Company Name: Goldman Sachs
Company Ticker: GS US
Date: 2018-07-17
Event Description: Q2 2018 Earnings Call

Market Cap: 90,633.65
Current PX: 231.02
YTD Change($): -23.74
YTD Change(%): -9.319

Bloomberg Estimates - EPS
Current Quarter: 5.274
Current Year: 23.237
Bloomberg Estimates - Sales
Current Quarter: 8455.786
Current Year: 35520.545

Q2 2018 Earnings Call

Company Participants

- Heather Kennedy Miner
- R. Martin Chavez

Other Participants

- Glenn Schorr
- Michael Carrier
- Christian Bolu
- Mike Mayo
- Jeffery J. Harte
- Betsy L. Graseck
- Brennan Hawken
- Guy Moszkowski
- James Mitchell
- Devin P. Ryan
- Gerard Cassidy
- Alevizos Alevizakos
- Brian Kleinhanzl

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Dennis and I will be your conference facilitator today. I would like to welcome everyone to the Goldman Sachs second quarter 2018 earnings conference call. This call is being recorded today, July 17, 2018. Thank you. Ms. Miner, you may begin your conference.

Heather Kennedy Miner

Good morning. This is Heather Kennedy Miner, Head of Investor Relations at Goldman Sachs. Welcome to our second quarter earnings conference call. Today's call may include forward-looking statements. These statements represent the firm's beliefs regarding future events that by their nature are uncertain and outside of the firm's control. The firm's actual results and financial condition may differ possibly materially from what is indicated in those forward-looking statements. For a discussion of some of the risks and factors that could affect the firm's future results please see the description of risk factors in our current Annual Report on Form 10-K for the year ended December 2017.

I would also direct you to read the forward-looking disclaimers in our quarterly earnings release, particularly as it relates to the impact of tax legislation, expenses, our investment banking transaction backlog, capital ratios, risk-weighted assets, total assets, global core liquid assets, supplementary leverage ratio, and stress capital buffer, and you should also read the information on the calculation of non-GAAP financial measures that's posted on the Investor Relations portion of our website www.gs.com.

This audiocast is copyrighted material of the Goldman Sachs Group, Inc. and may not be duplicated, reproduced, or rebroadcast without our consent. I will now pass the call over to our Chief Financial Officer, Marty Chavez. Marty?

R. Martin Chavez

Thanks, Heather, and thanks to everyone for joining us this morning. I'll walk you through our second quarter and first half results then cover each of our businesses and, of course, I'm happy to answer any questions.

Second quarter net revenues were $9.4 billion. Net earnings were $2.6 billion. Earnings per share were $5.98. Return on common equity was 12.8% and return on tangible common equity was 13.5%.

Turning to year-to-date results, we had firm-wide net revenues of $19.4 billion; net earnings of $5.4 billion; earnings per diluted share of $12.93. We grew first half revenues by 22% or $3.5 billion versus the first half of 2017, while pre-tax earnings were up 33%. Year-to-date, return on common equity was 14.1% and return on tangible common equity was 14.9%.

Stronger revenues across our businesses and positive operating leverage drove first half ROTE of roughly 15%, our best first half performance in nine years. We achieved those results and, at the same time, made meaningful investments to support future growth.

Our first half revenue growth resulted from broad-based momentum across the firm as all four of our business segments grew at a double-digit pace versus the first half of 2017. Institutional Client Services increased 24%, reflecting a 32% rebound in FICC where we continue to grow our client franchise and strengthened our market-making capabilities. During the second quarter, we saw solid client engagement across our businesses with positive macro trends supporting corporate and investor activity.

With the backdrop of rising U.S. rates and better visibility on QE in Europe, trends emerged across a variety of markets and asset classes. This quarter, our clients responded to a stronger U.S. dollar, weaker EM currencies, higher oil prices, and a divergence between U.S. investment-grade and high yield spreads. Despite the persistence of geopolitical and economic risks, the backdrop remains constructive as our clients continue to seek our advice and market-making services.

While it's impossible to predict the future, we remain cautiously optimistic that many of the broader drivers underpinning the solid start to the year, healthy economic growth, positive investor sentiment, and the emergence of new market trends, can remain in place. Let's review individual business performance for the second quarter.

Investment Banking produced net revenues of $2 billion, 14% higher than the first quarter, driven by robust growth in Advisory and continued strong and stable performance in Underwriting. Financial Advisory revenues were $804 million, up 37% relative to the first quarter, reflecting higher completed M&A volumes. During the quarter, we participated in announced transactions totaling $477 billion across 125 deals, our highest quarterly deal count in over a decade. Announced volumes remained strong globally.

Client engagement increased notably across the Americas and Europe. Year-to-date, healthy activity across a broad base of sectors, including tech, media, telecom, natural resources, and healthcare all strengthened our pipeline. For the year-to-date, we ranked first in announced M&A volumes.

Moving to Underwriting, net revenues were $1.2 billion in the second quarter. Results were our third highest on record and up 3% versus the first quarter as strength in equity offerings offset lower debt underwriting. Equity underwriting net revenues of $489 million increased 19% to the highest level in three years, as our volume growth outpaced the industry. For the year-to-date, we ranked number one globally in equity and equity-related underwriting with over $40 billion of deal volume across more than 200 transactions.

A healthy mix of activity supported our equity underwriting volumes during the second quarter. Our IPO volumes increased by over 50% versus the year-ago period and our follow-on and convertible volumes grew double digits, despite an overall decline in industry volumes. Strength across all regions drove performance, including notable deals in Asia, such as Xiaomi's $4.7 billion IPO, which was the largest technology IPO since 2014.

Debt underwriting net revenues were a robust $752 million, down 6% from last quarter. First half performance was a record, reflecting our strong client engagement and multi-year investment in the business. Debt underwriting performance this quarter included significant contributions from acquisition-related activity. Year-to-date, we ranked number one in institutional leverage loans globally and top three in high yield.

Our Investment Banking backlog increased significantly versus the first quarter to reach a record level driven by M&A and Underwriting. Clarity from U.S. tax reform, a supportive economic backdrop, generally resilient equity valuations, accessible financing, and the virtuous cycle of M&A in certain sectors are all supporting activity.

Moving to Institutional Client Services; net revenues were $3.6 billion in the second quarter, down 19% compared to the first quarter, but up 17% versus the second quarter last year. While performance declined from a solid first quarter, client engagement remained healthy and the overall backdrop remained constructive for our market-making franchises.

FICC Client Execution net revenues were $1.7 billion in the second quarter, down 19% versus the first quarter, but 45% higher than the second quarter of 2017. Our improvement reflected higher client activity and our efforts to both deepen and broaden our client relationships. The operating environment was more constructive and we faced fewer inventory headwinds than the second quarter of last year.

This quarter, we had lower sequential performance across many of our businesses. Nevertheless, client flows were healthy and this was particularly notable in our macro businesses where diverging economic outlooks drove major government bond markets. Within FICC, currencies declined significantly versus the first quarter as weaker performance in emerging markets more than offset better performance in G-10. Commodities decreased significantly versus the first quarter reflecting lower performance in natural gas. Commodities, however, increased significantly versus the second quarter of 2017, which included inventory challenges.

Credit also declined versus a solid first quarter amid wider spreads, particularly in Europe, partially offset by stronger performance in structured credit. Rates was modestly lower sequentially as lower revenues in Europe were partially offset by solid performance in the U.S. as clients responded to central bank activity. Mortgages was relatively flat sequentially.

Turning to Equities, net revenues for the second quarter were $1.9 billion, down 18% versus a strong first quarter as equity market volumes and volatility declined. Equities client execution net revenues of $691 million declined from the first quarter, which was our highest quarterly performance in three years. Our derivatives business declined significantly in the second quarter, driven by reduced volatility and a more limited opportunity set. Over the past three years, we have had a balanced franchise with derivatives in cash each contributing roughly half of Equities client execution revenues.

Commissions and fees net revenues of $763 million declined 7% on modestly lower market volumes across regions. We continue to pursue opportunities for market share consolidation, particularly in low touch execution, where we gained volume market share this quarter in every region. Securities services net revenues of $437 million were essentially flat quarter-on-quarter.

Moving to Investing & Lending, collectively, these activities produced net revenues of $1.9 billion in the second quarter. Equity securities generated net revenues of $1.3 billion, reflecting net gains from private equities driven by company-specific events and corporate performance. Approximately 60% of our revenues were from events such as sales in our private portfolio and mark-to-market on public securities. During the quarter, notable sales included contract food manufacturer Hearthside Food and capital markets data provider, Ipreo.

On a year-to-date basis, our equities I&L business generated $2.4 billion of net revenues, roughly 65% from corporate investments and 35% from real estate. Our global private and public equity portfolio remains well diversified with over 1,000 different investments. Our performance continues to be driven by investment discipline that emphasizes risk-adjusted returns. We achieve this by applying extensive operational expertise and working closely with portfolio companies to grow their businesses.

The portfolio remains diversified across industry, geography and balanced across investment vintage. By vintage, we made 42% of the investments in the equity portfolio in the last three and a half years, 27% between 2012 to 2014, and the remaining 31% in 2011 or earlier.

Net revenues from debt securities and loans were $663 million. Results included over $625 million of net interest income, equivalent to a $2.5 billion annual pace. Our net interest income continues to grow as we increase more recurring revenue streams and lend more to our broad client base. Results also included provision for loan losses of $234 million. Our I&L assets included approximately $106 billion in loans, debt securities, and other assets and $22 billion in equity investments.

Let me spend a moment and give you an update on Marcus. Today, we have three products in the U.S. market. Consumer personal loans, savings, and our recently-acquired personal financial management app, Clarity Money. We will launch our fourth product entering the UK deposit market later this year. We have originated over $4 billion of consumer loans since launch and we held $3.1 billion of loans on our balance sheet as of June 30. In addition, our retail deposits grew to over $23 billion as we continue to expand and diversify our funding. Across our businesses, Marcus now serves more than 1.5 million customers.

We continue to be prudent in our underwriting and pricing of risk in our consumer lending business to ensure attractive risk-adjusted returns. We only lend to creditworthy customers with a demonstrated ability to pay. We employ a conservative underwriting process, using multiple hard cuts to define the narrow credit sandbox in which we operate. In addition to FICO, we use proprietary scoring models which have been carefully vetted by our central risk management process. While the overall Marcus portfolio remains small relative to the size of the firm's balance sheet, we approach our credit risk management responsibility seriously and systematically.

The loans portfolio, however, will naturally season over time and see credit migration over the cycle. In our recent experience, a vast majority of the portfolio has remained in the same FICO band or even improves. As of June 30, loans with refreshed FICO scores below 660 measured in the low double digits as a percent of the portfolio. This reflects migration and our deliberate testing in the 630 to 660 range which represents less than 5% of originations. Importantly, the average FICO score of our portfolio continues to exceed 700 and our loss expectations remain approximately 4% to 5% on an annual basis.

We remain excited about the long-term opportunity to build a significant accretive and value-added consumer franchise. We continue to evaluate new product opportunities including wealth management, credit cards, and others, with our criteria for launch predicated on our ability to address consumer needs, apply the core competencies of Goldman Sachs, and deliver attractive returns to shareholders.

Moving to Investment Management, we produced record net revenues in the second quarter driven by strong incentive fee realizations and solid contributions from both our Asset Management and PWM businesses. Net revenues were $1.8 billion, up 4% sequentially, including stable management and other fees of $1.3 billion and significantly higher incentive fees triggered by harvesting, including one of our secondary vintage funds.

Transaction revenues of $182 million declined 14% driven primarily by lower PWM client activity. Assets under supervision finished the quarter at a record $1.5 trillion, up $15 billion versus the first quarter, driven by $8 billion of long-term net inflows spread across all asset classes, $10 billion of liquidity product net inflows, offset by $3 billion of market depreciation.

Now, let me turn to expenses. We continue to monitor and manage our overall expense base with an emphasis on paying for performance to attract and retain the best talent, and spending to support our clients while investing in technology and infrastructure to grow the firm for the future.

Compensation and benefits expense include salaries, bonuses, amortization of prior-year equity awards and other items such as benefits. We reduced our year-to-date compensation to net revenues ratio to 39%, down 200 basis points from the first half of last year, reflecting our strong year-to-date revenue growth and our emphasis on profitability. Non-compensation expenses were $2.7 billion, up 6% versus the first quarter and up 24% versus a year-ago. Roughly half of the increase versus last year was good expense growth, including approximately $175 million from investments to drive growth, including Marcus and our consolidated investments, and to build scale through technology.

Another roughly $75 million comes from client activity reflected in brokerage, clearing and exchange fees. The remainder includes approximately $125 million related to higher litigation and $80 million related to the new accounting standard.

As we look ahead, we currently expect non-compensation expenses for the second half of the year to be materially consistent with the first half. As we continue to build scale and platform businesses, there is a natural migration from compensation to non-compensation expenses over time. To ensure a disciplined approach, we monitor our costs holistically through measures such as efficiency or overhead ratios, and we're pleased to see these measures improve in the first half of 2018 versus first half 2017.

On taxes, our reported year-to-date tax rate was approximately 19%. We expect our full year 2018 tax rate to be approximately 20%. This rate can vary and is based on a number of factors including our overall level and mix of earnings and updated guidance from treasury on the implementation of tax legislation. We will provide updates on our future tax rate once we have final guidance from treasury.

Turning to balance sheet liquidity and capital. Our global core liquid assets averaged $237 billion during the quarter, which we expect to decline as we redeploy our balance sheet to meet client needs. Our balance sheet was $969 billion, roughly flat versus last quarter. Our Common Equity Tier 1 ratio was 12.6% using the Standardized approach and 11.5% under the Basel III Advanced approach. Our ratios improved by 50 basis points and 40 basis points, respectively, on a sequential basis driven primarily by increases in common equity. Our supplementary leverage ratio was 5.8%, up 10 basis points versus the first quarter.

On capital return, we paid $314 million in common stock dividends, which included a 7% increase this quarter to $0.80 per share. Last month, the Federal Reserve announced it did not object to our $6.3 billion capital return plan for the 2018 CCAR cycle, including $5 billion of share repurchases and $1.3 billion of dividends. The level of our share repurchase plan reflects our capital position post tax reform and our desire to invest in the growth of our client franchise. The $5 billion repurchase plan remains within the range of expectations we laid out in April and we will resume buybacks this quarter.

On the stress capital buffer, it's important to recognize that for several years, we have managed the firm's capital to a stressed concept. The Federal Reserve's SCB proposal is a formalization of this process. While the natural tendency is to extrapolate recent CCAR results to estimate stress capital requirements, which would imply a roughly 6 percentage point stress capital buffer, we caution against reading too much into a single data point. Over the past three and five years, our peak to trough CET1 ratio change averaged roughly 5 percentage points. We do not yet know precisely how this new capital requirement will be calculated. We submitted a comment letter to the Federal Reserve and, like many other rule changes, once we know the final requirements, we will comply and adapt accordingly.

Before taking questions, a few closing thoughts. We're pleased with our performance in the first half of 2018, including our execution on our $5 billion revenue growth initiatives, though these initiatives are not the limit of our ambition. Across each of our seven revenue initiatives, we are running ahead of plan and continue to make progress in each of our businesses.

For example, in Investment Banking, we're hiring new bankers and expanding and enhancing our client coverage. To-date, we have completed more than 10 notable transactions from these efforts and continue to grow the backlog for the targeted clients. We have also seen success year-to-date with corporate clients, supported by our expanded FICC and Investment Banking joint ventures.

In ICS, we continue to gather feedback on our performance directly from our clients and from third parties where indications continue to be positive and our client volume market shares have improved. In Equities, we generated over 100 basis points of market share expansion with low touch clients globally versus 2016.

In Investment Management, we're enhancing our client service offering, growing advisory mandates and driving inflows in long-term fee-based assets. And finally, we're making solid progress across a variety of lending initiatives including expanding our customer base of Marcus borrowers and depositors, growing our lending to PWM clients and continuing to prudently deploy capital through our Institutional Lending and Financing Business.

Clients remain the center of everything we do. We're investing in our global client franchise from a position of strength and will continue to make long-term investments to diversify our client footprint and expand the breadth of products and services we offer. By successfully implementing these initiatives, we expect to drive sustainable revenue and earnings growth and enhance the durability of the firm's earning profile.

In conclusion, when we think about our ability to drive value, we're encouraged by our roughly 15% returns year-to-date and the further benefit from our growth plans giving us increased confidence in our ability to deliver attractive long-term returns for shareholders. With that, thanks again for dialing in and we'll now open up the line for questions.

Q&A

Operator

[Operator Instructions] Your first question is from the line of Glenn Schorr with Evercore ISI. Please go ahead.

<A - R. Martin Chavez>: Good morning, Glenn.

<Q - Glenn Schorr>: Hi, thanks very much. Question on the I&L front. I know it was a great private equity quarter, but a lot of growth is still being fueled on the I&L side. You pointed out the, call it, $2.5 billion of run rate NII. You've been good enough to give us the [ph] 400 to 450 (27:06), like, what is set in stone based on the current portfolio? I don't want to read too much into it, so I want to ask specifically, is the $2.5 billion a new higher level because you keep building the lending book? I just want to make sure that I'm getting that right.

<A - R. Martin Chavez>: Yes, Glenn, that's right. The $625 million of net NII in the quarter reflects a $2.5 billion run rate and that is an outgrowth of growing the lending book.

<Q - Glenn Schorr>: Okay, great. Add-on to that question is just, I think you've been there for a long time and you're increasing your efforts, but it feels early days in the growth of private credit in general. And does it feel like the opportunities are accelerating there and are you constrained at all by your structure? Meaning, in the old days, you might raise a big fund like some of the alts do but Volcker limits your participation. Do you just put on balance sheet is the same capital treatment? I'm just curious if you could talk towards that.

<A - R. Martin Chavez>: So, Glenn, in our business, we have a variety of ways of looking at it, and our merchant bank, we raise funds of course, and then we also have the Special Situations Group. The best way to think about it is its franchise adjacent. What drives it is not market beta but rather the adjacency to our IBD platform. That's how the sourcing of the investments works. That's how the harvesting works, and this is an area where we are deploying capital. We're seeing attractive risk returns, and we're seeing that private credit is reemerging.

We've launched new funds. It's Volcker compliant. We partner with our clients in a variety of ways to participate in the lending and then our IBD platform can participate in the harvesting as well, so this is a core competency for the firm. We've been doing it for decades, and it's an important pillar of our growth.

<Q - Glenn Schorr>: Okay. Last quickie. I don't remember if and when there was ever a lower second quarter comp ratio. Is that just a function of revenues up 22% for the year? Better clarity on it being at least the 37%? Is there anything to read into on, if revenues continue at this pace, we could actually see a lower comp ratio? Thanks.

<A - R. Martin Chavez>: So, Glenn, it is just as you say, it's the strong revenue growth year-on-year and our emphasis on profitability. The compensation philosophy remains the same as it always has been. We pay for performance and we attract and retain talent.

<Q - Glenn Schorr>: All right. I tried. Thank you. Appreciate it.

<A - R. Martin Chavez>: You bet.

Operator

Your next question is from the line of Michael Carrier with Bank of America Merrill Lynch. Please go ahead.

<Q - Michael Carrier>: Thanks, Marty. Maybe first question, just on the backdrop, you mentioned pipeline at an all-time high and you've got the tax reform, but then you've got the trade stuff, and so just wanted to get some color on what you're seeing from clients both on the banking and the trading front.

<A - R. Martin Chavez>: So I'll start with the banking front. As we mentioned, the backlog's strong at record level and the M&A backlog within that also at a record level. Underwriting, strong pipeline as well, and the industry trends are robust. Yes, there's geopolitical and other discussions, but we're seeing the client engagement at high levels across the Americas, across Europe. It's broad.

I highlighted a few of the sectors, but it's really across many sectors not just the ones I mentioned, TMT, natural resources and healthcare, and CEO confidence is strong. Firms have cash. It's driven by a lot of things, lower taxes, and also the repatriation. So, the trade factor is there, but we have seen no impact on client activity. And it's clear to us and to our corporate clients that the strategic benefits outweigh the potential perceived challenges.

<Q - Michael Carrier>: Okay. That's helpful. And then just as a follow-up, just want to get your perspective. This is the second quarter where revenue growth has been strong. You guys produce operating leverage, ROE's year-to-date 14%, ROTE is 15%. But valuation, it doesn't seem like you get much credit. Is it more just consistency? Over time, you think it'll follow through and the growth in book value will eventually deliver from a disclosure standpoint and maybe some of the newer businesses, whether it's on the lending side, is there more that maybe could be done or that you guys are looking into to maybe improve disclosure and transparency?

<A - R. Martin Chavez>: Well, certainly, Michael, we're leading and running the business for the long term and we know that the importance, obviously, of delivering revenue and earnings growth, hence the growth strategy that we outlined for the market driving more recurring fee-based revenue, expanding products and services, and broadening the client base. And that's something that you can see in our results and it's something that we're going to continue to work on. And our view is that, as we do this, the market will, over time, recognize that.

For me, for Heather, for all of us at the firm, disclosure is a huge priority and we're open to any and all suggestions and recommendations from you, the analysts, from our investors, and we're taking them on board, and you can see some of that in my prepared remarks and, as we go through the Q&A, you'll see more of it.

<Q - Michael Carrier>: Okay. Thanks a lot, Marty.

<A - R. Martin Chavez>: You bet.

Operator

Your next question is from the line of Christian Bolu with Bernstein. Please go ahead.

<A - R. Martin Chavez>: Hello, Christian.

<Q - Christian Bolu>: Hello. Good morning, Marty. So just another follow-up on operating leverage; it was pretty impressive in the first half. As you said, revenue growth of 22% and pre-tax even higher at 33%, while all investing for growth. Question is how should we think about operating leverage for the full year? I guess the comp ratio was down 200 bps for the quarter. Is that a good way to think about the full year or should we be thinking about more on efficiency ratio? Just would love to get more color from you.

<A - R. Martin Chavez>: The comp-to-net revenue ratio, as you know, Christian, is the 39% is our best estimate at this point for the full year. Operating leverage is a lens through which we examine many of our decisions. We know its importance to our stakeholders. It's important to us, and as we make our investments, we keep that in mind, and when we set the compensation ratio, we're looking at a variety of scenarios, but we're especially looking at our three-year growth plan, and those are all the factors that go into it.

You're going to see from us we'll remain focused on operating leverage in the back half of the year. The revenue environment is certainly a factor, but I'd also just like to emphasize that the comp-to-net revenue ratio, our best estimate for the year, is an output of all of these other considerations. The main drivers are revenues and the growth plan and our emphasis on earnings and revenue growth.

<Q - Christian Bolu>: Okay. Thank you. Maybe a bigger picture question on Marcus and the competitive landscape there. I think your vision is really to build out a comprehensive digital consumer platform. Sounds like other folks are thinking the same thing. JPMorgan launched its Finn digital initiative, Citi is talking about expanding and enhancing its footprint, and even PNC is talking about its retail national bank. So, in light of that sort of – that evolving competitive landscape, what's Goldman's edge in building out Marcus here?

<A - R. Martin Chavez>: Well, Christian, as we outlined, and this is the way we are making all of our decisions, as we build out this business, indeed, as we launched ourselves into this business in the first place, with the insertion point that you know, which is the installment loans but also the deposit offering, we're always looking at it from a few perspectives.

First, is this a large addressable market? Are there significant pain points that we can solve for our new clients? Does it play to our strengths? And something that we've been doing for decades at the firm is prudently managing risk and deploying capital and also building software. And is it an opportunity where we can have results that are material for us without requiring a large market share, and are there attractive risk returns for our shareholders?

So as we develop this vision, you're seeing more of the offerings and it's coming into focus. And the emphasis for us is on what is the consumer's pain point and how can we solve it in a differentiated way, given also that we don't have the legacy of stale mainframe systems and we don't have the bricks and mortars. And so as we're doing this, and this is of course one of the things that attracted us to Clarity Money, is it's the A/B testing. It's the emphasis on making it an easy user experience, leading with the behavioral economics, a better service. We know this is a competitive and commoditized business and we know that we have to differentiate ourselves and earn our way into it. That's what we're doing.

<Q - Christian Bolu>: Awesome. Thank you very much, Marty.

<A - R. Martin Chavez>: You bet.

Operator

Your next question is from the line of Mike Mayo with Wells Fargo Securities. Please go ahead.

<A - R. Martin Chavez>: Good morning, Mike.

<Q - Mike Mayo>: Hi. My question relates to why isn't Lloyd Blankfein staying to the end of the year, and what changes do you expect with David Solomon taking over the helm? And if Lloyd or David's on this call, if they could answer, that would be great.

<A - R. Martin Chavez>: Well, Mike, you just got me for the call this morning, but I'm happy to answer it because this one's straightforward. What you saw in today's announcement was another step in the unfolding of the board's plan, which has been in place actually, looking back, for a real long time now. You've seen various moments in the succession plan and today is one of those moments. The board has made its choice and its selection clear and that's been developing over the last several months. Obvious but important to say, Lloyd and David and all of us have worked together over years and decades on our management committee. The average tenure's something like 20-some years and so this is all part of the plan.

As for strategy, David and Lloyd and I and many of us have been working on our strategy and you've seen that develop over time. You've seen it at conferences. There's going to be more discussions at upcoming conferences. You'll hear the emphasis on more recurring fee-based revenue, and you've seen that in the results, the emphasis on the growth plan, on driving revenue and earnings growth. All of these are parts of the strategy, and David has been instrumental in that strategy. I don't have any evolutions beyond that to announce right now, so stay tuned.

<Q - Mike Mayo>: All right. Well, if I can follow up. Just in terms of the backlog being up, what's the percentage change, because you're saying it's a record backlog first quarter to second quarter. How much is that up?

<A - R. Martin Chavez>: So I'm not going to break out the percentage change other than to say that it was strong growth on the quarter, it was significant on the quarter, and not only, as I mentioned, was it a record for the overall banking segment in the backlog, it's a record M&A or Financial Advisory backlog, and Underwriting is at the second highest level ever. And then if you look within underwriting separately, debt underwriting and equity underwriting, those are each at the second highest level ever.

<Q - Mike Mayo>: So last follow-up. So is this a sign that the economy is finally turning up a notch? We had the tax cut. We had some excitement about reflation, we're waiting for this to kick in more forcefully. So now you have record backlogs that you just described, is that a function of that or is that just unique to Goldman Sachs? Sometimes these revenues are lumpy.

<A - R. Martin Chavez>: Well we're certainly seeing all kinds of trends at play and you mentioned some of them. We're seeing resilient growth across many economies, rising U.S. rates, QE unwind, tax reform behind us and therefore a lot more clarity on it, stronger U.S. labor market, CEO confidence, GDP growth, all of those things are part of the macro backdrop and the momentum feels good. That combined with this franchise, that's by many most metrics, number one quarter-to-quarter, year-after-year, over the long haul, the combination of those two is powerful.

<Q - Mike Mayo>: All right. Thank you.

<A - R. Martin Chavez>: Thank you.

Operator

Your next question is from the line of Jeff Harte with Sandler O'Neill. Please go ahead.

<Q - Jeffery J. Harte>: Good morning.

<A - R. Martin Chavez>: Good morning, Jeff.

<Q - Jeffery J. Harte>: Good morning. So a couple from me. One, looking back at last quarter, one of the things I liked at least about the quarter was the spike in the balance sheet and we didn't really see a follow-through into this quarter. Can you talk a little bit about what you're seeing as far as client demand for your balance sheet and kind of what your outlook is there?

<A - R. Martin Chavez>: So Jeff, we talk about this a fair bit and we like to say we're in the moving rather than the storage business, and that's really something that you're seeing in the quarter. So balance sheet, as you noted and as I mentioned, was flat, down $5 billion on the quarter. Within that, the movement in the balance sheet remains high and that gives the opportunity to allocate the balance sheet on a daily basis, and to prioritize the way that we're dedicating financial resources and resources of various kinds to our clients. It's really a velocity story.

<Q - Jeffery J. Harte>: Okay. You mentioned the tax rate. I believe you said 20% for 2018, which is what you'd expected. Hadn't you before been talking about 23% or 24% kind of longer term? Is that a 2018-specific decline or should we be thinking about the longer term tax rate being lower as well?

<A - R. Martin Chavez>: Yes, it is a 2018 story and that's our estimate for the full year. As you know, when there are discrete items, equity-based compensation, for instance, we recognize those in the quarter where they happen. Certainly in terms of this year's tax rate, as we know, it's a transitional year for parts of the tax reform specifically the GILTI and the BEAT taxes. As for 2019, the 24% rate that I highlighted before, that's our best – that's what I would suggest to you as a sensible modeling assumption.

Operator

Your next question comes from the line of Betsy Graseck with Morgan Stanley. Please go ahead.

<A - R. Martin Chavez>: Hello, Betsy.

<Q - Betsy L. Graseck>: Hi. Good morning. How are you doing?

<A - R. Martin Chavez>: Very well. Thanks. You?

<Q - Betsy L. Graseck>: Good. One follow-up question and one other question. On the follow-up, I know we talked already about the comp ratio and I know in your commentary you indicated, you know, look, that's going to be a function of revenues but also profitability. So my question is around profitability. Are you kind of suggesting to us in that commentary that you really don't want to go below a 12% ROE because if we kept the 41%, it would have been below that.

<A - R. Martin Chavez>: We were not setting the comp ratio in that way at all, Betsy. Of course, we're looking at all kinds of things but as I mentioned, the philosophy of comp hasn't changed at all. The framework hasn't changed either and I'm well aware that we don't typically reduce the comp rate in the second quarter, though it has happened in the past. Really, the framework is the same. We're looking at where the revenues are and paying for performance. We don't have ROE targets.

One thing that I would say that is an evolution and I mentioned this in the prepared remarks is that as we build and scale our businesses, and apply more automation everywhere, it's natural to think about comp and non-comp holistically and that's, of course, the efficiency ratio is one way to do it, pre-tax margin does it too. And that is increasingly an emphasis for us on driving the efficiency ratio lower, and that's how we got there.

<Q - Betsy L. Graseck>: Okay. So when you mentioned the profitability as one of the factors for assessing that, were you thinking about ROE or is there a different profitability measure you're thinking about?

<A - R. Martin Chavez>: One of the fascinating things about our business is we're thinking about so many things. It's this combinatoric optimization across all kinds of metrics and constraints. We certainly do spend a lot of time thinking about our pre-tax as well as our pre-tax margin.

Operator

Your next question comes from the line of Brennan Hawken with UBS. Please go ahead.

<Q - Brennan Hawken>: Hey. Good morning, Marty. Sorry. I was just Googling combinatoric to try and figure out – quick one on Marcus. Thanks for the increased disclosure, especially on the refreshed FICO. That's helpful.

<A - R. Martin Chavez>: Sure.

<Q - Brennan Hawken>: I know it's a new business for you guys but I definitely appreciate the attempts to improve and enhance the disclosures there. You mentioned the 4% to 5% annual loss rate on Marcus. Is that still through-the-cycle view? Number one. And then are you provisioned at a level that's greater than that currently, given that we're in the later innings of the cycle and can you give us some perspectives on that?

<A - R. Martin Chavez>: Well, yes, Brennan. I'm happy to note that you saw the increased disclosure and we're working on it. The 4% to 5% is our best estimate and we are absolutely provisioned higher than that.

<Q - Brennan Hawken>: Cool. Thank you. And then another one is the narratives and chatter we're hearing on cash management and how you guys are considering a shift towards cash management. Actually, I think, Marty, you have referenced that in prior calls. How should we think about how you're considering positioning yourselves in the marketplace there? What do you think would differentiate Goldman's offering versus competitors? What do you think the value proposition of Goldman is in that business, because it's rather different than what we're used to thinking of as far as Goldman and the position in the marketplace?

<A - R. Martin Chavez>: Sure. So as you know and as we've discussed and you've seen this, we started by making a partner level hire of an engineer for this business, and I think that tells you a lot right there about how we're approaching it. One of the interesting things about technology and software, generally, is that there's paradigm shifts that happen about every 20 years and that's actually pretty stable cycle. And if you look at the cash management offerings that are out there, what's immediately obvious is they really haven't changed much for two whole 20-year cycles. So really, they're not too different than they were in the 1970s, and so that's an opportunity right there.

But especially as we evaluated this business, the adjacencies to our core franchise are striking and obvious. We have corporate relationships that are the best on the Street and we've been working to broaden those corporate relationships through the company through our clients well beyond the CEO and CFO to Treasurers, Assistant Treasurers procurement, and so we've been building that connectivity, and then also the adjacency to our foreign exchange business is obvious. And so there's some analogies to Marcus. The same evaluation criteria we laid out that led us to Marcus are leading us to this business, exactly.

There's a sizable revenue pool where having our small share of that revenue pool is going to be meaningful for us and it's an exciting opportunity, given changes in technology, payment rails and so many things, that's the opportunity. And we're seeing it as a two to three-year build.

Operator

Your next question is from the line of Guy Moszkowski with Autonomous Research.

<A - R. Martin Chavez>: Good morning, Guy.

<Q - Guy Moszkowski>: Thanks. Good morning. Before I ask a question, I know he's not on the call, but I just thought in case he listens to it later or something, I think, really, we all owe a hat tip to Lloyd for his leadership over these 12 years through good times and bad, and some things that were very idiosyncratic to Goldman Sachs, which he managed through, I think, super effectively with the team, so just a hat tip to him.

Beyond that, I also wanted to say thanks for the Marcus data, which I thought was interesting, and also a little bit of color you gave on some of the other initiatives that were laid out back in September of last year. We are coming up on the one-year anniversary of when you laid those out in some detail and I was wondering when might we expect a more fulsome discussion of kind of where you are in terms of meeting some of those objectives?

<A - R. Martin Chavez>: Well, sure, Guy. First, let me start with your hat tip to Lloyd. We feel the same way. That's a delightful lovely thing you said and also immensely well deserved, so I'll be sure to pass it on to Lloyd who's been an amazing leader and he's made all of us better.

So on to your next question on the growth initiatives. Yes, we – I'll step back for a minute. So the way we're looking at the growth initiatives is there's seven revenue lines in the growth initiatives, and we're making solid progress on all of them at or ahead, in some cases, well ahead, of our targets and, beneath that, there's 40-plus key performance indicators. We see those as precursors, harbingers of the revenue and important to track as well, which we do on a granular and, as you would expect, from a highly-automated basis, I and we, and many of us, David, all of us look at it weekly to see how we're going.

I laid out some of them for you. So, for instance, on the expanding client coverage in both FICC and Equities, you'll remember that that's a $600-plus million annual revenue target in three years' time for FICC, expanding across clients, especially the asset managers. And we're definitively seeing in broker votes and third-party surveys and all kinds of measures of wallet share that we're making solid progress there.

Equities, similarly, I mentioned 100-basis point expansion in wallet share since 2016, 140 basis points to be a little bit more precise, and that's with the systematic and quant clients, and half of that progress has happened this year. So that's to give you a flavor of some of the KPIs. But we know that the market is looking for the mark-to-market. We mentioned $5 billion annual revenue in three years' time. Without the market opportunity set expanding, that's just work that we're doing and we're going to give you that detail and you're going to hear it from us in the back half of this year.

<Q - Guy Moszkowski>: Okay. I think that that'll be really helpful, so thank you for that. Just on something that is related but is going to be maybe a little nitpicky given that it's a quarter, but I'm just curious. In the Equities business, which you pointed to, the fact is you were flat year-over-year in the second quarter at a time when your peer group that has reported so far were up on average, I think, so far about 20% year-over-year. Granted there's 10-point sensitivity to these types of analyses, but I'm just wondering, were there any particular things that might have held you back in the Equities business this quarter as we try to think about how we kind of annualize and go forward.

<A - R. Martin Chavez>: I'll start by saying our Equities franchise, which I had the opportunity to co-head some number of years ago, is one that I wouldn't trade for anyone else's equity franchise. It's global. It's balanced across cash and derivatives. We're doing exciting things in automation and engineering all over it. We have a leading prime platform. And that business also had, as you know, in the second quarter of last year, a strong performance, solid performance, and so the comp was tough.

We break out that segment, as you know, in three ways, so it's more granular than the peer group. I'll mention one of those in specific, but I'm happy to go into any of them if you'd like. But let's see, starting with commissions and fees, I'll note that those revenues were stable and, again, it is just one quarter versus the second quarter, with commission rates going down.

And so, while we always thought of 2018 as a year of adapting to MiFID II and observing and making changes in our business, we also highlighted for you that we had the view that MiFID II benefits would accrue to scale players with leading research content, and we're one of them, and we're seeing abundant signs of that picking up share from the lower tiers of people who do not have that kind of scale and diversification.

The last thing I would say is that, on the derivatives component, which we highlighted, so in equities client execution, same year-on-year, but greater contribution from cash and lower from derivatives. Some of those derivatives transactions can be lumpy and we certainly have them in the second quarter of last year; less of it in the second quarter of this year.

Operator

Your next question comes from the line of Jim Mitchell with Buckingham Research. Please go ahead.

<Q - James Mitchell>: Hey, good morning.

<A - R. Martin Chavez>: Good morning, Jim.

<Q - James Mitchell>: Hey, good morning. First, maybe just follow-up on Marcus; I thought it was interesting that you're looking to expand in the UK. Just what kind of drove that decision and could we see follow-through with perhaps a lending product in the UK or do we see other markets – do you enter other markets? How do we think about where that's heading?

<A - R. Martin Chavez>: So what drove that decision was the opportunity to continue to diversify our funding channels and we clearly saw that in the UK. And as we built out that offering, it fits all of the parameters that you've seen from us in our Digital Consumer Finance offering so far, and you'll see more of them as we evolve this strategy. We're always considering new products. There are many new products that we're determined to build in the U.S. and we're always considering them, expanding them geographically and have nothing beyond that to announce right now.

<Q - James Mitchell>: Fine. I mean you're not limiting Marcus to the domestic, I think is obviously the takeaway here, I guess?

<A - R. Martin Chavez>: Absolutely not.

<Q - James Mitchell>: Okay. And maybe just a question on the SCB impact. Obviously, as you pointed out, year-to-year it can be very different. Are there ways – if it stays – as the economy continues to get better and the test seems to get tougher and tougher, is there a way to reduce stressed volatility in your view or do you think there might be changes to the test? Because it is a pretty big step-up to the SCB from the prior buffer and just trying to think through your model and some of the pure play investment banks seem to get hit harder in the stress test. Is there anything you see that's sort of easy to do that could help alleviate some of that or is it just sort of you've got to deal with it year-to-year?

<A - R. Martin Chavez>: Well, let's start off by saying that the CCAR stress is hugely important for the safety and soundness of the financial system and it's an important part of our process and we're supporters of it. And we also have our own capital management plan and framework and analytics. And our view is we have ample capital where we are right now. So you know we're at 12.6%. Our benchmark for capital on standardized CET1 basis is 12.5%, and we designed that policy so that it is, as I said, one that gives us ample capital. So step back and look at the CCAR process.

It was more severe. If you look across the industry, you'll see that the best SCB estimate using DFAST 2018 is in several cases higher than the current capital levels. And the math is pretty straightforward. For us, it's a 6% peak-to-trough, add to that the 4.5% minimum and the 2.5% G-SIB buffer, you get 13-ish percent without any management buffer, so that math is easy and it is just one print.

The Federal Reserve has said quite specifically that they view overall capital levels in the industry to be appropriate. And then also if you look back historically, over three or five year periods, as I mentioned, for us, the peak-to-trough has been 5%, not 6% and there's a bunch of other things to consider here.

The SCB is a proposed rule and, as we know, as rules become final, all kinds of things happen. The regulators have been very specific that they're open to comments. You can see our bilateral comment to the Fed and you can see the industry letter so we certainly shared our views with the Fed and we'll wait-and-see how they adapt. I can think of many ways, averaging and so on, G-SIB recalibration is one. There's many ways to comport these statements that the results of this year's test are more severe, with the Fed's statement that capital levels are appropriate for the industry across-the-board.

The last thing I'll mention is that if the SCB is finalized, the relevant print would be DFAST 2019, not the one that we just saw. However this all settles as we always do with the rules, we'll comply and we'll adjust and it'll be fine.

Operator

Your next question comes from the line of Devin Ryan with JMP Securities. Please go ahead.

<A - R. Martin Chavez>: Hello, Devin?

<Q - Devin P. Ryan>: Great. Thanks. Good morning, Marty. I guess a question on Clarity Money and just what you guys have done since the acquisition, the strategy to drive more customers into the app, and then just how we should think about that in terms of kind of broader consumer finance and wealth management growth, especially as you add more products to the offering.

<A - R. Martin Chavez>: Well certainly. Actually, I was just talking to Adam Dell this morning, and if you walk into our building, you could see Clarity Money on the pillar, and I've absolutely some time ago downloaded it myself and use it. Generally, as you know, historically, over time, our approach at the firm has been we build all our own software. And as we've discussed in the past, we've changed that approach to see can we find it in open source or can we find something that's already out there. And in the case of Clarity Money, we saw something that was beautifully designed from the user experience for the consumer, and it made much more sense to join Clarity Money with our brand and our resources than to go build it on our own.

And what we immediately saw in it, and this is playing out, is we saw it as a front door to all of the Marcus offerings: buy, save, spend, protect, invest, and we saw it as a way to lower acquisition costs, which is a fascinating thing about the way that they have done it. And we see it as a platform in which we can aggregate content and provide all of the services and products that we're developing in a consistent way, consistent brand and look and feel.

<Q - Devin P. Ryan>: Okay. Great. Thanks for the color. And then maybe a follow-up here just on kind of the Investment Banking commentary. It seems that any time we're talking about record backlogs, we get questions around whether we're close to a cyclical peak. And so when you look across the franchise, how do you think about that just based on the metrics that you look at? Meaning what areas seem to be maybe hitting close to on all cylinders and are there areas or regions where you just feel like there could be quite a bit of upside just to even get back to some type of baseline activity level?

<A - R. Martin Chavez>: Well, the way I would look at first half of 2018 is it was great results and no question that we're pleased with them, and it was a good opportunity set. It wasn't a fantastic or great opportunity set, and so it really demonstrates the potential of our franchise, all of the businesses, all of the segments first half-on-first half growing double-digit percentages, with what's really a modest improvement in the backdrop.

Certainly in that macro backdrop we see all kinds of things which we've mentioned, GDP accelerating, CEO confidence, tax reform clarity, now that the reform act is behind us. All of those things suggest that that momentum is strong, and so there's a lot to play for in the back half of the year and going forward.

Operator

Your next question is from the line of Gerard Cassidy with RBC. Please go ahead.

<A - R. Martin Chavez>: Hello, Gerard?

<Q - Gerard Cassidy>: Good morning, Marty. Hi. Couple questions for you. You pointed out that you guys were the number one provider or underwriter of leveraged loans in the quarter. Can you give us some color on the underwriting trends you're seeing there since you're such a strong player in this market? For example, debt-to-EBITDA or other type of metrics that you guys look at. Are they becoming more aggressive, less aggressive? Can you share us some color there?

<A - R. Martin Chavez>: So, sure. I'll start by saying that we've been extremely successful in taking out bridges, syndicating risk. The vintages are profitable. Certainly in a small number of situations that have been a bit tougher, we've been well protected by the flex. And as we look at that business, we're seeing all kinds of evidence of the industry at large, our competitors repricing and changing the terms, and that's a dynamic that obviously is a good thing.

Terms, as you alluded to, had gotten higher but more recently, they have repriced. Our focus remains there always on the velocity of that book and as for the LBO book itself, I would say it's important to acknowledge the size of that book is small. It's order of $7.5 billion and there's a couple dozen transactions in the book and no one of those transactions is more than $1 billion. So all those parameters remain really well-controlled.

<Q - Gerard Cassidy>: Very good. And looking at your net interest income, you'd pointed out that it's at a run rate of about $2.5 billion, just under I think 7% or so of total revenues. Where do you see that over the next three to five years as Marcus grows and as you grow your corporate loan book, where do you think that can reach as a percentage of revenue?

<A - R. Martin Chavez>: Well, we've certainly highlighted for you that we are emphasizing in our strategy, not only expanding the client base and delivering more products and services to that expanded client base but also revenue growth, earnings growth, more recurring, stable fee-based revenues. And so I am not going to give a percentage overall firm target because we don't think about it in that way as a specific target, but it is something that we're working every day to grow over the long haul.

Operator

Your next question comes from the line of Al Alevizakos with HSBC.

<A - R. Martin Chavez>: Good morning, Al.

<Q - Alevizos Alevizakos>: Hi. Thank you. Hi, Marty, thank you for the color that you gave on the Equities business. I really appreciated the disclosure regarding the cash and the derivatives, however, I was mostly interested about Prime Brokerage. You basically suggested that the numbers were flat year-on-year despite the fact that it seems like all your peers said that year-on-year revenues were up. So I was trying to understand whether there was an issue primarily with the margins or something happened regarding your volumes and that you couldn't grow the business. And I've got a second question in Asset Management as well.

<A - R. Martin Chavez>: So let's start with that first question on Prime. Yes, the revenues in securities services year-on-year are essentially flat, but inside that, important to say that client balances grew year-on-year. Net spreads compressed and hence, flat revenue all-in.

<Q - Alevizos Alevizakos>: Okay. Thanks for that. And then from a modeling perspective, just trying to understand on the Asset Management. First of all, is there any kind of seasonality in incentive fees that we can use going forward? And then secondly, would you say -- I know that incentive fees are one off by nature but was there something particular one off this quarter?

<A - R. Martin Chavez>: Yes, so there is no particular seasonality that I can think of to share with you on the recognition of incentive fees. These incentive fees are difficult to predict and they did in part drive the revenue beat in that segment. In this case, they were triggered by harvesting and the variety of funds, but one of them that I'll mention is our Vintage V fund. So the harvesting of that triggered the recognition of the incentive fees in this quarter.

Operator

Your next question comes from the line of Brian Kleinhanzl with KBW. Please go ahead.

<A - R. Martin Chavez>: Hello, Brian?

<Q - Brian Kleinhanzl>: Hey, good morning. A quick question on the NII that's in the I&L. I know you gave the run rate of being $2.5 billion. Is there a way to give what's been the biggest contribution to that run rate right now? Is it the merchant bank? Is it the corporate lending initiatives? And then kind of what was the corporate lending growth quarter-on-quarter?

<A - R. Martin Chavez>: So it really is loan growth, very, very broad-based. And so if you look at our HFI loans receivable, they grew 3% on the quarter, so they now stand at $74 billion. And in dollar terms, they grew $2.4 billion. And there's a whole variety of components of that growth and essentially, all of them grew and contributed to those figures that I just gave you. And it's really across corporates, Private Wealth Management, our Institutional Lending and Financing, or SSG business, as well as Marcus.

<Q - Brian Kleinhanzl>: Great. And then just real quick on the stress test. Given your results and some of the specific loan categories tended to be much worse than what peers were, specifically kind of looking at how your results came out within residential mortgage. Does that affect how you manage that business going forward? Because that's hard to see how when the Fed's giving you almost 50% cumulative losses that you're going to get an appropriate risk-adjusted return on invested capital with those kind of loss rate assumptions being built in. Is that just a portfolio that you could walk away from at some point?

<A - R. Martin Chavez>: Well, we certainly look, as you know, at all of our businesses through a large number of metrics. And the way they're treated in CCAR is certainly one of the many metrics, and it's an important one overall at the firm level, it's a binding constraint for us. And certainly as we look at CCAR, and we've been very public in saying this, we saw differences, divergences in our calculations from the Fed's. We are always looking for more transparency. And I'm not going to comment on an individual asset class as it plays through CCAR, but certainly more transparency into the process and the modeling and the calculations would benefit everyone.

Operator

At this time, there are no further questions. Please continue with any closing remarks.

R. Martin Chavez

Since there are no more questions, I'd like to take a moment to thank everyone for joining the call. On behalf of our senior management team we hope to see many of you in the coming months. If any additional questions arise in the meantime, please don't hesitate to reach out to Heather. Otherwise, have a great summer and we look forward to speaking with you on our third quarter call in October.

Operator

Ladies and gentlemen, this does conclude the Goldman Sachs second quarter 2018 earnings conference call. Thank you for your participation. You may now disconnect.