FITCH RATINGS: CREDIT SUISSE'S 3Q18 HIGHLIGHTS DISCIPLINED EXECUTION; MUTED REVENUE GROWTH

Fitch Ratings-London-02 November 2018: Credit Suisse Group AG's 3Q18 results show continued progress towards meeting cost and non-core asset reduction targets, but highlight the importance of revenue growth to sustain profitability, Fitch Ratings says. The bank delivered CHF4.0 billion cumulative net cost savings between 1Q16 and 3Q18, just shy of the target of above CHF4.2 billion by end-2018. The delivery of significant cost reductions makes revenue growth a key driver of future profitability, in our view. Revenue growth was a muted 2% in 9M18 but fell 2% yoy in 3Q18.

Lower losses from the non-core Strategic Resolution Unit (SRU) were the single largest contributor to the yoy improvement in performance. We estimate Credit Suisse's annualised operating profit was a modest 1.0% of risk-weighted assets (RWA) in 3Q18, seasonally lower than 2Q18. The quarter highlighted that falling revenue from investment banking related activities, which accounted for a significant 43% of revenue in 9M18, can significantly dampen underlying improvements, even with a reduced cost base. In 3Q18, pre-tax profit falls in Global Markets (GM) and Asia Pacific Markets offset 80% of the y-o-y benefit from shrinking SRU losses. Fitch's Positive Outlook on Credit Suisse's rating indicates the possibility of an upgrade with a more sustained record of decreased earnings volatility in capital markets businesses, as well as the delivery of planned cost reductions. We consider the bank has yet to fully achieve this.

We expect profitability in 2019 to be supported by lower funding costs as Credit Suisse has redeemed CHF6.2 billion of hybrid capital instruments so far in 2018, and issued CHF3.7 billion in capital instruments at a materially lower cost. This should reduce funding costs by about CHF700 million in 2019 and boost the bank's profitability.

The Swiss Universal Bank remains Credit Suisse's key earnings driver, generating 49% of pre-tax profit excluding the SRU and the corporate centre, reflecting a 20% yoy improvement. Modest revenue growth (2%) concentrated on the corporate and institutional clients segment, led by commission revenue, while lower transaction-based income for private clients led to a 2% revenue fall in that segment. Pre-tax profit was supported by a 10% reduction in operating expenses, resulting in a sound 58% cost/income ratio. Net new asset growth of 2% in the quarter was satisfactory, and reflected the mature nature of the domestic market.

Pre-tax profit in International Wealth Management (IWM) was up 8% yoy to CHF383 million excluding a small loss on sale, mainly reflecting a 4% reduction in operating expenses and flat revenue. Private banking revenue grew 5%, buoyed largely by greater transaction and to a lesser extent net interest income, driven by higher deposit and loan volumes.

The 19% decline in Asia Pacific's pre-tax profit to CHF176 million reflected the sensitivity of divisional earnings to market performance. Lower stock market valuations depressed both trading revenue (27% yoy fall in US dollar terms) and transaction-based private banking revenue. The latter accounts for a higher) proportion of private banking revenue compared with other regions (36% in 9M18 compared with 28% for IWM in the same period). The markets segment within Asia Pacific reported a CHF4 million pre-tax loss. Credit Suisse's strategy in the region includes growing lending and asset-based financing, but net interest income growth in private banking could not offset the fall in transaction income. Advisory, underwriting and financing in the region nonetheless saw a strong 15% revenue increase. Rapid net new money growth (12% in the quarter) was not matched on the balance sheet, as net loans fell by 1% yoy.

Lower activity in credit (notably agency structured products in the US), and to a lesser extent the closure of certain activities in rates and emerging markets, led to a 20% yoy fall in fixed income trading revenue in GM, underperforming peers. A further 10% reduction in expenses was insufficient to avoid a CHF96 million pre-tax loss in the quarter. Equities trading revenue held up better (1% growth) reflecting senior hires, appetite for structured equity derivatives and equity underwriting activity, but accounted for only 36% of trading revenue.

With USD4.1 billion revenue in 9M18, Fitch believes that it is highly likely that Credit Suisse will not meet its USD6 billion revenue target for GM in 2018, which suggests a divisional cost/income ratio well above 80% for 2018. Lower leverage exposure (largely in relation to lower high-quality liquid assets, HQLA) leaves some room for opportunistic growth in future, suggesting further business realignments might be necessary to reach satisfactory profitability, in our view. In contrast, underwriting and advisory activities booked in Investment Banking & Capital Markets performed well, doubling pre-tax profit yoy to CHF70 million (a limited 7% of the group, excluding the SRU and the corporate centre).

Credit Suisse's fully-loaded Basel III CET1 ratio improved by 10bp qoq, to a sound 12.9% at end-3Q18. Leverage exposure remains the binding constraint for the group, at least in the short to medium term. The group's CET1 leverage ratio was a sound 4.0% (5.1% Tier 1 leverage ratio). Following lower liquidity requirements in the New York branch and lower usage in GM but also APAC, leverage exposure fell by a significant 4% qoq (CHF35 billion). This helped mitigate the impact of lower additional Tier 1 capital on the leverage ratio, following the redemption of legacy capital instruments.

The reduction of liquid assets held by the group will result in a lower liquidity coverage ratio, which in 3Q18 stood at a strong 202%. The reduced volume of HQLA, which at end-3Q18 stood at CHF149.4 billion, down from CHF172.5 billion at end-2Q18, was not fully reflected in the LCR, which under Swiss rules is calculated using a three-month average based on daily calculations during the quarter.

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