

E TRADE FINANCIAL CORP
Form 10-Q
August 09, 2007
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, 2007

or

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

Commission File Number 1-11921

E*TRADE Financial Corporation

(Exact Name of Registrant as Specified in its Charter)

Delaware
(State or Other Jurisdiction
of Incorporation or Organization)

135 East 57th Street, New York, New York 10022

(Address of Principal Executive Offices and Zip Code)

(646) 521-4300

(Registrant's Telephone Number, including Area Code)

94-2844166
(I.R.S. Employer

Identification Number)

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

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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

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 3, 2007, there were 423,629,118 shares of common stock outstanding.

Table of Contents

E*TRADE FINANCIAL CORPORATION

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended June 30, 2007

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)	32
<u>Consolidated Statement of Income</u>	32
<u>Consolidated Balance Sheet</u>	33
<u>Consolidated Statement of Comprehensive Income</u>	34
<u>Consolidated Statement of Shareholders' Equity</u>	35
<u>Consolidated Statement of Cash Flows</u>	36
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	38
<u>Note 1 Organization, Basis of Presentation and Summary of Significant Accounting Policies</u>	38
<u>Note 2 Discontinued Operations</u>	40
<u>Note 3 Facility Restructuring and Other Exit Activities</u>	41
<u>Note 4 Operating Interest Income and Operating Interest Expense</u>	42
<u>Note 5 Available-for-Sale Mortgage-Backed and Investment Securities</u>	43
<u>Note 6 Loans, Net</u>	46
<u>Note 7 Accounting for Derivative Financial Instruments and Hedging Activities</u>	46
<u>Note 8 Other Assets</u>	50
<u>Note 9 Asset Securitization</u>	51
<u>Note 10 Deposits</u>	51
<u>Note 11 Other Borrowings</u>	52
<u>Note 12 Accounts Payable, Accrued and Other Liabilities</u>	52
<u>Note 13 Income Taxes</u>	52
<u>Note 14 Earnings per Share</u>	53
<u>Note 15 Share Repurchases</u>	54
<u>Note 16 Regulatory Requirements</u>	54
<u>Note 17 Commitments, Contingencies and Other Regulatory Matters</u>	55
<u>Note 18 Segment Information</u>	58
<u>Note 19 Subsequent Event</u>	62
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	3
<u>Overview</u>	3
<u>Earnings Overview</u>	6
<u>Segment Results Review</u>	15
<u>Balance Sheet Overview</u>	18
<u>Liquidity and Capital Resources</u>	24
<u>Summary of Critical Accounting Policies and Estimates</u>	25
<u>Glossary of Terms</u>	26
Item 3. Quantitative and Qualitative Disclosures about Market Risk	29
Item 4. Controls and Procedures	63
<u>PART II OTHER INFORMATION</u>	
Item 1. Legal Proceedings	64
Item 1A. Risk Factors	65
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	65
Item 3. Defaults Upon Senior Securities	66
Item 4. Submission of Matters to a Vote of Security Holders	66
Item 5. Other Information	66
Item 6. Exhibits	66
Signatures	67

*Unless otherwise indicated, references to the Company, We, Us, Our and E*TRADE mean E*TRADE Financial Corporation or its subsidiaries.*

E*TRADE, E*TRADE Financial, E*TRADE Bank (Bank), ClearStation, Equity Edge, Equity Resource, 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

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements involving risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as expect, may, anticipate, intend, plan and similar expressions. Our actual results could differ materially from those discussed in these forward-looking statements, and we caution that we do not undertake to update these statements. Factors that could contribute to our actual results differing from any forward-looking statements include those discussed under Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report. The cautionary statements made in this report should be read as being applicable to all forward-looking statements wherever they appear in this report. Important factors that may cause actual results to differ materially from any forward-looking statements are set forth in our 2006 Form 10-K filed with the Securities and Exchange Commission (SEC) under the heading Risk Factors.

We further caution that there may be risks associated with owning our securities other than those discussed in such filings.

GLOSSARY OF TERMS

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

OVERVIEW

Strategy

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

Key Factors Affecting Financial Performance

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

customer demand for financial products and services;

competitors' pricing on financial products and services;

the weakness or strength of the consumer credit market;

interest rates and the shape of the interest rate yield curve; and

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

Table of Contents

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

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

deepening customer acceptance of our trading, investing, banking and lending products;

disciplined expense control and improved operational efficiency;

maintaining strong overall asset quality; and

prudent risk and capital management.

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

	At or For the			At or For the		
	Three Months Ended		Variance	Six Months Ended		Variance
	June 30,	2006		June 30,	2006	
	2007		2007 vs. 2006	2007		2007 vs. 2006
Customer Activity Metrics:						
Retail client assets (dollars in billions)	\$ 212.8	\$ 180.1	18 %	\$ 212.8	\$ 180.1	18 %
Customer cash and deposits (dollars in billions)	\$ 37.9	\$ 30.1	26 %	\$ 37.9	\$ 30.1	26 %
U.S. daily average revenue trades	141,606	142,621	(1)%	141,425	150,843	(6)%
International daily average revenue trades	27,516	22,981	20 %	28,146	22,475	25 %
Total daily average revenue trades	169,122	165,602	2 %	169,571	173,318	(2)%
Average commission per trade	\$ 12.03	\$ 12.23	(2)%	\$ 11.96	\$ 12.16	(2)%
Company Financial Metrics:						
Net revenue growth ⁽¹⁾	9%	58%	(49)%	8%	50%	(42)%
Enterprise net interest spread (basis points)	271	291	(7)%	272	290	(6)%
Enterprise interest-earning assets (average in billions)	\$ 57.7	\$ 44.1	31 %	\$ 55.3	\$ 42.7	29 %
Total non-performing loans receivable as a % of total gross loans receivable	0.53%	0.22%	0.31 %	0.53%	0.22%	0.31 %
Operating margin (%)	39%	43%	(4)%	41%	42%	(1)%
Compensation and benefits as a % of revenue	18%	21%	(3)%	19%	20%	(1)%

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

Customer Activity Metrics

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

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

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

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

Table of Contents

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

Company Financial Metrics

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

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

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

Total non-performing loans receivable as a percentage of gross loans receivable is an indicator of the performance of our total loan portfolio.

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

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

Significant Events in the Second Quarter of 2007*International Expansion*

We continued our expansion into international markets with the launch of operations in Norway and the Netherlands. In Norway, we now offer online trading of all Norwegian stocks registered on the Norwegian exchange Oslo Børs, as well as stocks from Scandinavian markets in Sweden, Denmark, Finland, and the American markets. In the Netherlands, we offer Dutch investors direct access to the US stock markets through our global trading platform.

Enhanced Distribution Network

We enhanced our distribution network by opening three new E*TRADE Financial centers during the period. With the addition of centers in Charlotte, NC; Houston, TX; and Minneapolis, MN, we increased the number of our nationwide financial centers to a total of 27.

Summary Financial Results

Income Statement Highlights for the Three and Six Months Ended June 30, 2007 (dollars in millions, except per share amounts)

	Three Months Ended June 30,		Variance	Six Months Ended June 30,		Variance
	2007	2006	2007 vs. 2006	2007	2006	2007 vs. 2006
Total net revenue	\$ 663.5	\$ 611.4	9 %	\$ 1,308.5	\$ 1,209.7	8 %
Net operating interest income after provision for loan losses	\$ 384.1	\$ 334.3	15 %	\$ 753.5	\$ 648.9	16 %
Operating margin	\$ 261.4	\$ 260.8	0 %	\$ 532.0	\$ 504.5	5 %

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

Net income	\$ 159.1	\$ 156.5	2 %	\$ 328.5	\$ 299.0	10 %
Diluted net earnings per share	\$ 0.37	\$ 0.36	3 %	\$ 0.75	\$ 0.69	9 %
Operating margin (%)	39%	43%	(4)%	41%	42%	(1)%

During the second quarter of 2007, despite volatility in the global equity markets and sustained pressure on the domestic real estate market, we continued to strengthen our financial performance. Total net revenue and net

Table of Contents

income increased 9% and 2%, respectively, when compared to the corresponding period in the prior year. We believe the investments we have made in marketing, operations and service are driving organic growth in customer cash and deposits and margin receivables, which are the primary drivers of our increase in net income. The decrease in operating margin to 39% in the second quarter of 2007 from 43% when compared to the same period in the prior year is due primarily to \$35.1 million in expense recorded for certain legal and regulatory matters⁽¹⁾.

Net operating interest income after provision for loan losses increased 15% to \$384.1 million for the three months ended June 30, 2007, compared with the same period in 2006. Net operating interest income benefited from increases in customer cash and deposits, which increased \$7.8 billion compared to the same period in 2006. The increase in customer cash and deposits resulted from organic growth, primarily in our new Complete Savings Account, which was launched at the end of 2006. This new product has driven meaningful growth in cash from new and existing customers. In addition, customers who utilized this new product tended to engage more broadly with our other products and services.

Balance Sheet Highlights (dollars in billions)

	June 30,	December 31,	Variance
	2007	2006	2007 vs. 2006
Total assets	\$ 63.0	\$ 53.7	17 %
Total enterprise interest-earning assets	\$ 58.7	\$ 49.5	19 %
Loans, net and margin receivables as a percentage of enterprise interest-earning assets ⁽²⁾	67%	68%	(1)%
Retail deposits and customer payables as a percentage of enterprise interest-bearing liabilities ⁽²⁾	61%	64%	(3)%

The increase in total assets was attributable primarily to an increase of \$5.1 billion in loans receivable, net. The increase in loans receivable, net was due principally to growth in our real estate loan portfolio, specifically first lien real estate loans. During the second quarter of 2007, we focused on growing our first lien real estate loan portfolio, allowing our consumer loan and second lien real estate portfolios to decline. Enterprise interest-earning assets were \$58.7 billion at June 30, 2007, an increase of \$9.2 billion from December 31, 2006, which was related primarily to the increase in loans, net and margin receivables.

Retail deposits and customer payables were \$33.9 billion at June 30, 2007, up 14% or \$4.1 billion compared to December 31, 2006. Retail deposits and customer payables are two of our lowest cost sources of funding and are important contributors to our net operating interest income growth. The increase during the period was due primarily to growth in the Complete Savings Account.

EARNINGS OVERVIEW

Net income increased 2% to \$159.1 million and 10% to \$328.5 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase was a result of strong growth in retail deposits and customer payables, which are the primary funding source for interest-earning assets.

We report corporate interest income and corporate interest expense separately from operating interest income and operating interest expense. We believe reporting these two items separately provides a clearer picture

-
- (1) Refer to Note 17 Commitments, Contingencies and Other Regulatory Matters for the disclosure around legal and regulatory matters.
- (2) Loans, net and margin receivables as a percentage of enterprise interest-earning assets and retail deposits and customer payables as a percentage of enterprise interest-bearing liabilities include balances not recorded on the balance sheet, such as margin and customer cash and deposits held by third parties.

Table of Contents

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

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

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

Revenue

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

	Three Months Ended		Variance		Six Months Ended		Variance	
	June 30,		2007 vs. 2006		June 30,		2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Revenue:								
Operating interest income	\$ 905,772	\$ 660,373	\$ 245,399	37 %	\$ 1,735,567	\$ 1,254,667	\$ 480,900	38 %
Operating interest expense	(491,608)	(315,771)	(175,837)	56 %	(930,817)	(585,276)	(345,541)	59 %
Net operating interest income	414,164	344,602	69,562	20 %	804,750	669,391	135,359	20 %
Provision for loan losses	(30,045)	(10,270)	(19,775)	193 %	(51,231)	(20,467)	(30,764)	150 %
Net operating interest income after provision for loan losses	384,119	334,332	49,787	15 %	753,519	648,924	104,595	16 %
Commission	169,768	167,296	2,472	1 %	328,761	343,165	(14,404)	(4)%
Fees and service charges	65,446	57,809	7,637	13 %	124,944	115,671	9,273	8 %
Principal transactions	27,768	31,590	(3,822)	(12)%	57,850	62,282	(4,432)	(7)%
Gain on sales of loans and securities, net	5,328	11,107	(5,779)	(52)%	22,703	22,735	(32)	(0)%
Other revenue	11,120	9,224	1,896	21 %	20,770	16,930	3,840	23 %
Total non-interest income	279,430	277,026	2,404	1 %	555,028	560,783	(5,755)	(1)%
Total net revenue	\$ 663,549	\$ 611,358	\$ 52,191	9 %	\$ 1,308,547	\$ 1,209,707	\$ 98,840	8 %

Table of Contents

Net operating interest income after provision for loan losses continues to be our largest source of revenue and represents 58% of total net revenue for both the three and six months ended June 30, 2007. This reflects our focus on retaining retail customer cash and deposits and retail credit balances. Net operating interest income is earned primarily through holding credit balances, which includes margin, real estate and consumer loans, and by holding customer cash and deposits, which are a low cost source of funding. The table below presents each revenue component as a percentage of total net revenue.

	Three Months Ended June 30,		Variance	Six Months Ended June 30,		Variance
	2007	2006	2007 vs. 2006	2007	2006	2007 vs. 2006
Revenue:						
Net operating interest income after provision for loan losses	58%	55%	3%	58%	54%	4%
Commission ⁽¹⁾	25	27	(2)	25	28	(3)
Fees and service charges	10	9	1	10	10	
Principal transactions	4	5	(1)	4	5	(1)
Gain on sales of loans and securities, net	1	2	(1)	2	2	
Other revenue	2	2		1	1	
Total net revenue	100%	100%	%	100%	100%	%

⁽¹⁾ Retail commission revenue represented 19% and 21% of total net revenue for the three months ended June 30, 2007 and 2006, respectively, and 19% and 22% for the six months ended June 30, 2007 and 2006, respectively. Institutional commission revenue represented 6% of total net revenue for both the three months ended June 30, 2007 and 2006, and 6% and 7% for the six months ended June 30, 2007 and 2006, respectively.

Net Operating Interest Income after Provision for Loan Losses

Net operating interest income after provision for loan losses increased 15% to \$384.1 million and 16% to \$753.5 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase in net operating interest income was due primarily to growth in enterprise interest-earning assets, specifically loans, net. Average loans, net as a percentage of average enterprise interest-earning assets increased 8% to 54% and 6% to 53% for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006.

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 thousands):

	Three Months Ended June 30,					
	Average Balance	2007 Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	2006 Operating Interest Inc./Exp.	Average Yield/Cost
Enterprise interest-earning assets:						
Loans, net	\$ 31,037,971	\$ 497,517	6.41%	\$ 20,419,936	\$ 303,499	5.95%
Margin receivables	7,003,411	127,335	7.29%	6,982,867	123,390	7.09%
Mortgage-backed and related available-for-sale securities	13,027,383	172,501	5.30%	11,715,510	147,374	5.03%
Available-for-sale investment securities	4,502,434	73,133	6.50%	3,048,166	47,287	6.21%
Trading securities	114,135	3,174	11.12%	142,452	2,946	8.27%
Cash and cash equivalents ⁽¹⁾	1,244,965	15,008	4.84%	1,260,684	13,421	4.27%
Stock borrow and other	752,280	14,688	7.83%	493,981	8,795	7.14%
Total enterprise interest-earning assets	57,682,579	903,356	6.27%	44,063,596	646,712	5.87%
Non-operating interest-earning assets ⁽²⁾	4,610,421			4,592,685		
Total assets	\$ 62,293,000			\$ 48,656,281		
Enterprise interest-bearing liabilities:						
Retail deposits	\$ 26,778,743	200,081	3.00%	\$ 19,848,322	115,062	2.33%
Brokered certificates of deposit	424,645	5,220	4.93%	577,068	6,696	4.65%
Customer payables	6,836,301	22,779	1.34%	6,416,136	16,957	1.06%
Repurchase agreements and other borrowings	13,558,998	175,337	5.12%	10,580,283	129,103	4.83%
Federal Home Loan Bank (FHLB) advances	6,151,086	78,800	5.07%	2,842,198	32,207	4.48%
Stock loan and other	1,194,006	8,381	2.82%	1,133,694	8,487	3.00%
Total enterprise interest-bearing liabilities	54,943,779	490,598	3.56%	41,397,701	308,512	2.96%
Non-operating interest-bearing liabilities ⁽³⁾	2,973,193			3,514,973		
Total liabilities	57,916,972			44,912,674		
Total shareholders' equity	4,376,028			3,743,607		
	\$ 62,293,000			\$ 48,656,281		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread						
	\$ 2,738,800	\$ 412,758	2.71%	\$ 2,665,895	\$ 338,200	2.91%
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.86%			3.07%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			104.98%			106.44%
Return on average:						
Total assets			1.02%			1.29%
Total shareholders' equity			14.55%			16.72%
Average equity to average total assets			7.02%			7.69%

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

Three Months Ended
June 30,
2007 2006

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

Enterprise net interest income ⁽⁴⁾	\$ 412,758	\$ 338,200
Taxable equivalent interest adjustment	(7,487)	(4,306)
Customer cash held by third parties and other ⁽⁵⁾	8,893	10,708
Net operating interest income	\$ 414,164	\$ 344,602

(1) Includes segregated cash balances.

(2) Non-operating interest-earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.

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

(4) Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.

(5) Includes interest earned on average customer assets of \$4.0 billion and \$3.4 billion for the three months ended June 30, 2007 and 2006, respectively, held by parties outside E*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions. Other consists of net operating interest income earned on average stock conduit assets of \$2.2 million and \$362.4 million for the three months ended June 30, 2007 and 2006, respectively.

Table of Contents

	Six Months Ended June 30,					
	Average Balance	2007 Operating Interest Inc./Exp.	Average Yield/Cost	Average Balance	2006 Operating Interest Inc./Exp.	Average Yield/Cost
Enterprise interest-earning assets:						
Loans, net	\$ 29,573,824	\$ 948,916	6.42%	\$ 19,997,845	\$ 584,769	5.85%
Margin receivables	6,896,215	251,321	7.35%	6,731,622	228,294	6.84%
Mortgage-backed and related available-for-sale securities	12,536,473	330,468	5.27%	11,138,767	272,878	4.90%
Available-for-sale investment securities	4,203,594	136,629	6.50%	2,785,456	84,676	6.08%
Trading securities	116,941	6,443	11.02%	140,566	5,594	7.96%
Cash and cash equivalents ⁽¹⁾	1,301,131	30,938	4.79%	1,403,846	29,320	4.21%
Stock borrow and other	662,044	24,739	7.54%	512,204	16,525	6.51%
Total enterprise interest-earning assets	55,290,222	1,729,454	6.27%	42,710,306	1,222,056	5.73%
Non-operating interest-earning assets ⁽²⁾	4,516,233			4,794,715		
Total assets	\$ 59,806,455			\$ 47,505,021		
Enterprise interest-bearing liabilities:						
Retail deposits	\$ 25,743,429	377,410	2.96%	\$ 18,988,979	205,567	2.18%
Brokered certificates of deposit	445,486	10,879	4.92%	499,266	10,809	4.37%
Customer payables	6,609,616	43,258	1.32%	6,586,985	33,330	1.02%
Repurchase agreements and other borrowings	12,852,361	334,368	5.17%	10,219,654	240,623	4.68%
Federal Home Loan Bank (FHLB) advances	5,576,927	141,652	5.05%	2,947,569	64,746	4.37%
Stock loan and other	1,271,225	20,896	3.31%	903,005	12,684	2.83%
Total enterprise interest-bearing liabilities	52,499,044	928,463	3.55%	40,145,458	567,759	2.83%
Non-operating interest-bearing liabilities ⁽³⁾	2,993,659			3,757,322		
Total liabilities	55,492,703			43,902,780		
Total shareholders' equity	4,313,752			3,602,241		
	\$ 59,806,455			\$ 47,505,021		
Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread						
	\$ 2,791,178	\$ 800,991	2.72%	\$ 2,564,848	\$ 654,297	2.90%
Enterprise net interest margin (net yield on enterprise interest-earning assets)			2.90%			3.06%
Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities			105.32%			106.39%
Return on average:						
Total assets			1.10%			1.26%
Total shareholders' equity			15.23%			16.60%
Average equity to average total assets			7.21%			7.58%
Reconciliation from enterprise net interest income to net operating interest income (dollars in thousands):						
	Six Months Ended June 30,					
	2007	2006				
Enterprise net interest income ⁽⁴⁾	\$ 800,991	\$ 654,297				
Taxable equivalent interest adjustment	(14,807)	(7,698)				
Customer cash held by third parties and other ⁽⁵⁾	18,566	22,792				
Net operating interest income	\$ 804,750	\$ 669,391				

-
- (1) Includes segregated cash balances.
 - (2) Non-operating interest-earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.
 - (3) Non-operating interest-bearing liabilities consist of corporate debt, accounts payable, accrued and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.
 - (4) Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.
 - (5) Includes interest earned on average customer assets of \$3.9 billion and \$3.5 billion for the six months ended June 30, 2007 and 2006, respectively, held by parties outside E*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions. Other consists of net operating interest income earned on average stock conduit assets of \$2.4 million and \$591.9 million for the six months ended June 30, 2007 and 2006, respectively.

Table of Contents

Average enterprise interest-earning assets increased 31% to \$57.7 billion and 29% to \$55.3 billion for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. Average loans, net grew 52% to \$31.0 billion and 48% to \$29.6 billion for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. Average loans, net grew as a result of our focus on growing real estate loan products.

Average enterprise interest-bearing liabilities increased 33% to \$54.9 billion and 31% to \$52.5 billion for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase in average enterprise interest-bearing liabilities was primarily in retail deposits. Average retail deposits increased 35% to \$26.8 billion and 36% to \$25.7 billion for the three and six months ended June 30, 2007, respectively, compared to the same period in 2006. Increases in average retail deposits were driven by growth in the Complete Savings Account.

Enterprise net interest spread decreased by 20 basis points to 2.71% and 18 basis points to 2.72% for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This decrease was primarily the result of a challenging interest rate environment throughout the past 12 months, during which the yield curve remained relatively flat to inverted.

Provision for Loan Losses

Provision for loan losses increased 193% to \$30.0 million and 150% to \$51.2 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase in the provision for loan losses was related primarily to the growth in our second lien real estate loan portfolio and the increase in delinquent loans during the period. While our credit standards have remained strong, we anticipate upward trends in delinquencies and charge-offs compared to 2006 as a result of the continued seasoning of our second lien real estate loan portfolio and the current instability in the overall consumer credit market. The provision for loan losses is expected to increase in future periods based on the seasoning of the portfolio and the increase in delinquencies and charge-offs. Further deterioration in the consumer credit market could drive an additional increase in the provision for loan losses.

Commission

Retail and institutional commission revenue increased 1% to \$169.8 million for the three months ended June 30, 2007, compared to the same period in 2006 and decreased 4% to \$328.8 million for six months ended June 30, 2007, compared to the same period in 2006. The primary factors that affect our retail commission revenue are DARTs and average commission per trade, which is impacted by both trade types and the mix between our domestic and international businesses. Each business has a different pricing structure, unique to its customer base and local market practices, and as a result, a change in the relative number of executed trades in these businesses impacts average commission per trade. Each business also has different trade types (e.g. equities, options, fixed income, exchange-traded funds, contract for difference and mutual funds) that can have different commission rates. As a result, changes in the mix of trade types within either of these businesses may impact average commission per trade. Institutional commission revenue is also impacted by negotiated rates, which differ by customer. Our institutional customers are provided with global execution and settlement services as well as worldwide access to research provided by third parties in exchange for commissions based on negotiated rates.

DARTs increased 2% to 169,122 for the three months ended June 30, 2007, compared to the same period in 2006 and decreased 2% to 169,571 for the six months ended June 30, 2007, compared to the same period in 2006. Our U.S. DART volume decreased 1% and 6% for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006, driven by changing market conditions and decreased trading activities. Our international DARTs grew by 20% and 25% for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006, driven entirely by organic growth. Our international operations continue to be a strong growth contributor within our retail trading business, and we believe that over time they will become a significant component of our entire business. In addition, option-related DARTs further increased as a percentage of our total U.S. DARTs and now represent 15% of U.S. trading volume versus 12% a year ago.

Table of Contents

Average commission per trade decreased 2% to \$12.03 and 2% to \$11.96 for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease was primarily a function of the mix of customers. Main Street Investors, who generally have a higher commission per trade, traded less during the period which resulted in a heavier weighting of Active Traders, who generally have a lower commission per trade.

Fees and Service Charges

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

Fees and service charges increased 13% to \$65.4 million and 8% to \$124.9 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase was due to an increase in our advisor management fees, mutual fund fees, order flow payment and CDO management fees, partially offset by a decrease in account maintenance fees and mortgage servicing fees. We expect our account maintenance fee income to continue to decline over time as we have fewer customers who are subject to the fee; however, we expect our advisory management fee income, which is not currently a significant portion of fees and service charges, to increase over time as we focus on growing this product.

Principal Transactions

Principal transactions decreased 12% to \$27.8 million and 7% to \$57.9 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease in principal transactions resulted from lower trading volumes as well as a decrease in the average revenue earned per trade. Our principal transactions revenue is influenced by overall trading volumes, the number of stocks for which we act as a market maker, the trading volumes of those specific stocks and the performance of our proprietary trading activities.

Gain on Sales of Loans and Securities, Net

Gain on sales of loans and securities, net decreased 52% to \$5.3 million for the three months ended June 30, 2007 compared to the same period in 2006 and remained flat at \$22.7 million for the six months ended June 30, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands):

	Three Months Ended June 30,		Variance 2007 vs. 2006		Six Months Ended June 30,		Variance 2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Gain on sales of originated loans	\$ 2,043	\$ 2,681	\$ (638)	(24)%	\$ 3,958	\$ 5,999	\$ (2,041)	(34)%
Gain (loss) on sales of loans held-for-sale, net	(25)	(409)	384	(94)%	(1,687)	(1,098)	(589)	54 %
Gain on sales of loans, net	2,018	2,272	(254)	(11)%	2,271	4,901	(2,630)	(54)%
Gain on sales of securities, net	3,310	8,835	(5,525)	(63)%	20,432	17,834	2,598	15 %
Total gain on sales of loans and securities, net	\$ 5,328	\$ 11,107	\$ (5,779)	(52)%	\$ 22,703	\$ 22,735	\$ (32)	(0)%

Table of Contents

The decrease in the total gain on sales of loans and securities, net during the three months ended June 30, 2007 was due primarily to a decrease in gain on sales of securities, net compared to the same period in 2006. The decrease in the total gain on sales of loans and securities, net during the six months ended June 30, 2007 was due primarily to a decrease in gain on sales of originated loans, partially offset by an increase in gain on sales of securities compared to the same period in 2006.

Other Revenue

Other revenue increased 21% to \$11.1 million and 23% to \$20.8 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase in other revenue was due to an increase in fees earned in connection with distribution of shares during initial public offerings and software consulting fees from our Corporate Services business.

Expense Excluding Interest

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

	Three Months Ended June 30,		Variance 2007 vs. 2006		Six Months Ended June 30,		Variance 2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Compensation and benefits	\$ 119,079	\$ 125,641	\$ (6,562)	(5)%	\$ 242,861	\$ 241,629	\$ 1,232	1 %
Clearing and servicing	74,177	64,138	10,039	16 %	141,429	127,426	14,003	11 %
Advertising and market development	35,938	30,420	5,518	18 %	81,530	65,201	16,329	25 %
Communications	25,821	27,834	(2,013)	(7)%	51,977	59,242	(7,265)	(12)%
Professional services	25,162	23,219	1,943	8 %	50,147	50,974	(827)	(2)%
Depreciation and amortization	20,075	18,827	1,248	7 %	39,458	37,616	1,842	5 %
Occupancy and equipment	22,820	20,428	2,392	12 %	46,399	40,932	5,467	13 %
Amortization of other intangibles	10,187	11,972	(1,785)	(15)%	20,455	23,304	(2,849)	(12)%
Facility restructuring and other exit activities	(1,500)	2,884	(4,384)	*	(767)	2,631	(3,398)	*
Other	70,426	25,208	45,218	179 %	103,101	56,213	46,888	83 %
Total expense excluding interest	\$ 402,185	\$ 350,571	\$ 51,614	15 %	\$ 776,590	\$ 705,168	\$ 71,422	10 %

* Percentage not meaningful

Expense excluding interest increased 15% to \$402.2 million and 10% to \$776.6 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase in expense excluding interest was driven primarily by \$35.1 million in expense recorded for certain legal and regulatory matters, which is reflected in the other line item within total expense excluding interest.

Compensation and Benefits

Compensation and benefits decreased 5% to \$119.1 million and remained relatively flat at 1% to \$242.9 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease for the three months ended June 30, 2007 compared to the same period in 2006 resulted primarily from lower incentive based compensation. We believe compensation and benefits as a percentage of revenue is a measure of our efficiency and the most relevant metric to assess this expense. This ratio declined to 18% and 19% for the three and six months ending June 30, 2007, respectively, compared to 21% and 20% for the same periods in 2006.

Table of Contents*Clearing and Servicing*

Clearing and servicing expense increased 16% to \$74.2 million and 11% to \$141.4 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase is due primarily to higher loan balances during the period, which resulted in higher servicing costs.

Advertising and Market Development

Advertising and market development expense increased 18% to \$35.9 million and 25% to \$81.5 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase is a result of expanded efforts to promote our products and services to the value-driven mass affluent customer.

Communications

Communications expense decreased 7% to \$25.8 million and 12% to \$52.0 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease is due to higher communications expenses in 2006 to our newly acquired customers from *Harrisdirect* and *BrownCo*.

Occupancy and Equipment

Occupancy and equipment increased 12% to \$22.8 million and 13% to \$46.4 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase is due primarily to opening new and expanding existing customer service centers.

Other

Other expenses increased 179% to \$70.4 million and 83% to \$103.1 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase is due primarily to \$35.1 million in expense recorded for certain legal and regulatory matters.

Other Income (Expense)

Other income (expense) decreased to an expense of \$20.4 million and to an expense of \$28.6 million for the three and six months ended June 30, 2007, compared to the same periods in 2006, as shown in the following table (dollars in thousands):

	Three Months Ended June 30,		Variance 2007 vs. 2006		Six Months Ended June 30,		Variance 2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Other income (expense):								
Corporate interest income	\$ 1,001	\$ 2,188	\$ (1,187)	(54)%	\$ 2,706	\$ 4,149	\$ (1,443)	(35)%
Corporate interest expense	(37,866)	(36,114)	(1,752)	5 %	(75,657)	(76,622)	965	(1)%
Gain on sales and impairment of investments	17,267	15,290	1,977	13 %	37,023	32,906	4,117	13 %
Gain (loss) on early extinguishment of debt	31	(568)	599	*	31	(703)	734	*
Equity in income (loss) of investments and venture funds	(840)	189	(1,029)	*	7,255	(818)	8,073	*
Total other income (expense)	\$ (20,407)	\$ (19,015)	\$ (1,392)	*	\$ (28,642)	\$ (41,088)	\$ 12,446	*

* Percentage not meaningful

Table of Contents

Total other income (expense) for the three and six months ended June 30, 2007 primarily consisted of corporate interest expense resulting from the senior notes and mandatory convertible notes held by the Company. During the six months ended June 30, 2007, we sold our investments in E*TRADE Australia and E*TRADE Korea, which resulted in \$17.3 million and \$37.0 million in gain on sales and impairment of investments for the three and six months ended June 30, 2007, respectively.

Income Tax Expense

Income tax expense from continuing operations decreased 4% to \$81.8 million for the three months ended June 30, 2007, compared to the same period in 2006 and increased 7% to \$174.8 million during the six months ended June 30, 2007, compared to the same period in 2006. The increase in income tax expense for the six months ended June 30, 2007 compared to the same period in prior year was related to the increase in pre-tax income over the comparable period. Our effective tax rates for the six months ended June 30, 2007 and 2006 were 34.7% and 35.3%, respectively. The decrease in our rate is principally due to the increasing tax benefit received on our tax exempt investment portfolio.

SEGMENT RESULTS REVIEW**Retail**

Retail segment income increased 8% to \$204.2 million and 2% to \$375.6 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006, as shown in the following table (dollars in thousands, except for key metrics):

	Three Months Ended June 30,		Variance 2007 vs. 2006		Six Months Ended June 30,		Variance 2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Retail segment income:								
Net operating interest income after provision for loan losses	\$ 250,504	\$ 228,706	\$ 21,798	10 %	\$ 477,985	\$ 434,626	\$ 43,359	10 %
Commission	128,183	127,567	616	0 %	251,488	263,431	(11,943)	(5)%
Fees and service charges	57,979	52,052	5,927	11 %	112,182	105,396	6,786	6 %
Gain on sales of loans and securities, net	7,351	8,958	(1,607)	(18)%	12,262	17,685	(5,423)	(31)%
Other revenue	11,173	10,903	270	2 %	20,924	20,202	722	4 %
Net segment revenue	455,190	428,186	27,004	6 %	874,841	841,340	33,501	4 %
Total segment expense	251,027	238,695	12,332	5 %	499,220	474,515	24,705	5 %
Total retail segment income	\$ 204,163	\$ 189,491	\$ 14,672	8 %	\$ 375,621	\$ 366,825	\$ 8,796	2 %
Key Metrics:								
Retail client assets (dollars in billions)	\$ 212.8	\$ 180.1	\$ 32.7	18 %	\$ 212.8	\$ 180.1	\$ 32.7	18 %
Customer cash and deposits (dollars in billions)	\$ 37.9	\$ 30.1	\$ 7.8	26 %	\$ 37.9	\$ 30.1	\$ 7.8	26 %
U.S. DARTs	141,606	142,621	(1,015)	(1)%	141,425	150,843	(9,418)	(6)%
International DARTs	27,516	22,981	4,535	20 %	28,146	22,475	5,671	25 %
DARTs	169,122	165,602	3,520	2 %	169,571	173,318	(3,747)	(2)%
Average commission per trade	\$ 12.03	\$ 12.23	\$ (0.20)	(2)%	\$ 11.96	\$ 12.16	\$ (0.20)	(2)%
Average margin debt (dollars in billions)	\$ 7.1	\$ 7.0	\$ 0.1	1 %	\$ 7.0	\$ 6.7	\$ 0.3	4 %

Table of Contents

Our retail segment generates revenue from trading, investing, banking and lending relationships with retail customers. These relationships essentially drive five sources of revenue: net operating interest income; commission; fees and service charges; gain on sales of loans and securities, net; and other revenue. Other revenue includes results from our stock plan administration products and services, as we ultimately service retail customers through these corporate relationships. Our geographically dispersed retail accounts grew 6% from June 30, 2006 to June 30, 2007. We believe this growth is a result of the investments we have made in marketing, operations and service. As of June 30, 2007, we had approximately 3.7 million active investing and trading accounts and 1.0 million active deposit and lending accounts.

The increase in retail segment income for the three and six months ended June 30, 2007 compared to the same periods in 2006 was due to an increase in net operating income after provision for loan losses slightly offset by a decrease in gains on sales of loans and securities, net.

Retail net operating interest income after provision for loan losses increased 10% to \$250.5 million and 10% to \$478.0 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase was driven by growth in customer cash and deposits, which generally translate into a lower cost of funds. The growth in customer cash and deposits was largely the result of the growth in the Complete Savings Account.

Retail commission revenue increased slightly to \$128.2 million and decreased 5% to \$251.5 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease in commission revenue was primarily the result of lower trading volumes in the overall domestic equity market. Slightly offsetting this decline was an increase in our international commissions where DARTs increased 25% from 22,475 to 28,146 for the six months ended June 30, 2007 compared to the same period in 2006.

Retail segment expense increased 5% to \$251.0 million and 5% to \$499.2 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. This increase related primarily to our increased marketing spend as we expanded efforts to promote our products and services to the value-driven mass affluent customer.

Table of Contents***Institutional***

Institutional segment income decreased 20% to \$57.2 million and increased 14% to \$156.3 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006, as shown in the following table (dollars in thousands, except for key metrics):

	Three Months Ended June 30,		Variance 2007 vs. 2006		Six Months Ended June 30,		Variance 2007 vs. 2006	
	2007	2006	Amount	%	2007	2006	Amount	%
Institutional segment income:								
Net operating interest income after provision for loan losses	\$ 133,615	\$ 105,626	\$ 27,989	26 %	\$ 275,534	\$ 214,298	\$ 61,236	29 %
Commission	41,585	39,729	1,856	5 %	77,273	79,734	(2,461)	(3)%
Fees and service charges	9,923	7,536	2,387	32 %	17,398	14,327	3,071	21 %
Principal transactions	27,768	31,590	(3,822)	(12)%	57,850	62,282	(4,432)	(7)%
Gain (loss) on sales of loans and securities, net	(2,023)	2,149	(4,172)	(194)%	10,441	5,050	5,391	107 %
Other revenue	91	52	39	75 %	132	163	(31)	(19)%
Net segment revenue	210,959	186,682	24,277	13 %	438,628	375,854	62,774	17 %
Total segment expense	153,758	115,386	38,372	33 %	282,292	238,140	44,152	19 %
Total institutional segment income	\$ 57,201	\$ 71,296	\$ (14,095)	(20)%	\$ 156,336	\$ 137,714	\$ 18,622	14 %
Key Metrics:								
Total nonperforming loans receivable as a % of total gross loans receivable	0.53%	0.22%	*	0.31 %	0.53%	0.22%	*	0.31 %
Average revenue capture per 1,000 equity shares	\$ 0.433	\$ 0.387	\$ 0.046	12 %	\$ 0.499	\$ 0.325	\$ 0.174	54 %

* Percentage not meaningful

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

Net operating interest income after provision for loan losses increased 26% to \$133.6 million and 29% to \$275.5 million for the three and six months ended June 30, 2007 compared to the same periods in 2006. These increases primarily were a result of growth in interest-earning assets, which are funded primarily by retail customer cash and deposit balances. These customer balances were kept on-balance sheet as a low-cost source of funding and then utilized by the institutional segment either to purchase interest-earning assets or pay down wholesale liabilities.

Fee and service charges revenue increased 32% to \$9.9 million and 21% to \$17.4 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase is related to higher CDO management fees.

Principal transactions decreased 12% to \$27.8 million and 7% to \$57.9 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease was due to lower trading volumes.

Table of Contents

Gain (loss) on sales of loans and securities, net decreased \$4.2 million for the three months ended June 30, 2007 compared to the same period in 2006 and increased \$5.4 million for the six months ended June 30, 2007 compared to the same period in 2006. We evaluate our portfolio of securities available-for-sale in light of changing market conditions and where appropriate, take steps intended to optimize our overall economic position. Based on this evaluation, we decided to sell certain securities, which resulted in a loss of \$2.0 million and a gain of \$10.4 million in gain (loss) on sales of loans and securities, net for the three and six months ended June 30, 2007, respectively.

Total institutional segment expense increased 33% to \$153.8 million and 19% to \$282.3 million for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006 and was due primarily to additional expense recorded for certain legal and regulatory matters.

BALANCE SHEET OVERVIEW

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

	June 30, 2007	December 31, 2006	Variance 2007 vs. 2006
Assets:			
Cash and equivalents ⁽¹⁾	\$ 1,392,028	\$ 1,493,856	(7)%
Trading securities	161,851	178,600	(9)%
Available-for-sale mortgage-backed and investment securities	16,893,248	13,921,983	21 %
Loans held-for-sale	242,269	283,496	(15)%
Margin receivables	7,399,916	6,828,448	8 %
Loans receivable, net	31,483,530	26,372,697	19 %
Other assets ⁽²⁾	5,402,224	4,660,223	16 %
Total assets	\$ 62,975,066	\$ 53,739,303	17 %
Liabilities and shareholders' equity:			
Deposits	\$ 27,770,749	\$ 24,071,012	15 %
Securities sold under agreements to repurchase	12,435,733	9,792,422	27 %
Customer payables	6,493,401	6,182,672	5 %
Other borrowings	7,785,101	5,323,962	46 %
Corporate debt ⁽³⁾	1,839,977	1,842,169	(0)%
Accounts payable, accrued and other liabilities	2,315,943	2,330,696	(1)%
Total liabilities	58,640,904	49,542,933	18 %
Shareholders' equity	4,334,162	4,196,370	3 %
Total liabilities and shareholders' equity	\$ 62,975,066	\$ 53,739,303	17 %

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

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

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

During the first quarter of 2007, we re-presented our balance sheet to report margin receivables and customer payables directly on the face of the balance sheet. The remaining components of brokerage receivables and brokerage payables are now reported in the Other assets and Accounts payable, accrued and other liabilities line items, respectively.

Table of Contents

The margin receivables balance is a component of the margin debt balance, which is reported as a key retail metric of \$7.5 billion and \$7.0 billion at June 30, 2007 and December 31, 2006, respectively. The total margin debt balance is summarized as follows (dollars in thousands):

	June 30, 2007	December 31, 2006
Margin receivables	\$ 7,399,916	\$ 6,828,448
Margin held by third parties and other	118,766	174,652
Margin debt	\$ 7,518,682	\$ 7,003,100

The increase in total assets was primarily the result of growth in loans receivable, net and available-for-sale mortgage-backed and investment securities. The growth in available-for-sale mortgage-backed and investment securities was driven primarily by growth in mortgage-backed securities. The growth in loans receivable, net was driven primarily by growth in first lien real estate loans. For this growth, the loans were originated, on average, 9 months prior to our purchase and typically include early payment default protection for up to 1 month.

The increase in total liabilities primarily was attributable to the increase in deposits and securities sold under agreements to repurchase and other borrowings. The \$3.7 billion increase in deposits was due primarily to the growth in the Complete Savings Account. The increase in securities sold under agreements to repurchase and other borrowings contributed to the growth of the loans receivable, net.

Loans Receivable, Net

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

	June 30, 2007	December 31, 2006	Variance 2007 vs. 2006
Real estate loans:			
One- to four-family	\$ 15,667,337	\$ 10,870,214	44 %
Home equity lines of credit (HELOC), Home equity installment loans (HEIL) and other	12,413,401	11,809,008	5 %
Consumer and other loans:			
Recreational vehicle	2,105,360	2,292,356	(8)%
Marine	581,724	651,764	(11)%
Commercial	275,367	219,008	26 %
Credit card	99,007	128,583	(23)%
Automobile	41,283	77,533	(47)%
Other	2,337	3,706	(37)%
Unamortized premiums, net	373,418	388,153	(4)%
Allowance for loan losses	(75,704)	(67,628)	12 %
Total loans receivable, net	\$ 31,483,530	\$ 26,372,697	19 %

Loans receivable, net increased 19% to \$31.5 billion at June 30, 2007 from \$26.4 billion at December 31, 2006. We continue to focus on our growth in first lien real estate loans while allowing our consumer loans to decline. We anticipate that our first lien real estate loan portfolio will continue to increase over time, and we believe this will improve our credit risk profile. We expect consumer loans to continue to decline as we no longer originate recreational vehicle, marine and auto loans.

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

The HELOC and HEIL portfolio is primarily second lien loans on residential real estate properties. We also hold the first lien position on the same residential real estate property for less than 1% of the loans in this portfolio.

Table of Contents

In recent months, there has been considerable attention in the financial media regarding rising delinquencies and default rates in the sub-prime⁽¹⁾ lending market. As a general matter, we do not originate or purchase sub-prime loans to hold on our balance sheet; however, in the normal course of purchasing large pools of real estate loans, we invariably end up acquiring a de minimis amount of these loans. As of June 30, 2007, sub-prime loans represented less than one-fifth of one percent of our total loan portfolio.

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

Allowance for Loan Losses

The allowance for loan losses is management's estimate of credit losses inherent in our loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of factors, including the composition and quality of the portfolio; delinquency levels and trends; probable expected losses for the next twelve months; current and historical charge-off and loss experience; current industry charge-off and loss experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate as it affects adjustable-rate loans; and general economic conditions. Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. We believe our allowance for loan losses at June 30, 2007 is representative of probable losses inherent in the loan portfolio at the balance sheet date.

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

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

	Consumer & Other Allowance as % of Consumer and Other Loans Receivable		Real Estate Allowance as % of Real Estate Loans Receivable		Total Allowance as % of Total Loans Receivable	
	Allowance		Allowance		Allowance	
June 30, 2007	\$ 22,060	0.70%	\$ 53,644	0.19%	\$ 75,704	0.24%
March 31, 2007	\$ 23,863	0.73%	\$ 44,126	0.17%	\$ 67,989	0.23%
December 31, 2006	\$ 28,197	0.82%	\$ 39,431	0.17%	\$ 67,628	0.26%

The following table provides an analysis of the allowance for loan losses for the three and six months ended June 30, 2007 and 2006 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Allowance for loan losses, beginning of period	\$ 67,989	\$ 64,509	\$ 67,628	\$ 63,286
Provision for loan losses	30,045	10,270	51,231	20,467
Charge-offs	(30,356)	(13,113)	(56,800)	(27,972)
Recoveries	8,026	5,455	13,645	11,340
Net charge-offs	(22,330)	(7,658)	(43,155)	(16,632)
Allowance for loan losses, end of period	\$ 75,704	\$ 67,121	\$ 75,704	\$ 67,121

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

Table of Contents

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

During the six months ended June 30, 2007, the allowance for loan losses increased by \$8.1 million from the level at December 31, 2006. The allowance for the real estate loan portfolio increased by \$14.2 million, which was due primarily to the seasoning of the portfolio and the increased delinquencies and charge-offs compared to 2006. The consumer loan portfolio decreased by \$6.1 million, mainly a result of the decline in the size of the portfolio.

Net charge-offs for the three and six months ended June 30, 2007 compared to the same periods in 2006 increased by \$14.7 million and \$26.5 million, respectively. The overall increase was primarily due to higher net charge-offs on second lien real estate loans, which was driven by the growth of this portfolio in prior periods and subsequent seasoning of that growth in 2007. In addition, overall pressure in the residential real estate market including slowing home price appreciation or depreciation, rising mortgage interest rates and tighter mortgage lending guidelines across the industry are impacting the mortgage portfolio performance, which could drive additional charge-offs in the future. Annualized net charge-offs as a percentage of average loans receivable, net were 0.29% at June 30, 2007 compared to 0.22% at December 31, 2006.

Nonperforming Assets

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

	June 30, 2007	December 31, 2006
Real estate loans	\$ 163,932	\$ 66,435
Consumer and other loans	3,501	8,906
Total nonperforming loans	167,433	75,341
Real estate owned (REO) and other repossessed assets, net	20,870	12,904
Total nonperforming assets, net	\$ 188,303	\$ 88,245
 Total nonperforming loans receivable as a percentage of total gross loans receivable	 0.53%	 0.28%
Total allowance for loan losses as a percentage of total nonperforming loans receivable	45.34%	90.52%

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

During the six months ended June 30, 2007, our nonperforming assets, net increased \$100.1 million from \$88.2 million at December 31, 2006. The increase was attributed to an increase in nonperforming real estate loans and REO and other repossessed assets, net of \$105.5 million, offset by a decrease in nonperforming consumer and other loans of \$5.4 million. These trends are primarily the result of our targeted growth in real estate loans as well as the seasoning of the real estate loan acquisitions made in prior periods.

The allowance as a percentage of total nonperforming loans receivable, net decreased from 91% at December 31, 2006 to 45% at June 30, 2007. Our total loan portfolio has shifted towards a larger concentration of first lien real estate loans, where the risk of loss is generally less than the risk of loss on second lien real estate and consumer loans. As such, the total allowance as a percentage of nonperforming assets decreased.

Table of Contents

In addition to nonperforming assets in the table above, we monitor loans where a borrower's past credit history casts doubt on their ability to repay a loan (Special Mention loans). Special Mention loans represented \$397.1 million, or 1%, and \$261.5 million, or 1%, of the total loan portfolio at June 30, 2007 and December 31, 2006, respectively, and are generally secured by real estate assets, reducing the potential loss should they become non-performing. These loans are actively monitored, continue to accrue interest and remain a component of the loans receivable balance. The increase in Special Mention loans was due primarily to an increase in the 30-day delinquency category of real estate loans. We expect migration from this category to more serious delinquency classifications to increase over time consistent with the current instability in the overall consumer credit market.

Available-for-Sale Mortgage-Backed and Investment Securities

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

	June 30,	December 31,	Variance
	2007	2006	2007 vs. 2006
Mortgage-backed securities:			
Backed by U.S. government sponsored and Federal agencies	\$ 10,610,913	\$ 9,109,307	16 %
Collateralized mortgage obligations and other	1,552,970	1,108,385	40 %
Total mortgage-backed securities	12,163,883	10,217,692	19 %
Investment securities:			
Asset-backed securities	2,957,963	2,161,728	37 %
Publicly traded equity securities:			
Preferred stock	461,607	458,674	1 %
Corporate investments	13,757	24,139	(43)%
FHLB stock	347,992	244,212	42 %
Other	948,046	815,538	16 %
Total investment securities	4,729,365	3,704,291	28 %
Total available-for-sale securities	\$ 16,893,248	\$ 13,921,983	21 %

Available-for-sale securities represented 27% and 26% of total assets at June 30, 2007 and December 31, 2006, respectively. Available-for-sale securities increased 21% to \$16.9 billion at June 30, 2007 compared to December 31, 2006, due primarily to the growth in our mortgage-backed securities portfolio. Substantially all mortgage-backed securities backed by U.S. Government sponsored and Federal agencies are AAA rated and the majority of the asset-backed securities portfolio consisted of AA or higher rated securities. We evaluate our available-for-sale securities in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall position. Based on this evaluation, we decided to grow the mortgage-backed and asset-backed securities portfolios, which resulted in an increase of \$2.7 billion in these portfolios during the six months ended June 30, 2007.

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

Table of Contents**Deposits**

Deposits are summarized as follows (dollars in thousands):

	June 30,	December 31,	Variance
	2007	2006	2007 vs. 2006
Sweep deposit accounts	\$ 10,995,856	\$ 10,837,124	1 %
Money market and savings accounts	11,354,555	7,634,241	49 %
Certificates of deposit ⁽¹⁾	4,617,397	4,737,253	(3)%
Brokered certificates of deposit ⁽²⁾	406,802	483,777	(16)%
Checking accounts	396,139	378,617	5 %
Total deposits	\$ 27,770,749	\$ 24,071,012	15 %

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

⁽²⁾ Represents institutional certificates of deposit.

Deposits represented 47% and 49% of total liabilities at June 30, 2007 and December 31, 2006, respectively. Deposits increased \$3.7 billion to \$27.8 billion at June 30, 2007 compared to December 31, 2006, driven by a \$3.7 billion increase in money market and savings accounts.

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

The deposits balance is a component of the total customer cash and deposits balance reported as a customer activity metric of \$37.9 billion for the six months ended June 30, 2007. The total customer cash and deposits balance is summarized as follows (dollars in thousands):

	June 30,	December 31,	Variance
	2007	2006	2007 vs. 2006
Deposits	\$ 27,770,749	\$ 24,071,012	15 %
Less: brokered certificates of deposit	(406,802)	(483,777)	(16)%
Deposits excluding brokered certificates of deposit	27,363,947	23,587,235	16 %
Customer payables	6,493,401	6,182,672	5 %
Customer cash balances held by third parties and other	4,065,512	3,819,860	6 %
Total customer cash and deposits	\$ 37,922,860	\$ 33,589,767	13 %

Securities Sold Under Agreements to Repurchase and Other Borrowings

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

	June 30,	December 31,	Variance
	2007	2006	2007 vs. 2006
Securities sold under agreements to repurchase	\$ 12,435,733	\$ 9,792,422	27%

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

FHLB advances	\$ 7,174,147	\$ 4,865,466	47%
Subordinated debentures	435,830	385,502	13%
Other	175,124	72,994	140%
Total other borrowings	\$ 7,785,101	\$ 5,323,962	46%

Table of Contents

Securities sold under agreements to repurchase increased by 27% at June 30, 2007 compared to December 31, 2006. Securities sold under agreements to repurchase coupled with FHLB advances are the primary wholesale funding sources of the Bank. The Bank used these wholesale sources along with deposit growth to fund the increase in loans receivable. Other borrowings represented 13% and 11% of total liabilities at June 30, 2007 and December 31, 2006, respectively. The increase of \$2.5 billion during the six months ended June 30, 2007 was due primarily to an increase in FHLB advances. We actively manage our funding sources and determine the optimal mix based on pricing, liquidity and capacity during each period.

LIQUIDITY AND CAPITAL RESOURCES

Our liquidity and capital resources enable us to fund our operating activities, finance acquisitions and grow our assets. Cash flows are derived from our operations in the retail and institutional segments and our capital market activities. The segment cash flows provide capital to fund growth in our regulated subsidiaries. The Company's cash and equivalents balance decreased to \$1.0 billion for the period ended June 30, 2007.

Corporate Debt

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

Liquidity Available from Subsidiaries

Liquidity available to the Company from its subsidiaries, other than Converging Arrows, Inc. (Converging Arrows), is limited by regulatory requirements. Converging Arrows is a subsidiary of the parent company. At June 30, 2007, Converging Arrows had \$57.1 million of cash and investment securities available as a source of liquidity for the parent company. Converging Arrows is not restricted in its dealings with the parent company and may transfer funds to the parent company without regulatory approval. In addition to Converging Arrows, brokerage and banking subsidiaries may provide liquidity to the parent; however, they are restricted by regulatory guidelines.

E*TRADE Bank is prohibited by regulations from lending to the parent company. At June 30, 2007, E*TRADE Bank had approximately \$221.1 million of capital available for dividend declaration without regulatory approval while still maintaining well capitalized status. E*TRADE Bank is also required by Office of Thrift Supervision (OTS) regulations to maintain tangible capital of at least 1.50% of tangible assets. E*TRADE Bank satisfied this requirement at June 30, 2007 and December 31, 2006.

Brokerage subsidiaries are required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions. At June 30, 2007 and December 31, 2006, all of our brokerage subsidiaries met their minimum net capital requirements. The Company's broker-dealer subsidiaries had excess net capital of \$686.0 million at June 30, 2007.

Other Sources of Liquidity

We maintain committed financing facilities with banks totaling \$250.0 million⁽¹⁾ to meet corporate liquidity needs and \$576.0 million in uncommitted financing to meet margin lending needs. There were no outstanding balances, and the full \$826.0 million was available under these lines at June 30, 2007 and December 31, 2006.

⁽¹⁾ The committed financing facility was amended in July 2007, improving the terms and conditions as well as extending the maturity of the credit facility to September 2010. See Note 19 Subsequent Events.

Table of Contents

We rely on borrowed funds, such as FHLB advances and securities sold under agreements to repurchase, to provide liquidity for the Bank. At June 30, 2007, the Bank had approximately \$10.1 billion in additional borrowing capacity.

Other Liquidity Matters

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

SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon the financial results of the Company. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: allowance for loan losses and uncollectible margin loans; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rate; deferred taxes and valuation allowances; and valuation of goodwill and other intangibles. These are more fully described in

Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2006.

Table of Contents

GLOSSARY OF TERMS

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

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

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

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

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

Basis point One one-hundredth of a percentage point.

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Operating margin Income before other income (expense), income taxes and discontinued operations.

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 and as updated in this report. Market risk is our exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Our exposure to interest rate risk is 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 our exposure to changes in interest rates. In general, we manage our interest rate risk by balancing variable-rate and fixed-rate assets and liabilities and we utilize derivatives in a way that reduces our overall exposure to changes in interest rates. In recent years, we have managed our interest rate risk to achieve a minimum to moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Exposure to interest rate risk requires management to make complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

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

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

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

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At June 30, 2007, 93% of our total assets were enterprise interest-earning assets.

At June 30, 2007, approximately 70% of our total assets were residential real estate loans and available-for-sale mortgage-backed and asset-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential real estate loans 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. E*TRADE Bank's Asset Liability Committee (ALCO) reviews estimates of the impact of changing market rates on loan production volumes and prepayments. This information is incorporated into our interest rate risk management strategy.

We held \$161.9 million in trading securities as of June 30, 2007. These securities and the associated interest rate risk are not material to the Company's financial position, results of operations, or cash flows.

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

Table of Contents

Derivative Financial Instruments

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

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

Scenario Analysis

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

E*TRADE Bank has 95% and 81% of our enterprise interest-earning assets at June 30, 2007 and December 31, 2006, respectively, and holds 95% and 79% of our enterprise interest-bearing liabilities at June 30, 2007 and December 31, 2006, respectively. The sensitivity of NPVE at June 30, 2007 and December 31, 2006 and the limits established by E*TRADE Bank's Board of Directors are listed below (dollars in thousands):

Parallel Change in Interest Rates (bps)	June 30, 2007 ⁽¹⁾		December 31, 2006		Board Limit
	Amount	Percentage	Amount	Percentage	
+300	\$ (466,608)	(12)%	\$ (52,325)	(2)%	(55)%
+200	\$ (287,178)	(7)%	\$ (32,680)	(1)%	(30)%
+100	\$ (153,897)	(4)%	\$ (15,303)	(1)%	(20)%
-100	\$ 84,004	2 %	\$ (159,618)	(6)%	(20)%
-200	\$ (95,405)	(2)%	\$ (560,142)	(20)%	(30)%

⁽¹⁾ Amounts and percentages include ETC.

Under criteria published by the OTS, E*TRADE Bank's overall interest rate risk exposure at June 30, 2007 was characterized as minimum. We actively manage our interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The ALCO monitors E*TRADE Bank's interest rate risk position.

Table of Contents

Other Market Risk

Equity Security Risk

Equity securities risk is the risk of potential loss from investing in public and private equity securities including foreign currency exchange risk. We hold equity securities for investment purposes and in trading securities for market-making purposes. The foreign currency exchange risk associated with these investments is not material to the Company. For investment purposes, we currently hold publicly traded equity securities, in which we had gross unrealized gains of \$4.6 million as of June 30, 2007. As each security's market price fluctuates, we are exposed to risk of a loss with respect to these unrealized gains. See publicly traded equity securities discussion at Note 5 Available-for-Sale Mortgage-Backed and Investment Securities in Item 1. Consolidated Financial Statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenue:				
Operating interest income	\$ 905,772	\$ 660,373	\$ 1,735,567	\$ 1,254,667
Operating interest expense	(491,608)	(315,771)	(930,817)	(585,276)
Net operating interest income	414,164	344,602	804,750	669,391
Provision for loan losses	(30,045)	(10,270)	(51,231)	(20,467)
Net operating interest income after provision for loan losses	384,119	334,332	753,519	648,924
Commission	169,768	167,296	328,761	343,165
Fees and service charges	65,446	57,809	124,944	115,671
Principal transactions	27,768	31,590	57,850	62,282
Gain on sales of loans and securities, net	5,328	11,107	22,703	22,735
Other revenue	11,120	9,224	20,770	16,930
Total non-interest income	279,430	277,026	555,028	560,783
Total net revenue	663,549	611,358	1,308,547	1,209,707
Expense excluding interest:				
Compensation and benefits	119,079	125,641	242,861	241,629
Clearing and servicing	74,177	64,138	141,429	127,426
Advertising and market development	35,938	30,420	81,530	65,201
Communications	25,821	27,834	51,977	59,242
Professional services	25,162	23,219	50,147	50,974
Depreciation and amortization	20,075	18,827	39,458	37,616
Occupancy and equipment	22,820	20,428	46,399	40,932
Amortization of other intangibles	10,187	11,972	20,455	23,304
Facility restructuring and other exit activities	(1,500)	2,884	(767)	2,631
Other	70,426	25,208	103,101	56,213
Total expense excluding interest	402,185	350,571	776,590	705,168
Income before other income (expense), income taxes and discontinued operations	261,364	260,787	531,957	504,539
Other income (expense):				
Corporate interest income	1,001	2,188	2,706	4,149
Corporate interest expense	(37,866)	(36,114)	(75,657)	(76,622)
Gain on sales and impairment of investments	17,267	15,290	37,023	32,906
Gain (loss) on early extinguishment of debt	31	(568)	31	(703)
Equity in (loss) income of investments and venture funds	(840)	189	7,255	(818)

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

Total other income (expense)	(20,407)	(19,015)	(28,642)	(41,088)
Income before income taxes and discontinued operations	240,957	241,772	503,315	463,451
Income tax expense	81,828	85,080	174,776	163,775
Net income from continuing operations	159,129	156,692	328,539	299,676
Loss from discontinued operations, net of tax		(208)		(721)
Net income	\$ 159,129	\$ 156,484	\$ 328,539	\$ 298,955
Basic earnings per share from continuing operations	\$ 0.38	\$ 0.37	\$ 0.78	\$ 0.72
Basic loss per share from discontinued operations		(0.00)		(0.00)
Basic net earnings per share	\$ 0.38	\$ 0.37	\$ 0.78	\$ 0.72
Diluted earnings per share from continuing operations	\$ 0.37	\$ 0.36	\$ 0.75	\$ 0.69
Diluted loss per share from discontinued operations		(0.00)		(0.00)
Diluted net earnings per share	\$ 0.37	\$ 0.36	\$ 0.75	\$ 0.69
Shares used in computation of per share data:				
Basic	423,308	421,929	423,546	418,324
Diluted	435,775	439,460	436,708	435,918

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)

	June 30, 2007	December 31, 2006
<u>ASSETS</u>		
Cash and equivalents	\$ 1,039,510	\$ 1,212,234
Cash and investments required to be segregated under Federal or other regulations	352,518	281,622
Trading securities	161,851	178,600
Available-for-sale mortgage-backed and investment securities (includes securities pledged to creditors with the right to sell or repledge of \$13,695,233 at June 30, 2007 and \$11,087,961 at December 31, 2006)	16,893,248	13,921,983
Loans held-for-sale	242,269	283,496
Margin receivables	7,399,916	6,828,448
Loans receivable, net (net of allowance for loan losses of \$75,704 at June 30, 2007 and \$67,628 at December 31, 2006)	31,483,530	26,372,697
Property and equipment, net	363,349	318,389
Goodwill	2,036,920	2,072,920
Other intangibles, net	451,528	471,933
Other assets	2,550,427	1,796,981
Total assets	\$ 62,975,066	\$ 53,739,303
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Liabilities:		
Deposits	\$ 27,770,749	\$ 24,071,012
Securities sold under agreements to repurchase	12,435,733	9,792,422
Customer payables	6,493,401	6,182,672
Other borrowings	7,785,101	5,323,962
Senior notes	1,396,906	1,401,592
Mandatory convertible notes	443,071	440,577
Accounts payable, accrued and other liabilities	2,315,943	2,330,696
Total liabilities	58,640,904	49,542,933
Shareholders' equity:		
Common stock, \$0.01 par value, shares authorized: 600,000,000; shares issued and outstanding: 425,256,687 at June 30, 2007 and 426,304,136 at December 31, 2006	4,253	4,263
Additional paid-in capital (APIC)	3,146,768	3,184,290
Retained earnings	1,522,925	1,209,289
Accumulated other comprehensive loss	(339,784)	(201,472)
Total shareholders' equity	4,334,162	4,196,370
Total liabilities and shareholders' equity	\$ 62,975,066	\$ 53,739,303

See accompanying notes to consolidated financial statements

Table of Contents**E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME****(In thousands)****(Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	\$ 159,129	\$ 156,484	\$ 328,539	\$ 298,955
Other comprehensive loss				
Available-for-sale securities:				
Unrealized losses, net	(199,636)	(125,208)	(192,747)	(181,891)
Less impact of realized gains (transferred out of accumulated other comprehensive loss) and included in net income, net	(9,653)	(14,695)	(20,821)	(27,523)
Net change from available-for-sale securities	(209,289)	(139,903)	(213,568)	(209,414)
Cash flow hedging instruments:				
Unrealized gains, net	63,494	75,209	62,370	150,743
Reclassifications into earnings, net	170	1,824	358	5,080
Net change from cash flow hedging instruments	63,664	77,033	62,728	155,823
Foreign currency translation gains	15,391	3,668	12,528	5,577
Other comprehensive loss	(130,234)	(59,202)	(138,312)	(48,014)
Comprehensive income	\$ 28,895	\$ 97,282	\$ 190,227	\$ 250,941

See accompanying notes to consolidated financial statements

Table of Contents**E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY****(In thousands)****(Unaudited)**

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders Equity
	Shares	Amount				
Balance, December 31, 2006	426,304	\$ 4,263	\$ 3,184,290	\$ 1,209,289	\$ (201,472)	\$ 4,196,370
Cumulative effect of adoption of FIN 48				(14,903)		(14,903)
Adjusted balance	426,304	4,263	3,184,290	1,194,386	(201,472)	4,181,467
Net income				328,539		328,539
Other comprehensive loss					(138,312)	(138,312)
Exercise of stock options and purchase plans, including tax benefit	2,672	27	37,664			37,691
Repurchases of common stock	(4,159)	(42)	(95,863)			(95,905)
Issuance of restricted stock	674	7	(7)			
Cancellation of restricted stock	(159)	(2)	2			
Retirement of restricted stock to pay taxes	(172)	(2)	(3,979)			(3,981)
Amortization of deferred stock compensation to APIC under SFAS No. 123(R)			22,449			22,449
Other	97	2	2,212			2,214
Balance, June 30, 2007	425,257	\$ 4,253	\$ 3,146,768	\$ 1,522,925	\$ (339,784)	\$ 4,334,162

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders Equity
	Shares	Amount				
Balance, December 31, 2005	416,582	\$ 4,166	\$ 2,990,676	\$ 580,430	\$ (175,712)	\$ 3,399,560
Net income				298,955		298,955
Other comprehensive loss					(48,014)	(48,014)
Exercise of stock options and warrants, including tax benefit	3,145	31	44,170			44,201
Issuance of common stock upon conversion of 6% convertible debt	7,772	78	183,333			183,411
Repurchases of common stock	(2,030)	(20)	(48,253)			(48,273)
Issuance of restricted stock	620	6	(6)			
Cancellation of restricted stock	(83)	(1)	1			
Retirement of restricted stock to pay taxes	(82)	(1)	(1,969)			(1,970)
Amortization of deferred stock compensation to APIC under SFAS No. 123(R)			19,230			19,230
Other			(115)			(115)
Balance, June 30, 2006	425,924	\$ 4,259	\$ 3,187,067	\$ 879,385	\$ (223,726)	\$ 3,846,985

See accompanying notes to consolidated financial statements

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

	Six Months Ended	
	June 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 328,539	\$ 298,955
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	51,231	20,467
Depreciation and amortization (including discount amortization and accretion)	140,307	144,358
Gain on sales of loans and securities, net and gain on sales and impairment of investments	(59,726)	(40,024)
Equity in (income) loss of investments and venture funds	(7,255)	818
Non-cash facility restructuring costs and other exit activities	(1,793)	2,631
Stock-based compensation	22,449	19,230
Tax benefit from tax deductions in excess of compensation expense	(14,260)	(15,560)
Other	22,467	11,948
Net effect of changes in assets and liabilities:		
(Increase) decrease in cash and investments required to be segregated under Federal or other regulations	(55,815)	343,110
Increase in margin receivables	(549,777)	(1,496,832)
Increase (decrease) in customer payables	255,326	(17,649)
Proceeds from sales, repayments and maturities of loans held-for-sale	837,538	517,194
Purchases and originations of loans held-for-sale	(796,806)	(913,378)
Proceeds from sales, repayments and maturities of trading securities	793,066	783,705
Purchases of trading securities	(759,686)	(485,671)
Other assets	(492,041)	514,973
Accounts payable, accrued and other liabilities	111,402	530,421
Facility restructuring liabilities	(2,929)	(7,031)
Net cash (used in) provided by operating activities	(177,763)	211,665
Cash flows from investing activities:		
Purchases of available-for-sale mortgage-backed and investment securities	(10,131,571)	(5,124,950)
Proceeds from sales, maturities of and principal payments on available-for-sale mortgage-backed and investment securities	6,788,055	2,697,868
Net increase in loans receivable	(5,249,979)	(1,447,412)
Purchases of property and equipment	(85,643)	(42,597)
Cash used in business acquisitions, net	(4,644)	(11,646)
Net cash flow from derivatives hedging assets	3,082	24,620
Other	(40,920)	17,564
Net cash used in investing activities	\$ (8,721,620)	\$ (3,886,553)

See accompanying notes to consolidated financial statements

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

	Six Months Ended	
	2007	June 30, 2006
Cash flows from financing activities:		
Net increase in deposits	\$ 3,699,401	\$ 5,256,350
Advances from other long-term borrowings	7,671,000	930,100
Payments on advances from other long-term borrowings	(5,364,311)	(1,840,100)
Net increase (decrease) in securities sold under agreements to repurchase	2,641,012	(913,735)
Net increase in other borrowed funds	112,486	148,534
Payments for redemption of 6% convertible notes		(1,754)
Proceeds from issuance of common stock from employee stock transactions	23,431	28,641
Tax benefit from tax deductions in excess of compensation expense recognition	14,260	15,560
Repurchases of common stock	(95,905)	(48,273)
Proceeds from issuance of subordinated debentures and trust preferred securities	41,000	44,900
Net cash flow from derivatives hedging liabilities	(15,715)	86,882
Net cash provided by financing activities	8,726,659	3,707,105
 Increase (decrease) in cash and equivalents	 (172,724)	 32,217
Cash and equivalents, beginning of period	1,212,234	844,188
 Cash and equivalents, end of period	 \$ 1,039,510	 \$ 876,405
Supplemental disclosures:		
Cash paid for interest	\$ 1,075,033	\$ 616,052
Cash paid for income taxes	\$ 128,821	\$ 108,511
Non-cash investing and financing activities:		
Transfers from loans to other real estate owned and repossessed assets	\$ 40,169	\$ 29,119
Reclassification of loans held-for-sale to loans held-for-investment	\$ 3,807	\$ 73,190
Issuance of common stock to retire debentures	\$	\$ 183,411

See accompanying notes to 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 (together with its subsidiaries, E*TRADE or the Company) is a global company offering a wide range of financial services to consumers under the brand E*TRADE Financial. The Company offers trading, investing, banking and lending products and services to its retail and institutional customers.

Basis of Presentation The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. Entities in which the Company holds at least a 20% ownership 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 20% ownership 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 evaluates investments including joint ventures, low income housing tax credit partnerships and other limited partnerships to determine if the Company is required to consolidate the entities under the guidance of FASB interpretation No. 46 (Revised 2003), *Consolidation of Variable Interest Entities-an interpretation of ARB No. 51* (FIN 46R).

Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. As discussed in Note 2 Discontinued Operations, the operations of certain businesses have been accounted for as discontinued operations in accordance with the Statement of Financial Accounting Standard (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, results of operations from prior periods have been reclassified to discontinued operations. Unless noted, discussions herein pertain to the Company's continuing operations.

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, and should be read in conjunction with the consolidated financial statements of E*TRADE Financial Corporation included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The Company reports corporate interest income and expense separately from operating interest income and 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 expense is generated from the operations of the Company and is a broad indicator of the Company's success in its banking, lending and balance sheet management businesses. Corporate debt, which is the primary source of the corporate interest expense has been used primarily to finance acquisitions, such as Harrisdirect and BrownCo and generally has not been downstreamed to any of the Company's operating subsidiaries.

Similarly, the Company reports gain on sales and impairment of investments separately from gain on sales of 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. Gain on sales of loans and securities, net are the result of activities in the Company's operations, namely its lending and balance sheet management businesses. Gain on sales and impairment of investments relates to historical equity investments of the Company at the corporate level and are not related to the ongoing business of the Company's operating subsidiaries.

New Income Statement Reporting Format During the first quarter of 2007, the Company re-defined the line item Service charges and fees by reclassifying certain fee-like revenue items formerly reported in Other revenue into the Service charges and fees line item, now called Fees and service charges. The fee-like revenue streams moved include payment for order flow, foreign exchange margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue.

Table of Contents

New Balance Sheet Reporting Format During the first quarter of 2007, the Company re-presented its balance sheet to report margin receivables and customer payables directly on the face of the balance sheet. The remaining components of brokerage receivables and brokerage payables are now reported in the Other assets and Accounts payable, accrued and other liabilities line items, respectively.

Use of Estimates The financial statements were prepared in accordance with GAAP, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and related notes for the periods presented. Actual results could differ from management's estimates. Material estimates in which management believes near-term changes could reasonably occur include allowance for loan losses and uncollectible margin receivables; classification and valuation of certain investments; valuation and accounting for financial derivatives; 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 Below are descriptions and accounting policies for the Company's new financial statement categories.

Margin Receivables Margin receivables represent credit extended to customers and non-customers to finance their purchases of securities by borrowing against securities they currently own. Receivables from non-customers represent credit extended to principal officers and directors of the Company to finance their purchase of securities by borrowing against securities owned by them. Securities owned by customers and non-customers are held as collateral for amounts due on the margin receivables, the value of which is not reflected in the consolidated balance sheet. In many cases, the Company is permitted to sell or re-pledge these securities held as collateral and use the securities to enter into securities lending transactions, to collateralize borrowings or for delivery to counterparties to cover customer short positions. At June 30, 2007, the fair value of securities that the Company received as collateral in connection with margin receivables and stock borrowing activities, where the Company is permitted to sell or re-pledge the securities, was approximately \$10.4 billion. Of this amount, \$2.3 billion had been pledged or sold at June 30, 2007 in connection with securities loans, bank borrowings and deposits with clearing organizations.

Customer Payables Customer payables to customers and non-customers represent credit balances in customer accounts arising from deposits of funds and sales of securities and other funds pending completion of securities transactions. The Company pays interest on certain customer payables balances.

Fees and Service Charges Fees and service charges consist of account maintenance fees, servicing fee income, payments for order flow, foreign exchange margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue. Account maintenance fees are charges to the customer either quarterly or annually and are accrued as earned. Payments for order flow are accrued in the same period in which the related securities transactions are completed or related services are rendered.

Other Revenue Other revenue primarily consists of stock plan administration services and other revenue ancillary to the Company's retail customer transactions. Stock plan administration services are recognized in accordance with applicable accounting guidance, including Statement of Position 97-2, *Software Revenue Recognition*.

New Accounting Standards Below are the new accounting pronouncements that relate to activities in which the Company is engaged.

FIN 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109

In July 2006, the FASB issued Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which became effective for the Company on January 1, 2007. The interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-

Table of Contents

likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The Company's reassessment of its tax positions in accordance with FIN 48 did not have a material impact on the results of operations, financial condition or liquidity. The impact of adoption was a \$14.9 million reduction to beginning retained earnings. For additional information regarding the adoption of FIN 48, see Note 13 Income Taxes.

SFAS No. 156 Accounting for Servicing of Financial Assets

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement establishes, among other things, the accounting for all separately recognized servicing assets and liabilities. This statement amends SFAS No. 140 to require that all separately recognized servicing assets and liabilities be initially measured at fair value. The Company adopted this statement on January 1, 2007 and the impact of adoption was not material to the Company's financial condition, results of operations or cash flows.

SFAS No. 157 Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement establishes, among other things, a framework for measuring fair value and expands disclosure requirements as they relate to fair value measurements. The statement is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007 or January 1, 2008 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement provides an option under which a company may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. This fair value option will be available on a contract-by-contract basis with changes in fair value recognized in earnings as those changes occur. The statement is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007 or January 1, 2008 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

NOTE 2 DISCONTINUED OPERATIONS

In December 2005, the Company decided to sell its professional agency business, E*TRADE Professional Trading, LLC. The Company executed and settled this transaction during the year ended December 31, 2006 and recorded approximately \$2.6 million in gain, net of tax, on the sale.

The following table summarizes the results of discontinued operations for the agency trading business (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net revenue	\$	\$ 2,825	\$	\$ 5,526
Loss from discontinued operations	\$	\$ (341)	\$	\$ (1,181)
Income tax benefit		(133)		(460)
Loss from discontinued operations, net of tax	\$	\$ (208)	\$	\$ (721)

Table of Contents**NOTE 3 FACILITY RESTRUCTURING AND OTHER EXIT ACTIVITIES**

The Company periodically evaluates and adjusts its estimated costs associated with its restructuring plans and other exit activities. Restructuring liabilities are included in accounts payable, accrued and other liabilities in the consolidated balance sheet. The following table summarizes the amount recognized by the Company as facility restructuring and other exit activities for the periods presented (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
2003 Restructuring Plan	\$ (329)	\$ (62)	\$ (329)	\$ (320)
2001 Restructuring Plan	(372)	368	(854)	(347)
Other exit activities	(799)	2,578	416	3,298
Total facility restructuring and other exit activities	\$ (1,500)	\$ 2,884	\$ (767)	\$ 2,631

2003 Restructuring Plan

In April 2003, the Company announced a restructuring plan (2003 Restructuring Plan) exiting and consolidating leased facilities and exiting and disposing of certain unprofitable product offerings and initiatives. Facility consolidation costs are expected to be paid over contractual periods ending in fiscal year 2010. The roll forward of the 2003 Restructuring Plan reserve is presented below (dollars in thousands):

	Facility Consolidation	Other	Total
Total 2003 Restructuring Reserve, originally recorded in 2003:			
Facility restructuring and other exit activities recorded	\$ 58,547	\$ 57,319	\$ 115,866
Cash payments	(26,371)	(18,949)	(45,320)
Non-cash charges	(19,254)	(38,370)	(57,624)
Restructuring liabilities at December 31, 2006	12,922		12,922
Activity for the six months ended June 30, 2007:			
Adjustments and additional charges	(329)		(329)
Cash payments	(2,103)		(2,103)
Total facility restructuring liabilities at June 30, 2007	\$ 10,490	\$	\$ 10,490

2001 Restructuring Plan

In August 2001, the Company announced a restructuring plan (2001 Restructuring Plan) aimed at streamlining operations primarily by consolidating facilities in the United States and Europe. Facility consolidation costs are expected to be paid over contractual periods ending in fiscal year 2010. The roll forward of the 2001 Restructuring Plan reserve is presented below (dollars in thousands):

	Facility Consolidation	Asset Write-Off	Other	Total
Total 2001 Restructuring Reserve, originally recorded in 2001:				
Facility restructuring and other exit activities recorded	\$ 149,684	\$ 54,384	\$ 26,401	\$ 230,469
Cash payments	(103,728)	(507)	(20,507)	(124,742)
Non-cash charges	(41,263)	(53,877)	(5,810)	(100,950)

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

Restructuring liabilities at December 31, 2006	4,693	84	4,777
Activity for the six months ended June 30, 2007:			
Adjustments and additional charges	(770)	(84)	(854)
Cash payments	(828)		(828)
Total facility restructuring and other exit activities liabilities at June 30, 2007	\$ 3,095	\$	\$ 3,095

Table of Contents***Other Exit Activities***

Toward the end of the second quarter of 2006, the Company decided to relocate certain functions out of the state of California as well as outsource certain clearing operations and costs related to the relocation of certain accounting functions. The Company incurred charges of \$(0.5) million and \$0.7 million for the three and six months ended June 30, 2007, respectively, related to costs for exiting those facilities. The total charge for this exit activity was \$29.9 million, all of which has been recorded in the retail segment. The Company expects to incur charges in future periods as it periodically evaluates the estimates made in connection with this activity; however, the Company does not expect those costs to be significant.

NOTE 4 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		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Operating interest income:				
Loans, net	\$ 497,517	\$ 303,499	\$ 948,916	\$ 584,769
Mortgage-backed and investment securities	238,147	190,355	452,290	349,856
Margin receivables	127,335	123,390	251,321	228,294
Other	42,773	43,129	83,040	91,748
Total operating interest income	905,772	660,373	1,735,567	1,254,667
Operating interest expense:				
Deposits	(205,301)	(121,758)	(388,289)	(216,376)
Other borrowings	(286,307)	(194,013)	(542,528)	(368,900)
Total operating interest expense	(491,608)	(315,771)	(930,817)	(585,276)
Net operating interest income	\$ 414,164	\$ 344,602	\$ 804,750	\$ 669,391

Table of Contents**NOTE 5 AVAILABLE-FOR-SALE MORTGAGE-BACKED AND INVESTMENT SECURITIES**

The amortized cost basis and estimated fair values of available-for-sale mortgage-backed and investment securities are shown in the following tables (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Values
June 30, 2007:				
Mortgage-backed securities:				
Backed by U.S. Government sponsored and Federal agencies	\$ 11,164,386	\$ 7	\$ (553,480)	\$ 10,610,913
Collateralized mortgage obligations and other	1,584,824	579	(32,433)	1,552,970
Total mortgage-backed securities	12,749,210	586	(585,913)	12,163,883
Investment securities:				
Debt securities:				
Asset-backed securities	3,020,630	3,523	(66,190)	2,957,963
Municipal bonds	837,061	2,776	(14,891)	824,946
Corporate bonds	46,852	2,403	(508)	48,747
Other debt securities	79,641		(6,801)	72,840
Total debt securities	3,984,184	8,702	(88,390)	3,904,496
Publicly traded equity securities:				
Preferred stock	472,665	3,587	(14,645)	461,607
Corporate investments	13,335	986	(564)	13,757
FHLB stock	347,992			347,992
Retained interests from securitizations	1,028	485		1,513
Total investment securities	4,819,204	13,760	(103,599)	4,729,365
Total available-for-sale securities	\$ 17,568,414	\$ 14,346	\$ (689,512)	\$ 16,893,248
December 31, 2006:				
Mortgage-backed securities:				
Backed by U.S. Government sponsored and Federal agencies	\$ 9,375,444	\$ 688	\$ (266,825)	\$ 9,109,307
Collateralized mortgage obligations and other	1,127,650	296	(19,561)	1,108,385
Total mortgage-backed securities	10,503,094	984	(286,386)	10,217,692
Investment securities:				
Debt securities:				
Asset-backed securities	2,163,538	9,929	(11,739)	2,161,728
Municipal bonds	620,261	13,316	(830)	632,747
Corporate bonds	105,692	481	(1,655)	104,518
Other debt securities	80,623		(5,743)	74,880
Total debt securities	2,970,114	23,726	(19,967)	2,973,873
Publicly traded equity securities:				
Preferred stock	455,801	4,905	(2,032)	458,674
Corporate investments	12,040	13,691	(1,592)	24,139
FHLB stock	244,212			244,212
Retained interests from securitizations	2,930	463		3,393

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

Total investment securities	3,685,097	42,785	(23,591)	3,704,291
Total available-for-sale securities	\$ 14,188,191	\$ 43,769	\$ (309,977)	\$ 13,921,983

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

The following tables show the fair values and unrealized losses on investments, aggregated by investment category, and the length of time that individual securities have been in a continuous unrealized loss position (dollars in thousands):

	Less than 12 Months Fair		12 Months or More Fair		Total Fair	
	Values	Unrealized Losses	Values	Unrealized Losses	Values	Unrealized Losses
June 30, 2007:						
Mortgage-backed securities:						
Backed by U.S. Government sponsored and Federal agencies	\$ 2,605,571	\$ (106,797)	\$ 8,004,412	\$ (446,683)	\$ 10,609,983	\$ (553,480)
Collateralized mortgage obligations and other	759,300	(11,613)	615,990	(20,820)	1,375,290	(32,433)
Debt securities:						
Asset-backed securities	1,802,165	(51,148)	674,718	(15,042)	2,476,883	(66,190)
Municipal bonds	626,203	(13,475)	25,628	(1,416)	651,831	(14,891)
Corporate bonds	231	(6)	24,844	(502)	25,075	(508)
Other debt securities	1,395	(9)	71,445	(6,792)	72,840	(6,801)
Publicly traded equity securities:						
Preferred stock	332,498	(13,709)	20,553	(936)	353,051	(14,645)
Corporate investments	9,499	(374)	172	(190)	9,671	(564)
Total temporarily impaired securities	\$ 6,136,862	\$ (197,131)	\$ 9,437,762	\$ (492,381)	\$ 15,574,624	\$ (689,512)
December 31, 2006:						
Mortgage-backed securities:						
Backed by U.S. Government sponsored and Federal agencies	\$ 1,482,684	\$ (38,671)	\$ 7,551,572	\$ (228,154)	\$ 9,034,256	\$ (266,825)
Collateralized mortgage obligations and other	399,779	(2,258)	640,811	(17,303)	1,040,590	(19,561)
Debt securities:						
Asset-backed securities	358,628	(2,520)	629,889	(9,219)	988,517	(11,739)
Municipal bonds	58,548	(467)	28,326	(363)	86,874	(830)
Corporate bonds	765	(23)	72,661	(1,632)	73,426	(1,655)
Other debt securities			72,750	(5,743)	72,750	(5,743)
Publicly traded equity securities:						
Preferred stock	37,663	(420)	25,971	(1,612)	63,634	(2,032)
Corporate investments	8,486	(1,386)	156	(206)	8,642	(1,592)
Total temporarily impaired securities	\$ 2,346,553	\$ (45,745)	\$ 9,022,136	\$ (264,232)	\$ 11,368,689	\$ (309,977)

The Company does not believe that any individual unrealized loss as of June 30, 2007 represents an other-than-temporary impairment. The majority of the unrealized losses on mortgage-backed securities are attributable to changes in interest rates and are not reflective of deterioration in the credit quality of the issuer and/or securitization. Substantially all mortgage-backed securities backed by U.S. Government sponsored and Federal agencies are AAA rated and have unrealized losses due to changes in market interest rates. As market interest rates increase, the fair value of fixed-rate securities will decrease. The Company has the intent and ability to hold these securities until the market value recovers or the securities mature. Municipal bonds, corporate bonds and other debt securities are evaluated by reviewing the credit-worthiness of the issuer and general market conditions. The majority of the asset-backed securities portfolio consisted of AA or higher rated securities. Based on its evaluation, the Company recorded other-than-temporary impairment charges for its asset-backed securities of \$2.8 million and \$3.0 million for the three and six months ended June 30, 2007. The Company recorded no impairment charges for the three months ended June 30, 2006 and \$0.4 million for the six months ended June 30, 2006, respectively.

Table of Contents***Gain on Sales of Loans and Securities, Net***

Gain on sales of loans and securities, net are as follows (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Gain on sales of originated loans	\$ 2,043	\$ 2,681	\$ 3,958	\$ 5,999
Gain (loss) on sales of loans held-for-sale, net	(25)	(409)	(1,687)	(1,098)
Gain on sales of securities, net ⁽¹⁾	3,310	8,835	20,432	17,834
Gain on sales of loans and securities, net	\$ 5,328	\$ 11,107	\$ 22,703	\$ 22,735

⁽¹⁾ Includes an other-than-temporary charge of \$2.8 million and \$3.0 million for impairment on asset-backed securities for the three and six months ended June 30, 2007. There was no such charge for the three and six months ended June 30, 2006.

Gain on Sales and Impairment of Investments

Gain on sales and impairment of investments are as follows (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Gain on sales of publicly traded equity securities	\$ 17,310	\$ 15,502	\$ 37,027	\$ 33,557
Loss on sales of investments and impairments				(455)
Loss on sales of other equity securities, net ⁽¹⁾	(43)	(212)	(4)	(196)
Gain on sales and impairment of investments	\$ 17,267	\$ 15,290	\$ 37,023	\$ 32,906

⁽¹⁾ There was no other-than-temporary charge on retained interests from securitizations for the three and six months ended June 30, 2007. There was no impairment charge for the three months ended June 30, 2006 and \$0.4 million on retained interests from securitizations for the six months ended June 30, 2006.

Table of Contents**NOTE 6 LOANS, NET**

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

	June 30, 2007	December 31, 2006
Loans held-for-sale	\$ 242,269	\$ 283,496
Loans receivable, net:		
Real estate loans:		
One- to four-family	15,667,337	10,870,214
HELOC, HEIL and other	12,413,401	11,809,008
Total real estate loans	28,080,738	22,679,222
Consumer and other loans:		
Recreational vehicle	2,105,360	2,292,356
Marine	581,724	651,764
Commercial	275,367	219,008
Credit card	99,007	128,583
Automobile	41,283	77,533
Other	2,337	3,706
Total consumer and other loans	3,105,078	3,372,950
Total loans receivable	31,185,816	26,052,172
Unamortized premiums, net	373,418	388,153
Allowance for loan losses	(75,704)	(67,628)
Total loans receivable, net	31,483,530	26,372,697
Total loans, net	\$ 31,725,799	\$ 26,656,193

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

NOTE 7 ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

The Company enters into derivative transactions to protect against the risk of market price or interest rate movements on the value of certain assets, liabilities and future cash flows. The Company is also required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative as promulgated by SFAS No. 133, as amended.

Fair Value Hedges***Overview of Fair Value Hedges***

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on swaps, interest rate caps and interest rate floors to offset its exposure to changes in value of certain fixed-rate assets and liabilities. Changes in the fair value of the derivatives and the related hedged items are recognized currently in earnings. 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 other expense excluding interest in the consolidated statement of income.

Table of Contents

The following table summarizes information related to financial derivatives in fair value hedge relationships (dollars in thousands):

	Notional Amount of Derivatives	Fair Value of Derivatives			Pay Rate	Weighted-Average		Remaining Life (Years)
		Asset	Liability	Net		Receive Rate	Strike Rate	
June 30, 2007:								
Pay-fixed interest rate swaps:								
Mortgage-backed securities	\$ 4,038,000	\$ 63,357	\$ (1,712)	\$ 61,645	5.12%	5.35%	N/A	5.55
Receive-fixed interest rate swaps:								
Corporate debt	1,400,000	102	(4,369)	(4,267)	3.02%	7.71%	N/A	5.88
Brokered certificates of deposit	124,848		(5,379)	(5,379)	5.30%	5.21%	N/A	10.88
FHLB advances	100,000		(3,453)	(3,453)	5.32%	3.64%	N/A	2.30
Purchased interest rate forward-starting swaps:								
Mortgage-backed securities	912,000	54	(773)	(719)	5.58%	N/A	N/A	7.01
Purchased interest rate options ⁽¹⁾ :								
Swaptions ⁽²⁾	3,830,000	83,772		83,772	N/A	N/A	5.50%	10.33
Caps	2,210,000	32,713		32,713	N/A	N/A	5.44%	3.80
Floors	1,810,000	14,906		14,906	N/A	N/A	5.07%	4.04
Total fair value hedges	\$ 14,424,848	\$ 194,904	\$ (15,686)	\$ 179,218	4.74%	5.90%	5.39%	6.51
December 31, 2006:								
Pay-fixed interest rate swaps:								
Mortgage-backed securities	\$ 4,774,000	\$ 22,399	\$ (25,894)	\$ (3,495)	5.12%	5.36%	N/A	4.20
Recreational vehicle loans	2,030,000		(8,046)	(8,046)	5.46%	5.35%	N/A	1.62
Home equity loans	490,000		(2,625)	(2,625)	5.40%	5.35%	N/A	2.16
Investment securities	335,162	1,128	(2,887)	(1,759)	5.07%	5.37%	N/A	6.69
Asset backed securities	232,000	1,013		1,013	5.08%	5.37%	N/A	6.52
Receive-fixed interest rate swaps:								
Brokered certificates of deposit	127,138		(3,392)	(3,392)	5.31%	5.21%	N/A	11.41
FHLB advances	100,000		(3,534)	(3,534)	5.35%	3.64%	N/A	2.79
Purchased interest rate options ⁽¹⁾ :								
Swaptions ⁽²⁾	3,338,000	50,218		50,218	N/A	N/A	5.37%	10.69
Caps	6,720,000	38,237		38,237	N/A	N/A	5.36%	2.18
Floors	1,200,000	19,786		19,786	N/A	N/A	4.74%	4.81
Total fair value hedges	\$ 19,346,300	\$ 132,781	\$ (46,378)	\$ 86,403	5.22%	5.34%	5.30%	4.44

(1) Purchased interest rate options were used to hedge mortgage loans and mortgage-backed securities.

(2) Swaptions are options to enter swaps starting on a given day.

De-designated Fair Value Hedges

During the three and six months ended June 30, 2007 and 2006, certain fair value hedges were de-designated; therefore, hedge accounting was discontinued during those periods. The net gain or loss on the underlying transactions being hedged is amortized to operating interest expense or operating interest income over the original forecasted period at the time of de-designation. Changes in the fair value of these derivative instruments after de-designation of fair value hedge accounting were recorded in the gain on sales of loans and securities, net line item in the consolidated statement of income.

Table of Contents**Cash Flow Hedges***Overview of Cash Flow Hedges*

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on caps and floors to hedge the variability of future cash flows associated with existing variable-rate liabilities and assets and forecasted issuances of liabilities. These cash flow hedge relationships are treated as effective hedges as long as the future issuances of liabilities remain probable and the hedges continue to meet the requirements of SFAS No. 133, as amended. The Company also enters into interest rate swaps to hedge changes in the future variability of cash flows of certain investment securities resulting from changes in a benchmark interest rate. Additionally, the Company enters into forward purchase and sale agreements, which are considered cash flow hedges, when the terms of the commitments exactly match the terms of the securities purchased or sold.

Changes in the fair value of derivatives that hedge cash flows associated with repurchase agreements, FHLB advances and HELOC are reported in accumulated other comprehensive loss as unrealized gains or losses. The amounts in accumulated other comprehensive loss are then included in operating interest expense or operating interest income as a yield adjustment during the same periods in which the related interest on the funding effects earnings. During the upcoming twelve months, the Company expects to include a pre-tax amount of approximately \$43.4 million of net unrealized gains that are currently reflected in accumulated other comprehensive loss in operating interest expense as a yield adjustment in the same periods in which the related items affect earnings.

The following table summarizes information related to the Company's financial derivatives in cash flow hedge relationships, hedging variable-rate assets and liabilities and the forecasted issuances of liabilities (dollars in thousands):

	Notional Amount of Derivatives	Fair Value of Derivatives			Pay Rate	Weighted-Average		Remaining Life (Years)
		Asset	Liability	Net		Receive Rate	Strike Rate	
June 30, 2007:								
Pay-fixed interest rate swaps:								
Repurchase agreements	\$ 3,195,000	\$ 48,326	\$ (3,266)	\$ 45,060	5.40%	5.34%	N/A	5.53
FHLB advances	530,000	12,358	(1,112)	11,246	5.32%	5.36%	N/A	8.83
Purchase interest rate forward-starting swaps:								
Repurchase agreements	990,000	4,552	(3,170)	1,382	5.66%	N/A	N/A	11.08
FHLB advances	410,000	5,221		5,221	5.47%	N/A	N/A	9.36
Purchased interest rate options ⁽¹⁾ :								
Caps	4,835,000	83,818		83,818	N/A	N/A	5.13%	3.63
Floors	1,900,000	13,815		13,815	N/A	N/A	7.41%	2.80
Total cash flow hedges	\$ 11,860,000	\$ 168,090	\$ (7,548)	\$ 160,542	5.44%	5.34%	5.78%	5.06
December 31, 2006:								
Pay-fixed interest rate swaps:								
Repurchase agreements	\$ 3,435,000	\$ 7,683	\$ (21,823)	\$ (14,140)	5.36%	5.36%	N/A	5.90
FHLB advances	730,000	3,671	(3,301)	370	5.16%	5.37%	N/A	8.56
Purchased interest rate options ⁽¹⁾ :								
Caps	4,690,000	62,710		62,710	N/A	N/A	5.05%	3.36
Floors	1,900,000	643		643	N/A	N/A	4.05%	2.09
Total cash flow hedges	\$ 10,755,000	\$ 74,707	\$ (25,124)	\$ 49,583	5.33%	5.36%	4.76%	4.30

⁽¹⁾ Caps are used to hedge repurchase agreements and FHLB advances. Floors are used to hedge HELOC.

Under SFAS No. 133, as amended, the Company is required to record the fair value of gains and losses on derivatives designated as cash flow hedges in accumulated other comprehensive income in the consolidated balance sheet. In addition, during the normal course of business, the Company terminates certain interest rate swaps and options.

Table of Contents

The following tables show: 1) amounts recorded in accumulated other comprehensive loss related to derivative instruments accounted for as cash flow hedges; 2) the notional amounts and fair values of derivatives terminated for the periods presented; and 3) the amortization of terminated interest rate swaps included in operating interest expense and operating interest income (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Impact on accumulated other comprehensive loss (net of taxes):				
Beginning balance	\$ (28,780)	\$ 7,959	\$ (27,844)	\$ (70,831)
Gains on cash flow hedges related to derivatives, net	63,494	75,209	62,370	150,743
Reclassifications into earnings, net	170	1,824	358	5,080
Ending balance	\$ 34,884	\$ 84,992	\$ 34,884	\$ 84,992

Derivatives terminated during the period:

Notional	\$ 3,015,000	\$ 4,850,000	\$ 3,705,000	\$ 8,110,000
Fair value of net gains recognized in accumulated other comprehensive loss	\$ 7,849	\$ 80,348	\$ 5,472	\$ 113,894
Amortization of terminated interest rate swaps and options included in operating interest expense and operating interest income	\$ (53)	\$ 2,568	\$ 255	\$ 7,690

The gains accumulated in other comprehensive loss on the derivative instruments terminated shown in the preceding table will be included in operating interest expense and operating interest income over the periods the variable rate liabilities and hedged forecasted issuance of liabilities will affect earnings, ranging from 11 days to almost 15 years.

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

	June 30,	
	2007	2006
Accumulated other comprehensive loss balance (net of taxes) related to:		
Open cash flow hedges	\$ 8,906	\$ 43,324
Discontinued cash flow hedges	25,978	41,668
Total cash flow hedges	\$ 34,884	\$ 84,992

Hedge Ineffectiveness

In accordance with SFAS No. 133, as amended, the Company recognizes hedge ineffectiveness on both fair value and cash flow hedge relationships. The amount of ineffectiveness recorded in earnings for cash flow hedges 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. These amounts are reflected in the other expense excluding interest line item in the consolidated statement of income. Cash flow and fair value ineffectiveness is re-measured on a quarterly basis. The following table summarizes income (expense) recognized by the Company as fair value and cash flow hedge ineffectiveness (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Fair value hedges	\$ 2,848	\$ 5,626	\$ 1,766	\$ 3,681
Cash flow hedges	(291)	(329)	(251)	(353)

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

Total hedge ineffectiveness	\$ 2,557	\$ 5,297	\$ 1,515	\$ 3,328
-----------------------------	----------	----------	----------	----------

Table of Contents***Mortgage Banking Activities***

The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding. These commitments are referred to as Interest Rate Lock Commitments (IRLCs). IRLCs on loans that the Company intends to sell are considered to be derivatives and are, therefore, recorded at fair value with changes in fair value recorded in earnings. For purposes of determining fair value, the Company performs a net present value analysis of the anticipated cash flows associated with these IRLCs. The net present value analysis performed excludes the market value associated with the anticipated sale of servicing rights related to each loan commitment. The fair value of these IRLCs was a \$0.2 million asset and a \$0.02 million liability at June 30, 2007 and December 31, 2006, respectively.

The Company also designates fair value relationships of closed loans held-for-sale against a combination of mortgage forwards and short treasury positions. Short treasury relationships are economic hedges, rather than fair value or cash flow hedges. Short treasury positions are marked-to-market, but do not receive hedge accounting treatment under SFAS No. 133, as amended. The mark-to-market of the mortgage forwards is included in the net change of the IRLCs and the related hedging instruments. The fair value of the mark-to-market on closed loans was a \$0.1 million and \$1.7 million asset at June 30, 2007 and December 31, 2006, respectively.

IRLCs, as well as closed loans held-for-sale, expose the Company to interest rate risk. The Company manages this risk by selling mortgages or mortgage-backed securities on a forward basis referred to as forward sale agreements. Changes in the fair value of these derivatives are included as gain on sales of loans and securities, net in the consolidated statement of income. The net change in IRLCs, closed loans, mortgage forwards and the short treasury positions generated net losses of \$0.7 million and \$2.2 million for the three and six months ended June 30, 2007, respectively. The net change in IRLCs, closed loans, mortgage forwards and the short treasury positions generated net losses of \$0.7 million and \$0.9 million for the three and six months ended June 30, 2006, respectively.

NOTE 8 OTHER ASSETS

Other assets consist of the following (dollars in thousands):

	June 30,	December 31,
	2007	2006
Deposits paid for securities borrowed	\$ 619,294	\$ 448,047
Derivative assets	374,300	208,136
Accrued interest receivable	315,515	182,265
Third party loan servicing receivable	231,352	241,511
Other investments	221,398	138,006
Net settlement and deposits with clearing organizations	181,625	137,571
Fails to deliver	160,537	86,517
Other receivables from brokers, dealers and clearing organizations	73,667	72,596
Prepays	35,622	41,216
Unamortized debt issue costs	22,377	26,498
Deferred compensation plan	21,398	20,584
Servicing rights	7,732	8,487
Other	285,610	185,547
Total other assets	\$ 2,550,427	\$ 1,796,981

Table of Contents**NOTE 9 ASSET SECURITIZATION*****Collateralized Debt Obligations (CDO)***

On April 12, 2007, an unrelated financial advisor (Advisor) transferred \$388.9 million in asset-backed securities to E*TRADE ABS CDO VI, Ltd. (CDO VI). The Company had previously transferred \$46.9 million in asset-backed securities to the Advisor for transfer to CDO VI. Additionally, the Company utilized a warehouse line with the Advisor to purchase \$342.0 million of asset-backed securities that were also transferred to CDO VI. Concurrent with these transfers, CDO VI sold total beneficial interests of \$420.0 million to investors in the form of senior notes, subordinated notes and preference shares collateralized by the asset-backed securities. Additional purchases of asset-backed securities were made in open market transactions and transferred to CDO VI within 60 days following the closing date. As of June 30, 2007, 100% of the pool of underlying securities had been transferred into CDO VI.

The CDO VI transaction is a managed deal whereby the portfolio manager, ETGAM, is appointed to actively manage the collateral of the CDO. Because CDO VI is a managed deal, it is a special purpose entity and not a qualified special purpose entity. The CDO VI transaction was accounted for as a sale in accordance with SFAS No. 140.

The Company purchased \$3.6 million of preference shares in CDO VI. Retained interests are subordinate to the notes sold by CDO VI and on an equal standing with the preference shares purchased by other preference share investors in CDO VI. Neither CDO VI itself nor the investors in the beneficial interests sold by CDO VI have recourse to the Company.

The Company reviewed CDO VI to determine if consolidation was necessary under the requirements of FIN 46R. The calculation of CDO VI s beneficial interests indicated that the Company was not the recipient of the majority of the potential benefits or losses of the deal. Therefore, the Company is not the primary beneficiary of the transaction and is not required to consolidate the CDO.

The following table summarizes the asset-backed securities transferred to CDO VI at closing, the amount of the cash proceeds and the preference shares purchased by the Company (dollars in millions):

CDO	Transaction Date	Asset-Backed Securities Transferred to CDO at closing				Preference Shares Purchased by E*TRADE	
		E*TRADE	Independent Investment Advisor	Total	Proceeds	Amount	
CDO VI	April 2007	\$ 46.9	\$ 342.0	\$ 388.9	\$ 420.0	\$	3.6

NOTE 10 DEPOSITS

Deposits are summarized as follows (dollars in thousands):

	Weighted-Average				Percentage	
	Rate		Amount		to Total	
	June 30,	December 31,	June 30,	December 31,	June 30,	December 31,
	2007	2006	2007	2006	2007	2006
Sweep deposit accounts	0.93%	0.94%	\$ 10,995,856	\$ 10,837,124	39.6%	45.0%
Money market and savings accounts	4.38%	4.33%	11,354,555	7,634,241	40.9	31.7
Certificates of deposit ⁽¹⁾	5.01%	5.02%	4,617,397	4,737,253	16.6	19.7
Brokered certificates of deposit ⁽²⁾	4.07%	3.95%	406,802	483,777	1.5	2.0
Checking accounts	1.39%	1.06%	396,139	378,617	1.4	1.6
Total deposits	3.07%	2.88%	\$ 27,770,749	\$ 24,071,012	100.0%	100.0%

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

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

Table of Contents**NOTE 11 OTHER BORROWINGS**

ETBH raises capital through the formation of trusts which sell trust preferred stock in the capital markets. The capital securities must be redeemed in whole at the due date, which is generally 30 years after issuance. Each trust issued Floating Rate Cumulative Preferred Securities, at par with a liquidation amount of \$1,000 per capital security. The trusts use the proceeds from the sale of issuances to purchase Floating Rate Junior Subordinated Debentures issued by ETBH, which guarantees the trust obligations and contributes proceeds from the sale of its subordinated debentures to E*TRADE Bank in the form of a capital contribution.

During January, March and May 2007, ETBH formed three trusts, ETBH Capital Trust XXVIII, ETBH Capital Trust XXIX and ETBH Capital Trust XXX, respectively. Information related to these trusts is shown below (dollars in thousands):

Trusts	Maturity		Annual Interest Rate
	Face Value	Date	
ETBH Capital Trust XXVIII	\$ 25,000	2037	2.00% above 3-month LIBOR
ETBH Capital Trust XXIX	\$ 15,000	2037	1.95% above 3-month LIBOR
ETBH Capital Trust XXX	\$ 20,000	2037	1.90% above 3-month LIBOR

NOTE 12 ACCOUNTS PAYABLE, ACCRUED AND OTHER LIABILITIES

Accounts payable, accrued and other liabilities consist of the following (dollars in thousands):

	June 30,	December 31,
	2007	2006
Deposits received for securities loaned	\$ 931,549	\$ 1,012,831
Other payables to brokers, dealers and clearing organizations	322,111	350,221
Accounts payable and accrued expenses	281,582	335,117
Fails to receive	143,265	84,864
Subserviced loan advances	66,284	44,780
Derivative liabilities	45,170	78,710
Senior and convertible debt accrued interest	20,283	20,125
Restructuring liabilities	19,639	26,892
Other	486,060	377,156
Total accounts payable, accrued and other liabilities	\$ 2,315,943	\$ 2,330,696

NOTE 13 INCOME TAXES

Effective January 1, 2007, the Company adopted FIN 48. As a result of the implementation the Company recognized a \$14.9 million increase to its liability for unrecognized tax benefits, which was accounted for as a reduction to the beginning balance of retained earnings. The total amount of gross unrecognized tax benefits as of January 1, 2007 was \$150.4 million. Of this total amount, \$51.6 million (net of the federal benefit on state issues) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in future periods. This amount increased to \$54.5 million for the period ended June 30, 2007. The gross unrecognized tax benefit was reduced to \$78.4 million at June 30, 2007 principally due to tax accounting method change requests filed with the Internal Revenue Service (IRS).

The following table summarizes the tax years that are either currently under audit or remain open under the statute of limitations and subject to examination by the major tax jurisdictions in which the Company operates:

Jurisdiction

Open Tax Year

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

Canada	2001	2006
United Kingdom	2005	2006
United States	2003	2006
Various States ⁽¹⁾	1996	2006

⁽¹⁾ Includes California, Georgia, New York and Virginia.

Table of Contents

It is likely that certain examinations may be settled or the statute of limitations could expire with regards to other tax filings, in the next twelve months. In addition, proposed legislation could favorably impact certain of the Company's unrecognized tax benefits. Such events would generally reduce the Company's unrecognized tax benefits, either because the tax positions are sustained or because the Company agrees to the disallowance, by as much as \$12.7 million, substantially all of which could affect the Company's total tax provision or the effective tax rate.

The Company's continuing practice is to recognize interest and penalties, if any, related to income tax matters in income tax expense. After the adoption of FIN 48, the Company has total gross reserves of \$15.1 million for the payment of interest as of January 1, 2007. The total gross reserves were reduced to \$7.8 million as of June 30, 2007 due to the filing of tax accounting method change requests with the IRS.

NOTE 14 EARNINGS PER SHARE

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Basic:				
Numerator:				
Net income from continuing operations	\$ 159,129	\$ 156,692	\$ 328,539	\$ 299,676
Loss from discontinued operations, net of tax		(208)		(721)
Net income	\$ 159,129	\$ 156,484	\$ 328,539	\$ 298,955
Denominator:				
Basic weighted-average shares outstanding	423,308	421,929	423,546	418,324
Diluted:				
Numerator:				
Net income	\$ 159,129	\$ 156,484	\$ 328,539	\$ 298,955
Denominator:				
Basic weighted-average shares outstanding	423,308	421,929	423,546	418,324
Effect of dilutive securities:				
Weighted-average options and restricted stock issued to employees	11,325	15,184	11,778	15,361
Weighted-average warrants and contingent shares outstanding	248	248	248	248
Weighted-average mandatory convertible notes	894	2,099	1,136	1,985
Diluted weighted-average shares outstanding	435,775	439,460	436,708	435,918
Per share:				
Basic earnings per share:				
Earnings per share from continuing operations	\$ 0.38	\$ 0.37	\$ 0.78	\$ 0.72
Loss per share from discontinued operations		(0.00)		(0.00)
Net earnings per share	\$ 0.38	\$ 0.37	\$ 0.78	\$ 0.72
Diluted earnings per share:				
Earnings per share from continuing operations	\$ 0.37	\$ 0.36	\$ 0.75	\$ 0.69
Loss per share from discontinued operations		(0.00)		(0.00)
Net earnings per share	\$ 0.37	\$ 0.36	\$ 0.75	\$ 0.69

Table of Contents

Excluded from the calculations of diluted earnings per share are 1.2 million and 4.5 million shares of common stock for the three and six months ended June 30, 2006, respectively, issuable under convertible subordinated notes as the effect of applying the treasury stock method on an if-converted basis would be anti-dilutive. There were not any shares issuable under convertible subordinated notes excluded from the calculation of diluted earnings per share for the three and six months ended June 30, 2007.

The following options to purchase shares of common stock have not been included in the computation of diluted earnings per share as their effect would be anti-dilutive (shares in thousands, except exercise price ranges):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Options excluded from computation of diluted earnings per share	10,515	5,036	9,387	3,828
Exercise price ranges:				
High	\$ 58.19	\$ 58.19	\$ 58.19	\$ 58.19
Low	\$ 19.11	\$ 19.11	\$ 19.11	\$ 18.62

NOTE 15 SHARE REPURCHASES

On April 18, 2007, the Company announced that its Board of Directors authorized an additional \$250.0 million common stock repurchase program (the April 2007 Plan). The April 2007 Plan is open-ended and allows for the repurchase of common stock on the open market, in private transactions or a combination of both.

During 2007, the Company repurchased common stock under the April 2007 Plan and a \$200.0 million repurchase program approved by the Board in December 2004 (the December 2004 Plan). During the three months ended June 30, 2007, the Company completed the December 2004 Plan. The table below shows the timing and impact of the repurchases during the six months ended June 30, 2007 (dollars in thousands, except per share amounts):

				Maximum Dollar Value of Shares That May Yet be Purchased Under the April 2007 and December 2004 Plans
Three Months Ended	Total Number of Shares Purchased	Aggregate Price	Average Price Paid per Share	
March 31, 2007	1,030,000	\$ 23,022	\$ 22.35	\$ 34,142
June 30, 2007	3,128,625	\$ 72,883	\$ 23.30	\$ 211,259

NOTE 16 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, the NYSE and NASD, 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 required to maintain minimum net capital of the greater of 6²/₃% 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 to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions.

The Company uses both the Aggregate Indebtedness and the Alternative methods to compute net capital. The method used depends on the U.S. individual broker-dealer subsidiary. The Company's international broker-dealer subsidiaries, located in Canada, Europe and Asia, are subject to

capital requirements determined by their respective regulators.

Table of Contents

As of June 30, 2007, all of the Company's broker-dealer subsidiaries met minimum net capital requirements. Total required net capital was \$0.2 billion at June 30, 2007. In addition, the Company's broker-dealer subsidiaries had excess net capital of \$0.7 billion at June 30, 2007.

Banking

During the first quarter of 2007, ETC became a wholly-owned operating subsidiary of E*TRADE Bank. ETC continues to be an SEC-registered broker-dealer and is included in the minimum net capital requirements under the Rule. 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 statements. 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. 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 June 30, 2007, the most recent date of notification, the OTS categorized E*TRADE Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed E*TRADE Bank's categorization. At June 30, 2007, management believes that E*TRADE Bank meets all capital adequacy requirements to which it is subject. However, events beyond management's control, such as fluctuations in interest rates or a downturn in the economy in areas in which E*TRADE Bank's loans or securities are concentrated, could adversely affect future earnings and E*TRADE Bank's ability to meet its future capital requirements.

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

	Minimum Required					
	Actual		to Qualify as		Minimum Required to be	
	Amount	Ratio	Adequately Capitalized	Ratio	Well Capitalized Under Prompt Corrective Action Provisions	Ratio
	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2007⁽¹⁾:						
Total Capital to risk-weighted assets	\$ 3,625,024	10.58%	>\$ 2,740,792	>8.0%	>\$ 3,425,990	>10.0%
Tier I Capital to risk-weighted assets	\$ 3,549,320	10.36%	>\$ 1,370,396	>4.0%	>\$ 2,055,594	>6.0%
Tier I Capital to adjusted total assets	\$ 3,549,320	6.15%	>\$ 2,308,714	>4.0%	>\$ 2,885,892	>5.0%
December 31, 2006:						
Total Capital to risk-weighted assets					>	
	\$ 2,593,081	10.55%	>\$ 1,967,129	>8.0%	\$ 2,458,911	>10.0%
Tier I Capital to risk-weighted assets					>	
	\$ 2,525,453	10.27%	>\$ 983,565	>4.0%	\$ 1,475,347	>6.0%
Tier I Capital to adjusted total assets					>	
	\$ 2,525,453	6.07%	>\$ 1,665,062	>4.0%	\$ 2,081,328	>5.0%

⁽¹⁾ Capital amounts and ratios include ETC.

NOTE 17 COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

Legal Matters

Litigation Matters

In June 2002, the Company acquired from MarketXT Holdings, Inc. (formerly known as Tradescape Corporation) the following entities: Tradescape Securities, LLC; Tradescape Technologies, LLC; and

Table of Contents

Momentum Securities, LLC. Disputes subsequently arose between the parties regarding the responsibility for liabilities that first became known to the Company after the sale. On April 8, 2004, MarketXT filed a complaint in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and other third parties, including SBI and Softbank Corporation, alleging that defendants were preventing plaintiffs from obtaining certain contingent payments allegedly due, and as a result, claiming damages of \$1.5 billion. On April 9, 2004, the Company filed a complaint in the United States District Court for the Southern District of New York against certain directors and officers of MarketXT seeking declaratory relief and unspecified monetary damages for defendants' fraud in connection with the 2002 sale, including, but not limited to, having presented the Company with fraudulent financial statements regarding the condition of Momentum Securities, LLC during the due diligence process. Subsequently, MarketXT was placed into bankruptcy, and the Company filed an adversary proceeding against MarketXT and others in January 2005, seeking declaratory relief, compensatory and punitive damages, in those Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York entitled, *In re MarketXT Holdings Corp., Debtor*. In that same court, the Company filed a separate adversary proceeding against Omar Amanat in those Chapter 7 bankruptcy proceedings entitled, *In re Amanat, Omar Shariff*. In October 2005, MarketXT answered the Company's adversary proceeding and asserted its counterclaims, subsequently amending its claims in 2006 to add a \$326 million claim for promissory estoppel in which MarketXT alleged, for the first time, that the Company breached a prior promise to purchase the acquired entities in 1999-2000. In April 2006, Omar Amanat answered the Company's separate adversary proceeding against him and asserted his counterclaims. In separate motions before the Bankruptcy Court, the Company has moved to dismiss certain counterclaims brought by MarketXT including those described above, as well as certain counterclaims brought by Mr. Amanat. In a ruling dated September 29, 2006, the Bankruptcy Court in the MarketXT case granted the Company's motion to dismiss four of the six bases upon which MarketXT asserts its fraud claims against the Company; its conversion claim; and its demand for punitive damages. In the same ruling, the Bankruptcy Court denied in its entirety MarketXT's competing motion to dismiss the Company's claims against it. On October 26, 2006, the Bankruptcy Court subsequently dismissed MarketXT's promissory estoppel claim. The Company continues to believe that the respective claims brought against it by MarketXT and Omar Amanat are without merit, and the Company will continue both to vigorously defend itself against all such claims and to fully pursue its own claims and damages as described above.

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 results of operation. 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 which could have a material adverse effect on its financial position, results of operations or cash flows. The Company contests liability or the amount of claimed damages in each pending matter. 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 predict with certainty 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.

Regulatory Matters

The securities and banking industries are subject to extensive regulation under Federal, state and applicable international laws. As a result, the Company is required to comply with many complex laws and rules, and its ability to comply is dependent in part on the establishment and maintenance of a qualified compliance system. From time to time, the Company has been threatened with or named as a defendant in, lawsuits, arbitrations and administrative

Table of Contents

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, the NYSE, the NASD or the OTS 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.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company's subsidiary E*TRADE Capital Markets, LLC (ETCM), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as trading ahead) during the period 1999-2005. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

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 and regulatory matters, reserves are established in accordance with SFAS No. 5. Once established, reserves are adjusted when an event occurs requiring an adjustment. During the second quarter of 2007, the Company increased its reserves by \$35.1 million to a level management believes is adequate at this time.

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 influence the impact that these commitments and contingencies have on the Company in the future.

Loans

The Company had the following mortgage loan commitments (dollars in thousands):

	June 30, 2007		
	Fixed Rate	Variable Rate	Total
Purchase loans	\$ 201,100	\$ 2,060,499	\$ 2,261,599
Originate loans	\$ 819,536	\$ 522,785	\$ 1,342,321
Sell loans	\$ 140,340	\$ 21,192	\$ 161,532

Table of Contents

Securities, Unused Lines of Credit and Certificates of Deposit

At June 30, 2007, the Company had commitments to purchase \$0.9 billion and sell \$0.4 billion in securities. In addition, the Company had approximately \$4.0 billion of certificates of deposit scheduled to mature in less than one year and \$7.9 billion of unfunded commitments to extend credit.

Guarantees

The Company provides guarantees to investors purchasing mortgage loans, which are considered standard representations and warranties within the mortgage industry. The primary guarantees are as follows:

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. 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. 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.

Should any eligible mortgage loan delivered pay off prior to the receipt of the first payment, the loan purchase and servicing release premiums shall be fully refunded.

Should any eligible mortgage loan delivered to an investor pay off between the receipt of the first payment and a contractually designated period of time (typically 60 - 120 days from the date of purchase), the servicing release premiums shall be fully refunded. Management has determined that quantifying the potential liability exposure is not meaningful due to the nature of the standard representations and warranties, which rarely result in loan repurchases. The current carrying amount of the liability recorded at June 30, 2007 is \$0.3 million, which the Company considers adequate based upon analysis of historical trends and current economic conditions for these guarantees.

ETBH raises capital through the formation of trusts, which sell trust preferred stock in the capital markets. The capital securities must be redeemed in whole at the due date, which is generally 30 years after issuance. Each trust issues Floating Rate Cumulative 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 Floating Rate Junior Subordinated Debentures.

During the 30-year period prior to the redemption of the Floating Rate Cumulative 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, 2007, management estimated that the maximum potential liability under this arrangement is equal to approximately \$442.2 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

NOTE 18 SEGMENT INFORMATION

The segments presented below reflect the manner in which the Company's chief operating decision maker assesses the Company's performance. The Company has two segments: retail and institutional.

Retail includes:

trading, investing, banking and lending products and services to individuals; and

stock plan administration products and services.

Table of Contents

Institutional includes:

balance sheet management activities including generation of institutional net interest spread, gain on sales of loans and securities, net and management income;

market-making; and

global equity execution and settlement services.

The Company evaluates the performance of its segments based on segment contribution (net revenue less expense excluding operating interest). All corporate overhead, administrative and technology charges are allocated to segments either in proportion to their respective direct costs or based upon specific operating criteria.

Financial information for the Company's reportable segments is presented in the following tables (dollars in thousands):

	Retail	Three Months Ended June 30, 2007		Total
		Institutional	Eliminations ⁽¹⁾	
Revenue:				
Operating interest income	\$ 502,336	\$ 741,770	\$ (338,334)	\$ 905,772
Operating interest expense	(251,832)	(578,110)	338,334	(491,608)
Net operating interest income	250,504	163,660		414,164
Provision for loan losses		(30,045)		(30,045)
Net operating interest income after provision for loan losses	250,504	133,615		384,119
Commission	128,183	41,585		169,768
Fees and service charges	57,979	9,923	(2,456)	65,446
Principal transactions		27,768		27,768
Gain (loss) on sales of loans and securities, net	7,351	(2,023)		5,328
Other revenue	11,173	91	(144)	11,120
Total non-interest income	204,686	77,344	(2,600)	279,430
Total net revenue	455,190	210,959	(2,600)	663,549
Expense excluding interest:				
Compensation and benefits	79,725	39,354		119,079
Clearing and servicing	22,658	54,119	(2,600)	74,177
Advertising and market development	34,382	1,556		35,938
Communications	22,570	3,251		25,821
Professional services	17,074	8,088		25,162
Depreciation and amortization	15,246	4,829		20,075
Occupancy and equipment	19,759	3,061		22,820
Amortization of other intangibles	9,536	651		10,187
Facility restructuring and other exit activities	(842)	(658)		(1,500)
Other	30,919	39,507		70,426
Total expense excluding interest	251,027	153,758	(2,600)	402,185

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

Segment income	\$ 204,163	\$ 57,201	\$	\$ 261,364
----------------	------------	-----------	----	------------

⁽¹⁾ Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.

Table of Contents

	Retail	Three Months Ended June 30, 2006		Total
		Institutional	Eliminations ⁽¹⁾	
Revenue:				
Operating interest income	\$ 372,732	\$ 503,168	\$ (215,527)	\$ 660,373
Operating interest expense	(144,026)	(387,272)	215,527	(315,771)
Net operating interest income	228,706	115,896		344,602
Provision for loan losses		(10,270)		(10,270)
Net operating interest income after provision for loan losses	228,706	105,626		334,332
Commission	127,567	39,729		167,296
Fees and service charges	52,052	7,536	(1,779)	57,809
Principal transactions		31,590		31,590
Gain on sales of loans and securities, net	8,958	2,149		11,107
Other revenue	10,903	52	(1,731)	9,224
Total non-interest income	199,480	81,056	(3,510)	277,026
Total net revenue	428,186	186,682	(3,510)	611,358
Expense excluding interest:				
Compensation and benefits	80,352	45,289		125,641
Clearing and servicing	20,124	47,524	(3,510)	64,138
Advertising and market development	28,388	2,032		30,420
Communications	24,520	3,314		27,834
Professional services	18,168	5,051		23,219
Depreciation and amortization	14,570	4,257		18,827
Occupancy and equipment	18,483	1,945		20,428
Amortization of other intangibles	9,814	2,158		11,972
Facility restructuring and other exit activities	2,824	60		2,884
Other	21,452	3,756		25,208
Total expense excluding interest	238,695	115,386	(3,510)	350,571
Segment income	\$ 189,491	\$ 71,296	\$	\$ 260,787

⁽¹⁾ Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing, servicing and order flow rebates.

Table of Contents

	Retail	Six Months Ended June 30, 2007		Total
		Institutional	Eliminations ⁽¹⁾	
Revenue:				
Operating interest income	\$ 960,100	\$ 1,413,013	\$ (637,546)	\$ 1,735,567
Operating interest expense	(482,115)	(1,086,248)	637,546	(930,817)
Net operating interest income	477,985	326,765		804,750
Provision for loan losses		(51,231)		(51,231)
Net operating interest income after provision for loan losses	477,985	275,534		753,519
Commission	251,488	77,273		328,761
Fees and service charges	112,182	17,398	(4,636)	124,944
Principal transactions		57,850		57,850
Gain on sales of loans and securities, net	12,262	10,441		22,703
Other revenue	20,924	132	(286)	20,770
Total non-interest income	396,856	163,094	(4,922)	555,028
Total net revenue	874,841	438,628	(4,922)	1,308,547
Expense excluding interest:				
Compensation and benefits	160,021	82,840		242,861
Clearing and servicing	43,419	102,932	(4,922)	141,429
Advertising and market development	78,306	3,224		81,530
Communications	45,365	6,612		51,977
Professional services	32,173	17,974		50,147
Depreciation and amortization	30,055	9,403		39,458
Occupancy and equipment	40,331	6,068		46,399
Amortization of other intangibles	19,155	1,300		20,455
Facility restructuring and other exit activities	175	(942)		(767)
Other	50,220	52,881		103,101
Total expense excluding interest	499,220	282,292	(4,922)	776,590
Segment income	\$ 375,621	\$ 156,336	\$	\$ 531,957

⁽¹⁾ Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.

Table of Contents

	Retail	Six Months Ended June 30, 2006		Total
		Institutional	Eliminations ⁽¹⁾	
Revenue:				
Operating interest income	\$ 690,934	\$ 956,644	\$ (392,911)	\$ 1,254,667
Operating interest expense	(256,308)	(721,879)	392,911	(585,276)
Net operating interest income	434,626	234,765		669,391
Provision for loan losses		(20,467)		(20,467)
Net operating interest income after provision for loan losses	434,626	214,298		648,924
Commission	263,431	79,734		343,165
Fees and service charges	105,396	14,327	(4,052)	115,671
Principal transactions		62,282		62,282
Gain on sales of loans and securities, net	17,685	5,050		22,735
Other revenue	20,202	163	(3,435)	16,930
Total non-interest income	406,714	161,556	(7,487)	560,783
Total net revenue	841,340	375,854	(7,487)	1,209,707
Expense excluding interest:				
Compensation and benefits	151,559	90,070		241,629
Clearing and servicing	37,489	97,424	(7,487)	127,426
Advertising and market development	61,443	3,758		65,201
Communications	53,003	6,239		59,242
Professional services	40,486	10,488		50,974
Depreciation and amortization	29,138	8,478		37,616
Occupancy and equipment	37,470	3,462		40,932
Amortization of other intangibles	19,687	3,617		23,304
Facility restructuring and other exit activities	3,199	(568)		2,631
Other	41,041	15,172		56,213
Total expense excluding interest	474,515	238,140	(7,487)	705,168
Segment income	\$ 366,825	\$ 137,714	\$	\$ 504,539

⁽¹⁾ Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing, servicing and order flow rebates.

Segment Assets

	Retail	Institutional	Eliminations	Total
As of June 30, 2007	\$ 14,754,603	\$ 48,220,463	\$	\$ 62,975,066
As of December 31, 2006	\$ 13,864,334	\$ 39,874,969	\$	\$ 53,739,303

No single customer accounted for more than 10% of total net revenue for the three and six months ended June 30, 2007 and 2006.

NOTE 19 SUBSEQUENT EVENT

In July 2007, the Company amended the terms of its \$250 million senior secured revolving credit facility, improving the terms and conditions of the agreement, as well as extending the maturity date until September 2010.

Table of Contents

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, 2007, 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.

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

In June 2002, the Company acquired from MarketXT Holdings, Inc. (formerly known as Tradescape Corporation) the following entities: Tradescape Securities, LLC; Tradescape Technologies, LLC; and Momentum Securities, LLC. Disputes subsequently arose between the parties regarding the responsibility for liabilities that first became known to the Company after the sale. On April 8, 2004, MarketXT filed a complaint in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and other third parties, including Softbank Investment Corporation (SBI) and Softbank Corporation, alleging that defendants were preventing plaintiffs from obtaining certain contingent payments allegedly due, and as a result, claiming damages of \$1.5 billion. On April 9, 2004, the Company filed a complaint in the United States District Court for the Southern District of New York against certain directors and officers of MarketXT seeking declaratory relief and unspecified monetary damages for defendants' fraud in connection with the 2002 sale, including, but not limited to, having presented the Company with fraudulent financial statements regarding the condition of Momentum Securities, LLC during the due diligence process. Subsequently, MarketXT was placed into bankruptcy, and the Company filed an adversary proceeding against MarketXT and others in January 2005, seeking declaratory relief, compensatory and punitive damages, in those Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York entitled, *In re MarketXT Holdings Corp., Debtor*. In that same court, the Company filed a separate adversary proceeding against Omar Amanat in those Chapter 7 bankruptcy proceedings entitled, *In re Amanat, Omar Shariff*. In October 2005, MarketXT answered the Company's adversary proceeding and asserted its counterclaims, subsequently amending its claims in 2006 to add a \$326 million claim for promissory estoppel in which Market XT alleged, for the first time, that the Company breached a prior promise to purchase the acquired entities in 1999-2000. In April 2006, Omar Amanat answered the Company's separate adversary proceeding against him and asserted his counterclaims. In separate motions before the Bankruptcy Court, the Company has moved to dismiss certain counterclaims brought by MarketXT including those described above, as well as certain counterclaims brought by Mr. Amanat. In a ruling dated September 29, 2006, the Bankruptcy Court in the MarketXT case granted the Company's motion to dismiss four of the six bases upon which MarketXT asserts its fraud claims against the Company; its conversion claim; and its demand for punitive damages. In the same ruling, the Bankruptcy Court denied in its entirety MarketXT's competing motion to dismiss the Company's claims against it. On October 26, 2006, the Bankruptcy Court subsequently dismissed MarketXT's promissory estoppel claim. The Company continues to believe that the respective claims brought against it by MarketXT and Omar Amanat are without merit, and the Company will continue both to vigorously defend itself against all such claims and to fully pursue its own claims and damages as described above.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company's subsidiary E*TRADE Capital Markets, LLC (ETCM), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as trading ahead) during the period 1999 - 2005. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on our business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in our 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 our results of operations. 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 which could have a material adverse effect on our financial position, results of operations or cash flows.

Table of Contents

We maintain insurance coverage that we believe is reasonable and prudent. The principal insurance coverage we maintain 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. We believe that such insurance coverage is adequate for the purpose of our business. Our 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

The additional risk factor presented below should be considered in addition to the risk factors previously disclosed in our 2006 Annual Report on Form 10-K.

The level of provision for loan losses in our mortgage loan portfolio may increase as a result of trends in the macro-economic environment

A substantial portion of our asset portfolio is composed of loans secured by first lien residential mortgages and second lien mortgages (home equity loans and home equity lines of credit). The overall performance of these assets can be affected by the macro trends of the economy in general and the residential real estate market, such as home price depreciation or slowing appreciation, rising mortgage interest rates and tighter mortgage lending guidelines across the industry. Such performance can also be impacted by our mix of first lien and second lien mortgages and factors particular to a given borrower. We expect nonperforming loan levels to fluctuate over time due to portfolio growth, portfolio seasoning and resolution through collections, sales or charge-offs. We increased the provision for loan losses for our first and second lien mortgages in recent periods based on the seasoning of our portfolio and higher delinquencies and charge-offs compared to 2006. Instability in the consumer credit markets and credit trends may require additional increases in our provision for loan losses, which would have an adverse effect on our results of operations in future periods.

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

On April 18, 2007, the Company announced that its Board of Directors authorized an additional \$250.0 million common stock repurchase program (the April 2007 Plan). The April 2007 Plan is open-ended and allows for the repurchase of common stock on the open market, in private transactions or a combination of both.

On December 15, 2004, the Company announced that its Board of Directors approved a \$200.0 million repurchase program (the December 2004 Plan). The December 2004 Plan is open-ended and provides the flexibility to buy back common stock, retire debt or a combination of both. The Company may conduct these repurchases on the open market, in private transactions or a combination of both. During the three months ended June 30, 2007, the Company completed the December 2004 Plan.

The table below shows the timing and impact of the repurchases under both the April 2007 Plan and the December 2004 Plan during the three months ended June 30, 2007 (dollars in thousands, except per share amounts):

Month	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the April 2007 and December 2004 Plans	Maximum Dollar Value of Shares That May Yet be Purchased Under the April 2007 and December 2004 Plans
April 2007	500,000	\$ 21.84	500,000	\$ 273,221
May 2007	1,288,825	\$ 22.56	1,288,825	\$ 244,141
June 2007	1,339,800	\$ 24.54	1,339,800	\$ 211,259
Total	3,128,625	\$ 23.30	3,128,625	\$ 211,259

Table of Contents**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The annual meeting of shareholders was held on May 23, 2007. There was no solicitation in opposition to the nominees proposed to be elected in the Proxy Statement. Ronald D. Fisher, George A. Hayter, R. Jarrett Lilien and Donna L. Weaver were elected as directors, as tabulated below:

Director	For	Withhold
Ronald D. Fisher	362,268,519	6,402,063
George A. Hayter	359,635,435	9,035,147
R. Jarrett Lilien	359,773,895	8,896,687
Donna L. Weaver	362,282,687	6,387,895

The proposal to ratify the selection of Deloitte & Touche LLP as independent public accountants for the Company for fiscal year 2007 was approved, as tabulated below:

For	Against	Abstain	Total
362,898,324	3,485,898	2,286,358	368,670,580

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

- *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

* 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 9, 2007

E*TRADE Financial Corporation

(Registrant)

By /s/ MITCHELL H. CAPLAN
 Mitchell H. Caplan

Chief Executive Officer

By /s/ ROBERT J. SIMMONS
 Robert J. Simmons

Chief Financial Officer

(Principal Financial and Accounting Officer)