Interactive Brokers Group's (IBKR)

Q2 2017 Results - Earnings Call Transcript

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Executives

Thomas Peterffy - Chairman and CEO

Paul J. Brody - CFO

Nancy Stuebe - Director, IR

Analysts

Christopher Allen - Rosenblatt Securities

Conor Fitzgerald - Goldman Sachs

Avi Fruchter – Anavon Capital

Christopher Harris - Wells Fargo Securities

Doug Mewhirter - SunTrust Robinson Humphrey

Robert Newell - Meritage Group

Richard Repetto - Sandler O'Neill

Kyle Voigt - Keefe, Bruyette, & Woods

Operator

Good day, ladies and gentlemen, and welcome to the Interactive Brokers Group Second Quarter Financial Results Conference Call. (Operator Instructions)

I would now like to introduce your host for today's program, Nancy Stuebe, Director of Investor Relations. Please go ahead.

Nancy Stuebe

Thank you, operator, and welcome, everyone, to our second quarter earnings call. Our earnings were released today after the market close and are also available on our website.

Our speakers today are Thomas Peterffy, our Chairman and CEO; and Paul Brody, our group CFO. They will start the call with some prepared remarks about the quarter, and then will take your questions.

As a reminder, today's call may include forward-looking statements, which represent the company's belief regarding future events, which by their nature are not certain and are outside of the company's control.

Our actual results and financial condition may differ, possibly materially, from what is indicated in these forward-looking statements. We ask that you refer to the disclaimers in our press release. You should also review a description of risk factors contained in our financial reports filed with the SEC.

I'd now like to turn the call over to Thomas Peterffy. Thomas?

Thomas Peterffy

Good afternoon, everyone, and thank you for joining us to review our 2017 second quarter performance.

In this quarter, we have again set new records for our brokerage business. In May, we exceeded $100 billion of customer equity for the first time and finished the quarter with $104.8 billion, up 42% from last year. We also hit all-time highs in both customer accounts, up 20%, to over 427,000, and in margin lending with $22.7 billion outstanding, up 51% from the year ago quarter.

Our growth and momentum continue to increase. And as we have said in the past, we think we can do even better growing new accounts, although recent asset growth rates will be hard to match.

Market volatility remains at historic lows, and this impacts the entire brokerage industry, especially Interactive Brokers, because our more frequently-trading clients find more opportunities in a moving market and less in a stationary one.

The average VIX for the second quarter was 11.45, which was down 27% from last year and was down even versus a weak first quarter. There are many theories about the cause of this, and I have offered my own theory, but for now, the low volatility continues, and we must work with it.

We did see encouraging signs with improved customer trading levels as the quarter progressed. Despite the drop in the VIX, our DARTs rose 3% versus last year. This meant positive results on the revenue side in our brokerage business. We have 2 sources of revenues, commissions and net interest.

Our commission revenue this quarter was ahead of last year's. New customers recognize the value of our platform and our superior price execution. This has led to strength in all of our customer segments, especially in hedge funds and introducing brokers.

We have seen throughout the quarter an improving trend in commissions overall as our customers traded more as the quarter went on.

Nevertheless, the rising commission revenue did not keep pace with the rise of client accounts or assets. Far from it. But at least in the course of this past quarter, the opposing trends - decreasing volatility on the one hand, and increasing customer accounts on the other - have come into balance, and begun to turn in our favor.

I'm confident that volatility is currently so low, at least on a historical perspective, it is difficult to imagine that it would go any lower while our client accounts are continuing to increase at an accelerated rate, portending increasing commission income.

On the interest income side, we continue to attract customers who want to borrow money at our very low margin rates, which - while they are the lowest in the industry- are still quite profitable for us, while also receiving interest on their cash. We pay more to lenders and charge less to borrowers than anyone we know in the banking or brokerage industry. This has helped our interest income grow to about 44% of our brokerage net revenues, and income from interest rose up 25% from last year.

The Federal Reserve has raised interest rates 3 times since early December. These increases continue to have positive impacts on our results, despite the fact that we have been rebating back to our customers, on the qualified cash in their accounts, 100% of these rate increases since the Fed funds first rose above 50 basis points in December.

But here, again, given rising interest rates and increasing cash balances, our shareholders could have expected a greater increase in reported interest income. Why did that not happen? When the Fed raises the Fed fund target rate, we adjust our benchmark the following day. Thus, interest we pay to our account holders rises by the full amount immediately, as do our margin rates, but our Treasury portfolio takes about 4 months to catch up.

We invest further out on the yield curve because nearby Treasuries trade at substantially lower rates than Fed funds. You have to go out all the way to next February to find the bill that yields even with the current rate of 1.16% while we know fully well that an additional quarter-percent rate rise will almost surely occur before that.

So we either invest short term, and pay out everything we earn or possibly even more, or we go out on the yield curve and take the risk of further rate rises.

We are trying to dance in between. As for the market maker, we continue to wind the bulk of this business down. In connection with this, we had to take a write down of $21.3 million on the ISE and Amex specialist seats that have become worthless. Without this write-off, the market maker, which we keep running at a reduced capacity, would have roughly broken even for the quarter.

We remain on track to complete the transfer of the majority of this business to Two Sigma by September of this year. We will say more on this at that time.

As we focus all of our attention and energy on our brokerage business, we have been fortunate that we could bring the resources of talented engineers and developers to the broker from the market maker. Historically, our biggest bottleneck has been, and continues to be, finding sufficient numbers of talented developers to program all the ambitious projects we have for the Interactive Brokers platform.

But by making the decision to wind down our market maker, we receive the benefit of immediately being able to put these developers, who know our systems well, to work on projects which will help us to build out, advance and improve our brokerage platform.

Our pretax profit for the quarter was $204 million. Subtracting $29 million for this quarter's favorable currency impact leaves $175 million. Of this amount, $198 million was generated by Brokerage as the Market Maker lost $24 million, which includes the aforementioned write-off, with the small remainder in Corporate.

I will now give you some statistics on how our brokerage business is evolving across different customer types and different geographic segments.

In our customer segments, we saw very strong growth in both accounts and client equity. Our most lucrative accounts continue to be hedge funds and proprietary trading groups, and they continue to migrate to our platform. These customers understand and appreciate the quality of our executions, our order routing algorithms, and the fact that we do not sell our order flow, that we pay interest on idle cash and short proceeds and option margins, we post at the exchanges on their behalf -- well, we post at the Options Clearing Corporation on their behalf, and that we provide them with margin financing at very low rates.

For the second quarter, hedge funds and proprietary trading trends were 4% of our accounts, 22% of our client equity and 26% of our commissions.

Individuals represent 55% of our accounts, 36% of customer equity and 51% of commissions.

Last quarter, you may have seen some of our competitors lowering their rates to capture more individual customers. However, despite these pricing cuts, client equity from individual customer segment grew over 34% in the second quarter versus last year.

What we have found is that when these individuals come to us, it is not only our pricing that attracts them. As people become more aware of the practice of brokers selling their customer orders to high-frequency traders, a practice that gets investors lower prices on their sell orders and forces them to pay higher prices on their buys, they are increasingly attracted to our platform that tries to find a matching order well within the NBBO.

Registered Investment Adviser and Introducing Brokers are the other 2 segments of our customers. These customers represent 19% and 22% of our customer accounts, 25% and 18% of our customer equity, and 17% and 6% of our commission income, respectively.

It was less than a year ago that we launched our Greenwich Compliance group, a new affiliate that assists RIAs with their legal and regulatory needs, and helps them set up their own businesses using our platform. Greenwich Compliance can walk a new adviser through the process of setting up his own business. It can also help existing registered investment advisers by showing them how to use the many tools our platform has to grow and improve their businesses.

Since its launch, Greenwich Compliance has fielded hundreds of inquiries and worked successfully with many advisers to set them up with us. We continue to carefully grow this affiliate as it drives more adviser business to us.

The Introducing Broker segment continues to benefit from the increasing regulatory burden worldwide, as well as the rising investor class in Asia. Complying with regulations and maintaining state-of-the-art technology and regulatory capital takes up increasing amounts of a broker's time and money. Brokerage companies of all sizes seek to outsource their operating needs. They look to white label the Interactive Brokers platform for their trading, clearing and custody.

In Asia, for example, investors new to the securities markets prefer to use a local broker for investment guidance. That broker will white brand our platform so he can focus on marketing and building his business, and not on processing and compliance.

We continue to roll out new products and services. This quarter, we released our new account management system, which has been rebuilt from the ground up with an intuitive, easy-to-use interface that moves seamlessly between any desktop or mobile device. We also added a new pre-trade compliance tool to our growing suite of tools and support functions for institutional customers.

Another popular new item is the ability to log into your account using your fingerprint on your iPhone.

When the MSCI Emerging Market Index announced the adding of China A Large Cap stocks, we had an opportunity to remind everyone that we listed these stocks on our platform for some time, and they could borrow against margin-eligible assets at our best-in-class margin rates or buy Chinese Renminbi to pay for the shares of over 200 companies.

We also added ForEx options on the CNH currency.

Later this year, we will celebrate our 40th year in business with 2 very significant additions to our platform and services. During these 40 years, there have been many changes in the investment growth but never a change in our focus: to provide investors with the best tools, at the lowest cost, to achieve their best possible performance.

And now, Paul Brody will give you the numbers.

Paul Brody

Thank you, Thomas, and welcome, everyone, to the call. Thanks for joining. As usual, I'm going to review our summary results and give segment highlights, and then we'll open it up to questions.

Second quarter operating results reflected a solid performance in brokerage led by gains in both commissions and net interest income. These were further supplemented by currency translation gains, but offset by several factors related to the winding down of the options Market Making business, including lower trading gains and some one-time charges.

Without those and other nonoperating items that I will enumerate a little later, pretax income increased 10% over the prior year quarter. Volatility still remains at historic lows, and lower volatility gives rise to fewer trading opportunities. But while our clear DARTs per account fell 13%, our quarterly total DARTs were up 3% year-over-year and 2% sequentially on the strength of continued growth in our account base.

We continue to see strength this quarter in asset gathering and margin balances in brokerage, as I will describe in my comments on that segment's performance. Electronic Brokerage continues to post robust increases in a number of customer accounts and customer equity, up 20% and 42%, respectively.

Market Making contract and share volumes were down across product types as we wind down that -- this activity, and I will discuss the market maker further in my comments on that segment's performance.

Second quarter reported net revenues rose 5% against a solid quarter that featured higher volatility last year. Pretax income was down 4% for a pretax margin of 53%. Excluding investments, currency translation effects and onetime charges in Market Making, net revenues were up 7% versus last year while pretax income was up 10%, for a pretax margin of 55%.

Looking at the main factors this quarter, the continued low market volatility, the average VIX fell 27% year-over-year. To bring some historical perspective to this number, this is the lowest quarterly average VIX in the 10 years we have been tracking this measurement, and it was even lower than the previous historical low in this year's first quarter.

Actual-to-implied volatility also fell 27% from the prior year quarter and is at a near 10-year low.

Generally, a low VIX dampens trading volume, and therefore brokerage revenues. Both measures negatively impact Market Making and did nothing to make us question our decision to exit this business.

The U.S. dollar weakened versus most other major currencies. As a result, the currency basket in which we keep our equity, which we call the GLOBAL, rose 1.1% against the dollar for the quarter, resulting in a gain of $66 million. We estimate the impact for the quarter on earnings per share from the GLOBAL to be a gain of $0.14 on comprehensive earnings and $0.05 on net income.

Finally, medium-term interest rates rose again in the quarter, as the Federal Reserve continued to raise its target rate with another 25 basis point increase.

Anticipating this increase and in light of the general uncertainty over future Fed actions, we had reduced the duration of our portfolio in order to reduce our overall yield curve exposure.

As a result, mark-to-market losses on our treasury portfolio were only about $3 million. Although we plan to hold these securities to maturity, we must as brokers, unlike banks, mark them to market in our financial reporting.

I'll summarize the quarter's revenues, adjustments and pretax results as follows: The reported net revenues for the quarter were $387 million. Deducting the $29 million gain on our currency strategy and adding back the $3 million loss from marking our Treasury portfolio to market results in adjusted net revenues of $361 million for the quarter. That's an increase of 7% from adjusted net revenue of $338 million in the year ago quarter.

General and administrative expenses were impacted by $22 million of onetime charges related to the wind down of Market Making. Reported pretax income was $204 million and adjusted for these nonoperating factors, pretax income was $200 million, and that's an increase of 10% from adjusted pretax income of $182 million in the year ago quarter.

Pretax margin in the latest quarter was 53% as reported and 55% as adjusted.

Turning to the income statement line items. Commissions were $160 million, up 5% primarily driven by higher stock and options volumes. Net interest income was $155 million, up 23%. Brokerage produced $148 million and Market Making $7 million with the remainder in Corporate. While the March Federal Reserve rate hike helped us this quarter, the benefit of the second hike in mid-June will be reflected primarily in our numbers going forward.

Trading gains were $13 million, down from $34 million in the year ago quarter. Historically low volatility and the winding down of our market maker led to reduced trading levels.

Other income, which, as I described earlier, includes the effects of our currency diversification strategy and Treasury portfolio marks, was a gain of $59 million, up 4% from the prior year quarter.

Noninterest expenses were $183 million for the quarter, up 17% from the last quarter. The rise reflects primarily the $22 million in expenses in connection with winding down the market maker.

At June 30, 2017, our total headcount stood at 1,206, an increase of 3% over the year ago quarter, but a slight decline sequentially. Versus the year ago quarter, we have expanded in a few key areas, notably customer service, software development and legal and compliance, all of which support the growing brokerage business.

As the modest sequential decline shows, we have been moderating the pace of hiring as we wind down Market Making and transfer certain existing staff from Market Making to Brokerage.

Comprehensive diluted earnings per share were $0.41 for the quarter as compared to $0.36 for the second quarter of 2016. On a non-comprehensive basis, which excludes OCI, diluted earnings per share on net income were $0.32 for the quarter as compared to $0.40 for the same period in 2016. And excluding the impact of noncore items, comprehensive diluted earnings per share were $0.32 for the current quarter versus $0.36 for the year ago quarter on the same basis.

As we did last quarter, to help investors better understand our earnings, we will break out our pretax income so that you can see the split between the public shareholders and the noncontrolling interests.

Starting with income before income taxes of $204 million, we deduct $7 million for income taxes paid by our operating companies, which are predominantly foreign taxes. That leaves us with $197 million, of which 83.1% or that $164 million reported on our income statement is attributable to noncontrolling interests. The remaining 16.9% or $33 million is available to the public company stockholders.

GAAP accounting prevents us from putting this $33 million number on our income statement. After we expense the remaining taxes of $10 million owed on the $33 million, the public company's net income is the $23 million that is reported on our income statement.

The total income tax expense of $17 million consists of this $10 million plus the $7 million paid by the operating companies.

Turning to the balance sheet. As a result of the growth of our brokerage business and the withdrawal of capital from our Market Making operations through regular and special dividends, brokerage accounts for about 86% of our combined balance sheet assets from the 2 segments and 72% of the consolidated equity. Our balance sheet remains highly liquid with low leverage. As a general practice, we hold an amount of cash on hand that provides us with a buffer should we need immediately available funds for any reason. At June 30, we maintained over $4 billion in excess regulatory capital in our broker dealer companies around the world, of which about 76% is in the brokerage segment.

From an operating standpoint, about $2.7 billion of our capital is deployed in supporting customer activity, leaving an amount in excess of $3 billion to grow the business and maintain a prudent liquidity management policy.

We continue to carry no long-term debt, and our consolidated equity capital at June 30, 2017, was $6.2 billion, of which approximately $4.5 billion was held in brokerage, $1.5 billion in Market Making and the remainder in the Corporate segment.

As we have stated, once we have closed on our Market Maker transaction, we plan to redeploy this capital to our brokerage business, both to bolster the broker's financial credibility, and to take advantage of greater customer financing opportunities that the extra capital will provide.

Turning now to the segments. In Electronic Brokerage this quarter, we saw a rise in stock volume, largely driven by trading in low-priced U.S. and Hong Kong shares versus the prior year quarter, a trend that continued from the first quarter.

Customer trade volumes were higher in stocks and options and lower in futures. The year-on-year 8% drop in our futures contract volume was generally in line with reported market volume.

Foreign exchange dollar volume was also down 15% from the year ago quarter.

Commission revenue rose 5% on a product mix that featured smaller average trade sizes in options, larger in futures and substantially larger in stocks. This mix resulted in an overall average cleared commission per DART of $4 for the quarter, up 2% from the year ago quarter and flat sequentially.

Customer equity grew to $104.8 billion, exceeding the $100 billion mark for the first time, up 42% from last year and 8% sequentially. The source of this growth continues to be a strong inflow of new accounts and customer assets.

We continue to attract larger customers, along with financial advisers and introducing brokers that manage groups of smaller accounts, which results in a blend that affects both average trade size and average account equity.

Our average equity per account rose 19% year-on-year to $245,000. As our own equity grows, we are able to attract larger accounts that seek other revenue-generating services, including margin lending and short-sale support.

Margin debits rose 51% year-over-year, reaching a record level of $22.7 billion. Customers' appetite for increased risk along with our competitive rates contributed to this increase. We continue to see demand from our customers for prime financing, and we'll be opportunistic in using our capital to satisfy it. Our margin balances are diverse and secured worldwide, with readily tradable exchange-traded securities only.

Net interest income rose to $148 million, up 25% from the second quarter of 2016. The Federal Reserve's increases in the Fed funds target rate in December, March and June, together with increased customer balances, has generated more net interest income on cash balances. Our continued success in asset gathering sets the stage for larger revenue contributions from interest-sensitive asset going forward and our Stock Yield Enhancement Program, where we share revenues from lending out fully paid securities with our customers, continues to expand, providing an additional source of interest revenue on securities assets.

Our net interest margin for the quarter was 1.17%, which widened from the year ago quarter's 1.10%. The increase reflects higher margin loan interest due to larger balances as well as higher rates, plus greater income on our segregated cash, also due to higher rates, despite relatively flat balances.

These items were partially offset by the higher customer credit interest that we paid, due both to higher rates and to larger customer credit balances. We are continually looking at ways to prudently maximize our interest income. We have several initiatives in the pipeline, including a multibank FDIC sweep program and expansion of investment into more government-backed instruments, which are expected to enhance our investment yield on funds. It is early days, so we cannot comment yet on what the final size and impact of these initiatives will be, but they are expected to be additive to our net interest income.

With a growing customer asset base, we continue to believe that we are well positioned to take advantage of opportunities presented by the market. Based on current balances, we estimate that a single rise in overnight interest rates of another 25 basis points would produce an additional $30 million in net interest income for the coming year and, with the full effect of reinvestment at higher rates, an additional $35 million annually.

As we have mentioned previously, further increases in rates may have a smaller impact, because the interest we pay to our customers is pegged to benchmark rates less a narrow spread.

Execution and clearing expenses were $54 million, up 26%. Ex a fee rebate that we received in the second quarter of 2016, these expenses would have been up 19%.

Fixed expenses in brokerage were $81 million, up 11% over the year ago quarter and up 3% sequentially. The primary component of this increase was the cost of migrating software developers from Market Making to brokerage in line with our earlier estimates.

Customer bad debt expense was again about $1 million this quarter, and our Risk Committee continually enhances our scenario-based risk models in order to reduce exposures to world events.

Pretax income from Electronic Brokerage was $198 million, up 4% despite lower volatility than in the prior year's quarter.

Reported pretax margin was 59% and adjusting for Treasury marks, core pretax income was $201 million, up 14% from last year, for a 60% pretax margin.

In Market Making, we announced in March that we would be discontinuing options market making, which represents the bulk of our Market Making activities. We began to pull back after that time, and the market maker results reflect this and will continue to reflect this until our transaction closes.

Market Making trade volume declined year-over-year across all product types. Options and futures contract volumes fell 74% and 62%, respectively. While stock share volume was down 51%, resulting from our own scale-back efforts.

Trading gains from Market Making in the second quarter were $13 million, down from a $34 million in the year ago quarter. Our pull back, together with unfavorable market volatility measures, contributed to this result.

Pretax income was a loss of $24 million in the quarter, down from pretax income of $5 million in the year ago quarter. And the primary reason was the $22 million charge, which represents the bulk of the $25 million of expected onetime expenses, that we announced on our first quarter call, to wind down this business.

On the cost side, execution and clearing fees expenses were down 44% on lower trading volumes. Fixed expenses increased to $38 million, up 73% from the year ago quarter. But adjusting for the onetime exit charges, fixed expenses were $16 million, down 27%.

Regarding the Market Maker wind down, the estimates we gave last quarter remain unchanged. We still estimate that the onetime cost to wind down options Market Making activities to be $25 million. We recognized less than $1 million in the first quarter, and now $22 million in the second quarter, and we expect to recognize the remainder in the third quarter.

We also expect the wind down to be complete by the end of the year, and that continuing certain market making operations outside the U.S. for some period of time may significantly defray these costs. We also intend to continue certain trading activities in stocks and related instruments that facilitate customer trading in products like ETFs, ADRs and CFDs.

Excluding any income from these facilitation activities, we still expect our brokerage operations to absorb approximately $39 million of expenses annually going forward, or about $0.07 impact on earnings per share. These consist of primarily personnel costs and certain technology infrastructure costs. We expect our brokerage business to benefit from additional software development resources, and these personnel transfers should also contribute to the slowdown in hiring, as we are seeing in our headcount numbers, for some period of time.

Finally, in Corporate. The earnings reported for the Corporate segment reflect the effects of our currency diversification strategy. Our overall equity as measured in U.S. dollars was increased by the weakening of the U.S. dollar against most other major currencies. We estimate the overall gain from our strategy of carrying our equity in proportion to the GLOBAL to be about $66 million for the second quarter of 2017.

In the income statement, $37 million of the GLOBAL gain is reported as Other Comprehensive Income, leaving a gain of $29 million to be included in reported earnings.

And as we disclosed in our March 8 press release, effective starting with the second quarter, we changed the composition of the GLOBAL to reflect the shift in our business toward Electronic Brokerage.

And now, we'll turn the call over to the moderator, and we will take questions.

Question-and-Answer Session

Operator

(Operator Instructions) Our first question comes from the line of Kyle Voigt from KBW.

Kyle Voigt

Paul, just on the FDIC sweep program, I'm just wondering if it's still on track to be rolled out in the third quarter. And then, just, is there any update on how much of the cash balances would be eligible for that program?

Paul Brody

Right. It is on track to be rolled out in the third quarter. We're at the very final stages of determining the parameters for the program. And so I can't give you figures on how much will flow into the program. But I can tell you that looking at the indicated bank rates will -- the amount that flows in the program will earn a somewhat higher rate than our average investment rate is right now.

Kyle Voigt

Okay. And then sorry if I missed the second program that you mentioned, but is it just investing in different securities than what you invest in now for the securities portfolio or...

Paul Brody

Yes.

Kyle Voigt

Did you -- is there any color on what different securities you'd be investing in or...

Thomas Peterffy

Government securities. Government.

Paul Brody

Right. Government securities that are not Treasuries, but that are permitted by the SEC as eligible investments by U.S. broker dealers.

Kyle Voigt

Okay, fair. And then one last for me is really on expenses. I think the brokerage noninterest expenses were up 15% in the first half of the year. Just wondering if you could give us some commentary on kind of core brokerage expenses for the back half of the year, I guess excluding the expenses you anticipate coming over from the Market Maker?

Paul Brody

Well, as I said, the original indication of the additional $39 million is still our best estimate. So -- and that will happen over this coming period of time. In other words, we're still on roughly our time line and our -- the amount estimated. There are no surprises.

Kyle Voigt

Sorry. Just -- this is -- my question, I guess, was in reference to the Electronic Brokerage segment. Just the core -- the noninterest expenses there were up 15% year-over-year. Just trying to get a sense of -- as to the trajectory of that going forward.

Paul Brody

So the fixed expenses were up in brokerage 11% year-over-year and -- are you asking for what we think the run rate will be? Because the migration of resources has not been completed, but we estimated that it would be completed over the remainder of this year and that the result of that would be approximately an extra $39 million in annual operating expenses absorbed in brokerage.

Operator

Our next question comes from the line of Rich Repetto from Sandler O'Neill.

Rich Repetto

Just a follow-up on the last question. Could you tell us, Paul, how many -- how much of the $39 million of expenses we might -- the e-broker might have absorbed in this quarter?

Paul Brody

I don't have the specific numbers.

Thomas Peterffy

But It's roughly even. So it's $10 million per quarter, right?

Paul Brody

Probably.

Rich Repetto

Okay. And that's the run rate with the -- but it wasn't all absorbed in this quarter? That's what the run rate will be going forward? When you hit the $39 million, it's $10 million per quarter. Okay. That's okay. I'll move on here. So you had $13 million of trading gains in the quarter. I know on last quarter, it still was not clear, I guess, what the -- I think, what the market maker was going to look like going forward. Are the trading gains of $13 million sort of representative of what the Market Maker will generate going forward given this climate, I guess, right now and where you're operating?

Thomas Peterffy

That's very hard to guess at. You mean before expenses?

Rich Repetto

Yes, just the...

Thomas Peterffy

Yes. I mean, so we generally expect whatever the leftover operations will be, somewhere between $0 and $5 million a quarter.

Rich Repetto

Okay. So it's not going to be -- right, okay, that answers my question.

Thomas Peterffy

It's not going to be a significant amount. As we said, we're maintaining those operations mostly because we would like to be able to facilitate customer trades in CFDs and the creation and destruction of ETFs and ADRs and that sort of thing.

Rich Repetto

Got it. Okay. And then, Paul, you talked about excess capital here and you said the $2.7 billion facilitated customer -- the customer. So I guess we're finally getting around, is it -- I know you can increase your lending with extra capital, but to actually current facilitation or coverage of capital requirements for customers, you have $3 billion in excess. Is that sort of the way to interpret it?

Paul Brody

The $3 billion would include capital freed up from Market Making as it becomes freed up, right? Currently, the equity in brokerage is about $4.5 billion. So if you take away the $2.7 billion, you got about $1.8 billion left, let's say. But understand that's -- you really have to maintain that, because the amount tied up, the $2.7 billion can go up by way of regulations, by way of lots of factors. Most of it is regulatory driven. Therefore, both from a "rainy day" aspect, from a liquidity management aspect and from an opportunistic aspect -as in we can provide more financing into higher-level customers and so forth the more house capital we have - for all of those reasons, it's not as much excess as it would seem, which is why I talked about it this time.

Rich Repetto

See, I -- when you look at -- and I understand the opportunity to lend more to customers and increase your margin lending. But you look at other brokers and maybe it's different because of the international. But they roughly carry 10% somewhere in margin loans, that would put your capital at -- in the $2-point-whatever-4 billion. So it does seem like a reasonable number that you gave, I guess. Because as you move all this other capital, the broker should be worth something more given all the excess capital or given the additional capital that sits there, I guess. Anyway, just a comment. Okay, that's all I had.

Operator

Our next question comes from the line of Chris Harris from Wells Fargo.

Chris Harris

A question on the trading environment. It seems like volatility is a major swing factor for your customers in regards to how active they are. And just wondering whether you guys think there's other drivers or secular factors that could really move trading activity higher. Just to give you some example, some of your peers talk about accelerating growth in mobile trading as a secular driver. They talk about increased adoption of derivatives as a secular driver. It just doesn't seem like you guys are benefiting from those types of trends. I know it's a different customer, but if you can comment a little bit on that, that would be great.

Thomas Peterffy

Well, the greatest factor that will influence our trading volume will be the ever-increasing customer base. So the fact is that we are growing incredibly fast, and that growth is increasing. It's not moderating. So if we go on like this, it's -- and keep growing at an increasing rate, the trading volume will be enormous. So any of these little trends like more mobile trading or -- mobile trading has been around for 10 years -- I think that will all be dwarfed by our increasing customer base.

Chris Harris

Okay. It sounds like the Introducing Broker segment is driving a ton of a growth, and correct me if that's a mischaracterization.

Thomas Peterffy

No, that is correct.

Chris Harris

Okay. Have you guys look at what the account growth has been excluding -- hat segment? Would you still say it's high-single-digit percent-type growth?

Thomas Peterffy

Well, I -- so if you look at the 20% total accounts, the I-Brokers grew at 48%; advisers, 15%; prop traders, 10%, hedge fund, 17%; individuals, 13%. So that looks like it's roughly, we'd say, about 13% on the average without the I-Brokers.

Chris Harris

Okay. So that's still very high growth, okay. And then last question. Again, this might be a little difficult to answer, but it sounds like you guys have a little bit more of a delayed rate benefit here because of the amount you have invested in the...

Thomas Peterffy

That's right.

Chris Harris

In the Treasury securities, yes. If you guys had to reprice your entire book today, if you were able to do that, any idea how much incremental revenue that would accrue to you guys in the net interest category?

Thomas Peterffy

Well, that was -- I think that equals the $3 million -- the mark-to-market loss, right?

Paul Brody

I think you're referring more to a run rate. So our asset sensitivity analysis, as I alluded to when I spoke, shows roughly $35 million extra a year, assuming that Treasuries roll off and are reinvested at more current rates.

Operator

Our next question comes from the line of Conor Fitzgerald from Goldman Sachs.

Conor Fitzgerald

Maybe just a follow-up on Rich's question. Once the Market Maker is sold, is a fair way to think about the expense run rate as $146 million so the $136 million, the electronic broker you saw this quarter plus a $10 million of these expenses that come over, just using this quarter as an example.

Paul Brody

That might be about right.

Conor Fitzgerald

That's helpful. And then some of the core expense growth you're seeing just in the electronic broker, just wondering kind of, (1) I guess, what you've been investing in; and then (2) where you are in the pace of those investments and how long we should kind of expect the -- I guess the nonvariable expense rate at low double digits to persist?

Thomas Peterffy

Well, I think we are investing as much as we can, not because we have limited funds, but we just -- we want to be able to manage what we build, well. And so we have a capacity restraint in development, not -- and not monetary restraint. In other words, I would be happy to spend another $1 billion if I could buy more technology for it. But I don't want to spend it the way companies normally do in this business where they go out and buy $1 billion worth of customer software and then 3 years later, when it's delivered, it doesn't work and they have to throw it out. That – you've probably heard that that happens a lot. So we are spending as much money as we can manage. I don't know if that makes sense to you.

Conor Fitzgerald

No, that makes sense. And then just a cleanup question, Paul. I think so the other revenue, excluding the impact of the currency move and the Treasury mark-to-market, was that $33 million for the quarter? Do I have that math right?

Paul Brody

Right. The other revenue excluding the Treasury?

Conor Fitzgerald

And the currency moves.

Paul Brody

Probably a little higher than that. So it's a total of $58 million less $29 million from currency and $3 million the other way. Yes, you are in the ballpark. Yes.

Conor Fitzgerald

Okay. And then just any -- it's a little higher than, I think, you've done historically. Just any color there on what drove the strength.

Paul Brody

The rest of other income is all the usual contributors. None of them are big standouts or changes but include things like market data fees and exposure fees and account activity fees and -- all of which contributed to the rest. They tend to be relatively stable.

Operator

Our next question comes from the line of Avi Fruchter of Anavon Capital.

Avi Fruchter

Actually, it's been asked in a way but I wanted to follow up on the brokerage net interest, if I may. The -- so you've had net interest margin up 7 basis points year-on-year and all the metrics up in the 40s, client equity up 42%, margin loans up 45%, and interest income up just 25%. It's a great number, but it's a lot slower than if you run these numbers. So where is the offset given that the net interest margin was still up? And I understand that there's a lag because the money sits in Treasuries that roll over 4 months. I just wanted to confirm what you said about the numbers, I understood correctly, which is you said that if -- on an underlying basis, if all the Treasuries roll today, you would have had $35 million more income on top of the 25%, so something like $180 million, $182 million on a quarterly run rate basis. Is that correct?

Paul Brody

Yes. And understand that the Treasuries rolling over is only a portion of what's invested in terms of segregated funds. And then to your comment, I think, about the net interest margin increase, it's -- that's a number that results from a number of underlying components, right? I mean, we do publish a table on the 10-Q, and that will be coming up, and that includes the improvement in yields on the segregated cash but also, of course, customer margin loans, and then offset by additional amounts paid on customer credit balances. So this sort of confluence of all of those things leads to that increase in the overall net interest margin.

Avi Fruchter

Right. I would have thought that the overall net interest margin goes up, that means the amount you earned on all those factors is higher than it did -- than it was last time, like in aggregate. And given all those factors comprehensively higher, more than 25% higher, and I would have thought the interest income would have also been more than 25% higher. I guess...

Paul Brody

I'm not sure you can confer one from the other necessarily.

Avi Fruchter

I'll look at that when the Q comes out. But just to confirm: the underlying net interest income sort of if everything is the same 4 months from now, right, if there's no growth in the business, everything is steady, then the quarterly number then should be like $180 million, $182 million net interest income. Is that the right math?

Paul Brody

Yes. What I was referring to is the fact that these underlying components change at different rates. So the balances change, and also the spreads change. And it's the interaction of how they all change together that leads to the one net interest margin number. So it's not necessarily -- it's a number everybody likes to see, a single number, but you'll learn a whole lot more from looking at the breakdown of the components.

Avi Fruchter

Right, right. No, but I was talking more about the rate increase and asset increase impact, so not the net interest margin. So the calculation that you made that you said if the Treasuries roll -- when the Treasuries roll, total net interest income will be $35 million higher than what was recorded this quarter sort of all else being equal. So that's how I got to the $180 million number.

Paul Brody

Well, the $35 million is the result of an assumption about a benchmark increase of 25 basis points, and that affects everything. It affects interest that we earn on margin balances, interest that we pay on credit balances and then it has assumptions built in about the rollover rate on treasuries.

Avi Fruchter

That's an increase that you're talking retrospectively, right, about the interest margin, that the interest -- the rate increase has already happened. So that is a fact.

Paul Brody

Maybe I would suggest that when they -- when our numbers come out, when the table is published that you compare it to the first quarter table. And I think you'll learn everything that you're asking for. And if not, by all means, please ask to explain it further at that time.

Avi Fruchter

And then -- just one quick one on the Market Maker and the reporting of it. Will you put it in discontinued ops at some point because you're selling it anyway? Or are you continuing to report it going forward until everything is set?

Paul Brody

So we have to follow GAAP requirements, obviously, in all of our reporting. There are some specific guidelines by which you have to determine when something is a discontinued operation. At the moment, as we described, the transaction is set to take place. However, at least in the first part, that's for the U.S. options Market Making operations only. As we have said, certain of the foreign operations, we are likely to continue for some period of time in order to defray the cost of the wind down, because they're small but they are profitable. And so it will be the interplay between that and whatever GAAP says about when something stops being reportable as a separate segment. At some point, we would expect that it will stop being reported.

Operator

(Operator Instructions) Our next question comes from the line of Rob Newell from Meritage Group.

Rob Newell

I have 2 -- well, okay, first question is on customer cash. Can you quantify the structural reasons why customers seem to hold more cash than at other brokerages? So for example, holding cash against futures positions? Or is it likely that credit balances as a percentage of equity will move towards the industry average as you guys continue to grow?

Paul Brody

Well, we pay much higher interest. If that's not reason alone, I'm not sure what else is. I mean, if they put their money in -- we pay more than they would get if they put their money at the bank.

Rob Newell

That's true. And you think that, that explains -- I mean, at other brokerages, I think it can range between 10% and 18%. You guys see something like in the 40s. You would attribute that almost exclusively to the higher interest rate that you pay?

Paul Brody

I think we'd certainly think so. I'm not sure what other factors there might be.

Rob Newell

Okay. I don't know if we have time for another, but do you have a view on how trades per account will evolve going forward?

Thomas Peterffy

On trades per account, we will continue to diminish but at a slower rate.

Rob Newell

Okay, understood. So if it's like -- I think it's been like a minus 5% CAGR, kind of, since 2010, still trending down bust just not quite at that same rate?

Thomas Peterffy

Right.

Operator

Our next question comes from the line of Chris Allen from Rosenblatt.

Chris Allen

I think most has been covered. Just any commentary on execution and clearing fees a bit higher than what I've expected given the pullback in Market Making. And then when you look at it within the brokerage business relative to DARTs, it seems like it's trending up. I'm wondering if there's just a mix issue there.

Thomas Peterffy

Well, it's partly...

Paul Brody

Go ahead, Thomas.

Thomas Peterffy

It's partly the mix issue but also, some of the exchange expenses have gone up because exchanges are finding -- ever -- always finding more and new ways to get some more money out of the members.

Operator

Our next question comes from the line of Doug Mewhirter from SunTrust.

Doug Mewhirter

Just really quick. Just a follow-up actually on the clearing costs, right. Did -- Paul, did I -- did you break out -- or is there a way to get the clearing expenses that are just associated with the Market Making group or the brokerage group, one or the other?

Paul Brody

So that's interesting because, I guess we don't reach that level of granularity in the breakdown, right? We just said noninterest, but I think we publish that in the Q if I'm not mistaken, and we talk about it in the MD&A. It -- certainly, the bulk of it is brokerage. It went up in brokerage and down in Market Making, as we described, along the lines of the volume.

Operator

Our final question is a follow-up from the line of Rich Repetto from Sandler O'Neill.

Rich Repetto

Just last quick question is, the margin loan balances are growing at 51% year-over-year and I know you've got the best rates, lowest rates, to borrow and best rates to earn on cash. But I guess the question, Thomas, is what -- whose -- which segment is driving the big margin loan growth, the 51% year-over-year growth?

Thomas Peterffy

Do you mean which segment...

Rich Repetto

Yes.

Thomas Peterffy

Okay. Well, we never broke that out. So I -- well, here, I'm guessing, right. I'm guessing.

Rich Repetto

Yes, just subjectively, I guess, where you think it's coming from.

Thomas Peterffy

I'm guessing that hedge funds are the bulk of it, and individuals come second, and financial advisers and I-Brokers do very little, and prop traders, too. Prop -- so it's hedge funds, prop traders and individuals, in that order, yes.

Operator

This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Nancy Stuebe for any further remarks.

Nancy Stuebe

Thank you, everyone, for participating today. And as a reminder, this call will be available for replay on our website, and we will also be posting a clean version of our transcript on our site tomorrow. Thank you again. We will talk to you next quarter end.

Operator

Thank you.

Thomas Peterffy

Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.