                     |
| Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities   |                           |  | 106.23%                   |                                      |  | 106.26%                   |
| Return on average:   |                           |  |                           |                                      |  |                           |
| Total assets   |                           |  | 0.39%                     |                                      |  | (0.06)%                   |
| Total shareholders equity  |                           |  | 4.20%                     |                                      |  | (0.65)%                   |
| Average equity to average total assets   |                           |  | 9.31%                     |                                      |  | 8.48%                     |
| Reconciliation from enterprise net interest income to net operating interest income (dollars in millions):                             |                           |  |                           |                                      |  |                           |
|  |                           |  |                           | <b>Six Months Ended<br/>June 30,</b> |  |                           |
|  |                           |  |                           | <b>2011</b>                          | <b>2010</b>                                |                           |
| Enterprise net interest income   |                           |  |                           | \$ 621.7                             | \$ 618.9                                   |                           |
| Taxable equivalent interest adjustment   |                           |  |                           | (0.6)                                | (0.6)                                      |                           |
| Customer cash held by third parties and other <sup>(4)</sup>   |                           |  |                           | 4.0                                  | 4.1  |                           |



## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                               |          |          |
|-------------------------------|----------|----------|
| Net operating interest income | \$ 625.1 | \$ 622.4 |
|-------------------------------|----------|----------|

- (1) Nonaccrual loans are included in the respective average loan balances. Income on such nonaccrual loans is recognized on a cash basis.
- (2) Non-operating interest-earning and non-interest earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.
- (3) Non-operating interest-bearing and non-interest bearing liabilities consist of corporate debt and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.
- (4) Includes interest earned on average customer assets of \$3.7 billion and \$3.1 billion for the six months ended June 30, 2011 and 2010, respectively, held by parties outside the Company, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

## **Table of Contents**

Average enterprise interest-earning assets increased 5% to \$42.9 billion and 3% to \$42.8 billion for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. This was primarily a result of the increases in average margin receivables and average available-for-sale and held-to-maturity securities, offset by decreases in average loans and average cash and equivalents.

Average enterprise interest-bearing liabilities increased 5% to \$40.4 billion and 3% to \$40.3 billion for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The increase in average enterprise interest-bearing liabilities was primarily due to increases in average retail deposits and average customer payables, offset by a decrease in average securities sold under agreements to repurchase.

Enterprise net interest spread was consistent at 2.89% and decreased by six basis points to 2.87% for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. In the current interest rate environment with historically low levels of interest rates, we expect moderate pressure on the enterprise net interest spread.

### *Commissions*

Commissions revenue decreased 13% to \$103.8 million and 2% to \$228.3 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The main factors that affect commissions are DARTs, average commission per trade and the number of trading days during the period. Average commission per trade is impacted by different trade types (e.g. equities, options, fixed income, stock plan, exchange-traded funds, mutual funds and cross border) that can have different commission rates. Accordingly, changes in the mix of trade types will impact average commission per trade.

DART volume decreased 13% to 147,908 and decreased slightly to 162,476 for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. Option-related DARTs as a percentage of total DARTs represented 20% and 19% of trading volume for the three and six months ended June 30, 2011, respectively, compared to 16% for the comparable periods in 2010. Exchange-traded funds-related DARTs as a percentage of total DARTs represented 10% and 9% of trading volume for the three and six months ended June 30, 2011, respectively, compared to 10% for the comparable periods in 2010.

Average commission per trade increased 1% to \$11.14 and increased slightly to \$11.24 for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The slight increase was due to an improvement in the product and customer mix when compared to the same periods in 2010.

### *Fees and Service Charges*

Fees and service charges increased 4% to \$36.6 million and decreased 5% to \$73.9 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The increase for the three months ended June 30, 2011 was driven by an increase in reorganization fees revenue when compared to the same period in 2010. The decrease for the six months ended June 30, 2011 was primarily due to the elimination of all account activity fees, which took effect in the second quarter of 2010.

### *Principal Transactions*

Principal transactions decreased 17% to \$23.8 million and 3% to \$53.3 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. Principal transactions are derived from our market making business in which we act as a market-maker for our brokerage customers' orders as well as orders from third party customers. The decrease in principal transactions revenue was driven by a decrease in trading volumes when compared to the same periods in 2010.

**Table of Contents***Gains on Loans and Securities, Net*

Gains on loans and securities, net were \$31.0 million and \$63.3 million for the three and six months ended June 30, 2011, respectively, as shown in the following table (dollars in millions):

|   | Three Months |         | Variance      |       | Six Months Ended |         | Variance      |       |
|---|--------------|---------|---------------|-------|------------------|---------|---------------|-------|
|   | Ended        |         | 2011 vs. 2010 |       | June 30,         |         | 2011 vs. 2010 |       |
|   | 2011         | 2010    | Amount        | %     | 2011             | 2010    | Amount        | %     |
| Gains on loans, net                         | \$ 0.1       | \$ 7.0  | \$ (6.9)      | *     | \$ 0.1           | \$ 6.2  | \$ (6.1)      | *     |
| Gains on available-for-sale securities, net | 25.3         | 42.9    | (17.6)        | (41)% | 61.1             | 72.3    | (11.2)        | (15)% |
| Gains (losses) on trading securities, net   | 0.3          | (0.4)   | 0.7           | *     | 0.9              | 0.3     | 0.6           | *     |
| Hedge ineffectiveness                       | 5.3          | (0.6)   | 5.9           | *     | 1.2              | (0.8)   | 2.0           | *     |
| Gains on securities, net                    | 30.9         | 41.9    | (11.0)        | (26)% | 63.2             | 71.8    | (8.6)         | (12)% |
| Gains on loans and securities, net          | \$ 31.0      | \$ 48.9 | \$ (17.9)     | (37)% | \$ 63.3          | \$ 78.0 | \$ (14.7)     | (19)% |

\* Percentage not meaningful.

*Net Impairment*

We recognized \$2.9 million and \$8.9 million of net impairment during the three and six months ended June 30, 2011, respectively, on certain securities in our non-agency CMO portfolio due to continued deterioration in the expected credit performance of the underlying loans in those specific securities. The gross other-than-temporary impairment ( OTTI ) and the noncredit portion of OTTI, which was or had been previously recorded through other comprehensive income, are shown in the table below (dollars in millions):

|  | Three Months Ended |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | 2011               | 2010      | 2011             | 2010      |
| Other-than-temporary impairment ( OTTI )   | \$ (2.0)           | \$ (15.1) | \$ (6.9)         | \$ (29.6) |
| Less: noncredit portion of OTTI recognized into (out of) other comprehensive income (before tax) | (0.9)              | 2.9       | (2.0)            | 8.8       |
| Net impairment   | \$ (2.9)           | \$ (12.2) | \$ (8.9)         | \$ (20.8) |

*Other Revenues*

Other revenues decreased 16% to \$9.9 million and 25% to \$19.3 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The decrease for the six months ended June 30, 2011, was due to a decline in the income from the cash surrender value of bank-owned life insurance when compared to the same period in 2010. Additionally, the decrease during the six months ended June 30, 2011 was primarily due to the gain on sale of approximately \$1 billion in savings accounts to Discover Financial Services in the first quarter of 2010, which increased other revenues during the six months ended June 30, 2010.

*Provision for Loan Losses*

Provision for loan losses decreased 38% to \$103.1 million and 49% to \$219.2 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The decrease in provision for loan losses was driven by improving credit trends, as evidenced by the lower levels of at-risk (30-179 days delinquent) loans in the one- to four-family and home equity loan portfolios. The provision

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

for loan losses has declined 80% from its peak of \$517.8 million in the third quarter of 2008 and we expect it to continue to decline in 2011 when compared to 2010, although performance is subject to variability from quarter to quarter.

**Table of Contents****Operating Expense**

The components of operating expense and the resulting variances are as follows (dollars in millions):

|  | Three Months Ended |          | Variance      |      | Six Months Ended |          | Variance      |       |
|--|--------------------|----------|---------------|------|------------------|----------|---------------|-------|
|  | June 30,           |          | 2011 vs. 2010 |      | June 30,         |          | 2011 vs. 2010 |       |
|  | 2011               | 2010     | Amount        | %    | 2011             | 2010     | Amount        | %     |
| Compensation and benefits                        | \$ 80.5            | \$ 80.9  | \$ (0.4)      | (1)% | \$ 164.5         | \$ 168.2 | \$ (3.7)      | (2)%  |
| Clearing and servicing                           | 39.2               | 38.2     | 1.0           | 3%   | 78.3             | 77.3     | 1.0           | 1%    |
| Advertising and market development               | 37.0               | 29.8     | 7.2           | 24%  | 81.4             | 67.9     | 13.5          | 20%   |
| Professional services                            | 21.5               | 19.5     | 2.0           | 10%  | 44.9             | 39.8     | 5.1           | 13%   |
| FDIC insurance premiums                          | 24.0               | 19.3     | 4.7           | 25%  | 44.6             | 38.6     | 6.0           | 16%   |
| Communications                                   | 17.2               | 18.4     | (1.2)         | (6)% | 32.8             | 38.9     | (6.1)         | (16)% |
| Occupancy and equipment                          | 17.2               | 17.6     | (0.4)         | (3)% | 34.0             | 35.8     | (1.8)         | (5)%  |
| Depreciation and amortization                    | 22.7               | 22.0     | 0.7           | 3%   | 44.8             | 42.6     | 2.2           | 5%    |
| Amortization of other intangibles                | 6.5                | 7.1      | (0.6)         | (8)% | 13.1             | 14.3     | (1.2)         | (8)%  |
| Facility restructuring and other exit activities | 2.1                | (1.8)    | 3.9           | *    | 5.6              | 1.5      | 4.1           | *     |
| Other operating expenses                         | 23.0               | 24.7     | (1.7)         | (7)% | 44.9             | 46.1     | (1.2)         | (3)%  |
| Total operating expense                          | \$ 290.9           | \$ 275.7 | \$ 15.2       | 6%   | \$ 588.9         | \$ 571.0 | \$ 17.9       | 3%    |

\* Percentage not meaningful.

Operating expense increased 6% to \$290.9 million and 3% to \$588.9 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The fluctuation was driven primarily by increases in advertising and market development expense and FDIC insurance premiums, which were partially offset by decreases in communications expense, compared to the same periods in 2010.

**Compensation and Benefits**

Compensation and benefits decreased 1% to \$80.5 million and 2% to \$164.5 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. These decreases resulted primarily from lower incentive compensation expense when compared to the same periods in 2010.

**Advertising and Market Development**

Advertising and market development expense increased 24% to \$37.0 million and 20% to \$81.4 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. These fluctuations were due largely to the planned increase in advertising expenditures in our continuing effort to attract new accounts and customer assets during the three and six months ended June 30, 2011.

**FDIC Insurance Premiums**

FDIC insurance premiums increased 25% to \$24.0 million and 16% to \$44.6 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The increase was due primarily to an industry wide change in the FDIC insurance premium assessment calculation.

**Communications**

Communications expense decreased 6% to \$17.2 million and 16% to \$32.8 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The decrease was driven primarily by a decline in vendor services fees when compared to the same periods in 2010.



**Table of Contents****Other Income (Expense)**

Other income (expense) increased 1% to \$41.0 million and 6% to \$84.6 million for the three and six months ended June 30, 2011, respectively, when compared to the same periods in 2010, as shown in the following table (dollars in millions):

|  | Three Months |           | Variance |    | Six Months Ended |           | Variance      |    |
|--|--------------|-----------|----------|----|------------------|-----------|---------------|----|
|  | Ended        |           | 2011 vs. |    | June 30,         |           | 2011 vs. 2010 |    |
|  | 2011         | 2010      | Amount   | %  | 2011             | 2010      | Amount        | %  |
| Corporate interest income                                | \$ 0.1       | \$ 0.1    | \$       | *  | \$ 0.7           | \$ 0.1    | \$ 0.6        | *  |
| Corporate interest expense                               | (44.8)       | (41.2)    | (3.6)    | 9% | (88.1)           | (82.2)    | (5.9)         | 7% |
| Gains on sales of investments, net                       |              |           |          | *  |                  | 0.1       | (0.1)         | *  |
| Gains on early extinguishment of debt                    | 3.1          |           | 3.1      | *  | 3.1              |           | 3.1           | *  |
| Equity in income (loss) of investments and venture funds | 0.6          | 0.7       | (0.1)    | *  | (0.3)            | 2.5       | (2.8)         | *  |
| Total other income (expense)                             | \$ (41.0)    | \$ (40.4) | \$ (0.6) | 1% | \$ (84.6)        | \$ (79.5) | \$ (5.1)      | 6% |

\* Percentage not meaningful.

Total other income (expense) for the three and six months ended June 30, 2011 primarily consisted of corporate interest expense on interest-bearing corporate debt. Offsetting interest expense for the three and six months ended June 30, 2011 was a \$3.1 million gain on early extinguishment of debt related to the call of the 7<sup>3</sup>/<sub>8</sub>% Notes in the second quarter of 2011.

**Income Tax Expense (Benefit)**

Income tax expense was \$35.5 million and \$69.2 million for the three and six months ended June 30, 2011, respectively compared to income tax expense of \$17.2 million and income tax benefit of \$0.9 million for the same periods in 2010. The effective tax rates were 43.0% and 32.9% for the three months ended June 30, 2011 and 2010, respectively and 42.8% and (6.6)% for the for the six months ended June 30, 2011 and 2010, respectively.

**Valuation Allowance**

We are required to establish a valuation allowance for deferred tax assets and record a charge to income if we determine, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax assets will not be realized. If we did conclude that a valuation allowance was required, the resulting loss could have a material adverse effect on our results of operations and financial condition.

We did not maintain a valuation allowance against federal deferred tax assets as of June 30, 2011 as we believe that it is more likely than not that all of these assets will be realized. We continue to maintain a valuation allowance for certain state and foreign deferred tax assets as it is more likely than not that they will not be realized.

**Tax Ownership Change**

During the third quarter of 2009, we exchanged \$1.7 billion principal amount of interest-bearing debt for an equal principal amount of non-interest-bearing convertible debentures. Subsequent to the Debt Exchange, \$592.3 million and \$128.7 million debentures were converted into 57.2 million and 12.5 million shares of common stock during the third and fourth quarters of 2009, respectively. As a result of these conversions, we believe we experienced a tax ownership change during the third quarter of 2009.

**Table of Contents**

As of the date of the 2009 ownership change, we had federal NOLs available to carryforward of approximately \$1.4 billion. Section 382 imposes an annual limitation on the amount of post-ownership change taxable income a corporation may offset with pre-ownership change NOLs. We believe the tax ownership change will extend the period of time it will take to fully utilize pre-ownership change NOLs, but will not limit the total amount of pre-ownership change NOLs we can utilize. Our estimate is that we will be subject to an overall annual limitation on the use of pre-ownership change NOLs of approximately \$194 million. Our overall pre-ownership change NOLs have a statutory carryforward period of 20 years (the majority of which expire in 17 years). As a result, we believe we will be able to fully utilize these NOLs in future periods.

**SEGMENT RESULTS REVIEW**

We report operating results in two segments: 1) trading and investing; and 2) balance sheet management. Trading and investing includes retail brokerage products and services; investor-focused banking products; market making; and corporate services. Balance sheet management includes the management of asset allocation and credit, liquidity and interest rate risk; loans previously originated or purchased from third parties; and customer cash and deposits. Costs associated with certain functions that are centrally-managed are separately reported in a corporate/other category.

**Trading and Investing**

The following table summarizes trading and investing financial information and key metrics as of and for the three and six months ended June 30, 2011 and 2010 (dollars in millions, except for key metrics):

|  | Three Months Ended |           | Variance      |       | Six Months Ended |           | Variance      |       |  |
|--|--------------------|-----------|---------------|-------|------------------|-----------|---------------|-------|--|
|  | June 30,           |           | 2011 vs. 2010 |       | June 30,         |           | 2011 vs. 2010 |       |  |
|  | 2011               | 2010      | Amount        | %     | 2011             | 2010      | Amount        | %     |  |
| Net operating interest income                    | \$ 191.8           | \$ 192.4  | \$ (0.6)      | (0)%  | \$ 380.6         | \$ 386.1  | \$ (5.5)      | (1)%  |  |
| Commissions                                      | 103.8              | 119.6     | (15.8)        | (13)% | 228.3            | 232.8     | (4.5)         | (2)%  |  |
| Fees and service charges                         | 35.8               | 35.4      | 0.4           | 1%    | 71.9             | 76.7      | (4.8)         | (6)%  |  |
| Principal transactions                           | 23.8               | 28.7      | (4.9)         | (17)% | 53.3             | 54.9      | (1.6)         | (3)%  |  |
| Other revenues                                   | 7.7                | 9.7       | (2.0)         | (20)% | 15.8             | 21.1      | (5.3)         | (25)% |  |
| Total net revenue                                | 362.9              | 385.8     | (22.9)        | (6)%  | 749.9            | 771.6     | (21.7)        | (3)%  |  |
| Total operating expense                          | 192.6              | 182.5     | 10.1          | 6%    | 395.2            | 382.5     | 12.7          | 3%    |  |
| Trading and investing income before income taxes | \$ 170.3           | \$ 203.3  | \$ (33.0)     | (16)% | \$ 354.7         | \$ 389.1  | \$ (34.4)     | (9)%  |  |
| <b>Key Metrics:</b>                              |                    |           |               |       |                  |           |               |       |  |
| DARTs  | 147,908            | 170,283   | (22,375)      | (13)% | 162,476          | 162,916   | (440)         | (0)%  |  |
| Average commission per trade                     | \$ 11.14           | \$ 11.05  | \$ 0.09       | 1%    | \$ 11.24         | \$ 11.21  | \$ 0.03       | 0%    |  |
| Margin receivables (dollars in billions)         | \$ 5.7             | \$ 4.8    | \$ 0.9        | 19%   | \$ 5.7           | \$ 4.8    | \$ 0.9        | 19%   |  |
| End of period brokerage accounts                 | 2,759,773          | 2,649,500 | 110,273       | 4%    | 2,759,773        | 2,649,500 | 110,273       | 4%    |  |
| Net new brokerage accounts                       | 24,950             | 17,523    | 7,427         | *     | 75,462           | 19,421    | 56,041        | *     |  |
| Customer assets (dollars in billions)            | \$ 185.6           | \$ 143.8  | \$ 41.8       | 29%   | \$ 185.6         | \$ 143.8  | \$ 41.8       | 29%   |  |
| Net new brokerage assets (dollars in billions)   | \$ 1.5             | \$ 2.1    | \$ (0.6)      | *     | \$ 5.4           | \$ 4.3    | \$ 1.1        | *     |  |
| Brokerage related cash (dollars in billions)     | \$ 26.3            | \$ 20.7   | \$ 5.6        | 27%   | \$ 26.3          | \$ 20.7   | \$ 5.6        | 27%   |  |

\* Percentage not meaningful.





## **Table of Contents**

Our trading and investing segment generates revenue from brokerage and banking relationships with investors and from market making and corporate services activities. This segment generates five main sources of revenue: net operating interest income; commissions; fees and service charges; principal transactions; and other revenues. Other revenues include results from providing software and services for managing equity compensation plans from our corporate customers, as we ultimately service retail investors through these corporate relationships.

Trading and investing income before income taxes decreased 16% to \$170.3 million and 9% to \$354.7 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. We continued to generate net new brokerage accounts, ending the quarter with 2.8 million accounts. Our brokerage related cash, which is one of our most profitable sources of funding, increased by \$5.6 billion when compared to the same period in 2010.

Trading and investing commissions decreased 13% to \$103.8 million and 2% to \$228.3 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. These decreases in commissions were primarily the result of a decrease in DARTs of 13% to 147,908 and a slight decrease to 162,476 for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010.

Trading and investing fees and service charges increased 1% to \$35.8 million and decreased 6% to \$71.9 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. This decrease for the six months ended June 30, 2011 was driven primarily by our elimination of all account activity fees in the second quarter of 2010.

Trading and investing principal transactions decreased 17% to \$23.8 million and 3% to \$53.3 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The decrease in principal transactions revenue was driven by a decrease in trading volumes when compared to the same periods in 2010.

Trading and investing operating expense increased 6% to \$192.6 million and 3% to \$395.2 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The increase for the three and six months ended June 30, 2011 related primarily to an increase in advertising and market development expense.

As of June 30, 2011, we had approximately 2.8 million brokerage accounts, 1.0 million stock plan accounts and 0.5 million banking accounts. For the three months ended June 30, 2011 and 2010, our brokerage products contributed 68% for both periods and our banking products, which include sweep products, contributed 32% for both periods, of total trading and investing net revenue. For the six months ended June 30, 2011 and 2010, our brokerage products contributed 70% and 68%, respectively, and our banking products contributed 30% and 32%, respectively, of total trading and investing net revenue.

**Table of Contents****Balance Sheet Management**

The following table summarizes balance sheet management financial information and key metrics as of and for the three and six months ended June 30, 2011 and 2010 (dollars in millions):

|  | Three Months Ended |            | Variance      |         | Six Months Ended |            | Variance      |         |
|--|--------------------|------------|---------------|---------|------------------|------------|---------------|---------|
|  | June 30,           |            | 2011 vs. 2010 |         | June 30,         |            | 2011 vs. 2010 |         |
|  | 2011               | 2010       | Amount        | %       | 2011             | 2010       | Amount        | %       |
| Net operating interest income                              | \$ 123.7           | \$ 109.6   | \$ 14.1       | 13%     | \$ 244.5         | \$ 236.3   | \$ 8.2        | 3%      |
| Fees and service charges                                   | 0.8                | (0.2)      | 1.0           | *       | 1.9              | 0.8        | 1.1           | 144%    |
| Gains on loans and securities, net                         | 31.4               | 48.9       | (17.5)        | (36)%   | 63.6             | 78.0       | (14.4)        | (18)%   |
| Net impairment   | (2.9)              | (12.2)     | 9.3           | (76)%   | (8.9)            | (20.8)     | 11.9          | (57)%   |
| Other revenues   | 1.8                | 2.1        | (0.3)         | (13)%   | 3.3              | 4.7        | (1.4)         | (29)%   |
| Total net revenue  | 154.8              | 148.2      | 6.6           | 4%      | 304.4            | 299.0      | 5.4           | 2%      |
| Provision for loan losses                                  | 103.1              | 165.7      | (62.6)        | (38)%   | 219.2            | 433.6      | (214.4)       | (49)%   |
| Total operating expense                                    | 58.3               | 53.2       | 5.1           | 9%      | 111.7            | 105.0      | 6.7           | 6%      |
| Balance sheet management loss before income taxes          | \$ (6.6)           | \$ (70.7)  | \$ 64.1       | (91)%   | \$ (26.5)        | \$ (239.6) | \$ 213.1      | (89)%   |
| <b>Key Metrics:</b>  |                    |            |               |         |                  |            |               |         |
| Special mention loan delinquencies                         | \$ 461.3           | \$ 660.3   | \$ (199.0)    | (30)%   | \$ 461.3         | \$ 660.3   | \$ (199.0)    | (30)%   |
| Allowance for loan losses                                  | \$ 878.6           | \$ 1,102.9 | \$ (224.3)    | (20)%   | \$ 878.6         | \$ 1,102.9 | \$ (224.3)    | (20)%   |
| Allowance for loan losses as a % of gross loans receivable | 6.04%              | 6.09%      | *             | (0.05)% | 6.04%            | 6.09%      | *             | (0.05)% |

\* Percentage not meaningful.

Our balance sheet management segment generates revenue from managing loans previously originated or purchased from third parties as well as our customer cash and deposit relationships to generate additional net operating interest income.

The balance sheet management segment reported a loss of \$6.6 million and \$26.5 million for the three and six months ended June 30, 2011, respectively. The losses in the segment are due primarily to the provision for loan losses of \$103.1 million and \$219.2 million for the three and six months ended June 30, 2011, respectively.

Gains on loans and securities, net were \$31.4 million and \$63.6 million for the three and six months ended June 30, 2011, respectively, compared to \$48.9 million and \$78.0 million for the same periods in 2010. The gains on loans and securities, net were due primarily to gains on the sale of certain agency mortgage-backed securities and agency debentures during the three and six months ended June 30, 2011.

We recognized \$2.9 million and \$8.9 million of net impairment during the three and six months ended June 30, 2011, respectively, on certain securities in the non-agency CMO portfolio due to continued deterioration in the expected credit performance of the underlying loans in those specific securities. The net impairment included gross OTTI of \$2.0 million and \$6.9 million for the three and six months ended June 30, 2011. The amount that had been previously recorded through other comprehensive income and was reclassified into earnings during the three and six months ended June 30, 2011 was \$0.9 million and \$2.0 million, respectively.

Provision for loan losses decreased 38% to \$103.1 million and 49% to \$219.2 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The decrease in provision for loan losses was driven by improving credit trends, as evidenced by the lower levels of at-risk (30-179 days delinquent) loans in the one- to four- family and home equity loan portfolios.

Total balance sheet management operating expense increased 9% to \$58.3 million and 6% to \$111.7 million for the three and six months ended June 30, 2011, respectively, compared to the same periods in 2010. The



**Table of Contents**

increase in operating expense for the three and six months ended June 30, 2011 was due primarily to increased FDIC insurance premiums as a result of an industry wide change in the FDIC insurance premium assessment calculation.

**Corporate/Other**

The following table summarizes corporate/other financial information for the three and six months ended June 30, 2011 and 2010 (dollars in millions):

|  | Three Months |           | Variance      |       | Six Months Ended |            | Variance      |       |
|--|--------------|-----------|---------------|-------|------------------|------------|---------------|-------|
|  | Ended        |           | 2011 vs. 2010 |       | June 30,         |            | 2011 vs. 2010 |       |
|  | 2011         | 2010      | Amount        | %     | 2011             | 2010       | Amount        | %     |
| Total net revenue                                | \$ (0.0)     | \$ (0.0)  | \$            | *     | \$ (0.0)         | \$ (0.0)   | \$            | *     |
| Compensation and benefits                        | 17.3         | 19.9      | (2.6)         | (13)% | 35.0             | 41.0       | (6.0)         | (15)% |
| Professional services                            | 8.0          | 7.0       | 1.0           | 13%   | 17.5             | 15.4       | 2.1           | 14%   |
| Communications                                   | 0.4          | 0.5       | (0.1)         | (15)% | 0.7              | 0.9        | (0.2)         | (26)% |
| Occupancy and equipment                          | 0.8          | 0.7       | 0.1           | 9%    | 1.8              | 1.4        | 0.4           | 30%   |
| Depreciation and amortization                    | 4.7          | 6.4       | (1.7)         | (27)% | 9.4              | 11.3       | (1.9)         | (16)% |
| Facility restructuring and other exit activities | 2.1          | (1.8)     | 3.9           | *     | 5.6              | 1.5        | 4.1           | *     |
| Other operating expenses                         | 6.8          | 7.3       | (0.5)         | (6)%  | 12.0             | 12.1       | (0.1)         | (1)%  |
| Total operating expense                          | 40.1         | 40.0      | 0.1           | 0%    | 82.0             | 83.6       | (1.6)         | (2)%  |
| Operating loss                                   | (40.1)       | (40.0)    | (0.1)         | 0%    | (82.0)           | (83.6)     | 1.6           | (2)%  |
| Total other income (expense)                     | (41.0)       | (40.4)    | (0.6)         | 1%    | (84.6)           | (79.5)     | (5.1)         | 6%    |
| Corporate/other loss before income taxes         | \$ (81.1)    | \$ (80.4) | \$ (0.7)      | 1%    | \$ (166.6)       | \$ (163.1) | \$ (3.5)      | 2%    |

\* Percentage not meaningful.

Our corporate/other category includes costs that are centrally-managed, technology related costs incurred to support centrally-managed functions, restructuring and other exit activities, corporate debt and corporate investments.

Our corporate/other loss before income taxes was \$81.1 million and \$166.6 million for the three and six months ended June 30, 2011, compared to \$80.4 million and \$163.1 million, respectively, for the same periods in 2010. Total other income (expense) consisted primarily of \$44.8 million and \$88.1 million in corporate interest expense for the three and six months ended June 30, 2011, respectively, on interest-bearing corporate debt. Offsetting interest expense for the three and six months ended June 30, 2011 was a \$3.1 million gain on early extinguishment of debt related to the call of the 7<sup>3</sup>/<sub>8</sub>% Notes in the second quarter of 2011.

**Table of Contents****BALANCE SHEET OVERVIEW**

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

|   | June 30,<br>2011   | December<br>31,<br>2010 | Variance<br>2011 vs. 2010 |             |
|---|--------------------|-------------------------|---------------------------|-------------|
|   |                    |                         | Amount                    | %           |
| <b>Assets:</b>  |                    |                         |                           |             |
| Cash and equivalents  | \$ 1,369.7         | \$ 2,374.3              | \$ (1,004.6)              | (42)%       |
| Cash and investments required to be segregated under federal or other regulations | 668.0              | 609.5                   | 58.5                      | 10%         |
| Securities <sup>(1)</sup>   | 19,947.0           | 17,330.6                | 2,616.4                   | 15%         |
| Margin receivables  | 5,661.0            | 5,120.6                 | 540.4                     | 11%         |
| Loans, net  | 13,679.7           | 15,127.4                | (1,447.7)                 | (10)%       |
| Investment in FHLB stock  | 152.8              | 164.4                   | (11.6)                    | (7)%        |
| Other <sup>(2)</sup>  | 5,506.1            | 5,646.2                 | (140.1)                   | (2)%        |
| <b>Total assets</b>   | <b>\$ 46,984.3</b> | <b>\$ 46,373.0</b>      | <b>\$ 611.3</b>           | <b>1%</b>   |
| <b>Liabilities and shareholders' equity:</b>                                      |                    |                         |                           |             |
| Deposits  | \$ 25,998.1        | \$ 25,240.3             | \$ 757.8                  | 3%          |
| Wholesale borrowings <sup>(3)</sup>   | 7,915.0            | 8,620.0                 | (705.0)                   | (8)%        |
| Customer payables   | 5,341.7            | 5,020.1                 | 321.6                     | 6%          |
| Corporate debt  | 1,543.4            | 2,145.9                 | (602.5)                   | (28)%       |
| Other liabilities   | 1,373.8            | 1,294.3                 | 79.5                      | 6%          |
| <b>Total liabilities</b>  | <b>42,172.0</b>    | <b>42,320.6</b>         | <b>(148.6)</b>            | <b>(0)%</b> |
| <b>Shareholders' equity</b>   | <b>4,812.3</b>     | <b>4,052.4</b>          | <b>759.9</b>              | <b>19%</b>  |
| <b>Total liabilities and shareholders' equity</b>                                 | <b>\$ 46,984.3</b> | <b>\$ 46,373.0</b>      | <b>\$ 611.3</b>           | <b>1%</b>   |

(1) Includes balance sheet line items trading, available-for-sale and held-to-maturity securities.

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

(3) Includes balance sheet line items securities sold under agreements to repurchase and FHLB advances and other borrowings.

**Securities**

Trading, available-for-sale and held-to-maturity securities are summarized as follows (dollars in millions):

|  | June 30,<br>2011 | December 31,<br>2010 | Variance<br>2011 vs. 2010 |      |
|--|------------------|----------------------|---------------------------|------|
|  |                  |                      | Amount                    | %    |
| Trading securities                         | \$ 79.9          | \$ 62.2              | \$ 17.7                   | 28%  |
| Available-for-sale securities:             |                  |                      |                           |      |
| Residential mortgage-backed securities:    |                  |                      |                           |      |
| Agency mortgage-backed securities and CMOs | \$ 13,578.4      | \$ 12,898.1          | \$ 680.3                  | 5%   |
| Non-agency CMOs                            | 375.7            | 395.4                | (19.7)                    | (5)% |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  |             |             |            |       |
|--|-------------|-------------|------------|-------|
| Total residential mortgage-backed securities | 13,954.1    | 13,293.5    | 660.6      | 5%    |
| Investment securities                        | 1,078.5     | 1,512.2     | (433.7)    | (29)% |
| Total available-for-sale securities          | \$ 15,032.6 | \$ 14,805.7 | \$ 226.9   | 2%    |
| <b>Held-to-maturity securities:</b>          |             |             |            |       |
| Agency mortgage-backed securities and CMOs   | \$ 4,076.2  | \$ 1,928.6  | \$ 2,147.6 | 111%  |
| Investment securities                        | 758.3       | 534.1       | 224.2      | 42%   |
| Total held-to-maturity securities            | \$ 4,834.5  | \$ 2,462.7  | \$ 2,371.8 | 96%   |
| Total securities                             | \$ 19,947.0 | \$ 17,330.6 | \$ 2,616.4 | 15%   |

**Table of Contents**

Securities represented 42% and 37% of total assets at June 30, 2011 and December 31, 2010, respectively. The increase in available-for-sale securities was due primarily to an increase of \$0.7 billion in agency mortgage-backed securities and CMOs, partially offset by the sale or call of agency debentures. The increase in held-to-maturity securities was due primarily to the purchase of \$2.1 billion in agency mortgage-backed securities and CMOs.

**Loans, Net**

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

|                           | June 30,<br>2011   | December 31,<br>2010 | Variance<br>2011 vs. 2010 |              |
|---------------------------|--------------------|----------------------|---------------------------|--------------|
|                           |                    |                      | Amount                    | %            |
| Loans held-for-sale       | \$ 4.7             | \$ 5.5               | \$ (0.8)                  | (15)%        |
| One- to four-family       | 7,347.2            | 8,170.3              | (823.1)                   | (10)%        |
| Home equity               | 5,833.6            | 6,410.3              | (576.7)                   | (9)%         |
| Consumer and other        | 1,262.0            | 1,443.4              | (181.4)                   | (13)%        |
| Unamortized premiums, net | 110.8              | 129.1                | (18.3)                    | (14)%        |
| Allowance for loan losses | (878.6)            | (1,031.2)            | 152.6                     | (15)%        |
| <b>Total loans, net</b>   | <b>\$ 13,679.7</b> | <b>\$ 15,127.4</b>   | <b>\$ (1,447.7)</b>       | <b>(10)%</b> |

Loans, net decreased 10% to \$13.7 billion at June 30, 2011 from \$15.1 billion at December 31, 2010. This decline was due primarily to the strategy of reducing balance sheet risk by allowing the loan portfolio to pay down, which we plan to do for the foreseeable future.

**Deposits**

Deposits are summarized as follows (dollars in millions):

|   | June 30,<br>2011   | December 31,<br>2010 | Variance<br>2011 vs. 2010 |           |
|---|--------------------|----------------------|---------------------------|-----------|
|   |                    |                      | Amount                    | %         |
| Sweep deposits                          | \$ 17,582.7        | \$ 16,139.6          | \$ 1,443.1                | 9%        |
| Complete savings deposits               | 6,227.7            | 6,683.6              | (455.9)                   | (7)%      |
| Other money market and savings deposits | 1,083.9            | 1,092.9              | (9.0)                     | (1)%      |
| Checking deposits                       | 794.6              | 825.6                | (31.0)                    | (4)%      |
| Certificates of deposit                 | 265.5              | 407.1                | (141.6)                   | (35)%     |
| Brokered certificates of deposit        | 43.7               | 91.5                 | (47.8)                    | (52)%     |
| <b>Total deposits</b>                   | <b>\$ 25,998.1</b> | <b>\$ 25,240.3</b>   | <b>\$ 757.8</b>           | <b>3%</b> |

Deposits represented 62% and 60% of total liabilities at June 30, 2011 and December 31, 2010, respectively. At June 30, 2011, 93% of our customer deposits were covered by FDIC insurance. Deposits generally provide the benefit of lower interest costs compared with wholesale funding alternatives. The increase in deposits of \$0.8 billion during the six months ended June 30, 2011 was driven primarily by an increase of \$1.4 billion in sweep deposits, partially offset by decreases of \$0.5 billion and \$0.1 billion in complete savings deposits and certificates of deposit, respectively.



**Table of Contents**

The deposits balance is a component of the total customer cash and deposits balance reported as a customer activity metric of \$34.7 billion and \$33.5 billion at June 30, 2011 and December 31, 2010, respectively. The total customer cash and deposits balance is summarized as follows (dollars in millions):

|  | June 30,<br>2011 | December 31,<br>2010 | Variance<br>2011 vs. 2010 |       |
|--|------------------|----------------------|---------------------------|-------|
|  |                  |                      | Amount                    | %     |
| Deposits   | \$ 25,998.1      | \$ 25,240.3          | \$ 757.8                  | 3%    |
| Less: brokered certificates of deposit                 | (43.7)           | (91.5)               | 47.8                      | (52)% |
| Retail deposits  | 25,954.4         | 25,148.8             | 805.6                     | 3%    |
| Customer payables                                      | 5,341.7          | 5,020.1              | 321.6                     | 6%    |
| Customer cash balances held by third parties and other | 3,428.2          | 3,363.8              | 64.4                      | 2%    |
| Total customer cash and deposits                       | \$ 34,724.3      | \$ 33,532.7          | \$ 1,191.6                | 4%    |

**Wholesale Borrowings**

Wholesale borrowings, which consist of securities sold under agreements to repurchase and FHLB advances and other borrowings are summarized as follows (dollars in millions):

|  | June 30,<br>2011 | December 31,<br>2010 | Variance<br>2011 vs. 2010 |       |
|--|------------------|----------------------|---------------------------|-------|
|  |                  |                      | Amount                    | %     |
| Securities sold under agreements to repurchase | \$ 5,184.2       | \$ 5,888.3           | \$ (704.1)                | (12)% |
| FHLB advances                                  | \$ 2,299.7       | \$ 2,284.1           | \$ 15.6                   | 1%    |
| Subordinated debentures                        | 427.5            | 427.5                |                           | 0%    |
| Other  | 3.6              | 20.1                 | (16.5)                    | (82)% |
| Total FHLB advances and other borrowings       | \$ 2,730.8       | \$ 2,731.7           | \$ (0.9)                  | (0)%  |
| Total wholesale borrowings                     | \$ 7,915.0       | \$ 8,620.0           | \$ (705.0)                | (8)%  |

Wholesale borrowings represented 19% and 20% of total liabilities at June 30, 2011 and December 31, 2010, respectively. Securities sold under agreements to repurchase and FHLB advances are the primary wholesale funding sources of the Bank. As a result, we expect these balances to fluctuate over time as deposits and interest-earning assets fluctuate. The decrease in securities sold under agreements to repurchase of \$0.7 billion during the six months ended June 30, 2011 was due to a planned decrease in the forecasted issuance of debt. We do not anticipate another significant decrease in securities sold under agreements to repurchase in the near term.

**Table of Contents****Corporate Debt**

Corporate debt by type is shown as follows (dollars in millions):

|   | Face Value | Discount   | Fair Value<br>Hedge<br>Adjustment | Net        |
|---|------------|------------|-----------------------------------|------------|
| <b>June 30, 2011</b>  |            |            |                                   |            |
| Interest-bearing notes:   |            |            |                                   |            |
| Senior notes:   |            |            |                                   |            |
| 7 <sup>7</sup> / <sub>8</sub> % Notes, due 2015                 | \$ 243.2   | \$ (1.3)   | \$ 8.3                            | \$ 250.2   |
| 6 <sup>3</sup> / <sub>4</sub> % Notes, due 2016                 | 435.0      | (8.3)      |                                   | 426.7      |
| Total senior notes  | 678.2      | (9.6)      | 8.3                               | 676.9      |
| 12 <sup>1</sup> / <sub>2</sub> % Springing lien notes, due 2017 | 930.2      | (170.5)    | 6.8                               | 766.5      |
| Total interest-bearing notes                                    | 1,608.4    | (180.1)    | 15.1                              | 1,443.4    |
| Non-interest-bearing debt:                                      |            |            |                                   |            |
| 0% Convertible debentures, due 2019                             | 100.0      |            |                                   | 100.0      |
| Total corporate debt  | \$ 1,708.4 | \$ (180.1) | \$ 15.1                           | \$ 1,543.4 |

|   | Face<br>Value | Discount   | Fair Value<br>Hedge<br>Adjustment | Net        |
|---|---------------|------------|-----------------------------------|------------|
| <b>December 31, 2010</b>  |               |            |                                   |            |
| Interest-bearing notes:   |               |            |                                   |            |
| Senior notes:   |               |            |                                   |            |
| 8% Notes, due 2011  | \$ 3.6        | \$         | \$                                | \$ 3.6     |
| 7 <sup>3</sup> / <sub>8</sub> % Notes, due 2013                 | 414.7         | (2.5)      | 15.1                              | 427.3      |
| 7 <sup>7</sup> / <sub>8</sub> % Notes, due 2015                 | 243.2         | (1.5)      | 9.3                               | 251.0      |
| Total senior notes  | 661.5         | (4.0)      | 24.4                              | 681.9      |
| 12 <sup>1</sup> / <sub>2</sub> % Springing lien notes, due 2017 | 930.2         | (177.5)    | 7.3                               | 760.0      |
| Total interest-bearing notes                                    | 1,591.7       | (181.5)    | 31.7                              | 1,441.9    |
| Non-interest-bearing debt:                                      |               |            |                                   |            |
| 0% Convertible debentures, due 2019                             | 704.0         |            |                                   | 704.0      |
| Total corporate debt  | \$ 2,295.7    | \$ (181.5) | \$ 31.7                           | \$ 2,145.9 |

Corporate debt decreased 28% to \$1.5 billion at June 30, 2011 from \$2.1 billion at December 31, 2010. The decline was due to the conversion of approximately \$604 million in convertible debentures into 58.4 million shares of common stock during the six months ended June 30, 2011. The remaining face value of the convertible debentures as of June 30, 2011 was \$100.0 million.

During the second of quarter of 2011, we issued an aggregate principal amount of \$435 million in 6<sup>3</sup>/<sub>4</sub>% Notes, and used the proceeds to redeem all of the outstanding 7<sup>3</sup>/<sub>8</sub>% Notes due September 2013, approximately \$415 million aggregate principal amount, including paying the associated redemption premium, accrued interest and related fees and expenses.

**Table of Contents****Shareholders' Equity**

The activity in shareholders' equity during the six months ended June 30, 2011 is summarized as follows (dollars in millions):

|   | Common Stock/<br>Additional Paid-In<br>Capital | Accumulated<br>Deficit/Other<br>Comprehensive Loss | Total      |
|---|--|--|------------|
| Beginning balance, December 31, 2010          | \$ 6,642.9                                     | \$ (2,590.5)                                       | \$ 4,052.4 |
| Net income                                    |  | 92.4   | 92.4       |
| Conversions of convertible debentures         | 603.9  |  | 603.9      |
| Net change from available-for-sale securities |  | 79.7   | 79.7       |
| Net change from cash flow hedging instruments |  | (23.4)   | (23.4)     |
| Other <sup>(1)</sup>                          | 3.8  | 3.5  | 7.3        |
| Ending balance, June 30, 2011                 | \$ 7,250.6                                     | \$ (2,438.3)                                       | \$ 4,812.3 |

<sup>(1)</sup> Other includes employee share-based compensation accounting and changes in accumulated other comprehensive loss from foreign currency translation. Shareholders' equity increased 19% to \$4.8 billion at June 30, 2011 from \$4.1 billion at December 31, 2010. This increase was due primarily to the conversion of \$603.9 million in convertible debentures into 58.4 million shares of common stock during the six months ended June 30, 2011.

**LIQUIDITY AND CAPITAL RESOURCES**

We have established liquidity and capital policies to support the successful execution of our business strategies, while ensuring ongoing and sufficient liquidity through the business cycle. These policies are especially important during periods of stress in the financial markets, which have been ongoing since the fourth quarter of 2007 and could continue for some time.

We believe liquidity is of critical importance to the Company and especially important within E\*TRADE Bank. The objective of our policies is to ensure that we can meet our corporate and banking liquidity needs under both normal operating conditions and under periods of stress in the financial markets. Our corporate liquidity needs are primarily driven by the amount of principal and interest due on our corporate debt as well as any capital needs at E\*TRADE Bank. Our banking liquidity needs are driven primarily by the level and volatility of our customer deposits. Management maintains an extensive set of liquidity sources and monitors certain business trends and market metrics closely in an effort to ensure we have sufficient liquidity and to avoid dependence on other more expensive sources of funding. Management believes the following sources of liquidity are of critical importance in maintaining ample funding for liquidity needs: Corporate cash, Bank cash, deposits and unused FHLB borrowing capacity. Management believes that within deposits, sweep deposits are of particular importance as they are the most stable source of liquidity for E\*TRADE Bank when compared to non-sweep deposits. Overall, management believes that these liquidity sources, which we expect to fluctuate in any given period, are more than sufficient to meet our needs for the foreseeable future.

Capital is generated primarily through our business operations and our capital market activities. The trading and investing segment has been profitable and a generator of capital for the past seven years and we expect that trend to continue. The balance sheet management segment has generated cumulative losses in prior periods, driven primarily by the provision for loan losses; we believe the provision for loan losses will decline in 2011 as compared to 2010 but is subject to variability from quarter to quarter. The primary business operations of both the trading and investing and balance sheet management segments are contained within E\*TRADE Bank; therefore, we believe a key indicator of the capital generated or used in our business operations is the level of regulatory capital in E\*TRADE Bank. During the six months ended June 30, 2011, E\*TRADE Bank generated

**Table of Contents**

an additional \$284 million of risk-based capital in excess of the level our regulators define as well-capitalized. The continued generation of additional risk-based capital is a positive indicator that the regulatory capital in E\*TRADE Bank is sufficient to meet its operating needs.

**Consolidated Cash and Equivalents**

The consolidated cash and equivalents balance decreased by \$1.0 billion to \$1.4 billion for the six months ended June 30, 2011. The majority of this balance is cash held in regulated subsidiaries, primarily the Bank, outlined as follows (dollars in millions):

|  | June 30,<br>2011 | December 31,<br>2010 | Variance<br>2011 vs. 2010 |
|--|------------------|----------------------|---------------------------|
| Corporate cash                         | \$ 423.7         | \$ 470.5             | \$ (46.8)                 |
| Bank cash                              | 883.7            | 1,812.1              | (928.4)                   |
| International brokerage and other cash | 62.3             | 91.7                 | (29.4)                    |
| <br>Total consolidated cash            | <br>\$ 1,369.7   | <br>\$ 2,374.3       | <br>\$ (1,004.6)          |

Corporate cash is the primary source of liquidity at the parent company. We define corporate cash as cash held at the parent company as well as cash held in certain subsidiaries that can distribute cash to the parent company without any regulatory approval. We believe corporate cash is a useful measure of the parent company's liquidity as it is the primary source of capital above and beyond the capital deployed in our regulated subsidiaries. Corporate cash can fluctuate in any given quarter and is impacted primarily by tax settlements, approval and timing of subsidiary dividends, debt service costs and other unallocated overhead costs.

**Liquidity Available from Subsidiaries**

Liquidity available to the Company from its subsidiaries is limited by regulatory requirements. In addition, E\*TRADE Bank may not pay dividends to the parent company without approval from its regulator. Loans by E\*TRADE Bank to the parent company and its other non-bank subsidiaries are subject to various quantitative, arm's length, collateralization and other requirements.

We maintain capital in excess of regulatory minimums at our regulated subsidiaries, the most significant of which is E\*TRADE Bank. As of June 30, 2011, we held \$1.4 billion of risk-based total capital at E\*TRADE Bank in excess of the regulatory minimum level required to be considered well capitalized. In the current credit environment, we plan to maintain excess risk-based total capital at E\*TRADE Bank in order to enhance our ability to absorb credit losses while still maintaining well capitalized status. However, events beyond management's control, such as a continued deterioration in residential real estate and credit markets, could adversely affect future earnings and E\*TRADE Bank's ability to meet its future capital requirements.

The Company's broker-dealer subsidiaries are subject to capital requirements determined by their respective regulators. At June 30, 2011 and December 31, 2010, all of our brokerage subsidiaries met their minimum net capital requirements. Our broker-dealer subsidiaries had excess net capital of \$720.7 million<sup>1</sup> at June 30, 2011, an increase of \$71.5 million from December 31, 2010. While we cannot assure that we would obtain regulatory approval in the future to withdraw any of this excess net capital, \$539.0 million is available for dividend while still maintaining a capital level above regulatory early warning guidelines.

<sup>1</sup> The excess net capital of the broker-dealer subsidiaries at June 30, 2011 included \$460.9 million and \$188.8 million of excess net capital at E\*TRADE Clearing LLC and E\*TRADE Securities LLC, respectively, which are subsidiaries of E\*TRADE Bank and are also included in the excess risk-based capital of E\*TRADE Bank.

**Table of Contents****Financial Regulatory Reform Legislation and Basel III Accords**

We believe the majority of the changes in the Dodd-Frank Act will have no material impact on our business. We believe, however, that the implementation of holding company capital requirements is relevant to us as the parent company is not currently subject to capital requirements. These requirements are expected to become effective within the next four years. We believe the requirements are an important measure of our capital strength and we have begun to track these ratios internally, using the current capital ratios that apply to bank holding companies, as we plan for this future requirement. The Tier I leverage, Tier I risk-based capital and total risk-based capital ratios are non-GAAP measures as the holding company is not yet held to these capital requirements and are calculated as follows (dollars in millions):

|   | June 30,<br>2011   | December 31,<br>2010 | Variance<br>2011 vs. 2010 |            |
|---|--------------------|----------------------|---------------------------|------------|
|   |                    |                      | Amount                    | %          |
| Shareholders equity   | \$ 4,812.3         | \$ 4,052.4           | \$ 759.9                  | 19%        |
| Deduct:   |                    |                      |                           |            |
| Losses in other comprehensive income on available-for-sale debt securities and cash flow hedges, net of tax | (383.6)            | (439.9)              | 56.3                      | (13)%      |
| Goodwill and other intangible assets, net of deferred tax liabilities                                       | 1,992.8            | 2,046.4              | (53.6)                    | (3)%       |
| Add:  |                    |                      |                           |            |
| Qualifying restricted core capital elements   | 433.0              | 433.0                |                           | 0%         |
| <b>Subtotal</b>   | <b>3,636.1</b>     | <b>2,878.9</b>       | <b>757.2</b>              | <b>26%</b> |
| Deduct:   |                    |                      |                           |            |
| Disallowed servicing assets and deferred tax assets   | 1,248.4            | 1,351.3              | (102.9)                   | (8)%       |
| <b>Tier I capital</b>   | <b>2,387.7</b>     | <b>1,527.6</b>       | <b>860.1</b>              | <b>56%</b> |
| Add:  |                    |                      |                           |            |
| Allowable allowance for loan losses   | 296.7              | 295.6                | 1.1                       | 0%         |
| <b>Total capital</b>  | <b>2,684.4</b>     | <b>1,823.2</b>       | <b>861.2</b>              | <b>47%</b> |
| <b>Total average assets</b>   | <b>47,198.5</b>    | <b>46,043.4</b>      | <b>1,155.1</b>            | <b>3%</b>  |
| Deduct:   |                    |                      |                           |            |
| Goodwill and other intangible assets, net of deferred tax liabilities                                       | 1,992.8            | 2,046.4              | (53.6)                    | (3)%       |
| <b>Subtotal</b>   | <b>45,205.7</b>    | <b>43,997.0</b>      | <b>1,208.7</b>            | <b>3%</b>  |
| Deduct:   |                    |                      |                           |            |
| Disallowed servicing assets and deferred tax assets   | 1,248.4            | 1,351.3              | (102.9)                   | (8)%       |
| <b>Average total assets for leverage capital purposes</b>   | <b>\$ 43,957.3</b> | <b>\$ 42,645.7</b>   | <b>1,311.6</b>            | <b>3%</b>  |
| <b>Total risk-weighted assets<sup>(1)</sup></b>   | <b>23,154.7</b>    | <b>22,915.8</b>      | <b>238.9</b>              | <b>1%</b>  |
| Tier I capital/Average total assets for leverage capital purposes   | 5.4%               | 3.6%                 | *                         | 1.8%       |
| Tier I capital/Total risk-weighted assets   | 10.3%              | 6.7%                 | *                         | 3.6%       |
| Total capital/Total risk-weighted assets  | 11.6%              | 8.0%                 | *                         | 3.6%       |

\* Percentage not meaningful.

(1) Under the regulatory guidelines for risk-based capital, on-balance sheet assets and credit equivalent amounts of derivatives and off-balance sheet items are assigned to one of several broad risk categories according to the obligor or, if relevant, the guarantor or the nature of any collateral. The aggregate dollar

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

amount in each risk category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are aggregated for determining total risk-weighted assets.

**Table of Contents**

During the first half of 2011, \$603.9 million in convertible debentures were converted into 58.4 million shares of common stock, which improved our holding company ratios. The increase to capital as a result of these additional conversions raised our estimated holding company capital ratios to exceed the well capitalized minimums under current bank holding company guidelines. As of June 30, 2011, the parent company Tier I leverage ratio was approximately 5.4% compared to the minimum ratio required to be well capitalized of 5%, the Tier I risk-based capital ratio was approximately 10.3% compared to the minimum ratio required to be well capitalized of 6%, and the total risk-based capital ratio was approximately 11.6% compared to the minimum ratio required to be well capitalized of 10%.

We have also begun to track our Tier I common ratio internally, which is a non-GAAP measure and currently has no mandated minimum or well capitalized standard. We believe this ratio is an important measure of our capital strength. The Tier I common ratio is defined as the Tier I capital less elements of Tier I capital that are not in the form of common equity, such as trust preferred securities, divided by total risk-weighted assets. As of June 30, 2011, the parent company Tier I common ratio was approximately 8.4%. The following table shows the calculation of Tier I common ratio (dollars in millions):

|   | June 30,<br>2011 | December 31,<br>2010 | Variance<br>2011 vs. 2010 |            |
|---|------------------|----------------------|---------------------------|------------|
|   |                  |                      | Amount                    | %          |
| Shareholders equity   | \$ 4,812.3       | \$ 4,052.4           | \$ 759.9                  | 19%        |
| Deduct:   |                  |                      |                           |            |
| Losses in other comprehensive income on available-for-sale debt securities and cash flow hedges, net of tax | (383.6)          | (439.9)              | 56.3                      | (13)%      |
| Goodwill and other intangible assets, net of deferred tax liabilities                                       | 1,992.8          | 2,046.4              | (53.6)                    | (3)%       |
| <b>Subtotal</b>   | <b>3,203.1</b>   | <b>2,445.9</b>       | <b>757.2</b>              | <b>31%</b> |
| Deduct:   |                  |                      |                           |            |
| Disallowed servicing assets and deferred tax assets   | 1,248.4          | 1,351.3              | (102.9)                   | (8)%       |
| <b>Tier I common</b>  | <b>1,954.7</b>   | <b>1,094.6</b>       | <b>860.1</b>              | <b>79%</b> |
| <b>Total risk-weighted assets</b>   | <b>23,154.7</b>  | <b>22,915.8</b>      | <b>238.9</b>              | <b>1%</b>  |
| Tier I common/Total risk-weighted assets  | 8.4%             | 4.8%                 | *                         | 3.6%       |

\* Percentage not meaningful.

The Federal Reserve Bank announced that it expects to issue a notice of proposed rule-making in 2011 that will outline how the Basel III Accords will be implemented for U.S. institutions. We will continue to monitor the ongoing rule-making process to assess both the timing and the impact of the Dodd-Frank Act and Basel III Accords on our business.

**Other Sources of Liquidity**

We also maintain \$350 million in uncommitted financing to meet margin lending needs. At June 30, 2011, there were no outstanding balances and the full \$350 million was available.

We rely on borrowed funds, from sources such as securities sold under agreements to repurchase and FHLB advances, to provide liquidity for E\*TRADE Bank. Our ability to borrow these funds is dependent upon the continued availability of funding in the wholesale borrowings market. At June 30, 2011, E\*TRADE Bank had approximately \$3.1 billion in additional collateralized borrowing capacity with the FHLB. We also have the ability to generate liquidity in the form of additional deposits by raising the yield on our customer deposit accounts.

**Off-Balance Sheet Arrangements**

We enter into various off-balance-sheet arrangements in the ordinary course of business, primarily to meet the needs of our customers and to reduce our own exposure to interest rate risk. These arrangements include firm





---

## **Table of Contents**

commitments to extend credit and letters of credit. Additionally, we enter into guarantees and other similar arrangements as part of transactions in the ordinary course of business. For additional information on each of these arrangements, see Item 1. Consolidated Financial Statements (Unaudited).

### **RISK MANAGEMENT**

As a financial services company, we are exposed to risks in every component of our business. The identification and management of existing and potential risks are the keys to effective risk management. Our risk management framework, principles and practices support decision-making, improve the success rate for new initiatives and strengthen the organization. Our goal is to balance risks and rewards through effective risk management. Risks cannot be completely eliminated; however, we do believe risks can be identified and managed within the Company's risk tolerance.

Our businesses expose us to the following four major categories of risk that often overlap:

*Credit Risk* the risk of loss resulting from adverse changes in the ability or willingness of a borrower or counterparty to meet the agreed-upon terms of their financial obligations.

*Liquidity Risk* the risk of loss resulting from the inability to meet current and future cash flow and collateral needs.

*Interest Rate Risk* the risk of loss from adverse changes in interest rates, which could cause fluctuations in our long-term earnings or in the value of the Company's net assets.

*Operational Risk* the risk of loss resulting from fraud, inadequate controls or the failure of the internal controls process, third party vendor issues, processing issues and external events.

For additional information on liquidity risk, see Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources. For additional information about our interest rate risk, see Item 3. Quantitative and Qualitative Disclosures about Market Risk. Operational risk and the management of risk are more fully described in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2010. We are also subject to other risks that could impact our business, financial condition, results of operations or cash flows in future periods. See Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2010, and as updated in this report.

#### ***Credit Risk Management***

Our primary sources of credit risk are our loan and securities portfolios, where risk results from extending credit to customers and purchasing securities, respectively. The degree of credit risk associated with our loans and securities varies based on many factors including the size of the transaction, the credit characteristics of the borrower, features of the loan product or security, the contractual terms of the related documents and the availability and quality of collateral. Credit risk is one of the most common risks in financial services and is one of our most significant risks.

Credit risk is monitored by our Credit Risk Committee, whose objective is to monitor current and expected market conditions and the associated probable impact on the Company's credit risk. The Credit Risk Committee establishes credit risk guidelines in accordance with the Company's strategic objectives and existing policies. The Credit Risk Committee reviews investment and lending activities involving credit risk to ensure consistency with those established guidelines. These reviews involve an analysis of portfolio balances, delinquencies, losses, recoveries, default management and collateral liquidation performance, as well as, any credit risk mitigation efforts relating to the portfolios. In addition, the Credit Risk Committee reviews and approves credit related counterparties engaged in financial transactions with the Company.

---

## **Table of Contents**

### *Loss Mitigation*

We have a credit management team that focuses on the mitigation of potential losses in the loan portfolio. Through a variety of strategies, including voluntary line closures, automatically freezing lines on all delinquent accounts, and freezing lines on loans with materially reduced home equity, we have reduced our exposure to open home equity lines from a high of over \$7 billion in 2007 to \$0.5 billion as of June 30, 2011.

We also have an active loan modification program that focuses on the mitigation of potential losses in the loan portfolio. We consider modifications in which we made an economic concession to a borrower experiencing financial difficulty a troubled debt restructuring ( TDR ). During the six months ended June 30, 2011, we modified \$274.4 million and \$62.3 million of one- to four-family and home equity loans, respectively, in which the modification was considered a TDR.

We also processed minor modifications on a number of loans through traditional collections actions taken in the normal course of servicing delinquent accounts. These actions typically result in an insignificant delay in the timing of payments; therefore, we do not consider such activities to be economic concessions to the borrowers. As of June 30, 2011 and December 31, 2010, we had \$45.6 million and \$49.9 million of mortgage loans, respectively, in which the modification was not considered a TDR due to the insignificant delay in the timing of payments. Approximately 9% and 8% of these loans were classified as nonperforming as of June 30, 2011 and December 31, 2010, respectively.

We continue to review the mortgage loan portfolio in order to identify loans to be repurchased by the originator. Our review is primarily focused on identifying loans with violations of transaction representations and warranties or material misrepresentation on the part of the seller. Any loans identified with these deficiencies are submitted to the original seller for repurchase. Approximately \$12.6 million and \$25.8 million of loans were repurchased by the original sellers for the three and six months ended June 30, 2011, respectively. A total of \$247.5 million of loans were repurchased by the original sellers since we actively started reviewing our purchased loan portfolio beginning in 2008.

We also have an initiative to assess our servicing relationships and where appropriate transfer certain mortgage loans to higher quality servicers, including servicers who specialize in handling troubled loans. We believe this initiative will improve the credit performance of the loans transferred in future periods when compared to the expected credit performance of these same loans if they had not been transferred. As of June 30, 2011, \$1.1 billion of mortgage loans were at these higher quality servicers. We also completed a transfer of an additional \$1.4 billion of mortgage loans in early July 2011, which resulted in a total of \$2.5 billion, or approximately 20%, of our mortgage loan portfolio at higher quality servicers as of July 2011.

### *Underwriting Standards Originated Loans*

We provide access to real estate loans for our customers through a third party company. This product is offered as a convenience to our customers and is not one of our primary product offerings. We structured this arrangement to minimize our assumption of any of the typical risks commonly associated with mortgage lending. The third party company providing this product performs all processing and underwriting of these loans. Shortly after closing, the third party company purchases the loans from us and is responsible for the credit risk associated with these loans. We originated \$28.2 million and \$56.0 million in loans during the three and six months ended June 30, 2011, respectively, and we had commitments to originate mortgage loans of \$19.2 million at June 30, 2011.

## **CONCENTRATIONS OF CREDIT RISK**

### *Loans*

We track and review factors to predict and monitor credit risk in the mortgage loan portfolio on an ongoing basis. These factors include: loan type, estimated current loan-to-value ( LTV )/combined loan-to-value ( CLTV ) ratios, documentation type, borrowers' current credit scores, housing prices, acquisition channel, loan vintage and geographic location of the property. In economic conditions in which housing prices generally appreciate, we believe that loan type, LTV/CLTV ratios, documentation type and credit scores are the key factors

**Table of Contents**

in determining future loan performance. In a housing market with declining home prices and less credit available for refinance, we believe the LTV/CLTV ratio becomes a more important factor in predicting and monitoring credit risk. The factors are updated on at least a quarterly basis. We track and review delinquency status to predict and monitor credit risk in the consumer and other loan portfolio on an ongoing basis.

The home equity loan portfolio is primarily second lien loans on residential real estate properties, which have a higher level of credit risk than first lien mortgage loans. Approximately 14% of the home equity portfolio was in the first lien position as of June 30, 2011. We hold both the first and second lien positions in less than 1% of the home equity loan portfolio. We believe home equity loans with a CLTV of 90% or higher or a Fair Isaac Credit Organization ( FICO ) score below 700 are the loans with the highest levels of credit risk in our portfolios.

The following tables show the distribution of the mortgage loan portfolios by credit quality indicator (dollars in millions):

| Current LTV/CLTV <sup>(1)</sup>                     | One- to Four-Family |                   | Home Equity   |                   |
|---|---------------------|-------------------|---------------|-------------------|
|   | June 30, 2011       | December 31, 2010 | June 30, 2011 | December 31, 2010 |
| <=70%   | \$ 1,157.5          | \$ 1,380.3        | \$ 975.7      | \$ 1,084.9        |
| 70% - 80%   | 715.0               | 852.9             | 345.7         | 400.0             |
| 80% - 90%   | 916.0               | 1,168.3           | 475.6         | 575.9             |
| 90% - 100%  | 1,030.1             | 1,161.2           | 611.0         | 727.0             |
| >100%   | 3,528.6             | 3,607.6           | 3,425.6       | 3,622.5           |
| Total mortgage loans receivable                     | \$ 7,347.2          | \$ 8,170.3        | \$ 5,833.6    | \$ 6,410.3        |
| Average estimated current LTV/CLTV <sup>(2)</sup>   | 105.1%              | 100.8%            | 110.6%        | 107.7%            |
| Average LTV/CLTV at loan origination <sup>(3)</sup> | 70.8%               | 70.6%             | 79.2%         | 79.3%             |

(1) Current CLTV calculations for home equity loans are based on the maximum available line for home equity lines of credit and outstanding principal balance for home equity installment loans. Current property values are updated on a quarterly basis using the most recent property value data available to us. For properties in which we did not have an updated valuation, we utilized home price indices to estimate the current property value.

(2) The average estimated current LTV/CLTV ratio reflects the outstanding balance at the balance sheet date, divided by the estimated current property value.

(3) Average LTV/CLTV at loan origination calculations are based on LTV/CLTV at time of purchase for one- to four-family purchased loans and undrawn balances for home equity loans.

| Documentation Type              | One- to Four-Family |                   | Home Equity   |                   |
|---------------------------------|---------------------|-------------------|---------------|-------------------|
|                                 | June 30, 2011       | December 31, 2010 | June 30, 2011 | December 31, 2010 |
| Full documentation              | \$ 3,158.2          | \$ 3,556.5        | \$ 2,938.0    | \$ 3,201.4        |
| Low/no documentation            | 4,189.0             | 4,613.8           | 2,895.6       | 3,208.9           |
| Total mortgage loans receivable | \$ 7,347.2          | \$ 8,170.3        | \$ 5,833.6    | \$ 6,410.3        |

| Current FICO <sup>(1)</sup>     | One- to Four-Family |                   | Home Equity   |                   |
|---------------------------------|---------------------|-------------------|---------------|-------------------|
|                                 | June 30, 2011       | December 31, 2010 | June 30, 2011 | December 31, 2010 |
| >=720                           | \$ 4,009.3          | \$ 4,438.4        | \$ 3,072.8    | \$ 3,101.8        |
| 719 - 700                       | 603.1               | 709.6             | 531.2         | 665.7             |
| 699 - 680                       | 529.9               | 566.3             | 428.9         | 550.8             |
| 679 - 660                       | 400.0               | 434.8             | 352.2         | 411.7             |
| 659 - 620                       | 589.9               | 634.0             | 480.8         | 512.5             |
| <620                            | 1,215.0             | 1,387.2           | 967.7         | 1,167.8           |
| Total mortgage loans receivable | \$ 7,347.2          | \$ 8,170.3        | \$ 5,833.6    | \$ 6,410.3        |

(1) FICO scores are updated on a quarterly basis; however, as of June 30, 2011 and December 31, 2010, there were some loans for which the updated FICO scores were not available. The current FICO distribution as of June 30, 2011 included original FICO scores for approximately \$178 million and \$63 million

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

of one- to four-family and home equity loans, respectively. The current FICO distribution as of December 31, 2010 included original FICO scores for approximately \$218 million and \$168 million of one- to four-family and home equity loans, respectively.

**Table of Contents**

| <b>Acquisition Channel</b>             | <b>One- to Four-Family</b> |                          | <b>Home Equity</b>   |                          |
|--|----------------------------|--------------------------|----------------------|--------------------------|
|  | <b>June 30, 2011</b>       | <b>December 31, 2010</b> | <b>June 30, 2011</b> | <b>December 31, 2010</b> |
| Purchased from a third party           | \$ 6,021.6                 | \$ 6,687.7               | \$ 5,102.6           | \$ 5,607.2               |
| Originated by the Company              | 1,325.6                    | 1,482.6                  | 731.0                | 803.1                    |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347.2</b>          | <b>\$ 8,170.3</b>        | <b>\$ 5,833.6</b>    | <b>\$ 6,410.3</b>        |

| <b>Vintage Year</b>                    | <b>One- to Four-Family</b> |                          | <b>Home Equity</b>   |                          |
|--|----------------------------|--------------------------|----------------------|--------------------------|
|  | <b>June 30, 2011</b>       | <b>December 31, 2010</b> | <b>June 30, 2011</b> | <b>December 31, 2010</b> |
| 2003 and prior                         | \$ 272.1                   | \$ 297.6                 | \$ 345.2             | \$ 392.1                 |
| 2004                                   | 685.1                      | 759.3                    | 529.9                | 585.7                    |
| 2005                                   | 1,528.1                    | 1,713.4                  | 1,496.2              | 1,615.8                  |
| 2006                                   | 2,800.1                    | 3,108.3                  | 2,716.9              | 2,999.1                  |
| 2007                                   | 2,050.3                    | 2,276.6                  | 733.9                | 805.0                    |
| 2008                                   | 11.5                       | 15.1                     | 11.5                 | 12.6                     |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347.2</b>          | <b>\$ 8,170.3</b>        | <b>\$ 5,833.6</b>    | <b>\$ 6,410.3</b>        |

| <b>Geographic Location</b>             | <b>One- to Four-Family</b> |                          | <b>Home Equity</b>   |                          |
|--|----------------------------|--------------------------|----------------------|--------------------------|
|  | <b>June 30, 2011</b>       | <b>December 31, 2010</b> | <b>June 30, 2011</b> | <b>December 31, 2010</b> |
| California                             | \$ 3,407.2                 | \$ 3,773.6               | \$ 1,705.7           | \$ 2,038.3               |
| New York                               | 546.9                      | 613.0                    | 416.4                | 459.0                    |
| Florida                                | 515.0                      | 563.4                    | 412.9                | 456.0                    |
| Virginia                               | 313.6                      | 338.1                    | 256.9                | 278.0                    |
| Other states                           | 2,564.5                    | 2,882.2                  | 3,041.7              | 3,179.0                  |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347.2</b>          | <b>\$ 8,170.3</b>        | <b>\$ 5,833.6</b>    | <b>\$ 6,410.3</b>        |

Approximately 39% and 40% of the Company's real estate loans were concentrated in California at June 30, 2011 and December 31, 2010, respectively. No other state had concentrations of real estate loans that represented 10% or more of the Company's real estate portfolio.

*Allowance for Loan Losses*

The allowance for loan losses is management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of quantitative and qualitative factors, including the composition and quality of the portfolio; delinquency levels and trends; current and historical charge-off and loss experience; historical loss mitigation experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate; the overall availability of housing credit; and general economic conditions. The allowance for loan losses is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date as well as the estimated losses, including economic concessions to borrowers, over the estimated remaining life of loans modified in TDRs.

The general allowance for loan losses also included a specific qualitative component to account for a variety of economic and operational factors that are not directly considered in the quantitative loss model but are factors we believe may impact the level of credit losses. Examples of these economic and operational factors are the current level of unemployment and the limited historical charge-off and loss experience on modified loans. As of June 30, 2011, this qualitative component was 15% of the general allowance for loan losses and was applied by loan portfolio segment.

**Table of Contents**

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

Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. We believe the allowance for loan losses at June 30, 2011 is representative of probable losses inherent in the loan portfolio at the balance sheet date.

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

|                   | One- to Four-Family |   | Home Equity |   | Consumer and Other |   | Total      |   |
|-------------------|---------------------|---|-------------|---|--------------------|---|------------|---|
|                   | Allowance           | Allowance as a % of Loans Receivable <sup>(1)</sup> | Allowance   | Allowance as a % of Loans Receivable <sup>(1)</sup> | Allowance          | Allowance as a % of Loans Receivable <sup>(1)</sup> | Allowance  | Allowance as a % of Loans Receivable <sup>(1)</sup> |
| June 30, 2011     | \$ 326.6            | 4.43%   | \$ 493.5    | 8.36%   | \$ 58.5            | 4.58%   | \$ 878.6   | 6.04%   |
| December 31, 2010 | \$ 389.6            | 4.75%   | \$ 576.1    | 8.87%   | \$ 65.5            | 4.48%   | \$ 1,031.2 | 6.38%   |

<sup>(1)</sup> Allowance as a percentage of loans receivable is calculated based on the gross loans receivable for each respective category.

During the six months ended June 30, 2011, the allowance for loan losses decreased by \$152.6 million from the level at December 31, 2010. The decrease was driven by improving credit trends, as evidenced by the lower levels of at-risk (30-179 days delinquent) loans in the one- to four-family and home equity loan portfolios. The provision for loan losses has declined 80% from its peak of \$517.8 million in the third quarter of 2008 and we expect it to continue to decline in 2011 when compared to 2010, although performance is subject to variability from quarter to quarter.

**Troubled Debt Restructurings**

Included in allowance for loan losses was a specific allowance of \$329.2 million and \$357.0 million that was established for TDRs at June 30, 2011 and December 31, 2010, respectively. The specific allowance for these individually impaired loans represents the expected loss over the remaining life of the loan, including the economic concession to the borrower. The following table shows loans that have been modified in a TDR and the specific valuation allowance by loan portfolio as well as the percentage of total expected losses as of June 30, 2011 and December 31, 2010 (dollars in millions):

|                          | Recorded Investment in TDRs | Specific Valuation Allowance | Net Investment in TDRs | Specific Valuation Allowance as a % of TDR Loans | Total Expected Losses |
|--------------------------|-----------------------------|------------------------------|------------------------|--|-----------------------|
| <b>June 30, 2011</b>     |                             |                              |                        |  |                       |
| One- to four-family      | \$ 756.6                    | \$ 96.1                      | \$ 660.5               | 13%  | 27%                   |
| Home equity              | 452.8                       | 233.1                        | 219.7                  | 51%  | 55%                   |
| Total                    | \$ 1,209.4                  | \$ 329.2                     | \$ 880.2               | 27%  | 37%                   |
| <b>December 31, 2010</b> |                             |                              |                        |  |                       |
| One- to four-family      | \$ 548.6                    | \$ 84.5                      | \$ 464.1               | 15%  | 28%                   |
| Home equity              | 488.3                       | 272.5                        | 215.8                  | 56%  | 59%                   |
| Total                    | \$ 1,036.9                  | \$ 357.0                     | \$ 679.9               | 34%  | 42%                   |



**Table of Contents**

The recorded investment in TDRs includes the charge-offs related to certain loans that were written down to the estimated current property value less costs to sell. These charge-offs were recorded on loans that were delinquent in excess of 180 days or in bankruptcy prior to the loan modification. The total expected loss on TDRs includes both the previously recorded charge-offs and the specific valuation allowance.

The following table shows the TDRs by delinquency category as of June 30, 2011 and December 31, 2010 (dollars in millions):

|                          | TDRs Current      | TDRs 30-89 Days<br>Delinquent | TDRs 90-179 Days<br>Delinquent | TDRs 180+ Days<br>Delinquent | Total Recorded<br>Investment<br>in<br>TDRs |
|--------------------------|-------------------|-------------------------------|--------------------------------|------------------------------|--|
| <b>June 30, 2011</b>     |                   |                               |                                |                              |  |
| One- to four-family      | \$ 631.3          | \$ 58.0                       | \$ 19.7                        | \$ 47.6                      | \$ 756.6                                   |
| Home equity              | 370.6             | 47.6                          | 30.7                           | 3.9                          | 452.8                                      |
| <b>Total</b>             | <b>\$ 1,001.9</b> | <b>\$ 105.6</b>               | <b>\$ 50.4</b>                 | <b>\$ 51.5</b>               | <b>\$ 1,209.4</b>                          |
| <b>December 31, 2010</b> |                   |                               |                                |                              |  |
| One- to four-family      | \$ 420.2          | \$ 55.5                       | \$ 21.6                        | \$ 51.3                      | \$ 548.6                                   |
| Home equity              | 388.7             | 56.7                          | 39.8                           | 3.1                          | 488.3                                      |
| <b>Total</b>             | <b>\$ 808.9</b>   | <b>\$ 112.2</b>               | <b>\$ 61.4</b>                 | <b>\$ 54.4</b>               | <b>\$ 1,036.9</b>                          |

The average twelve month re-delinquency rates on loans that have been modified in a TDR were 31% and 43% for one- to four- family loans and home equity loans, respectively, as of June 30, 2011.

*Net Charge-offs*

The following table provides an analysis of the allowance for loan losses and net charge-offs for the three and six months ended June 30, 2011 and 2010 (dollars in millions):

|   | Charge-offs       | Recoveries     | Net<br>Charge-offs | % of<br>Average Loans<br>(Annualized) |
|---|-------------------|----------------|--------------------|---------------------------------------|
| <b>Three Months Ended June 30, 2011</b> |                   |                |                    |                                       |
| One- to four-family                     | \$ (59.6)         | \$             | \$ (59.6)          | 3.18%                                 |
| Home equity                             | (119.3)           | 9.0            | (110.3)            | 7.12%                                 |
| Consumer and other                      | (12.7)            | 4.5            | (8.2)              | 2.49%                                 |
| <b>Total</b>                            | <b>\$ (191.6)</b> | <b>\$ 13.5</b> | <b>\$ (178.1)</b>  | <b>4.74%</b>                          |
| <b>Three Months Ended June 30, 2010</b> |                   |                |                    |                                       |
| One- to four-family                     | \$ (69.6)         | \$             | \$ (69.6)          | 2.95%                                 |
| Home equity                             | (150.7)           | 7.5            | (143.2)            | 7.64%                                 |
| Consumer and other                      | (19.6)            | 7.3            | (12.3)             | 2.83%                                 |
| <b>Total</b>                            | <b>\$ (239.9)</b> | <b>\$ 14.8</b> | <b>\$ (225.1)</b>  | <b>4.82%</b>                          |
| <b>Six Months Ended June 30, 2011</b>   |                   |                |                    |                                       |
| One- to four-family                     | \$ (113.9)        | \$             | \$ (113.9)         | 2.96%                                 |
| Home equity                             | (253.4)           | 15.8           | (237.6)            | 7.49%                                 |
| Consumer and other                      | (30.2)            | 10.0           | (20.2)             | 2.96%                                 |



Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                                       |            |         |            |       |
|---------------------------------------|------------|---------|------------|-------|
| Total                                 | \$ (397.5) | \$ 25.8 | \$ (371.7) | 4.82% |
| <b>Six Months Ended June 30, 2010</b> |            |         |            |       |
| One- to four-family                   | \$ (172.2) | \$ 14.0 | \$ (172.2) | 3.50% |
| Home equity                           | (327.4)    | 14.0    | (313.4)    | 8.18% |
| Consumer and other                    | (42.7)     | 14.9    | (27.8)     | 3.12% |
| Total                                 | \$ (542.3) | \$ 28.9 | \$ (513.4) | 5.32% |

**Table of Contents**

Loan losses are recognized when it is probable that a loss will be incurred. The policy for both one- to four-family and home equity loans is to assess the value of the property when the loan has been delinquent for 180 days or is in bankruptcy, regardless of whether or not the property is in foreclosure, and charge-off the amount of the loan balance in excess of the estimated current property value less costs to sell. The policy is to charge-off credit cards when collection is not probable or the loan has been delinquent for 180 days and to charge-off closed-end consumer loans when the loan is 120 days delinquent or when we determine that collection is not probable.

Net charge-offs for the three and six months ended June 30, 2011 compared to the same periods in 2010 decreased by \$47.0 million and \$141.7 million, respectively. Net charge-offs declined for the eighth consecutive quarter and are now 54% below their peak of \$386.4 million in the second quarter of 2009. The overall decrease was due primarily to lower delinquencies in both one- to four- family and home equity loans. We believe net charge-offs will continue to decline in future periods when compared to the level of charge-offs in the three months ended June 30, 2011 as a result of the decline in special mention delinquencies, which is discussed below. However, because the timing and magnitude of the improvement is affected by many factors, we anticipate variability from quarter to quarter while continuing to see a downward trend over the long term. The following graph illustrates the net charge-offs by quarter:

**Table of Contents***Nonperforming Assets*

We classify loans as nonperforming when they are 90 days past due. The following table shows the comparative data for nonperforming loans and assets (dollars in millions):

|  | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|--------------------------|------------------------------|
| One- to four-family  | \$ 812.0                 | \$ 1,011.2                   |
| Home equity  | 166.5                    | 194.7                        |
| Consumer and other   | 4.6                      | 5.5                          |
| <br>   |                          |                              |
| Total nonperforming loans  | 983.1                    | 1,211.4                      |
| Real estate owned ( REO ) and other repossessed assets, net  | 116.9                    | 133.5                        |
| <br>   |                          |                              |
| Total nonperforming assets, net  | \$ 1,100.0               | \$ 1,344.9                   |
| <br>   |                          |                              |
| Nonperforming loans receivable as a percentage of gross loans receivable                                 | 6.75%                    | 7.50%                        |
| One- to four-family allowance for loan losses as a percentage of one- to four-family nonperforming loans | 40.22%                   | 38.53%                       |
| Home equity allowance for loan losses as a percentage of home equity nonperforming loans                 | 296.46%                  | 295.91%                      |
| Consumer and other allowance for loan losses as a percentage of consumer and other nonperforming loans   | 1261.25%                 | 1194.56%                     |
| Total allowance for loan losses as a percentage of total nonperforming loans                             | 89.37%                   | 85.12%                       |

During the six months ended June 30, 2011, nonperforming assets, net decreased \$244.9 million to \$1.1 billion when compared to December 31, 2010. This was attributed primarily to a decrease in nonperforming one- to four-family loans of \$199.2 million and home equity loans of \$28.2 million for the six months ended June 30, 2011 when compared to December 31, 2010.

The following graph illustrates the nonperforming loans by quarter:

The allowance as a percentage of total nonperforming loans receivable, net increased from 85.12% at December 31, 2010 to 89.37% at June 30, 2011. This increase was driven by a decrease in both one- to four-family and home equity allowance, which was more than offset by a decrease in both one- to four-family and

**Table of Contents**

home equity nonperforming loans. The balance of nonperforming loans includes loans delinquent 90 to 179 days as well as loans delinquent 180 days and greater. We believe the distinction between these two periods is important as loans delinquent 180 days and greater have been written down to their expected recovery value, whereas loans delinquent 90 to 179 days have not (unless they are in process of bankruptcy). We believe loans delinquent 90 to 179 days is an important measure because these loans are expected to drive the vast majority of future charge-offs. Additional charge-offs on loans delinquent 180 days are possible if home prices decline beyond current expectations, but we do not anticipate these charge-offs to be significant, particularly when compared to the expected charge-offs on loans delinquent 90 to 179 days. We expect the balances of one- to four-family loans delinquent 180 days and greater to decline over time; however, we expect the balances to remain at high levels in the near term due to the extensive amount of time it takes to foreclose on a property in the current real estate market.

The following table shows the comparative data for loans delinquent 90 to 179 days (dollars in millions):

|  | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|--------------------------|------------------------------|
| One- to four-family  | \$ 167.4                 | \$ 226.1                     |
| Home equity  | 115.3                    | 143.0                        |
| Consumer and other loans   | 4.2                      | 4.8                          |
| Total loans delinquent 90-179 days <sup>(1)</sup>                      | \$ 286.9                 | \$ 373.9                     |
| Loans delinquent 90-179 days as a percentage of gross loans receivable | 1.97%                    | 2.31%                        |

<sup>(1)</sup> The decrease in loans delinquent 90-179 days includes the impact of loan modification programs in which borrowers who were 90-179 days past due were made current. Loans modified as TDRs are accounted for as nonaccrual loans at the time of modification and return to accrual status after six consecutive payments are made in accordance with the modified terms.

The following graph shows the loans delinquent 90 to 179 days for each of our major loan categories:

**Table of Contents**

In addition to nonperforming assets, we monitor loans in which a borrower's past credit history casts doubt on their ability to repay a loan (special mention loans). We classify loans as special mention when they are between 30 and 89 days past due. The following table shows the comparative data for special mention loans (dollars in millions):

|  | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|--------------------------|------------------------------|
| One- to four-family  | \$ 286.0                 | \$ 388.6                     |
| Home equity  | 155.6                    | 175.6                        |
| Consumer and other loans   | 19.7                     | 25.2                         |
| <br>   |                          |                              |
| Total special mention loans <sup>(1)</sup>                                 | \$ 461.3                 | \$ 589.4                     |
| <br>   |                          |                              |
| Special mention loans receivable as a percentage of gross loans receivable | 3.17%                    | 3.65%                        |

<sup>(1)</sup> The decrease in special mention loans includes the impact of loan modification programs in which borrowers who were 30 to 89 days past due were made current. Loans modified as TDRs are accounted for as nonaccrual loans at the time of modification and return to accrual status after six consecutive payments are made in accordance with the modified terms.

The trend in special mention loan balances are generally indicative of the expected trend for charge-offs in future periods, as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge-off. One- to four-family loans are generally secured in a first lien position by real estate assets, reducing the potential loss when compared to an unsecured loan. Home equity loans are generally secured by real estate assets; however, the majority of these loans are secured in a second lien position, which substantially increases the potential loss when compared to a first lien position.

During the six months ended June 30, 2011, special mention loans decreased by \$128.1 million to \$461.3 million and are down 55% from their peak of \$1.0 billion in the fourth quarter of 2008. This decrease was largely due to a decrease in both one- to four-family and home equity special mention loans. While the level of special mention loans can fluctuate significantly in any given period, we believe the continued decrease we observed in recent quarters is an encouraging sign regarding the future credit performance of this portfolio.

The following graph illustrates the special mention loans by quarter:

**Table of Contents****Securities**

We focus primarily on security type and credit rating to monitor credit risk in our securities portfolios. We believe our highest concentration of credit risk within this portfolio is the non-agency CMO portfolio. The table below details the amortized cost of debt securities and FHLB stock by average credit ratings and type of asset as of June 30, 2011 and December 31, 2010 (dollars in millions):

| <b>June 30, 2011</b>                            | <b>AAA</b>         | <b>AA</b>      | <b>A</b>       | <b>BBB</b>     | <b>Below<br/>Investment<br/>Grade and<br/>Non-Rated</b> | <b>Total</b>       |
|---|--------------------|----------------|----------------|----------------|---|--------------------|
| Agency mortgage-backed securities and CMOs      | \$ 17,652.7        | \$             | \$             | \$             | \$  | \$ 17,652.7        |
| Agency debentures                               | 1,064.1            |                |                |                |   | 1,064.1            |
| Other agency debt securities                    | 748.1              |                |                |                |   | 748.1              |
| Non-agency CMOs                                 | 17.2               | 10.7           | 7.9            | 18.2           | 397.9   | 451.9              |
| Municipal bonds, corporate bonds and FHLB stock | 190.7              | 1.2            | 8.0            | 29.4           |   | 229.3              |
| <b>Total</b>                                    | <b>\$ 19,672.8</b> | <b>\$ 11.9</b> | <b>\$ 15.9</b> | <b>\$ 47.6</b> | <b>\$ 397.9</b>   | <b>\$ 20,146.1</b> |

| <b>December 31, 2010</b>                        | <b>AAA</b>         | <b>AA</b>      | <b>A</b>        | <b>BBB</b>     | <b>Below<br/>Investment<br/>Grade and<br/>Non-Rated</b> | <b>Total</b>       |
|---|--------------------|----------------|-----------------|----------------|---|--------------------|
| Agency mortgage-backed securities and CMOs      | \$ 14,946.9        | \$             | \$              | \$             | \$  | \$ 14,946.9        |
| Agency debentures                               | 1,543.7            |                |                 |                |   | 1,543.7            |
| Other agency debt securities                    | 502.5              |                |                 |                |   | 502.5              |
| Non-agency CMOs                                 | 37.4               | 49.3           | 115.7           | 9.0            | 278.9   | 490.3              |
| Municipal bonds, corporate bonds and FHLB stock | 194.8              |                | 17.4            | 19.9           |   | 232.1              |
| <b>Total</b>                                    | <b>\$ 17,225.3</b> | <b>\$ 49.3</b> | <b>\$ 133.1</b> | <b>\$ 28.9</b> | <b>\$ 278.9</b>   | <b>\$ 17,715.5</b> |

While the vast majority of this portfolio is AAA-rated, we concluded during the three and six months ended June 30, 2011 that approximately \$91.0 million and \$187.4 million of the non-agency CMOs in this portfolio were other-than-temporarily impaired, respectively. As a result of the deterioration in the expected credit performance of the underlying loans in those specific securities, they were written down by recording \$2.9 million and \$8.9 million of net impairment during the three and six months ended June 30, 2011, respectively. Further declines in the performance of our non-agency CMO portfolio could result in additional impairments in future periods.

**SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with GAAP. Note 1 Organization, Basis of Presentation and Summary of Significant Accounting Policies of Item 8. Financial Statements and Supplementary Data in our Annual Report on Form 10-K for the year ended December 31, 2010 contains a summary of our significant accounting policies, many of which require the use of estimates and assumptions. We believe that of our significant accounting policies, the following are noteworthy because they are based on estimates and assumptions that require complex and subjective judgments by management, which can materially impact reported results: allowance for loan losses; fair value measurements; classification and valuation of certain investments; accounting for derivative instruments; estimates of effective tax rates, deferred taxes and valuation allowances; valuation of goodwill and other intangibles; and valuation and expensing of share-based payments. These are more fully described in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2010.

## **Table of Contents**

### **GLOSSARY OF TERMS**

*Active accounts* Accounts with a balance of \$25 or more or a trade in the last six months.

*Active customers* Customers that have an account with a balance of \$25 or more or a trade in the last six months.

*Active Trader* The customer group that includes those who execute 30 or more stock or options trades per quarter.

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

*Agency* U.S. Government sponsored and federal agencies, such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporate and Government National Mortgage Association.

*ALCO* Asset Liability Committee.

*APIC* Additional paid-in capital.

*ARM* Adjustable-rate mortgage.

*Average commission per trade* Total trading and investing segment commissions revenue divided by total number of trades.

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

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

*Basis point* One one-hundredth of a percentage point.

*BOLI* Bank-Owned Life Insurance.

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

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

*CLTV* Combined loan-to-value.

*CMOs* Collateralized mortgage obligations.

*Corporate cash* Cash held at the parent company as well as cash held in certain subsidiaries that can distribute cash to the parent company without any regulatory approval.

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

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

## **Table of Contents**

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

*Debt Exchange* In the third quarter of 2009, we exchanged \$1.7 billion aggregate principal amount of our corporate debt, including \$1.3 billion principal amount of our 12 1/2% Notes and \$0.4 billion principal amount of our 8% Notes, for an equal principal amount of newly-issued non-interest-bearing convertible debentures.

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

*DIF* Deposit Insurance Fund.

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

*Enterprise interest-earning assets* Consists of the primary interest-earning assets of the Company and includes: loans, available-for-sale securities, held-to-maturity securities, margin receivables, trading securities, securities borrowed balances and cash and investments required to be segregated under regulatory guidelines that earn interest for the Company.

*Enterprise net interest income* The taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense and interest earned on customer cash held by third parties.

*Enterprise net interest margin* The enterprise net operating interest income divided by total enterprise interest-earning assets.

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

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

*Fair value* The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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

*Fannie Mae* Federal National Mortgage Association.

*FASB* Financial Accounting Standards Board.

*FDIC* Federal Deposit Insurance Corporation.

*FHLB* Federal Home Loan Bank.

*FICO* Fair Isaac Credit Organization.



## **Table of Contents**

*FINRA* Financial Industry Regulatory Authority.

*Fixed Charge Coverage Ratio* Net income (loss) before taxes, depreciation and amortization and corporate interest expense divided by corporate interest expense. This ratio indicates the Company's ability to satisfy fixed financing expenses.

*Freddie Mac* Federal Home Loan Mortgage Corporation.

*FSA* United Kingdom Financial Services Authority.

*Generally Accepted Accounting Principles ( GAAP )* Accounting principles generally accepted in the United States of America.

*Ginnie Mae* Government National Mortgage Association.

*IFRS* International Financial Reporting Standards.

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

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

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

*LIBOR* London Interbank Offered Rate. LIBOR is the interest rate at which banks borrow funds from other banks in the London wholesale money market (or interbank market).

*Long-term investor* The customer group that includes those who invest for the long term.

*LTV* Loan-to-value.

*NASDAQ* National Association of Securities Dealers Automated Quotations.

*Net new customer asset flows* The total inflows to all new and existing customer accounts less total outflows from all closed and existing customer accounts, excluding the effects of market movements in the value of customer assets.

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

*NOLs* Net operating losses.

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

**Table of Contents**

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

*NYSE* New York Stock Exchange.

*OCC* Office of the Comptroller of the Currency.

*Operating margin* Income (loss) before other income (expense), income tax benefit and discontinued operations.

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

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

*OTTI* Other-than-temporary impairment.

*Real estate owned ( REO ) and other repossessed assets* Ownership of real property by the Company, generally acquired as a result of foreclosure or repossession.

*Recovery* Cash proceeds received on a loan that had been previously charged off.

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

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

*Return on average total assets* Annualized net income divided by average assets.

*Return on average total shareholders equity* Annualized net income divided by average shareholders equity.

*Risk-weighted assets* Primarily computed by the assignment of specific risk-weightings assigned by the regulators to assets and off-balance sheet instruments for capital adequacy calculations.

*SEC* U.S. Securities and Exchange Commission.

*Special mention loans* Loans where a borrower's past credit history casts doubt on their ability to repay a loan. Loans are classified as special mention when loans are between 30 and 89 days past due.

*Stock plan trades* Trades that originate from our corporate services business, which provides software and services to assist corporate customers in managing their equity compensation plans. The trades typically occur when an employee of a corporate customer exercises a stock option or sells restricted stock.

*Sweep deposit accounts* Accounts with the functionality to transfer brokerage cash balances to and from a FDIC insured account at the banking subsidiaries.

*Sub-prime* Defined as borrowers with FICO scores less than 620 at the time of origination.

**Table of Contents**

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

*Tier 1 capital* Adjusted equity capital used in the calculation of capital adequacy ratios. Tier 1 capital equals: total shareholders' equity, plus/(less) unrealized losses (gains) on available-for-sale securities and cash flow hedges and qualifying restricted core capital elements, less disallowed servicing and deferred tax assets, goodwill and certain other intangible assets.

*Troubled Debt Restructuring ( TDR )* A loan modification that involves granting an economic concession to a borrower who is experiencing financial difficulty.

## **Table of Contents**

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion about market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2010, and as updated in this report. Market risk is exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Exposure to interest rate risk is related primarily to interest-earning assets and interest-bearing liabilities.

#### ***Interest Rate Risk***

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

Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.

The yield curve may steepen, flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.

Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At June 30, 2011, 90% of our total assets were enterprise interest-earning assets.

At June 30, 2011, approximately 67% of total assets were residential real estate loans and available-for-sale and held-to-maturity mortgage-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

When real estate loans prepay, unamortized premiums are written off. Depending on the timing of the prepayment, the write-offs of unamortized premiums may result in lower than anticipated yields. The Asset Liability Committee (ALCO) reviews estimates of the impact of changing market rates on prepayments. This information is incorporated into our interest rate risk management strategy.

Our liability structure consists of two central sources of funding: deposits and wholesale borrowings. Cash provided to us through deposits is the primary source of funding. Key deposit products include sweep accounts, complete savings accounts and other money market and savings accounts. Wholesale borrowings include securities sold under agreements to repurchase and FHLB advances. Other sources of funding include customer payables, which is customer cash contained within our broker-dealers, and corporate debt issued by the parent company.

Deposit accounts and customer payables tend to be less rate-sensitive than wholesale borrowings. Agreements to repurchase securities re-price as interest rates change. Sweep accounts, complete savings accounts and other money market and savings accounts re-price at management's discretion. FHLB advances and corporate debt generally have fixed rates.

**Table of Contents****Derivative Instruments**

We use derivative instruments to help manage interest rate risk. Interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments between two parties based on a contractual underlying notional amount, but do not involve the exchange of the underlying notional amounts. Option products are utilized primarily to decrease the market value changes resulting from the prepayment dynamics of the mortgage portfolio, as well as to protect against increases in funding costs. The types of options employed include Cap Options ( Caps ), Floor Options ( Floors ), Payor Swaptions and Receiver Swaptions . Caps mitigate the market risk associated with increases in interest rates while Floors mitigate the risk associated with decreases in market interest rates. Similarly, Payor and Receiver Swaptions mitigate the market risk associated with the respective increases and decreases in interest rates. See derivative instruments discussion at Note 6 Accounting for Derivative Instruments and Hedging Activities in Item 1. Consolidated Financial Statements (Unaudited).

**Scenario Analysis**

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the NPVE approach, the present value of all existing assets, liabilities, derivatives and forward commitments are estimated and then combined to produce a NPVE figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 basis points. The NPVE method is used at the E\*TRADE Bank level and not for the Company. E\*TRADE Bank had 99% of enterprise interest-earning assets at both June 30, 2011 and December 31, 2010 and held 98% of enterprise interest-bearing liabilities at both June 30, 2011 and December 31, 2010. The sensitivity of NPVE at June 30, 2011 and December 31, 2010 and the limits established by E\*TRADE Bank s Board of Directors are listed below (dollars in millions):

| Parallel Change in<br>Interest Rates (basis points) <sup>(1)</sup> | June 30, 2011 |            | December 31, 2010 |            | Board Limit |
|--|---------------|------------|-------------------|------------|-------------|
|  | Amount        | Percentage | Amount            | Percentage |             |
| +300   | \$ (154.0)    | (5)%       | \$ (88.5)         | (3)%       | (25)%       |
| +200   | \$ (70.6)     | (2)%       | \$ (37.0)         | (1)%       | (15)%       |
| +100   | \$ (3.3)      | (0)%       | \$ 8.0            | 0%         | (10)%       |
| -100   | \$ (202.5)    | (6)%       | \$ (147.5)        | (4)%       | (10)%       |

<sup>(1)</sup> On June 30, 2011 and December 31, 2010, the yield for the three-month treasury bill was 0.03% and 0.12%, respectively. As a result, the requirements of the NPV Model were temporarily modified, resulting in the removal of the minus 200 and 300 basis points scenarios for the periods ended June 30, 2011 and December 31, 2010.

Under criteria published by its regulator, E\*TRADE Bank s overall interest rate risk exposure at June 30, 2011 was characterized as minimum. We actively manage interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The ALCO monitors E\*TRADE Bank s interest rate risk position.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF INCOME (LOSS)****(In thousands, except per share amounts)****(Unaudited)**

|  | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|  | <b>2011</b>               | <b>2010</b> | <b>2011</b>             | <b>2010</b> |
| <b>Revenue:</b>  |                           |             |                         |             |
| Operating interest income  | \$ 394,653                | \$ 381,780  | \$ 782,119              | \$ 788,746  |
| Operating interest expense   | (79,232)                  | (79,753)    | (156,996)               | (166,322)   |
| Net operating interest income  | 315,421                   | 302,027     | 625,123                 | 622,424     |
| Commissions  | 103,850                   | 119,554     | 228,283                 | 232,806     |
| Fees and service charges   | 36,608                    | 35,204      | 73,853                  | 77,434      |
| Principal transactions   | 23,756                    | 28,706      | 53,332                  | 54,917      |
| Gains on loans and securities, net   | 31,011                    | 48,908      | 63,345                  | 77,954      |
| Other-than-temporary impairment ( OTTI )   | (2,027)                   | (15,108)    | (6,901)                 | (29,632)    |
| Less: noncredit portion of OTTI recognized into (out of) other comprehensive income (before tax) | (857)                     | 2,950       | (2,045)                 | 8,822       |
| Net impairment   | (2,884)                   | (12,158)    | (8,946)                 | (20,810)    |
| Other revenues   | 9,857                     | 11,760      | 19,324                  | 25,779      |
| Total non-interest income  | 202,198                   | 231,974     | 429,191                 | 448,080     |
| Total net revenue  | 517,619                   | 534,001     | 1,054,314               | 1,070,504   |
| Provision for loan losses  | 103,136                   | 165,666     | 219,194                 | 433,645     |
| <b>Operating expense:</b>  |                           |             |                         |             |
| Compensation and benefits  | 80,518                    | 80,940      | 164,521                 | 168,150     |
| Clearing and servicing   | 39,192                    | 38,141      | 78,347                  | 77,300      |
| Advertising and market development   | 37,019                    | 29,777      | 81,384                  | 67,912      |
| Professional services  | 21,492                    | 19,480      | 44,960                  | 39,770      |
| FDIC insurance premiums  | 24,031                    | 19,260      | 44,598                  | 38,575      |
| Communications   | 17,227                    | 18,424      | 32,782                  | 38,871      |
| Occupancy and equipment  | 17,163                    | 17,614      | 33,977                  | 35,821      |
| Depreciation and amortization  | 22,724                    | 22,001      | 44,771                  | 42,647      |
| Amortization of other intangibles  | 6,537                     | 7,141       | 13,075                  | 14,283      |
| Facility restructuring and other exit activities   | 2,046                     | (1,853)     | 5,598                   | 1,520       |
| Other operating expenses   | 22,969                    | 24,736      | 44,919                  | 46,148      |
| Total operating expense  | 290,918                   | 275,661     | 588,932                 | 570,997     |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|   |           |           |           |             |
|---|-----------|-----------|-----------|-------------|
| Income before other income (expense) and income tax expense (benefit) | 123,565   | 92,674    | 246,188   | 65,862      |
| Other income (expense):   |           |           |           |             |
| Corporate interest income   | 63        | 57        | 679       | 80          |
| Corporate interest expense  | (44,824)  | (41,205)  | (88,101)  | (82,248)    |
| Gains on sales of investments, net                                    | 38        |           | 38        | 109         |
| Gains on early extinguishment of debt                                 | 3,091     |           | 3,091     |             |
| Equity in income (loss) of investments and venture funds              | 675       | 733       | (323)     | 2,527       |
| Total other income (expense)  | (40,957)  | (40,415)  | (84,616)  | (79,532)    |
| Income (loss) before income tax expense (benefit)                     | 82,608    | 52,259    | 161,572   | (13,670)    |
| Income tax expense (benefit)  | 35,490    | 17,183    | 69,221    | (909)       |
| Net income (loss)   | \$ 47,118 | \$ 35,076 | \$ 92,351 | \$ (12,761) |
| Basic earnings (loss) per share                                       | \$ 0.18   | \$ 0.17   | \$ 0.37   | \$ (0.06)   |
| Diluted earnings (loss) per share                                     | \$ 0.16   | \$ 0.12   | \$ 0.32   | \$ (0.06)   |
| Shares used in computation of per share data:                         |           |           |           |             |
| Basic   | 269,119   | 211,642   | 249,817   | 201,972     |
| Diluted   | 289,643   | 289,150   | 289,725   | 201,972     |

See accompanying notes to consolidated financial statements

**Table of Contents****E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEET****(In thousands, except share amounts)****(Unaudited)**

|   | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|--------------------------|------------------------------|
| <b><u>ASSETS</u></b>  |                          |                              |
| Cash and equivalents  | \$ 1,369,711             | \$ 2,374,346                 |
| Cash and investments required to be segregated under federal or other regulations   | 668,004                  | 609,510                      |
| Trading securities  | 79,852                   | 62,173                       |
| Available-for-sale securities (includes securities pledged to creditors with the right to sell or repledge of \$4,614,111 at June 30, 2011 and \$5,621,156 at December 31, 2010)  | 15,032,599               | 14,805,677                   |
| Held-to-maturity securities (fair value of \$4,850,710 at June 30, 2011 and \$2,422,335 at December 31, 2010; includes securities pledged to creditors with the right to sell or repledge of \$1,663,816 at June 30, 2011 and \$884,214 at December 31, 2010) | 4,834,512                | 2,462,710                    |
| Margin receivables  | 5,661,002                | 5,120,575                    |
| Loans, net (net of allowance for loan losses of \$878,615 at June 30, 2011 and \$1,031,169 at December 31, 2010)  | 13,679,679               | 15,127,390                   |
| Investment in FHLB stock  | 152,772                  | 164,381                      |
| Property and equipment, net   | 301,153                  | 302,658                      |
| Goodwill  | 1,934,232                | 1,939,976                    |
| Other intangibles, net  | 298,880                  | 325,403                      |
| Other assets  | 2,971,916                | 3,078,202                    |
| <b>Total assets</b>   | <b>\$ 46,984,312</b>     | <b>\$ 46,373,001</b>         |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>  |                          |                              |
| <b>Liabilities:</b>   |                          |                              |
| Deposits  | \$ 25,998,073            | \$ 25,240,297                |
| Securities sold under agreements to repurchase  | 5,184,169                | 5,888,249                    |
| Customer payables   | 5,341,714                | 5,020,086                    |
| FHLB advances and other borrowings  | 2,730,831                | 2,731,714                    |
| Corporate debt  | 1,543,421                | 2,145,881                    |
| Other liabilities   | 1,373,759                | 1,294,329                    |
| <b>Total liabilities</b>  | <b>42,171,967</b>        | <b>42,320,556</b>            |
| Commitments and contingencies (see Note 13)   |                          |                              |
| <b>Shareholders' equity:</b>  |                          |                              |
| Common stock, \$0.01 par value, shares authorized: 400,000,000 at June 30, 2011 and December 31, 2010; shares issued and outstanding: 279,734,171 at June 30, 2011 and 220,840,821 at December 31, 2010   | 2,797                    | 2,208                        |
| Additional paid-in-capital ( APIC )   | 7,247,894                | 6,640,715                    |
| Accumulated deficit   | (2,059,487)              | (2,151,838)                  |
| Accumulated other comprehensive loss  | (378,859)                | (438,640)                    |
| <b>Total shareholders' equity</b>   | <b>4,812,345</b>         | <b>4,052,445</b>             |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 46,984,312</b>     | <b>\$ 46,373,001</b>         |



See accompanying notes to the consolidated financial statements

**Table of Contents**

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

(In thousands)

(Unaudited)

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |             |
|---|--------------------------------|-----------|------------------------------|-------------|
|   | 2011                           | 2010      | 2011                         | 2010        |
| Net income (loss)   | \$ 47,118                      | \$ 35,076 | \$ 92,351                    | \$ (12,761) |
| Other comprehensive income  |                                |           |                              |             |
| Available-for-sale securities:  |                                |           |                              |             |
| OTTI, net <sup>(1)</sup>  | 1,264                          | 9,373     | 4,252                        | 18,249      |
| Noncredit portion of OTTI reclassification (into) out of other comprehensive income, net <sup>(2)</sup> | 535                            | (1,830)   | 1,263                        | (5,418)     |
| Unrealized gains, net <sup>(3)</sup>  | 99,104                         | 124,497   | 111,991                      | 178,399     |
| Reclassification into earnings, net <sup>(4)</sup>  | (15,802)                       | (26,590)  | (37,761)                     | (44,555)    |
| Net change from available-for-sale securities   | 85,101                         | 105,450   | 79,745                       | 146,675     |
| Cash flow hedging instruments:  |                                |           |                              |             |
| Unrealized losses, net <sup>(5)</sup>   | (63,604)                       | (76,078)  | (56,803)                     | (109,973)   |
| Reclassification into earnings, net <sup>(6)</sup>  | 17,089                         | 11,317    | 33,352                       | 22,705      |
| Net change from cash flow hedging instruments   | (46,515)                       | (64,761)  | (23,451)                     | (87,268)    |
| Foreign currency translation gains (losses)   | 1,452                          | (6,113)   | 3,487                        | (8,202)     |
| Other comprehensive income  | 40,038                         | 34,576    | 59,781                       | 51,205      |
| Comprehensive income  | \$ 87,156                      | \$ 69,652 | \$ 152,132                   | \$ 38,444   |

(1) Amounts are net of benefit from income taxes of \$0.8 million and \$2.6 million for the three and six months ended June 30, 2011, respectively, compared to benefit from income taxes of \$5.8 million and \$11.4 million for the three and six months ended June 30, 2010, respectively.

(2) Amounts are net of benefit from income taxes of \$0.3 million and \$0.8 million for the three and six months ended June 30, 2011, respectively, compared to benefit from income taxes of \$1.1 million and \$3.4 million for the three and six months ended June 30, 2010, respectively.

(3) Amounts are net of provision for income taxes of \$59.8 million and \$67.9 million for the three and six months ended June 30, 2011, respectively, compared to provision for income taxes of \$76.2 million and \$110.5 million for the three and six months ended June 30, 2010, respectively.

(4) Amounts are net of provision for income taxes of \$9.5 million and \$23.4 million for the three and six months ended June 30, 2011, respectively, compared to provision for income taxes of \$16.3 million and \$27.7 million for the three and six months ended June 30, 2010, respectively.

(5) Amounts are net of benefit from income taxes of \$38.3 million and \$34.3 million for the three and six months ended June 30, 2011, respectively, compared to benefit from income taxes of \$46.3 million and \$63.8 million for the three and six months ended June 30, 2010, respectively.

(6) Amounts are net of benefit from income taxes of \$10.3 million and \$19.9 million for the three and six months ended June 30, 2011, respectively, compared to benefit from income taxes of \$6.9 million and \$12.8 million for the three and six months ended June 30, 2010, respectively.

See accompanying notes to the consolidated financial statements

Table of Contents

## E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(In thousands)

(Unaudited)

|   | Common Stock |          |                                  | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders<br>Equity |
|---|--------------|----------|----------------------------------|------------------------|---|---------------------------------|
|   | Shares       | Amount   | Additional<br>Paid-in<br>Capital |                        |   |                                 |
| <b>Balance, December 31, 2010</b>   | 220,841      | \$ 2,208 | \$ 6,640,715                     | \$ (2,151,838)         | \$ (438,640)                                  | \$ 4,052,445                    |
| Net income  |              |          |                                  | 92,351                 |   | 92,351                          |
| Other comprehensive income  |              |          |                                  |                        | 59,781  | 59,781                          |
| Conversion of convertible debentures  | 58,405       | 584      | 603,347                          |                        |   | 603,931                         |
| Exercise of stock options and related tax effects                             | 29           |          | 1,504                            |                        |   | 1,504                           |
| Issuance of restricted stock, net of forfeitures and retirements to pay taxes | 459          | 5        | (4,673)                          |                        |   | (4,668)                         |
| Share-based compensation  |              |          | 7,022                            |                        |   | 7,022                           |
| Other   |              |          | (21)                             |                        |   | (21)                            |
| <b>Balance, June 30, 2011</b>   | 279,734      | \$ 2,797 | \$ 7,247,894                     | \$ (2,059,487)         | \$ (378,859)                                  | \$ 4,812,345                    |

|   | Common Stock |          |                                  | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders<br>Equity |
|---|--------------|----------|----------------------------------|------------------------|---|---------------------------------|
|   | Shares       | Amount   | Additional<br>Paid-in<br>Capital |                        |   |                                 |
| <b>Balance, December 31, 2009</b>   | 189,397      | \$ 1,894 | \$ 6,275,157                     | \$ (2,123,366)         | \$ (404,130)                                  | \$ 3,749,555                    |
| Net loss  |              |          |                                  | (12,761)               |   | (12,761)                        |
| Other comprehensive income  |              |          |                                  |                        | 51,205  | 51,205                          |
| Conversion of convertible debentures  | 30,079       | 301      | 310,732                          |                        |   | 311,033                         |
| Exercise of stock options and related tax effects                             | 16           |          | (2,094)                          |                        |   | (2,094)                         |
| Issuance of restricted stock, net of forfeitures and retirements to pay taxes | 748          | 7        | (5,259)                          |                        |   | (5,252)                         |
| Share-based compensation  |              |          | 13,888                           |                        |   | 13,888                          |
| Claims settlement under Section 16(b)   |              |          | 35,000                           |                        |   | 35,000                          |
| Other   |              |          | (139)                            |                        |   | (139)                           |
| <b>Balance, June 30, 2010</b>   | 220,240      | \$ 2,202 | \$ 6,627,285                     | \$ (2,136,127)         | \$ (352,925)                                  | \$ 4,140,435                    |

See accompanying notes to the consolidated financial statements

**Table of Contents****E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF CASH FLOWS****(In thousands)****(Unaudited)**

|  | <b>Six Months Ended<br/>June 30,</b> |                     |
|--|--------------------------------------|---------------------|
|  | <b>2011</b>                          | <b>2010</b>         |
| <b>Cash flows from operating activities:</b>   |                                      |                     |
| Net income (loss)  | \$ 92,351                            | \$ (12,761)         |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:                 |                                      |                     |
| Provision for loan losses  | 219,194                              | 433,645             |
| Depreciation and amortization (including discount amortization and accretion)                            | 164,870                              | 166,080             |
| Net impairment, gains on loans and securities, net and gains on sales of investments, net                | (54,437)                             | (57,253)            |
| Equity in (income) loss of investments and venture funds   | 323                                  | (2,527)             |
| Gains on early extinguishment of debt  | (3,091)                              |                     |
| Share-based compensation   | 7,022                                | 13,888              |
| Deferred taxes   | 72,128                               | 3,513               |
| Other  | 8,241                                | (13,922)            |
| Net effect of changes in assets and liabilities:   |                                      |                     |
| (Increase) decrease in cash and investments required to be segregated under federal or other regulations | (58,494)                             | 1,284,436           |
| Increase in margin receivables   | (540,427)                            | (1,035,898)         |
| Increase (decrease) in customer payables   | 321,628                              | (841,699)           |
| Proceeds from sales of loans held-for-sale   | 56,860                               | 80,295              |
| Originations of loans held-for-sale  | (55,971)                             | (61,766)            |
| Proceeds from sales, repayments and maturities of trading securities                                     | 275,096                              | 638,292             |
| Purchases of trading securities  | (283,483)                            | (650,249)           |
| (Increase) decrease in other assets  | (47)                                 | 303,275             |
| (Decrease) increase in other liabilities   | (62,470)                             | 150,507             |
| <b>Net cash provided by operating activities</b>   | <b>159,293</b>                       | <b>397,856</b>      |
| <b>Cash flows from investing activities:</b>   |                                      |                     |
| Purchases of available-for-sale securities   | (4,510,115)                          | (6,548,576)         |
| Proceeds from sales, maturities of and principal payments on available-for-sale securities               | 4,429,091                            | 7,462,495           |
| Purchases of held-to-maturity securities   | (2,493,536)                          | (781,592)           |
| Proceeds from maturities of and principal payments on held-to-maturity securities                        | 116,849                              |                     |
| Net decrease in loans receivable   | 1,140,538                            | 1,321,541           |
| Capital expenditures for property and equipment  | (43,556)                             | (38,895)            |
| Proceeds from sale of REO and repossessed assets   | 85,483                               | 116,313             |
| Net cash flow from derivatives hedging assets  | 30,469                               | (4,953)             |
| Other  | 26,213                               | (156,678)           |
| <b>Net cash (used in) provided by investing activities</b>   | <b>\$ (1,218,564)</b>                | <b>\$ 1,369,655</b> |

See accompanying notes to the consolidated financial statements

**Table of Contents**

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS-(Continued)**

(In thousands)

(Unaudited)

|  | Six Months Ended<br>June 30, |              |
|--|------------------------------|--------------|
|  | 2011                         | 2010         |
| <b>Cash flows from financing activities:</b>                           |                              |              |
| Net increase (decrease) in deposits                                    | \$ 757,607                   | \$ (845,249) |
| Sale of deposits   |                              | (980,549)    |
| Net decrease in securities sold under agreements to repurchase         | (704,080)                    | (189,862)    |
| Advances from FHLB   | 1,000,000                    | 1,350,000    |
| Payments on advances from FHLB   | (1,000,000)                  | (1,350,000)  |
| Net proceeds from issuance of senior notes                             | 427,388                      |              |
| Payments on senior notes   | (425,956)                    |              |
| Claims settlement under Section 16(b)                                  |                              | 35,000       |
| Net cash flow from derivatives hedging liabilities                     | 16,724                       | (178,995)    |
| Other  | (17,047)                     | 3,781        |
| Net cash provided by (used in) financing activities                    | 54,636                       | (2,155,874)  |
| Effect of exchange rates on cash                                       |                              | (1,788)      |
| Decrease in cash and equivalents                                       | (1,004,635)                  | (390,151)    |
| Cash and equivalents, beginning of period                              | 2,374,346                    | 3,483,238    |
| Cash and equivalents, end of period                                    | \$ 1,369,711                 | \$ 3,093,087 |
| <b>Supplemental disclosures:</b>                                       |                              |              |
| Cash paid for interest   | \$ 212,910                   | \$ 224,926   |
| Refund received for income taxes                                       | \$ (319)                     | \$ (95,671)  |
| Non-cash investing and financing activities:                           |                              |              |
| Conversion of convertible debentures to common stock                   | \$ 603,931                   | \$ 311,033   |
| Transfers from loans to other real estate owned and repossessed assets | \$ 107,237                   | \$ 161,070   |
| Reclassification of loans held-for-investment to loans held-for-sale   | \$                           | \$ 252,627   |
| Transfers from loans to available-for-sale securities                  | \$                           | \$ 222,729   |

See accompanying notes to the consolidated financial statements

---

**Table of Contents**

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1 ORGANIZATION, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization** E\*TRADE Financial Corporation is a financial services company that provides online brokerage and related products and services primarily to individual retail investors under the brand E\*TRADE Financial. The Company also provides investor-focused banking products, primarily sweep deposits and savings products, to retail investors.

**Basis of Presentation** The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries as determined under the voting interest model. Entities in which the Company holds at least a 20% ownership interest or in which there are other indicators of significant influence are generally accounted for by the equity method. Entities in which the Company holds less than a 20% ownership interest and does not have the ability to exercise significant influence are generally carried at cost. Intercompany accounts and transactions are eliminated in consolidation. The Company also evaluates its continuing involvement with certain entities to determine if the Company is required to consolidate the entities under the variable interest entity model. This evaluation is based on a qualitative assessment of whether the Company has both: 1) the power to direct matters that most significantly impact the activities of the variable interest entity; and 2) the obligation to absorb losses or the right to receive benefits of the variable interest entity that could potentially be significant to the variable interest entity.

Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. These consolidated financial statements reflect all adjustments, which are all normal and recurring in nature, necessary to present fairly the financial position, results of operations and cash flows for the periods presented.

The Company reports corporate interest income and corporate interest expense separately from operating interest income and operating interest expense. The Company believes reporting these two items separately provides a clearer picture of the financial performance of the Company's operations than would a presentation that combined these two items. Operating interest income and operating interest expense is generated from the operations of the Company. Corporate debt, which is the primary source of corporate interest expense, has been issued primarily in connection with recapitalization transactions and past acquisitions.

Similarly, the Company reports gains on sales of investments, net separately from gains on loans and securities, net. The Company believes reporting these two items separately provides a clearer picture of the financial performance of its operations than would a presentation that combined these two items. Gains on loans and securities, net are the result of activities in the Company's operations, namely its balance sheet management segment. Gains on sales of investments, net relate to investments of the Company at the corporate level and are not related to the ongoing business of the Company's operating subsidiaries.

**Related Party** As of June 30, 2011, Citadel was the Company's largest stockholder, and based upon the Company's review of publicly available information, the Company believes Citadel owned approximately 9.8% of its outstanding common stock and none of its non-interest bearing convertible debentures. In addition, Kenneth Griffin, President and CEO of Citadel, joined the Board of Directors on June 8, 2009 pursuant to a director nomination right granted to Citadel in 2007. The contractual arrangements that required the Company to route substantially all of its customer orders in exchange-listed options and 40% of its customer orders in Regulation NMS Securities to an affiliate of Citadel expired at December 31, 2010. During both the three and six months ended June 30, 2011, the Company routed approximately 50% of its customer orders in exchange-listed options and approximately 20% of its customer orders in Regulation NMS Securities to an affiliate of Citadel for order handling and execution at current market rates.

---

## **Table of Contents**

**Use of Estimates** The consolidated financial statements were prepared in accordance with GAAP, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented. Actual results could differ from management's estimates. Certain significant accounting policies are noteworthy because they are based on estimates and assumptions that require complex and subjective judgments by management. Changes in these estimates or assumptions could materially impact the Company's financial condition and results of operations. Material estimates in which management believes near-term changes could reasonably occur include: allowance for loan losses; fair value measurements; classification and valuation of certain investments; accounting for derivative instruments; estimates of effective tax rates, deferred taxes and valuation allowances; valuation of goodwill and other intangibles; and valuation and expensing of share-based payments.

**Financial Statement Descriptions and Related Accounting Policies** Financial statement descriptions and related accounting policies are more fully described in Item 8. Financial Statements and Supplementary Data in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

**Margin Receivables** The fair value of securities that the Company received as collateral in connection with margin receivables and securities borrowing activities, where the Company is permitted to sell or re-pledge the securities, was approximately \$7.9 billion and \$7.1 billion as of June 30, 2011 and December 31, 2010, respectively. Of this amount, \$1.3 billion and \$1.2 billion had been pledged or sold in connection with securities loans, bank borrowings and deposits with clearing organizations as of June 30, 2011 and December 31, 2010, respectively.

**New Accounting and Disclosure Guidance** Below is the new accounting and disclosure guidance that relates to activities in which the Company is engaged.

### *Improving Disclosures about Fair Value Measurements*

In January 2010, the FASB amended the disclosure guidance related to fair value measurements. The amended disclosure guidance requires new fair value measurement disclosures and clarifies existing fair value measurement disclosure requirements. The amended disclosure guidance requiring separate presentation of purchases, sales, issuances and settlements of Level 3 instruments was effective January 1, 2011 for the Company. The Company's disclosures about fair value measurements reflect the adoption of the amended disclosure guidance in Note 3 Fair Value Disclosures.

### *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*

In July 2010, the FASB amended the disclosure guidance for financing receivables and the allowance for credit losses. The amendments require new and amended disclosures about nonaccrual and past due financing receivables; the allowance for credit losses related to financing receivables; impaired loans (individually evaluated for impairment); credit quality information; and modifications. The Company's disclosures reflect the adoption of the amended disclosure guidance related to non-TDR information in Note 5 Loans, Net. The amended disclosure guidance related to TDRs is effective for interim and annual periods beginning on or after June 15, 2011, or July 1, 2011 for the Company. The Company's disclosures will reflect the adoption of the amended disclosure guidance related to TDR information in the Form 10-Q for the quarterly period ended September 30, 2011.

### *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*

In April 2011, the FASB amended the accounting guidance for TDRs. The amendments clarify the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. The amended accounting guidance will be effective for the first interim or annual period beginning

## **Table of Contents**

on or after June 15, 2011, or July 1, 2011 for the Company, and will be applied retrospectively to the beginning of the annual period of adoption, or January 1, 2011 for the Company. The adoption of the amended accounting guidance will not affect the Company's conclusion that the Company's modification of loans through traditional collections actions taken in the normal course of servicing delinquent accounts that typically result in an insignificant delay in the timing of payments are not TDRs. The adoption of the amended accounting guidance will not have a material impact on the Company's financial condition, results of operations, or cash flows.

### *Reconsideration of Effective Control for Repurchase Agreements*

In April 2011, the FASB amended the accounting guidance for repurchase agreements. The amendments change the effective control assessment by removing the criterion that required the transferor to have the ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, and the collateral maintenance guidance related to that criterion. The amended accounting guidance will be effective for the first interim or annual period beginning on or after December 15, 2011, or January 1, 2012 for the Company, and will be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of the amended accounting guidance will not have a material impact on the Company's financial condition, results of operations, or cash flows.

### *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*

In May 2011, the FASB amended the accounting and disclosure guidance related to fair value measurements. The amended guidance will result in common fair value measurement and disclosure requirements in GAAP and IFRSs. The amended guidance changes the wording used to describe certain requirements in GAAP for measuring fair value and for disclosing information about fair value measurement. The amended accounting guidance will be effective for interim and annual periods beginning after December 15, 2011, or January 1, 2012 for the Company, and will be applied prospectively. The adoption of the amended guidance will not have a material impact on the Company's financial condition, results of operations, or cash flows.

### *Presentation of Comprehensive Income*

In June 2011, the FASB amended the presentation guidance for comprehensive income. Among other presentation changes, the amended guidance provides the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amended presentation guidance will be effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, or January 1, 2012 for the Company and will be applied retrospectively.



**Table of Contents****NOTE 2 OPERATING INTEREST INCOME AND OPERATING INTEREST EXPENSE**

The following table shows the components of operating interest income and operating interest expense (dollars in thousands):

|  | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2011                           | 2010              | 2011                         | 2010              |
| Operating interest income:                     |                                |                   |                              |                   |
| Loans  | \$ 180,974                     | \$ 225,340        | \$ 367,319                   | \$ 466,920        |
| Available-for-sale securities                  | 106,759                        | 93,929            | 217,640                      | 203,222           |
| Margin receivables                             | 58,682                         | 49,963            | 114,975                      | 94,676            |
| Held-to-maturity securities                    | 32,973                         | 1,261             | 53,723                       | 1,261             |
| Securities borrowed and other                  | 15,265                         | 11,287            | 28,462                       | 22,667            |
| <b>Total operating interest income</b>         | <b>394,653</b>                 | <b>381,780</b>    | <b>782,119</b>               | <b>788,746</b>    |
| Operating interest expense:                    |                                |                   |                              |                   |
| Securities sold under agreements to repurchase | (37,981)                       | (30,721)          | (75,974)                     | (65,467)          |
| FHLB advances and other borrowings             | (26,978)                       | (30,751)          | (52,242)                     | (60,179)          |
| Deposits                                       | (11,715)                       | (16,160)          | (23,989)                     | (36,120)          |
| Customer payables and other                    | (2,558)                        | (2,121)           | (4,791)                      | (4,556)           |
| <b>Total operating interest expense</b>        | <b>(79,232)</b>                | <b>(79,753)</b>   | <b>(156,996)</b>             | <b>(166,322)</b>  |
| <b>Net operating interest income</b>           | <b>\$ 315,421</b>              | <b>\$ 302,027</b> | <b>\$ 625,123</b>            | <b>\$ 622,424</b> |

**NOTE 3 FAIR VALUE DISCLOSURES**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company may use various valuation approaches, including market, income and/or cost approaches. The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is a market-based measure considered from the perspective of a market participant. Accordingly, even when market assumptions are not readily available, the Company's own assumptions reflect those that market participants would use in pricing the asset or liability at the measurement date. The fair value measurement accounting guidance describes the following three levels used to classify fair value measurements:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 Unobservable inputs that are significant to the fair value of the assets or liabilities.

The availability of observable inputs can vary and in certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to a fair value measurement requires judgment and consideration of factors specific to the asset or liability.

**Recurring Fair Value Measurement Techniques**

*U.S. Treasury Securities and Agency Debentures*

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

The fair value measurements of U.S. Treasury securities were classified as Level 1 of the fair value hierarchy as they were based on quoted market prices in active markets. The fair value measurements of agency

**Table of Contents**

debentures were classified as Level 2 of the fair value hierarchy as they were based on quoted market prices that can be derived from assumptions observable in the marketplace.

*Residential Mortgage-backed Securities*

The Company's residential mortgage-backed securities portfolio was comprised of agency mortgage-backed securities and CMOs, which represented the majority of the portfolio, and non-agency CMOs. As agency mortgage-backed securities and CMOs were guaranteed by U.S. government sponsored and federal agencies, these securities were AAA-rated as of June 30, 2011. The majority of the Company's non-agency CMOs were backed by first lien mortgages and were below investment grade or non-rated as of June 30, 2011. The weighted average coupon rates for the residential mortgage-backed securities as of June 30, 2011 are shown in the following table:

|                                   | <b>Weighted Average<br/>Coupon Rate</b> |
|-----------------------------------|---|
| Agency mortgage-backed securities | 3.60%                                   |
| Agency CMOs                       | 3.61%                                   |
| Non-agency CMOs                   | 4.21%                                   |

The fair value of agency mortgage-backed securities was determined using market and income approaches with quoted market prices, recent market transactions and spread data for similar instruments. The fair value of agency CMOs was determined using market and income approaches with the Company's own trading activities for identical or similar instruments. Agency mortgage-backed securities and CMOs were generally categorized in Level 2 of the fair value hierarchy.

Non-agency CMOs were valued using market and income approaches with market observable data, including recent market transactions when available. The Company also utilized a pricing service to corroborate the market observability of the Company's inputs used in the fair value measurements. The valuations of non-agency CMOs reflect the Company's best estimate of what market participants would consider in pricing the financial instruments. The following table presents additional information about the underlying loans and significant inputs for the valuation of non-agency CMOs as of June 30, 2011:

|                             | <b>Weighted<br/>Average</b> | <b>Range</b>  |
|-----------------------------|-----------------------------|---------------|
| <b>Underlying loans:</b>    |                             |               |
| Coupon rate                 | 4.28%                       | 2.47% - 6.83% |
| Maturity (years)            | 24                          | 12 - 27       |
| <b>Significant inputs:</b>  |                             |               |
| Yield                       | 4%                          | 1% - 10%      |
| Default rate <sup>(1)</sup> | 15%                         | 2% - 45%      |
| Loss severity               | 43%                         | 0% - 106%     |
| Prepayment rate             | 9%                          | 0% - 29%      |

<sup>(1)</sup> The default rate reflects the implied rate necessary to equate market price to the book yield given the market credit assumption.

The Company considers the price transparency for these financial instruments to be a key determinant of the degree of judgment involved in determining the fair value. As of June 30, 2011, the majority of the Company's non-agency CMOs were categorized in Level 3 of the fair value hierarchy.

*Other Debt Securities*

The fair value measurement of other agency debt securities was determined using market and income approaches along with the Company's own trading activities for identical instruments and was categorized in

## **Table of Contents**

Level 2 of the fair value hierarchy. The Company's municipal bonds are revenue bonds issued by state and other local government agencies. The valuation of corporate bonds is impacted by the credit worthiness of the corporate issuer. All of the Company's municipal bonds and corporate bonds were rated investment grade as of June 30, 2011. These securities were valued using a market approach with pricing service valuations corroborated by recent market transactions for similar or identical bonds. Municipal bonds and corporate bonds were generally categorized in Level 2 of the fair value hierarchy.

### *Derivative Instruments*

Interest rate swap and option contracts were valued with an income approach using pricing models that are commonly used by the financial services industry. The market observable inputs used in the pricing models include the swap curve, the volatility surface and prime basis from a financial data provider. The Company does not consider these models to involve significant judgment on the part of management and corroborated the fair value measurements with counterparty valuations. The Company's derivative instruments were categorized in Level 2 of the fair value hierarchy. The consideration of credit risk, the Company's or the counterparty's, did not result in an adjustment to the valuation of its derivative instruments in the periods presented.

### *Securities Owned and Securities Sold, Not Yet Purchased*

Securities transactions entered into by broker-dealer subsidiaries are included in trading securities and securities sold, not yet purchased in the Company's fair value disclosures. For equity securities, the Company's definition of actively traded is based on average daily volume and other market trading statistics. The fair value of the majority of securities owned and securities sold, not yet purchased was determined using listed or quoted market prices and were categorized in Level 1 or Level 2 of the fair value hierarchy.

**Table of Contents****Recurring Fair Value Measurements**

Assets and liabilities measured at fair value on a recurring basis are summarized below (dollars in thousands):

|  | Level 1   | Level 2       | Level 3    | Fair Value    |
|--|-----------|---------------|------------|---------------|
| <b>June 30, 2011:</b>  |           |               |            |               |
| <b>Assets</b>  |           |               |            |               |
| Trading securities   | \$ 63,945 | \$ 6,695      | \$ 9,212   | \$ 79,852     |
| Available-for-sale securities:   |           |               |            |               |
| Residential mortgage-backed securities:                                      |           |               |            |               |
| Agency mortgage-backed securities and CMOs                                   |           | 13,578,425    |            | 13,578,425    |
| Non-agency CMOs  |           | 160,908       | 214,793    | 375,701       |
| Total residential mortgage-backed securities                                 |           | 13,739,333    | 214,793    | 13,954,126    |
| Investment securities:   |           |               |            |               |
| Agency debentures  |           | 807,975       |            | 807,975       |
| Other agency debt securities   |           | 209,443       |            | 209,443       |
| Municipal bonds  |           | 40,641        |            | 40,641        |
| Corporate bonds  |           | 20,414        |            | 20,414        |
| Total investment securities  |           | 1,078,473     |            | 1,078,473     |
| Total available-for-sale securities  |           | 14,817,806    | 214,793    | 15,032,599    |
| Other assets:  |           |               |            |               |
| Derivative assets <sup>(1)</sup>   |           | 172,106       |            | 172,106       |
| Deposits with clearing organizations <sup>(2)</sup>                          | 29,000    |               |            | 29,000        |
| Total other assets measured at fair value on a recurring basis               | 29,000    | 172,106       |            | 201,106       |
| Total assets measured at fair value on a recurring basis <sup>(3)</sup>      | \$ 92,945 | \$ 14,996,607 | \$ 224,005 | \$ 15,313,557 |
| <b>Liabilities</b>   |           |               |            |               |
| Derivative liabilities <sup>(1)</sup>  | \$        | \$ 149,434    | \$         | \$ 149,434    |
| Securities sold, not yet purchased   | 56,789    | 2,594         |            | 59,383        |
| Total liabilities measured at fair value on a recurring basis <sup>(3)</sup> | \$ 56,789 | \$ 152,028    | \$         | \$ 208,817    |

(1) All derivative assets and liabilities are interest rate contracts. Information related to derivative instruments is detailed in Note 6 Accounting for Derivative Instruments and Hedging Activities.

(2) Represents U.S. Treasury securities held by a broker-dealer subsidiary.

(3) Assets and liabilities measured at fair value on a recurring basis represented 33% and less than 1% of the Company's total assets and total liabilities, respectively.

**Table of Contents**

|  | Level 1   | Level 2       | Level 3    | Fair Value    |
|--|-----------|---------------|------------|---------------|
| <b>December 31, 2010:</b>  |           |               |            |               |
| <b>Assets</b>  |           |               |            |               |
| Trading securities   | \$ 55,630 | \$ 5,913      | \$ 630     | \$ 62,173     |
| Available-for-sale securities:   |           |               |            |               |
| Residential mortgage-backed securities:                                      |           |               |            |               |
| Agency mortgage-backed securities and CMOs                                   |           | 12,898,114    |            | 12,898,114    |
| Non-agency CMOs  |           | 200,169       | 195,220    | 395,389       |
| Total residential mortgage-backed securities                                 |           | 13,098,283    | 195,220    | 13,293,503    |
| Investment securities:   |           |               |            |               |
| Agency debentures  |           | 1,269,552     |            | 1,269,552     |
| Other agency debt securities   |           | 187,462       |            | 187,462       |
| Municipal bonds  |           | 37,331        |            | 37,331        |
| Corporate bonds  |           | 17,829        |            | 17,829        |
| Total investment securities  |           | 1,512,174     |            | 1,512,174     |
| Total available-for-sale securities  |           | 14,610,457    | 195,220    | 14,805,677    |
| Other assets:  |           |               |            |               |
| Derivative assets <sup>(1)</sup>   |           | 248,911       |            | 248,911       |
| Deposits with clearing organizations <sup>(2)</sup>                          | 38,000    |               |            | 38,000        |
| Total other assets measured at fair value on a recurring basis               | 38,000    | 248,911       |            | 286,911       |
| Total assets measured at fair value on a recurring basis <sup>(3)</sup>      | \$ 93,630 | \$ 14,865,281 | \$ 195,850 | \$ 15,154,761 |
| <b>Liabilities</b>   |           |               |            |               |
| Derivative liabilities <sup>(1)</sup>  | \$        | \$ 106,863    | \$         | \$ 106,863    |
| Securities sold, not yet purchased   | 51,889    | 2,846         |            | 54,735        |
| Total liabilities measured at fair value on a recurring basis <sup>(3)</sup> | \$ 51,889 | \$ 109,709    | \$         | \$ 161,598    |

(1) All derivative assets and liabilities are interest rate contracts. Information related to derivative instruments is detailed in Note 6 Accounting for Derivative Instruments and Hedging Activities.

(2) Represents U.S. Treasury securities held by a broker-dealer subsidiary.

(3) Assets and liabilities measured at fair value on a recurring basis represented 33% and less than 1% of the Company's total assets and total liabilities, respectively.

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis (dollars in thousands):

|  | Trading Securities | Available-for-sale Securities Non-agency CMOs |
|--|--------------------|---|
| Balance, March 31, 2011                                | \$ 553             | \$ 255,066                                    |
| Realized and unrealized gains (losses): <sup>(1)</sup> |                    |   |
| Included in earnings <sup>(2)</sup>                    | (270)              | (191)   |
| Included in other comprehensive income <sup>(3)</sup>  |                    | 2,679   |
| Settlements  |                    | (12,181)                                      |
| Transfers in to Level 3 <sup>(4)</sup>                 | 8,929              | 131,135                                       |
| Transfers out of Level 3 <sup>(4)</sup>                |                    | (161,715)                                     |

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                        |          |            |
|------------------------|----------|------------|
| Balance, June 30, 2011 | \$ 9,212 | \$ 214,793 |
|------------------------|----------|------------|

- (1) The majority of total realized and unrealized gains (losses) were related to instruments held at June 30, 2011.
- (2) The majority of realized and unrealized gains (losses) included in earnings are reported in the gains on loans and securities, net and net impairment line items.
- (3) The majority of realized and unrealized gains (losses) included in other comprehensive income are reported in the net change from available-for-sale securities line item.
- (4) The Company's transfers in and out of Level 3 are as of the beginning of the reporting period on a quarterly basis.

**Table of Contents**

|  |                               | <b>Available-for-sale<br/>Securities</b> |                                  |
|--|-------------------------------|--|----------------------------------|
|  | <b>Trading<br/>Securities</b> | <b>Non-agency<br/>CMOs</b>               | <b>Corporate<br/>Investments</b> |
| Balance, March 31, 2010                                | \$ 898                        | \$ 233,130                               | \$ 164                           |
| Realized and unrealized gains (losses): <sup>(1)</sup> |                               |  |                                  |
| Included in earnings <sup>(2)</sup>                    | (86)                          | (11,980)                                 |                                  |
| Included in other comprehensive income <sup>(3)</sup>  |                               | 26,762                                   |                                  |
| Purchases, sales, other settlements and issuances, net | (9)                           | (9,093)                                  | (119)                            |
| Transfers in to Level 3 <sup>(4)</sup>                 |                               | 6,369                                    |                                  |
| Transfers out of Level 3 <sup>(4)</sup>                |                               | (58,268)                                 |                                  |
| Balance, June 30, 2010                                 | \$ 803                        | \$ 186,920                               | \$ 45                            |

(1) The majority of total realized and unrealized gains (losses) were related to instruments held at June 30, 2010.

(2) The majority of realized and unrealized gains (losses) included in earnings are reported in the net impairment line item.

(3) The majority of realized and unrealized gains (losses) included in other comprehensive income are reported in the net change from available-for-sale securities line item.

(4) The Company's transfers in and out of Level 3 are as of the beginning of the reporting period on a quarterly basis.

|  |                               | <b>Available-for-sale<br/>Securities</b> |  |
|--|-------------------------------|--|--|
|  | <b>Trading<br/>Securities</b> | <b>Non-agency<br/>CMOs</b>               |  |
| Balance, December 31, 2010                             | \$ 630                        | \$ 195,220                               |  |
| Realized and unrealized gains (losses): <sup>(1)</sup> |                               |  |  |
| Included in earnings <sup>(2)</sup>                    | (347)                         | (5,958)                                  |  |
| Included in other comprehensive income <sup>(3)</sup>  |                               | 14,342                                   |  |
| Settlements  |                               | (20,446)                                 |  |
| Transfers in to Level 3 <sup>(4)</sup>                 | 8,929                         | 194,822                                  |  |
| Transfers out of Level 3 <sup>(4)</sup>                |                               | (163,187)                                |  |
| Balance, June 30, 2011                                 | \$ 9,212                      | \$ 214,793                               |  |

(1) The majority of total realized and unrealized gains (losses) were related to instruments held at June 30, 2011.

(2) The majority of realized and unrealized gains (losses) included in earnings are reported in the net impairment line item.

(3) The majority of realized and unrealized gains (losses) included in other comprehensive income are reported in the net change from available-for-sale securities line item.

(4) The Company's transfers in and out of Level 3 are as of the beginning of the reporting period on a quarterly basis.



**Table of Contents**

|  | Available-for-sale Securities |  |                 |                       |
|--|-------------------------------|--|-----------------|-----------------------|
|  | Trading Securities            | Agency Mortgage-backed Securities and CMOs | Non-agency CMOs | Corporate Investments |
| Balance, December 31, 2009                             | \$ 1,491                      | \$ 17,972                                  | \$ 234,629      | \$ 173                |
| Realized and unrealized gains (losses): <sup>(1)</sup> |                               |  |                 |                       |
| Included in earnings <sup>(2)</sup>                    | (728)                         |  | (20,455)        |                       |
| Included in other comprehensive income <sup>(3)</sup>  |                               |  | 45,756          | (9)                   |
| Purchases, sales, other settlements and issuances, net | 40                            |  | (19,246)        | (119)                 |
| Transfers in to Level 3 <sup>(4)</sup>                 |                               |  | 13,608          |                       |
| Transfers out of Level 3 <sup>(4)</sup>                |                               | (17,972)                                   | (67,372)        |                       |
| Balance, June 30, 2010                                 | \$ 803                        | \$   | \$ 186,920      | \$ 45                 |

(1) The majority of total realized and unrealized gains (losses) were related to instruments held at June 30, 2010.

(2) The majority of realized and unrealized gains (losses) included in earnings are reported in the net impairment line item.

(3) The majority of realized and unrealized gains (losses) included in other comprehensive income are reported in the net change from available-for-sale securities line item.

(4) The Company's transfers in and out of Level 3 are as of the beginning of the reporting period on a quarterly basis.

**Level 3 Assets and Liabilities**

Level 3 assets and liabilities included instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. While the Company's fair value estimates of Level 3 instruments utilized observable inputs where available, the valuation included significant management judgment in determining the relevance and reliability of market information considered.

The Company's transfers of certain CMOs in and out of Level 3 are generally driven by changes in price transparency for the securities. Financial instruments for which actively quoted prices or pricing parameters are available will have a higher degree of price transparency than financial instruments that are thinly traded or not quoted. As of June 30, 2011, less than 1% of the Company's total assets and none of its total liabilities represented instruments measured at fair value on a recurring basis categorized as Level 3.

**Nonrecurring Fair Value Measurements**

The Company records certain other assets at fair value on a nonrecurring basis: 1) one- to four-family and home equity loans in which the amount of the loan balance in excess of the estimated current property value less costs to sell has been charged-off; and 2) real estate acquired through foreclosure that is carried at the lower of the property's carrying value or fair value, less estimated selling costs. The following table presents the fair value of assets prior to deducting estimated selling costs that were carried on the consolidated balance sheet as of June 30, 2011 and December 31, 2010, and for which a nonrecurring fair value measurement has been recorded during the period (dollars in thousands):

|   | June 30,<br>2011 | December 31,<br>2010 |
|---|------------------|----------------------|
| One- to four-family                           | \$ 632,504       | \$ 880,044           |
| Home equity                                   | 39,904           | 61,940               |
| Total loans receivable measured at fair value | \$ 672,408       | \$ 941,984           |
| REO   | \$ 109,696       | \$ 140,029           |

Loans that have been delinquent for 180 days and are charged off based on estimated current property value remain classified as nonperforming loans until they complete the foreclosure process and become REO. Property



**Table of Contents**

valuations for one- to four-family and home equity loans are based on the most recent as is property valuation data available, which may include appraisals, prices for identical or similar properties, broker price opinions or home price indices. The Company obtains property valuation data quarterly. If the valuation data obtained is significantly different from the valuation previously received, the Company orders additional property valuation data to corroborate or update the valuation. Property valuations for real estate acquired through foreclosure are based on the lowest value of the most recent property valuation data available, which may include appraisals, listing prices or offer prices. These fair value measurements were classified as Level 3 of the fair value hierarchy as the majority of the valuations included Level 3 inputs that were significant to the estimate of fair value.

The following table presents the losses associated with the assets measured at fair value on a nonrecurring basis during the three and six months ended June 30, 2011 and 2010 (dollars in thousands):

|   | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2011                           | 2010       | 2011                         | 2010       |
| One- to four-family                                     | \$ 56,742                      | \$ 69,390  | \$ 107,942                   | \$ 165,301 |
| Home equity   | 28,262                         | 45,500     | 59,173                       | 83,073     |
| Total losses on loans receivable measured at fair value | \$ 85,004                      | \$ 114,890 | \$ 167,115                   | \$ 248,374 |
| REO   | \$ 7,173                       | \$ 8,483   | \$ 16,318                    | \$ 20,561  |

**Disclosures about Fair Value of Financial Instruments**

The fair value measurements accounting guidance also requires the disclosure of the fair value of financial instruments not otherwise disclosed above. Different market assumptions and estimation methodologies could significantly affect fair value amounts. The fair value of financial instruments, not otherwise disclosed above, whose fair value approximates carrying value is summarized as follows:

*Cash and equivalents, cash and investments required to be segregated, margin receivables and customer payables* Fair value is estimated to be carrying value.

*Investment in FHLB stock* FHLB stock is carried at cost, which is considered to be a reasonable estimate of fair value. Financial instruments whose fair values were different from their carrying values are summarized below (dollars in thousands):

|  | June 30, 2011  |               | December 31, 2010 |               |
|--|----------------|---------------|-------------------|---------------|
|  | Carrying Value | Fair Value    | Carrying Value    | Fair Value    |
| <b>Assets</b>                                  |                |               |                   |               |
| Held-to-maturity securities                    | \$ 4,834,512   | \$ 4,850,710  | \$ 2,462,710      | \$ 2,422,335  |
| Loans, net <sup>(1)</sup>                      | \$ 13,679,679  | \$ 12,371,301 | \$ 15,127,390     | \$ 13,431,465 |
| <b>Liabilities</b>                             |                |               |                   |               |
| Deposits                                       | \$ 25,998,073  | \$ 26,012,048 | \$ 25,240,297     | \$ 25,259,496 |
| Securities sold under agreements to repurchase | \$ 5,184,169   | \$ 5,246,362  | \$ 5,888,249      | \$ 5,955,283  |
| FHLB advances and other borrowings             | \$ 2,730,831   | \$ 2,679,468  | \$ 2,731,714      | \$ 2,658,311  |
| Corporate debt                                 | \$ 1,543,421   | \$ 1,894,924  | \$ 2,145,881      | \$ 2,855,318  |

<sup>(1)</sup> The carrying value of loans, net includes the allowance for loan losses of \$878.6 million and \$1.0 billion as of June 30, 2011 and December 31, 2010, respectively.

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

*Held-to-maturity securities* The held-to-maturity securities portfolio included agency mortgage-backed securities and CMOs, agency debentures, and other agency debt securities. The fair value of agency mortgage-backed securities is determined using market and income approaches with quoted market prices, recent market

**Table of Contents**

transactions and spread data for similar instruments. The fair value of agency CMOs and other agency debt securities is determined using market and income approaches with the Company's own trading activities for identical or similar instruments. The fair value of agency debentures is based on quoted market prices that can be derived from assumptions observable in the marketplace.

*Loans, net* For the held-for-investment one- to four-family, home equity and consumer and other loans portfolio, fair value is estimated using a discounted cash flow model. Loans are differentiated based on their individual portfolio characteristics, such as product classification, loan category, pricing features and remaining maturity. Assumptions for expected losses, prepayments and discount rates are adjusted to reflect the individual characteristics of the loans, such as credit risk, coupon, term, and payment characteristics, as well as the secondary market conditions for these types of loans. There was limited or no observable market data for the home equity and one- to four-family loan portfolios, which indicates that the market for these types of loans is considered to be inactive. Given the limited market data, these fair value measurements cannot be determined with precision and changes in the underlying assumptions used, including discount rates, could significantly affect the results of current or future fair value estimates. In addition, the amount that would be realized in a forced liquidation, an actual sale or immediate settlement could be significantly lower than both the carrying value and the estimated fair value of the portfolio.

For loans held-for-sale that were originated through, but not yet purchased by a third party company, fair value is estimated using third party commitments to purchase loans.

*Deposits* For sweep deposits, complete savings deposits, other money market and savings deposits and checking deposits, fair value is the amount payable on demand at the reporting date. For certificates of deposit and brokered certificates of deposit, fair value is estimated by discounting future cash flows at the rates currently offered for deposits of similar remaining maturities.

*Securities sold under agreements to repurchase* Fair value is determined by discounting future cash flows at the rate implied for other similar instruments with similar remaining maturities.

*FHLB advances and other borrowings* For FHLB advances, fair value is estimated by discounting future cash flows at the rates currently offered for borrowings of similar remaining maturities. For subordinated debentures, fair value is estimated by discounting future cash flows at the rate implied by dealer pricing quotes. For margin collateral, overnight and other short-term borrowings and collateralized borrowings, fair value approximates carrying value.

*Corporate debt* Fair value is estimated using dealer pricing quotes. The fair value of the non-interest-bearing convertible debentures is directly correlated to the intrinsic value of the Company's underlying stock. As the price of the Company's stock increases relative to the conversion price, the fair value of the convertible debentures increases.

**Table of Contents****NOTE 4 AVAILABLE-FOR-SALE AND HELD-TO-MATURITY SECURITIES**

The amortized cost basis and fair value of available-for-sale and held-to-maturity securities are shown in the following tables (dollars in thousands):

|   | Amortized<br>Cost    | Gross<br>Unrealized /<br>Unrecognized<br>Gains | Gross<br>Unrealized /<br>Unrecognized<br>Losses | Fair Value           |
|---|----------------------|--|---|----------------------|
| <b>June 30, 2011:</b>                               |                      |  |   |                      |
| Available-for-sale securities:                      |                      |  |   |                      |
| Residential mortgage-backed securities:             |                      |  |   |                      |
| Agency mortgage-backed securities and CMOs          | \$ 13,576,040        | \$ 104,160                                     | \$ (101,775)                                    | \$ 13,578,425        |
| Non-agency CMOs                                     | 451,925              | 3,700  | (79,924)  | 375,701              |
| <b>Total residential mortgage-backed securities</b> | <b>14,027,965</b>    | <b>107,860</b>                                 | <b>(181,699)</b>                                | <b>13,954,126</b>    |
| Investment securities:                              |                      |  |   |                      |
| Agency debentures                                   | 844,925              | 826  | (37,776)  | 807,975              |
| Other agency debt securities                        | 209,023              | 2,166  | (1,746)   | 209,443              |
| Municipal bonds                                     | 42,410               |  | (1,769)   | 40,641               |
| Corporate bonds                                     | 25,356               |  | (4,942)   | 20,414               |
| <b>Total investment securities</b>                  | <b>1,121,714</b>     | <b>2,992</b>                                   | <b>(46,233)</b>                                 | <b>1,078,473</b>     |
| <b>Total available-for-sale securities</b>          | <b>\$ 15,149,679</b> | <b>\$ 110,852</b>                              | <b>\$ (227,932)</b>                             | <b>\$ 15,032,599</b> |
| Held-to-maturity securities:                        |                      |  |   |                      |
| Residential mortgage-backed securities:             |                      |  |   |                      |
| Agency mortgage-backed securities and CMOs          | \$ 4,076,228         | \$ 29,224                                      | \$ (16,758)                                     | \$ 4,088,694         |
| Investment securities:                              |                      |  |   |                      |
| Agency debentures                                   | 219,206              | 1,679  |   | 220,885              |
| Other agency debt securities                        | 539,078              | 5,886  | (3,833)   | 541,131              |
| <b>Total investment securities</b>                  | <b>758,284</b>       | <b>7,565</b>                                   | <b>(3,833)</b>                                  | <b>762,016</b>       |
| <b>Total held-to-maturity securities</b>            | <b>\$ 4,834,512</b>  | <b>\$ 36,789</b>                               | <b>\$ (20,591)</b>                              | <b>\$ 4,850,710</b>  |
| <b>December 31, 2010:</b>                           |                      |  |   |                      |
| Available-for-sale securities:                      |                      |  |   |                      |
| Residential mortgage-backed securities:             |                      |  |   |                      |
| Agency mortgage-backed securities and CMOs          | \$ 13,017,814        | \$ 71,274                                      | \$ (190,974)                                    | \$ 12,898,114        |
| Non-agency CMOs                                     | 490,250              | 2,885  | (97,746)  | 395,389              |
| <b>Total residential mortgage-backed securities</b> | <b>13,508,064</b>    | <b>74,159</b>                                  | <b>(288,720)</b>                                | <b>13,293,503</b>    |
| Investment securities:                              |                      |  |   |                      |
| Agency debentures                                   | 1,324,464            | 3,470  | (58,382)  | 1,269,552            |
| Other agency debt securities                        | 187,622              | 2,880  | (3,040)   | 187,462              |
| Municipal bonds                                     | 42,399               |  | (5,068)   | 37,331               |
| Corporate bonds                                     | 25,356               |  | (7,527)   | 17,829               |
| <b>Total investment securities</b>                  | <b>1,579,841</b>     | <b>6,350</b>                                   | <b>(74,017)</b>                                 | <b>1,512,174</b>     |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  |                     |                 |                    |                     |
|--|---------------------|-----------------|--------------------|---------------------|
| Total available-for-sale securities            | \$ 15,087,905       | \$ 80,509       | \$ (362,737)       | \$ 14,805,677       |
| <b>Held-to-maturity securities:</b>            |                     |                 |                    |                     |
| <b>Residential mortgage-backed securities:</b> |                     |                 |                    |                     |
| Agency mortgage-backed securities and CMOs     | \$ 1,928,651        | \$ 4,747        | \$ (36,348)        | \$ 1,897,050        |
| <b>Investment securities:</b>                  |                     |                 |                    |                     |
| Agency debentures                              | 219,197             |                 | (3,025)            | 216,172             |
| Other agency debt securities                   | 314,862             |                 | (5,749)            | 309,113             |
| <b>Total investment securities</b>             | <b>534,059</b>      |                 | <b>(8,774)</b>     | <b>525,285</b>      |
| <b>Total held-to-maturity securities</b>       | <b>\$ 2,462,710</b> | <b>\$ 4,747</b> | <b>\$ (45,122)</b> | <b>\$ 2,422,335</b> |

**Table of Contents*****Contractual Maturities***

The contractual maturities of all available-for-sale and held-to-maturity debt securities at June 30, 2011 are shown below (dollars in thousands):

|   | <b>Amortized Cost</b> | <b>Fair Value</b>    |
|---|-----------------------|----------------------|
| <b>Available-for-sale debt securities:</b>      |                       |                      |
| Due within one to five years                    | \$ 87,137             | \$ 87,913            |
| Due within five to ten years                    | 968,431               | 966,322              |
| Due after ten years                             | 14,094,111            | 13,978,364           |
| <b>Total available-for-sale debt securities</b> | <b>\$ 15,149,679</b>  | <b>\$ 15,032,599</b> |
| <b>Held-to-maturity securities:</b>             |                       |                      |
| Due within one to five years                    | \$ 225,301            | \$ 226,978           |
| Due within five to ten years                    | 1,298,135             | 1,301,942            |
| Due after ten years                             | 3,311,076             | 3,321,790            |
| <b>Total held-to-maturity debt securities</b>   | <b>\$ 4,834,512</b>   | <b>\$ 4,850,710</b>  |



**Table of Contents****Other-Than-Temporary Impairment of Investments**

The following tables show the fair value and unrealized or unrecognized losses on available-for-sale and held-to-maturity securities, aggregated by investment category, and the length of time that individual securities have been in a continuous unrealized or unrecognized loss position (dollars in thousands):

|  | Less than 12 Months |                                  | 12 Months or More |                                  | Total        |                                  |
|--|---------------------|----------------------------------|-------------------|----------------------------------|--------------|----------------------------------|
|  | Fair Value          | Unrealized / Unrecognized Losses | Fair Value        | Unrealized / Unrecognized Losses | Fair Value   | Unrealized / Unrecognized Losses |
| <b>June 30, 2011:</b>                                    |                     |                                  |                   |                                  |              |                                  |
| Available-for-sale securities:                           |                     |                                  |                   |                                  |              |                                  |
| Residential mortgage-backed securities:                  |                     |                                  |                   |                                  |              |                                  |
| Agency mortgage-backed securities and CMOs               | \$ 6,802,630        | \$ (100,551)                     | \$ 73,653         | \$ (1,224)                       | \$ 6,876,283 | \$ (101,775)                     |
| Non-agency CMOs  | 737                 | (19)                             | 352,355           | (79,905)                         | 353,092      | (79,924)                         |
| Investment securities:                                   |                     |                                  |                   |                                  |              |                                  |
| Agency debentures  | 748,744             | (37,776)                         |                   |                                  | 748,744      | (37,776)                         |
| Other agency debt securities                             | 128,598             | (1,746)                          |                   |                                  | 128,598      | (1,746)                          |
| Municipal bonds  | 19,786              | (344)                            | 20,855            | (1,425)                          | 40,641       | (1,769)                          |
| Corporate bonds  |                     |                                  | 20,414            | (4,942)                          | 20,414       | (4,942)                          |
| Total temporarily impaired available-for-sale securities | \$ 7,700,495        | \$ (140,436)                     | \$ 467,277        | \$ (87,496)                      | \$ 8,167,772 | \$ (227,932)                     |
| Held-to-maturity securities:                             |                     |                                  |                   |                                  |              |                                  |
| Residential mortgage-backed securities:                  |                     |                                  |                   |                                  |              |                                  |
| Agency mortgage-backed securities and CMOs               | \$ 1,372,682        | \$ (16,758)                      | \$                | \$                               | \$ 1,372,682 | \$ (16,758)                      |
| Investment securities:                                   |                     |                                  |                   |                                  |              |                                  |
| Agency debentures  | 149,583             | (3,833)                          |                   |                                  | 149,583      | (3,833)                          |
| Total temporarily impaired held-to-maturity securities   | \$ 1,522,265        | \$ (20,591)                      | \$                | \$                               | \$ 1,522,265 | \$ (20,591)                      |
| <b>December 31, 2010:</b>                                |                     |                                  |                   |                                  |              |                                  |
| Available-for-sale securities:                           |                     |                                  |                   |                                  |              |                                  |
| Residential mortgage-backed securities:                  |                     |                                  |                   |                                  |              |                                  |
| Agency mortgage-backed securities and CMOs               | \$ 8,204,906        | \$ (188,159)                     | \$ 165,478        | \$ (2,815)                       | \$ 8,370,384 | \$ (190,974)                     |
| Non-agency CMOs  |                     |                                  | 377,309           | (97,746)                         | 377,309      | (97,746)                         |
| Investment securities:                                   |                     |                                  |                   |                                  |              |                                  |
| Agency debentures  | 877,135             | (58,382)                         |                   |                                  | 877,135      | (58,382)                         |
| Other agency debt securities                             | 105,113             | (3,040)                          |                   |                                  | 105,113      | (3,040)                          |
| Municipal bonds  | 17,937              | (2,193)                          | 19,394            | (2,875)                          | 37,331       | (5,068)                          |
| Corporate bonds  |                     |                                  | 17,829            | (7,527)                          | 17,829       | (7,527)                          |
| Total temporarily impaired available-for-sale securities | \$ 9,205,091        | \$ (251,774)                     | \$ 580,010        | \$ (110,963)                     | \$ 9,785,101 | \$ (362,737)                     |
| Held-to-maturity securities:                             |                     |                                  |                   |                                  |              |                                  |
| Residential mortgage-backed securities:                  |                     |                                  |                   |                                  |              |                                  |
| Agency mortgage-backed securities and CMOs               | \$ 1,283,817        | \$ (36,348)                      | \$                | \$                               | \$ 1,283,817 | \$ (36,348)                      |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  |              |             |    |         |                          |
|--|--------------|-------------|----|---------|--------------------------|
| Investment securities:                                 |              |             |    |         |                          |
| Agency debentures                                      | 216,172      | (3,025)     |    | 216,172 | (3,025)                  |
| Other agency debt securities                           | 309,113      | (5,749)     |    | 309,113 | (5,749)                  |
| Total temporarily impaired held-to-maturity securities | \$ 1,809,102 | \$ (45,122) | \$ | \$      | \$ 1,809,102 \$ (45,122) |

**Table of Contents**

The Company does not believe that any individual unrealized loss in the available-for-sale or unrecognized loss in the held-to-maturity portfolio as of June 30, 2011 represents a credit loss. The credit loss component is the difference between the security's amortized cost basis and the present value of its expected future cash flows, and is recognized in earnings. The noncredit loss component is the difference between the present value of its expected future cash flows and the fair value and is recognized through other comprehensive income. The Company assessed whether it intends to sell, or whether it is more likely than not that the Company will be required to sell a security before recovery of its amortized cost basis. For debt securities that are considered other-than-temporarily impaired and that the Company does not intend to sell and will not be required to sell prior to recovery of its amortized cost basis, the Company determines the amount of the impairment that is related to credit and the amount due to all other factors.

The majority of the unrealized or unrecognized losses on mortgage-backed securities are attributable to changes in interest rates and a re-pricing of risk in the market. All agency mortgage-backed securities and CMOs and agency debentures are AAA-rated. Municipal bonds and corporate bonds are evaluated by reviewing the credit-worthiness of the issuer and general market conditions. The Company does not intend to sell the securities in an unrealized loss position and it is not more likely than not that the Company will be required to sell the debt securities before the anticipated recovery of its remaining amortized cost of the securities in an unrealized loss position at June 30, 2011.

The majority of the Company's available-for-sale and held-to-maturity portfolio consists of residential mortgage-backed securities. For residential mortgage-backed securities, the Company calculates the credit portion of OTTI by comparing the present value of the expected future cash flows with the amortized cost basis of the security. The expected future cash flows are determined using the remaining contractual cash flows adjusted for future credit losses. The estimate of expected future credit losses includes the following assumptions: 1) expected default rates based on current delinquency trends, foreclosure statistics of the underlying mortgages and loan documentation type; 2) expected loss severity based on the underlying loan characteristics, including loan-to-value, origination vintage and geography; and 3) expected loan prepayments and principal reduction based on current experience and existing market conditions that may impact the future rate of prepayments. The expected cash flows of the security are then discounted at the interest rate used to recognize interest income on the security to arrive at the present value amount. The following table presents a summary of the significant inputs considered for securities that were other-than-temporarily impaired as of June 30, 2011:

|                             | June 30, 2011    |           |
|-----------------------------|------------------|-----------|
|                             | Weighted Average | Range     |
| Default rate <sup>(1)</sup> | 10%              | 2% - 30%  |
| Loss severity               | 47%              | 40% - 65% |
| Prepayment rate             | 7%               | 2% - 25%  |

<sup>(1)</sup> Represents the expected default rate for the next twelve months.

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that have noncredit loss recognized in other comprehensive income and credit loss recognized in earnings for the periods presented (dollars in thousands):

|  | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|--------------------------------|------------|------------------------------|------------|
|  | 2011                           | 2010       | 2011                         | 2010       |
| Credit loss balance, beginning of period | \$ 194,100                     | \$ 159,024 | \$ 188,038                   | \$ 150,372 |
| Additions:                               |                                |            |                              |            |
| Initial credit impairment                | 54                             | 798        | 61                           | 1,522      |
| Subsequent credit impairment             | 2,830                          | 11,360     | 8,885                        | 19,288     |
| Credit loss balance, end of period       | \$ 196,984                     | \$ 171,182 | \$ 196,984                   | \$ 171,182 |

**Table of Contents**

Within the securities portfolio, the highest concentration of credit risk is the non-agency CMO portfolio. The Company concluded that approximately \$91.0 million and \$187.4 million of non-agency CMO securities for the three and six months ended June 30, 2011, respectively, were other-than-temporarily impaired as a result of deterioration in the expected credit performance of the underlying loans in the securities. The following table shows the components of net impairment for the periods presented (dollars in thousands):

|  | Three Months Ended<br>June 30, |                    | Six Months Ended<br>June 30, |                    |
|--|--------------------------------|--------------------|------------------------------|--------------------|
|  | 2011                           | 2010               | 2011                         | 2010               |
| Other-than-temporary impairment ( OTTI )   | \$ (2,027)                     | \$ (15,108)        | \$ (6,901)                   | \$ (29,632)        |
| Less: noncredit portion of OTTI recognized into (out of) other comprehensive income (before tax) | (857)                          | 2,950              | (2,045)                      | 8,822              |
| <b>Net impairment</b>  | <b>\$ (2,884)</b>              | <b>\$ (12,158)</b> | <b>\$ (8,946)</b>            | <b>\$ (20,810)</b> |

**Gains on Loans and Securities, Net**

The detailed components of the gains on loans and securities, net line item on the consolidated statement of income (loss) are as follows (dollars in thousands):

|   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2011                           | 2010             | 2011                         | 2010             |
| Gains on loans, net   | \$ 91                          | \$ 7,054         | \$ 143                       | \$ 6,169         |
| Gains on securities, net                                      |                                |                  |                              |                  |
| Gains on available-for-sale securities and other investments  | 25,331                         | 42,881           | 61,152                       | 72,469           |
| Losses on available-for-sale securities and other investments |                                | (6)              |                              | (139)            |
| Gains (losses) on trading securities, net                     | 264                            | (414)            | 860                          | 265              |
| Hedge ineffectiveness   | 5,325                          | (607)            | 1,190                        | (810)            |
| <b>Gains on securities, net</b>                               | <b>30,920</b>                  | <b>41,854</b>    | <b>63,202</b>                | <b>71,785</b>    |
| <b>Gains on loans and securities, net</b>                     | <b>\$ 31,011</b>               | <b>\$ 48,908</b> | <b>\$ 63,345</b>             | <b>\$ 77,954</b> |

**NOTE 5 LOANS, NET**

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

|                               | June 30,<br>2011  | December 31,<br>2010 |
|-------------------------------|-------------------|----------------------|
| Loans held-for-sale           | \$ 4,677          | \$ 5,471             |
| Loans receivable, net:        |                   |                      |
| One- to four-family           | 7,347,179         | 8,170,329            |
| Home equity                   | 5,833,567         | 6,410,311            |
| Consumer and other            | 1,262,048         | 1,443,398            |
| <b>Total loans receivable</b> | <b>14,442,794</b> | <b>16,024,038</b>    |
| Unamortized premiums, net     | 110,823           | 129,050              |
| Allowance for loan losses     | (878,615)         | (1,031,169)          |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                             |               |               |
|-----------------------------|---------------|---------------|
| Total loans receivable, net | 13,675,002    | 15,121,919    |
| Total loans, net            | \$ 13,679,679 | \$ 15,127,390 |

**Table of Contents**

The following table represents the breakdown of total loans receivable and allowance for loan losses by loans that have been collectively evaluated for impairment and those that have been individually evaluated for impairment (dollars in thousands):

|  | Carrying Amount      |                      | Allowance for Loan Losses |                     |
|--|----------------------|----------------------|---------------------------|---------------------|
|  | June 30, 2011        | December 31, 2010    | June 30, 2011             | December 31, 2010   |
| Loans collectively evaluated for impairment        | \$ 13,233,356        | \$ 14,987,167        | \$ 549,360                | \$ 674,202          |
| Loans individually evaluated for impairment (TDRs) | 1,209,438            | 1,036,871            | 329,255                   | 356,967             |
| <b>Total loans receivable</b>                      | <b>\$ 14,442,794</b> | <b>\$ 16,024,038</b> | <b>\$ 878,615</b>         | <b>\$ 1,031,169</b> |

**Credit Quality**

The Company tracks and reviews factors to predict and monitor credit risk in its mortgage loan portfolio on an ongoing basis. These factors include: loan type, estimated current LTV/CLTV ratios, documentation type, borrowers' current credit scores, housing prices, acquisition channel, loan vintage and geographic location of the property. In economic conditions in which housing prices generally appreciate, the Company believes that loan type, LTV/CLTV ratios, documentation type and credit scores are the key factors in determining future loan performance. In a housing market with declining home prices and less credit available for refinance, the Company believes the LTV/CLTV ratio becomes a more important factor in predicting and monitoring credit risk. The factors are updated on at least a quarterly basis. The Company tracks and reviews delinquency status to predict and monitor credit risk in its consumer and other loan portfolio on an ongoing basis.

The home equity loan portfolio is primarily second lien loans on residential real estate properties, which have a higher level of credit risk than first lien mortgage loans. Approximately 14% of the home equity portfolio was in the first lien position as of June 30, 2011. We hold both the first and second lien positions in less than 1% of the home equity loan portfolio. The Company believes home equity loans with a CLTV of 90% or higher or a FICO score below 700 are the loans with the highest levels of credit risk in our portfolios.

The following tables show the distribution of the Company's mortgage loan portfolios by credit quality indicator (dollars in thousands):

| Current LTV/CLTV <sup>(1)</sup>                           | One- to Four-Family |                     | Home Equity         |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | June 30, 2011       | December 31, 2010   | June 30, 2011       | December 31, 2010   |
| <=70%   | \$ 1,157,458        | \$ 1,380,327        | \$ 975,689          | \$ 1,084,876        |
| 70%-80%   | 714,995             | 852,906             | 345,716             | 400,029             |
| 80%-90%   | 916,006             | 1,168,293           | 475,626             | 575,924             |
| 90%-100%  | 1,030,116           | 1,161,238           | 610,995             | 727,006             |
| >100%   | 3,528,604           | 3,607,565           | 3,425,541           | 3,622,476           |
| <b>Total mortgage loans receivable</b>                    | <b>\$ 7,347,179</b> | <b>\$ 8,170,329</b> | <b>\$ 5,833,567</b> | <b>\$ 6,410,311</b> |
| <b>Average estimated current LTV/CLTV<sup>(2)</sup></b>   | <b>105.1%</b>       | <b>100.8%</b>       | <b>110.6%</b>       | <b>107.7%</b>       |
| <b>Average LTV/CLTV at loan origination<sup>(3)</sup></b> | <b>70.8%</b>        | <b>70.6%</b>        | <b>79.2%</b>        | <b>79.3%</b>        |

(1) Current CLTV calculations for home equity loans are based on the maximum available line for home equity lines of credit and outstanding principal balance for home equity installment loans. Current property values are updated on a quarterly basis using the most recent property value data available to the Company. For properties in which the Company did not have an updated valuation, it utilized home price indices to estimate the current property value.

(2) The average estimated current LTV ratio reflects the outstanding balance at the balance sheet date, divided by the estimated current property value.

(3) Average LTV/CLTV at loan origination calculations are based on LTV/CLTV at time of purchase for one- to four-family purchased loans and undrawn balances for home equity loans.

**Table of Contents**

| Documentation Type                     | One- to Four-Family |                     | Home Equity         |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | June 30, 2011       | December 31, 2010   | June 30, 2011       | December 31, 2010   |
| Full documentation                     | \$ 3,158,172        | \$ 3,556,480        | \$ 2,938,011        | \$ 3,201,381        |
| Low/no documentation                   | 4,189,007           | 4,613,849           | 2,895,556           | 3,208,930           |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347,179</b> | <b>\$ 8,170,329</b> | <b>\$ 5,833,567</b> | <b>\$ 6,410,311</b> |

| Current FICO <sup>(1)</sup>            | One- to Four-Family |                     | Home Equity         |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | June 30, 2011       | December 31, 2010   | June 30, 2011       | December 31, 2010   |
| >=720                                  | \$ 4,009,321        | \$ 4,438,443        | \$ 3,072,782        | \$ 3,101,814        |
| 719 - 700                              | 603,135             | 709,635             | 531,148             | 665,741             |
| 699 - 680                              | 529,892             | 566,256             | 428,940             | 550,756             |
| 679 - 660                              | 399,969             | 434,775             | 352,215             | 411,709             |
| 659 - 620                              | 589,839             | 633,983             | 480,757             | 512,528             |
| <620                                   | 1,215,023           | 1,387,237           | 967,725             | 1,167,763           |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347,179</b> | <b>\$ 8,170,329</b> | <b>\$ 5,833,567</b> | <b>\$ 6,410,311</b> |

- (1) FICO scores are updated on a quarterly basis; however, as of June 30, 2011 and December 31, 2010, there were some loans for which the updated FICO scores were not available. The current FICO distribution as of June 30, 2011 included original FICO scores for approximately \$178 million and \$63 million of one- to four-family and home equity loans, respectively. The current FICO distribution as of December 31, 2010 included original FICO scores for approximately \$218 million and \$168 million of one- to four-family and home equity loans, respectively.

| Acquisition Channel                    | One- to Four-Family |                     | Home Equity         |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | June 30, 2011       | December 31, 2010   | June 30, 2011       | December 31, 2010   |
| Purchased from a third party           | \$ 6,021,580        | \$ 6,687,741        | \$ 5,102,613        | \$ 5,607,236        |
| Originated by the Company              | 1,325,599           | 1,482,588           | 730,954             | 803,075             |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347,179</b> | <b>\$ 8,170,329</b> | <b>\$ 5,833,567</b> | <b>\$ 6,410,311</b> |

| Vintage Year                           | One- to Four-Family |                     | Home Equity         |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | June 30, 2011       | December 31, 2010   | June 30, 2011       | December 31, 2010   |
| 2003 and prior                         | \$ 272,097          | \$ 297,639          | \$ 345,219          | \$ 392,112          |
| 2004                                   | 685,048             | 759,307             | 529,862             | 585,729             |
| 2005                                   | 1,528,121           | 1,713,400           | 1,496,153           | 1,615,736           |
| 2006                                   | 2,800,139           | 3,108,280           | 2,716,940           | 2,999,072           |
| 2007                                   | 2,050,240           | 2,276,632           | 733,925             | 805,045             |
| 2008                                   | 11,534              | 15,071              | 11,468              | 12,617              |
| <b>Total mortgage loans receivable</b> | <b>\$ 7,347,179</b> | <b>\$ 8,170,329</b> | <b>\$ 5,833,567</b> | <b>\$ 6,410,311</b> |

| Geographic Location | One- to Four-Family | Home Equity |
|---------------------|---------------------|-------------|
|---------------------|---------------------|-------------|

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                                     | June 30,<br>2011 | December 31,<br>2010 | June 30,<br>2011 | December 31,<br>2010 |
|-------------------------------------|------------------|----------------------|------------------|----------------------|
| California                          | \$ 3,407,259     | \$ 3,773,623         | \$ 1,705,663     | \$ 2,038,325         |
| New York                            | 546,862          | 612,988              | 416,433          | 459,018              |
| Florida                             | 514,979          | 563,412              | 412,931          | 456,029              |
| Virginia                            | 313,572          | 338,132              | 256,863          | 277,993              |
| Other states                        | 2,564,507        | 2,882,174            | 3,041,677        | 3,178,946            |
| <br>Total mortgage loans receivable | <br>\$ 7,347,179 | <br>\$ 8,170,329     | <br>\$ 5,833,567 | <br>\$ 6,410,311     |



**Table of Contents****Nonperforming Loans**

The following table shows total loans receivable by delinquency category as of June 30, 2011 and December 31, 2010 (dollars in thousands):

|                          | Current       | 30-89 Days<br>Delinquent | Nonperforming Loans<br>90-179 Days<br>Delinquent | 180+ Days<br>Delinquent | Total         |
|--------------------------|---------------|--------------------------|--|-------------------------|---------------|
| <b>June 30, 2011</b>     |               |                          |  |                         |               |
| One- to four-family      | \$ 6,249,178  | \$ 286,022               | \$ 167,354                                       | \$ 644,625              | \$ 7,347,179  |
| Home equity              | 5,511,530     | 155,558                  | 115,312  | 51,167                  | 5,833,567     |
| Consumer and other       | 1,237,695     | 19,716                   | 4,242  | 395                     | 1,262,048     |
| Total loans receivable   | \$ 12,998,403 | \$ 461,296               | \$ 286,908                                       | \$ 696,187              | \$ 14,442,794 |
| <b>December 31, 2010</b> |               |                          |  |                         |               |
| One- to four-family      | \$ 6,770,513  | \$ 388,580               | \$ 226,052                                       | \$ 785,184              | \$ 8,170,329  |
| Home equity              | 6,040,021     | 175,607                  | 142,997  | 51,686                  | 6,410,311     |
| Consumer and other       | 1,412,707     | 25,209                   | 4,802  | 680                     | 1,443,398     |
| Total loans receivable   | \$ 14,223,241 | \$ 589,396               | \$ 373,851                                       | \$ 837,550              | \$ 16,024,038 |

**Allowance for Loan Losses**

The allowance for loan losses is management's estimate of credit losses inherent in the Company's loan portfolio as of the balance sheet date. For loans that are not TDRs, the Company established a general allowance that is assessed in accordance with the loss contingencies accounting guidance. The estimate of the allowance for loan losses is based on a variety of quantitative and qualitative factors, including the composition and quality of the portfolio; delinquency levels and trends; current and historical charge-off and loss experience; historical loss mitigation experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate; the overall availability of housing credit; and general economic conditions. The Company's one- to four-family and home equity loan portfolios are separated into risk segments based on key risk factors, which include but are not limited to loan type, loan acquisition channel, documentation type, LTV/CLTV ratio and borrowers' credit scores. Based upon the segmentation, the Company utilizes historical performance data to forecast future delinquency and default for these risk segments. The Company's consumer and other loan portfolio is separated into risk segments by product and delinquency status. The Company utilizes historical performance data and historical recovery rates on collateral liquidation to forecast future delinquency and loss at the product level. The general allowance for loan losses is typically equal to management's forecast of loan losses in the twelve months following the balance sheet date. Management believes this level is representative of probable losses inherent in the loan portfolio at the balance sheet date.

The general allowance for loan losses also included a specific qualitative component to account for a variety of economic and operational factors that are not directly considered in the quantitative loss model but are factors the Company believes may impact the level of credit losses. Examples of these economic and operational factors are the current level of unemployment and the limited historical charge-off and loss experience on modified loans. As of June 30, 2011, this qualitative component was 15% of the general allowance for loan losses and was applied by loan portfolio segment.

For modified loans accounted for as TDRs, the Company establishes a specific allowance. The impairment of a loan is measured using a discounted cash flow analysis. A specific allowance is established to the extent that the recorded investment exceeds the discounted cash flows of a TDR with a corresponding charge to the provision for loan losses. The specific allowance for these individually impaired loans represents the expected loss over the remaining life of the loan, including the economic concession to the borrower.

**Table of Contents**

The following table provides a roll-forward by loan portfolio of the allowance for loan losses for the three and six months ended June 30, 2011 and 2010 (dollars in thousands):

|  | Three Months Ended June 30, 2011 |             |                    | Total      |
|--|----------------------------------|-------------|--------------------|------------|
|  | One- to Four-Family              | Home Equity | Consumer and Other |            |
| Allowance for loan losses, beginning of period | \$ 353,117                       | \$ 539,171  | \$ 61,318          | \$ 953,606 |
| Provision for loan losses                      | 33,067                           | 64,664      | 5,405              | 103,136    |
| Charge-offs                                    | (59,604)                         | (119,274)   | (12,734)           | (191,612)  |
| Recoveries                                     |                                  | 8,990       | 4,495              | 13,485     |
| Charge-offs, net                               | (59,604)                         | (110,284)   | (8,239)            | (178,127)  |
| Allowance for loan losses, end of period       | \$ 326,580                       | \$ 493,551  | \$ 58,484          | \$ 878,615 |

|  | Three Months Ended June 30, 2010 |             |                    | Total        |
|--|----------------------------------|-------------|--------------------|--------------|
|  | One- to Four-Family              | Home Equity | Consumer and Other |              |
| Allowance for loan losses, beginning of period | \$ 433,863                       | \$ 657,173  | \$ 71,355          | \$ 1,162,391 |
| Provision for loan losses                      | 69,408                           | 88,857      | 7,401              | 165,666      |
| Charge-offs                                    | (69,613)                         | (150,694)   | (19,656)           | (239,963)    |
| Recoveries                                     |                                  | 7,531       | 7,318              | 14,849       |
| Charge-offs, net                               | (69,613)                         | (143,163)   | (12,338)           | (225,114)    |
| Allowance for loan losses, end of period       | \$ 433,658                       | \$ 602,867  | \$ 66,418          | \$ 1,102,943 |

|  | Six Months Ended June 30, 2011 |             |                    | Total        |
|--|--------------------------------|-------------|--------------------|--------------|
|  | One- to Four-Family            | Home Equity | Consumer and Other |              |
| Allowance for loan losses, beginning of period | \$ 389,594                     | \$ 576,089  | \$ 65,486          | \$ 1,031,169 |
| Provision for loan losses                      | 50,906                         | 155,013     | 13,275             | 219,194      |
| Charge-offs                                    | (113,920)                      | (253,389)   | (30,194)           | (397,503)    |
| Recoveries                                     |                                | 15,838      | 9,917              | 25,755       |
| Charge-offs, net                               | (113,920)                      | (237,551)   | (20,277)           | (371,748)    |
| Allowance for loan losses, end of period       | \$ 326,580                     | \$ 493,551  | \$ 58,484          | \$ 878,615   |

|  | Six Months Ended June 30, 2010 |             |                    | Total        |
|--|--------------------------------|-------------|--------------------|--------------|
|  | One- to Four-Family            | Home Equity | Consumer and Other |              |
| Allowance for loan losses, beginning of period | \$ 489,887                     | \$ 620,067  | \$ 72,784          | \$ 1,182,738 |
| Provision for loan losses                      | 115,941                        | 296,189     | 21,515             | 433,645      |
| Charge-offs                                    | (172,170)                      | (327,412)   | (42,766)           | (542,348)    |
| Recoveries                                     |                                | 14,023      | 14,885             | 28,908       |
| Charge-offs, net                               | (172,170)                      | (313,389)   | (27,881)           | (513,440)    |

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  |            |            |           |              |
|--|------------|------------|-----------|--------------|
| Allowance for loan losses, end of period | \$ 433,658 | \$ 602,867 | \$ 66,418 | \$ 1,102,943 |
|--|------------|------------|-----------|--------------|

### ***Impaired Loans Troubled Debt Restructurings***

The Company has an active loan modification program that focuses on the mitigation of potential losses in the loan portfolio. As part of the program, the Company considers modifications in which it made an economic concession to a borrower experiencing financial difficulty a TDR. The various types of economic concessions

**Table of Contents**

that may be granted typically consist of interest rate reductions, maturity date extensions, principal or accrued interest forgiveness or a combination of these concessions. The Company has also modified a number of loans through traditional collections actions taken in the normal course of servicing delinquent accounts. These actions typically result in an insignificant delay in the timing of payments; therefore, the Company does not consider such activities to be economic concessions to the borrowers. A loan is impaired when it meets the definition of a TDR. Upon being classified as a TDR loan, such loan is categorized as an impaired loan and impairment is measured on an individual basis.

The average recorded investment in TDR loans was \$1.2 billion and \$828.8 million for the three months ended June 30, 2011 and 2010, respectively, and \$1.1 billion and \$749.0 million for the six months ended June 30, 2011 and 2010, respectively. TDRs are accounted for as nonaccrual loans at the time of modification and return to accrual status after six consecutive payments are made in accordance with the modified terms. The interest income recognized both on a cash and accrual basis on TDRs was \$9.2 million and \$4.1 million for the three months ended June 30, 2011 and 2010, respectively, and \$16.5 million and \$7.6 million for the six months ended June 30, 2011 and 2010, respectively.

Included in the allowance for loan losses was a specific allowance of \$329.2 million and \$357.0 million that was established for TDRs at June 30, 2011 and December 31, 2010, respectively. The specific allowance for these individually impaired loans represents the expected loss over the remaining life of the loan, including the economic concession to the borrower. The following table shows detailed information related to the Company's loans that have been modified in a TDR as of June 30, 2011 and December 31, 2010 (dollars in thousands):

|                          | <b>Recorded<br/>Investment<br/>in TDRs</b> | <b>Specific<br/>Valuation<br/>Allowance</b> | <b>Net<br/>Investment<br/>in TDRs</b> | <b>Specific Valuation<br/>Allowance as<br/>a %<br/>of TDR<br/>Loans</b> | <b>Total Expected<br/>Losses</b> |
|--------------------------|--|---|---------------------------------------|---|----------------------------------|
| <b>June 30, 2011</b>     |  |   |                                       |   |                                  |
| One- to four-family      | \$ 756,570                                 | \$ 96,110                                   | \$ 660,460                            | 13%   | 27%                              |
| Home Equity              | 452,868                                    | 233,145                                     | 219,723                               | 51%   | 55%                              |
| <b>Total</b>             | <b>\$ 1,209,438</b>                        | <b>\$ 329,255</b>                           | <b>\$ 880,183</b>                     | <b>27%</b>  | <b>37%</b>                       |
| <b>December 31, 2010</b> |  |   |                                       |   |                                  |
| One- to four-family      | \$ 548,542                                 | \$ 84,492                                   | \$ 464,050                            | 15%   | 28%                              |
| Home Equity              | 488,329                                    | 272,475                                     | 215,854                               | 56%   | 59%                              |
| <b>Total</b>             | <b>\$ 1,036,871</b>                        | <b>\$ 356,967</b>                           | <b>\$ 679,904</b>                     | <b>34%</b>  | <b>42%</b>                       |

At June 30, 2011 and December 31, 2010, respectively, \$943.4 million and \$865.0 million of TDRs had an associated specific valuation allowance, and \$266.1 million and \$171.9 million did not have an associated specific valuation allowance as the amount of the loan balance in excess of the estimated current property value less costs to sell had been charged-off. At June 30, 2011 and December 31, 2010, the unpaid principal balance in one- to four-family TDRs was \$753.0 million and \$546.4 million, respectively. For home equity loans, the recorded investment in TDRs represents the unpaid principal balance.

**Table of Contents****NOTE 6 ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company enters into derivative transactions primarily to protect against interest rate risk on the value of certain assets, liabilities and future cash flows. Cash flow hedges, which include a combination of interest rate swaps and purchased options, including caps and floors, are used primarily to reduce the variability of future cash flows associated with existing variable-rate assets and liabilities and forecasted issuances of liabilities. Fair value hedges, which include interest rate swaps, forward-starting swaps and swaptions, are used to offset exposure to changes in value of certain fixed-rate assets and liabilities. The Company also recognizes certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative. Each derivative is recorded on the consolidated balance sheet at fair value as a freestanding asset or liability. The following table summarizes the fair value amounts of derivatives designated as hedging instruments reported in the consolidated balance sheet (dollars in thousands):

|  | Notional     | Asset <sup>(1)</sup> | Fair Value Liability <sup>(2)</sup> | Net <sup>(3)</sup> |
|--|--------------|----------------------|-------------------------------------|--------------------|
| <b>June 30, 2011</b>   |              |                      |                                     |                    |
| Interest rate contracts:   |              |                      |                                     |                    |
| Cash flow hedges:  |              |                      |                                     |                    |
| Purchased options  | \$ 3,295,000 | \$ 88,684            | \$                                  | \$ 88,684          |
| Pay-fixed rate swaps   | 2,525,000    | 4,557                | (130,874)                           | (126,317)          |
| Total cash flow hedges   | 5,820,000    | 93,241               | (130,874)                           | (37,633)           |
| Fair value hedges:   |              |                      |                                     |                    |
| Pay-fixed rate swaps   | 1,484,750    | 44,195               | (13,836)                            | 30,359             |
| Receive-fixed rate swaps   | 725,950      | 403                  | (4,724)                             | (4,321)            |
| Purchased swaptions  | 725,000      | 34,267               |                                     | 34,267             |
| Total fair value hedges  | 2,935,700    | 78,865               | (18,560)                            | 60,305             |
| Total derivatives designated as hedging instruments <sup>(4)</sup> | \$ 8,755,700 | \$ 172,106           | \$ (149,434)                        | \$ 22,672          |
| <b>December 31, 2010</b>   |              |                      |                                     |                    |
| Interest rate contracts:   |              |                      |                                     |                    |
| Cash flow hedges:  |              |                      |                                     |                    |
| Purchased options  | \$ 4,230,000 | \$ 123,561           | \$                                  | \$ 123,561         |
| Pay-fixed rate swaps   | 1,925,000    | 15,314               | (87,494)                            | (72,180)           |
| Purchased forward-starting swaps                                   | 200,000      |                      | (581)                               | (581)              |
| Total cash flow hedges   | 6,355,000    | 138,875              | (88,075)                            | 50,800             |
| Fair value hedges:   |              |                      |                                     |                    |
| Pay-fixed rate swaps   | 1,156,561    | 63,404               | (689)                               | 62,715             |
| Receive-fixed rate swaps   | 725,950      |                      | (18,099)                            | (18,099)           |
| Purchased swaptions  | 1,495,000    | 46,632               |                                     | 46,632             |
| Total fair value hedges  | 3,377,511    | 110,036              | (18,788)                            | 91,248             |
| Total derivatives designated as hedging instruments <sup>(4)</sup> | \$ 9,732,511 | \$ 248,911           | \$ (106,863)                        | \$ 142,048         |

(1) Reflected in the other assets line item on the consolidated balance sheet.

(2) Reflected in the other liabilities line item on the consolidated balance sheet.

(3) Represents derivative assets net of derivative liabilities for presentation purposes only.

<sup>(4)</sup> All derivatives were designated as hedging instruments as of June 30, 2011 and December 31, 2010.

***Cash Flow Hedges***

The effective portion of changes in fair value of the derivative instruments that hedge cash flows is reported as a component of accumulated other comprehensive loss, net of tax in the consolidated balance sheet, for both

**Table of Contents**

active and discontinued hedges. Amounts are included in net operating interest income as a yield adjustment in the same period the hedged forecasted transaction affects earnings. The ineffective portion of changes in fair value of the derivative instrument, which is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of a hypothetical derivative which is created to match the exact terms of the underlying instruments being hedged, is reported in the gains on loans and securities, net line item in the consolidated statement of income (loss).

If it becomes probable that a hedged forecasted transaction will not occur, amounts included in accumulated other comprehensive loss related to the specific hedging instruments would be immediately reclassified into the gains on loans and securities, net line item in the consolidated statement of income (loss). If hedge accounting is discontinued because a derivative instrument ceases to be a highly effective hedge or if the derivative is sold, terminated or de-designated, amounts included in accumulated other comprehensive loss related to the specific hedging instrument continue to be reported in accumulated other comprehensive loss until the forecasted transaction affects earnings.

The future issuances of liabilities, including repurchase agreements, are largely dependent on the market demand and liquidity in the wholesale borrowings market. As of June 30, 2011, the Company believes the forecasted issuance of all debt in cash flow hedge relationships is probable. However, unexpected changes in market conditions in future periods could impact the ability to issue this debt. The Company believes the forecasted issuance of debt in the form of repurchase agreements is most susceptible to an unexpected change in market conditions.

The following table summarizes the effect of interest rate contracts designated and qualifying as hedging instruments in cash flow hedges on accumulated other comprehensive loss and on the consolidated statement of income (loss) (dollars in thousands):

|  | For the Three Months<br>Ended June 30, |             | For the Six Months<br>Ended June 30, |              |
|--|--|-------------|--------------------------------------|--------------|
|  | 2011                                   | 2010        | 2011                                 | 2010         |
| Losses on derivatives recognized in OCI (effective portion)      | \$ (63,604)                            | \$ (76,078) | \$ (56,803)                          | \$ (109,973) |
| Amounts reclassified from AOCI into earnings (effective portion) | \$ 17,089                              | \$ 11,317   | \$ 33,352                            | \$ 22,705    |
| Cash flow hedge ineffectiveness <sup>(1)</sup>                   | \$ 56                                  | \$ (61)     | \$ 101                               | \$ (231)     |

<sup>(1)</sup> The cash flow hedge ineffectiveness is reflected in the gains on loans and securities, net line item on the statement of consolidated income (loss). During the upcoming 12 months, the Company expects to include a pre-tax amount of approximately \$1.4 million of net unrealized gains that are currently reflected in accumulated other comprehensive loss in net operating interest income as a yield adjustment in the same periods in which the related items affect earnings. The maximum length of time over which transactions are hedged is 11 years.

The following table shows the balance in accumulated other comprehensive loss attributable to active and discontinued cash flow hedges (dollars in thousands):

|   | June 30,<br>2011 | December 31,<br>2010 |
|---|------------------|----------------------|
| Accumulated other comprehensive loss balance (net of tax) related to: |                  |                      |
| Discontinued cash flow hedges   | \$ (253,207)     | \$ (271,595)         |
| Active cash flow hedges   | (78,742)         | (36,903)             |
| Total cash flow hedges  | \$ (331,949)     | \$ (308,498)         |

**Table of Contents**

The following table shows the balance in accumulated other comprehensive loss attributable to cash flow hedges by type of hedged item (dollars in thousands):

|  | June 30,<br>2011    | December 31,<br>2010 |
|--|---------------------|----------------------|
| Repurchase agreements                                | \$ (441,464)        | \$ (424,509)         |
| FHLB advances  | (117,601)           | (111,170)            |
| Home equity lines of credit                          | 27,563              | 42,199               |
| Other  | (497)               | (628)                |
| <b>Total balance of cash flow hedges before tax</b>  | <b>(531,999)</b>    | <b>(494,108)</b>     |
| Tax benefit  | 200,050             | 185,610              |
| <b>Total balance of cash flow hedges, net of tax</b> | <b>\$ (331,949)</b> | <b>\$ (308,498)</b>  |

Additionally, the Company enters into forward purchase and sale agreements, which may be considered cash flow hedges, when the terms of the commitments exactly match the terms of the securities purchased or sold. As of June 30, 2011 and December 31, 2010, there were no forward contracts accounted for as cash flow hedges.

**Fair Value Hedges**

Fair value hedges are accounted for by recording the fair value of the derivative instrument and the fair value of the asset or liability being hedged on the consolidated balance sheet. Changes in the fair value of the derivatives are recognized in the gains on loans and securities, net line item in the consolidated statement of income (loss). To the extent that the hedge is ineffective, the changes in the fair values will not offset and the difference, or hedge ineffectiveness, is reflected in the gains on loans and securities, net line item in the consolidated statement of income (loss).

Hedge accounting is discontinued for fair value hedges if a derivative instrument ceases to be highly effective as a hedge or if the derivative is sold, terminated or de-designated. If fair value hedge accounting is discontinued, the net gain or loss on the asset or liability being hedged at the time of de-designation is amortized to interest expense or interest income over the expected remaining life of the hedged item using the effective interest method. Changes in the fair value of the derivative instruments after de-designation of fair value hedge accounting are recorded in the gains on loans and securities, net line item in the consolidated statement of income (loss). For a discontinued fair value hedge, the previously hedged item is no longer adjusted for changes in fair value through the consolidated statement of income (loss).

The following table summarizes the effect of interest rate contracts designated and qualifying as hedging instruments in fair value hedges and related hedged items on the consolidated statement of income (loss) (dollars in thousands):

|  | Three Months Ended June 30, |                        |   |                       |                        |   |
|--|-----------------------------|------------------------|---|-----------------------|------------------------|---|
|  | Hedging<br>Instrument       | 2011<br>Hedged<br>Item | Hedge<br>Ineffectiveness <sup>(1)</sup> | Hedging<br>Instrument | 2010<br>Hedged<br>Item | Hedge<br>Ineffectiveness <sup>(1)</sup> |
| U.S. Treasury securities and agency debentures   | \$ (22,715)                 | \$ 27,186              | \$ 4,471                                | \$ (25,786)           | \$ 25,240              | \$ (546)                                |
| Agency mortgage-backed securities                | (10,377)                    | 11,310                 | 933                                     |                       |                        |   |
| FHLB advances                                    | 20,718                      | (20,853)               | (135)                                   |                       |                        |   |
| Corporate debt                                   |                             |                        |   | (1,399)               | 1,399                  |   |
| <b>Total gains (losses) included in earnings</b> | <b>\$ (12,374)</b>          | <b>\$ 17,643</b>       | <b>\$ 5,269</b>                         | <b>\$ (27,185)</b>    | <b>\$ 26,639</b>       | <b>\$ (546)</b>                         |



**Table of Contents**

|  | Six Months Ended June 30, |                        |   |                       |                        |   |
|--|---------------------------|------------------------|---|-----------------------|------------------------|---|
|  | Hedging<br>Instrument     | 2011<br>Hedged<br>Item | Hedge<br>Ineffectiveness <sup>(1)</sup> | Hedging<br>Instrument | 2010<br>Hedged<br>Item | Hedge<br>Ineffectiveness <sup>(1)</sup> |
| U.S. Treasury securities and agency debentures   | \$ (10,745)               | \$ 13,795              | \$ 3,050                                | \$ (25,611)           | \$ 25,032              | \$ (579)                                |
| Agency mortgage-backed securities                | (4,139)                   | 2,054                  | (2,085)                                 |                       |                        |   |
| FHLB advances                                    | 15,762                    | (15,638)               | 124                                     |                       |                        |   |
| Corporate debt                                   |                           |                        |   | (241)                 | 241                    |   |
| <b>Total gains (losses) included in earnings</b> | <b>\$ 878</b>             | <b>\$ 211</b>          | <b>\$ 1,089</b>                         | <b>\$ (25,852)</b>    | <b>\$ 25,273</b>       | <b>\$ (579)</b>                         |

<sup>(1)</sup> Reflected in the gains on loans and securities, net line item on the consolidated statement of income (loss).

**NOTE 7 DEPOSITS**

Deposits are summarized as follows (dollars in thousands):

|   | Weighted-Average Rate |                      | Amount               |                      |
|---|-----------------------|----------------------|----------------------|----------------------|
|   | June 30,<br>2011      | December 31,<br>2010 | June 30,<br>2011     | December 31,<br>2010 |
| Sweep deposits <sup>(1)</sup>           | 0.08%                 | 0.08%                | \$ 17,582,722        | \$ 16,139,585        |
| Complete savings deposits               | 0.30%                 | 0.30%                | 6,227,730            | 6,683,631            |
| Other money market and savings deposits | 0.24%                 | 0.24%                | 1,083,900            | 1,092,949            |
| Checking deposits                       | 0.10%                 | 0.10%                | 794,558              | 825,561              |
| Certificates of deposit                 | 2.82%                 | 2.62%                | 265,488              | 407,091              |
| Brokered certificates of deposit        | 5.16%                 | 4.52%                | 43,675               | 91,480               |
| <b>Total deposits</b>                   | <b>0.17%</b>          | <b>0.20%</b>         | <b>\$ 25,998,073</b> | <b>\$ 25,240,297</b> |

<sup>(1)</sup> A sweep product transfers brokerage customer balances to banking subsidiaries, which hold these funds as customer deposits in FDIC insured demand deposits and money market deposit accounts.

**NOTE 8 SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND FHLB ADVANCES AND OTHER BORROWINGS**

Total borrowings, including maturities, at June 30, 2011 and total borrowings at December 31, 2010 are shown below (dollars in thousands):

| Years Ending December 31,    | Repurchase<br>Agreements <sup>(1)</sup> | FHLB Advances and<br>Other Borrowings |                | Total            | Weighted<br>Average<br>Interest Rate |
|------------------------------|---|---------------------------------------|----------------|------------------|--------------------------------------|
|                              |   | FHLB<br>Advances                      | Other          |                  |                                      |
| 2011                         | \$ 3,250,064                            | \$ 500,000                            | \$ 1,320       | \$ 3,751,384     | 0.16%                                |
| 2012                         | 934,105                                 | 350,000                               | 1,277          | 1,285,382        | 0.45%                                |
| 2013                         | 100,000                                 |                                       | 1,021          | 101,021          | 2.01%                                |
| 2014                         | 200,000                                 | 320,000                               |                | 520,000          | 4.67%                                |
| 2015                         | 200,000                                 | 483,600                               |                | 683,600          | 3.24%                                |
| Thereafter                   | 500,000                                 | 650,000                               | 427,558        | 1,577,558        | 3.54%                                |
| <b>Subtotal</b>              | <b>5,184,169</b>                        | <b>2,303,600</b>                      | <b>431,176</b> | <b>7,918,945</b> | <b>1.47%</b>                         |
| Fair value hedge adjustments |   | (3,945)                               |                | (3,945)          |                                      |

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|                                       |              |              |            |              |       |
|---------------------------------------|--------------|--------------|------------|--------------|-------|
| Total borrowings at June 30, 2011     | \$ 5,184,169 | \$ 2,299,655 | \$ 431,176 | \$ 7,915,000 | 1.47% |
| Total borrowings at December 31, 2010 | \$ 5,888,249 | \$ 2,284,144 | \$ 447,570 | \$ 8,619,963 | 1.41% |

<sup>(1)</sup> The maximum amount at any month end for repurchase agreements was \$5.9 billion for the six months ended June 30, 2011 and \$6.5 billion for the year ended December 31, 2010.

**Table of Contents****NOTE 9 CORPORATE DEBT**

The Company's corporate debt by type is shown below (dollars in thousands):

|   | Face Value   | Discount     | Fair Value Hedge Adjustment <sup>(1)</sup> | Net          |
|---|--------------|--------------|--|--------------|
| <b>June 30, 2011</b>  |              |              |  |              |
| Interest-bearing notes:   |              |              |  |              |
| Senior notes:   |              |              |  |              |
| 7 <sup>7</sup> / <sub>8</sub> % Notes, due 2015                 | \$ 243,177   | \$ (1,322)   | \$ 8,334                                   | \$ 250,189   |
| 6 <sup>3</sup> / <sub>4</sub> % Notes, due 2016                 | 435,000      | (8,259)      |  | 426,741      |
| Total senior notes  | 678,177      | (9,581)      | 8,334                                      | 676,930      |
| 12 <sup>1</sup> / <sub>2</sub> % Springing lien notes, due 2017 | 930,230      | (170,524)    | 6,758                                      | 766,464      |
| Total interest-bearing notes                                    | 1,608,407    | (180,105)    | 15,092                                     | 1,443,394    |
| Non-interest-bearing debt:                                      |              |              |  |              |
| 0% Convertible debentures, due 2019                             | 100,027      |              |  | 100,027      |
| Total corporate debt  | \$ 1,708,434 | \$ (180,105) | \$ 15,092                                  | \$ 1,543,421 |
|   | Face Value   | Discount     | Fair Value Hedge Adjustment <sup>(1)</sup> | Net          |
| <b>December 31, 2010</b>  |              |              |  |              |
| Interest-bearing notes:   |              |              |  |              |
| Senior notes:   |              |              |  |              |
| 8% Notes, due 2011  | \$ 3,644     | \$           | \$   | \$ 3,644     |
| 7 <sup>3</sup> / <sub>8</sub> % Notes, due 2013                 | 414,665      | (2,475)      | 15,117                                     | 427,307      |
| 7 <sup>7</sup> / <sub>8</sub> % Notes, due 2015                 | 243,177      | (1,471)      | 9,273                                      | 250,979      |
| Total senior notes  | 661,486      | (3,946)      | 24,390                                     | 681,930      |
| 12 <sup>1</sup> / <sub>2</sub> % Springing lien notes, due 2017 | 930,230      | (177,520)    | 7,283                                      | 759,993      |
| Total interest-bearing notes                                    | 1,591,716    | (181,466)    | 31,673                                     | 1,441,923    |
| Non-interest-bearing debt:                                      |              |              |  |              |
| 0% Convertible debentures, due 2019                             | 703,958      |              |  | 703,958      |
| Total corporate debt  | \$ 2,295,674 | \$ (181,466) | \$ 31,673                                  | \$ 2,145,881 |

<sup>(1)</sup> The fair value hedge adjustment is related to changes in fair value of the debt while in a fair value hedge relationship.

In May of 2011, the Company issued an aggregate principal amount of \$435 million in senior notes due May 2016 ( 6<sup>3</sup>/<sub>4</sub>% Notes ). Interest is payable semi-annually and the notes may be called by the Company at a premium, which declines over time. The 6<sup>3</sup>/<sub>4</sub>% Notes are unsecured and will rank equal in right of payment with all of our existing and future unsubordinated indebtedness and will rank senior in right of payment to all our existing and future subordinated indebtedness. The 6<sup>3</sup>/<sub>4</sub>% Notes have terms which include customary financial covenants. As of June 30, 2011, the Company was in compliance with all such covenants.

The Company used the proceeds from the sale of the 6<sup>3</sup>/<sub>4</sub>% Notes to redeem all of its outstanding 7<sup>3</sup>/<sub>8</sub>% Notes due September 2013, including paying the associated redemption premium, accrued interest and related fees and expenses. The Company recorded a \$3.1 million gain on early extinguishment of debt related to the redemption of the 7<sup>3</sup>/<sub>8</sub>% Notes for the three and six months ended June 30, 2011.

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

In June 2011, the Company granted a security interest to the holders of the 12 1/2% springing lien notes and the 0% convertible debentures pursuant to the terms of the related indentures. The maximum amount of the security interest is initially limited under the terms of the indentures to \$300 million, but is expected to grow in

**Table of Contents**

the future as the Company's profitability increases. The collateral consists of property and assets specified in the indentures requiring the grant of a security interest. Although the indentures initially limit the amount of the security interest to \$300 million, the Company cannot assure that the collateral would provide \$300 million of value after a default or foreclosure. Also in June 2011, certain of the Company's subsidiaries issued guarantees on each outstanding series of senior notes and the convertible debentures. E\*TRADE Bank and E\*TRADE Securities LLC, among others, did not issue such guarantees.

During the six months ended June 30, 2011, \$603.9 million of the Company's convertible debentures were converted into 58.4 million shares of common stock, respectively. As of June 30, 2011, a cumulative total of \$1.6 billion of the Class A convertible debentures and \$2.2 million of the Class B convertible debentures had been converted into 158.6 million shares and 0.1 million shares, respectively, of the Company's common stock.

**NOTE 10 SHAREHOLDERS' EQUITY**

The activity in shareholders' equity during the six months ended June 30, 2011 is summarized as follows (dollars in thousands):

|   | Common Stock/<br>Additional Paid-In<br>Capital | Accumulated<br>Deficit/Other<br>Comprehensive<br>Loss | Total        |
|---|--|---|--------------|
| Beginning balance, December 31, 2010          | \$ 6,642,923                                   | \$ (2,590,478)  | \$ 4,052,445 |
| Net income                                    |  | 92,351  | 92,351       |
| Conversions of convertible debentures         | 603,931  |   | 603,931      |
| Net change from available-for-sale securities |  | 79,745  | 79,745       |
| Net change from cash flow hedging instruments |  | (23,451)  | (23,451)     |
| Other <sup>(1)</sup>                          | 3,837  | 3,487   | 7,324        |
| Ending balance, June 30, 2011                 | \$ 7,250,691                                   | \$ (2,438,346)  | \$ 4,812,345 |

<sup>(1)</sup> Other includes employee share-based compensation accounting and changes in accumulated other comprehensive loss from foreign currency translation.

**Conversions of Convertible Debentures**

During the six months ended June 30, 2011, \$603.9 million of the Company's convertible debentures were converted into 58.4 million shares of common stock.

**Table of Contents****NOTE 11 EARNINGS (LOSS) PER SHARE**

The following table is a reconciliation of basic and diluted earnings (loss) per share (in thousands, except per share amounts):

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |             |
|---|--------------------------------|-----------|------------------------------|-------------|
|   | 2011                           | 2010      | 2011                         | 2010        |
| <b>Basic:</b>   |                                |           |                              |             |
| Numerator:  |                                |           |                              |             |
| Net income (loss)   | \$ 47,118                      | \$ 35,076 | \$ 92,351                    | \$ (12,761) |
| Denominator:  |                                |           |                              |             |
| Basic weighted-average shares outstanding                         | 269,119                        | 211,642   | 249,817                      | 201,972     |
| <b>Diluted:</b>   |                                |           |                              |             |
| Numerator:  |                                |           |                              |             |
| Net income (loss)   | \$ 47,118                      | \$ 35,076 | \$ 92,351                    | \$ (12,761) |
| Denominator:  |                                |           |                              |             |
| Basic weighted-average shares outstanding                         | 269,119                        | 211,642   | 249,817                      | 201,972     |
| Effect of dilutive securities:                                    |                                |           |                              |             |
| Weighted-average convertible debentures                           | 20,139                         | 76,953    | 39,311                       |             |
| Weighted-average options and restricted stock issued to employees | 385                            | 555       | 597                          |             |
| Diluted weighted-average shares outstanding                       | 289,643                        | 289,150   | 289,725                      | 201,972     |
| <b>Per share:</b>   |                                |           |                              |             |
| Basic earnings (loss) per share                                   | \$ 0.18                        | \$ 0.17   | \$ 0.37                      | \$ (0.06)   |
| Diluted earnings (loss) per share                                 | \$ 0.16                        | \$ 0.12   | \$ 0.32                      | \$ (0.06)   |

The Company excluded the following shares from the calculations of diluted earnings (loss) per share as the effect would have been anti-dilutive (shares in millions):

|   | Three Months Ended<br>June 30, |      | Six Months Ended<br>June 30, |      |
|---|--------------------------------|------|------------------------------|------|
|   | 2011                           | 2010 | 2011                         | 2010 |
| Weighted-average shares excluded as a result of the Company's net loss: |                                |      |                              |      |
| Convertible debentures  | N/A                            | N/A  | N/A                          | 86.4 |
| Stock options and restricted stock awards and units                     | N/A                            | N/A  | N/A                          | 0.8  |
| Other stock options and restricted stock awards and units               | 3.6                            | 2.9  | 3.4                          | 2.8  |
| Total   | 3.6                            | 2.9  | 3.4                          | 90.0 |

**NOTE 12 REGULATORY REQUIREMENTS****Registered Broker-Dealers**

The Company's U.S. broker-dealer subsidiaries are subject to the Uniform Net Capital Rule (the "Rule") under the Securities Exchange Act of 1934 administered by the SEC and FINRA, which requires the maintenance of minimum net capital. The minimum net capital requirements can be met under either the Aggregate Indebtedness method or the Alternative method. Under the Aggregate Indebtedness method, a broker-dealer is

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

required to maintain minimum net capital of the greater of  $6\frac{2}{3}\%$  of its aggregate indebtedness, as defined, or a minimum dollar amount. Under the Alternative method, a broker-dealer is required to maintain net capital equal

**Table of Contents**

to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions. The method used depends on the individual U.S. broker-dealer subsidiary. The Company's international broker-dealer subsidiaries, located in Europe and Asia, are subject to capital requirements determined by their respective regulators.

As of June 30, 2011, all of the Company's broker-dealer subsidiaries met minimum net capital requirements. Total required net capital was \$0.1 billion at June 30, 2011. In addition, the Company's broker-dealer subsidiaries had excess net capital of \$0.7 billion at June 30, 2011.

The table below summarizes the minimum excess capital requirements for the Company's broker-dealer subsidiaries (dollars in thousands):

|   | June 30, 2011           |                   | Excess<br>Net<br>Capital |
|---|-------------------------|-------------------|--------------------------|
|   | Required Net<br>Capital | Net Capital       |                          |
| E*TRADE Clearing LLC <sup>(1)</sup>         | \$ 120,325              | \$ 581,215        | \$ 460,890               |
| E*TRADE Securities LLC <sup>(1)</sup>       | 250                     | 189,044           | 188,794                  |
| E*TRADE Capital Markets, LLC <sup>(2)</sup> | 1,000                   | 47,419            | 46,419                   |
| International broker-dealers                | 9,680                   | 34,326            | 24,646                   |
| <b>Total</b>                                | <b>\$ 131,255</b>       | <b>\$ 852,004</b> | <b>\$ 720,749</b>        |

(1) Elected to use the Alternative method to compute net capital.

(2) Elected to use the Aggregate Indebtedness method to compute net capital.

**Banking**

E\*TRADE Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on E\*TRADE Bank's financial condition and results of operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, E\*TRADE Bank must meet specific capital guidelines that involve quantitative measures of E\*TRADE Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. In addition, E\*TRADE Bank may not pay dividends to the parent company without approval from its regulator and any loans by E\*TRADE Bank to the parent company and its other non-bank subsidiaries are subject to various quantitative, arm's length, collateralization and other requirements. E\*TRADE Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require E\*TRADE Bank to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and Tier I capital to adjusted total assets. As shown in the table below, at both June 30, 2011 and December 31, 2010, E\*TRADE Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. However, events beyond management's control, such as a continued deterioration in residential real estate and credit markets, could adversely affect future earnings and E\*TRADE Bank's ability to meet its future capital requirements.



**Table of Contents**

E\*TRADE Bank's actual and required capital amounts and ratios are presented in the table below (dollars in thousands):

|   | Actual       |        | Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions |          | Excess Capital |
|---|--------------|--------|---|----------|----------------|
|   | Amount       | Ratio  | Amount  | Ratio    |                |
| <b>June 30, 2011:</b>                   |              |        |   |          |                |
| Total capital to risk-weighted assets   | \$ 3,625,167 | 16.22% | > \$2,235,166   | > 10.00% | \$ 1,390,001   |
| Tier I capital to risk-weighted assets  | \$ 3,342,439 | 14.95% | > \$1,341,100   | > 6.00%  | \$ 2,001,339   |
| Tier I capital to adjusted total assets | \$ 3,361,370 | 7.89%  | > \$2,128,929   | > 5.00%  | \$ 1,232,441   |
| <b>December 31, 2010:</b>               |              |        |   |          |                |
| Total capital to risk-weighted assets   | \$ 3,308,991 | 15.02% | > \$2,203,369   | > 10.00% | \$ 1,105,622   |
| Tier I capital to risk-weighted assets  | \$ 3,028,647 | 13.75% | > \$1,322,021   | > 6.00%  | \$ 1,706,626   |
| Tier I capital to adjusted total assets | \$ 3,052,012 | 7.30%  | > \$2,091,530   | > 5.00%  | \$ 960,482     |

**NOTE 13 COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS***Legal Matters**Litigation Matters*

On October 27, 2000, Ajaxo, Inc. ( Ajaxo ) filed a complaint in the Superior Court for the State of California, County of Santa Clara. Ajaxo sought damages and certain non-monetary relief for the Company's alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology that Ajaxo offered the Company as well as damages and other relief against the Company for their alleged misappropriation of Ajaxo's trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for \$1.3 million for breach of the Ajaxo non-disclosure agreement. Although the jury found in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets, the trial court subsequently denied Ajaxo's requests for additional damages and relief. On December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury's previous finding in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets. Although the Company paid Ajaxo the full amount due on the above-described judgment, the case was remanded back to the trial court, and on May 30, 2008, a jury returned a verdict in favor of the Company denying all claims raised and demands for damages against the Company. Following the trial court's filing of entry of judgment in favor of the Company on September 5, 2008, Ajaxo filed post-trial motions for vacating this entry of judgment and requesting a new trial. By order dated November 4, 2008, the trial court denied these motions. On December 2, 2008, Ajaxo filed a notice of appeal with the Court of Appeal of the State of California for the Sixth District. Oral argument on the appeal was heard on July 15, 2010. On August 30, 2010, the Court of Appeal affirmed the trial court's verdict in part and reversed the verdict in part, remanding the case. E\*TRADE petitioned the Supreme Court of California for review of the Court of Appeal decision. On December 16, 2010, the California Supreme Court denied the Company's petition for review and remanded for further proceedings to the trial court. A motion to re-open discovery is under submission at the trial court. The Company will continue to defend itself vigorously.

On October 2, 2007, a class action complaint alleging violations of the federal securities laws was filed in the United States District Court for the Southern District of New York against the Company and its then Chief Executive Officer and Chief Financial Officer, Mitchell H. Caplan and Robert J. Simmons, by Larry Freudenberg on his own behalf and on behalf of others similarly situated (the Freudenberg Action ). On July 17, 2008, the trial court consolidated this action with four other purported class actions, all of which were filed in the United States District Court for the Southern District of New York and which were based on the same facts and circumstances. On January 16, 2009, plaintiffs served their consolidated amended class action complaint in

---

**Table of Contents**

which they also named Dennis Webb, the Company's former Capital Markets Division President, as a defendant. Plaintiffs contend, among other things, that the value of the Company's stock between April 19, 2006 and November 9, 2007 was artificially inflated because the defendants issued materially false and misleading statements and failed to disclose that the Company was experiencing a rise in delinquency rates in its mortgage and home equity portfolios; failed to timely record an impairment on its mortgage and home equity portfolios; materially overvalued its securities portfolio, which included assets backed by mortgages; and based on the foregoing, lacked a reasonable basis for the positive statements made about the Company's earnings and prospects. Plaintiffs seek to recover damages in an amount to be proven at trial, including interest and attorneys' fees and costs. Defendants filed their motion to dismiss on April 2, 2009, and briefing on defendants' motion to dismiss was completed on August 31, 2009. On May 11, 2010, the Court issued an order denying defendants' motion to dismiss. The Company filed an Answer to the Complaint on June 25, 2010. Fact discovery and expert discovery are expected to conclude on May 15, 2012. The Company intends to vigorously defend itself against these claims.

On August 15, 2008, Ronald M. Tate as trustee of the Ronald M. Tate Trust Dtd 4/13/88, and George Avakian filed an action in the United States District Court for the Southern District of New York against the Company, Mitchell H. Caplan and Robert J. Simmons based on the same facts and circumstances, and containing the same claims, as the Freudenberg consolidated actions discussed above. By agreement of the parties and approval of the court, the Tate action has been consolidated with the Freudenberg consolidated actions for the purpose of pre-trial discovery. Plaintiffs seek to recover damages in an amount to be proven at trial, including interest, attorneys' and expert fees and costs. The Company intends to vigorously defend itself against these claims.

Based upon the same facts and circumstances alleged in the Freudenberg consolidated actions discussed above, a verified shareholder derivative complaint was filed in the United States District Court for the Southern District of New York on October 4, 2007 by Catherine Rubery, against the Company and its then Chief Executive Officer, President/Chief Operating Officer, Chief Financial Officer and individual members of its board of directors. The Rubery complaint was consolidated with another shareholder derivative complaint brought by shareholder Marilyn Clark in the same court and against the same named defendants. On July 26, 2010, Plaintiffs served their consolidated amended complaint, in which they also named Dennis Webb, the Company's former Capital Markets Division President, as a defendant. Plaintiffs allege, among other things, causes of action for breach of fiduciary duty, waste of corporate assets, unjust enrichment, and violation of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The complaint seeks, among other things, unspecified monetary damages in favor of the Company, changes to corporate governance procedures and various forms of injunctive relief. Pursuant to a stipulation, defendants' motion to dismiss the consolidated federal derivative actions is not due until July 2012.

On April 2, 2008, a class action complaint alleging violations of the federal securities laws was filed by John W. Oughtred on his own behalf and on behalf of all others similarly situated in the United States District Court for the Southern District of New York against the Company. Plaintiff contends, among other things, that the Company committed various sales practice violations in the sale of certain auction rate securities to investors between April 2, 2003, and February 13, 2008 by allegedly misrepresenting that these securities were highly liquid and safe investments for short term investing. On December 18, 2008, plaintiffs filed their first amended class action complaint. Defendants filed their pending motion to dismiss plaintiffs' amended complaint on February 5, 2009, and briefing on defendants' motion to dismiss was completed on April 15, 2009. Plaintiffs seek to recover damages in an amount to be proven at trial, or, in the alternative, rescission of auction rate securities purchases, plus interest and attorney's fees and costs. On March 18, 2010, the District Court dismissed the complaint without prejudice. On April 22, 2010, Plaintiffs amended their complaint. The Company has moved to dismiss the amended complaint. By an Order dated March 31, 2011, the Court granted E\*TRADE's motion and dismissed the action with prejudice. On May 2, 2011, Plaintiffs filed a Notice of Appeal.

---

**Table of Contents**

On February 3, 2010, a class action complaint was filed in the United States District Court for the Northern District of California against E\*TRADE Securities LLC by Joseph Roling on his own behalf and on behalf of all others similarly situated. The lead plaintiff alleges that E\*TRADE Securities LLC unlawfully charged and collected certain account activity fees from its customers. Claimant, on behalf of himself and the putative class, asserts breach of contract, unjust enrichment and violation of California Civil Code Section 1671 and seeks equitable and injunctive relief for alleged illegal, unfair and fraudulent practices under California's Unfair Competition Law, California Business and Professional Code Section 17200 et seq. The plaintiff seeks, among other things, certification of the class action on behalf of alleged similarly situated plaintiffs, unspecified damages and restitution of amounts allegedly wrongfully collected by E\*TRADE Securities LLC, attorneys fees and expenses and injunctive relief. The Company moved to transfer venue on the case to the Southern District of New York; that motion was denied. The Court granted E\*TRADE's motion to dismiss in part and denied the motion to dismiss in part. The Court bifurcated discovery to permit initial discovery on individual claims and class certification. Discovery on the merits will not commence until a class could be certified; the Court has set a date in 2012 for conclusion of discovery. The Company intends to vigorously defend itself against the claims raised in this action.

On May 16, 2011, Droplets Inc., the holder of two patents pertaining to user interface servers, filed a complaint in the U.S. District Court for the Eastern District of Texas against E\*TRADE Financial Corporation, E\*TRADE Securities LLC, E\*TRADE Bank N.A. and multiple other unaffiliated financial services firms. Plaintiff contends that the defendants engaged in patent infringement under federal law. Plaintiff seeks unspecified damages and an injunction against future infringements, plus royalties, costs, interest and attorney's fees. The Company's time to answer or otherwise respond to the complaint has been extended. The Company will defend itself vigorously in this matter.

Several cases have recently been filed involving the April 2007 leveraged buyout (LBO) of the Tribune Company (Tribune) by Sam Zell, and the subsequent bankruptcy of Tribune. In William Niese et al. v. A.G. Edwards et al., in Superior Court of Delaware, New Castle County, former Tribune employees and retirees claimed that Tribune was actually insolvent at the time of the LBO and that the LBO constituted a fraudulent transaction that depleted the plaintiffs' retirement plans, rendering them worthless. E\*TRADE Clearing LLC, along with numerous other financial institutions, is a named defendant, but has not been served with process. One of the defendants removed the action to federal district court in Delaware on July 1, 2011. In Deutsche Bank Trust Company Americas et al. v. Adaly Opportunity Fund et al., filed in the Supreme Court of New York, New York County on June 3, 2011, the Trustees of certain notes issued by Tribune, allege wrongdoing in connection with the LBO. In particular the Trustees claim that the LBO constituted a constructive fraudulent transfer under various state laws. E\*TRADE Capital Markets, LLC, along with numerous other financial institutions, is a named defendant. The Company's time to answer or otherwise respond to the complaint has been extended. The Company will defend itself vigorously in these matters.

In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business. In each pending matter, the Company contests liability or the amount of claimed damages. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, the Company cannot reasonably estimate the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what any eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, the Company believes that the outcome of any such pending matter will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome could be material to the Company's or a business segment's operating results in the future, depending, among other things, upon the Company's or business segment's income for such period.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company's favor, the defense of such litigation could entail considerable

---

**Table of Contents**

cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

*Regulatory Matters*

The securities and banking industries are subject to extensive regulation under federal, state and applicable international laws. From time to time, the Company has been threatened with or named as a defendant in, lawsuits, arbitrations and administrative claims involving securities, banking and other matters. The Company is also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators, such as the SEC, FINRA or FDIC by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers or disciplinary action being taken against the Company or its employees by regulators. Any such claims or disciplinary actions that are decided against the Company could have a material impact on the financial results of the Company or any of its subsidiaries.

On October 17, 2007, the SEC initiated an informal inquiry into matters related to the Company's mortgage loan and mortgage-related securities investment portfolios. The Company is cooperating fully with the SEC in this matter.

Beginning in approximately August 2008, representatives of various states attorneys general and FINRA initiated inquiries regarding the purchase of auction rate securities by E\*TRADE Securities LLC's customers. On February 9, 2011, E\*TRADE Securities LLC received a Wells Notice from FINRA Staff stating that they have made a preliminary determination to recommend that disciplinary action be brought against E\*TRADE Securities LLC for alleged violations of certain FINRA rules in connection with the purchases of auction rate securities by customers of E\*TRADE Securities LLC. E\*TRADE Securities LLC is cooperating with these inquiries and has submitted a Wells response to FINRA setting forth the bases for E\*TRADE Securities' belief that disciplinary action is not warranted. As of June 30, 2011, the total amount of auction rate securities held by all E\*TRADE Securities LLC customers was approximately \$123.1 million.

On January 19, 2010, the North Carolina Securities Division filed an administrative petition before the North Carolina Secretary of State against E\*TRADE Securities LLC seeking to revoke the North Carolina securities dealer registration of E\*TRADE Securities LLC or, alternatively, to suspend that registration until all North Carolina residents are made whole for their investments in auction rate securities purchased through E\*TRADE Securities LLC. On March 8, 2011, E\*TRADE Securities LLC, without admitting or denying the underlying allegations, findings or conclusions, resolved the North Carolina administrative action by entering into a consent order (North Carolina Order) pursuant to which E\*TRADE Securities LLC agreed to pay a \$25,000 civil penalty and to reimburse the North Carolina Securities Division's investigative costs of \$400,000. E\*TRADE Securities LLC also agreed to various undertakings set forth in the North Carolina Order, including additional internal training on fixed income products and the retention of an independent consultant to review E\*TRADE Securities LLC's policies and procedures related to the approval and sale of fixed income products. As of June 30, 2011, no existing North Carolina customers held any auction rate securities.

On July 21, 2010, the Colorado Division of Securities filed an administrative complaint in the Colorado Office of Administrative Courts against E\*TRADE Securities LLC based upon purchases of auction rate securities through E\*TRADE Securities LLC by Colorado residents. The complaint seeks to revoke, suspend, or otherwise impose conditions upon the Colorado broker-dealer license of E\*TRADE Securities LLC. E\*TRADE Securities LLC is defending that action. As of June 30, 2011, the total amount of auction rate securities held by Colorado customers was approximately \$3.4 million.

On August 24, 2010, the South Carolina Securities Division filed an administrative complaint before the Securities Commissioner of South Carolina against E\*TRADE Securities LLC based upon purchases of auction rate securities through E\*TRADE Securities LLC by South Carolina residents. The complaint sought to suspend

## **Table of Contents**

the South Carolina broker-dealer license of E\*TRADE Securities LLC until South Carolina customers who purchased auction rate securities through E\*TRADE Securities LLC and who wished to liquidate those positions were able to do so, and sought a fine not to exceed \$10,000 for each potential violation of South Carolina statutes or rules. On March 25, 2011, E\*TRADE Securities LLC, without admitting or denying the underlying allegations, findings or conclusions, resolved the South Carolina administrative action by entering into a consent order ( South Carolina Order ), pursuant to which E\*TRADE Securities LLC agreed to pay a \$10,000 civil penalty and to reimburse the South Carolina Securities Division's investigative costs of \$2,500. As of June 30, 2011, no existing South Carolina customers held any auction rate securities.

### *Insurance*

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company's ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

### *Reserves*

For all legal matters, reserves are established in accordance with the loss contingencies accounting guidance. Once established, reserves are adjusted based on available information when an event occurs requiring an adjustment.

### *Commitments*

In the normal course of business, the Company makes various commitments to extend credit and incur contingent liabilities that are not reflected in the consolidated balance sheet. Significant changes in the economy or interest rates may influence the impact that these commitments and contingencies have on the Company in the future.

### *Loans*

The Company provides access to real estate loans for its customers through a third party company. This lending product is being offered as a convenience to the Company's customers and is not one of its primary product offerings. The Company structured this arrangement to minimize the assumption of any of the typical risks commonly associated with mortgage lending. The third party company providing this product performs all processing and underwriting of these loans. Shortly after closing, the third party company purchases the loans from the Company and is responsible for the credit risk associated with these loans. The Company had \$19.2 million in commitments to originate loans, \$4.7 million in commitments to sell loans and no commitments to purchase loans at June 30, 2011.

### *Securities, Unused Lines of Credit and Certificates of Deposit*

At June 30, 2011, the Company had commitments to purchase \$0.1 billion in securities and no commitments to sell securities. In addition, the Company had approximately \$0.2 billion of certificates of deposit scheduled to mature in less than one year and \$0.9 billion of unfunded commitments to extend credit.

### *Guarantees*

In prior periods when the Company sold loans, the Company provided guarantees to investors purchasing mortgage loans, which are considered standard representations and warranties within the mortgage industry. The

## **Table of Contents**

primary guarantees are that: the mortgage and the mortgage note have been duly executed and each is the legal, valid and binding obligation of the Company, enforceable in accordance with its terms; the mortgage has been duly acknowledged and recorded and is valid; and the mortgage and the mortgage note are not subject to any right of rescission, set-off, counterclaim or defense, including, without limitation, the defense of usury, and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto. The Company is responsible for the guarantees on loans sold. If these claims prove to be untrue, the investor can require the Company to repurchase the loan and return all loan purchase and servicing release premiums. Management does not believe the potential liability exposure will have a material impact on the Company's results of operations, cash flows or financial condition due to the nature of the standard representations and warranties, which have resulted in a minimal amount of loan repurchases.

ETBH raised capital through the formation of trusts, which sold trust preferred securities in the capital markets. The capital securities are mandatorily redeemable in whole at the due date, which is generally 30 years after issuance. Each trust issues trust preferred securities at par, with a liquidation amount of \$1,000 per capital security. The proceeds from the sale of issuances are invested in ETBH's subordinated debentures.

During the 30-year period prior to the redemption of the trust preferred securities, ETBH guarantees the accrued and unpaid distributions on these securities, as well as the redemption price of the securities and certain costs that may be incurred in liquidating, terminating or dissolving the trusts (all of which would otherwise be payable by the trusts). At June 30, 2011, management estimated that the maximum potential liability under this arrangement is equal to approximately \$436.5 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

## **NOTE 14 SEGMENT INFORMATION**

The Company reports its operating results in two segments, based on the manner in which its chief operating decision maker evaluates financial performance and makes resource allocation decisions: 1) trading and investing; and 2) balance sheet management. Trading and investing includes retail brokerage products and services; investor-focused banking products; market making; and corporate services. Balance sheet management includes the management of asset allocation and credit, liquidity and interest rate risk; loans previously originated or purchased from third parties; and customer cash and deposits.

The Company does not allocate costs associated with certain functions that are centrally-managed to its operating segments. These costs are separately reported in a corporate/other category, along with technology related costs incurred to support centrally-managed functions; restructuring and other exit activities; and corporate debt and corporate investments. Balance sheet management pays the trading and investing segment for the use of its deposits via a deposit transfer pricing arrangement, which is eliminated in consolidation. The deposit transfer pricing arrangement is based on matching deposit balances with similar interest rate sensitivities and maturities.

**Table of Contents**

The Company evaluates the performance of its segments based on the segment's income (loss) before income taxes. Financial information for the Company's reportable segments is presented in the following tables (dollars in thousands):

|  | <b>Three Months Ended June 30, 2011</b> |                                     |                             |              |
|--|---|-------------------------------------|-----------------------------|--------------|
|  | <b>Trading and<br/>Investing</b>        | <b>Balance Sheet<br/>Management</b> | <b>Corporate/<br/>Other</b> | <b>Total</b> |
| Net operating interest income                                | \$ 191,752                              | \$ 123,663                          | \$ 6                        | \$ 315,421   |
| Total non-interest income                                    | 171,128                                 | 31,113                              | (43)                        | 202,198      |
| Total net revenue  | 362,880                                 | 154,776                             | (37)                        | 517,619      |
| Provision for loan losses                                    |   | 103,136                             |                             | 103,136      |
| Total operating expense                                      | 192,594                                 | 58,265                              | 40,059                      | 290,918      |
| Income (loss) before other income (expense) and income taxes | 170,286                                 | (6,625)                             | (40,096)                    | 123,565      |
| Total other income (expense)                                 |   |                                     | (40,957)                    | (40,957)     |
| Income (loss) before income taxes                            | \$ 170,286                              | \$ (6,625)                          | \$ (81,053)                 | 82,608       |
| Income tax expense   |   |                                     |                             | 35,490       |
| Net income   |   |                                     |                             | \$ 47,118    |

|  | <b>Three Months Ended June 30, 2010</b> |   |                             |              |
|--|---|---|-----------------------------|--------------|
|  | <b>Trading<br/>and<br/>Investing</b>    | <b>Balance<br/>Sheet<br/>Management</b> | <b>Corporate/<br/>Other</b> | <b>Total</b> |
| Net operating interest income                                | \$ 192,425                              | \$ 109,598                              | \$ 4                        | \$ 302,027   |
| Total non-interest income                                    | 193,366                                 | 38,645                                  | (37)                        | 231,974      |
| Total net revenue  | 385,791                                 | 148,243                                 | (33)                        | 534,001      |
| Provision for loan losses                                    |   | 165,666                                 |                             | 165,666      |
| Total operating expense                                      | 182,451                                 | 53,263                                  | 39,947                      | 275,661      |
| Income (loss) before other income (expense) and income taxes | 203,340                                 | (70,686)                                | (39,980)                    | 92,674       |
| Total other income (expense)                                 |   |   | (40,415)                    | (40,415)     |
| Income (loss) before income taxes                            | \$ 203,340                              | \$ (70,686)                             | \$ (80,395)                 | 52,259       |
| Income tax expense   |   |   |                             | 17,183       |
| Net income   |   |   |                             | \$ 35,076    |

|                               | <b>Six Months Ended June 30, 2011</b> |   |                             |              |
|-------------------------------|---------------------------------------|---|-----------------------------|--------------|
|                               | <b>Trading<br/>and<br/>Investing</b>  | <b>Balance<br/>Sheet<br/>Management</b> | <b>Corporate/<br/>Other</b> | <b>Total</b> |
| Net operating interest income | \$ 380,604                            | \$ 244,507                              | \$ 12                       | \$ 625,123   |
| Total non-interest income     | 369,333                               | 59,901                                  | (43)                        | 429,191      |
| Total net revenue             | 749,937                               | 304,408                                 | (31)                        | 1,054,314    |
| Provision for loan losses     |                                       | 219,194                                 |                             | 219,194      |
| Total operating expense       | 395,208                               | 111,730                                 | 81,994                      | 588,932      |

Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

|  |            |             |              |           |
|--|------------|-------------|--------------|-----------|
| Income (loss) before other income (expense) and income taxes | 354,729    | (26,516)    | (82,025)     | 246,188   |
| Total other income (expense)                                 |            |             | (84,616)     | (84,616)  |
| Income (loss) before income taxes                            | \$ 354,729 | \$ (26,516) | \$ (166,641) | 161,572   |
| Income tax expense   |            |             |              | 69,221    |
| Net income   |            |             |              | \$ 92,351 |



**Table of Contents**

|  | <b>Six Months Ended June 30, 2010</b> |                                     |                             |                  |
|--|---------------------------------------|-------------------------------------|-----------------------------|------------------|
|  | <b>Trading and<br/>Investing</b>      | <b>Balance Sheet<br/>Management</b> | <b>Corporate/<br/>Other</b> | <b>Total</b>     |
| Net operating interest income                                | \$ 386,066                            | \$ 236,346                          | \$ 12                       | \$ 622,424       |
| Total non-interest income                                    | 385,486                               | 62,627                              | (33)                        | 448,080          |
| <b>Total net revenue</b>                                     | <b>771,552</b>                        | <b>298,973</b>                      | <b>(21)</b>                 | <b>1,070,504</b> |
| Provision for loan losses                                    |                                       | 433,645                             |                             | 433,645          |
| <b>Total operating expense</b>                               | <b>382,465</b>                        | <b>104,965</b>                      | <b>83,567</b>               | <b>570,997</b>   |
| Income (loss) before other income (expense) and income taxes | 389,087                               | (239,637)                           | (83,588)                    | 65,862           |
| Total other income (expense)                                 |                                       |                                     | (79,532)                    | (79,532)         |
| Income (loss) before income taxes                            | \$ 389,087                            | \$ (239,637)                        | \$ (163,120)                | (13,670)         |
| Income tax benefit   |                                       |                                     |                             | (909)            |
| Net loss   |                                       |                                     |                             | \$ (12,761)      |

*Segment Assets*

|                         | <b>Trading<br/>and<br/>Investing</b> | <b>Balance<br/>Sheet<br/>Management</b> | <b>Corporate/<br/>Other</b> | <b>Total</b>  |
|-------------------------|--------------------------------------|---|-----------------------------|---------------|
| As of June 30, 2011     | \$ 9,655,812                         | \$ 36,334,546                           | \$ 993,954                  | \$ 46,984,312 |
| As of December 31, 2010 | \$ 9,049,333                         | \$ 36,118,175                           | \$ 1,205,493                | \$ 46,373,001 |

**NOTE 15 SUBSEQUENT EVENT**

A total of \$56.5 million in convertible debentures were converted into 5.5 million shares of common stock during the period July 1, 2011 through August 4, 2011. As of August 4, 2011, a total of \$1.7 billion of the convertible debentures has been converted into 164.2 million shares of common stock. The remaining face value of the convertible debentures as of August 4, 2011 was approximately \$44 million.

**ITEM 4. CONTROLS AND PROCEDURES**

- (a) Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report, have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.
- (b) Our Chief Executive Officer and our Chief Financial Officer have evaluated the changes to the Company's internal control over financial reporting that occurred during our last fiscal quarter ended June 30, 2011, as required by paragraph (d) of Exchange Act Rules 13a-15 and 15d-15, and have concluded that there were no such changes that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

## Edgar Filing: E TRADE FINANCIAL CORP - Form 10-Q

On October 27, 2000, Ajaxo, Inc. ( Ajaxo ) filed a complaint in the Superior Court for the State of California, County of Santa Clara. Ajaxo sought damages and certain non-monetary relief for the Company s alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology that Ajaxo offered the Company as well as damages and other relief against the Company for their alleged misappropriation

---

**Table of Contents**

of Ajaxo's trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for \$1.3 million for breach of the Ajaxo non-disclosure agreement. Although the jury found in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets, the trial court subsequently denied Ajaxo's requests for additional damages and relief. On December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury's previous finding in favor of Ajaxo on its claim against the Company for misappropriation of trade secrets. Although the Company paid Ajaxo the full amount due on the above-described judgment, the case was remanded back to the trial court, and on May 30, 2008, a jury returned a verdict in favor of the Company denying all claims raised and demands for damages against the Company. Following the trial court's filing of entry of judgment in favor of the Company on September 5, 2008, Ajaxo filed post-trial motions for vacating this entry of judgment and requesting a new trial. By order dated November 4, 2008, the trial court denied these motions. On December 2, 2008, Ajaxo filed a notice of appeal with the Court of Appeal of the State of California for the Sixth District. Oral argument on the appeal was heard on July 15, 2010. On August 30, 2010, the Court of Appeal affirmed the trial court's verdict in part and reversed the verdict in part, remanding the case. E\*TRADE petitioned the Supreme Court of California for review of the Court of Appeal decision. On December 16, 2010, the California Supreme Court denied the Company's petition for review and remanded for further proceedings to the trial court. A motion to re-open discovery is under submission at the trial court. The Company will continue to defend itself vigorously.

On October 2, 2007, a class action complaint alleging violations of the federal securities laws was filed in the United States District Court for the Southern District of New York against the Company and its then Chief Executive Officer and Chief Financial Officer, Mitchell H. Caplan and Robert J. Simmons, by Larry Freudenberg on his own behalf and on behalf of others similarly situated (the "Freudenberg Action"). On July 17, 2008, the trial court consolidated this action with four other purported class actions, all of which were filed in the United States District Court for the Southern District of New York and which were based on the same facts and circumstances. On January 16, 2009, plaintiffs served their consolidated amended class action complaint in which they also named Dennis Webb, the Company's former Capital Markets Division President, as a defendant. Plaintiffs contend, among other things, that the value of the Company's stock between April 19, 2006 and November 9, 2007 was artificially inflated because the defendants issued materially false and misleading statements and failed to disclose that the Company was experiencing a rise in delinquency rates in its mortgage and home equity portfolios; failed to timely record an impairment on its mortgage and home equity portfolios; materially overvalued its securities portfolio, which included assets backed by mortgages; and based on the foregoing, lacked a reasonable basis for the positive statements made about the Company's earnings and prospects. Plaintiffs seek to recover damages in an amount to be proven at trial, including interest and attorneys' fees and costs. Defendants filed their motion to dismiss on April 2, 2009, and briefing on defendants' motion to dismiss was completed on August 31, 2009. On May 11, 2010, the Court issued an order denying defendants' motion to dismiss. The Company filed an Answer to the Complaint on June 25, 2010. Fact discovery and expert discovery are expected to conclude on May 15, 2012. The Company intends to vigorously defend itself against these claims.

On October 17, 2007, the SEC initiated an informal inquiry into matters related to the Company's mortgage loan and mortgage-related securities investment portfolios. The Company is cooperating fully with the SEC in this matter.

On August 15, 2008, Ronald M. Tate as trustee of the Ronald M. Tate Trust Dtd 4/13/88, and George Avakian filed an action in the United States District Court for the Southern District of New York against the Company, Mitchell H. Caplan and Robert J. Simmons based on the same facts and circumstances, and containing the same claims, as the Freudenberg consolidated actions discussed above. By agreement of the parties and approval of the court, the Tate action has been consolidated with the Freudenberg consolidated actions for the purpose of pre-trial discovery. Plaintiffs seek to recover damages in an amount to be proven at trial, including interest, attorneys' and expert fees and costs. The Company intends to vigorously defend itself against these claims.

**Table of Contents**

Based upon the same facts and circumstances alleged in the Freudenberg consolidated actions discussed above, a verified shareholder derivative complaint was filed in the United States District Court for the Southern District of New York on October 4, 2007 by Catherine Rubery, against the Company and its then Chief Executive Officer, President/Chief Operating Officer, Chief Financial Officer and individual members of its board of directors. The Rubery complaint was consolidated with another shareholder derivative complaint brought by shareholder Marilyn Clark in the same court and against the same named defendants. On July 26, 2010, Plaintiffs served their consolidated amended complaint, in which they also named Dennis Webb, the Company's former Capital Markets Division President, as a defendant. Plaintiffs allege, among other things, causes of action for breach of fiduciary duty, waste of corporate assets, unjust enrichment, and violation of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The complaint seeks, among other things, unspecified monetary damages in favor of the Company, changes to corporate governance procedures and various forms of injunctive relief. Pursuant to a stipulation, defendants' motion to dismiss the consolidated federal derivative actions is not due until July 2012.

On April 2, 2008, a class action complaint alleging violations of the federal securities laws was filed by John W. Oughtred on his own behalf and on behalf of all others similarly situated in the United States District Court for the Southern District of New York against the Company. Plaintiff contends, among other things, that the Company committed various sales practice violations in the sale of certain auction rate securities to investors between April 2, 2003, and February 13, 2008 by allegedly misrepresenting that these securities were highly liquid and safe investments for short term investing. On December 18, 2008, plaintiffs filed their first amended class action complaint. Defendants filed their pending motion to dismiss plaintiffs' amended complaint on February 5, 2009, and briefing on defendants' motion to dismiss was completed on April 15, 2009. Plaintiffs seek to recover damages in an amount to be proven at trial, or, in the alternative, rescission of auction rate securities purchases, plus interest and attorney's fees and costs. On March 18, 2010, the District Court dismissed the complaint without prejudice. On April 22, 2010, Plaintiffs amended their complaint. The Company has moved to dismiss the amended complaint. By an Order dated March 31, 2011, the Court granted E\*TRADE's motion and dismissed the action with prejudice. On May 2, 2011, Plaintiffs filed a Notice of Appeal.

Beginning in approximately August 2008, representatives of various states attorneys general and FINRA initiated inquiries regarding the purchase of auction rate securities by E\*TRADE Securities LLC's customers. On February 9, 2011, E\*TRADE Securities LLC received a Wells Notice from FINRA Staff stating that they have made a preliminary determination to recommend that disciplinary action be brought against E\*TRADE Securities LLC for alleged violations of certain FINRA rules in connection with the purchases of auction rate securities by customers of E\*TRADE Securities LLC. E\*TRADE Securities LLC is cooperating with these inquiries and has submitted a Wells response to FINRA setting forth the bases for E\*TRADE Securities' belief that disciplinary action is not warranted. As of June 30, 2011, the total amount of auction rate securities held by all E\*TRADE Securities LLC customers was approximately \$123.1 million.

On January 19, 2010, the North Carolina Securities Division filed an administrative petition before the North Carolina Secretary of State against E\*TRADE Securities LLC seeking to revoke the North Carolina securities dealer registration of E\*TRADE Securities LLC or, alternatively, to suspend that registration until all North Carolina residents are made whole for their investments in auction rate securities purchased through E\*TRADE Securities LLC. On March 8, 2011, E\*TRADE Securities LLC, without admitting or denying the underlying allegations, findings or conclusions, resolved the North Carolina administrative action by entering into a consent order (North Carolina Order) pursuant to which E\*TRADE Securities LLC agreed to pay a \$25,000 civil penalty and to reimburse the North Carolina Securities Division's investigative costs of \$400,000. E\*TRADE Securities LLC also agreed to various undertakings set forth in the North Carolina Order, including additional internal training on fixed income products and the retention of an independent consultant to review E\*TRADE Securities LLC's policies and procedures related to the approval and sale of fixed income products. As of June 30, 2011, no existing North Carolina customers held any auction rate securities.

On February 3, 2010, a class action complaint was filed in the United States District Court for the Northern District of California against E\*TRADE Securities LLC by Joseph Roling on his own behalf and on behalf of all

---

**Table of Contents**

others similarly situated. The lead plaintiff alleges that E\*TRADE Securities LLC unlawfully charged and collected certain account activity fees from its customers. Claimant, on behalf of himself and the putative class, asserts breach of contract, unjust enrichment and violation of California Civil Code Section 1671 and seeks equitable and injunctive relief for alleged illegal, unfair and fraudulent practices under California's Unfair Competition Law, California Business and Professional Code Section 17200 et seq. The plaintiff seeks, among other things, certification of the class action on behalf of alleged similarly situated plaintiffs, unspecified damages and restitution of amounts allegedly wrongfully collected by E\*TRADE Securities LLC, attorneys fees and expenses and injunctive relief. The Company moved to transfer venue on the case to the Southern District of New York; that motion was denied. The Court granted E\*TRADE's motion to dismiss in part and denied the motion to dismiss in part. The Court bifurcated discovery to permit initial discovery on individual claims and class certification. Discovery on the merits will not commence until a class could be certified; the Court has set a date in 2012 for conclusion of discovery. The Company intends to vigorously defend itself against the claims raised in this action.

On July 21, 2010, the Colorado Division of Securities filed an administrative complaint in the Colorado Office of Administrative Courts against E\*TRADE Securities LLC based upon purchases of auction rate securities through E\*TRADE Securities LLC by Colorado residents. The complaint seeks to revoke, suspend, or otherwise impose conditions upon the Colorado broker-dealer license of E\*TRADE Securities LLC. E\*TRADE Securities LLC is defending that action. As of June 30, 2011, the total amount of auction rate securities held by Colorado customers was approximately \$3.4 million.

On August 24, 2010, the South Carolina Securities Division filed an administrative complaint before the Securities Commissioner of South Carolina against E\*TRADE Securities LLC based upon purchases of auction rate securities through E\*TRADE Securities LLC by South Carolina residents. The complaint sought to suspend the South Carolina broker-dealer license of E\*TRADE Securities LLC until South Carolina customers who purchased auction rate securities through E\*TRADE Securities LLC and who wished to liquidate those positions were able to do so, and sought a fine not to exceed \$10,000 for each potential violation of South Carolina statutes or rules. On March 25, 2011, E\*TRADE Securities LLC, without admitting or denying the underlying allegations, findings or conclusions, resolved the South Carolina administrative action by entering into a consent order ( South Carolina Order ), pursuant to which E\*TRADE Securities LLC agreed to pay a \$10,000 civil penalty and to reimburse the South Carolina Securities Division's investigative costs of \$2,500. As of June 30, 2011, no existing South Carolina customers held any auction rate securities.

On May 16, 2011, Droplets Inc., the holder of two patents pertaining to user interface servers, filed a complaint in the U.S. District Court for the Eastern District of Texas against E\*TRADE Financial Corporation, E\*TRADE Securities LLC, E\*TRADE Bank N.A. and multiple other unaffiliated financial services firms. Plaintiff contends that the defendants engaged in patent infringement under federal law. Plaintiff seeks unspecified damages and an injunction against future infringements, plus royalties, costs, interest and attorney's fees. The Company's time to answer or otherwise respond to the complaint has been extended. The Company will defend itself vigorously in this matter.

Several cases have recently been filed involving the April 2007 leveraged buyout ( LBO ) of the Tribune Company ( Tribune ) by Sam Zell, and the subsequent bankruptcy of Tribune. In William Niese et al. v. A.G. Edwards et al., in Superior Court of Delaware, New Castle County, former Tribune employees and retirees claimed that Tribune was actually insolvent at the time of the LBO and that the LBO constituted a fraudulent transaction that depleted the plaintiffs' retirement plans, rendering them worthless. E\*TRADE Clearing LLC, along with numerous other financial institutions, is a named defendant, but has not been served with process. One of the defendants removed the action to federal district court in Delaware on July 1, 2011. In Deutsche Bank Trust Company Americas et al. v. Adaly Opportunity Fund et al., filed in the Supreme Court of New York, New York County on June 3, 2011, the Trustees of certain notes issued by Tribune, allege wrongdoing in connection with the LBO. In particular the Trustees claim that the LBO constituted a constructive fraudulent transfer under various state laws. E\*TRADE Capital Markets, LLC, along with numerous other financial institutions, is a named defendant. The Company's time to answer or otherwise respond to the complaint has been extended. The Company will defend itself vigorously in these matters.

**Table of Contents**

In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business. In each pending matter, the Company contests liability or the amount of claimed damages. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, the Company cannot reasonably estimate the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what any eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, the Company believes that the outcome of any such pending matter will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome could be material to the Company's or a business segment's operating results in the future, depending, among other things, upon the Company's or business segment's income for such period.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company's favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company's ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

**ITEM 1A. RISK FACTORS**

There have been no material changes in the Company's risk factors from those disclosed in its Annual Report on Form 10-K for the year ended December 31, 2010.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**Table of Contents**

**ITEM 6. EXHIBITS**

|          |   |
|----------|---|
| *4.1     | Security Agreement dated June 15, 2011, among the Company, the Subsidiary Grantors Party Hereto and The Bank of New York Mellon., as Collateral Trustee, relating to the 2016 Notes.                              |
| *4.2     | First Supplemental Indenture dated June 15, 2011, among the Company, the Guaranteeing Subsidiaries Party Hereto and The Bank of New York Mellon Trust Company, N.A., as Trustee, relating to the 2016 Notes.      |
| *4.3     | Second Supplemental Indenture dated June 15, 2011, among the Company, the Guaranteeing Subsidiaries Party Hereto and The Bank of New York Mellon Trust Company, N.A., as Trustee, relating to the 2015 Notes.     |
| *4.4     | Fourth Supplemental Indenture dated June 15, 2011, among the Company, the Guaranteeing Subsidiaries Party Hereto and The Bank of New York Mellon Trust Company, N.A., as Trustee, relating to the 2017 Notes.     |
| *4.5     | Third Supplemental Indenture dated June 15, 2011, among the Company, the Guaranteeing Subsidiaries Party Hereto and The Bank of New York Mellon Trust Company, N.A., as Trustee, relating to the 2019 Debentures. |
| *31.1    | Certification Section 302 of the Sarbanes-Oxley Act of 2002   |
| *31.2    | Certification Section 302 of the Sarbanes-Oxley Act of 2002   |
| *32.1    | Certification Section 906 of the Sarbanes-Oxley Act of 2002   |
| *101.INS | XBRL Instance Document  |
| *101.SCH | XBRL Taxonomy Extension Schema Document   |
| *101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document   |
| *101.DEF | XBRL Taxonomy Extension Definition Linkbase Document  |
| *101.LAB | XBRL Taxonomy Extension Label Linkbase Document   |
| *101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document  |

\* Filed herein.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: August 4, 2011

E\*TRADE Financial Corporation

(Registrant)

By            /s/ STEVEN J. FREIBERG  
                 Steven J. Freiberg

*Chief Executive Officer*

*(Principal Executive Officer)*

By            /s/ MATTHEW J. AUDETTE  
                 Matthew J. Audette

*Chief Financial Officer*

*(Principal Financial and Accounting Officer)*