UPDATE: E-Trade Exits Wholesale-mortgage Business

by dow-jones

SAN FRANCISCO (Dow Jones) -- On the eve of much-anticipated earnings reports from some of the biggest bankers in the country, discount broker E-Trade Financial Corp. said that it planned to exit the wholesale-mortgage business and also lowered its profit expectations more than 25% for the year.

The online financial-services firm (ETFC) told investors Monday it plans to realign its mortgage-loan business. The moves include setting aside $245 million and are expected to result in charge-offs of $95 million.

New York-based E-Trade cut its 2007 earnings forecast range to $1.05 to $1.15 a share from $1.53 to $1.67 a share on the changes.

Beginning with Lehman Brothers Holdings (LEH) , four of the country's five leading investment banks are scheduled to report third quarter earnings. Others in coming days include Goldman Sachs Group (GS) , Morgan Stanley (MS) and Bear Stearns Cos. (BSC)

"We won't be writing off any loans. We're going to set aside more money to cover those bad loans," E-Trade President Jarrett Lilien said in an interview Monday.

The company expects exit charges, which will primarily be recorded during the fourth quarter, to be about $32 million, including severance pay.

Still uncertain is E-Trade's talks with T.D. Ameritrade Holding Corp. (AMTD) , which reportedly has expressed concern about E-Trade's mortgage business.

In recent research, Bank of America upgraded its earnings estimates for E-Trade by 1.3% to nearly 41 cents per share. That was less than analysts' consensus of 42 cents per share at the time, according to the report.

But in the report, analyst Michael Hecht pointed to stronger August trading activity than expected. He also noted in keeping a neutral rating on shares of E-Trade that the online broker "may be underinvesting in transitioning their business model to [the] next level -- that is, more of an asset-gathering model, which is an absolute necessity in our view as the transactional business faces continued price pressure, which will likely offset much of [the] growth in volumes from here."

On Monday, Lilien argued that E-Trade is well fortified. It reported some $60 billion in interest-earning assets in the second quarter. "If you look at that on the balance sheet, on one side you've got cash and the other side loans. Of our cash piece or funding piece, about 62% comes from our own customer. That means about 38% comes from outside funding sources."

That includes private and federal sources, the executive added.

"What we want to do is replace those wholesale funding sources with more retail sources," Lilien said. "Our target is to get those retail sources up into the 80% to 85% range."

The same holds true on the loan side of the balance sheet, he said. "Today, we've got about $40 billion in loans and roughly $20 billion of securities."

Of that loan amount, some $2.7 billion represents consumer loans. Slightly less than $30 billion come from mortgages and around $8 billion come from margin-type loans, he added.

The crux of the issue is E-Trade has found that slightly less than $13 billion of its home loans through second mortgages are running into default problems, according to Lilien.

Another $17 billion from first-tier mortgages aren't experiencing any unusual issues, he said.

Hardly any of E-Trade's home-loan business is involved in subprime loans. "The changes we're making have very little to do with subprime lending," Lilien said. "It appears that some people with second mortgages are defaulting more at this point in the credit cycle. They extended themselves way too far."

The result is that E-Trade executives say they're becoming frustrated with second-tier mortgages, since they're such a small part of the company's overall portfolio.

"All of this credit stuff that's going on now is hiding our core business. We're a diversified financial-services company," Lilien said, referring to activities such as trading and banking. "The core business is really operating very well and having record quarters in terms of new customers."

While E-Trade is considering selling off some of its second mortgages, "more than likely what we'll do is let some of these mortgages prepay or mature on their own," he added. "We'll do new mortgages, but they'll be more from our existing base of customers. And the ones we do from outside sources will focus on first mortgages."

E-Trade's charge-offs a year ago were running about 0.19% of its assets in that area. In the second quarter, such second-tier mortgages were costing the company about 0.46%.

Lilien said that jumped to around 0.87% in July. "That's a big change. But it's a small portion of the company's overall balance sheet."

Shares of E-Trade finished down 1.25% on Monday to $14.21.

By Murray Coleman

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