Goldman Sachs Group Inc. (GS) Management on Q2 2018 Results - Earnings Call Transcript

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Q2: 07-17-18 Earnings Summary

SEC *10-Q*

EPS of $5.98 beats by $1.33 | Revenue of $9.4B (19.21% Y/Y) beats by $658.57M

Goldman Sachs Group Inc. (NYSE:GS) Q2 2018 Earnings Conference Call July 17, 2018 9:30 AM ET

Executives

Heather Kennedy Miner - Head, Investor Relations

Marty Chavez - Chief Financial Officer

Analysts

Glenn Schorr - Evercore ISI

Michael Carrier - Bank of America/Merrill Lynch

Christian Bolu - Bernstein

Mike Mayo - Wells Fargo Securities

Jeff Harte - Sandler O'Neill

Betsy Graseck - Morgan Stanley

Brennan Hawken - UBS

Guy Moszkowski - Autonomous Research

Jim Mitchell - Buckingham Research

Devin Ryan - JMP Securities

Gerard Cassidy - RBC

Al Alevizakos - HSBC

Brian Kleinhanzl - KBW

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 belief 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?

Marty Chavez

Thanks, Heather and thanks to everyone for joining us this morning. I will walk you through our second quarter and first half results and then cover each of our businesses and of course I am 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 9 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 firms 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 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 3 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 since 2014. Debt underwriting net revenues were robust $752 million, down 6% from last quarter. First half performance was a record reflecting our strong client engagement and multiyear 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 leveraged loans globally and top 3 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 reforms, 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, 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 your 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 is 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 the 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 the 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 3 years. Our derivatives business declined significantly in the second quarter driven by reduced volatility and the more limited opportunity set. Over the past 3 years, we have had a balanced franchise with derivatives and 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. Security 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 businesses 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 an investment discipline that emphasizes risk-adjusted returns. We achieved this by applying extensive operational expertise and working closely with portfolio companies to grow their businesses. The portfolio remains diversified across the industry, geography and balanced across investment vintage. By vintage, we made 42% of the investments in the equity portfolio in the last 3.5 years, only 7% 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 $2.5 billion annual pace. Our net interest income continues to grow as we increased more recurring revenue streams and lends 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. markets, 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 continued 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 markets 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 fee credit migration over the cycle. And 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-digit as a percent of the portfolio. This reflects migration and our deliberate testing in the 632 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 continued to evaluate new product opportunities including wealth management, credit cards and others with our criteria to 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 our asset classes, $10 billion of liquidity product net inflows, offset by $3 billion of market depreciation.

Now let me turn to expenses, we continued 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 includes 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 markets 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 in platform businesses, there is a natural migration from compensation to non-compensation expenses over time. To ensure a disciplined approach, we monitor our cost holistically through measures such as efficiency or overhead ratios and we are 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 3 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 points stress capital buffer we caution against reading too much into a single data point. Over the past 3 and 5 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 are pleased with our performance in the first half of 2018, including our execution on our $5 billion revenue growth initiatives. So, these initiatives are not the limit of our ambition. Across each of our 7 revenue initiatives, we are running ahead of plan and continue to make progress in each of our businesses. For example, in investment banking, we are 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 fixed 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 are enhancing our client service offering growing advisory mandates and driving inflows in long-term fee-based assets.

And finally, we are 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 to our institutional lending and financing business. Clients remain the center of everything we do. We are 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 earnings profile.

In conclusion, when we think about our ability to drive value, we are encouraged by roughly 15% returns year-to-date and to 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 will now open up the line for questions.

Question-and-Answer Session

Operator

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

Marty Chavez

Good morning, Glenn.

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 have been good enough to give us the 400, 450 like what is like setting 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 am getting that right?

Marty Chavez

Yes, Glenn, that's right. The $625 million of net NII in the quarter reflects $2.5 billion dollar run-rate and that is an outgrowth of growing the lending look.

Glenn Schorr

Okay, great. To add on to that question is just I think you have been there for a long time and you are increasing 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 old [indiscernible] but Volcker limits your participation like you just put on balance sheet is the same capital treatment, I am just curious if you could talk towards that?

Marty Chavez

So, Glenn, in our business, we have, well, a variety of ways of looking at it in our merchant bank, we raised 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 are seeing attractive risk returns and we are seeing the private credit is reemerging. We have 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 the core competency for the firms. We have been doing it for decades. And it's an important pillar of our growth.

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 to the 37%, is there anything to read into on if revenues continue at this pace we could actually see a lower comp ratio? Thanks.

Marty Chavez

So, Glenn there, it is just as you say it, it's a strong revenue growth year-on-year and our emphasis on profitability. The compensation philosophy remains the same as it always has been, we pay it for performance and we attract and retain talent.

Glenn Schorr

Alright, that's all I have. Thank you. I appreciate it.

Marty Chavez

You bet.

Operator

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

Michael Carrier

Thanks Marty. Maybe first question, just on the backdrop you mentioned pipeline at an all time high and you have got the tax reform, but then you get the trade stuff and so I just wanted to get some color on what you are seeing from clients both on the banking and the training front?

Marty Chavez

So, I will start with the banking front and you know as we mentioned the backlog is 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 is geopolitical and other discussions, but we are 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, PMT, natural resources and healthcare. And CEO confidence is strong, the firms have cash. It's driven by a lot of things, lower taxes and also the repatriations. So, the trade factor is there, but we have seen no impact on client's activity and it's clear to us and to our corporate clients that those strategic benefits outweigh the potential to receive challenges.

Michael Carrier

Okay, that's helpful. And then just as a follow-up, just want to get your perspective, like this is the second quarter where revenue growth has been strong, you guys produced operating leverage, ROE is year-to-date 14, TE is 15%, but valuation, it doesn't seem like you get much credit, is there – is it more just consistency over time, do you think they will follow through and the growth in book value will eventually deliver or 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 down or that you guys are looking into to maybe improve disclosure and transparency?

Marty Chavez

Well, certainly Michael, we are leading in running the business for the long-term and we know that that the importance obviously of delivering revenue and earnings growth, hence the growth strategy that we outlined for the market is driving more recurring fee based revenue banding 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 are 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 are open to any and all suggestions and recommendations from you, the analysts, from our investors and we are taking them on board and you can see some of that in my prepared remarks and as we go through the Q&A you will see more of it.

Michael Carrier

Okay. Thanks a lot Marty.

Marty Chavez

You bet.

Operator

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

Marty Chavez

Hello Christian.

Christian Bolu

Hello, good morning Marty. So just to have follow-up on operating leverage, it was pretty impressive in the first half as you said revenue growth of 22% in pre-tax even high 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 in efficiency ratio, just we would like to get more color from you?

Marty Chavez

The comp to net revenue ratio, and as you know, Christian, is 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 it's important to our stakeholders, it's important to us and as we make our investments, we keep those, we keep that in mind. And when we set the compensation ratio, we are looking at a variety of scenarios, but we are especially looking at our 3-year growth plan and those are all the factors that go into it. If you are going to see from us, we will remain focused on operating leverage in the back half of the year, the revenue environment is certainly a factor, but it also just like to emphasize that the comps in that 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.

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, it sounds like other folks are thinking the same thing, JPMorgan launched its FIN digital initiative, Citi is talking about expanding and enhancing its footprint, even PNC is talking about its international bank. So, in light of that sort of that evolving competitive landscape kind of what's Goldman's edge in building out Marcus here?

Marty 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 that offers the deposit offering, we are 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 have been doing for decades that the firm is prudently managing risk in 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 other attractive risk returns for our shareholders? So as we developed this vision, you are 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 scale mainframe systems and we don't have the bricks and mortars. And so as we are doing this and this was of course one of the things that attracted us to Clarity Money, it's the AB 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 are doing.

Christian Bolu

Awesome. Thank you very much, Marty.

Marty Chavez

You bet.

Operator

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

Marty Chavez

Good morning, Mike.

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 helmet, Lloyd or David saw in this call if they could answer that would be great?

Marty Chavez

Well, Mike, you just got me for the call this morning and but I am happy to answer it, because this one is 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 have seen various moments in the succession plans and today is one of those moments. The board has made its choice and its selection fair and that's been developing over the last – 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 is something like 20 some years. And so this is all part of the plan is for strategy, David and Lloyd and I and many of us have been working on our strategy and you have seen that develop over time you have seen it in conferences, there is going to be more discussions at upcoming conferences. You will hear the emphasis on more recurring fee-based revenue and you have 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.

Mike Mayo

Alright. Well, if I can follow-up, just in terms of the backlog being up, what's the percentage change, because you are saying it's a record backlog first quarter to second quarter, how much is that up?

Marty Chavez

So, I am not going to breakout the percentage change other than to say that it was strong growth on the quarter with significance on the quarter and not only as I mentioned was it a record for the overall banking segment in 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.

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 are 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?

Marty Chavez

Well, we are certainly seeing all kinds of trends at play and you mentioned some of them, we have seen resilient growth across many economies, rising U.S. rates, do the unwinds, tax reform behind us and therefore a lot more clarity on its 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.

Mike Mayo

Alright, thank you.

Operator

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

Marty Chavez

Good morning, Jeff.

Jeff Harte

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

Marty Chavez

So, Jeff, we talked about this a fair bit. We like to say we are in the moving rather than the storage business and that's really something that you are seeing in the quarter. So balance sheet, as you noted 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 are dedicating financial resources and resources of various kinds to our clients that it's really a velocity story.

Jeff Harte

Okay. You mentioned the tax rate, I believe you said 20% for 2018, which you had expected, hadn't you been before been talking about 23% or 24% kind of longer term is, is that a 2018 specific decline or should we be thinking about the longer term tax rate being lower as well?

Marty Chavez

Yes, it is a 2018 story and that's our estimate for the full year. As you know when they are discrete items, equity-based compensation, for instance, we recognized 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 guilty and the beat taxes. As for 2019, the 24% rate that I highlighted before that's our best – that's what I would suggest you as the sensible model and assumption.

Operator

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

Marty Chavez

Hello Betsy.

Betsy Graseck

Hi, good morning, how are you doing?

Marty Chavez

Great. Thank you.

Betsy Graseck

Good. I have one follow-up question and then one other question, on the follow-up I know we talked already about the comp ratio and I know in your commentary you indicated, 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 12% ROE, because we kept the 41, it would have been below that?

Marty Chavez

We were not setting the comp ratio in that way at all Betsy, I mean of course we are looking at all kinds of things. As I mentioned, the philosophy of comps hasn't changed at all, but the framework hasn't changed either. The – I am well aware that we don't typically reduce the comp rates in the second quarter and though it has happened in the past really the framework is the same we are 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, pretax margin does it too and that is increasingly an emphasis for us on driving the efficiency ratio lower. And that's how we got that.

Betsy Graseck

Okay. So you have mentioned the profitability as one of the factors for assessing that, are we thinking about ROE or is there a different profitability measure you are thinking about?

Marty Chavez

One of the fascinating things about our businesses where we are 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 pretax as well as our pretax margin.

Operator

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

Brennan Hawken

Hey good morning, Marty. So I was just Googling combinatoric to try to figure out. Quick one on Marcus, thanks for the increased disclosure especially on the refreshed FICO, that's helpful, 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 the through the cycle view or – number one and then are you provisioned at a level that's greater than that currently given that we are in the later innings of the cycle and can you can you give us some perspectives on that?

Marty Chavez

Well, yes Brennan as I am happy to note that you saw the increased disclosure, I am working on it. The 4% to 5% is our best estimate and we are absolutely provisioned higher than that.

Brennan Hawken

Cool. Thank you. And then another one is the narratives and chatter we are 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, could you – how should we think about how you are considering positioning yourselves in the marketplace there, what do you think would differentiate Goldman's offering versus competitors, why do you – what do you think the value proposition of Goldman is in blues in that business, because it's rather different than what we are used to thinking of as far as Goldman and the position in the marketplace?

Marty Chavez

Sure. So as you know and as we have discussed and you have seen this we have 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 are approaching it. One of the interesting things about technology and software generally is that there is paradigm shifts that happens 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, they are not too different than they were in the '70s 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 have been working to broaden those corporate relationships through the companies who are our clients, well beyond the CEO and CFO to treasurers, assistant treasurers, procurement and so we have been building that connectivity and then also the adjacency to our foreign exchange business is obvious. And so there is some analogies to the Marcus. The same evaluation criteria we laid out that led us to Marcus are leading us to this business exactly. There is 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 are seeing it as a 2 to 3-year build.

Operator

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

Marty Chavez

Good morning, Guy.

Guy Moszkowski

Thanks. Good morning. Before I ask a question, I just – I know he is 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 want 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 1 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?

Marty Chavez

Well, sure. 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 will be sure to pass it on to Lloyd, who has been an amazing leader and he has made all of us better. So on to your next question on the growth initiatives, yes, I will step back for a minute. So the way we are looking at the growth initiatives is there are 7 revenue lines in the growth initiatives and we are making solid progress on all of them at or ahead in some cases, well ahead of our targets. And beneath that there is 40 plus key performance indicators and 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 us highly automated basis. I, we, many of us, David, all of us look at it weekly to see how we are going. I laid out some of them for you. So, for instance, on the expanding client coverage in both FICC and equities, you will remember that that's a $600 plus million annual revenue target in 3 years' time, for FICC, expanding across clients, especially the asset managers. And we are definitively seeing in broker votes and third-party surveys and all kinds of measures of wallet share that we are making solid progress there. Equities, similarly I mentioned 100 basis point expansion in wallet share since 2016, up 140, to be a little bit more precise and that's with those systematic in quant clients and half of that progress has happened this year to give you a flavor of some of the KPIs, but we know that the market is looking for the mark-to-market. We have mentioned $5 billion annual revenue in 3 years time without the market opportunity set expanding that's just work that we are doing. And we are going to give you that detail and you are going to hear it from us in the back half of this year.

Guy Moszkowski

Okay. I think that, that will 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 am 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 is 10 point sensitivity to these types of analyses, but I am 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?

Marty Chavez

I will start by saying our equities franchise, which I had the opportunity to co-head some number of years ago, it's one that I wouldn't trade for anyone else's equity franchise, it's global, it's balanced across cash and derivatives, we are 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 strong performance, solid performance and so the comp was tough. We breakout that segment as you know in three ways. So, it's more granular than the peer group. I mentioned one of those in specific, but I am happy to go into any of them if you would like, but let's say starting with commissions and fees, I will 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 the 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, do scale players with leading research content and we are one of them and we are seeing abundant signs of that, picking up share from the lower tiers, 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 derivative transactions can be lumpy and we certainly have them in the second quarter and less of it – second quarter last year, less of it in the second quarter of this year.

Operator

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

Jim Mitchell

Hey, good morning.

Marty Chavez

Good morning, Jim.

Jim Mitchell

Good morning. First, maybe just on follow-up on Marcus, I thought it was interesting that you are 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?

Marty 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 have seen from us in our digital consumer finance offering so far and you will see more of them as we evolve the strategy. We are always considering new products. There are many new products that were determined to build in the U.S. and we are always considering them, expanding them geographically. And I have nothing beyond that to announce right now.

Jim Mitchell

Fine, I mean you are not limiting markets to the domestic, I think is obviously the takeaway here.

Marty Chavez

Absolutely not.

Jim Mitchell

Okay. And maybe just a question on the SCB impact, obviously it's as you pointed out year-to-year it's going to be very different, is there other way 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, so that is still a pretty big step up to the SCB from the prior buffer, I am just trying to think through that your model and some of the pure play investment banks tend to get – seem to get harder, let's say 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 got up that year-to-year?

Marty Chavez

Well, let's start off by saying that the CCAR stress was hugely important for the safety and soundness of the financial system and it's an important part of our process and we are supporters of it. 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 are at 12.6%. Our benchmark for capital on standardized CET1 basis was 12.5% and we designed that policy and so that it is as I said want to give this ample capital. To step back and to look at the CCAR process, it was more severe. If you look across the industry, you will see that that the best SCB estimate using DFAST 2018 is in several cases higher than the current capital level. And the math is pretty straightforward, so for us it's 6% the peak to trough, add to that the 4.5% minimum and the 2.5% GSIB buffer, you get 13% 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 3 year to 5 year period as I mentioned for us the peak to trough has been 5, not 6. And there is 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 are open to comments. You can see our bilateral comments to the Fed and you can see the industry rather, so we have certainly shared our views with the Fed. And we will wait and see how they will adapt, I can think of many ways averaging and so on and you said recalibration is one. There is many ways to comport these statements that 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 mentioned 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 them and it will be fine.

Operator

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

Marty Chavez

Hello Devin.

Devin Ryan

Great. Thanks. Good morning Marty, I guess question here 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 wealth management growth especially as you had more products of the offering?

Marty Chavez

Well, certainly – actually, I was just talking to Adam Dell this morning and if you walk into our building, you can see Clarity Money on the pillar and I have absolutely sometime ago downloaded it myself and used it. Generally, as you know, historically over time, our approach at the firm has been we build all our own software. And as we have discussed in the past, we have 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 are developing in a consistent way, consistent brand and look and feel.

Devin Ryan

Okay, great. Thanks for the color. And then maybe a follow-up here just on kind of the investment bank commentary, I mean, it seems that anytime we are talking about record backlogs, we get questions around whether we are close to a cyclical peak. 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?

Marty Chavez

Well, the way I would look at the first half of 2018 is it was great results and no question that we are 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 really a modest improvement in the backdrop. Certainly in that macro backdrop, we see all kinds of things, which we have mentioned, GDP accelerating, CEO confidence, tax reform clarity, now that the reform act is behind us. All of those things suggest that momentum is strong and so there is 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.

Marty Chavez

Hello, Gerard.

Gerard Cassidy

Good morning, Marty. Hi. Couple of questions for you. You pointed out that you guys were the number one provider or underwriter of leverage loans in the quarter. Can you give us some color on the underwriting trends you are seeing there since you are 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?

Marty Chavez

So, sure. I will start by saying that we have been extremely successful in taking out bridges indicating risk. The vintages are profitable certainly in a small number of situations that have been a bit tougher. We have been well protected by the flex. And as we look at that business, we are seeing all kinds of evidence of the industry at large, our competitors re-pricing and changing the terms. And that's a dynamic that obviously is a good thing. Terms, as you have alluded to, had gotten tighter, but more recently they have re-priced. 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 is a couple of dozen transactions in the book and no one of those transactions is more than $1 billion. So, all of those parameters remain really well-controlled.

Gerard Cassidy

Very good. And in looking at your net interest income, you pointed out that it's at a run-rate of about $2.5 billion. Just under, I think 7% or so of total revenues. What do you see that, over the next 3 to 5 years, as Marcus grows and as you grow your corporate loan book, what do you think that can reach as a percentage of revenue?

Marty Chavez

Well, we have 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 are working everyday to grow over the long-haul.

Operator

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

Marty Chavez

Good morning, Al.

Al 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 if it was an issue primarily with the margins or something happened regarding your volumes and you couldn't grow the business. And I have got a second question on asset management as well.

Marty Chavez

So, let's start with that first question on prime. Yes, the revenues and securities services year-on-year are essentially flat, but inside that, it's important to say that client balances grew year-on-year, net spreads compressed and hence flat revenue all-in.

Al Alevizakos

Okay, thanks for that. And then from a modeling perspective, I am 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 particularly one-off this quarter?

Marty 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 will mention is our Vintage 5 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.

Marty Chavez

Hello, Brian.

Brian Kleinhanzl

Hey, good afternoon or good morning still. 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 kind of give what's been the biggest driver or what's 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?

Marty Chavez

So it really is loan growth, very, very broad-based. And so if you look at our HFI loans receivable, they grew $3 billion on the quarter. So, they now stand at – I am sorry, 3%. They now stand at $74 billion and in dollar terms, they grew $2.4 billion. And there is 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 corporate, private wealth management, our institutional lending and financing or SSG business as well as Marcus.

Brian Kleinhanzl

Great. And then just real quick of stress test that given your results in some of these specific loan categories tended to be much worse from what peers were specifically kind of looking at how your results came out within residential mortgage. So did that affect how you manage that business going forward, because it's hard to see how when the Fed has given you almost 50% cumulative losses that you have got to get an appropriate risk-adjusted return or risk adjusted return on invested capital with those kind of loss rate assumptions being built in? I mean is that just a portfolio that you can walk away from at some point?

Marty Chavez

Well, we certainly look as you know at all of our businesses through a large number of metrics and the way they are 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 have been very public in saying this, we saw differences, divergences in our calculations from the Fed. We are always looking for more transparency and I am going to comment on an individual asset class as it plays through CCAR, but certainly more transparency into the process, in the modeling, in the calculations would benefit everyone.

Operator

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

Marty 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. 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 the third quarter call in October.

Operator

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

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