Credit Suisse AG

Restructured businesses will be more sustainably profitable and have an improved funding profile

Credit Suisse Group AG (CS, A1/A1 positive; baa2) has completed a restructuring that has substantially cut the bank’s previously high structural cost base and meaningfully lowered its refinancing risk and funding costs. Our positive outlook on the bank’s ratings takes account of the progress CS has made to date, and also reflects our expectation of a continued stronger, more stable profitability and proactive management of risk positions, in particular concerning the bank’s leverage finance exposures in its capital markets-oriented businesses.

» Structurally lower cost base increases the bank’s profit potential. The 20% decline in operating expenses since CS initiated its restructuring is more than double the cumulative decline in revenue of 8%. The resulting positive operating leverage has substantially improved the bank’s loss-absorption capacity and lowered its break-even point. However, the group’s structurally higher potential returns may prove harder to sustain in more difficult markets.

» An increased share of earnings comes from more stable, less capital-intensive businesses. CS has substantially reduced its dependence on more volatile income streams, making the group easier to monitor and manage. CS will continue to rely more on capital markets earnings than most of its closest peers, but large losses that strain the group’s profitability are now less likely, and its capital levels will be more resilient. CS will have to prove this resilience as and when the credit cycle turns, and keep contained any losses from its exposures to leveraged finance and high-yield debt markets.

» Superior liquidity and funding profile. CS retains a strategy to maintain liquidity well above the group’s combined requirements, as reflected in a Liquidity Coverage Ratio (LCR) of around 190% compared with an average of 133% for its peer group. The group’s total loss-absorbing capacity (TLAC) is also greatly improved, and the related debt issuances have significantly extended CS’s debt maturity profile and lowered its refinancing risk. If maintained, CS’s improved ability to manage funding and liquidity needs across the group will increase its resilience to periods of high volatility or funding market dislocation.

» Solid capitalization is supported by conservative pay-out policy. CS reported a Tangible Common Equity ratio of above 16% as of the end of September 2019 and an improved 5.5% Tier 1 leverage ratio. We expect these ratios to remain stable over the next two years. A conservative distribution strategy should help CS retain about CHF4 billion of core capital over the next two years, further building its buffer against market volatility and helping offset regulatory tightening and other contingencies.
Structurally lower cost base increases the bank's profit potential
The exit or trimming of non-strategic capital markets businesses has substantially reduced CS’s underlying quarterly cost base (see Exhibit 1), although the forgone activity has dragged on group revenue in the interim, exacerbated by declining customer activity and lower industrywide fee pools.

Exhibit 1
Structurally lower cost base helps offset revenue challenges
Adjusted operating expenses by quarter, CHF billion

Sources: Company reports, Moody’s Investors Service

The 20% decline in operating expenses since CS initiated its restructuring is more than double the cumulative decline in revenue of 8%. The structural changes have also helped offset temporary weakness in some capital markets-related businesses that remain geared towards global fixed income and emerging market activities. The group’s improved business mix and operating leverage has resulted in more steady income from quarter to quarter (Exhibit 2), which meaningfully supports its loss-absorption capacity and has lowered its break-even point.

Exhibit 2
Restructuring supports more stable revenue development across quarters
Adjusted operating income by quarter, CHF billion

Sources: Company reports, Moody’s Investors Service

CS consistently reported positive operating leverage over the first nine months of 2019, despite a difficult operating environment. The group’s reported return on tangible equity (ROTE) was 8.8% over this period, up from 6.3% for the first nine months of 2018. The group’s cost to income ratio of 77% was also significantly below the 82% recorded during the first nine months of 2018.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
With a net ROTE already close to its 10% - 11% target for 2019, CS is on track to sustain higher earnings and returns that will support improved credit strength if sustained over time. As Exhibit 3 shows, CS has steadily improved its underlying profitability over the last eleven quarters from an unsustainably low base, raising its average quarterly pretax profit to around CHF1.0 billion in 2019 from just CHF154 million in 2016.

However, the group’s higher potential returns may prove harder to sustain in a more difficult operating environment, particularly because revenue growth is partly dependent on client-driven, as well as market-driven transaction- and performance-related income. We nevertheless believe CS’s now lower break-even point will help withstand market strain; and meeting the bank’s return targets relies on known actions to date rather than assuming any revenue growth.

At the same time, risk for revenue arises because of the bank’s capital markets franchise, that, albeit reduced in size, continues to rely on healthy fixed income and equity markets and - in particular - continued solid activity in leveraged finance markets. Any adverse development in the leveraged finance and sponsor business could have a detrimental effect on the industry’s and, therefore, CS’s ability to sustain revenue and, ultimately, strain earnings in an environment of a severe global leveraged finance market deterioration. With regard to the latter, CS will have to ensure it maintains strong underwriting criteria that help shield it from losses as and when the currently benign cycle for these exposures turns.

An increased share of earnings comes from more stable, less capital-intensive businesses
Credit Suisse’s large-scale restructuring during the 2015-18 period has reduced the capital and risk allocated to its capital markets and investment banking segments; lowered its inherent reliance on less predictable revenue; and lifted the returns and operating leverage of the remaining businesses. As of the end of September 2019, CS had risk-weighted assets (RWAs) of CHF302 billion, virtually unchanged from the end of 2015 (CHF295 billion). However, the segment mix of RWAs shifted clearly in favor of non-capital-markets businesses (Exhibit 4).

Looking ahead, we anticipate that the group’s more stable business divisions – the Swiss Universal Bank, International Wealth Management and Asia Pacific Wealth Management & Connected – will together consume about two thirds of group RWAs and 60% of the group’s leverage exposure (excluding Corporate Center) while contributing at least two thirds of group revenue and pretax profit. It is these steady and predictable earnings from the group’s international wealth management and domestic universal banking franchises that we expect will help buffer potential adverse developments in CS’s capital markets businesses.
Stable businesses command greater RWA share post restructuring

RWA consumption by segment, CHF billion

SUB = Swiss Universal Bank; IWM = International Wealth Management; APAC = Asia Pacific; GM = Global Markets; IB & CM = Investment Banking & Capital Markets; SRU = Strategic Resolution Unit, now reported as ‘ARU’ (Asset Resolution Unit) in Corporate Center; CC = Corporate Center (excluding ARU).

Sources: Company reports, Moody’s Investors Service

As a result of the restructuring, there has also been a significant reduction in the resource consumption of the capital markets-oriented business segments from 2015 levels (Exhibit 5).

Going forward, CS needs to ensure that its downsized capital markets operations improve their returns on both a relative basis (e.g., measured against RWAs) and an absolute basis, making a sustainably stronger contribution to group profitability that justifies these segments’ resource consumption over the medium term, supporting an improved credit strength.

Capital markets resource consumption reduced meaningfully, but profitability still needs to improve

Operating income by business line, CHF million

*Note: Segments as defined by Credit Suisse (‘Core results by business activity’).

Sources: Company reports, Moody’s Investors Service
Leveraged lending remains one key risk within Credit Suisse’s capital markets franchise
CS has been a top-three player in the leveraged lending space for almost two decades, with a strong focus on the $2.7 trillion US leveraged finance market (as of year-end 2018), the largest globally.

Exhibit 6
CS has managed its leveraged finance exposures through multiple credit cycles
Leveraged Finance Street Fees ($bn) and CS share of wallet (RHS)*

*Note: Street fees include HY Bonds, Institutional Loans and Bridge Loans. CS share of wallet represents Moody’s estimates on absolute Share of Wallet over each period.
Sources: Dealogic as of 30 June 2019, Credit Suisse, Moody’s Investors Service

CS offers loan underwriting and debt trading activities, as well as funded term loans and committed revolver facilities. It has also increased its protection against unfavorable developments by negotiating more flexible rates, meaningfully shortening underwriting durations and significantly lowering its trading inventory from the levels seen before and into the 2007/08 financial crisis. In addition, CS’s leveraged loan underwriting commitments are significantly smaller and more granular today, limiting the potential loss on any single transaction or in the event of a sudden and sharp market slowdown.

Credit Suisse’s improvements on this front are consistent with a more general, and positive, market trend. To illustrate, the Top 5 deals of all underwriters during the 2006-08 period averaged $27 billion of debt at 7.7x leverage and an equity cushion of just 18%. During the 2016-18 period, the Top 5 deals averaged $8.4 billion of debt at 6.1x leverage and a 33% equity cushion.

Despite these positive factors, we believe that the group’s risk-management and control framework as well as the robustness of its underwriting standards will only be tested in a severe market slowdown and adverse cycle. Having said this, we acknowledge the bank’s long-standing relationships with many of its core institutional and financial sponsor clients as well as the high integration of the origination (IB) and distribution (capital markets) side of the business, both of which will continue to allow for a fast and proactive reaction to market developments. This should help the bank withstand potential collateral value depletion better than some of its peers.

Superior liquidity and funding profile
CS reported a strong LCR of 189% in Q3 2019, reflecting the group’s superior liquidity profile resulting from conservative management of liquidity across its various branches and subsidiaries. Management retains a strategy to maintain liquidity well above the group entities’ unconsolidated requirements. When combined, these requirements are meaningfully above the group’s consolidated regulatory requirements, which will keep its peer-leading LCR well in excess of the 100% minimum (Exhibit 7).
Exhibit 7
Credit Suisse's conservative liquidity management supports peer-leading LCR
Global Investment Banks' LCR, as of 30 September 2019

Source: Company reports, Moody’s Investors Service

At the same time, the group’s total loss-absorbing capacity (TLAC) improved substantially to CHF95.2 billion as of the end of the third quarter (Q3 2018: CHF83.1 billion), corresponding to a TLAC ratio of 31.6%, well above the 2020 regulatory requirement of 28.6%.

The related TLAC-eligible debt issuances have helped extend CS’s debt maturity profile, reducing the risk that funding market dislocations might impair its ability to refinance maturing debt. The resulting smoothening of CS’s market funding maturities will allow the bank to better manage its funding needs and liquidity across the group, ultimately increasing its flexibility in more volatile markets; for example, if funding spreads move materially. We estimate the weighted average maturity of CS’s TLAC-eligible market funds to be around 6.5 years, superior to many of its global investment banking peers. In addition, the weighted maturity of the bank’s total liabilities, excluding deposits and derivatives (Exhibit 8), is the second highest in the peer group.

Exhibit 8
Credit Suisse has one of the longest funding tenures within its peer group
Average maturity of total liabilities excluding deposits and derivatives in years

Note: As of 31 December 2018; Mid-point approach used for disclosed maturity buckets in absence of more detailed information across all peers. Maturity of 7.5 years applied to >5 year bucket across all banks; *Identifies banks with limited disclosure on the duration of their short-term liabilities. The average duration of peers’ short-term liabilities was applied as an approximation.

Source: Company reports, Moody’s Investors Service

Given its significant excess funding beyond the Swiss regulator’s strict requirements, we expect Credit Suisse to continue meeting its gone-concern capital requirements primarily with senior holding company debt and that this will only partially replace maturing senior operating (bank) company debt and legacy capital instruments. We, therefore, anticipate CS to be a net negative issuer over the next two years, further lowering its funding costs and supporting its profitability. At the same time, Swiss regulation ensures that CS will largely maintain its maturity profile and level of TLAC debt over the next few years, safeguarding the above-mentioned structural benefits. If maintained, the improved funding profile will support the bank’s improved credit strength.
Solid capitalization supported by conservative pay-out policy

CS reported a BIS® fully-applied Common Equity Tier 1 (CET1) capital ratio of 12.4% in the third quarter of 2019, a decline of 50 basis points from the third quarter of 2018. Retained earnings supported underlying capital and the sequential stabilisation of the CET1 ratio in line with the group’s 12.5% year-end target, digesting a 9% year-over-year increase in RWAs mainly owing to model adjustments, business growth and regulatory inflation. CS further reported an unchanged 4.1% CET1 leverage ratio and an improved 5.5% Tier 1 leverage ratio as of the end of September 2019 (Exhibit 9).

We expect these ratios, as well as our Tangible Common Equity (TCE7, Exhibit 10) ratio to remain stable over the next two years, aided by the bank’s conservative distribution strategy. We anticipate CS will retain about CHF4 billion of core capital that will help it build thicker buffers against market volatility as well as offset regulatory tightening and other contingencies8.

CS aims to increase returns to shareholders by distributing at least 50% of its net income through dividends or share buybacks, and has started its share buyback program in 2019. The remainder of net income generated will be used as a buffer for the RWA inflation likely to result from anticipated regulatory changes as well as investments into the group’s core wealth management as well as its investment banking and capital markets businesses, provided market conditions allow.

Credit Suisse will maintain its TCE metrics at current levels, despite regulatory tightening

Tangible Common Equity (TCE) and related ratios

---

Notes: (1) Basel III fully phased in advanced approach for all US banks. Citi has only reported CET1 ratio under the standardized approach, which is the binding constraint. The CET1 ratio under the advanced approach shown in the chart is Moody's estimate; (2) Tier 1 leverage ratio for US banks is the supplemental leverage ratio (SLR).

*UBS and CS leverage ratios reflect Common Equity Tier 1 plus Low Trigger Additional Tier 1 and High-Trigger Additional Tier 1 securities.

**Barclays (BCS) leverage is reflective of the spot UK leverage ratio.

Sources: Companies’ results presentations and financials, Moody’s Investors Service
Moody's related publications

Issuer and Sector In-Depth

» GIBs heighten readiness against constant cyber threat, October 2019

» Sector stratification will relegate some from top flight of capital markets competition, September 2019

» Outlook for Global Investment Banks revised to stable as global economic slowdown adds to profit pressures, August 2019

» Global Investment Banks - GIBs generally prepared for stress in leveraged lending; degree of impact varies, May 2019

» Global Investment Banks - Readying for Brexit, deal or no deal, January 2019

» Fintech: Most GIBs have means to meet the digital threat, but need agile strategies to respond, November 2018

» UBS Group AG and Credit Suisse Group AG: Review of UBS's ratings for upgrade reflects its lower capital markets risk and more predictable earnings, April 2018

Rating Action

» Moody's affirms Credit Suisse AG's A1 senior unsecured debt and deposit ratings; outlook changed to positive, December 2019

Rating Methodology

» Banks methodology, November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 The ratings shown are the bank’s deposit and senior unsecured debt rating and outlook(s), as well as its Baseline Credit Assessment (BCA).

2 Moody’s estimate.

3 Based on adjusted annualized 9-month 2019 figures over 2015.

4 This target is based on flat revenue, while adjusted 9-month 2019 revenue declined 1% year-over-year.

5 To illustrate this point, CS had no inventory losses in Q4 2018.

6 Bank for International Settlements.

7 In addition to CET1 capital, our TCE ratio includes going-concern capital instruments such as high-trigger additional Tier capital notes.

8 One of those contingencies is the enactment of the of the new minimum tax regime in the US (so-called BEAT). CS believes it will more likely than not become subject to the BEAT, increasing its US tax liability. Should CS stay 'in BEAT', the group tax rate would reach around 30% in 2019, slightly constraining its bottom-line profitability and, thereby, capital-generation capacity. The proposed retention of capital will, therefore, help buffer potential negative effects from being 'in BEAT'.
MOODY'S INVESTORS SERVICE

© 2019 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MOODY'S PUBLICATIONS MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT OR IMPAIRMENT. SEE MOODY'S RATING SYMBOLS AND DEFINITIONS PUBLICATION FOR INFORMATION ON THE TYPES OF CONTRACTUAL FINANCIAL OBLIGATIONS ADDRESSED BY MOODY'S RATINGS. CREDIT RATINGS DO NOT ADDRESS OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK; MARKET VALUE RISK; OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PREPARED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY ANY PERSON AS A BENCHMARK AS THAT TERM IS DEFINED FOR REGULATORY PURPOSES AND MUST NOT BE USED IN ANY WAY THAT COULD RESULT IN THEM BEING CONSIDERED A BENCHMARK.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY CREDIT RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for ratings opinions and services rendered by it fees ranging from $1,000 to approximately $2,700,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan K.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

REPORT NUMBER 1202071
Credit Suisse AG: Restructured businesses will be more sustainably profitable and have an improved funding profile