MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
13 July 2021

Rate this Research

RATINGS

Credit Suisse Group AG

LT Senior unsecured debt rating	Baa1
Outlook	Stable

Credit Suisse AG

LT Bank deposit rating	A1
Outlook	Stable
LT Senior unsecured debt rating	A1
Outlook	Stable
Baseline Credit Assessment	baa2

Source: Moodys.com

Analyst Contacts

Michael Rohr +49.69.70730.901
Senior Vice President
michael.rohr@moodys.com

Yana Ruvinskaya +33.1.53.30.33.93
Associate Analyst
yana.ruvinskaya@moodys.com

David Fanger +1.212.553.4342
Senior Vice President
david.fanger@moodys.com

Laurie Mayers +44.20.7772.5582
Associate Managing Director
laurie.mayers@moodys.com

Ana Arsov +1.212.553.3763
MD-Financial Institutions
ana.arsov@moodys.com

Credit Suisse Group AG

Risk management and governance issues may undermine franchise and earnings stability

Events in early 2021 revealed that Credit Suisse AG's (CS, A1/A1 stable; baa2[1]) risk awareness and controls have been inadequate and that the group was operating at an elevated risk appetite in certain business segments (see box page 2). Until CS's underlying risk-management deficiencies are resolved, the bank remains exposed to reputational and financial risks that may erode its capital and franchise strength, a credit negative reflected in the 13 July downgrade of the bank's ratings. However, several ongoing measures and underlying strengths will help protect bondholders during this period of heightened risk.

» **Further major disruptions or business model changes would strain CS's profitability and credit strength.** Operating leverage may be harder to achieve if there is more negative news flow around preceding events or yet another large-scale restructuring. In the event of the latter, revenue attrition and restructuring costs could put prolonged strain on the bank's ability to earn its cost of capital, in particular if CS decides to make bigger cuts to its capital markets operations or materially lower its risk appetite in this segment.

» **Sustainably improved capital markets operations will be essential to stabilise profitability and support franchise.** CS's capital markets segment has struggled to earn returns that justify its inordinate resource consumption, risk-management challenges and earnings volatility. Personnel costs remain stubbornly high, far outpacing peers, and the effort to maintain its narrower and highly specialized capital markets franchise has undermined the solid results of CS's Swiss operations and its large asset and wealth management segment.

» **Earnings from more stable, less capital-intensive businesses will help buffer unexpected losses.** The group's asset and wealth management franchises and domestic universal banking operations should deliver steady and highly predictable earnings to help buffer unexpected losses in the capital markets businesses. However, the bank still relies more on capital markets earnings than most of its close peers, and a turn in the credit cycle will put the bank's earnings stability to the test.

» **Superior liquidity and sound funding protect bondholders.** Liquidity remains a comparative and credit positive strength of CS, significantly reducing its refinancing risk. The group's total loss-absorbing capacity (TLAC) is also greatly improved, and the related debt issuances have significantly extended CS's debt maturities. The continued strength of these credit drivers – together with solid capitalisation and a conservative capital distribution strategy – will be critical to sustaining CS's baa2 Baseline Credit Assessment.

Events in early 2021 raise questions on CS's risk awareness and controls

During the first quarter of 2021, CS realised CHF4.4 billion of losses in its prime brokerage business related to the default of US-based hedge fund client, Archegos Capital Management. It also had to contend with the closure of its supply-chain finance funds and subsequent default of Greensill, the originator of the funds' assets. These events unveiled deficiencies in cross-divisional governance and risk control as well as in management awareness across business segments. There also remains significant uncertainty regarding the final financial, regulatory, legal and reputational implications pertaining to these issues.

» **The Archegos default** and related losses incurred highlight the inherent credit-negative risks and opacities of CS's (and other banks') prime brokerage services, particularly when these services are provided to lightly regulated entities with very limited financial disclosures. One central challenge for prime brokers is the opacity of client positions held at other prime brokers, making it difficult to ascertain the clients' overall financial well-being and exposures. This risk is magnified in the case of lightly regulated clients without substantial public financial reporting requirements, which appears to have been the case for Archegos. Prime brokers can manage such risks indirectly by requiring elevated margin postings and frequently refreshing these requirements based on changes in the value and riskiness of their clients' holdings and broader market considerations. However, we anticipate that CS's margin requirements were not sufficient to cover the risks the client had taken in a concentrated and leveraged portfolio composed of just a handful of US- and Asia-Pacific-based public companies, magnified by total return swaps and other derivatives. Our understanding also is that CS reacted late to the risks building up at Archegos, and that its risk management, monitoring and decision processes lagged those of many of its peers.

» **The closure of CS's supply-chain finance funds and subsequent default of Greensill** earlier in March over doubts around the quality of the funds' underlying assets raise additional concerns regarding the monitoring and control processes in CS's Asset Management segment. CS acquired the funds' assets through Greensill, an innovative provider of supply chain financing transactions that were securitized and put into a bond-like format (some of these notes carried insurance cover). These assets were supposed to be short-term, low-risk, cash-flow-based transaction funding for the sellers, but CS identified $2.3 billion of assets with 'considerable uncertainty with respect to their valuation' generated from a concentrated portfolio of just three obligors. This concentrated 'focus area' also includes financed future sales of goods and services[2]. A stricter monitoring and control framework might have prevented CS Asset Management from acquiring these assets, which later grew to a size and exposure to concentrated positions that made it impossible to continue operating the funds safely for investors.

To sustain its credit strength, CS will have to demonstrate that these events do not result in a sustained further negative financial impact, in particular on its capital position, or additional disruption to its overall franchise. In this regard, we positively take account of the bank's strong underlying business performance, which mitigated the drop in the bank's capital and leverage ratios during the first quarter of 2021, as well as the announced capital measures.

Further major disruptions or business model changes would strain CS's profitability and credit strength

CS's business setbacks in early 2021 have the potential to substantially curtail the bank's ability to generate earnings on par with those of the preceding two years, and put its targeted return on tangible equity of 10%-12% at risk. The bank's results will be burdened by further losses as it unwound positions relating to its defaulted US hedge fund client Archegos during the second quarter of 2021 as well as potential losses resulting from the wind-down of the Greensill-related supply chain finance funds.

On top of these two key reverses to its franchise and earnings, CS will likely have to contend with lower pre-provision profitability as client-driven trading revenue normalises from extraordinarily high levels in 2020 and during the first half of 2021. A pronounced decline in trading activity would hit CS harder than some peers given its comparatively high reliance on transaction-driven capital markets revenue and high exposure to the underwriting of leveraged lending and high-yield debt transactions.

In response to the most recent events, CS has already announced cuts to its prime brokerage activities that, together with other measures, will reduce its Investment Bank (IB) leverage exposure by at least $35 billion. And there could be additional business cuts or exits in areas that carry high risk or consume inordinate resources in terms of risk-weighted assets (RWA) or leverage exposures. The bank is undertaking a strategic review of its business model and mix under new chairman Antonio Horta-Osario which aims to stabilise its franchise and revenue; foster stronger risk management, assessment and controls; as well as reinforcing a culture of personal accountability and responsibility.

These measures taken alone are positive, but come with potential trade-offs for CS's underlying profitability and franchise strength. A sharp reduction in capital markets operations or a large-scale business model overhaul would make it difficult for the bank to earn its cost of capital because of revenue attrition and restructuring costs. And a large reduction in risk appetite would undermine CS's ability to underwrite new business or maintain the lucrative client relationships it has fostered for decades through an integrated business model. Setting these caveats aside, quick and steady progress in repositioning its business model would be credit positive for CS, producing more stable, predictable earnings and freeing up capital to invest in the strategic segments that distinguish – and ultimately safeguard – its franchise.

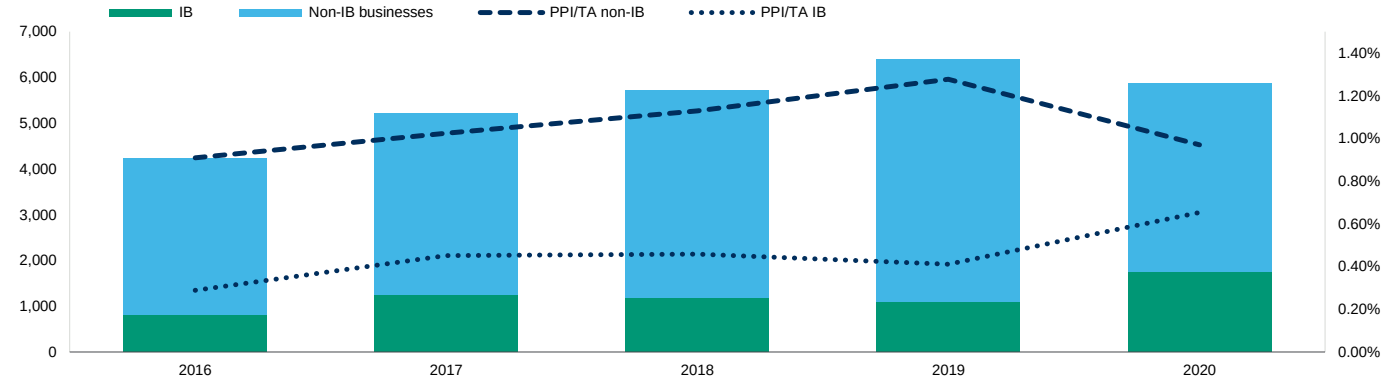
Sustainably improved returns from capital markets operations will be essential to stabilise profitability and support franchise

Any large-scale overhaul of CS's business model is likely to aim first and foremost at resolving the structurally low profitability of its Investment Bank. Since its 2015-18 restructuring, this segment has contributed about 20% to the group's pretax profitability, but its results have lagged the group's overall return on assets (Exhibit 1). The IB's profitability in part suffers from comparison with other, more stable segments across CS's integrated business model. However, the segment's stubbornly high compensation expenses and inordinate consumption of resources also contribute to its comparatively low returns.

Exhibit 1

The Investment Bank has chronically underperformed CS's more stable businesses

Pretax profit by segment (CHF million) and pretax return on assets by segment (%)



PTP = Pretax profit (adjusted); TA = Total assets; IB = Investment Bank; excludes Corporate Center.
Sources: Company reports, Moody's Investors Service

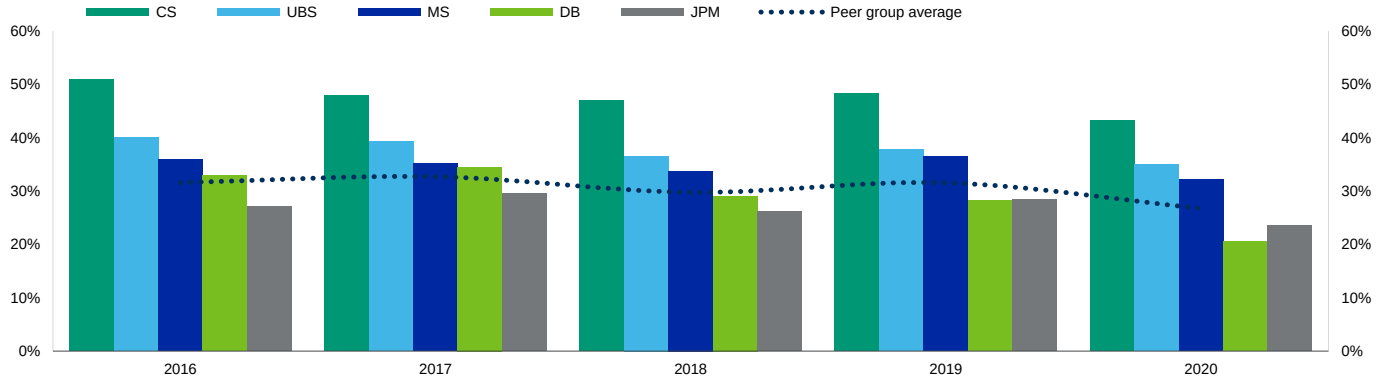
CS's Investment Bank compensation ratio is among the highest in the industry

Compensation and benefits expense equaled 47% of the IB's revenue base during the 2016-20 period, well above the peer group average of 31% (Exhibit 2). This substantially higher cost base in part reflects the large pool of specialists CS requires to handle the complex high-yield and leveraged finance products it offers through its fixed-income franchise. And despite this investment in talent, specialized fixed-income products have not helped increase the IB's revenue and returns. Nor has cross-selling of capital markets products to CS's wealth management or corporate banking clientele materially increased the IB segment's contribution to overall group profitability.

Exhibit 2

CS displays the highest compensation ratio in its peer group

IB segment* compensation and benefits over total segment revenue



*Segments as defined by the reporting banks.

Sources: Company reports, Moody's Investors Service

CS's compensation ratio has declined in absolute terms since 2016, which in isolation is positive but when contrasted with compensation increases at several close peers might lower staff motivation and increase staff turnover. Reducing compensation also risks creating detrimental incentives for employees to seek short-term results for their immediate benefit instead of lasting solutions that support the bank's business strategy and prospects. It will be a delicate undertaking to realign the Investment Bank's cost base without risking a loss of talent and, thereby, a loss of market share.

Returns do not justify high resource consumption

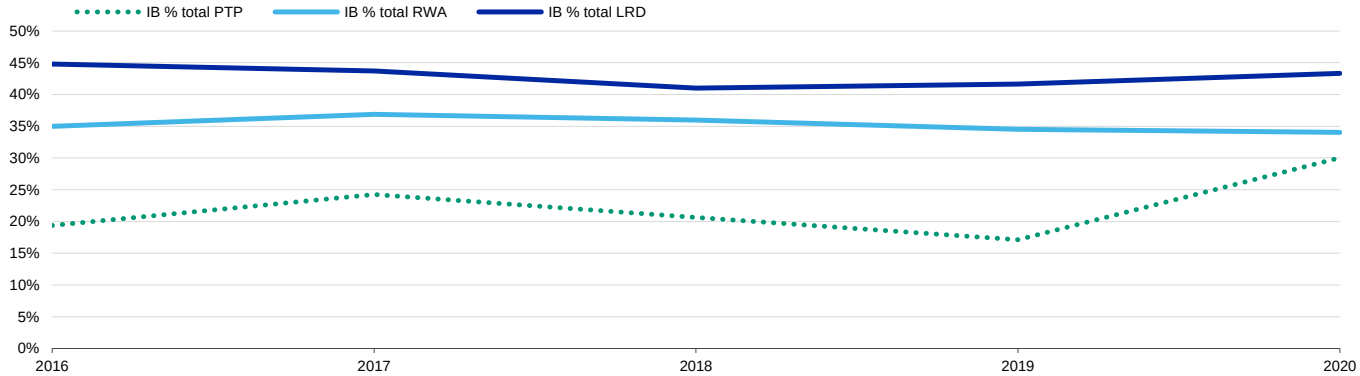
CS aims to limit the IB's resource consumption following its segment reshuffle and the resulting restatement of its historic financial data in Q3 2020 (2020: 34% of group RWA; Q1 2021: 37%[3]). The segment's RWA consumption has hovered at this level over the past couple of years, but has not appreciably declined since the group's 2015-18 restructuring concluded (Exhibit 3, light blue line). And the IB consumes an even higher proportion of the group's leverage exposure, and is back to 2016-17 levels of around 45% (dark blue line).

In our view, this points to CS enlarging its positions in high-yield and leveraged debt capital markets in expectations that the favourable market environment and high market liquidity of 2020 and early 2021 will endure. High market liquidity and the search for yield will indeed help increase balance sheet velocity. But this strategy also risks higher losses in case of a pronounced capital markets decline or if customer appetite for high-yield or leveraged capital markets products fades.

Exhibit 3

The IB's resource consumption and risk have not produced commensurate profitability

IB pretax profit share versus RWA and LRD share



PTP = Pretax profit (adjusted); RWA = Risk-weighted assets; LRD = Leverage ratio denominator; IB = Investment Bank; excludes Corporate Center.
Sources: Company reports, Moody's Investors Service

Earnings from more stable, less capital-intensive businesses will help buffer unexpected losses

Leading up to the recent setbacks in prime brokerage and asset management, CS has grown its sources of recurring revenue, particularly in asset and wealth management-related businesses. This effectively lowered its dependence on more volatile Investment Bank income (also see Exhibit 1). The favourable market environment helped in the bank's effort to increase the share of earnings from less capital-intensive businesses. CS's more stable divisions – the Swiss Universal Bank (SUB), International Wealth Management (IWM) and the private banking business within the Asia-Pacific segment – have together consistently consumed about 60% of the group's RWAs and leverage exposures (excluding the Corporate Center) while contributing almost three quarters of the group's pretax profit (Exhibit 4). The steady and predictable earnings from these three divisions will help buffer potential adverse developments in capital markets that could exert significant strain on CS's earnings generation in related businesses.

Exhibit 4

Asset-gathering and Swiss universal banking businesses help offset capital markets-related earnings volatility

Cumulative pretax profit by segment (2017-2020)

Excludes Corporate Center. The Swiss Universal Bank also generates a significant part of its pretax profit from CS's Swiss private banking (asset-gathering) business.
Sources: Company reports, Moody's Investors Service estimates

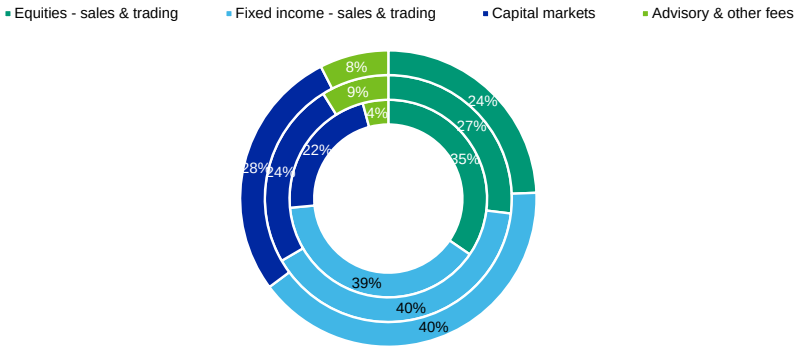
However, sustaining steady, robust earnings through adverse market conditions will remain a challenge because, even at reduced size, the capital markets franchise will continue to rely on healthy fixed income and equity markets. Solid client activity for high-yield products in debt capital markets and leveraged finance markets will be particularly important (Exhibit 5).

Moreover, any adverse development in the leveraged finance and sponsor industry could damage CS's ability to sustain revenue, as would a severe deterioration in global leveraged finance markets. CS will have to maintain strong underwriting criteria to help shield itself from losses when the benign cycle for these exposures turns.

Exhibit 5

CS's capital markets franchise is focused on fixed income, and more concentrated than market-leading peers

CS capital markets revenue by type, 2013 versus 2019 and 2020



Outer circle 2020, mid circle 2019, inner circle 2013. Capital markets includes Debt Capital Markets, Equity Capital Markets and certain advisory revenue. 2020 and 2019 based on USD disclosure; 2013 in Swiss Francs.

Sources: Company reports, Moody's Investors Service

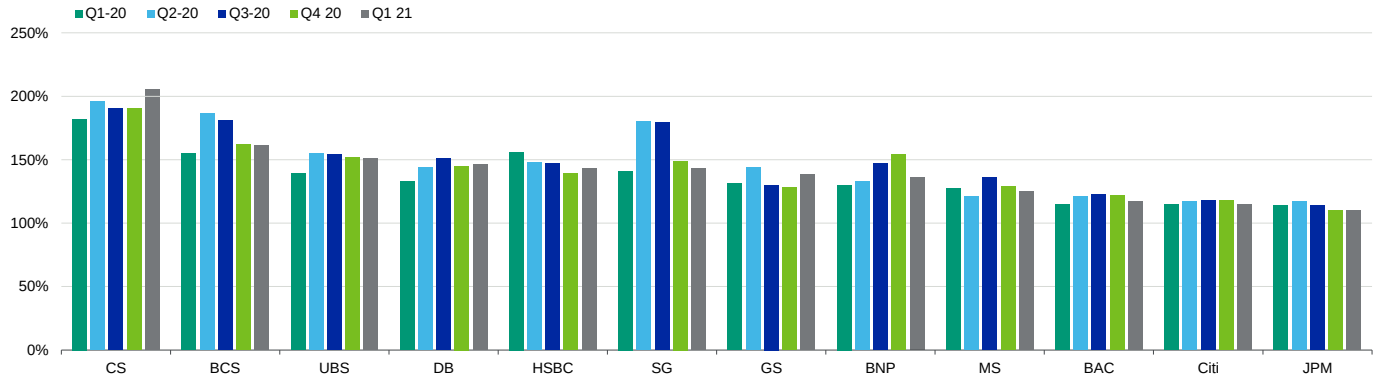
Superior liquidity and sound funding protect bondholders

CS reported a strong liquidity coverage ratio (LCR) of 205% in Q1 2021, up from 190% in Q4 2021 and well above the 135% average for its global investment bank (GIB) peer group (Exhibit 6). Maintaining above-average liquidity and strong capital ratios remains important to CS because of its sizeable global wealth management and capital markets franchises. The deposits and short-term market funding of these businesses may be more confidence-sensitive than for traditional banks, exposing CS to liquidity stress in an adverse scenario (e.g., a material reputational event).

Exhibit 6

Credit Suisse's conservative liquidity management supports peer-leading LCR

Global Investment Banks' LCR, Q1 2020 - Q1 2021



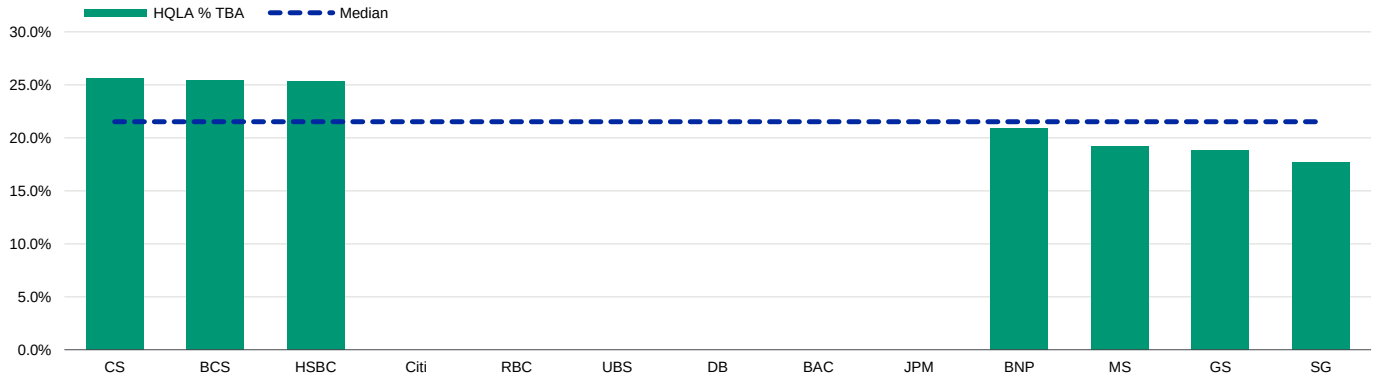
Source: Company reports, Moody's Investors Service

CS further benefits from strong on-balance-sheet liquidity, with a reported liquidity reserve and other unencumbered liquid assets of CHF231 billion as of the end of the first quarter, largely comprising central bank cash and other highly liquid securities. Its high share of cash deposits with central banks, unencumbered government securities, and other highly rated non-sovereign obligations further enhances the quality of its liquid assets. Moreover, high-quality liquid assets (HQLA) have grown to above 25% of its total assets as of the end of 2020, a clear credit strength (Exhibit 7).

Exhibit 7

High quality liquid assets (HQLA) support balance sheet liquidity

HQLA as a % of tangible banking assets (TBA)



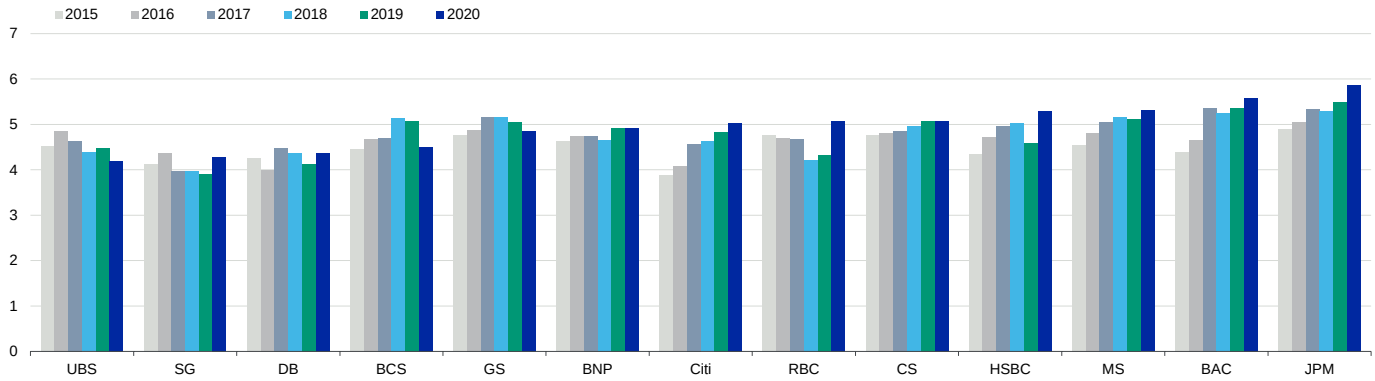
Average weighted HQLA reported in banks' Q4 2020 LCR disclosures; LCR measure considers 'due from financial institutions' as liquidity inflow, but not as part of the banks' HQLA stock.
Sources: Company reports, Moody's Investors Service

CS also issued most of its loss-absorbing debt earlier than many peers, which has significantly extended its debt maturity profile and lowered its refinancing risk. CS's total loss-absorbing capacity (TLAC) improved substantially to CHF105.6 billion as of the end of the first quarter (Q1 2020: CHF92.9 billion), corresponding to a TLAC ratio of 34.8%, well above regulatory requirements. We estimate the weighted average maturity of CS's TLAC-eligible long-term market funds to be around 6.5 years, superior to many of its GIB peers. We further estimate the funding tenure of the bank's long-term senior debt is around five years (Exhibit 8). This funding structure will give CS greater flexibility to manage refinancing costs as well as groupwide funding and liquidity needs, increasing its ability to weather periods of heightened market or spread volatility.

Exhibit 8

Credit Suisse has one of the longest funding tenures within its peer group

Average weighted maturity of long-term debt in market funds in years



Midpoint 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.
Source: Company reports, Moody's Investors Service

Moody's related publications

Issuer and Sector In-Depth

» Global Investment Banks – Europe: Q1 2021 Update - Favourable capital markets and lower loan loss charges support profitability, May 2021

» Global Investment Banks – US: Q1 2021 Update - Income up with robust capital markets,reserve releases; capital may have peaked, April 2021

» Moody's - Global Investment Banks' 2021 Outlook is stable – diversification, strong capital and liquidity counter pandemic effects, December 2020

» Biggest banks are better set to withstand COVID-19 stress than banks as a whole, September 2020

» Stable wealth-management arms of largest Swiss and US banks are a credit positive offset to COVID-19 disruption, September 2020

» Global investment banks' strong liquidity helps insulate creditors, May 2020

» Global Investment Banks: Estimated profit hit in coronavirus shock scenario should not take toll on capital, April 2020

» Fintech - Global Investment Banks: GIBs can keep pace with fintechs, but retail banking is most at risk of a digital divide, February 2020

» GIBs heighten readiness against constant cyber threat, October 2019

» Sector stratification will relegate some from top flight of capital markets competition, September 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 downgrades Credit Suisse AG's senior unsecured debt and deposit ratings to A1; outlook stable, July 2021

Rating Methodology

» Banks Methodology, July 2021

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/senior unsecured debt rating and outlook(s); as well as its Baseline Credit Assessment (BCA).

2 Such advances on future sales led to a purchase of a receivable when the planned transaction between the supplier and its customer took place and generated a receivable.

3 Original guidance was to limit the IB's resource consumption to one-third of deployed capital. CS updated its guidance in April 2021 and now plans to reduce IB leverage exposure by at least $35 billion and to no more than the prior-year level by the end of 2021.

REPORT NUMBER 1288812

Contributors

Michael R Porta
VP-Senior Research Writer

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S
INVESTORS SERVICE