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# Credit Suisse Weighs Break With Trading Unit That Minted Billions

- New CEO tasked with cutting risk from securitized debt trading
- But that may mean giving up one of firm's standout units


Credit Suisse Group AG bank branch in Geneva, Switzerland. *Photographer: Jose Cendon/Bloomberg*

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When bailed-out US mortgage giant Fannie Mae wanted to sell almost $2 billion of troubled American home loans in early 2017, only one bank showed up for the auction: Credit Suisse Group AG.

The Swiss seemed unlikely bidders, having been battered by US mortgages in the financial crisis. And the division pushing for the deal -- known as the securitized products group, or SPG -- had contributed to steep losses just months earlier that blindsided top management in Zurich.



In the end, the Credit Suisse unit won not only that auction. Its bosses gave it so much leeway that it went on to buy $27 billion of loans from Fannie Mae, several times as much as its nearest banking rival, Goldman Sachs Group Inc. It sold some to investors and packaged the rest into new securities, generating hundreds of millions of dollars in revenue, according to a person involved in the deals.

Such lucrative deals explain how one of the riskiest Credit Suisse units, which traces its roots back to Wall Street's raucous mortgage-bond scene in the 1980s, survived multiple cuts to the investment bank. But as new Chief Executive Officer Ulrich Koerner seeks to embrace the safer business of wealth management, and move past two years of scandals and losses that have shaken the bank to the core, the era of the SPG may finally be ending -- if Koerner can afford to do without it.

### Credit Suisse's Mortgage Monster

Swiss bank's SPG unit was among the biggest buyers of US home loans

Source: Bloomberg calculations based on Fannie Mae press releases
Note: dollar amount is the unpaid principle balance on the loans

"It is a conundrum," said Simon Adamson, CEO of CreditSights Inc. in London. "If they wanted to drastically reduce the capital allocation to investment banking, they would presumably sell or exit this business. The trouble is, it's too lucrative from a revenue point of view to do that."



This account of the bank's securitized products group is based in part on conversations with people who know the unit well and who asked for anonymity to discuss internal information. Credit Suisse didn't comment on the details but said it will provide an update on its strategy review with third-quarter earnings.

"Any reporting on potential outcomes before then is entirely speculative," said Candice Sun, a spokeswoman for the lender.

While SPG was the only business specifically mentioned in Credit Suisse's announcement of a strategy shift last month, the firm's executives have said they'd like to avoid a full sale and keep some control or stake in the business. Analysts are skeptical they can pull that off.

The business, overseen since 2016 by New York-based trader Jay Kim, buys and sells securities that are backed by pools of mortgages and other assets, such as car loans and credit-card debts. The division also provides finance to clients who want to buy these products and will "securitize" loans -- dice them into new securities of varying risk and return -- on their behalf and sell them on to investors for a fee.

In all, the SPG has generated about $20 billion of revenue over the past decade, according to estimates from Vali Analytics Ltd. in London. It frequently made annual profits of around $1 billion, at times driving the performance of the entire investment bank, and has relationships with some of the biggest asset managers in the world, the people familiar with it say.

Ulrich Koerner *Source: Credit Suisse AG*

Now that business is in focus as Credit Suisse vows fundamental changes to the investment bank. Koerner, who this month became the bank's fourth CEO since 2015, is going to create a "more focused" trading unit that compliments the wealth-management business, the bank has said. Executives are discussing scrapping thousands of jobs as part of a plan to cut $1 billion in costs, Bloomberg reported Aug 4.

The new plan is just the latest attempt to restore stability to the beleaguered lender, which has been hit by self-inflicted debacles such as a spying scandal, the collapse of partner Greensill Capital and billions of dollars in losses from the implosion of Archegos Capital Management. Its shares have tumbled about 40% so far this year and recently hit a record low.

Looming large over Koerner's plans is the SPG, which houses $20 billion of risk-weighted assets, or close to a quarter of the entire investment bank, and has little connection to the wealth unit. He's mulling ways to take the bank's money out of this business and move it to "growth areas," potentially replacing it with "third-party capital," the bank has said.



The discussions come as the business struggled this year with volatile markets. While Credit Suisse doesn't disclose the unit's performance, it was partly responsible for a 42% plunge in revenue from fixed-income trading in the first half of 2022, as the bank reported its worst overall trading performance so far this century.

Top executives are leaving, part of an exodus that's compounding the bank's challenges. The head of securitized-products trading, Joe Steffa, left in May and has since joined Cerberus Capital Management LP, and the division's head of finance, Michael Dryden, joined Sixth Street Partners LLC in February.

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Credit Suisse Weighs Cutting Thousands of Jobs in Turnaround Bid

Credit Suisse's Worst Trading First-Half in Decades Augurs Cuts

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The SPG traces its roots to the 1980s, a heady Wall Street era driven in part by the popularization of mortgage-backed securities. Credit Suisse owned a stake in First Boston Corp., which competed with Salomon Brothers Inc. and Lehman Brothers Holdings Inc. for the spoils of the lucrative new industry.

Credit Suisse pushed aggressively into U.S. real estate in the following years under the colorful leadership of Andrew Stone, a former mortgage-bond trader. Stone departed in 1999 but the obsession with American property didn't stop there. The bank embraced the industry's more complex products in the 2000s, like collateralized debt obligations, or CDOs, and expanded into the riskiest home loans through the purchase of Select Portfolio Servicing Inc., a firm that collected payments on subprime mortgages.

The financial crisis upended the business, triggering billions of dollars of losses. Three Credit Suisse traders pleaded guilty to falsifying the value of CDOs and one went to jail. The lender later agreed to $5.3 billion in penalties to settle allegations by the US Department of Justice that it knowingly sold shoddy mortgage-backed securities to investors. Other legacy cases related to the matter have yet to be settled.

## 'High-Risk' Proposition

"Up to 2006, it was a high-risk, high-profit proposition when managed well," said Oswald Gruebel, a veteran Swiss banker who was Credit Suisse CEO during the years before the financial crisis. "In hindsight, it obviously was not a good idea to be in that business."

While competitors cut back after the market for such debt collapsed in the financial crisis, Credit Suisse's bankers decided to rebuild. They gathered various businesses into one division and formed the securitized products group in 2012.

Around the same time, the Federal Reserve Bank of New York was auctioning off toxic mortgage assets that it had taken on as part the mammoth taxpayer bailout of insurer American International Group Inc. The newly-formed SPG spent $15 billion on the securities, far more than any other Wall Street bank, data from the central bank show.

### AIG's Loss Was SPG's Gain

Group spent $15b scooping up rescued insurance firm's assets

Source: Bloomberg calculations based on data from the Federal Reserve Bank of New York
Note: New York Fed sold off AIG's mortgage assets as part of $182.3b bailout

The group developed a hallmark for such large transactions, often buying up huge volumes of loans, and then working with a partner to offload them for a profit. Other European lenders avoided such deals for years after the financial crisis, spooked by past losses but also dissuaded by post-crash rules that forced banks to increase the size of their capital buffers when holding such securities.



That didn't sway former CEO Tidjane Thiam, who took over in 2015 with a plan to pivot Credit Suisse more toward wealth management and make the investment bank less volatile. He defended the business as an "ugly duckling" that was still worth the risk because it was so highly profitable, even though rivals had given up on similar operations.

Yet only months after Thiam took over, the group contributed to steep losses when its portfolio of hard-to-sell assets plunged in value. The build-up of illiquid positions had blindsided Thiam, who quickly ordered more cuts to the investment bank, including to securitized products. The SPG survived, however, and began its Fannie Mae spending spree just a few months later. The division paid almost $5 billion to HSBC Holdings Plc for a portfolio of US home loans around the same time.

## 'Strategic Options'

Even as Koerner now explores "strategic options" for the group, Chief Financial Officer David Mathers told analysts on a July 27 conference call that doesn't necessarily mean an exit. That leaves moves such as carving out the group's assets and transferring them into a joint venture with investors, similar to what other Wall Street banks did with some trading units in the years following the financial crisis.

But the CEO will struggle to raise investor money no matter what option he chooses, according to finance executives and analysts. Global markets have become more volatile as central banks raise interest rates and the war in Ukraine spurs geopolitical havoc. The value of US mortgage-backed securities has fallen as the Federal Reserve -- long the industry's biggest buyer -- halts its purchases.

"The chances of Credit Suisse attracting third-party capital in current market conditions are slim to non-existent," said David Benson, a former senior banker at Credit Suisse and Nomura Holdings Inc.

If Koerner does manage to attract investors to the SPG, the economics of any deal are "unlikely to be favorable" for Credit Suisse, said Tom Hallett, an analyst in London with Keefe, Bruyette & Woods who recommends investors sell the bank's shares.

### Growing Gap

Credit Suisse has a net loss since the start of 2020 while rivals thrived

Source: Company filings

The CEO would be in a stronger position if Credit Suisse's other businesses were outperforming but they're not, analysts said. Revenue at the wealth-management business tumbled 39% in the first half. Equities trading has been in turmoil since Credit Suisse lost $5.5 billion on Archegos last year. And fees from managing stock and bond sales for clients have plunged along with financial markets.

S&P Global Ratings cut its credit outlook to negative this month while its senior bonds were downgraded by Moody's Investors Service, underscoring market concerns about its financial health. That raises the question of whether the CEO can go without the SPG.

"There is a problem here," said Adamson at CreditSights. "You don't want to cut off a source of revenues at this point when you're struggling on the profit side. But you need to manage your capital at the same time."

## 'Trust Me'

On the July 27 conference call, analysts peppered departing CEO Thomas Gottstein and Chief Financial Officer David Mathers with questions about how Koerner might pull off his plan.



"Good luck on finding third-party money," Kian Abouhossein, an analyst in London with JPMorgan Chase & Co., told the executives. "Now let's assume that is not going to happen. What is the second alternative in terms of exiting the securitization platform?"



The executives declined to give details, and instead praised the group's profits.

"Trust me," said Gottstein, who was replaced by Koerner the following week, after less than three years as CEO. "We will do the right steps."

*– With assistance by Myriam Balezou*