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Issuer Comment: Credit Suisse Group AG: Earnings Commentary - Fourth Quarter 2010

Global Credit Research - 25 Feb 2011

Credit Suisse Group AG reported fourth quarter net income attributable to shareholders of CHF841 million, with pre-tax profits of CHF 1.3 billion. Excluding fair value losses on own debt due to spread tightening, pre-tax profits were CHF 1.5 billion in the quarter, up from CHF 1.2 billion in the third quarter but still well below the CHF 2.5 billion quarterly average pre-tax profits reported between the first quarter of 2009 and the first quarter of 2010 (excluding fair value gains on own debt).

Credit Suisse AG has a stand-alone bank financial strength rating (BFSR) of B, which translates into a baseline credit assessment for the bank of Aa3. The bank's rating for deposits and senior debt is Aa1, which incorporates our very high systemic support assumptions. The rating on the senior debt of the holding company, Credit Suisse Group AG, is Aa2. The outlook for all ratings is negative.

When announcing fourth quarter results, Credit Suisse also announced it was cutting its dividend and lowering its medium-term earnings targets, from an 18% return on equity (after-tax) to an above 15% return on equity. Moody's views these actions positively. The reduced dividend will allow the bank to retain more capital, while the lower earnings target may reduce the pressure on management to increase risk taking in response to profit challenges. Nonetheless, we note that Credit Suisse's ratings are currently higher than nearly all of its large wholesale investment banking peers. This already reflects our view that Credit Suisse may be able to resist these pressures more than many of its peers. We intend to monitor risk trends at the bank closely.

Satisfying shareholder's expectations for return on capital is a particular challenge for Credit Suisse given the Swiss proposal for significantly higher regulatory capital requirements for "too-big-to-fail" banks. While a portion of the proposed requirements can be met with contingent capital securities, the market for such securities has not yet been fully established.

Last week Credit Suisse also announced the issuance or agreement to issue approximately CHF 7.8 billion in contingent convertible securities. The issuance lowers Credit Suisse's overall common equity capital requirement relative to what it would have been if the bank had been unable to issue any contingent convertibles. As a result, we believe last week's issuance of contingent convertibles reduces the risk to senior creditors that management might choose to increase risk taking or restructure the bank in order to generate a return on equity that satisfies shareholders.

Regarding fourth quarter results, the improvement over the third quarter was driven largely by the Investment Banking (IB) segment. While net revenues in IB were largely unchanged from the third quarter, lower costs boosted profits, although at 83%, the cost to income ratio (excluding fair value losses on own debt) remains relatively weak. Within net revenues, a strong performance in debt underwriting and advisory, and improved equities sales and trading helping to offset a sharp decline in fixed income sales and trading (a decline matched by many of Credit Suisse's peers).

Average VaR declined from the third quarter, as did investment banking (IB) risk-weighted assets, although both average risk management VaR and average regulatory VaR (which gives less weight to prices in the most recent 6 month period) were still 10% and 18%, respectively, above the fourth quarter of 2009. Nonetheless, the daily distribution of trading revenues shows a tighter distribution of results compared to 2009, providing some indication that the bank has taken steps to reduce tail risk, notwithstanding the higher VaR metrics.

Profits in Private Banking (CHF 824 million pre-tax) were largely unchanged from the third quarter, with higher operating expenses and slightly higher credit costs offsetting an increase in transaction revenues. Wealth Management continued to benefit from healthy inflows of net new assets, albeit at a reduced pace than experienced during the first three quarters of the year. Higher transaction revenues boosted the gross margin above the third quarter, although margins remain under pressure as a result of the sizeable net inflows over the past year. Management reports that new assets under management are not initially as productive as existing assets.

Pre-tax profits of CHF 180 million in Asset Management included CHF 95 million in investment-related gains. Absent these gains, the business line would have earned CHF 85 million pre-tax in the quarter. This is a significant improvement over the previous quarters of 2010, reflecting sharply higher performance fees and carried interest, together with lower operating expenses. Nonetheless, further work is still needed to improve the core profitability of this segment and reduce its reliance on volatile investment gains.

Credit Suisse's credit profile continues to be supported by a strong capital position. Tier 1 capital ratio ended the

year at 17.2% (Basel 2), up from 16.3% a year ago. However, we estimate that on a pro forma basis under the proposed Swiss regulatory capital requirements (including Basel 2.5 and Basel 3) this ratio would decline significantly, stemming from both a sizeable increase in risk-weighted assets as well as the exclusion of the bank's hybrid capital securities, which currently comprise 38% of its Tier 1 capital. In addition, the bank reported a FINMA leverage ratio of 4.4% at year-end. Although exceeds the current FINMA regulatory requirements, Moody's believes that Credit Suisse's leverage as measured by tangible common equity to total assets (adjusted for accounting differences between US GAAP and IFRS) remains high compared to many of its global peers.

The bank's cash position weakened modestly during the quarter, owing to an increase in short-term borrowings and wholesale CDs. Cash and due from banks ended the year at approximately 86% of short-term borrowings (including wholesale CDs and due to banks), down from 102% both last quarter and year-end 2009. However, the bank's overall liquidity profile improved slightly, with total liquid assets exceeding total market funds by 7.2% of total assets, up from 6.6% at September 30 and 6.9% at year-end 2009. The bank has also been increasing and extending the average maturity of its long-term debt. As a result, total liquid assets exceeded total short-term market funds (including estimated long-term debt maturing within one year) by 22.9%, up from 20.8% last quarter and 19.8% at year-end 2009.

Contacts

David Fanger/New York

Elisabeth Rudman/London

Bineesha Wickremaratchi/London

Johannes Wassenberg/London

Phone

12125534342

442077721684

442077721373

442077721543

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