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Research Update:

IBG LLC Outlook Revised To Positive, Ratings Affirmed On Reduced Market Making And Growing Retail Client Base

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Research Update:

IBG LLC Outlook Revised To Positive, Ratings Affirmed On Reduced Market Making And Growing Retail Client Base

Overview

- IBG LLC has substantially reduced its market-making business and continues to expand its more-stable direct and indirect retail client base.
- IBG's business and profitability have held up much better than we expected in the face of COVID-19-related market and economic stress, low interest rates, and its competitors' move to zero commission pricing.
- As a result, we are revising the outlook to positive from stable and affirming our 'BBB' issuer credit rating on IBG and our 'BBB+' long-term and 'A-2' short-term issuer credit ratings on its core U.S. brokerage subsidiary, Interactive Brokers LLC.
- The positive outlook reflects our view that growth of less confidence-sensitive retail brokerage clients and the shrinking market-making business could reduce the firm's risk and bolster its business and financial stability.

Rating Action

On Nov. 24, 2020, S&P Global Ratings revised the outlook on IBG LLC and its subsidiary Interactive Brokers LLC to positive from stable. At the same time, we affirmed our 'BBB' issuer credit rating on IBG and 'BBB+' long-term and 'A-2' short-term issuer credit ratings on Interactive Brokers LLC.

Rationale

The positive outlook reflects our view that growth of less confidence-sensitive retail brokerage clients and the shrinking market-making business could reduce the IBG's risk and bolster its business and financial stability. IBG continues to grow its direct and indirect retail clients (that are served through financial advisers and introducing brokers), which we view as more sticky. This has reduced its institutional clients, which we view as more confidence sensitive, to 17% of total client equity.

IBG has shut down its market making in all but India and Hong Kong, which has reduced operational risk and shrunk the securities it holds on balance sheet by 76% since the beginning of 2020. That said, the pandemic-related increase

in market volatility caused the value at risk-measured market risk of this business to rise slightly in 2020.

The rating affirmation on IBG and subsidiary Interactive Brokers reflects the consolidated firm's solid market position, very strong capitalization, resilient earnings in the face of lower rates and competitive pressure, and adequate funding and liquidity. While risk has decreased with the shrinkage of market making, we believe IBG still faces model and operational risks from this business. Its reliance on more-volatile transactional revenues and still-material portion of more confidence-sensitive institutional clients, as well as the highly competitive nature of the businesses continues to at least partially offset these strengths. We think that, even though IBG has settled its anti-money laundering and Bank Secrecy Act-compliance issues with its regulators, compliance risk is elevated because it remains the subject of a U.S. Dept. of Justice (DOJ) inquiry.

IBG is a holding company that, through its regulated broker-dealer subsidiaries, is a major global electronic broker serving both retail and institutional clients. We believe IBG's market position and profitability benefit from its technology-enabled, low-cost provider status, which supports unique, low-cost, and high-functionality offerings. While the firm's brokerage has been the leader in daily average revenue trades, it is substantially smaller than its main retail peers in terms of total client assets, with \$233 billion as of Sept. 2020. IBG remains reliant on market-sensitive revenues, and the decline in short-term interest rates and increase in trading activity lowered the contribution of net interest income to about 40% in 2020 versus 56% in 2019.

IBG continues to post very strong pretax profit margins above 65% despite its competitor discount brokers' move to zero commissions on trades of U.S. equities and exchange-traded funds and the base-rate on listed options, as well as the reduction in short-term interest rates to close to zero. Unlike its competitors, IBG offers customers both its traditional low commission pricing option and a zero commission option that includes revenue-increasing measures (such as higher rates on margin loans) that offset the reduction in commissions.

IBG's risk-adjusted capital (RAC) ratio of 45% as of Sept. 30, 2020, is the highest among the U.S. securities firms we rate and a key rating strength. It provides, in our view, an ample cushion to absorb potential losses arising in the large margin loan book (over \$30 billion) or associated with customers' active derivatives trading activity (such as the over \$100 million loss in April this year to indemnify clients in West Texas Intermediate (WTI) energy futures).

Although customers' derivatives trading activity can give rise to substantial margin calls at clearinghouses (such as Options Clearing Corp. in March this year), the firm can, under certain conditions, pledge derivatives customers' securities to meet margin calls, greatly mitigating liquidity risk in a stress scenario, in our view.

Our rating on Interactive Brokers, IBG's U.S. broker-dealer subsidiary, is at the same level as the 'bbb+' group credit profile because it is an operating company. Our issuer credit rating on IBG is one notch lower than the group credit profile, reflecting the entity's structural subordination as a nonoperating holding company for regulated subsidiaries.

Outlook

The positive outlook on IBG reflects the shrinkage in its market-making business and the related market and operational risk, as well as the continued growth of its less-confidence-sensitive retail clients, which we believe, if continued, could improve its business and financial stability. This also reflects the fact that IBG's business and profitability have been less affected by COVID-19-related market and economic stress, and more of its competitors moving to zero commission pricing than we expected. We forecast that the firm will maintain its risk-adjusted capital (RAC) ratio well above 25%, gross stable funding ratio (GSFR) above 110% and solid liquidity, including a coverage metric typically above 90%.

Over the next 12-24 months, we could raise the ratings if:

- Profitability remains very strong;
- IBG's portion of more-stable and less-confidence-sensitive retail and financial adviser clients grows to provide improved diversification and stability;
- The DOJ inquiry is resolved and the company establishes a strong regulatory compliance track record;
- It remains committed to holding very strong levels of capital and successfully manages its margin loan exposures with minimal losses; and
- Options market-making risk runs down materially.

Downside scenario

Over the same time horizon, we could revise the outlook to stable if we expect the firm's RAC ratio to weaken to below 20%, or if its business displays less stability or higher risk or losses, or liquidity deteriorates.

Ratings Score Snapshot

Issuer credit rating (ICR)	BBB/Positive/--
Interactive brokers LLC ICR	BBB+/Positive/A-2
GCP	bbb+
Anchor	bbb-
Business position	Adequate (0)
Capital and earnings	Very strong (+2)
Risk position	Adequate (0)

Funding and liquidity	Adequate/Adequate-high (0)
Comparable ratings adjustment	0
External influence;	-1
Government influence	0
Group influence	-1
Rating above the sovereign	0

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
IBG LLC Issuer Credit Rating	BBB/Positive/--	BBB/Stable/--
Interactive Brokers LLC Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2

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