

Operator

Good morning. My name is Dennis and I'll be your conference facilitator today. I would like to welcome everyone to the Goldman Sachs Second Quarter 2015 Earnings Conference Call. This call is being recorded today, July 16, 2015. Thank you.

Mr. Holmes, you may begin your conference.

Dane E. Holmes - Head-Investor Relations

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 discussion of some of the risk 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 2014.

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 posted on the Investor Relations portion of our website at www.gs.com. This audiocast is copyrighted material to Goldman Sachs Group, Inc. and may not be duplicated, reproduced or rebroadcast without our consent.

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

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks, Dane, and thanks to everyone for dialing in. I'll walk you through the second quarter and year-to-date results then I'm happy to answer any questions.

Net revenues were \$9.1 billion, net earnings \$1 billion, earnings per diluted share \$1.98, and our annualized return on common equity was 4.8%. For

the year-to-date, net revenues were \$19.7 billion, net earnings \$3.9 billion, earnings per diluted share \$7.93, and our annualized return on common equity was 9.7%.

In the second quarter, we recorded net provisions for mortgage related litigation and regulatory matters of \$1.45 billion. Despite these charges, book value per common share was up 4% relative to year-end 2014. Excluding these litigation charges, net earnings were \$2.3 billion, earnings per diluted share were \$4.75, and our annualized return on common equity was 11.5%.

The second quarter of 2015 was another example of the benefits that come with having a diversified global client franchise. Certain businesses showed year-over-year strengths while others faced headwinds.

Investment Banking and Investment Management net revenues increased year-over-year by 13% and 14% respectively. The increase in net revenues within these primarily fee-based businesses largely offset net revenue declines and are more capital-intensive businesses with a 6% year-over-year decline in Institutional Client Services and a 13% year-over-year decline in Investing and Lending.

The benefits of diversity were even demonstrated at a business level. For example, strength in advisory and equity underwriting more than offset the year-over-year decline in debt underwriting, which was lower versus a record last year. And for Institutional Client Services, revenue strength within equities helped offset a difficult operating environment for FICC. Ultimately, we continue to benefit from our diverse set of market leading businesses.

If you look at our first half results, excluding the \$1.45 billion litigation charge in the second quarter of 2015, you can see the embedded operating leverage, with expenses flat relative to revenues that are up 7% compared to last year. You can also see the improvement in several underlying performance metrics.

These include a 440 basis point improvement in pre-tax margin, a 27% increase in net earnings, a 31% increase to diluted earnings per share, and finally, a 220 basis point improvement in ROE, to 13.1%.

Now I will discuss each of our businesses. Investment Banking produced second quarter revenues of \$2 billion, 6% higher than a strong first quarter. We continue to see the benefit of our leading global franchise, with second quarter revenues at the highest level since 2007.

Our Investment Banking backlog was down slightly compared to the first quarter and remained higher year-over-year. Breaking down the components of Investment Banking in the second quarter, advisory revenues were \$821 million. The 15% decrease relative to the first quarter reflects a decrease in completed M&A.

Year-to-date, Goldman Sachs ranked first in worldwide announced and completed M&A. We advised on a number of significant transactions that closed during the second quarter, including BHP Billiton's \$12.7 billion demerger of South32; Synageva Biopharma's \$8.4 billion sale to Alexion Pharmaceuticals; and Imperial Tobacco Group's \$7.1 billion acquisition of certain cigarette brands and other assets of Reynolds American and Lorillard.

We also advised on a number of important transactions that were announced during the second quarter. These include BG Group's £47 billion acquisition by Royal Dutch Shell; Altera Corporation's \$16.7 billion sale to Intel Corporation; and Pall Corporation's \$13.8 billion sale to Danaher Corporation.

Moving to underwriting, revenues were \$1.2 billion in the second quarter, up 27% sequentially, primarily due to debt issuance. This was our second highest quarterly performance in underwriting. Year-to-date, we ranked first in global equity and equity-related and common stock offerings.

Equity underwriting revenues of \$595 million rose 12% compared to the first quarter, due to an increase in IPOs. Debt underwriting revenues of \$603 million improved 47% quarter-over-quarter, largely driven by an increase in leverage finance activity.

During the second quarter, we actively supported our client's financing needs. Leading Qualcomm's \$10 billion debt IPO, Daiichi Sankyo's \$3.2 billion sale of its stake in Sun Pharmaceutical, and AIG's \$3.5 billion sale of its stake in AerCap.

Turning to Institutional Client Services, which comprises both our FICC and Equity businesses, net revenues were \$3.6 billion in the second quarter, down 34% compared to the seasonally-stronger first quarter. FICC Client Execution net revenues were \$1.6 billion in the second quarter, and include \$153 million of DBA gains.

Net revenues were down substantially from the first quarter, as client activity declined across our businesses and market-making conditions were more difficult. Within interest rates and currencies, a shifting macro backdrop negatively impacted client activity and results. While currency has experienced a significant decline, client activity and interest rates, though sequentially lower, remain solid.

Credit was significantly lower, as credit spreads generally widened during the second quarter and activity levels declined. Mortgages also declined versus the first quarter, as volatility and client activity remained generally low. Commodities decreased significantly, with reduced levels of volatility and client activity.

In Equities, which includes Equities Client Execution, commissions and fees, and security services, net revenues for the second quarter were \$2 billion, down 14% quarter-over-quarter and included \$32 million in DBA gains.

Equities Client Execution net revenues decreased 30% sequentially, to \$787 million. Client activity levels remained high this quarter, though not as high as the first quarter. Commissions and fees were \$767 million, down 5% relative to the first quarter. Security services generated net revenues of \$443 million, up 13% sequentially, reflecting seasonally-stronger client activity and higher customer balances.

Turning to risk, average daily VaR in the second quarter was \$77 million, down from \$81 million in the first quarter, reflecting a decrease in commodities and interest rates.

Moving on to our Investing and Lending activities, collectively, these businesses produced net revenues of \$1.8 billion in the second quarter. Equity securities generated net revenues of \$1.3 billion, primarily reflecting strong corporate performance and company-specific events in private equity, as well as net gains in public equities. Net revenues from debt securities and loans were \$547 million, with roughly \$225 million in net interest income, and the balance coming from net gains.

In Investment Management, we reported second quarter net revenues of \$1.6 billion, up 4% from the first quarter. This represented the second highest quarterly performance for Investment Management. Management and other fees were up 4% sequentially, to a record \$1.25 billion.

Revenues benefited from a higher average mix of long-term fee-based products relative to liquidity products. Assets under supervision increased \$5 billion, to a record \$1.182 trillion. Long-term net inflows of \$14 billion, largely driven by fixed income products, were somewhat offset by net market depreciation of \$3 billion and net outflows of \$6 billion in liquidity products.

Moving to performance, across the global platform, 76% of our client mutual fund assets were in funds ranked in the top two quartiles on a three-year and a five-year basis.

Now let me turn to expenses. Compensation and benefits expense, which includes salaries, bonuses, amortization of prior-year equity awards and other items such as benefits was again accrued at a compensation to net revenues ratio of 42%. Second quarter non-compensation expenses were 59% higher than the first quarter. Substantially all of the increase was related to litigation charges.

Now, I'd like to take you through a few key statistics for the second quarter. Total staff was approximately 34,900 up 1% from the first quarter. Our effective tax rate for the year-to-date was 31.2%. Our global core of liquid assets averaged \$181 billion. Our common equity tier 1 ratio was 11.8% using standardized approach. It was 12.5% under the Basel III Advanced approach. Our supplementary leverage ratio finished at 5.7%.

And finally, we repurchased 1.2 million shares of common stock for \$245 million in the second quarter. As discussed last quarter, related to our share repurchase capacity, any potential share repurchases over the next four quarters will be back-end weighted.

In closing, a few comments. The second quarter of 2015 provided its share of opportunities and challenges. On one hand, our results reflect a continuation of some positive macro trends. Our Investment Banking clients remain focused on their strategic alternatives. There is also a strong demand for financing solutions. We see solid client activity in equity products, particularly outside of the United States, and there was a growing need for active investment management options.

On the other hand, the operating environment for our FICC clients was more challenged in the second quarter. The combination of current concern surrounding Greece's widening credit spreads and the reversal of certain macro trends led to lower client activity and a more difficult operating environment. More recently, market participants have been focused on the Chinese economy. This follows the more than 30% decline in the Shanghai Index during the early part of July from peak levels in June.

Against this mixed backdrop, we remain focused on driving value for our shareholders. Year-to-date, excluding litigation charges, we have posted strong results in many of our key investor metrics, including earnings per share, ROE, and book value per share.

As we have mentioned many times before, our management team isn't overly focused on any one quarter or, for that matter, any six month period. Our focus is on the strength of our global client franchise, the quality of our people, and the long term trends driving our businesses.

Regarding trends, we see many opportunities ahead. For example, the competitive landscape is in significant flux. In addition to strengthening the banking system, one of the positive things the regulation has achieved is leveling the competitive playing field.

The world changed after 2008. We began to adapt to this new world immediately, and particularly to comply with new regulations. As part of this process we also scrutinized each of our businesses with the goal of both improving the client experience and our ability to generate appropriate shareholder returns.

We started early, we cut costs, we on-boarded new regulations, we sold businesses, and we developed a new capital framework. At the same time, we have been able to both expand and deepen our global client franchise.

As much as we are focused on the present, we are also focused on the future, and we enter it knowing we have a great set of businesses, we have tremendous client relationships, we have world-class people and execution capabilities, and last but not least, we have an improving competitive and operating landscape.

Thank you again for dialing in, and I'm happy to answer your questions.

Question-and-Answer Session

Operator

Ladies and gentlemen, we will now take a moment to compile the Q&A roster. Please limit yourself to one question and one follow-up question. Your first question is from the line of Glenn Schorr with Evercore ISI. Please go ahead.

Glenn P. Schorr - Evercore ISI

Hi. Thanks very much.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Good morning, Glenn.

Glenn P. Schorr - Evercore ISI

Good morning. So pretty darn good all around. I think FICC and I&L take a lot of everyone's focus, but in FICC specifically, I wonder if you could help us, how much of that was a late quarter phenomenon? You spelled out what fell off in credit and mortgage, things like that. How much was a late

quarter? How much have you seen some stabilization or reversal so far? And then most importantly, I think last quarter you felt really good about market share in client facilitation side of the business, and I'm curious if you can give any comments on parsing that out, the facilitation versus the marks in the quarter? Thank you.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So in terms of timing of the quarter, we came off a strong first quarter, as you mentioned, and then we came in basically you saw a number of factors. I think the most significant one, obviously, Greece in the headlines continuously. And that certainly weighed on spread sensitive parts of the business like credit and mortgages. Early in the quarter, obviously, there was a big reversal in the macro trend with respect to how people were thinking about currencies and interest rates. And that was really more an interest rate differential and what's the Fed going to do discussion. And so it's not surprising that we saw reduced client activity in the quarter and obviously more difficult market-making environment.

In terms of – it was really more pronounced as the quarter went along as Greece really dominated the headlines and liquidity was challenged in parts of the market. And so it was really – it was more of an end of quarter phenomenon. Too early to tell in terms of where we are in this quarter, Glenn, but obviously, the news around Greece has been obviously very positive in the last couple of days. And so hopefully some of these trends are behind us.

Glenn P. Schorr - Evercore ISI

And then I think you talked about the competitive landscape in flux and we all see what's going on at each and every one of the European banks. I think your franchise composition is different in general. You see it in results this quarter, and mostly good. Just a question on the European shrinking. Do you want what they're shrinking? In other words, theoretically, they're going to shrink the tougher parts, the lower ROA types of the business.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So in terms of how we think about it, and obviously these competitive trends they take years to really formulate. But I think the big change and I talked about this a little bit in my script, but to be more specific about it, the capital-intensive parts of the business and really let's just start with the fixed income parts of the business, given the regulatory demands around that part of the business to deliver for your clients and drive appropriate

returns for shareholders, that is actually where we think the competitive advantage is most significant.

So if you just look at last year's collective industry ROEs, which are in the mid to higher single digits. Our relative position both the strength and the franchise but aggregate position of the firm just positions us quite well over the next couple of years if firms follow through on what they saying and they actually restructure and they begin to redesign those businesses. And so, as people exit the business, obviously, the impact of the marginal pressure on risk when you're deploying capital should be beneficial and we're leaders in all those parts of the franchise, but I think this is going to be a multi-year phenomenon.

Glenn P. Schorr - Evercore ISI

Okay. I don't want to put words in your mouth, but it sounds like there might be more volatility, but in the end, your shareholders are going to love the fact that you are bigger in some of those areas.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Well, we feel very confident about the business. That's the way I would describe it.

Glenn P. Schorr - Evercore ISI

All right, thanks. I respect the one and one. Thank you.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks.

Operator

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

Christian Bolu - Credit Suisse Securities ([USA](#)) LLC (Broker)

Good morning, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey. Good morning, Christian.

Christian Bolu - Credit Suisse Securities ([USA](#)) LLC (Broker)

Hi. So my first question is on the CCAR and G-SIB – possible G-SIB's surcharges. So I'm sure you're aware that this chatter that that could be included in the CCAR process going forward. You know, you have been or Goldman has been pretty proactive in optimizing for CCAR, be it preferred issuance or reducing the gross balance sheet, but what are the levers can you pull if G-SIB buffers are included?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So as you pointed out, we obviously have been pretty dynamic with respect – I think the greatest example was a year ago when we brought the balance sheet down by nearly \$60 million in the quarter. And that was predominately driven by CCAR and that was a repricing exercise, which led us to do that. So the way we'll think about this is a couple ways. First of all, it's only preliminary and we'll have to see the final rule, but our expectation is that at this stage given the information that we have, again preliminary, that any incremental buffer will be roughly 1%. And so, relative to the peer group, obviously, that puts us in a good position.

Now in terms of how to think about the implications for the test, we have no visibility into how the Federal Reserve is going to change the test. And so to the extent to which it changes, we'll look at all the same levers again. There will be an evaluation of how we should think about the capital structure of the firm, how we should think about how we're deploying our capital, how we think about pricing the marginal balance sheet and other aspects of our business. But we won't do that in advance of any changes in any regulatory rules. And we just don't know what they're going to do yet.

Christian Bolu - Credit Suisse Securities ([USA](#)) LLC (Broker)

Okay. That's helpful. And then litigation costs, so how should we think about go-forward litigation costs? I guess over the last four quarters, you've averaged about \$200 million per quarter, just given the big charge this quarter, all else equal, should we expect that run rate to slow down a bit?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So obviously, we took a significant charge this quarter. The vast majority of that is related to the RMBS Working Group. But the process with respect to these kind of legacy cost issues is, every quarter, based on the best information available, we create our best estimate and it's very case-by-case

dependent. And so it can be somewhat unpredictable quarter-to-quarter. That's how I'd frame it for you.

Christian Bolu - Credit Suisse Securities ([USA](#)) LLC (Broker)

Okay. So it doesn't sound like anything changes in terms of just kind of look forward here?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

I'm sure you understand this, Christian, given that these are – this is active litigation, very difficult for me to comment beyond what I said.

Christian Bolu - Credit Suisse Securities ([USA](#)) LLC (Broker)

That's fair. Okay. Thank you for taking my questions.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks so much, Christian.

Operator

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

Michael R. Carrier - Bank of America Merrill Lynch

Hey, Harvey. Thanks a lot.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey, Mike.

Michael R. Carrier - Bank of America Merrill Lynch

Hey. Just on the equity trading, so year-over-year, the strength was pretty significant. I think you mentioned a few drivers of that. But just wanted to get a sense, are you seeing any, either market share gains in that part of the business or is it more environment and clients' investors getting more active in the asset class? I know you pointed to Asia, but I just wanted to find out if there was anything else driving that?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

No. I think, obviously, it has been a good solid couple of quarters. Environmentally, for the first half of the year, the environment has clearly been better, both from a activity level and also from a market-making perspective, and so you're seeing that. The franchise is very diverse, both geographically and product line. And so I think when market activity picks up, you're just seeing the value of the franchise pull through. And as I said earlier, as activity has picked up outside of the U.S., I can't tell necessarily whether or not it's share pickup from other firms, but obviously, you've seen actually in the first quarter even, those firms with strong equity franchises seem to be getting the lion's share of the activity.

Michael R. Carrier - Bank of America Merrill Lynch

Okay. Got it. And then just two kind of minor items, but on the legal cost, you mentioned this reserve, and it's always tough in terms of the outlook. But when you think about some of the major things that you guys have put behind you, and even the industry, when we think about the run rate going forward, are the majority of those items behind you? And then on the tax rate, just wanted to understand, if I exclude the item related to the legal reserve, it looks like the core tax rate still was relatively low versus expectations, in line with last quarter. So is the revenue mix away from the legal charge still beneficial? Meaning it's still coming in in lower jurisdictions? And so does that, for the full year, should we be thinking about that continuing?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So with respect to tax, you're right. It's roughly consistent with the first quarter and we're running below last year's full year, so you're right about that. That's both earnings-mix driven, and an election. You'll see in the earnings release this quarter with respect to certain earnings that we'll leave overseas. With respect to litigation, again, the charge we took this quarter is – the vast majority of that is related to the RMBS Working Group. And I'd really encourage you to look through our disclosure, and while I wish I could give you more detail, obviously, that's one significant item, a legacy item, that we look forward to getting behind us. But I really can't comment in more detail on that, given it's a live discussion.

Michael R. Carrier - Bank of America Merrill Lynch

Okay. All right. Thanks a lot.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

Matthew Derek O'Connor - Deutsche Bank Securities, Inc.

Good morning.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey, Mike – Matt, sorry.

Matthew Derek O'Connor - Deutsche Bank Securities, Inc.

Maybe a bigger picture question, on your traditional bank strategy, you had a key hire on the consumer side, or former consumer person. Maybe just talk about what you're thinking there on traditional bank strategy in general?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, yeah, as everyone saw, we hired Harit and we're thrilled to have someone of his experience and caliber on board as a one of our partners. I would say at this stage, it's very early days and we've really done two things. We've identified a potential opportunity and we've identified a key hire, as I said, which we're very excited about. When we look at new opportunities what we look for in terms of making that evaluation is, what core competencies do we have and how can we bring them to any client base that we deal with. And so, we feel like there is a couple of strengths here that we have.

One, we have a long history and a core competency in risk management. Two, we have a very, very big commitment to technology. Three, historically, we've been pretty good builders of new businesses. And, obviously, as it relates to, let's just call it the space of digitally-led consumer finance, we have no legacy cost, we have no legacy infrastructure to deal with. And so to the extent to which we can work with Harit and develop a strategy, which we believe is accretive to the firm and valuable to clients, we'll pursue it. But at this stage, it's early days. Harit's just on board, and so we'll be back to you with more details as things develop.

Matthew Derek O'Connor - Deutsche Bank Securities, Inc.

And then maybe separately, you mentioned head count was up just 1% linked quarter. Year-over-year, it's up 8%. Obviously, it's not causing any expense pressure as the expense management's been good, but just remind us just where those people are being added? And I guess are they more kind of junior, lower salaried staff?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, the 1% increase in the quarter and the longer term increase it's really happening in two places. Part of it is driven by our growth in the Investment Management business and people that we've been adding there as that business continues to grow and our ongoing investment there. And really the other large portion of it relates to resources that we needed to deploy as we come into the more significant part of regulatory compliance. And so, these are all the new rules that the industry is affected by over the next couple of years. And so it's a bit of a surge, if you will, in terms of having people on board. And for example in the second quarter, about three-quarters of those folks were in places like Salt Lake City, Bangalore, and other locations.

Matthew Derek O'Connor - Deutsche Bank Securities, Inc.

Sorry, three-quarters of the people in the reg-related staff or of the additions?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Of the additions.

Matthew Derek O'Connor - Deutsche Bank Securities, Inc.

Got it. Okay. Thank you.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks.

Operator

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

Elizabeth Lynn Graseck - Morgan Stanley & Co. LLC

Hey, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey. How are you?

Elizabeth Lynn Graseck - Morgan Stanley & Co. LLC

Good. I just had a couple of quick questions. One was on the G-SIFI buffer that you talked about earlier on the call. I just wanted to see – did you give us an update on what you think your surcharge is? I thought you were – before the most recent commentary it was like 2.5%. Are you saying now it's 2%?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

No, no. Same. No change. We don't have any incremental information. We think it's – obviously, we started with 1.5%. Under the proposal, we believe there's an incremental 100 (29:17), but again, I cautioned you that's the preliminary. We haven't seen the final rule, obviously.

Elizabeth Lynn Graseck - Morgan Stanley & Co. LLC

Okay. Got it. All right. Just wanted to make sure of that. And then on European competitors fading some of these businesses over time, how much does that matter to you when you think about the fact that the SIFI surcharge is in part a relative charge? So they fade naturally, you're going to grow as a percentage of total business. How much room is there to take on new business given the way the SIFI surcharge is structured?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah, it's a great question, Betsy, and obviously, a difficult one to think about over the next couple of years. But obviously there may be some unevenness in the playing field depending on how the rules actually get rolled out. But in the end, it's more about I think how you deploy that capital and the returns you're able to generate. And I think one of the reasons why, as you point out, we're seeing potential big restructurings on the European side is that even without the SIFI charge potential that we have in the United States – and who knows what they'll do over time, maybe the playing field will be completely level – they're struggling in those businesses at current capital levels. (30:35).

Now, our commitment to Europe is very significant. And it's not just across the capital intensive businesses, but it's the entire integration of banking.

And when you think about Europe over the next several years as they work through what is – our research folks have them at 1.5% growth, but as they work themselves more and more away from the crisis, this is a very good environment for a firm like Goldman Sachs where clients need sound advice across all of our businesses.

Elizabeth Lynn Graseck - Morgan Stanley & Co. LLC

Yup. No, I get that. All right. Hey, thanks.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

Mike L. Mayo - CLSA Americas LLC

Hey, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey, Mike. How are you?

Mike L. Mayo - CLSA Americas LLC

Good. You ended your prepared remarks saying the world changed in 2008, you cut costs, you implemented regulation and the implication is others are now catching up, implying a little more bit rational pricing, which you've said on prior calls. Can you just give us a description of the areas where you're seeing the biggest repricing or the areas that you're watching the most?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So it's a great question, Mike. And I think it's very clear at this stage that the increased regulatory requirements, however you think about them, but let's just think mostly in terms of capital, while obviously very good for the system and significant improvement for all firms. For example, Goldman Sachs was carrying 85% more capital than we did prior to the crisis.

As we said, they have leveled the playing field a bit, but even without the leveling of the playing field, it makes balance sheet at one point, depending on the metric, and capital itself more expensive. And so, I don't know if it's an intended or unintended consequence in terms of the regulation, but the regulation does reprice things. And the vast majority of the industry is really a handful of us that are earning above the cost of capital, whatever you want to call it – 8%, 9%, 10%.

And so we're starting to see repricing come through now. We saw it mostly in balance sheet. Came a little slower than we would've liked, but it's starting to come through in balance sheet. By balance sheet I mean things like those businesses that were maybe most mispriced relative to the new requirements. Things like the repo business, it's extended into the prime brokerage business. Again, that's a regulatory heavy business. We're world-class in that business, but it is regulatory heavy business. And you have seen it in parts of the derivative business particularly in things like those transactions requiring or not requiring collateral. So I'd say it's slow. These are not huge needle movers, but this feels like a trend that's in place for a number of years.

Mike L. Mayo - CLSA Americas LLC

So would you call this as an increase in your cost of goods sold that you're passing on to customers?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

I think that's probably a reasonable way to say it. I mean our clients are very sophisticated. And when you sit down with them and you say, listen, everyone in the industry, Mike, that issues preferred they are issuing them slightly north of 5%. That's expensive shareholder capital to fund the leverage of your balance sheet. And so, it's pretty easy to explain to people how actually the returns that you have to require on business. And so what we think will happen over time is potentially repricing, but also the competitive dynamic looks like one where those firms that can't deliver or can't respond or don't have the same quality franchise, they get removed. But anyway, this is going to be a – this will be a long process. We went through a pretty substantial repricing as you know (34:17) last year.

Mike L. Mayo - CLSA Americas LLC

And last follow up on this. Can you give a sense of magnitude? Are we talking basis point or tens of basis points or what?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Too soon to quantify. As I said, this is not big needle moving. It's more, I would describe it more as a trend for the balance sheet and capital intensive parts of the business. And you'd expect it given the regulatory constraints, so.

Mike L. Mayo - CLSA Americas LLC

All right. Thank you.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks, Mike.

Operator

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

Guy Moszkowski - Autonomous Research US LP

Yeah, good morning. I don't want to beat a dead horse, but on the litigation question, the litigation charge, presumably to add that much based on the Working Group issues that you referred to, there must have been an event, a point in your discussions with them that began to give you a sense for a figure. And I was just wondering if that's a correct assumption?

And also does your view of kind of the your – where your litigation reserve stands now relative to what you will ultimately need, is that affected in anyway by the New York Court of Appeals judgment on statute of limitations which came down during the quarter?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So again, and I'd like to share more with you but obviously this is active discussion. With respect to this quarter, again, every quarter we incorporate all the information we have, Guy. And obviously we received information that resulted in us taking this charge. I know you've looked and you've read all of our financial disclosures in the past. And so I would encourage you to go back to that. But as you know, based on that we have not historically taken reserves for the RMBS Working Group. And so obviously we got information during the course of the quarter that led to this realization.

Guy Moszkowski - Autonomous Research US LP

Okay. That's helpful. Thanks. And then on, just to follow up on an answer that you gave earlier. That 1% that you gave in terms of the G-SIB buffer, which I think what you were saying was that is your working assumption as to how much would go into the CCAR, sort of the increase, the stress minimum in CCAR. Is that right? So you're thinking that 1% out of your 2.5% G-SIB buffer is how much you think is likely to get added to the stress minimum in CCAR?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, again, the 1% was based on the preliminary. We'll have to see the final rule, so I really want to emphasize that. In terms of CCAR, we just don't know how they're going to include it, what they will do, whether it will be offset. We have no visibility and we'll all hear when the Federal Reserve announces any changes that they plan to make.

Guy Moszkowski - Autonomous Research US LP

Okay. Fair enough. And then just one more if I might just on the SLR. You made a lot of progress on your SLR in the quarter relative to where your core equity tier 1 ratios moved. So you are now 70 basis points ahead of the minimum. You increased 40 basis points in the quarter. Can you give a sense of some of the things that you did presumably to the denominator to continue to tighten up there?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah, so on the SLR, the 70 basis points, if you break that down, roughly 20 basis points really comes from capital and the issuance of preferred and then the balance are all things that drive the ratio, things like notional (38:10), collateral back and forth and things like derivative. And so, there's a lot of give and gets in there but accretive for the quarter.

Guy Moszkowski - Autonomous Research US LP

Okay. Great. Thanks very much.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

James F. Mitchell - The Buckingham Research Group, Inc.

Hey. Good morning, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Morning, Jim.

James F. Mitchell - The Buckingham Research Group, Inc.

Maybe just circling back to equities in China, we've had a – obviously as you pointed out, a big selloff and most of you and your peers have talking about equities being driven by strength in Asia. Have you seen any change in the environment and activity levels given the big selloff, or has that just helped – the volatility helped? Just trying to think through how that should be thought of going forward in terms of the equity franchise.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So again, whenever you see these kind of market reactions, obviously, it has some impact in terms of how clients think through their portfolios. It's more isolated, obviously, to the onshore market. And I think that – at this stage, I would describe it as being pretty fluid and dynamic with respect to the near term.

I think longer term, what we're really focused on is the extent to which the recent events, do they really have a significant negative impact from an economic perspective or in terms of the liberalization policies, because obviously we have a very big focus on China, a big commitment there.

And our early read of all this is that it's not going to have a big – when we talk to our research folks, it's not going to have a big impact on the local economy, and we don't expect a major change in sort of the focus on liberalization. And given everything China's done, maybe we should expect as they go through this, there were (39:51) going to be growing pains from year to year, but the long term trend feels okay to us. From a...

James F. Mitchell - The Buckingham Research Group, Inc.

Yeah, that's – okay. That's helpful. And maybe just circling back to the – I know it's early days on the lending side, but historically, you guys have shied away from retail risk, right, with regulatory and higher legal risk. This

seems to be a bit of a departure from that historical viewpoint. So could you maybe just walk us through your – clearly there's an opportunity to make money, but the question is how you view the potentially higher risk in a retail lending format?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah. So we've always been very cautious, and you're right to point that out. Now we do have millions of clients that touch us in our investment management business through our mutual funds every day. And so they're actually a big part of what we do. And when we think about it, obviously, we're going to move very cautiously in the space and make sure we get things right, because you're right to point out that, like any new business, there are risks and we want to make sure that we work with the consumers and the regulators in absolutely a first-class and best-class way. And so – but again, too early for us to identify any specific parts of the market. But we'll be back to you with more details again down the road.

James F. Mitchell - The Buckingham Research Group, Inc.

Okay. Great. Thanks.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

Brennan McHugh Hawken - UBS Securities LLC

Good morning, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Hey. Good morning, Brennan.

Brennan McHugh Hawken - UBS Securities LLC

So first question, you made some reference to it earlier when you talked a little bit about pricing, but it looks like we're seeing some momentum in your Prime Brokerage business. Clearly, the current quarter was a bit seasonal.

But could you give some color to that? Is some of it down to pricing? Is it down to other factors? Maybe, could you help us out a little around there?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

I really think there's two drivers. The biggest driver is just the quality of the franchise. And so, we've been a beneficiary of getting balances just because of the – really the longstanding history and our involvement in this business, and it's global for us. But pricing is an important input, but it's not the primary driver of the performance.

Brennan McHugh Hawken - UBS Securities LLC

Okay. Thanks for that. And on I&L, pretty solid, especially given some of the action we saw in markets this quarter. Can you – was a lot of it harvesting? Were there any particular regions that contributed? For example, was Asia a contributor in the quarter on the I&L line?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, in terms of I&L, and why don't I just run through it, I can run through it from the debt line through the equity line. So in the debt line we had \$547 million, roughly \$550 million in revenues in the quarter. And remember, I underscore for you there that roughly \$225 million of that is interest income, okay, and the rest is gains in sales.

In the equity line, of the \$1.25 billion, roughly a third of that actually comes from public market shares that we own, in entities we've already taken public. And so there you're just seeing the idiosyncratic performance of the portfolio. And another third – and I'll just break it down for you in thirds – a third is the public portfolio performance. A third is things that we refer to as event-driven, like actually taking a company public or making a sale, and the other third is performance-driven. And so the idiosyncratic nature of the portfolio, the team is just doing a very good job here.

Brennan McHugh Hawken - UBS Securities LLC

Terrific. Thanks for that color, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Okay, thank you.

Operator

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

Brian M. Kleinhanzl - Keefe, Bruyette & Woods, Inc.

Great. Thank you. Hey, Harvey, earlier you mentioned that you saw that liquidity was challenged in parts of the market when you were talking about the FICC business. Can you give a little bit further color as to maybe what regions and which products that we saw the liquidity dry up?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, it was most challenging in Europe. The credit market in particular, and let's just say the spread sensitive product, the markets aren't as deep there, obviously, as they are in the United States. And then, with all the issues with Greece, liquidity was quite challenging for all of our clients, and quite challenging for market makers.

Brian M. Kleinhanzl - Keefe, Bruyette & Woods, Inc.

Okay. And then also in Europe, are you impacted by the UK bank tax and the higher – it looked like – if you look at the Goldman Sachs International?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah, so it's an important part of our business, obviously, given our presence in Europe. Too early for me to quantify anything for you, but obviously the tax rate's going up over there.

Brian M. Kleinhanzl - Keefe, Bruyette & Woods, Inc.

But is that \$2 billion that you had in profit on ordinary activity before taxes in Goldman Sachs International the right number to look at when you're thinking about the potential impact on tax rates?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

I have to come back to you on that in terms of exactly the number you look at. I believe the answer to that is yes, but why don't I have Dane follow up with you, and we'll make sure we reconcile that for you.

Brian M. Kleinhanzl - Keefe, Bruyette & Woods, Inc.

Great. Thank you.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Okay.

Operator

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

Eric Wasserstrom - Guggenheim Securities LLC

Thanks very much. Harvey, a couple of follow-ups, please. On your non-comp, core non-comp expenses, it looks like they came in under the consensus estimate by about \$120 million this quarter. Should we consider all of that improvement to be core, or did some of it perhaps relate to slowing volume or activity over the course of the period?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

No, not driven by slowing activity. Any changes in non-comp that you're seeing away, obviously, from the legacy charge, that would have to do with impairments that we might take from time-to-time, is the real driver there.

Eric Wasserstrom - Guggenheim Securities LLC

Okay. And in terms of the incentive fees in the Investment Management segment, I'm sorry if I missed this earlier, but did you explain why they were so strong in this quarter, because that's not typically seasonally the case?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah. So there's always two drivers to incentive fees. There's going to be the normal or what we'll call year-end incentive fees that you're used to seeing. And then there are fund specific events where we've above a certain performance metric and then we'll begin to recognize those fees. And so this is very fund specific in terms of this quarter.

Eric Wasserstrom - Guggenheim Securities LLC

Okay. And just lastly, one of the metrics that we, and I imagine others use to gain some insight into the M&A outlook is the index of CEO Confidence which has been generally moving in a straight line up until recently where it took a dip down. I'm guessing may be because of Greece and other macro

events, but I'm wondering does that index accurately reflect the tenor of conversations that you've been having with – in corporate board rooms over the past few weeks?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So when we talk to our M&A bankers, the momentum in the advisor side of the business feels very strong. The CEOs and boards are obviously going to incorporate all the relevant news and so not surprising to me that when you see Greece dominating the headlines and lots of volatility in the markets that you might see some dip in confidence. But in terms of the degree of conversations we're having in the activity levels, it feels quite good. And you see that halfway through the year, in announced transactions, the Investment Banking team is actually we have announced \$112 billion plus of transactions, actually more than the next competitor. And so the dialogue for us with our clients is pretty robust right now.

Eric Wasserstrom - Guggenheim Securities LLC

Okay. Thanks very much.

Operator

Your next question is from the line of Richard Bove with Rafferty Capital Markets. Please go ahead.

Richard Bove - Rafferty Capital Markets, LLC

Good morning.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Good morning, Dick.

Richard Bove - Rafferty Capital Markets, LLC

Hi. This is more of an accounting question. Basically, your Investment Banking was up quarter-over-quarter, commissions and fees were up, your principal transactions were up, and obviously there was a big jump in your debt underwriting. And yet there was almost a \$200 million drop in your net interest income. And I'm just wondering why that would be? what are the accounting recognition that would allow that to happen?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah. So you're looking at the GAAP income statement, Dick, obviously. And that has a lot to do with under the GAAP rules, how we have to treat certain hedges versus the portfolios. We have to break out certain hedges and move them into the market making business. So it ends up being a net offset.

Richard Bove - Rafferty Capital Markets, LLC

I see. So this is interest income loss on hedging?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

(48:48) The hedges are hedging parts of the portfolio, so you might get a decrease in the underlying, for example, the income being driven by the portfolio, but then you pick it up in the hedges offsetting that portfolio in the market making business.

Richard Bove - Rafferty Capital Markets, LLC

Okay. But the market making in the FICC side of the business was down 49% so...

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Correct. That may be completely unrelated to the interest component. That's why in the script, Dick, I break out for you in the investing and lending segment, that net interest income was \$225 million in the lending businesses to try and clarify it. I'm happy to have Dane walk you through it but it's an accounting aspect.

Richard Bove - Rafferty Capital Markets, LLC

Okay. And then the second question would be, basically, I understand trading is not totally related to underwriting, but when you have such an incredibly strong increase in underwriting of a certain segment like that, and at the same point in time the FICC income goes down fairly substantially, it would suggest that what you're underwriting is something that isn't traded?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

No, I wouldn't draw that conclusion. Usually the secondary activity flows for a long period of time, Dick. I think it's hard to draw those kind of conclusions in an individual quarter. I think if you look at our that debt underwriting activity in the first quarter, it wasn't as strong as the second quarter, but yet the FICC results were stronger. And so, if you look at FICC, for example, on

a year-to-date basis, it's down. But the second quarter was definitely tougher for us, Dick.

Richard Bove - Rafferty Capital Markets, LLC

Okay. All right. Thank you very much.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

Steven J. Chubak - Nomura Securities International, Inc.

Hi. Good morning.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Morning, Steve.

Steven J. Chubak - Nomura Securities International, Inc.

So, Harvey, given the challenging market making backdrop that you experienced in 2Q, I was wondering how that informed your thinking around the issue of trading liquidity more broadly. And I might be interested in hearing some of your thoughts regarding the recent feedback that we've heard from regulators as well as some of the results based on their recently-conducted studies.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, obviously, there has been a whole host of discussion around liquidity in the markets. And I think in the end, I think it leaves us quite frankly all with more questions more than answers. I think you can point to some very specific parts of the market where you can say regulation has impacted liquidity.

I think, the best example of that is the government bond repo market. I think it's hard after that to point to a specific regulation and say, oh, this regulation has impacted liquidity in this market. That doesn't mean it's not

happening. I think it's just hard to quantify. I think the repo market you can easily quantify it. You can see the reduction in repo commitment from various banks, including ourselves, and you can see over quarter-end how repo spreads react.

By the way, to me that looks like that's an intended desire by the regulators. They wanted people to either reprice or shrink that business. And so I think away from that the reason why this is difficult is because it's a question of really what is the multi-year accumulation of regulation?

Things being pushed more electronically, inability to hold as much balance sheet, increasing RWAs, all these things so vocal. But I think these things reveal themselves over many years. But obviously, you can't have as much regulation as we've had and not have some unintended consequences. I think it's just the cost of regulation. Doesn't mean the regulation is not good.

Steven J. Chubak - Nomura Securities International, Inc.

Understood. And maybe just switching gears for a moment. Just wanted to dig into some your comments that you made on the debt underwriting side. You cited strong DCM really driven by higher leverage finance activity, which is certainly a nice surprise just given some of the regulatory pressures in that area. I wanted to get a better sense of how you're thinking about the outlook for the business more broadly. And one of the questions we hear most often is whether the recent pickup in activity is more tactical driven versus a reflection of what could be sustained strength in that business.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

So, you're right to ask that question and the question's been coming up for the last couple years, obviously, as we've gone through this part of the cycle with tighter credit spreads and lower rates. And we talked about this. If the M&A cycle remains strong, then obviously that will be a positive tailwind to the underwriting business. And it was for us. When I said leverage finance activity, I could have said leverage finance activity facilitated in part by our advisory business. So if the M&A backdrop continues the way it feels today – but I think M&A will help.

Steven J. Chubak - Nomura Securities International, Inc.

All right. That's it for me. Thanks for taking my questions.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thanks, Steven. Take care.

Operator

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

Devin P. Ryan - JMP Securities LLC

Hey. Thanks. Good morning.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Morning, Devin.

Devin P. Ryan - JMP Securities LLC

Most have been asked and answered, but just a question on the market volatility. We hear the term healthy volatility versus unhealthy volatility in the market. So can you help us think about what you think could drive that healthy volatility that seem to be missing? It seems like every time we have one of these macro flare-ups, like Greece as an example, we just see more extreme market moves which I think would be put in the unhealthy bucket. So any perspective there would be appreciated.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

I think in an effort to overly simplify this, I think healthy volatility is volatility in which client activity picks up and liquidity exists, clients feel confident. Unhealthy volatility is the reverse of that where clients get more conservative and they derisk. And so as we go through these periods, the general trend, obviously, feels like volatility is picking up in a healthy way, but that doesn't mean from time to time we're not going to hit these kind of pockets.

Devin P. Ryan - JMP Securities LLC

Okay. Got it. And then just secondly, on debt underwriting again, not to beat a dead horse, but just given the strength there, and speaking to the leverage finance market, do you feel like you're gaining market share there doing transactions that maybe others are moving away from, or does it just feel like you're benefiting with the rising tide as M&A is picking up?

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Yeah, no, there's nothing we're doing. We're being pretty conservative in terms of our thought process in terms of the business. And our risk-taking is being very prudent. It really is all about M&A activity.

Again, as I mentioned to you, I talked about at the announce (55:42), but when you look at the completed lead tables (55:44), obviously, our team is really in the center of all the M&A dialogs.

Devin P. Ryan - JMP Securities LLC

Yup. Got it. Thanks, Harvey.

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Thank you.

Operator

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

Harvey M. Schwartz - Chief Financial Officer & Executive Vice President

Okay. Since there are no more questions, I just want to take a moment to thank all of you for joining the call. Hopefully I and other members of senior management will see many of you in the coming months. If any additional questions arise, please feel free to reach out to Dane, otherwise enjoy the rest of your day, and I look forward to speaking with you on our third quarter call in October. Take care, everyone. Thank you.