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 2016 Earnings conference call. This call is being recorded today, July 19, 2016. Thank you.

Mr. Holmes, you may begin your conference.

Dane Holmes

Good morning. This is Dane Holmes, 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 2015.

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

Our Chief Financial Officer, Harvey Schwartz, will now review the firm's results. Harvey?

Harvey Schwartz

Thanks Dane, and thanks to everyone for dialing in. I'll walk you through the second quarter results, then I'm happy to answer any questions. Net revenues $7.9 billion, net earnings $1.8 billion, earnings per diluted share $3.72, and our annualized return on common equity was 8.7%.

As you all remember, the first quarter of 2016 was dominated by renewed uncertainty regarding the global economic outlook. This impacted prices across various asset classes and drove macro headwinds in each of our businesses. Many of the concerns that existed in the first quarter moderated as we started the second quarter. This was a better environment for our clients and our performance.

This was also reflected in equity markets; for example, the S&P 500 was relatively unchanged for most of April and May. In addition, we saw sequential improvements in global investment banking volumes. Activity for the first two months of the quarter was on pace to be up over 20% for equity offerings and nearly 15% for announced M&A; however, as we approached June, the market became increasingly focused on Brexit. The focus was on both the economic uncertainty surrounding the potential outcome and the potential economic implications of leaving the EU. These concerns negatively impacted client sentiment, risk appetite and activity levels heading into the vote.

In response to the Leave vote on June 23, market volatility spiked and global equity markets declined significantly, with the MSCI World down roughly 7% in two days. While equity markets largely reversed those losses in the last three days of the quarter, clients and the border marketplace continue to wrestle with the Brexit vote and related uncertainty.

With that as a backdrop, let's now discuss individual business performance in greater detail. Investment banking produced second quarter net revenues of $1.8 billion, 22% higher than the first quarter as we saw increased client activity across equity and debt underwriting. Our investment banking backlog decreased relative to the end of the first quarter and the year ago.

Breaking down the components of investment banking in the second quarter, advisory revenues were $794 million, up 3% from the first quarter. Year-to-date, Goldman Sachs ranked first in worldwide announced and completed M&A. We advised a number of important transactions that were announced during the second quarter, including NorthStar Asset Management's $16.9 billion tri-party merger with Colony Capital and NorthStar Realty Finance; Great Plains Energy's $12.2 billion acquisition of Westar Energy, and Hewlett Packard Enterprises' $8.5 billion spinoff and merger of its enterprise services business with Computer Sciences Corporation.

We also advised on a number of significant transactions that closed during the second quarter, including Charter Communications' $78.7 billion acquisition of Time Warner Cable and $10.4 billion acquisition of Bright House Networks; Visa Inc.'s €18.7 billion of Visa Europe, and Airgas Inc.'s $13.4 billion sale to Air Liquide.

Moving to underwriting, net revenues were $993 million in the second quarter, up 43% sequentially as capital markets activity picked up from the first quarter. Equity underwriting revenues were $269 million. This was up significantly compared to weak activity in the first quarter due to an increase in IPOs. Debt underwriting revenues were up 42% to $724 million and benefited from asset-backed issuance and strong leveraged finance activity.

During the second quarter, we actively supported our clients' financing needs, participating in Mylan's $6.5 billion investment-grade offering to support its acquisition of Meda AB; U.S. Foods' $1.2 billion IPO; and the approximately €850 million IPO of Philips Lighting.

Turning to institutional client services, which comprises both our FICC and equities businesses, net revenues were $3.7 billion in the second quarter, up 7% compared to the first quarter. FICC client execution net revenues were $1.9 billion in the second quarter, up 16% sequentially as market making conditions improved in many businesses from the first quarter. Credit and mortgages increased as the backdrop for providing liquidity was more normalized compared to the first quarter. Rates was also higher sequentially given better market making conditions. Currencies declined relative to solid client activity levels in the first quarter, and commodities declined slightly during the quarter.

In equities, which includes equities client execution, commissions and fees, and securities services, net revenues for the second quarter were $1.8 billion, down slightly quarter over quarter. Equities client execution net revenues of $587 million were up 25% sequentially. Better market making conditions for most of the quarter and select corporate activity drove improved performance. Commissions and fees were $745 million, down 15% quarter over quarter as client activity decreased following heightened volumes in the first quarter. Securities services generated net revenues of $422 million, down 2% relative to the first quarter as seasonally stronger client activity was offset by slightly lower customer balances and spreads.

Turning to risk, average daily borrowing in the second quarter was $62 million, down from $72 million in the first quarter.

Moving on to our investing and lending activities, collectively these businesses produced net revenues of $1.1 billion in the second quarter. Equities securities generated net revenues of $626 million primarily reflecting company-specific events, sales, and gains in public equity investments. Net revenues from debt securities and loans were $485 million and included more than $250 million of net interest income. In investment management, we reported second quarter net revenues of $1.4 billion, consistent with the first quarter. During the quarter, management and other fees were roughly flat sequentially at $1.2 billion.

Assets under supervision increased $23 billion sequentially to a record $1.31 trillion. The $23 billion increase was substantially driven by $19 billion of net market appreciation. We also had $4 billion of net inflows with $3 billion from liquidity products, and the remainder from long-term fee-based products.

Now let me turn to expenses. Compensation and benefits expense for the year to date, which includes salaries, bonuses, amortization of prior year equity work and other items such as benefits, was accrued at a compensation to net revenues ratio of 42%, consistent with the first half of last year. To respond to the more challenging backdrop, we completed an expense initiative during the first and second quarter. The run rate expense savings will be roughly $700 million. In 2016, these expected savings will be partially offset by severance and other related costs. Second quarter non-compensation expenses were $2.1 billion, up slightly compared to the first quarter.

Now I'd like to take you through a few key statistics. Total staff was approximately 34,800, down 5% from the first quarter. Our effective tax rate for the year to date was 26.8%. Our global core of liquid assets ended the second quarter at $211 billion and our balance sheet was $897 billion. Our common equity Tier 1 ratio was 12.2% under the Basel III advanced approach. It was 13.7% using the standardized approach. Our supplementary leverage ratio finished at 6.1%. All of our capital ratios are well in excess of regulatory requirements. This reflects our multi-year effort to de-risk the firm and strengthen our financial profile. Given robust capital ratios, the firm is well positioned to return excess capital to shareholders.

In the quarter, we repurchased 11.1 million common shares of common stock for $1.7 billion. For the five quarter CCAR cycle for 2015, we provided shareholders with $6.2 billion in share buybacks and $1.5 billion in common stock dividends. In terms of this year's CCAR test, we announced that the Federal Reserve Board did not object to our plan.

In conclusion, the first half of 2016 has certainly presented its fair share of challenges and concerns. At the core of these concerns is the outlook for the global economy. As you have heard us state many times before, confidence in economic growth is the most important long-term driver of our business. Confidence incentivizes client activity, which increases demand for our advice, our content and our execution capabilities. While like the rest of the world we would welcome more robust economic growth, ultimately we have to manage the firm for both the current environment and potential future opportunities.

How we’ve navigated the difficult environment in the first half of 2016 demonstrates both the strength and resilience of our culture. We remain vigilant regarding our cost structure, our capital usage and our risk profile, and at the same time we have maintained the necessary commitment to ensure that we can meet our clients’ needs as they grow.

Being in a position to deliver for our clients and our shareholders requires ongoing investment and a long-term perspective. While we continue to invest in our existing set of businesses, we are also looking for new opportunities. One example is our digital consumer lending platform. While still in its early stages, we expect to begin the initial phase of engaging consumers this fall. As we have discussed with you in the past, we are taking a very deliberate and methodical approach to this effort. We are looking to build a durable business, so it will take time. Similar to our other businesses, creating a valuable and differentiated service for our clients is core to our strategy.

In summary, our ability to both react to the current world and simultaneously invest in the future will position the firm to deliver superior value to our clients and our shareholders in the years ahead.

Thanks again for dialing in, and I’m happy to answer your questions.

Question-and-Answer Session

Operator

[Operator instructions]

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

Glenn Schorr

Hi, thanks a lot.

Harvey Schwartz

Hey, good morning Glenn.

Glenn Schorr

Good morning. A question on comps. It’s always a little touchy, but if you look at it on a year-to-date basis, the ratio is flat with last year but the dollars are down 28% six months year-on-year. So I’m just curious, I know you’ve been remixing a little bit in the employee base. How much of that can help that ratio when you look at it on a full year, and then just how do you balance between a higher ratio versus the 37% you had the last couple of years, three years, and then just having it be a little bit more belt tightening?

Harvey Schwartz

So obviously 42 at this stage is our best estimate, but incorporated in that is all the steps that we're taking. So as I communicated, year-to-date the cost efforts themselves on a run rate basis translate into $700 million of run rate savings. Now, after severance that number is going to be more like 350 this year, but obviously we're staying very focused on this and I think you see that performance has been down, and with that compensation and benefits expenses down 28% year-to-date.

Glenn Schorr

Just so I understand, the—your run rate savings comments - 700, 350 ex-severance, is that in this quarter's number and therefore just sets a lower bar as we roll through the rest of the year? I just want to make sure what we're looking at versus what's on the [indiscernible].

Harvey Schwartz

The way I would think about it is it's in 2016, and it gives us operating flexibility. But that's executed - the $700 million is done. Again, that's run rate, severance costs and other things.

Glenn Schorr

Okay. Then your comment on the investment banking pipeline's down, I'm just curious, how much of that is just off of great numbers and as you execute, including the debt underwriting that you talked about, and then versus how much does Brexit play a role in just kind of slowing things down on deals that might have been happening across Europe?

Harvey Schwartz

So when you look at the backlog, I think one way to look at it is the year-over-year, so if you're actually standing here at the end of June last year, obviously the second quarter and first half of last year were very dynamic. If you look at the backlog in aggregate, it's sort of down mid-single digits, and so that's the trajectory of the backlog. I don't think it's surprising coming off of high levels - it is where it is. Obviously our market shares have been very significant.

In terms of Brexit, where we sit today, given I think that the base case expectation is that the dynamic is going to play out over a long period of time, and in some respects it may contribute to some of the same factors that contributed to a very active M&A environment, other than maybe very specific transactions that are geographic in nature, that are really driven by geography, which is generally few, when we talk to our bankers, if we continue in this low growth environment, they don't feel sitting here today that Brexit is going to be a headwind but obviously it's going to be a dynamic situation.

Glenn Schorr

Okay, I appreciate it. Thanks Harvey.

Harvey Schwartz

Thank you.

Operator

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

Christian Bolu

Good morning, Harvey.

Harvey Schwartz

Hey, good morning Christian. How are you?

Christian Bolu

Good, good. Thanks for the update on expenses. I might just ask a question, just to try and understand the knock-on impact of Brexit on your cost base. So do you have a sense, a rough sense of what percentage of your revenues and expenses are denominated in pound sterling? I presume you have significant more cost in sterling than revenues, so curious if the decline in the pound could be a further tailwind to expenses in 2H16.

Harvey Schwartz

No, it's not the case necessarily that we have significantly more expenses denominated in sterling. There's a whole host of processes through which we go through in terms of how employees elect to get compensated, et cetera, so that's an issue obviously we monitor very closely in terms of our foreign currency risk broadly across the globe, managing a global business, but I wouldn't point to that as a significant consideration, although it's a consideration of the many things we look at.

In terms of Brexit, the way I would frame it for you is I'd say there's sort of the near-term observations I can give you and then sort of a longer term perspective. The near-term ones would be just sort of going through the process. Now, obviously we were preparing for Brexit well in advance, even though we all expected it to be a very, very unlikely outcome, but we were significantly prepared for that and that really left us in a position, we feel, to be very front footed with clients. Going into Brexit, client activity tapered off, but at the point of Brexit and potentially thereafter in a number of our businesses, we either near-peak volumes or peak volumes, or new peaks, so that was quite good to see.

In terms of the longer term perspective on Brexit, as I said before, this looks like this process is going to take a while, and we're hopeful, along with everyone else, that the parties that are engaged in these negotiations will be prudent and thoughtful because obviously it's good for all of us, a thoughtful negotiation and outcome will just be good for economic growth. As it relates to our business, we've been in Europe and the U.K. for a very long period of time, and we're completed committed to our clients in the region, and regardless of how these negotiations go, we're going to make sure that we're there for them. That would be my broad comment on Brexit.

Christian Bolu

Great. Thanks for the detailed response. On debt underwriting, very, very strong numbers and well in excess of what we can see in the kind of public lead tables. So just curious maybe if you can detail some of the growth initiatives around the debt underwriting business and particularly any color on businesses that we would not typically be able to see in the public lead tables.

Harvey Schwartz

So one of the drivers in this quarter, as I referenced, was an asset-backed related activity, and there was one significant transaction where earlier on, we had committed capital to purchase a portfolio, which ultimately translated through in the debt underwriting line that would not be included in a lead table, so it'd be difficult for you to see.

Christian Bolu

Okay, thank you very much.

Harvey Schwartz

Thanks Christian.

Operator

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

Michael Carrier

Thanks Harvey.

Harvey Schwartz

Hey, how are you?

Michael Carrier

Good. First, just on the G-SIB surcharge, just wanted to get an update where you stand, and then probably more importantly when you think of wanting to reduce that versus taking advantage of opportunities to take market share, just given some of the exits that we've seen throughout the industry, just want to get a sense on where you're at and kind of the pullback versus the growth, just given some of the dislocations out there with some of the competitors.

Harvey Schwartz

Yes, so you're right - I would summarize it because I think you framed it well. It's a bit of a balance, and so at this stage we're at 2.5 on the surcharge. Obviously we're very focused on reducing our systemic footprint. We believe that and all firms obviously should make that a priority; but you're right to say that as the competitive environment is shifting and a number of our competitors have stated restructuring plans, we want to make sure that in all of our efforts, whether it's managing our capital, that we're focused on costs, that we remain full service across all of our businesses and we're there for our clients. We believe at this stage we've found that balance, and for shareholders it gives them a lot of operating leverage.

Michael Carrier

Okay, got it. Just as a follow-up, I guess just two things on the regulatory side. So with CCAR, I know you guys don't disclose what you're going to do, but just from a quarter as we kind of go through the third quarter through 2017, should we expect the same type of ramp that we saw last year just in terms of the lighter up front and then the heavier buybacks as that plays out? And then just any update on the—you know, you guys' capital and funds that would have to be liquidated in 2017? I guess just when you think about those investments, any way for us to gauge where those are marked or where the potential gains could be as those are exited over time?

Harvey Schwartz

So what's expected of CCAR and the CCAR process, obviously you say the 11.1 million shares this quarter and the 1.7 billion-plus in dollar buybacks, so last year's test had some idiosyncrasies in it which led to this profile where, to the extent of which and we ended up using capacity that we're repurchasing, that we were more constrained in the early quarters versus the later quarters. And even though we don't disclose the buyback capacity, and you know we don't want shareholders to conflate that with dividends, and that's why we don't, the profile that you would expect this year doesn't have those idiosyncratic elements to it, so the extent to which we repurchase, it won't necessarily follow that profile.

In terms of the—I think what you're asking, the question really relates to the harvesting in the funds. Is that what you're asking?

Michael Carrier

Yes, that's it.

Harvey Schwartz

Okay. So I've walked you through that, for lack of better language, that waterfall, so why don't I just do that. So right now, dollars that are invested predominantly alongside our clients, where we act as a fiduciary, is $7.3 billion. There is $900 million that you would characterize as permitted under the Vogel rule. That leaves us with $6.4 billion. Of the $6.4 billion, $2.1 billion is public; that leaves us with $4.3 billion that is still private sitting alongside those funds.

Michael Carrier

Okay.

Harvey Schwartz

Actually, I think you asked a question—did you ask a question about - I tried to write them all down. Did you ask a question about how we mark them?

Q - Michael Carrier

Well you know, because these would be relatively seasoned. I was just trying to get a sense on based on the investment versus where it is today, is it running at 1.5 times the cost when you invested? Just trying to get a sense of where things are marked in terms of what the potential gain could be.

Harvey Schwartz

I understand. Yes, so we mark everything to fair value, so we're marking it quarter to quarter. So whatever gains or losses that are occurring in those investments, you're seeing those translate through every quarter.

Michael Carrier

Got it, okay, but we don't have a cost base versus a fair value, meaning to—

Harvey Schwartz

It's across multiple funds, and so I don't have an aggregate number for you on that.

Michael Carrier

Okay, all right. Thanks a lot.

Harvey Schwartz

The funds have obviously performed well - you've seen that translate through the performance over the last couple years.

Michael Carrier

Yes.

Operator

Your next question is from the line of Matt O'Connor with Deutsche Bank. Please go ahead.

Matt O'Connor

Good morning.

Harvey Schwartz

Hey Matt, how are you?

Matt O'Connor

Good, thank you. Could you talk a little bit more about investment management in terms of why the fees were so weak there, say, versus a year ago? I realize a lot of it is the incentive fees, which tend to be lumpy, but even the other, call it more [indiscernible] like fees were sluggish. Is there something on the timing of when you collect, say, versus equity prices and the volatility there, or is there something else going on?

Harvey Schwartz

So the biggest driver in the quarter when you look year-over-year is obviously the incentive fees, and that's reflective of the environment and incentive fees from time to time are going to be lumpy. With respect to the management and other fees, it really is just about mix and the average fee coming down, although offset in part by the fact that obviously [indiscernible] has grown pretty significantly year over year.

Matt O'Connor

Okay, and I guess what exactly is the negative mix shift? I mean, obviously liquidity under supervision has increased, but it seems like the overall balances for equity and fixed income really across the board, it seems like the balances have increased. When you talk about the mix shift, what exactly is that?

Harvey Schwartz

So as you know, in the business obviously we have a number of different client segments so it's full service across a number of different lines. One of those lines is large advisory institutional mandates. Those mandates, given their size, tend to come at a lower fee base, and so that's really the mix shift. So it's basically away from classic mutual funds and into those types of mandates. You can see—I think we break it out for you in the 10-Q, you can see all that.

Matt O'Connor

Okay. Then just separately on the bank initiative, you did mention about rolling out the digital consumer lending platform in the fall. But just more broadly speaking, maybe give us an update on where you are on the lending thought process overall, and then on the deposit side as well, I think you did the brand conversion of the deposit acquisition this past quarter.

Harvey Schwartz

Yes, so by view of the separate banks, this one's really about liability management. Are you talking about the GE deposit acquisition? Is that what you're asking about in terms of the brand acquisition? Is that what you're talking about?

Matt O'Connor

Correct.

Harvey Schwartz

Yes, okay, so why don't I just start there and I'll take your question in reverse. So we view those—obviously that's separate in terms of—obviously we view asset liability management as an integrated exercise, but those two efforts are separate. But having said that, the acquisition went quite well, added in excess of $15 billion of deposits to the firm. It's great for us because it diversifies our sources of funding, which as you know we're always looking to do. Since the acquisition date, it's been well received by consumers - we've had in excess of 20,000 consumers open up new accounts for us, so it's had very significant growth in a short period of time. So it really speaks to the brand strength, which has been very nice to see.

Now in terms of the longer term objectives, maybe I'll just take an opportunity to level set you on where we are in the online lending. So as we talked about, we hired Harit over a year ago and he's been a fantastic addition to the team, and he's built a very capable team over that period of time. So I think it's probably important just to level set you on how we approach this process.

So we've obviously keenly aware of the fact that this is a new business opportunity for us and, importantly, a new client base, so one of the things we did is we reached out to thousands of consumers to really understand what they want and their borrowing priorities. Through that, we learned some things that probably aren't so surprising - they want a product that's simple, it's straightforward, it provides a lot of value, and they also want what they refer to as really a high quality user experience. So what we have attempted to do is take all this feedback, we developed one product. I've emphasized—you know, we've emphasized a number of times that we're going to be very deliberate and slow with this, so we've developed one product which we plan to launch later this fall, so that's where we stand [indiscernible] over the next several months.

Matt O'Connor

Okay, and sorry - what is that one product? Is it an unsecured loan, or what's the—

Harvey Schwartz

Yes, it's an unsecured consumer loan product.

Matt O'Connor

Okay. Would they ask—I mean, target a customer of kind of short duration, small loan size, bigger loan size? What's kind of the—

Harvey Schwartz

We'll come back with all those details in the fall.

Matt O'Connor

Okay, fair enough. Okay, thanks for all the answers.

Harvey Schwartz

Thank you.

Operator

Your next question is from the line of Mike Mayo with CLSA. Please go ahead.

Harvey Schwartz

Morning, Mike.

Mike Mayo

Hi. So headcount was down a lot just over three months, I guess down 5%. Is that right?

Harvey Schwartz

That's correct.

Mike Mayo

So where were those—where did those headcount reductions occur?

Harvey Schwartz

So in terms of the headcount process, the process itself really started back in February in terms of our analytics. Now as you know, Mike, we go through—what gets a lot of attention is that we referred to it as a review of the 5%. In years, it varies. Sometimes those reviews yield small reductions, sometimes we actually add people. It varied by business. Obviously for businesses that have hit heavier headwinds, like fixed income, they elected to go beyond the 5% in terms of their exercise, and then there are supporting businesses that are adjacent there, so things like ops and tech. This is a broad exercise across the firm.

Now, I would point out again that this is netted against hiring, so we're still hiring, and so—but the 5%, as I pointed out, on a run rate basis it's $700 million.

Mike Mayo

I'm sorry - what's $700 million?

Harvey Schwartz

$700 million is the cost savings on a run rate basis associated with that exercise.

Mike Mayo

And that's not reflected in the second quarter?

Harvey Schwartz

It is reflected in the quarter to the extent to which it's reflected in our compensation accrual, which is our best estimate for the year.

Mike Mayo

Okay, so what was the gross headcount reduction? Net is 5%, before the hiring, was it 6 or 7%?

Harvey Schwartz

The biggest addition offsetting that would have been, for example, roughly 600 new analysts that joined the firm in June.

Mike Mayo

That's a really big headcount reduction in just three months. How do you know that you did it correctly? I mean, did you cut into muscle, did you cut fat?

Harvey Schwartz

You know, it's interesting. We, as you know, like sometimes—sometimes I think that because we don't announce targets in advance, that people misunderstand a bit about the way we run the business. So we view this as a very thoughtful exercise. We don't feel like we've sacrificed any optionality. We certainly have not sacrificed any commitment to our clients.

These exercises are done at the business level and built up from the business level.

Mike Mayo

All right, thank you.

Harvey Schwartz

Thanks, Mike.

Operator

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

Guy Moszkowski

Good morning.

Harvey Schwartz

Morning, Guy.

Guy Moszkowski

I just wanted to return first of all to the capital management question and maybe ask it a little bit differently in terms of what we might expect over the next several quarters. So you bumped up the buyback to $1.7 billion, the diluted share count fell by about 2% in the quarter. If you annualize, then you're two or three percentage points ahead of what the kind of last five years' run rate has been in terms of how you've reduced the diluted share count. So in the absence of a specific guide post-CCAR, what should we be thinking about in terms of that attempt to reduce the share count? Should we be thinking in terms of that 5% run rate, or maybe a couple of percentage points higher in line with what you've done recently?

Harvey Schwartz

I think the reluctance for me to be more specific in terms of guiding you really reflects the dynamic nature of how we do it. So you have to think about—and it's obviously more complicated than this, but you have to think about the three competing factors that we're always managing. The first and most important is that we put ourselves in a very strong financial position so that we're there for our clients, so if we saw a big uptick in client demand for our capital, we would be very happy to deploy that capital and actually not return it to shareholders. So this really reflects the fact that the client demand of a period of time hasn't been there.

Now, the second things we do and the strength of the financial footings of the firm, obviously you've seen us do a huge amount of work and you see it reflected in our ratios with 13.7 standardized at the end of this quarter. Obviously we've been very focused on how we've been de-risking the firm and deploying that capital when demanded for us. Ultimately, that gives you the flexibility to either return it or not, and that's why you've seen the uptick over the past couple of years in terms of levels of activity. But the average diluted share count, as you pointed, is at a low level.

Guy Moszkowski

Okay, that's actually useful in terms of understanding your overall framework, so thanks for that. This actually turns out to be a related question - you caveated in the release that the environment for FICC continues to be pretty challenging because of low rates and volumes and low client activity, which implies that there is a more normal run rate that you think is achievable. Can you give us a sense of what that might be, and does that take into account revenue pressures from shifts to electronic trading as well as alternatively the potential to gain share from global competitors who may be retrenching?

Harvey Schwartz

So I'll make a couple of comments on that. You know, Guy, I'd say that first in terms of client activity levels and run rate, if you will, run rate is a difficult thing but I don't think anyone would disagree that when you look at the trading activity levels and the industry trends over the last couple years, obviously they've been in decline. When you look at the factors in terms of our clients and what they need, our clients are still there and they still need those services, they need them from us, and so the type of environment we've been in, if you actually look at the sort of—for lack of better language, the violence of the first quarter in January and February, and then the concerns about Brexit in the second quarter, I think it's fair for us to say these feel like low levels—these are the type of factors that contribute to reduced client sentiment, reduced confidence, and as a result reduced activity.

Now, one interesting takeaway, and we've seen this before sporadically, is after Brexit when volumes were much higher for those couple of days, in all the things that we watch, we could see a demonstrable uptick in our market shares. That may be the result of the current competitive environment as we've talked about a number of the global competitors are going through restructurings, they've been quite challenged. So when volumes pick up, we feel like we see it, but it's difficult for me to tell you what the run rate will be over a long period of time, given the dynamic nature of markets and the unique place we find ourselves with respect to global growth and interest rates.

Guy Moszkowski

So can you elaborate a little bit on those metrics, even though I recognize it was just for a short period of time, but the metrics that told you that you were picking up market share, because up until now when we've asked you that question, you've generally said it's still hard to measure, it's early days, you're not really going to be able to tell in this kind of environment. But you sound much more concrete about it now.

Harvey Schwartz

Yes. One of the things that we're able to do over time, given all of the public regulatory reporting, is we're able to monitor those things more closely in fixed income than historically exists, and obviously you have exchanges that you can monitor. Exchange volumes are not necessarily the greatest indicator, but over long periods of time you can see it, or under unique circumstances when you get big spikes in activity. But it feels like it to us, Guy.

Guy Moszkowski

Okay, that's helpful. Thank you.

Harvey Schwartz

Thanks.

Operator

Your next question is from the line of Fiona Swaffield with RBC Capital Markets. Please go ahead.

Fiona Swaffield

Hi, I have questions in two areas. Firstly, I think you made some comments about security services and margins and volumes being somewhat down. I wonder if you could go into that in more detail, and are we—historically we've seen wider spreads, this is kind of a real change in trend. The second question was on your clients. In a recent presentation, Goldman talked about a mix shift in clients, or stronger growth among some clients versus others over 2015, going back. I mean, has there been a continued shift change if you looked at the client mix in 2016? Thanks.

Harvey Schwartz

Yes, thanks Fiona. So with respect to [indiscernible] client services, that's just reflective of activity levels, and as markets were volatile in the first and second quarter, you saw that translate through with respect to demand, market prices and spreads, so there's nothing really to highlight there other than its reflective of the environment.

In terms of the client base and our client footings, we're always looking to grow our market share across all segments, across all regions, and so we continue to focus on that and there's always things we can do better.

Thanks Fiona.

Operator

Your next question is from the line of Kian Abouhossein with JP Morgan. Please go ahead.

Kian Abouhossein

Yes, hi. First question—

Harvey Schwartz

Kian, are you there? Kian, I think we lost you. I don't know if you can hear us.

Operator

Kian, maybe your line has been placed on mute? Okay, we'll move onto the next question, and that's from the line of Jim Mitchell with Buckingham Research. Please go ahead.

Jim Mitchell

Hey, good morning.

Harvey Schwartz

Good morning, Jim.

Jim Mitchell

Just a couple of quick small questions. On FICC, you guys mentioned that mortgages were down significantly. None of your peers really talked about that. Is there anything unusual there for you guys in mortgage that hurt you in the quarter?

Harvey Schwartz

No, I think that's maybe just reflective of different product lines that businesses may have. We're not as big in things like credit cards and other parts of things which may flow through those business lines. I don't really have the visibility into the competitor base well enough to tell you.

Jim Mitchell

But why was mortgages so much weaker than a year ago? I'm just trying to think through the dynamic there this quarter.

Harvey Schwartz

Client activities and inventory, in terms of the way it moved year over year.

Jim Mitchell

Right, okay. Maybe I missed it - did you give us the fully phased in ratios?

Harvey Schwartz

No, I didn't. So you want me to [indiscernible] for you, so just to recap again, I'll start with the advanced. Transitional 12:2, the fully phased is 11:8, standardized 13:7, fully phased 13:1.

Jim Mitchell

Okay, so those gaps are closing as you kind of sell down the private equity, so that's progressing nicely. Okay, great. Thanks.

Harvey Schwartz

Okay, thank you.

Operator

Your next question is from the line of Kian Abouhossein with JP Morgan. Please go ahead.

Harvey Schwartz

Welcome back, Kian.

Kian Abouhossein

Yes, sorry. I got disconnected somehow. Just briefly on Brexit, and I really have two questions. The first one is related to clearly we had the sell-off, high volatility, a lot of transaction volumes as you indicated in FX, et cetera. Historically after such an environment, we've seen more of a dry-up of the business. Is that something that you're seeing, or do you see more seasonal adjustments to the business as you see in normal times, or is there a more pronounced adjustment to the business environment transaction volumes is getting a bit lower than usual what you would expect?

Harvey Schwartz

Yes, I think that's a reasonable question in terms of just the unique nature of Brexit. It's interesting how the world—so the market reaction, the activity level right around Brexit obviously I don't think was surprising to any of us. I think you could have sat there those couple days after Brexit and if you were forecasting the next month of activity, I think you might have been surprised if we could have known in advance that equity markets would rebound so strongly, there would be a rebound in currencies, and the world would sort of normalize. I think that may be a little bit different, to go back to the core of your question about things we've seen in the past, so this normalization was so quick that it actually may be something that's a better harbinger in the near term usually following one of these events for activity levels. I can frame that for you in a bit more detail.

So I talked about the merger business earlier. If we stay in this low growth environment, unless something is really uniquely impacted by Brexit and if the negotiation process takes a long period of time, then as I said, our bankers don't necessarily see this being a headwind. If we stay in this low interest rate environment and you take a look at our asset management business, then this is really an environment where clients need advice, and that also translates into our ITS business. This is a very content-rich environment now and markets have stabilized so quickly, whether it's debt or equity, et cetera, that I don't know if I would have guessed a couple of weeks ago that the market would have rebounded so quickly, but it feels pretty normalized for now.

Kian Abouhossein

The [indiscernible] that you underlined, do you see that already so far planning out?

Harvey Schwartz

Well, I think there would have been a lot of questions a few weeks ago about the cross-border mergers, for example, into the U.K., and obviously we've seen that within two weeks, so I think there's evidence.

Kian Abouhossein

Okay. The second question on Brexit is I think there was an earlier question about the impact of Brexit on you, but clearly there's this issue of EU passporting and there's clearly the potential of using [indiscernible] Article 4647 assuming there is no EU passporting. Is that something that you feel as a European player sitting in the U.K. you would be able to use to your benefit, or is that not strong enough of a regulatory setting in order to operate out of the U.K.?

Harvey Schwartz

I think the answer is it's just too early to tell in terms of how this process was going to unfold. Again as I said earlier, like everyone else, yourself included, we're hopeful that this is a really thoughtful and prudent process, but it really is a question—you know, we're contingency planners and so we'll contingency plan for multiple outcomes, but way too early to speak specifically.

Kian Abouhossein

Okay, thank you very much.

Harvey Schwartz

Thanks Kian.

Operator

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

Brennan Hawken

Thanks, good morning. How are you doing, Harvey?

Harvey Schwartz

Good.

Brennan Hawken

A quick one on NII. I think when you were walking through INL, you said that NII was around $250 million or so, so if we're run rating that at about

$1 billion, when we look at your INL balance sheet in the Q and just using the last quarter's numbers because I doubt they're that different, if we sum up the debt and loans, you get to about $70 billion or so, just over, which is a little over a 1% net yield. Is it that funding costs for that portfolio are really high? What causes that, or is it that the asset yields are low? What causes that yield to seem a bit low to folks?

Harvey Schwartz

So that's a good question. So let's start with—why don't I just level set you on the balance sheet, the INL balance sheet first. So you were very accurate in your high level commentary, but the balance sheet is down roughly $2 billion quarter over quarter, down to 97.1, and that breaks out between roughly $20.8 billion of what we call equity, and of that $3.5 billion is public equity and the total $16.8 billion of corporate equity, and then the rest, as you said, is debt. With respect to the NIM, in part it has to do with deposits but for the most part it has to do with the quality of the portfolio. So as you know, a large portion of the portfolio is collateralized, so it's just less risky.

Brennan Hawken

So it's more on the asset side rather than on the funding side.

Harvey Schwartz

It's a mix. We don't have branches all over the United States, so we don't have the lowest marginal cost of funding in terms of deposits, but it really is more of the collateralized nature of the lending that we're doing.

Brennan Hawken

Got it, that helps. Thanks Harvey. Then one question on capital post-CCAR here. We in the past have gotten the dividend increase in the first quarter for you guys post-CCAR. I believe you mentioned in your press release post-CCAR that you were approved for a dividend hike, so was the difference this year just around timing with the Board not having time to meet before the third quarter dividend got announced, or should we think about this CCAR year differently than past years?

Harvey Schwartz

I think what we intended to communicate was that the approval gave us the flexibility to do all those things, but we weren't speaking specifically to any decision making with respect to the dividend. The way we—as you know, our preferred methodology, because it gives us a lot more flexibility internally how we manage our capital, is to provide capital return to shareholders, but there’s nothing specific or you shouldn’t interpret anything as a takeaway year to year as we think about the dividend. Those will be discrete decisions that we make as we think through the capital planning process.

Brennan Hawken

Okay, thanks Harvey.

Harvey Schwartz

Thank you.

Operator

Your next question is from the line of Steven Chubak with Nomura. Please go ahead.

Steven Chubak

Hi, good morning.

Harvey Schwartz

Morning Steven. How are you?

Steven Chubak

Well, thanks. So Harvey, first question I have is on CCAR. You noted in the past that CCAR is the firm’s binding constraint on capital, and I’m just wondering whether the favorable result in the latest exam positions you to maybe attribute or allocate less capital to market making activities; or said a bit differently, does it enable you to be more competitive on pricing assuming that your attributable equity has come down?

Harvey Schwartz

Yes, so it’s an interesting question. I guess you could say CCAR is binding if you ask of capital return and you have to revise it. That’s not necessarily what we’ve meant to communicate. Obviously if you just looked at our headline ratios at 13:7 and 12:2, we have significant excess capital relative to the required regulatory minimum. It’s a dynamic process for us, and so in this particular year the Federal Reserve’s interpretation of their scenario was more favorable than our interpretation of the scenario, but it’s our interpretation of the scenario that’s going to govern our capital policy and how we think about capital management, so that’s how we’ll approach it. It’s our test.

Steven Chubak

Got it, okay. So in thinking about capital allocation, should we look at your own submission as a way to infer how much capital you're allocating for certain activities, or is that not reasonable?

Harvey Schwartz

Yes, except for the fact that—the one thing I would say is that the capital allocation process itself, and now we're talking about operating principles, we're not talking about tests, the operating principles, we design the firm, we manage the firm to be very flexible. So if there is client demand for capital in investment banking, we want to be in a position to deploy that. If there's client demand for capital—because the vast majority of our capital is high velocity. If there are opportunities and client demand in investing and lending, which tend to be longer term commitments of capital, obviously we engage in those also, but we don't allocate down a capital in a way that says, okay, here's your capital Mr. and Mrs. Business, you use that, we'll see you in a year. We feel like we get a much better ability to deliver to our clients globally if we can be more flexible and dynamic with it.

Steven Chubak

Right, thanks Harvey. Just one more follow-up from me. There was a senior regulator who recently made remarks suggesting that they could impose some tougher capital requirements for activities specifically in the physical commodities space. I know that's been debated for some time, but do you have any sense as to what form that proposal might take and whether it could compel any changes in terms of how you strategically manage that business?

Harvey Schwartz

No, we'll have to see what the rule comes out with. The vast majority of our business, as you know, is not unlike a lot of the other capital markets businesses where we're working with corporate clients on hedging their exposures, we're working with investors who want access to the commodity markets. So commodity hedging for a consumer or a producer of a commodity, to them it's no different than the way a corporate would hedge foreign exchange.

We'll have to see what ultimately the rules look like, but obviously we're very committed to those clients.

Steven Chubak

Thanks Harvey. Do you have any sense as to timing as to when we'll get clarity on that rule?

Harvey Schwartz

No, I only have the same information you have.

Steven Chubak

Fair enough. All right, Harvey. Thanks for taking my questions.

Harvey Schwartz

Thank you.

Operator

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

Matt Burnell

Good morning, Harvey. Thanks for taking my questions. Just a couple of quick follow-ups. First of all, in terms of the additional global core liquidity you had on the balance sheet at both the end of the quarter and for the average of the quarter, that was up a bit from last quarter. Is that primarily due to the GE deposits, or is there something else going on there?

Harvey Schwartz

No, that's correct. We took in $16 billion roughly of deposits, and that's really the whole driver of the increase, both in the balance sheet and in the GCLA.

Matt Burnell

Okay, fair enough. Then just in terms of the backlog decline both sequentially and year over year, is there any specific geography - you know, Asia, Europe, North AmericA - that is meaningfully stronger or weaker within that trend?

Harvey Schwartz

No, not necessarily.

Matt Burnell

Okay, that's it for me. Thank you.

Harvey Schwartz

Thanks.

Operator

Your next question is from the line of Eric Wasserstrom with Guggenheim Partners. Please go ahead.

Eric Wasserstrom

Thanks very much. Harvey, just to circle back to the expense commentary for a moment, would it be your expectation that the actions you've taken will allow you to generate positive operating leverage, or maybe just more broadly, what is your expectation about operating leverage for the back half of this year?

Harvey Schwartz

Look, you've seen it - it seems like ages ago now, but in the first quarter of 2015, we had an improved market environment, we were very quickly able to deliver lots of operating leverage, and you saw a near 15% ROE in that quarter. Like I said, it feels like a long time ago now. We continually review all the businesses to ensure that we're maintaining the right footprint, so this is all about making sure that we find the right balance between our commitment to clients over the long term and expense management, and obviously the first half of this year has not been the greatest environment, so you're just seeing us respond to it.

Eric Wasserstrom

Can you just help me understand - when you say $700 million of run rate savings, from what level and under what revenue circumstances?

Harvey Schwartz

So the way to think about that is, if we finish the end of the 2015 with a certain [indiscernible], all those adjustments and resources on a run rate basis would be $700 million, so all other factors being equal. But that won't translate into this year because there are severance and other related costs, and net of that will be something more like 350, so you should really think of that as translating into 2017. Now, this will be dynamic of course because we'll be hiring more people, so you and I are really sterilizing the discussion for this number, but I think that's the best way to explain it to you.

Eric Wasserstrom

It sounds like you think that the actions you've taken are sufficient to address this current revenue circumstance, but what would cause you perhaps reconsider and make additional adjustments?

Harvey Schwartz

Well certainly if the environment continued to be challenged, we would continue to refine the businesses. On the flipside, if the environment globally improved dramatically and there was a real demand for our resources, which has been no difficulty in attracting very, very high quality talent to the firm, so we're also being very thoughtful about giving people an opportunity to want to be at Goldman Sachs that we want to be here.

Eric Wasserstrom

Great. Then just one quick accounting question. I think last quarter you indicated that your expected tax rate for the full year would be around 31%. Has that changed at all, given the second quarter's figure?

Harvey Schwartz

Yes, given where we're running now, I would say something just shy of 30 feels like a better expectation where we stand right now.

Eric Wasserstrom

Great. Thanks very much.

Operator

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

Devin Ryan

Hey, good morning Harvey.

Harvey Schwartz

Good morning, Devin.

Devin Ryan

I appreciate the update on the digital consumer finance business initiative, understand the current view that this is going to be a slow build. It sounds like it could take some time to really move the needle under the current path, but is there a case for buying something to enhance either the lending capabilities or liability gathering, just so that you get to that critical mass more quickly, or just thinking about the strategy, is it just kind of by its nature it needs to be built up organically, just so that it's a differentiated platform?

Harvey Schwartz

Yes, it's a good question. So obviously you've seen us do a number of smaller bolt-on acquisitions in IMD, and the thesis behind those, because we're certainly not reluctant to do that, is when we feel like we had a capability that we would—if there's a service we'd like to enhance for our clients or a capability that we're quite good at, that we think we can add scale to, we'll just weigh the costs and benefits of acquiring versus building in-house.

This particular effort, when we looked at it, we really felt like best designed from scratch, and the reason for that is I think we're kind of uniquely positioned. It allows us to leverage our technology skills and our risk skills, but this is really about if you look at sort of the competitive landscape, there are benefits that online lending platforms provide to consumers and there are benefits that large commercial providers of credit provide to consumers. We're just really looking to bridge the gap between those strengths and offer consumers as best we can a really thoughtful and differentiated product.

Devin Ryan

Got it, that's very helpful. Separately, just love some thoughts about how you guys are thinking about the upcoming election just as an influence on business, either from a client perspective or even how you're thinking about planning in your business. There's been a lot of rhetoric just around some pretty bold proposals recently, reinstating Glass-Steagall, for example in financials, some similar kind of bold themes in other sectors. I'm just curious how much is this uncertainty into the election delaying decision-making, if at all, or keeping a lid on client activity.

Harvey Schwartz

Look, I think this cycle will have its unique aspects to it versus other presidential cycles, but historically there's always been some element which may have ultimately deferred a decision that a client might make to a later period. But these are short term in nature, so we don't see any significant impact in terms of the near term.

Devin Ryan

Got it, okay. Just last one quickly - the decline in VAR, I know that can bounce around, but was that just de-risking into the U.K. referendum or just the reduced volatility? Just curious what drove that - it was at the lowest level in quite some time.

Harvey Schwartz

It was a combination. Obviously the VAR declined pretty meaningfully in average over the quarter. Really, that was a combination of two factors. There was reduced client activity going into Brexit, and as I mentioned earlier, we were being pretty prudent as we approached the date.

Devin Ryan

Understood, got it. Thanks Harvey.

Harvey Schwartz

Thank you.

Operator

Your next question is from the line of Marty Mosby with Vining Sparks. Please go ahead.

Marty Mosby

Thanks. Harvey, I wanted to go back into the CCAR and think about adjustments on operational risk. Like we had talked about, there had been some double counting. You did get a benefit of 250 basis points, so to speak, in your minimum ratios going higher. Is that—you know, as we talked about double counting and SIFI possibly going into CCAR, it looks like you got a break on operational risk that almost equals your SIFI charge almost exactly.

Harvey Schwartz

We don’t have any visibility into those calculations, Marty. As you know, there’s no transparency in that process, so I really can’t comment. I think this year’s test and last year’s test and the year prior to that, I think it just confirms what the Federal Reserve has been very clear about. Their test is going to be dynamic from year to year. They’re going to incorporate lots of different variables - that’s how they designed it, so I actually think they’re just fulfilling their design criteria.

Marty Mosby

The other thing I was going to ask you was on this quarter and the headcount reductions, where the severance costs would probably hit, when you look at kind of dividing it, if you just said well, you're at full run rate in the second quarter, which I know you probably weren't, but $175 million per quarter, and then you look at the net for the year you're talking about for this year of being 350 net severance then being possible $350 million, I was trying to think of the timing in relation to the gains in the sense of the expense savings and how that might have affected the second quarter.

Harvey Schwartz

Yes, so the way to think about it is on an annualized basis, Marty, so you should incorporate those numbers as $700 million on a run rate basis, that run rate basis—and this is again a very sterilized way we're doing this conversation. That's all other factors being equal going into 2017, and this year that will translate roughly into $350 million of savings this year. How that flows through quarter to quarter, that's very specific to a number of circumstances.

Marty Mosby

Would it be safe to say that a majority of the severance was going to be at least in the second quarter?

Harvey Schwartz

Some, but not all.

Marty Mosby

Thanks.

Operator

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

Brian Kleinhanzl

Hey, morning Harvey.

Harvey Schwartz

Hey Brian.

Brian Kleinhanzl

I just had a quick question on the Volcker investments. I know you said previously that there is a chance that it could get extended as you get into 2017, but there's really been no discussion as far as I've seen with regards to that. So how should we think about those Volcker investments over the course of next year? Is it really just some type of liquidity event in 2Q17 that will become or happen because if there is no extension or you're just going to take a wait-and-see approach on winding those down?

Harvey Schwartz

So as I mentioned before, we have $4.3 billion that's private, $2.1 billion—I went through the waterfall, so I won't do it again. You would have seen a communication from the regulators that basically spoke to the confirmation of the extension to 2017, and then there's been public submissions in terms of industry-wide requests for incremental extensions, which I believe under the Volcker interpretations can be as much as an incremental five years.

If you remember, if you go back to the genesis of Volcker, it wasn't designed to force fire sales or anything like that, so the industry again has been working with the regulators through various bodies, and we'll see how the regulators finally respond to that. But I think the industry has done a good job, as have we, of bringing down these levels, but we're sitting alongside our clients mostly in these funds, so we don't have unilateral authority just to sell these assets.

Brian Kleinhanzl

Okay, good. Thanks.

Harvey Schwartz

Thank you.

Operator

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

Harvey Schwartz

That's great. Since there aren't any more questions, we just want to thank everybody for joining the call. Hopefully we'll all get to see you over the course of the coming months. If you have any other questions, give a call into Dane and the team; but otherwise thanks again for participating and have a great summer.