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Contacts

Michael Eberhardt, CFA 44-20-7772-8611
VP-Sr Credit Officer
michael.eberhardt@moodys.com

Daniel Forssen,CFA 44-20-7772-1553
Associate Analyst
daniel.forssen@moodys.com

Laurie Mayers 44-20-7772-5582
Associate Managing Director
laurie.mayers@moodys.com

Robert Young 212-553-4122
MD-Financial Institutions
robert.young@moodys.com

Credit Suisse Group AG

Q3 2016 Results: Profits dampened by subdued market activity and restructuring effort, cost reduction supportive

Summary

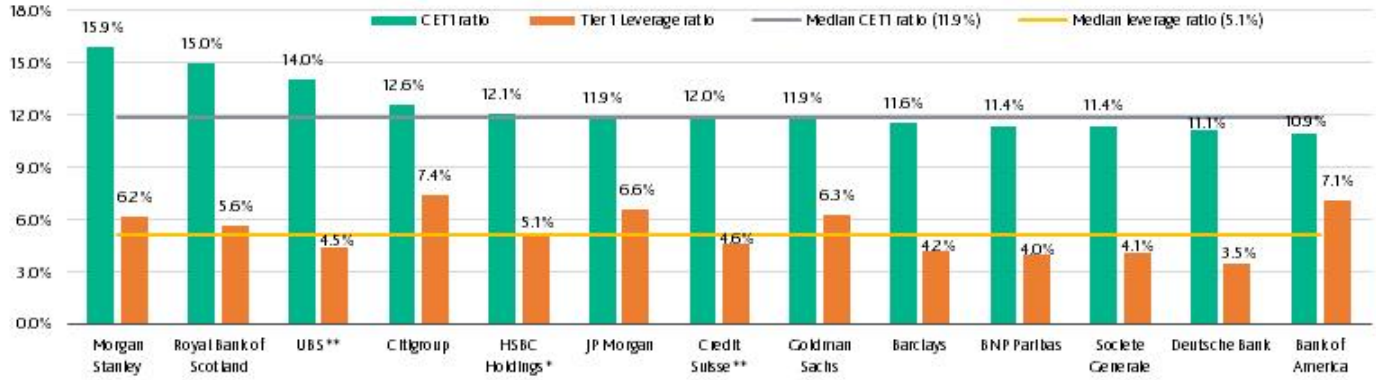
In Q3 2016, Credit Suisse Group AG[1] reported a CHF 222 million pre-tax profit. On a Moody's adjusted basis, pretax net income from continuing operations was a negative CHF 124 million, excluding CHF 346 million in gains on the sale of real estate from the Swiss Universal Bank. These results are in line with our expectation that Credit Suisse's profitability will remain weak over 2016, reflecting challenges stemming from the restructuring exercise launched in October 2015.

Credit Suisse' adjusted net revenues were down 6% versus the prior year period, largely a result of pressures in the Global Markets business where the Equities business significantly underperformed. Elsewhere, subdued market activity weighed on the business, particularly in transaction-based income. The quarter also included net litigation provisions of CHF 357 million, much of which is related to litigation for mortgage related matters. Positively, cost reduction and headcount reduction achieved thus far appear on track with management's end-2016 targets.

The bank's Basel III common equity tier 1 (CET1) ratio on a BIS look-through basis improved 20 basis points (bps) for the quarter to 12%, in line with peers (see exhibit 1). This improved CET1 ratio is largely a result of an increase in CET1 capital, due to retained capital associated with the firm's share-based compensation. As a result, CET1 capital increased to CHF32.4 billion. RWAs remained largely unchanged at CHF 270 billion (look through) for the quarter. The bank had a going-concern capital ratio (CET1 plus high-trigger and eligible low-trigger legacy capital instruments) of 16.2% for 3Q16. The bank reported a look-through BIS CET1 leverage ratio of 3.4%, an improvement of 10 bps. from the prior quarter. BIS Tier 1 leverage ratio (including CET1 plus additional Tier 1 securities) improved 20 bps. to 4.6% for the quarter, however remains below the peer median of 5.1%, yet ahead of its 2020 Swiss requirement. Total look-through leverage exposure was lower versus the prior quarter to CHF 949 billion, as CS cut CHF 29 billion in leverage exposure in the SRU, largely through exit of derivatives. We view the firm's leverage and 20 basis point increase in the CET1 ratio over 3Q16 as important to support the ongoing restructuring exercise as well as buffer against the potential for future litigation related charges and possible top-ups to pension commitments. The bank continued to report high levels of liquidity with its 3Q16 Liquidity Coverage Ratio at 163%, a decrease from 172% at 2Q16. The decrease is attributable to a reduction in high-quality liquid assets, some of which are now within CS' US intermediate holding company that went live on 1 July 2016.

Exhibit 1

Common Equity Tier 1 (CET1) ratio and Tier 1 Leverage Ratio for Global Investment Banks, End-September 2016



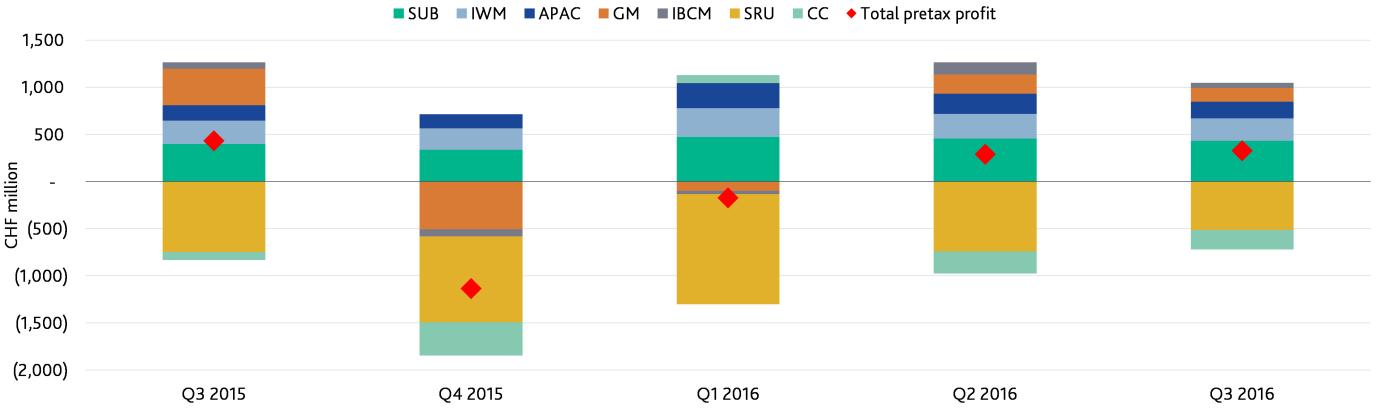
*End-June 2016, **Tier 1 leverage ratio for UBS and Credit Suisse reflects CET1 plus Low-Trigger Additional Tier 1 and High-Trigger Additional Tier 1. CET1 ratio and Leverage ratio on a look-through/fully-loaded basis. Medians relate to end-September 2016 for all but one bank which is due to report their third quarter results

Source: Company results presentations and financials, Moody's

Within the business segments, key operating and financial trends were as follows

Exhibit 2

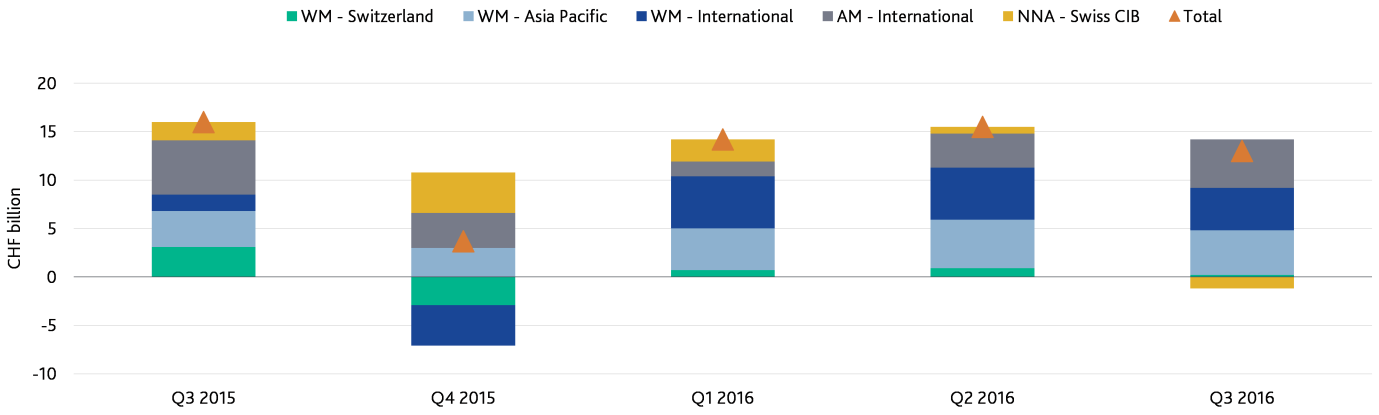
Credit Suisse Adjusted Profit Before Tax by Segment



*SUB: Swiss Universal Bank, IWM: International Wealth Management, APAC Asia Pacific, GM: Global Markets; IBCM: Investment Banking and Capital Markets, SRU: Strategic Resolution Unit, CC: Corporate Center

Source: Company results presentations and financials, Moody's

Exhibit 3
Net New Assets by Region



Note: excluding Strategic Resolution Unit and not adjusted for assets managed across businesses, WM: Wealth Management (Private Banking), AM: Asset Management, NNA - Swiss CIB: Net New Assets Swiss Corporate and Institutional Banking
Source: Company financials, Moody's

Swiss Universal Bank ("SUB") reported adjusted pre-tax profits of CHF 431 million, up 8% versus the quarter a year ago as expense reductions of 7% offset a revenue decline of 3%. SUB Private Banking's (PB) adjusted pre-tax profits improved 5%, as lower operating expenses (-8%) mitigated revenue declines (-5%), in comparison to the prior year period. Within Corporate and Institutional Banking (CIB), pre-tax profits increased 11%, as flat revenues were supported by a 5% decline in operating expenses. Across the two divisions, transaction-based revenues fell 16%, partially offset by an improvement in net interest income of 2% versus 3Q15. These results highlight the continued pressure of low client activity upon the business. The PB's adjusted net margin improved to 35 bps, from 34 bps in 3Q15, mainly due to lower operating expenses. Underlying CS' broader strategy exercise where resources are being reallocated to divisions with better risk-return prospects, the SUB has increased its divisional RWAs and leverage by CHF 1 billion versus the prior year period due to business growth. Assets under management (AUM) across the division increased by CHF 6.8 billion to CHF 529.1 billion, largely due to market movements.

International Wealth Management ("IWM") reported adjusted pre-tax profits of CHF 241 million for the third quarter, down 2% from the quarter a year ago. Within IWM, Private Banking adjusted pre-tax income in the quarter was down 8% versus the prior year due to an increase in compensation and benefits expenses while revenues were largely unchanged. In line with similar trends in SUB, IWM's transaction and performance-based revenues declined significantly, down 22% versus the prior year. IWM's net interest income improved 26% versus the prior year on higher loan and deposit margins on both higher loan and deposit volumes. Asset Management reported a 24% increase in pre-tax profits of CHF 51 million for the third quarter versus the quarter a year ago. This was driven largely by 10% lower expenses, with the cost/income ratio improving 4% to 83%. IWM saw net new assets of CHF 9.4 billion during the quarter, with asset management benefiting from a joint-venture with ICBC in China. Across IWM, the division manages a total CHF 636 billion in assets under management, an increase of 6% versus 3Q15.

Asia Pacific ("APAC") reported adjusted pre-tax profits of CHF 175 million in the third quarter, an 8% improvement compared to the prior year. While net revenues were up 4%, operating expense increased 1% as the division took on higher compensation expenses due to the addition of relationship managers as well as investments in risk management and compliance and controls infrastructure to meet strategic growth and regulatory requirements. This increase in operating expenses was partially offset by cost reductions in the investment bank. The division took CHF 34 million in credit provisions, a result of 2012 share-backed Lombard lending in Hong Kong despite the average loan-to-value on such lending is 55%. In APAC, the firm increased its RWAs by 21% versus the prior year to CHF 32.3 billion, largely in the form of credit risk as net loans increased 12% to CHF 38.7 billion. While this new lending in the Private Bank has supported a 39% increase in net interest income versus the prior year, we anticipate such lending growth could prove unsustainable. In APAC Private Banking, adjusted pre-tax income was flat as net revenue growth (+14%) was matched by similar expense growth. APAC Investment Banking reported adjusted pre-tax profits for the quarter of CHF 106 million, a 14% increase relative to the prior year, largely reflecting modest revenue declines while expenses declined 4%. Within Investment Banking, fixed income sales and trading increased 50% versus the prior year, a result of financing income, foreign exchange products and the increase in

funding value of structured deposits originated in Asia Pacific. In contrast, equity sales and trading fell 25% as activity diminished relative to a strong 3Q15.

Global Markets ("GM") reported adjusted USD 150 million pretax profit in the third quarter of 2016, a 63% decline versus the prior year and a 28% decline versus the prior quarter. GM appears to now be operating with a lower operating expense base in line with management's 2018 targeted cost base of USD 5.4 billion, helping improve GM's operational leverage. In contrast to recent quarters, GM did not engage in an exercise of reallocation of RWAs to the SRU due to the fact that GM now operates with USD 52.7 billion in RWAs, below the 2016 RWA ceiling of USD 60 billion. Versus the prior year, RWAs fell 16% while leverage fell 6% to USD 296 billion. Within the business, the Equities and Solutions revenues declined by 38% and 13% respectively, while Credit improved 2% versus the prior year. Performance in credit and equities was relatively weak versus peers and suggests the restructuring exercise could be weighing on CS' franchise strengths in credit and equities .

Investment Banking and Capital Markets ("IBCM") reported adjusted pre-tax income of USD 55 million for 3Q16, down 19% versus the prior year. Net revenues improved 16% versus the prior year period as management highlighted its 'share of wallet' gains across M&A, Equity Capital Markets and Leveraged Finance for the year-to-date period to 31 September 2016. This revenue growth was supported by strong growth in debt (+13%) and equity (+40%) underwriting, partially offset by lower advisory (-2%) revenues. Total operating expenses increased 25% due to higher variable compensation in the quarter. An increase in underwriting volumes led to increases in risk weighted assets of USD 1.6 billion versus the prior quarter, while leverage exposure increased by USD 0.7 billion for similar reasons to USD 45.6 billion.

The Strategic Resolution Unit ("SRU") reported a (unadjusted) pre-tax loss of CHF 852 million in the quarter, up 10% year-over-year. Excluding the rise in litigation expenses to CHF334 million (CHF61 million last year), SRU's non-core loss would have been narrower reflecting the exit from the US Private Banking onshore business and the reduced legacy Investment Banking business in the period. In the quarter, Credit Suisse focused on reducing leverage exposures, recording a CHF29 billion reduction (-20%) in the quarter, and a smaller reduction in risk-weighted assets of CHF3 billion (-6%). These reductions reflect the sale of some loan facilities to external parties (c. 15% of exposure), reduction in bilateral derivatives trade positions by c.30% in the quarter and the sale of an investment management company, Credit Suisse Park View BDC, Inc. (unrated).

Corporate Center reported a pre-tax loss of CHF 207 million in the quarter, relative to a pre-tax profit of CHF 540 million (CHF 83 million loss excluding fair value changes in own debt, which Credit Suisse reports in Other Comprehensive Income) in the same period last year . The higher adjusted pre-tax loss in the third quarter reflected higher operating expenses, on the back of higher valuations for deferred compensation expenses not offset by lower general and administrative expenses associated with the set-up of new legal entities (US intermediate holding company[2] and Swiss legal entity[3]).

Endnotes

1 Credit Suisse Group AG (LT senior unsecured (P)Baa3) is the parent holding company of Credit Suisse AG (LT deposits A1 stable, LT senior unsecured A2 stable, baa2 BCA). BCA: Baseline Credit Assessment

2 On 1 July 2016, Credit Suisse established Credit Suisse Holdings (USA), Inc. (unrated) as its US Intermediate Holding Company (IHC). The IHC consolidates all of Credit Suisse's US subsidiaries, including Credit Suisse (USA) Inc. (CSUSA, long-term senior unsecured A2 stable)

3 Credit Suisse (Switzerland) Ltd (unrated)

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Contacts

Michael Eberhardt, CFA 44-20-7772-8611
VP-Sr Credit Officer
michael.eberhardt@moodys.com

Daniel Forssen,CFA 44-20-7772-1553
Associate Analyst
daniel.forssen@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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