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Discontinuation of the CHF minimum exchange rate: Far-reaching impacts on the large Swiss banks

Scope Ratings believes that the decision last week of the Swiss National Bank (SNB) to discontinue the minimum exchange rate of the CHF against the EUR has far-reaching consequences: while the move makes sense with regards to the financial stability of Switzerland (in particular the necessity to reduce the balance sheet size of the central bank), the consequences of a higher Swiss Franc on the Swiss economy may be ultimately negative. The two large banks' profitability and shareholders' equity should be hit, on our estimates. We nevertheless expect lower-to-positive impact of the SNB move on UBS's and Credit Suisse's regulatory capital ratios (both CET1 and leverage), but the sudden strengthening of the CHF raises questions about the sustainable profitability of the Swiss-based Private Banking business model.

- **The discontinuation by the SNB of the minimum exchange rate is a sign that the central bank is choosing financial stability over economic growth**: the size of the SNB's balance sheet was becoming too large versus GDP and the impending QE move by the ECB would have forced the Swiss central bank to buy even more EUR to protect the CHF peg and ultimately sustain more losses. Last week's unexpected decision therefore emphasises the SNB's focus on protecting Switzerland's financial stability first and foremost, in our view.

- **The impacts to be sustained by the two large Swiss banks are likely to be far-reaching.** We estimate that the impact of a 20% strengthening of the CHF against the USD and the EUR could impact UBS's underlying annual pre-tax profits by -19%, while a similar appreciation on Credit Suisse's 9m 2014 earnings would have led to a -38% hit. Bar the immediacy of the numbers (which need to be taken with the appropriate care), it is necessary to raise additional questions on (1) the long-term impact of lower economic growth on the banks' Swiss asset quality; (2) the impact of a -0.75% interest rate on deposits held at the central bank; and (3) the sustainable profitability of a Private Banking business model applied in a country with an excessively strong currency. This report also concludes that a 20% appreciation of the CHF over the EUR and the USD has a significant impact on the two large banks' shareholders' equity (-6% estimated for UBS, -14% for Credit Suisse). Conversely, we believe that the impact will be low to marginally positive on the two banks' regulatory capital ratios (both CET1 and leverage ratios) as we explain in this report.

- **Increased pressure on Credit Suisse's long-term ratings**. The more pronounced negative impact of the CHF appreciation on Credit Suisse's metrics is due to the weight of the bank's capital denominated in USD and in EUR. This aspect, combined with the likelihood of more stringent leverage rules stemming from the Brunetti Report (on which Scope wrote a detailed report dated 8 December 2014) and the opening of an investigation from the New York attorney general on fraudulent RMBS transactions are maintaining negative pressure on Credit Suisse's A+ long-term ratings (which already carry a negative outlook).

Analysts

Jacques-Henri Gaulard (author)
j-h.gaulard@scoperatings.com
+44 (0) 203 714 4983

Ilona Dmitrieva
i.dmitrieva@scoperatings.com
+44 (0) 203 714 4984

Sam Theodore (team leader)
s.theodore@scoperatings.com

Scope Ratings AG

The Gridiron Building, 8th floor
One Pancras Square
London N1C 4AG
T: +44 203 714 4980

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100

info@scoperatings.com

www.scoperatings.com

The remainder of this report examines the impact of the discontinuation of the minimum exchange rate on the Swiss financial sector, and on the two large Swiss banks in particular. We look at the different effects, starting with the most relevant first. Our analysis assumes that the CHF appreciates 20% against the EUR and the USD on a sustainable basis.

The choice of the SNB: financial stability over economic growth

It is not the purpose of this report to cast any judgment on the SNB's decision. Various opinions on it have already been expressed by market participants in light of the immediate consequences -- temporary dislocation in the foreign exchange markets, material decline in Swiss equity prices, and pressure on forex brokers throughout the world. The shock of the SNB's communication of such an important decision without forward guidance was also commented upon. Focusing on the SNB's move last week, we consider that it makes sense in the context of respecting the balances of the Swiss economy (even if it means a negative impact on economic growth) and preserving the financial stability of the country at a time when large areas of EU economies display stresses and imbalances.

As far as the balances of the Swiss economy are concerned, Switzerland has traditionally posted a healthily positive current account, but there has been a shift since 2012-2013 showing a strong increase in capital inflows. By lowering the interest rate for balances held on sight deposit accounts to -0.75% from January 22, the SNB is hoping to somewhat mitigate the impact of its decision and in effect discourage the inflows of capital in CHF.

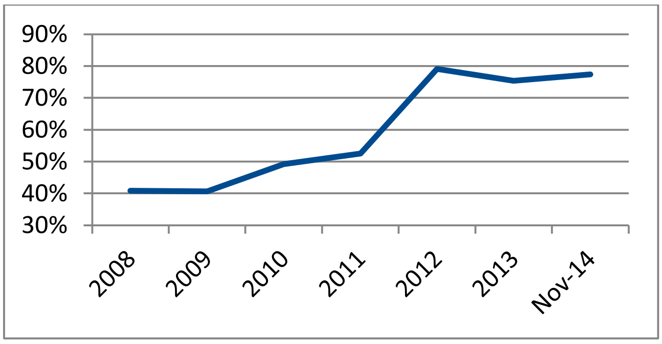
The level of the CHF/EUR has now stabilised at roughly 1.00 (versus 1.20 before the discontinuation of the minimum exchange rate). This 20% appreciation will be painfully felt by Swiss exporters. As a result of the SNB's decision we expect negative pressure on exports, increase in deflation, negative pressure on labour costs and on employment, and ultimately a decline in the Swiss GDP's growth rate. We note that several Swiss exporting companies have already decided to relocate outside the country.

We thus believe that it is important to view the SNB's decision from the angle of financial stability (which is one of the core missions of the SNB). One of the main problems faced by the SNB has been the sheer increase of its balance sheet's size. Indeed, the necessity for the central bank to defend the CHF/EUR 1.20 minimum exchange rate (that had been put into place on 6 September, 2011) led it to buy a considerable quantity of EUR, leading to a ballooning of the balance sheet as a percentage of Swiss GDP (see Chart 1). Since 2012 the total assets of the SNB have represented close to 80% of the Swiss GDP, double the equivalent percentage in 2008-2009. The increase is due almost exclusively to foreign currency investments (to support the value of the CHF), which have increased tenfold between 2008 and 2014.

The combination of a lower value of the EUR triggered by the adoption of QE by the ECB, together with the obligation the SNB would have had to buy even more depreciated EUR assets to maintain the minimum exchange rate would have led to material losses for the SNB, to a further increase of its balance sheet, and also to a depletion of its capital base. The latter could have had a serious impact on the SNB's capacity to transfer funds to the Swiss cantons – which is one of its responsibilities.

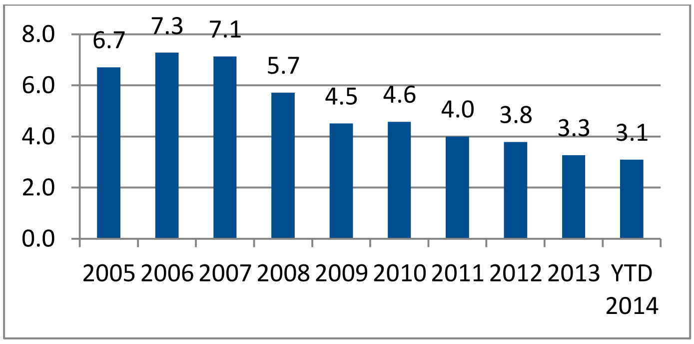
On a different note, we also believe that the 2008 financial crisis has left serious scars in the Swiss financial psyche that may not be dissimilar to what hyperinflation did for Germany in the 1920s. Chart 2 has a look at the relative size of the two large banks' assets versus Swiss GDP (nominal, translated in USD). In this respect, Swiss regulators and policymakers have prioritized the reduction in the size of the large banks' consolidated assets as a proportion of the economy.

Chart 1: SNB's balance sheet as a % of Swiss GDP



Source: SNB

Chart 2: Total assets of CS and UBS x Swiss GDP



Source: Scope Ratings, SNL, Company Data, SNB

Against this backdrop and with the prospect of further EUR-induced stress, we believe that the size and the financial condition of the SNB may have started to become uncomfortable for its governors, thus triggering the decision to discontinue the minimum exchange rate and let the CHF float at its fair value.

Overall, we find it reassuring that the SNB views financial stability as a key priority (including for its own balance sheet). We highlight again that the pro-active and constructive decisions and policies of both the SNB and FINMA (Swiss financial regulatory authority) have represented a positive rating driver for the large Swiss banks rated by Scope from the beginning.

The impact of the SNB move on the profitability of the large two Swiss banks is significant thus raising questions about the Swiss-based Private Banking business model

Among all the impacts that we have identified and tried to quantify, Scope believes that the impact of the SNB move on the profitability of Credit Suisse and UBS is the most significant. Credit Suisse discloses the full revenues and cost lines by currency for the whole group, while UBS limits its disclosure to the impact of a 10% weakening of the Swiss franc against major global currencies for its wealth management, retail and asset management businesses – excluding the investment bank and the corporate centre. UBS also adds the positive impact of such a weakening on its cost base. The disclosure of both banks is therefore not directly comparable. Based on what is communicated by the companies though, **we believe that UBS's scenario applied to a 20% strengthening of the CHF could have an annual impact on underlying (as defined by the company) pre-tax profits of around -19%, while the same assumption applied to Credit Suisse's 9m 2014 earnings would lead to a -38% impact.** Again, we stress that both numbers are not directly comparable, but we note that 55% of Credit Suisse's revenues are USD-denominated.

On top of the immediate impact of the currency strengthening, longer-term negative impacts on profitability are likely to include deteriorating Swiss asset quality (from the very strong base Swiss banks operate in at the moment) and the negative impact of the SNB's deposit rate being lowered to -0.75%.

Taking a bit of perspective from the immediacy of the numbers, we would question the longer-term viability of a Private Banking business model that is so ultimately geared to the fluctuation of the CHF. In the aftermath of the crisis years the public communication of the two large Swiss banks was aimed at explaining the somewhat disappointing profitability metrics of the Private Bank by the combination of low interest rates and a strong CHF. This particular communication subsided somewhat in 2011 and 2012, before re-emerging in more detail in 2013 and 2014, up to a point when both UBS and Credit Suisse engaged in communicating detailed sensitivity analysis (on which most of the conclusions of this report are based) as to what would happen to their financial metrics in case of specific movements in interest rates and currency fluctuation. It is relevant to note that as late as Q3 2014 both banks were focusing their analysis on the strengthening of the USD against the CHF.

Based on the current developments, we believe that in order to avoid decreasing their profitability targets in private banking both Credit Suisse and UBS will probably have to further cut costs or relocate some activities outside Switzerland. At the same time, we note that the strength of the CHF reflects the “safe haven” status of Switzerland, and that the Private Banking business at both banks strongly benefits from this status (in terms of money inflows) even if this has a frustrating impact on profitability. The apparent dichotomy between a growing franchise and a profitability not developing in the same proportion is a question worth asking, even if ultimate answers are yet to be formulated by both banks.

The impact of the SNB move on the shareholders’ equity of both Credit Suisse and UBS is also quite material

The second largest impact of the SNB move is on the shareholders’ equity of both Credit Suisse and UBS. Again, we find a strong disparity in disclosure between banks as UBS discloses the breakdown of its equity by currency (56% CHF, 35% USD, 3% EUR, 6% other) while Credit Suisse does not. Applying a 20% appreciation of the CHF against the EUR and the USD leads to **an impact of -6% on UBS’s shareholders’ equity**.

In the case of Credit Suisse we decided to compare shareholders’ equity as a whole at two given points in time corresponding to a similar change in the CHF/EUR and CHF/USD exchange rate. We find that the currency experienced the same movement between Q3 2009 and Q2 2011. Between 30 September 2009 and 30 June 2011 the CHF appreciated by 19.2% against the USD and by 19.7% against the EUR. Comparing the shareholders’ equity trends at both Swiss banks in-between these two time periods provides relevant information (Tables 1 and 2).

We note first that despite very solid profitability between the two time periods, Credit Suisse’s shareholders equity went down in absolute terms. The main reason is the FX translation reserve (booked in Other Comprehensive Income) which has strongly deteriorated during the same time period. We also observe that share premium/additional paid-in capital also suffered from a strengthening CHF in the time period. **Proxying the change in translation reserve to the Q2 2009 shareholders’ equity gives a negative impact of a 20% strengthening of the CHF of -13.6% decline in Credit Suisse’s shareholders equity**. This is likely to be the lower end of the impact (as this measure does not include the impact of currency fluctuations on the share premium).

For UBS, the conclusions are not dissimilar but they are much more muted. We note that in the case of UBS neither the share premium nor the FX translation reserve move to extent that they move for Credit Suisse, reflecting a larger portion of the equity denominated in CHF for the former compared to the latter.

Table 1: Change in shareholders' equity Credit Suisse Q3 2009-Q2 2011 (CHF m)

Credit Suisse	30.09.09	30.06.11
Common shares & additional paid-in capital	25,471	21,155
Retained earnings	24,527	27,121
Other comprehensive income	-11,166	-16,949
Other	-641	-111
Total	**38,191**	**31,216**
o/w FX translation	-8,651	-13,858
Chge in FX translation % Q2 2009 Equity		-13.63%

Source: Company data

Table 2: Change in shareholders' equity UBS Q3 2009-Q2 2011 (CHF m)

UBS	30.09.09	30.06.11
Common shares & additional paid-in capital	34,584	34,035
Retained earnings	10,546	22,107
Other comprehensive income	-4,523	-7,805
Other	-1,071	-1,075
Total	**39,536**	**47,262**
o/w FX translation	-6,436	-8,751
Chge in FX translation % Q2 2009 Equity		-5.86%

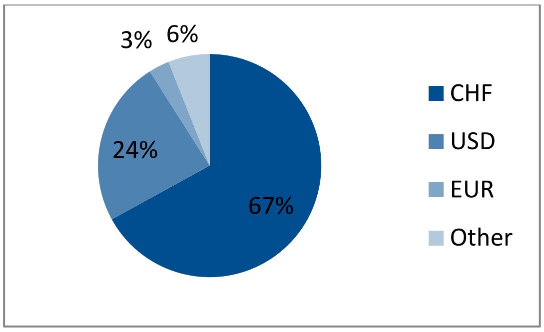
Source: Company data

Lower-to-positive impact on regulatory capital metrics (CET1 and leverage)

Because of the natural hedge existing between CET1 and RWAs on the one hand, and between CET1 and leverage exposure on the other hand, the impact of the SNB's move on the regulatory ratios of the two large Swiss banks is likely to be minimum. **On the basis of the exhaustive (and comparable) disclosure at both banks, we calculate that a 20% appreciation of the CHF against the EUR and the USD is likely to have a -9bps impact on Credit Suisse's CET1 ratio and a +2bps impact on its leverage ratio. For UBS, our estimates of a similar appreciation would give an impact of +20bps and +19bps, respectively.**

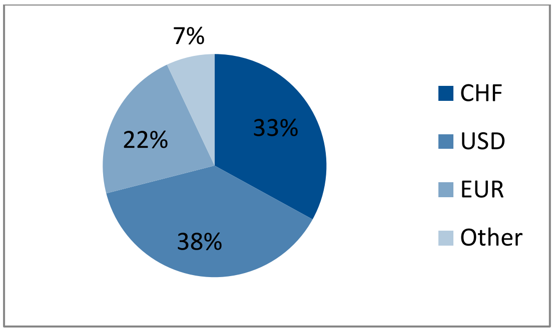
The more reduced impact for UBS versus Credit Suisse, everything else being equal, can partly be explained by the currency breakdown of the bank's shareholders' equity. We can find a proxy for the shareholders' equity in the CET1 of both UBS and Credit Suisse (see Charts 3 and 4 below).

Chart 3: Fully-applied Basel 3 CET1 capital by currency, UBS, 30.09.2014 (in %)



Source: Company data

Chart 4: Fully-applied Basel 3 CET1 capital by currency, Credit Suisse, 30.09.2014 (in %)



Source: Company data

As we can see, the fact that UBS's CET1 capital is more than two-thirds anchored in CHF gives the bank a better ability to resist to the fluctuations of the currency. Credit Suisse's capital is only denominated in CHF up to 33%, and the USD and the EUR represent 60% of the bank's CET1 capital (versus 27% at UBS). This makes Credit Suisse more sensitive to currency fluctuations, and therefore more impacted than UBS by the recent SNB move.

Scope's Bank Rating Team

Lead Bank Analysts

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Pauline Lambert
p.lambert@scoperatings.com

Marco Troiano
m.troiano@scoperatings.com

Macro and Public-Sector Analyst

Ilona Dmitrieva
i.dmitrieva@scoperatings.com

Associate Analysts

Juan Villalobos
j.villalobos@scoperatings.com

Chiara Romano
c.romano@scoperatings.com

Associate

Thue Sondergaard
t.sondergaard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

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