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Weekly Credit Brief Jun 14 - Jun 20 2022

Despite its strong capital position, consecutive losses worsen credit profile of Credit Suisse Group AG

by Amrita Parab

- **NUS-CRI 1-year PD of Credit Suisse climbs higher as the bank faces consecutive quarters of losses driven primarily by poor investment banking performance and high litigation costs**
- **NUS CRI Forward PD suggests that the bank's credit outlook may improve following the bank's actions to reduce costs and improve risk management**

Recently, Credit Suisse Group AG issued a statement indicating that it is headed for a third consecutive quarterly loss in Q2 2022. Credit Suisse, which has been hit by major setbacks following the collapse of Archegos and Greensill, finds itself amidst yet another precarious situation of successive loss-making quarters which can be attributed to the slowdown in its investment banking division, amid wider macroeconomic events that have affected the global markets such as the Ukraine-Russia war. While these factors create headwinds for the entire industry, Credit Suisse continues to exhibit higher credit risk than its peers. The NUS-CRI 1-year Probability of Default (PD) for Credit Suisse in Figure 1a showcases an overall increasing trend since Jan-2022, with occasional spikes concurrent with the bank's consecutive losses in the past two quarters, jumps in litigation provisions and increased scrutiny by regulators. Going forward, the bank has made a commitment to improving its risk management processes, whilst simultaneously reducing costs by restructuring business segments and possibly curtailing headcount. As can be seen in Figure 1b, the NUS-CRI Forward 1-year PD (Forward PD[1]) suggests a potential improvement in Credit Suisse's financial health, especially as the bank navigates the incumbent macroeconomic headwinds in global markets with strong and stable capital position.

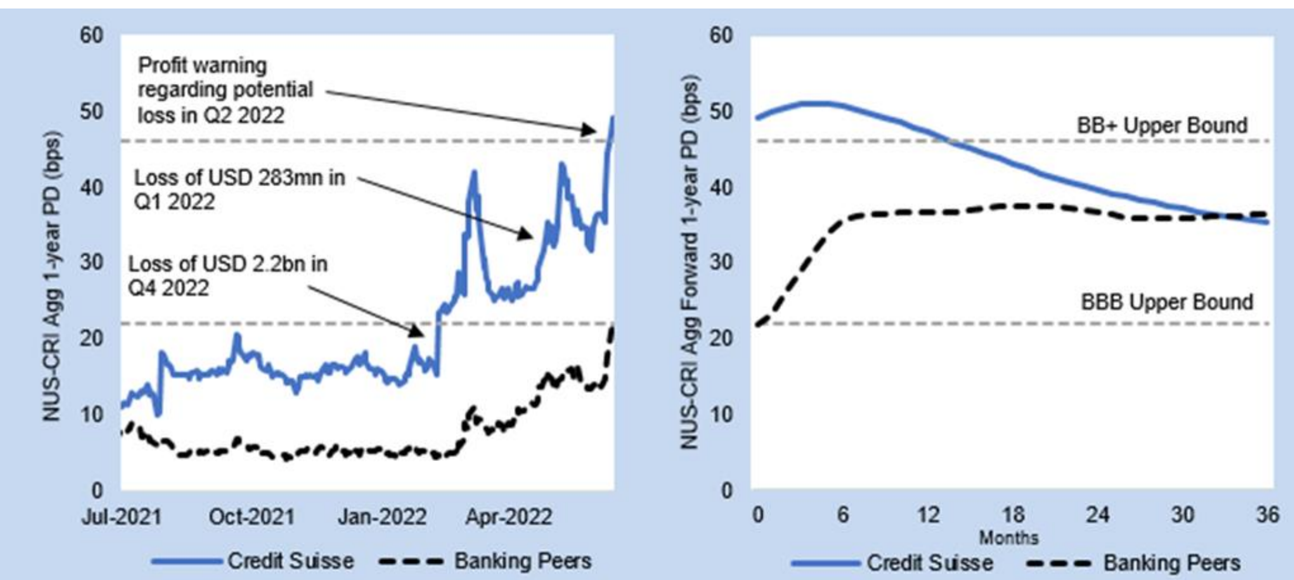

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Credit Suisse and its banking peers[2] from Jul-2021 to Jun-2022 with reference to PDiR2.0[3] bounds. Figure 1b (RHS): NUS-CRI Forward Agg 1-year PD for Credit Suisse and its banking peers as of Jun-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[2] Peer group identified on the basis of Credit Suisse's corporate presentation - JPMorgan Chase & Co, Citigroup Inc, Societe Generale SA, Goldman Sachs Group, Bank of America Corp, Barclays PLC, HSBC Holdings PLC, UBS Group AG,Morgan Stanley, BNP Paribas SA, and Deutsche Bank AG.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The most recent warning issued by Credit Suisse to the market regarding its worsening financial performance follows two consecutive loss-making quarters driven by a slowdown in its investment banking revenue and an increase in litigation-related provisions. The bank's investment banking division, which took a USD 5.5bn hit (22% of FY 2021 revenue) due to the collapse of Archegos Capital Management, has been facing headwinds since 2021[4] as the bank reduces its exposure across asset classes to reign in market risk. With the bank recording a 42% YoY drop in revenue in Q1 2022, Credit Suisse's deteriorating financial performance, especially when compared to its peers (See Figure 2a), could spell trouble for the bank's near-term credit risk outlook. Subsequent quarterly revenue reductions and even short-term losses may continue to mount, especially with equity and debt issuances depressed across the globe as companies navigate market volatility.

Adding further trouble to the bank's woes are a plethora of legal-based challenges. The bank has been embroiled in numerous litigations which have been a drag on its profitability. Its litigation provisions have been increasing since Q3 2021 (See Figure 2b), which, combined with a 50% YoY drop in investment banking revenue, drove the bank to register a loss for the quarter. The current macroeconomic environment and the resultant market volatility could mean that the bank may still have to contend with profitability challenges and expectations that asset inflows will remain muted as clients remain wary of adverse market reactions to the bank's performance. Nevertheless, Credit Suisse still benefits from a strong CET1 ratio (Q1 2022: 13.8%), which may provide potential relief to the bank as it still has a strong capital position.

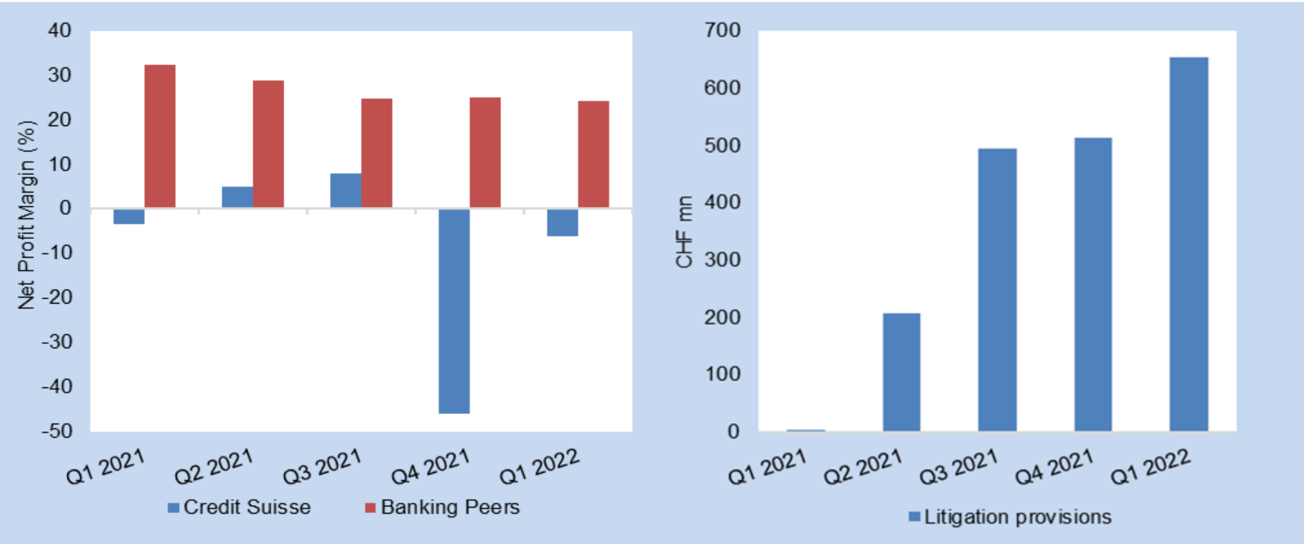

Figure 2a (LHS): Quarterly Net Profit Margin (NPM) of Credit Suisse and its banking peers. Figure 2b (RHS): Quarterly Litigation provisions by Credit Suisse. *Source: Bloomberg, Credit Suisse's Financial Statements*

To ensure that the bank has enough liquidity and is in line with regulatory capital requirements, Credit Suisse is planning to raise an additional USD 1.25bn by offering a new AT1 bond[5]. The cost of borrowing on this issuance is close to 10%, almost 3 percentage points above a similar issuance by the company in the past, and far above the costs incurred by its peers. Furthermore, with close to 16% of Credit Suisse's debt maturing over the next year, should the bank wish to refinance, it is likely that Credit Suisse will face similarly high costs of borrowing in the near future, worsening its credit risk outlook in the short term, as suggested by the short-term increase in Forward PD in Figure 1b.

The Archegos and Greensill scandals resulted not only in a monetary loss but also a reputation[6] loss for the bank. The bank faces a tough task as it tries to rebuild its reputation by addressing lapses in risk management and building better risk control processes[7]. However, going forward, to optimize costs, the management has undertaken a plan to restructure business segments and potentially reduce headcount. However, the current macroeconomic environment may not allow for a smooth transition to recovery as potential recessionary headwinds depress revenue-generating opportunities. If the bank successfully executes the planned overhaul of its business, it may see a potential improvement in its credit health in the medium term. The Forward PD curve in Figure 1b suggests that data-based prediction supports the possibility of such a scenario.

[4] The drop in revenue also occurred partly as the bank decided to exit its prime brokerage business post the Archegos scandal.
[5] AT1 bonds, or convertible "Coco" bonds, are converted to equity when certain covenants are breached, normally witnessed during periods of stress for the issuer. For Credit Suisse's latest issuance, the bond will not be converted to equity if the bank's capital ratio falls below the regulatory requirement, but will rather be written down.
[6] The fact that the bank continues to face repercussions on multiple current and legacy litigations may prolong its revenue recovery as some litigations such as Greensill are expected to drag on till 2027.
[7] The bank also plans to focus on key businesses such as asset and wealth management as these segments typically require lower capital allocation and have a more stable revenue stream as compared to investment banking.

Credit News

Corporate bond funds bleed billions as Fed ramps up inflation fight

Jun 17. USD 6.6bn was withdrawn from funds that buy lower-quality debt securities, such as US high-yield bonds, in the second week of Jun-2022. While funds that buy US investment-grade bonds reached outflows totaling USD 2.1bn, making it the most bruising week for fund managers since the pandemic sell-off in Mar-2020. High inflation data in the US raised expectations of aggressive monetary policy tightening by the Fed, which might stamp out US growth and send the economy into recession. Investors fear that a looming economic downturn could test companies' ability to repay their debts, sending bond prices even lower this week. (FT)

U.S. banking stress indicator could worsen after Fed hike

Jun 17. The so-called FRA-OIS spread, which measures the gap between the U.S. three-month forward rate agreement and the overnight index swap rate, increased to 29.55bps on Thursday, its widest since May 23. Widely viewed as a proxy for banking sector risk, a higher spread reflects rising interbank lending risk. Wall Street is also pricing a greater risk of default by U.S. banks. Spreads on five-year credit default swaps (CDS) of JP Morgan, Goldman Sachs, Morgan Stanley, Citigroup, Wells Fargo and Bank of America peaked at fresh two-year highs on Thursday. As such, the stress in the global banking system continues to rise as the interest rate hikes continue to pick up steam. (Reuters)

Corporate loan rates head higher in Europe

Jun 18. Amidst soaring inflation, tighter monetary policy has increased borrowing costs, opposing the trend witnessed during the Covid-19 pandemic where global central banks responded to the economic slowdown through monetary easing. The bond market felt the effect of tighter monetary policy early on, with the cost of borrowing for corporate issuers almost doubling QoQ in Q1 2022. As banks' cost of capital continues to rise, the effect is most likely to potentially seep into the corporate borrowing sector, with the utility sector expected to be hardest hit owing to weakened liquidity. (Bloomberg)

China under pressure to reform debt market as foreign inflows slow

Jun 15. Global investor confidence in China continues to diminish amid capital outflows between Jan-2022 to Apr-2022 amounting to USD 35bn, owing primarily to reduced procedural clarity in handling defaults in the country's high-profile debt-laden companies. Furthermore, domestic demand for China's corporate debt remains low despite government efforts, adding to concerns about growing outflows. Rising US treasury yields have further curtailed the attractiveness of Chinese bonds to bond investors. The market views improving default procedures transparency and access to Chinese futures as potential measures to improve investor activity. (FT)

With the Fed raising rates, companies take a fresh look at financing costs

Jun 17. In response to recent interest rate hikes by the Federal Reserve, companies have been refining their cash flow strategies to address the rising borrowing costs. Interest rates were hiked for the third time this 2022 and are expected to continue to rise further over the next few quarters of the year. Companies with floating-rate debt seem the hardest hit, expecting higher interest costs to arise earlier than expected. Businesses attempt to improve cash flow by collecting receivables, delaying payables, retiring debt, switching to short-term cash investments, and delaying new bond and loan issuance. (WSJ)

Credit investors are hoarding cash after biggest loss since 2020 (Bloomberg)

Tech bear market's latest casualty is pandemic-era convertible debt (Bloomberg)

Looming debt crunch positions Laos as next possible Asia default (Bloomberg)

Regulatory Updates

Kuroda deepens BOJ's outlier status, keeping pressure on Yen

Jun 17. The BOJ reiterated its determination to keep rates steady despite rising inflation and the weakening yen. According to the central bank, increasing rates could further deteriorate the still-recovering economy. This direction diverged from the Fed's strong tightening stance and has led to the depreciation of the country's currency, with the yen plunging to a 24-year low. With its most recent statement, the BOJ expects and warns investors of more volatilities in the movement of the yen. With the pressure on the BOJ mounting, funds have been betting against the currency and its capacity to control the yield curve. (Bloomberg)

ECB tool to avert debt crisis 2.0 takes shape as market on edge

Jun 18. The market is anticipating that the ECB will release a new instrument to avert any impending sovereign debt crisis like the previous blow experienced by the region in the last decade. The expedited development of the said instrument was announced following ECB's emergency meeting to discuss the widening gap between Italian and German bond yields. Prospectively, continued widening of the yield gap beyond set thresholds or at an excessively rapid pace would trigger the instrument. With the ECB expected to start hiking interest rates by Jul-2022, the market is optimistic that the instrument would have been completed, and in place to prevent any adverse impact of the monetary tightening on weaker member economies. (Bloomberg)

Fed raises rates by 0.75 percentage point, largest increase since 1994 (WSJ)

Bank of England hikes rates for the fifth time in a row as inflation soars (CNBC)

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