FITCH: BUSINESS MODEL REPOSITIONING WEIGHS ON CREDIT SUISSE'S 3Q16 RESULTS

Fitch Ratings-London-04 November 2016: Fitch Ratings says that Credit Suisse's muted 3Q16 returns illustrate the challenges in implementing its strategy, despite well-executed cost reductions and resilient performances of its three wealth management-focused divisions against a backdrop of low transactional volumes. Successfully refocusing the group's business profile towards growth markets and wealth management will in our view depend on the ability to continue reducing legacy exposures, generate sustained and robust profitability in the resized sales and trading business, and favourable macroeconomic conditions, particularly in Asia-Pacific.

Credit Suisse generated CHF222m reported pre-tax income and a 40bp return on equity in 3Q16. Reported results were impacted by CHF145m restructuring charges and CHF306m major litigation provisions, partly offset by CHF346m non-recurring real-estate gains. Excluding these items, adjusted pre-tax profit stood at CHF327m in 3Q16, 24% lower yoy on a comparable basis, reflecting sound execution on underlying cost reduction (-3% yoy) more than offset by underlying revenue declines (6% yoy).

Since the group's new strategy was originally announced in October 2015, Credit Suisse has incurred CHF846m restructuring costs over the last four quarters, consistent with its guidance of around CHF1bn for 2016 and related to its cost-saving plans. The latter saw good progress in the quarter, as the group reached its 2016 full-year net savings target of CHF1.4bn by end-9M16 compared to the 2015 cost base. Improving the group's operating leverage will be key to sustaining profitability in light of revenue pressure in wealth management businesses and a reduced revenue base in Global Markets.

Credit Suisse booked a total of CHF357m in net litigation provisions in 3Q16, mostly related to mortgage-related matters. We believe a potential settlement on US RMBS matters is among the group's most significant contingent liabilities, which together with its annual review of defined-benefit pension plan actuarial assumptions in 4Q16 could be negative for the group's capitalisation.

We therefore expect the group to continue building up capital despite having reached a Basel III fully-loaded CET1 ratio of 12.0%, the upper end of its CET1 ratio guidance of 11% to 12% for 2016. The 20bp qoq increase in the CET1 ratio reflected technical effects related to share-based compensation and to a lesser extent deleveraging. This also enabled an improvement in the group's CET1 (3.4%, up 10bp qoq) and Tier l leverage (4.6%, up 20bp qoq) ratios, as leverage exposure in the Strategic Resolution Unit shrank by 20% qoq to CHF115bn.

Potential upward momentum in risk-weighted assets (RWAs) in the coming years as a result of regulatory revisions to the capital framework, including the fundamental review of the trading book and the standardised approach to counterparty credit risk, provides further incentives for capital accretion.

Subdued client activity and consequently low transaction-based revenues led to a 3% yoy decline in revenues at the Swiss Universal Bank (SUB), adjusted for real-estate gains. The division generated adjusted pre-tax income of CHF431m (8% higher yoy), broadly evenly split between private banking and corporate and institutional banking. The improvement was led by sound cost control, as underlying operating expenses fell by 7% yoy despite continued investments in digitalisation and compliance. Net interest income improved yoy on the corporate and institutional

side due to higher margins on deposits and loans, while it marginally fell in the private bank, primarily due to lower deposit margins.

Cost control was also key in SUB's private banking segment, where it helped mitigate adjusted gross margin erosion (134bp in 3Q16, 7bp lower yoy). Net margins on assets under management (AuM) were resilient at 35bp (+1bp yoy). Net new money (NNM) inflows were marginally positive at CHF0.2bn in 3Q16, as sound gross inflows were partly offset by CHF0.4bn outflows linked to client tax regularisation and CHF0.5bn related to external asset managers. The SUB division will constitute the bulk of Credit Suisse (Schweiz) AG (A(EXP)/Stable/a(exp)), which the bank expects will start operating by the end of November. Subject to the relevant regulatory approvals and market conditions, Credit Suisse plans to sell part of this Swiss legal entity in 2H17 through an initial public offering.

International Wealth Management (IWM) includes private banking outside Switzerland and Asia Pacific and global asset management. Asset management suffered from 5% yoy lower revenues but broadly stable costs, resulting in a 2% yoy decrease in IWM's adjusted pre-tax profit to CHF241m in 3Q16. Decreases in transaction and commission revenues in the private bank were offset by a 26% yoy improvement in net interest income, partly due to higher loan balances.

Higher loan and deposit volumes contributed to a 39% improvement in net interest income in the Asia-Pacific division's private banking segment, whose revenues and expenses rose by 14% yoy in 3Q16, resulting in unchanged private banking adjusted pre-tax profit in Asia-Pacific of CHF69m. The division's 4% yoy revenue increase and 8% adjusted pre-tax profit rise was due to investment banking results, which benefited from strong recoveries in fixed-income sales and trading and in underwriting and advisory, where the bank improved its market share in the region. NNM grew at a sound 12% annualised rate, also contributing to a 2bp yoy fall in net AuM margins to 17bp for 3Q16 on flat pre-tax profit.

The Asia-Pacific division saw an uptick in loan impairment charges (up 42% to CHF34m in 3Q16), which still remained modest. The unusual credit losses reflected sharp falls in the market value of certain Hong Kong shares used as collateral for Lombard lending, where low loan-to-value ratios (around 55%) protect the bank against even material declines in collateral values. While the loans were originated in 2012, the losses in our view highlight the possibility of highly volatile stock values in the APAC region, and consequently the importance of measured and conservatively underwritten loan growth and tight monitoring of collateral.

Performance in Global Markets illustrated in our view that substantial progress will need to be made in repositioning Credit Suisse's franchise following the closure of its distressed debt trading and European securitised trading businesses in 2Q16. Although cost reductions are ahead of schedule, potentially reaching the bank's USD5.4bn 2018 target as early as 2016, we believe the bank will have to demonstrate the strength of its remaining franchises and their ability to generate sustainable profits. Adjusted pre-tax income fell by 63% yoy to CHF150m in 3Q16, as revenues fell 14% to CHF1.4bn. The revenue decline largely reflected 38% lower equities trading revenue due to weaker performance in Europe.

Investment Banking and Capital Markets (IBCM) posted a sound 16% increase in adjusted revenues, but higher operating expenses in part due to higher variable compensation led to a 19% yoy decrease in adjusted pre-tax profits.

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