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Issuer Comment: Credit Suisse Group AG: Earnings Commentary - Third Quarter 2010

Global Credit Research - 02 Nov 2010

In 3Q10 Credit Suisse Group AG reported net income of CHF636 million, with pre-tax profits of CHF 753 million. Reported net income was down sharply from both the previous quarter and a year ago, however, 2Q10 included CHF 855 million in fair value gains on own debt due to spread widening, whereas the latest quarter included CHF 456 million in fair value losses on own debt due to spread tightening. Excluding these items, pre-tax profits were CHF 1.2 billion in the third quarter, a strong improvement over the second quarter's CHF 951 million but still down considerably from the first quarter and a year ago.

Credit Suisse AG has a stand-alone bank financial strength rating (BFSR) of B, which translates into a baseline credit assessment for the bank of Aa3. The bank's rating for deposits and senior debt is Aa1, which incorporates our very high systemic support assumptions. The rating on the senior debt of the holding company, Credit Suisse Group AG, is Aa2. The outlook for all ratings is negative.

The improvement over the second quarter largely reflects the absence of a charge for the UK bonus tax and reduced litigation charges. However, while fixed income sales and trading revenues rebounded modestly from the second quarter, equities trading revenues dropped sharply, reflecting the decline in market volumes during the summer. Equity underwriting and advisory fees were also lower, and revenues were adversely affected by a decline in the value of the dollar.

The decline in revenues was compounded by an apparent reduction in expense flexibility brought on by the recent shift to higher base salaries and a reduction in bonuses. As a result, for the Investment Banking segment, the ratio of compensation expense to revenue rose to 54% in the quarter, and on a year-to-date basis is 48% compared with a 44% ratio for the first nine months of 2009.

Average risk management VaR was unchanged from last quarter, while investment banking (IB) risk-weighted assets declined. However, on a dollar basis both average VaR and IB risk-weighted assets increased over the second quarter (up 9% and 6.5%, respectively). Average risk management VaR is now 27% above the level of a year ago, while average regulatory VaR (which gives less weight to prices in the most recent 6 month period) is up 49%. This apparent increase in risk-taking raises concerns, especially in light of the bank's weaker revenues over the past two quarters. Management points to the daily distribution of trading revenues for the quarter, which show a tighter distribution of results compared to either 2Q10 or 3Q09. This provides some indication that the bank has taken steps to reduce tail risk, notwithstanding the higher VaR metrics. Nonetheless, we believe that overall these metrics point towards a higher level of risk taking. Were this trend to continue, it could put additional negative pressure on the bank's ratings.

Earnings in Private Banking dropped slightly again in the quarter, with lower transaction based revenues negatively affecting both Corporate & Institutional Clients and Wealth Management, reflecting continued cautious client behavior. Wealth Management continued to benefit from healthy inflows of net new assets, although the inflows are pressuring margins since new assets under management are not initially as productive as existing assets.

Earnings in Asset Management increased, but as in previous periods, this was largely due to investment-related gains. Pre-tax profits of CHF 135 million included CHF 153 million in investment-related gains. Absent these gains, the business line would have lost CHF 18 million pre-tax in the quarter. While this is an improvement over both the previous quarter and a year ago, the negative result before investment-related gains highlights that further work is still needed to improve the core profitability of this segment and reduce its reliance on volatile investment gains.

Credit Suisse's credit profile continues to be supported by a strong capital position. Tier 1 capital ratio ended the quarter at 16.7% (Basel 2), up from 16.3% last quarter. However, Credit Suisse's Tier 1 ratio grew even more heavily reliant on hybrid capital instruments; hybrid capital and qualifying noncontrolling interests represented 39.2% of Tier 1 at September 30, 2010. The bank reported a FINMA leverage ratio of 4.3% at quarter-end, up from 3.9% the previous quarter. However, despite the improvement, Moody's believes that Credit Suisse's leverage as measured by tangible common equity to total assets (adjusted for accounting differences between US GAAP and IFRS) remains high compared to many of its global peers.

The bank's cash position held steady during the quarter, ending at approximately 102% of short-term borrowings (including wholesale CDs and due to banks), down from 104% last quarter and unchanged from 102% at year-end 2009. At the same time, total liquid assets exceeded total market funds by 6.6% of total assets, up from 6.3% at June 30 and down only slightly from 6.9% at year-end 2009. The bank has also been increasing and extending the average maturity of its long-term debt. As a result, total liquid assets exceeded total short-term market funds (including estimated long-term debt maturing within one year) by 20.8%, up from 20.6% last quarter, 19.8% at year-end 2009, and 14.6% a year ago.

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