

Research Update:

IBG LLC Rating Raised To 'BBB+' On Strengthening Franchise, Strong Profitability, Lower Risks; Outlook Revised To Stable

April 26, 2022

Overview

- Despite the industry's switch to zero commissions and an extended period of low interest rates, IBG has successfully maintained strong profitability and strengthened its franchise in the U.S and abroad, while maintaining capital ratios that are materially higher than peers.
- We think the wind-down of most of the company's options market-making activities has lowered risks.
- We raised our long-term rating on the parent company IBG LLC to 'BBB+' from 'BBB' and its subsidiary Interactive Brokers LLC to 'A-' from 'BBB+'.
- The stable outlook reflects our expectation that the company will continue to solidify its market position with focus on the less confidence-sensitive retail segment, ably manage competitive price pressures, maintain its risk-adjusted capital (RAC) ratio well above 25%, a gross stable funding ratio (GSFR) above 110%, and solid liquidity.

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Rating Action

On April 26, 2022, S&P Global Ratings raised its issuer credit rating on IBG LLC to 'BBB+' from 'BBB' and on Interactive Brokers LLC to 'A-' from 'BBB+'. At the same time, we affirmed the 'A-2' short-term rating on Interactive Brokers LLC. The outlook on both entities is stable.

Rationale

Our ratings upgrade of IBG and its subsidiary, Interactive Brokers, incorporate our view of their solid and strengthening market position with low confidence-sensitive retail clients, very strong capitalization, very good profitability, adequate funding and liquidity, and reduced risks following the wind-down of most options market-making activities. We think these factors act as rating strengths compared with similarly rated peers. We believe the highly competitive and

transactional nature of its businesses, as well as the confidence-sensitive nature of institutional trading clients, at least partly offset these strengths.

IBG's market position benefits from its technology-enabled, low-cost provider status, which supports unique, low-cost, and high-functionality offerings, providing its clients with the capacity to trade in more than 150 exchanges and 25 currencies. IBG LLC is a holding company that, through its regulated broker-dealer subsidiaries, is a major global electronic broker serving both retail and institutional clients. IBG has consolidated its franchise since the inception of the pandemic by more than doubling the number of clients since January 2020 and adding 132,000 new clients in first-quarter 2022 alone. IBG continues to grow its retail, financial adviser, and introducing brokers clientele (they represented in aggregate 84% of client equity and 82% of commissions in 2021), which we view as low confidence-sensitive clients. It is rapidly expanding in Asia and Europe, where customers mostly use IBG to trade U.S stocks (and equity derivatives) and international customers represent now close to 75% of total clients. While the company has been the leader in daily average transactions, it remains substantially smaller than its main retail peers in terms of total client assets, with \$355.9 billion as of March 2022. Unlike peers, IBG has institutional trading clients (about 16% of client equity and 18% of commissions), which we view as more confidence-sensitive.

With a high 67% profit margin in 2021 despite close-to-zero interest rates, IBG has successfully navigated the "zero commission" trend that has hit the industry since November 2019. We think IBG's bifurcated pricing strategy for its customers has contributed to its success. Unlike its competitors that have entirely switched to a zero commission offering on cash equity and ETFs (resulting in lower profitability), IBG differentiates itself by offering customers both a traditional low commission (but not zero) pricing option (IBKR Pro), as well as a zero commission option (IBKR Lite). For clients who choose the IBKR Pro offering, IBG directly clears and executes client's transactions without selling order flows to wholesale trading firms. By contrast, IBKR Lite generates revenue from payment for order flows and also from higher margin rates and lower deposit rates that, in part, offset the zero commission. Since most clients choose IBKR Pro, we think the company is potentially less exposed to risks related to payment for order flows--an area that is under U.S. regulatory scrutiny, in contrast with peers.

We expect the company to incrementally benefit from the upward trajectory in interest rates.

IBG remains reliant on market-sensitive revenues. The prolonged decline in short-term interest rates, coupled with the increase in trading activity decreased the contribution of net interest income to about 42% in 2021 from 56% in 2019. Future interest rate hikes by the Federal Reserve should support IBG's profitability. The company estimates the first 50 basis points (bps) rise could add about \$289 million of net revenues to the bottom line in the first full year. Additional hikes after 50 bps, though, should translate into lower incremental revenues (about \$50 million for each hike of 25 bps), notably because the company intends to pass through the integrality of future raises to most U.S. customers (through higher interest on brokerage cash balances of more than \$10,000).

Our ratings upgrade also considers that at 39.7% as of end-year 2021, our RAC ratio was the highest among the U.S. securities firms we rate, reflecting IBG's commitment to strong capitalization and limited payout (28.7% in 2021). IBG added about \$1.2 billion of additional equity in 2021 (and an additional \$260 million in first-quarter 2022). The company operates with over \$7 billion of excess capital over minimum regulatory requirements at regulated subsidiaries.

We think risks have subsided following the wind-down of most options market-making operations, except in India and Hong Kong. Securities on the balance sheet were down to a small \$577 million at the end of March 2022 (of which only \$31 million of derivatives receivables related to options), against a balance sheet of about \$114 billion. Counterparty risk exposure to Russian financial institutions was negligible as March 31, 2022. Nevertheless, the company incurs credit and market risk related to its large clients' margin loan book (\$48.3 billion as of March 31, 2022) or related to clients' derivatives trading on the main exchanges worldwide. Although we regard these risks as well monitored, we note that clients' derivatives activity caused IBG to indemnify \$104 million of clients' losses in April 2020 related to an IBG system issue that prevented clients from seeing or acting on negative prices in West Texas Intermediate (WTI) futures.

We view IBG's funding and liquidity as neutral to the rating given its very liquid balance sheet, absence of long-term debt, and a 137% gross stable funding ratio. While most of IBG's clients are more stable retail customers, we think its institutional customers (such as hedge funds) expose it to more customer confidence-sensitivity than purely retail peers given the company's reliance on client balances to support client activity.

Outlook

The stable outlook reflects our expectation that IBG will solidify its market position with a focus on the less confidence-sensitive retail segment, ably manage competitive price pressures, and maintain strong profitability. We also expect it will maintain its RAC ratio well above 25%, GSFR above 110%, and solid liquidity.

Downside scenario

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

- Profitability eroded substantially;
- The firm suffered material losses or an increase in risk;
- Its commitment to strong capitalization unexpectedly erodes; or
- Liquidity deteriorates.

Upside scenario

We see little upside to the ratings over the outlook horizon given peer relativities.

Ratings Score Snapshot

| | To: | From: |
|----------------------|--------------|--------------|
| Issuer Credit Rating | BBB+/Stable | BBB/Positive |
| GCP | a- | bbb+ |
| Anchor | bbb- | bbb- |
| Business Position | Adequate (0) | Adequate (0) |

| | To: | From: |
|-----------------------------|-----------------------|-----------------------|
| Capital and Earnings | Very Strong (+2) | Very Strong (+2) |
| Risk Position | Adequate (0) | Adequate (0) |
| Funding and Liquidity | Adequate/adequate (0) | Adequate/adequate (0) |
| Comparable Ratings Analysis | +1 | 0 |
| Support: | -1 | -1 |
| GRE Support | 0 | 0 |
| Group Support | -1 | -1 |
| Sovereign Support | 0 | 0 |
| Additional Factors | 0 | 0 |

Related Criteria

- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; CreditWatch/Outlook Action

| | To | From |
|----------------------|----------------|-----------------|
| IBG LLC | | |
| Issuer Credit Rating | BBB+/Stable/-- | BBB/Positive/-- |

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

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

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