Interactive Brokers Group's (IBKR)

Q1 2017 Results - Earnings Call Transcript

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Executives

Thomas Peterffy - Chairman and CEO

Paul Brody – CFO

Nancy Stuebe - Director, IR

Analysts

Richard Repetto - Sandler O'Neill

Conor Fitzgerald - Goldman Sachs

Mac Sykes - Gabelli

Doug Mewhirter - SunTrust

Chris Harris - Wells Fargo

Rob Koehn - Ivy Lane Capital

Kyle Voigt - KBW

Michael Trica - Oakum Bay Capital

Operator

Good day, ladies and gentlemen. And welcome to the Interactive Brokers Group First Quarter Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, today's program maybe recorded.

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 first quarter earnings call. Our earnings were released today after the market closed 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 we will take your questions.

As a reminder, today's call may include forward-looking statements which represent the Company's beliefs 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 Peterffy

Good afternoon everyone, and thank you for joining us to review our 2017 first quarter performance. This quarter we made the difficult decision to wind down our options market making operations. Timber Hill is widely known in the industry as the pioneer of electronic trading. Starting in 1977, we built technology for market making that in subsequent years was adopted by everyone who remained in the industry as exchanges moved from open outcry to the electronic method.

This technology also became the foundation for our brokerage business, giving us the technological edge and a deep knowledge of international exchanges and markets that strengthens and drives our electronic broker today.

Recently, we have come to the conclusion that, in a low volatility environment that may go on indefinitely, it is difficult to earn a profit as a market maker without substantial order flow to interact with. Interestingly, that was the very same reasoning that drove us in the early 90s to expand our market making systems to providing brokerage services in the first place.

At that time, we saw the large bulge bracket brokers, that are today banks, making great efforts to sell their customers on OTC derivatives at the expense of exchange traded ones. We feared that soon, we'll have no one to trade with at the exchanges and that we had to develop a source to generate our own order flow.

As we began working on building this software, the idea was supplanted by what we saw as a more urgent need for a trading platform that floor traders could adopt as the exchanges started to go electronic. Providing that platform became our niche in the brokerage business.

Initially we served floor traders who had to move upstairs. Later our customer base grew into the generally, financially more sophisticated customer. Our typical customer understands the conflict of interest a broker has who either directly or indirectly takes the opposite side of his customers' orders. For this very reason, we decided not to trade against our customer orders and we have invested in building algorithms and routing systems to seek out and trade at the best possible prices, only as agents, on behalf of our customers.

Indeed, as our monthly brokerage metrics indicate for the past 12 months, we were able to achieve an all-in total average execution cost of 0.7 basis points on U.S. stocks for our customers. This cost includes market impact, our commissions and exchange and regulatory fees.

People interested in the methodology of how we derive this number, will find a clear description in our monthly brokerage metrics which we release on the first business day of each month. We encourage all brokers to publish and the SEC to require the publication of these statistics, which would give investors an objective measure of their true cost of execution.

Now returning to the market maker. We are currently in negotiations to transfer the bulk of our market making business to another firm. While we are pretty far along in the process, we are not yet done. Should that not work out, we have other parties who have expressed an interest. One way or another we plan to be out of this business and hope to have this completed by the third quarter of this year.

Without the market maker, we will focus all of our attention and energy on building our brokerage business. We think our greatest opportunity and the best use of our strength is in Electronic Brokerage. To capture this, we will to use the equity from the market maker to bolster the financial credibility of the Electronic Broker for future growth.

With our total equity of $6 billion, with very limited exposure to counterparties, only cash forex and stock loan, we must be among the strongest, most credible brokers.

Now getting into the numbers. Financially, the first quarter was favorably impacted by the decrease in the value of the U.S. dollar relative to the basket of currencies in which we keep our capital, leading to a gain of $73 million in the GLOBAL, of which $49 million is reported in income.

Our pre-tax profit for the first quarter was $213 million. Subtracting the $49 million from this quarter's favorable currency impact leaves $164 million. Of this amount, $185 million was generated by brokerage and the market maker lost $22 million, with the small remainder in Corporate.

For this quarter, we have again seen several new records for our brokerage business. We are approaching $100 billion of customer equity with $96.8 billion as of March 31, up 38% in one year. We hit an all-time high of 406,000 customer accounts and $20.9 billion of margin loans, up 18% and 39% respectively from the year ago quarter. This increasing momentum we are experiencing is encouraging, and the trajectory we are now on points even higher.

However, market volatility remained at historic lows, and this has affected commissions throughout the industry, including at Interactive Brokers. The average VIX for the first quarter was 11.72. This compares with last year's strong 20.60 in the first quarter. Yet despite this 43% drop in the VIX, our total DARTs declined much less, down 12% versus last year, and they are up 3% from the fourth quarter.

And to answer your questions in advance, I will give you some statistics of 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. These are sophisticated customers who trade and invest for their own livelihood and depend on our very low transaction costs, even lower financing rates and prime brokerage capabilities for their income.

As I said earlier, these customers understand and appreciate the quality of our executions, our order routing algorithms, and that we do not sell our order flow.

For the first quarter, hedge funds and proprietary trading firms accounted for 4% of our accounts, 22% of our client equity, and 25% of our commissions. Individuals represented 55% of our accounts, 36% of our customer equity, and 51% of our commissions.

You may have seen this quarter that, to capture more individual customers, several online brokers lowered their commission rates.

You may also have noticed that these brokers did not mention Interactive Brokers in their comparison ads. Why would that be? It is because our commission rates and margin loan interest rates are still lower - much lower - than theirs. Plus, other brokers still sell their customers' orders to others rather than route them to the exchange or other venue should a high likelihood of a better price be available there.

As a result, the Interactive Brokers customer wins on both better execution prices and lower commissions. Despite the pricing cuts taken by other brokers, our individual customers' client equity grew over 32% from the year ago quarter and 46% this quarter on an annualized basis.

Registered investment advisors and introducing brokers are the other two segments of our customers. These customers represent 19% and 22% of our customer accounts, 25% and 17% of our customer equity, and 17% and 7% of our commission income, respectively.

Last summer, we launched Greenwich Compliance which assists RIAs with their legal and regulatory needs. We help RIAs set up their own businesses using our platform, which has contributed to the growth of this segment. We are able to help an advisor through the registration process of setting up his or her firm at a reasonable cost, and then help with ongoing compliance questions at no cost.

The introducing broker segment has benefited from the growth of the rising investor class in Asia. These new investors look to their local brokers for investment guidance. In turn, that local broker comes to Interactive Brokers for trading, clearing and custody. This minimizes the costs and operational complexities for the local broker, allowing the broker to focus on his customers.

This segment also benefits from the increased regulatory burden in the U.S. market. Complying with regulations increases costs, and this has forced small and medium-sized brokers to cut their operating expenses by looking to us for a white branded solution. This gives them the freedom to do what they do best - customer acquisition and client service - while we do what we do best - provide state-of-the-art technology, trade processing and detailed billing and reporting, all at low cost.

The outlook for the growth of our brokerage business remains excellent. Prime brokers are setting higher required minimum commissions that their accounts must pay or be asked to leave their platform. Correspondent clearers for introducing brokers continue to boost charges, and large banks continue to shrink in this area as increasing capital requirements make this business harder to justify. Registered investment advisors continue to leave large wealth managers in order to go independent and to set up their own businesses, and keep more of the money they earn for themselves and split the savings with their customers.

We continue to roll out new products and services. This quarter we made offshore mutual funds available to our non-U.S. customers. More offshore fund families will be added this year. These will give our non-U.S. customers the ability to diversify their holdings at low cost. We have a new forex auto-swap program, offered at no cost, with no commissions or markups, to give clients with large forex positions exceptionally low financing costs on their short currencies.

We also upgraded the look and feel of our popular Portfolio Analyst interface. And we rolled out Covestor Smart Beta portfolios for customers seeking a low cost robo-advisor solution.

Next month we'll celebrate 10 years as a public company, and later this year we'll be celebrating our 40th year in the business. We spent this time continually building and improving our technology and what we offer to our customers. We intend to continue delivering innovative products and services in the decades to come.

Paul?

Paul Brody

Thank you, Thomas, and welcome everyone to the call. We have a few extra things to go over today so we'll jump right into the summary results. We will give some additional color on the winding up of the market maker and then segment highlights before we open it up to questions.

First quarter operating results reflected a solid performance in brokerage led by gains in net interest income. These were supplemented by currency translation gains but offset by a lack of trading gains in the market making segment.

Operating metrics reflected a still sluggish trading environment amid historically low market volatility. As Thomas mentioned, volatility as measured by the average VIX was down 43% from the year ago quarter to 11.7 this quarter. Lower volatility gives rise to a fewer trading opportunities and in fact, our clear DART's per account were down 25%. However, on the strength of continued growth in our account base, our quarterly total DARTs were down only 12% year-over-year and up 3% sequentially.

We continued 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 metrics showed robust increases in the number of customer accounts and customer equity up 18% and 38% respectively. The decline of 12% in total DARTs should be viewed in the context of the strong year ago quarter, during which the VIX averaged 20.6 and market volumes were higher.

Market making contract and share volumes were down across product types and I'll discuss the impact of winding down the market maker in my comments on that segments performance.

First quarter reported net revenues declined 24% against an unusually strong quarter that benefited from high volatility last year. Pre-tax income was down 37%, for a pre-tax margin of 57%.

Excluding our Treasury marks and currency translation effects, net revenues were down 11% versus last year, while pre-tax income was down 24% for a pre-tax margin of 51%. The main factors were continued low market volatility; as I mentioned the average VIX fell 43% year-over-year and, to bring some historical perspective to this number, this is the lowest quarterly average VIX in the 10 years we've been tracking this measurement.

Actual to implied volatility fell 37% from the prior year quarter, and this is the second lowest in 10 years. Generally, a low VIX dampens trading volume and therefore brokerage revenues, and both measures negatively impacted market making this quarter.

Second, the U.S. dollar weakened versus other major currencies; as a result, of currency basket in which we keep our equity which we call the GLOBAL, rose 1.3% against the dollar for the quarter, resulting in a gain of $73 million. This includes a gain of $49 million reported in other income and a gain of $24 million in other comprehensive income or OCI.

We estimate the total impact to earnings per share from the GLOBAL to be a gain of $0.13 for the quarter with $0.07 reported as other income and $0.06 as OCI.

Finally, medium-term interest rates rose in the quarter as the Federal Reserve followed through on its target rate increase of 25 basis points. Anticipating this increase and in light of the general uncertainty over future Fed actions, we actively reduced the duration of our portfolio in order to reduce our yield curve exposure. As a result, mark-to-market losses on our Treasury portfolio were only about $1 million. Although we plan to hold these securities to maturity, we must as brokers, unlike banks, mark them to market in our financial reporting.

Now I’ll summarize the revenues - the quarter's revenues, adjustments and pre-tax results as follows. Reported net revenues for the quarter were $374 million; deducting $49 million gain on our currency strategy and adding back $1 million loss from marking our Treasury portfolio to market, results in adjusted net revenues of $326 million for the quarter and that’s a decline of 11% from adjusted net revenue of $368 million in the year ago quarter.

Reported pre-tax income was $213 million and adjusted for these factors pre-tax income was $165 million, and that’s a decline of 24% from adjusted pre-tax income of $216 million in the year ago quarter. Pre-tax margin in the latest quarter was 57% as reported and 51% as adjusted.

The adjusted numbers make clear that the primary driver of the declines from the prior year was a drop in trading gains from market making.

Turning to the income statement line items, commissions and execution fees were $154 million, down 7%, primarily driven by lower futures volume. Net interest income was $142 million up 12%. Brokerage produced $135 million and market making $6 million, with the remainder in corporate. While the December Federal Reserve rate hike helped us this quarter, the benefited of the second hike in mid-March will be reflected in our numbers going forward.

Trading gains were $2 million down from $52 million in the year ago quarter, and as Thomas noted the historically low volatility and market structure challenges led to slim trading opportunities.

Other income which as I described earlier includes the effect of our currency diversification strategy and the Treasury portfolio marks was a gain of $76 million, down 47% from the prior year quarter. Noninterest expenses were $161 million for the quarter, up 6% from the same quarter last year. The rise reflects specific increases in fixed expense categories, in particular software development, legal and compliance cost.

Generally, we continue to closely manage our expenses as we selectively build our capabilities in growth areas.

At March 31, 2017 our total headcount stood at 1,211 an increase of 9% over the year ago quarter, but less than 1% over the year end count.

Versus a year ago, 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 increase shows, we have been moderating the pace of hiring after building up our capacity over last year, and I’ll speak more about the effects of winding down the market maker a little further on.

Comprehensive diluted earnings per share were $0.40 for the quarter as compared to $0.60 in the first quarter of 2016. On a non-comprehensive basis, which excludes OCI, diluted earnings per share on net income were $0.34 the quarter, as compared to $0.51 for the same period in 2016.

Excluding the impact of non-core items, comprehensive diluted earnings per share were $0.27 for the current quarter versus $0.32 for the year ago quarter on the same basis.

Now, by popular demand, to help investors better understand our earnings, we're going to break out our pre-tax income so that you can see the split between the public shareholders and the non-controlling interests.

Starting with income before income taxes of $213 million, we deduct $8 million for income taxes paid by our operating companies, which are predominantly foreign taxes. That leaves us with $205 million of which 83.4% or that $171 million reported on our income statement, is attributable to the non-controlling interests. 16.6%, or $34 million, is available to the public company stockholders.

GAAP accounting prevents us from putting that $34 million on our income statement. But you can see, after we expense the remaining taxes of $10 million owed on the $34 million, that the public company's net income is the $24 million that is reported on our income statement. Total income tax expense of $18 million consists of this $10 million, plus the $8 million paid by the operating companies.

Turning to the balance sheet, as a result of the growth of the brokerage business and the withdrawal of capital from our market making operations through regular and special dividends, brokerage accounts for about 83% of our combined balance sheet assets from the two segments and 74% of the consolidated equity.

Our balance sheet remains highly liquid with low leverage. We actively manage our excess liquidity and we maintain significant borrowing facilities through the securities lending markets and with banks. 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 March 31, we maintained over $4 billion in excess regulatory capital in our broker-dealer companies around the world, of which about 77% is in the brokerage segment. We continue to carry no long-term debt. Our consolidated equity capital at March 31, 2017 reached $6 billion, of which approximately $4.3 billion was held in brokerage, $1.5 billion in market making and the remainder in the corporate segment.

As the market maker is wound down, we plan to redeploy this capital in our brokerage business, both to bolster the broker's financial credibility - as Thomas mentioned - and to take advantage of greater customer financing opportunities that the extra capital will provide.

Turning 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. Customer trade volumes were higher in stocks and lower in options and particularly in futures.

Our year-on-year 24% drop in futures contract volumes was not out of line with the CME's reported drop of 29% in equity index futures and an 11% increase in interest rate futures. Foreign exchange dollar volume was off 13% from the year ago quarter but up 17% sequentially.

Commission revenue declined 7% 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 $4.01 for the quarter, up 4% from the year ago quarter and flat sequentially.

Customer equity grew to $96.8 billion, up 38% from last year and up 13% 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 advisors 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 account equity rose 17% year-on-year to $238,000. As our own equity grows, we are able to attract larger accounts that seek securities finance services, including margin lending and short sale support.

Margin debits rose 39% year-over-year, reaching a record level of $20.9 billion. Customer's appetite for increased risk along with our expanded prime broker financing contributed to this increase. We continue to see demand from our customers for prime financing and will be opportunistic in using our capital to satisfy it.

Net interest income rose to $135 million, up 13% from the first quarter of 2016. The Federal Reserve's increases in the Fed Funds target rate in December and March, 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 assets 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.

In our 2016 10-K report, we began reporting net interest margin information. For the 2016 year, our overall net interest margin was 1.11%, and for the first quarter of 2017 it was 1.12%. We are currently preparing to initiate a multibank FDIC sweep program, which is expected to enhance our investment yield on a portion of customer funds. Implementation is targeted to occur by the third quarter.

With the growing customer asset base, we continue to believe we're well-positioned to prudently maximize our net interest income, given the 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 $36 million in net interest income for the coming year, and with the full effect of reinvestment at higher rates, an addition of $49 million annually.

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

Fixed expenses in brokerage were $79 million, up 20% over the year-ago quarter, and down 1% sequentially. The primary component of this increase was higher general and administrative costs, particularly related to software development and also advertising.

Customer bad debt expense was under $1 million this quarter. Our Risk Committee continues to enhance our scenario-based risk models, in order to reduce exposures to world events.

Pre-tax income from Electronic Brokerage was $185 million, down from last year's high volatility first quarter up $235 million. Excluding Treasury marks, core pre-tax income was $186 million, down from $198 million last year, for a 59% pre-tax margin.

Taking a look at market making, we announced on March 8 that we would be discontinuing our options market maker, which represents the bulk of our market making activities. We began to pull back from market making activities after this time. Market making trade volume declined year-over-year across all product types. Options and futures contract volumes fell 36% and 42% respectively, while stock share volume was down 58%.

This was due to our pulling back from this segment and a substantial portion of the drop in stock volume came from low-priced stocks trading in Hong Kong and at various venues in the U.S.

Trading gains from market making for the first quarter were $2 million, down from $52 million in the year ago quarter. Our pull back, together with unfavorable market volatility measures, contributed to this result.

Pre-tax income was a loss of $22 million in the quarter, down from pre-tax income of $20 million in the year ago quarter. On the cost side, execution and clearing fees expenses were down 19% due to lower trading volumes and fixed expenses decreased to $17 million, down 26% from the year-ago quarter as we continued to tear down the cost of running this business.

Now regarding the market maker wind-down, we estimate the one-time costs to wind down options market making activities to be $25 million, which includes severance and other closure costs. We expect to recognize these expenses in the second and possibly the third quarters, and we expect the wind down to be complete by the end of the year.

We also expect that continuing certain market making operations outside the U.S. for some period of time during the wind down will significantly defray these costs.

We intend to continue conducting certain trading activities in stocks and related instruments that will facilitate customer trading in products like ETS, ADRs and CFDs. We do not expect this activity to be at sufficient size as to require reporting as a separate segment. So at the point in time when market making is deemed to be a discontinued operation under GAAP rules, we will cease reporting segments.

Excluding any income from these facilitation activities, we 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 transfer should also contribute to the slowdown in hiring for some period of time.

Finally turning to 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, increased by the weakening of the U.S. dollar against all other major currencies. We estimate the overall gain from our strategy of carrying our equity in proportion to the GLOBAL to be about $73 million for the first quarter of 2017. As I described, because $24 million of the GLOBAL gain is reported as other comprehensive income, this leads a gain of $49 million to be included in reported earnings.

As we disclosed in our March 8 press release, effective March 31, we made changes to the composition of the GLOBAL to reflect the shift in our business toward Electronic Brokerage. These changes will be reflected in our results beginning in the second quarter of 2017.

Now I'll turn the call back over to the moderator and we can take some questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Rich Repetto from Sandler O'Neill. Your question please.

Richard Repetto

Good evening, Paul. The first question I have is to Paul, and just trying to understand the increase in interest expense, looks like $35 million this quarter versus run rate of $18 to $22 per quarter last year.

Paul Brody

Well of course, it's primarily related to the increase in benchmark rates, and we had the full effect of a 25 basis point Fed move this quarter. The thing that we focus on, obviously, is the net interest income because, given our interest tiers, and our published interest rates to our customers, we started paying more interest on credit balances as the benchmark rates increased, and that will continue.

However, likewise, we earned more on the investment of those funds and charged - and earned more on funds loaned to customers who are borrowing on margin. And so I just caution you to – not take it in a vacuum; you have to actually look at both sides of the interest equation.

Richard Repetto

Okay. And one just follow-up on that, but if you look at on the interest revenues they went up $17 million quarter-to-quarter and the interest expense went up by $13 million, that what you got combined then the changes – I would expect a lot less – a lot more in interest revenue compared to the change in interest expense or am I looking at that wrong?

Paul Brody

So are you looking at brokerage or overall?

Richard Repetto

I'm looking at overall, is that …okay.

Paul Brody

You mean sequentially quarter.

Richard Repetto

Yes.

Paul Brody

The $17 million yes, well what I can tell you is that when we publish the 10-Q we'll have more details in the net interest margin which we will now publish quarterly, and you'll get a little bit more color on the balances that go into each component of net interest income.

Richard Repetto

Okay, thank you. And then, Thomas, I guess on the broker, now could you talk about how you will get executions and as you observe, will there be any impact to execution quality given that your market maker, and I guess in absorbing the cost as well?

Thomas Peterffy

Well as we always said, the market maker has absolutely nothing to do with the broker's executions. So we never traded against our customers' orders; customer orders are always routed to the best – potentially best venue at any moment and that will continue to be done.

So if anything - some folks that have been working on routing market maker orders, where the emphasis on speed was very important, are now going to join our Brokerage Group. And so, we will get some additional out in our routing algorithms so, if anything the executions will improve as a result of closing the market marker.

Richard Repetto

Understood. And last question, Paul I thought I heard you say something about - you reduced the duration of the Treasury portfolio and just trying to understand what you meant by that?

Paul Brody

Sure, yes I mean we never went out very far on the yield curve but in the past, we took a little more advantage of the yield curve when we felt that the environment was a bit more predictable. Going into the latter part of last year and then, through the first quarter and certainly through election season, we just felt there was more uncertainty over – the markets predictability of the future interest rate picture.

And therefore we allowed some of the medium term - we never went long-term - but medium term Treasuries to expire and reinvested in shorter duration, which we have maintained for the time being. If we feel that the market's predictions become probably more reliable, then we may go further out the yield curve again.

Thomas Peterffy

I may add we really think that there will be further interest rate increases and we don't want to be "long" almost two years, so that's why we had – we let the duration come in closer.

Richard Repetto

Got it, understood. Thank you. That's all I had, thanks.

Operator

Thank you. Our next question comes from the line of Conor Fitzgerald from Goldman Sachs. Your question, please.

Conor Fitzgerald

Thanks for taking my questions. First one, just on the market maker, thanks for calling out the $39 million of expenses. Just wondering if we should think about any revenue coming along with that $39 million, given that I think you're still market making in a couple of stocks?

Thomas Peterffy

A couple of stocks, I'm sorry I misunderstood?

Conor Fitzgerald

Yes. Looking at your release I don't think you fully exited the market making business 100%. I think you said you would continue to selectively make markets in a couple of products.

Thomas Peterffy

Not in a couple of stocks - in a couple of locations.

Conor Fitzgerald

Okay.

Thomas Peterffy

Specifically in Asia, we are keeping some market making operations running.

Conor Fitzgerald

And any sense how much revenue would be associated with that? Just trying to think about the net impact of shutting down the market maker?

Thomas Peterffy

Yes, I understand...

Paul Brody

That would be very forward-looking, Thomas.

Thomas Peterffy

We didn't used to give forecasts when we were fully in market making, so I think I'd like to stick to that, because it's very hard to estimate. But we still believe that those couple of locations will generate a profit, that's why we're keeping them.

Conor Fitzgerald

Okay. So not really to quantify but fair to say that $39 million is not a net number.

Thomas Peterffy

Right.

Conor Fitzgerald

And then just following up on Rich's question, a couple of questions on the net interest income. Sounds like there were a couple of moving pieces, was just hoping you could quantify a couple of them. How much was the uplift you got from the Fed hike in December? And if you could quantify how much net interest income you gave up from shortening the duration? Just trying to understand a couple of the moving pieces.

Paul Brody

Yes, I think we'll probably just be publishing it in the 10-Q, Conor. We had given some expectations of the 25 basis point increase – well, in the last number of quarters we've been putting that out. I would say we're not out of line with what we talked about.

So in other words, the fact that we are projecting that a further 25 basis point increase would, on a full year reinvestment rate basis be $49 million, that number is somewhat lower than it was in the past quarter and the quarter before because – it does – because we pay a narrow spread off the benchmark, and pay and charge to our customers a narrow spread off the benchmark, as these rates go up, it kind of becomes locked in.

And our further earnings are on increases in the balances, which have been robust so that's an offsetting factor, that as balances go up that number is going to go up on a projected basis. Otherwise, once you're into solidly positive interest rate territory, our published tiers are locked in, and then we have a certain portion of our smaller customer balances on which we don't pay interest, so we continue to earn more and more on those.

Conor Fitzgerald

That's helpful. And then just last one from me. You mentioned potentially sweeping your deposits to third-party banks starting in 3Q, and brokers who do similar programs generally earn Fed Funds or LIBOR plus a spread. Should we be expecting kind of similar economics for you, and any way you could kind of help us quantify how much of a revenue driver that could be?

Paul Brody

Sure. So we've had our eye on one of these programs for quite a while, and we've seen generally banks' demand for deposits ebb and flow, or flow and ebb, because somewhat after the financial crisis, the banks were scrambling for money and they all filled up and all that demand went away. It's returning now. For whatever reason, we're seeing more demand out of banks, and so while we don't know exactly what we can earn on it yet until we initiate the program, it's going to be higher than Fed Funds.

And as far as the overall impact, we don't want to estimate it just yet, but a portion of customer balances would be eligible, and then it's a question of which customers actually sign up for this program, and so only experience will tell us that, but we hope to get the program started fairly soon - over the next few months - and hopefully it gets good pick up from the customers.

Conor Fitzgerald

That's helpful. That's also capital light, right, because it's no longer - it moves onto somebody else's balance sheet. Should we think about that having maybe a positive impact on your capital flexibility?

Paul Brody

Well, certainly, capital light and yes, the balances do move off our balance sheet. We're not under ratio constraints the way the banks are. Deposits aren't a bad thing for us. In fact they provide a source of funds for us to lend money to our margin borrowing customers. Therefore, we're seeing this as sort of two parts - one is investment opportunity and the other is a value added service to the customers, who will then get FDIC coverage in addition to whatever they are currently getting with us.

Conor Fitzgerald

Thank you for taking my questions.

Operator

Thank you. Our next question comes from the line of Mac Sykes from Gabelli. Your question please.

Mac Sykes

Good afternoon, gentlemen. I wanted to know on the prime financing - just thinking about that business being ramped up, will that be additive to the 1.12% current NIM?

Paul Brody

Well any incremental amount would be additive.

Mac Sykes

In terms of percentage NIM; I understand the revenue impact but would that be…?

Paul Brody

So on the spread itself?

Mac Sykes

Yes.

Paul Brody

The prime customers tend to get the best rates, so it might tend to trim the spread a little bit overall, but you know, at the opportunity to increase their revenue. We would be willing to do that at the higher levels, just like high volume customers get the best commission rates. It's a similar impact.

Mac Sykes

And when we think about moving the $1.5 billion to support some of this prime financing, how much could that support in terms of extra balances?

Paul Brody

Sorry, not sort of understanding the question?

Mac Sykes

The $1.5 billion of capital - how much could that support in additional interest balances? Maybe $10 billion?

Thomas Peterffy

We are nowhere near any capital restrictions here. We are not restrained by the available capital. The primary purpose - so we're far away from the time when we'll be needing all of our capital to do customer financing. So at this moment, the purpose of the capital is to continue to bolster our credibility and hopefully, at a future date, all of it will be needed.

Mac Sykes

And Thomas, could you just weigh in a little bit about the volatility we're seeing? Absent some of the political/geopolitical aspects, is there something that's going on structurally with the markets, flow of funds, maybe participants, just customer engagement, that would sort of lead you to believe that the outlook for volatility will be lower than it has been in the past?

Thomas Peterffy

I don't want to repeat myself, but on a CNBC interview, I explained what I think is going on, or what I see going on. And it is partly due to the exchanges rebating fees to traders who put in resting limit orders. So to very high volume traders, we charge $0.10 per 100, and the exchange rebates $0.23 per 100.

So these traders who trade back and forth, actually get paid to trade. Because we are rebating those $0.23 per 100 back to our customers. So now couple this with the rising popularity of writing calls against a portfolio of stocks. And the fact that our margin rates are so low, so many of our customers come to us, they borrow money on margin, they go long the big stocks, and they sell calls against it, even though the VIX is low so those calls are sold at a fairly low premium.

So the traders come and buy these calls, and they trade against them in the sense that they delta hedge it. So they buy the calls, they go short the stock in the proper ratio.

Now as the market picks up, they become long delta. And if the market picks down, they become short delta with these positions. So every time they even out the delta, that means that they sell into rising markets and they buy into dropping markets, and so they generate a trading profit and add to this the rebate from the exchanges. So to a large extent, this low volatility is structural, because of the popularity of selling covered calls, and the rebates from the exchanges.

Mac Sykes

Thank you. And thanks Paul, for the additional comments and disclosure.

Operator

Thank you. And we do have a full queue today so we ask that you please limit yourself to one question and one follow-up. Our next question comes from the line of Doug Mewhirter from SunTrust. Your question please.

Doug Mewhirter

Hi good evening. Just one question, most of my number questions have been answered. So the increase in margin, that our margin loans had a very nice increase sequentially and year-over-year, do you - is that mostly due to your increase in your prime brokerage business where a lot of hedge funds or most hedge funds are levered, or is that more just more popularity on the individual investor side levering up because of market conditions, or confidence, or what have you - or is it a little bit of both?

Thomas Peterffy

So our margin loans increased because we are the lowest cost providers of margin loans. And first of all, it's an opportunity for more profit, but in addition we are using this really as a bait to get people to bring their accounts to us. We do not really keep track of margin loans as far as what percentage of them goes to prime brokerage customers and what percentage goes to individuals. So I really can't quite tell you the answer to that question.

Doug Mewhirter

Okay, thanks. That’s all my questions.

Operator

Thank you. Our next question comes from the line of Chris Harris from Wells Fargo. Your question please.

Chris Harris

Thanks guys. I just had one question, and it relates to the commission cuts we've been seeing across the industry. It seems pretty clear that you guys don't need to respond, based on where the competitors are and where you guys are from a pricing standpoint. But if your competitors keep cutting, is there a level, do you think, where IBKR would actually need to respond, or do you think your value proposition is such - you don't do payment for order flow, you have better execution capability and fill - that you just really wouldn't need to address it all? Just maybe a little bit of your thoughts on that topic would be great.

Thomas Peterffy

Well, on the one hand you are right, we don't think that they will ever compete with us as far as total execution cost is concerned. But as far as advertising these goals, if they really were to cut the commissions to zero, as Schwab for example could easily do, I think we would have to go out and explain in advertisements more thoroughly as to what is going on here behind the scenes. Because interestingly enough, they advertise that their commissions now are $4.65 a trade, but we see that their commissions are more like $8 or $9 a trade. So - how do you figure out what's happening?

Chris Harris

Got you. Thank you.

Operator

Thank you. Our next question comes from the line of Rob Koehn from Ivy Lane Capital. Your question please.

Rob Koehn

Thanks. So in the first quarter, there was a pretty big step up in new accounts and assets and I wanted to ask if there were geographies or customer segments that you could point to that drove that step up in the quarter?

Thomas Peterffy

Yes. Of course as far as new accounts, Asia grew faster and even Europe grew faster than Americas, and that was also the case at least for Asia as far as client equity is concerned. So yes, Asia is the shining star here.

Rob Koehn

Asia okay. And what are you seeing in terms of the average size of new accounts, compared with what you've seen historically. I mean it just looks like, looking at the numbers, that maybe the new accounts are bigger but maybe that moves around.

Thomas Peterffy

It does move around, and the difficulty in tracking that is that, generally, an account that opens with X dollars tends to have nearly 2X dollars in a year and a half after the account opening.

Rob Koehn

So because, somebody puts in a small amount, then they add to it?

Thomas Peterffy

That's right.

Rob Koehn

Okay. And anything you can call out in the prime brokerage business in terms of growth, and maybe impact in Europe, with some of the European banks?

Thomas Peterffy

Interestingly enough, prime brokerage accounts grew second fastest, prime broker accounts having grown the fastest. So, hedge funds are the second fastest growing segment.

Rob Koehn

Okay. Good, thank you.

Operator

Thank you. Our next question comes from the line of Kyle Voigt from KBW. Your question please.

Kyle Voigt

Hi, just had two questions. One was really just around kind of the customer segments where you're growing faster. I think you mentioned some of them have smaller accounts sizes, some of the segments specifically. And just thinking about those accounts that would have potentially less than $100,000 in assets that they need to hit to get paid on their cash balances.

I am just wondering if you could just give some more details around the percentage of those $43.8 billion of credit balances, credit balances that you're not paying interest on, I guess, what percentage of those balances are held in accounts with less than $100,000 in client equity or if its cash balance is under $10,000?

Thomas Peterffy

No, the bulk of it is smaller accounts.

Kyle Voigt

Okay. And I guess just a follow-up I guess on the brokerage expenses. I see non-interest expenses were up 15%. I know you've made a lot of investments on the customer service area and a few other areas. Can you just help us think about the investment areas, going forward over the next 12 to 18 months, and whether you still expect kind of strong expense growth through the next year?

Thomas Peterffy

We are certainly going to continue to build up our development team and our customer service team. So we get a big shot in the arm from transferring all these folks from the market making area to these areas. But in addition to that, we are also going to continue to add to our strengths there.

Kyle Voigt

Okay, thanks.

Operator

Thank you. And our last question comes from the line of Michael Trica from Oakum Bay Capital. Your question please.

Michael Trica

Good evening guys. This question is probably more for Thomas, and it’s part question, part suggestion. Speaking to the development of developing a platform, kind of a marketplace ecosystem more than just a brokerage, have you guys considered extending Wall Street research capabilities to clients? Meaning, personally, we have an account of Bloomberg, and we can access Wall Street research through the Bloomberg platform. Are you guys considering or would you consider enabling that sort of functionality?

Thomas Peterffy

Sure we would, but we have a lot of research on our platform currently. Now it may not be the type of research you are looking for, but we certainly - we have the soft dollar methodology, but it's very rarely used for reasons I don’t really understand. So I assume that if you, for example, wanted to buy Wall Street research with soft dollars and you were on our platform, then you would use it, right?

Michael Trica

Not to opine on the relative value of the research - I was actually on the portal today and yes, like you said, the research available through the portal may not be appropriate for hedge funds such as ours; maybe it’s for other clients of yours. But we, as other institutional investors, definitely want access to Wall Street research, and typically, I know a bunch of my contemporaries that they traditionally access it through systems like Bloomberg. And I'm just thinking, that to develop the ecosystem marketplace, the platform, that you suggested you'd like to build out for Interactive Brokers, I just thought it would be an additional mechanism to build out the platform, allowing clients to access research through that.

Thomas Peterffy

No, I would appreciate if I could call you about that, to understand then in detail what you're talking about, and figure out how we could do that.

Operator

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

Operator

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