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Credit Suisse Group AG

Q1 2018: Wealth management and lower legacy losses balance capital markets weakness

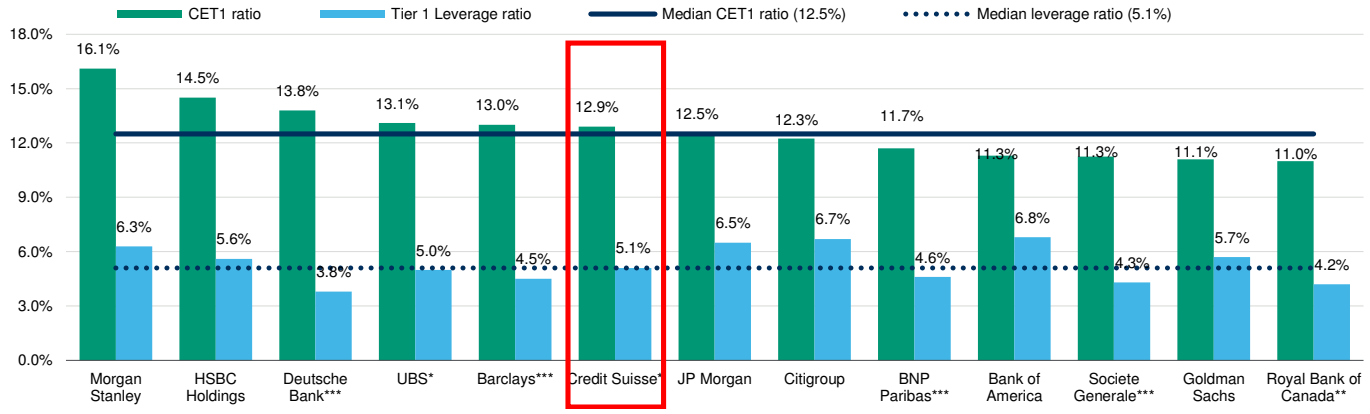
In Q1 2018[1], Credit Suisse Group AG (CS, Baa2 stable[2]), the parent holding company of Credit Suisse AG (A1 stable/A1 stable, baa2[3]) reported[4] consolidated (unadjusted) pre-tax profits of CHF1.1 billion and a net profit of CHF694 million, up 57% and 16% year-over-year, respectively. As expected, the first quarter results were burdened by a CHF362 million pre-tax loss in the group's Strategic Resolution Unit (SRU), as it continued to wind down non-core legacy positions. Excluding the SRU and other items, adjusted core pre-tax profits stood at CHF1.6 billion, up 13% year-over-year. Assuming a 30% tax rate, this corresponds to an underlying annualised net return on average tangible equity of 11.8% (Moody's calculation), compared to 10.6% a year ago.

Credit Suisse continued reducing its cost base as well as non-core losses, offsetting some Investment Banking weaknesses. CS's operating expenses declined 6% year-over-year whilst revenues increased 1%, delivering solid positive operating leverage for the group. In Q1 2018, however, capital markets revenues[5] declined 4% in Global Markets, largely driven by weaker underwriting (-8%) and only flat sales and trading revenues. Investment Banking and & Capital Markets (IBCM) revenues declined 13%, driven by lower advisory (-21%) as well as weak debt underwriting (-12%) revenues. These declines could not be offset by Asia Pacific Markets, where combined equity and fixed income sales and trading increased 12%. Overall, and in $-terms, CS investment banking operations underperformed peers, in particular in equity sales and trading (combined[6] revenues up 7% versus UBS +25% and US peers[7] +32%) and, to a lesser extent, in advisory and underwriting revenues (-2% versus UBS +22% and US peers[8] -1%). In fixed income sales and trading, however, CS's revenues outpaced peers (+8% versus UBS -6% and US peers[9] +4%). Supporting revenues at group level, International Wealth Management (+15%) and Asia Pacific Wealth Management and Connected (+13%) delivered solid results on the back of record assets under management (AuM). Although CS displayed positive operating leverage in the first quarter of 2018, we believe that – because of the uncertain revenue outlook post restructuring – the group will have difficulty maintaining a sizeable positive revenue-cost gap.

Stable capital metrics over the quarter. CS reported a Swiss fully-applied common equity Tier 1 (CET1) capital ratio of 12.9% in the quarter, up from 12.8% in Q4 2017 (see Exhibit 1). The increase was largely owing to flat RWAs[10] as CS re-allocated operational risk RWAs among the divisions following regulatory discussions, resulting in a net CHF2.5 billion reduction in operational risk RWAs. In addition, net profits supported underlying capital. CS further reported a virtually unchanged 3.8% CET1 leverage ratio and a 5.1% Tier 1 leverage ratio.

Exhibit 1

Common Equity Tier 1 (CET1) ratios and Tier 1 leverage ratios for Global Investment Banks, as of 31 March 2018



Notes: *Tier 1 leverage ratios for UBS and Credit Suisse reflect CET1 plus low-trigger Additional Tier 1 (AT1) and high-trigger AT1. Tier1 leverage ratio for US banks is the supplemental leverage ratio (SLR). **data as of 31 January 2018 ***data as of 31 December 2017.

Sources: Companies' results presentations and financials, Moody's Investors Service

Detailed considerations

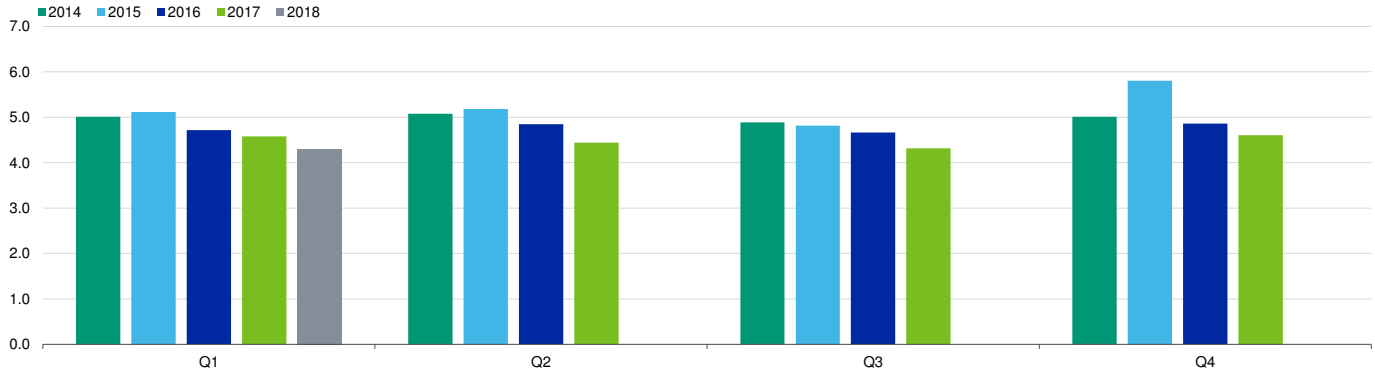
Positive operating leverage in the quarter supported by continued cost cutting, but revenue outlook remains uncertain

Credit Suisse achieved another CHF225 million of net cost savings versus Q1 2017, resulting in the lowest quarterly expenses since 2014 (see Exhibit 2[11]). Operating expenses were lower in the Swiss Universal Bank segment (SUB; -6% year-over-year) and in Asia Pacific (APAC; -3%). In the Global Markets (GM) and Investment Banking and & Capital Markets (IBCM) divisions, costs also declined further, by 5% and 2%, respectively.

Exhibit 2

Lowest quarterly operating cost base supported profitability

Adjusted operating expenses, CHF billion



Note: CS total adjusted operating expenses, excluding restructuring and litigation expenses

Sources: Company financials, Moody's Investors Service

At the same time, group revenues only increased 1% year-over-year, supported by the group's wealth management and universal banking activities that offset weaknesses in CS's capital markets operations. In particular, weak revenue generation in IBCM (-13%) led to negative operating leverage for the quarter in this segment, whereas GM cost cuts offset lower revenues (5% cost reduction versus 4% revenue decline). In all other segments, cost reductions were outpaced by revenues, supporting the group through improved operating leverage.

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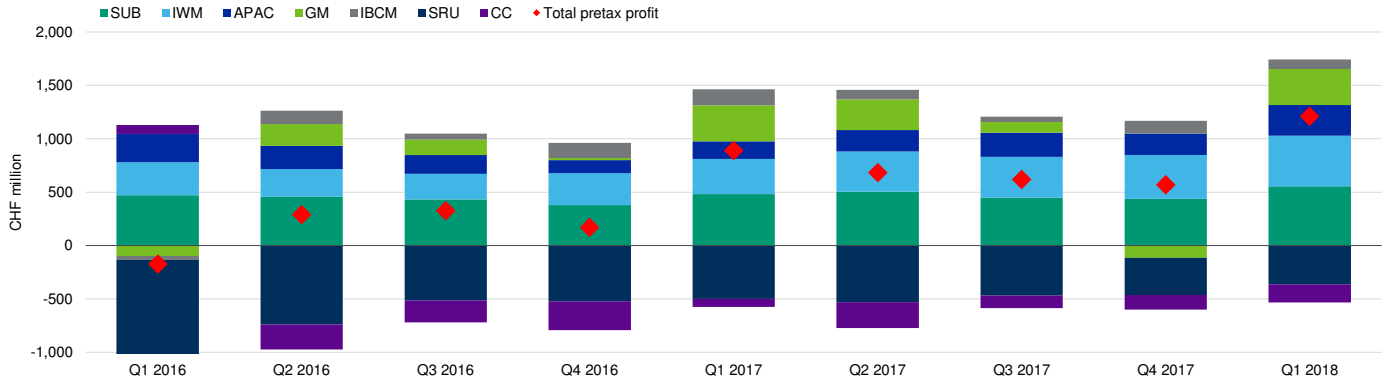
As stated earlier, we believe the group's significantly reduced operating expense base is credit positive and demonstrates CS's progress in executing on its promises. In 2019 and 2020, CS expects costs to remain flat at CHF16.5 to CHF17.0 billion. If Credit Suisse achieves its strategic plan and medium-term earnings targets on a sustainable basis, the improved loss-absorption capacity will be positive for its creditors. Nonetheless, and because of the revenue weakness in CS's two largest capital markets segments, we believe CS will be challenged to maintain positive operating leverage as it enters 2019 post its re-alignment, in particular as the effects of its larger cost cutting exercise fade. Whilst the group's profitability will continue to benefit from lower losses from the SRU[12], we believe the group will have difficulty maintaining a sizeable positive revenue-cost gap in the medium-term. This somewhat constrains its profitability profile.

During the first quarter of 2018, the benefits of lower operating expenses and lower SRU losses, coupled with solid wealth management and universal banking revenues, drove the underlying increase in profitability, as evidenced by the highest quarterly pre-tax profit since CS announced its restructuring in late 2015 (Exhibit 3).

Exhibit 3

Credit Suisse Group's adjusted profit before tax by segment, CHF million



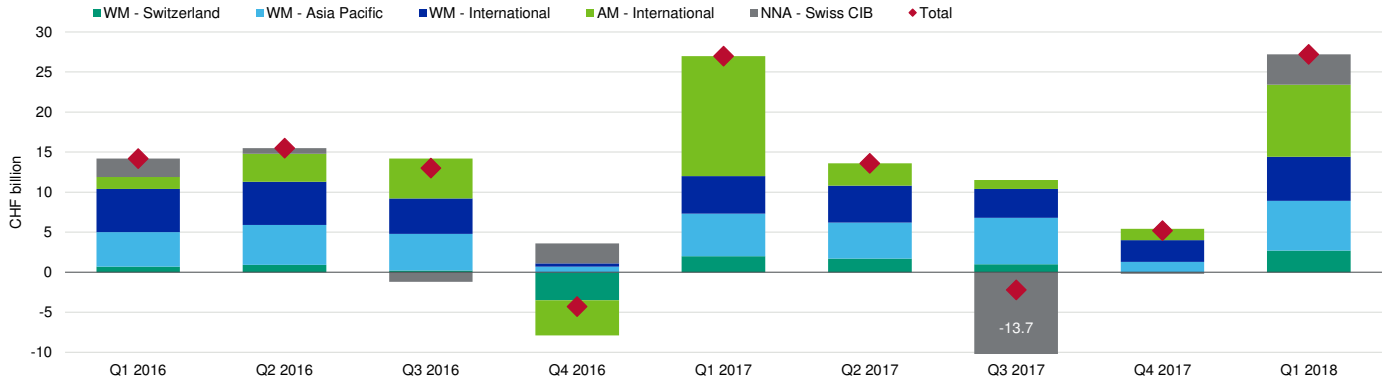
Notes: SUB: Swiss Universal Bank, IWM: International Wealth Management, APAC: Asia Pacific, GM: Global Markets; IBCM: Investment Banking and Capital Markets, SRU: Strategic Resolution Unit, CC: Corporate Center.

Sources: Company results presentations and financials, Moody's Investors Service

CS's wealth and asset management businesses benefitted from positive net new money inflows (see Exhibit 4), repeating the strong performance of Q1 2017. During the first quarter of 2018, CS's wealth and asset management businesses combined recorded net new money inflows of CHF27.2 billion. Invested assets in IWM and Asia Pacific Private Banking maintained their highest levels since 2013, supporting future recurring revenue generation.

Exhibit 4

Net New Assets (NNA) by region, CHF billion



Notes: Excluding Strategic Resolution Unit and not adjusted for assets managed across businesses (double-counting). WM: Wealth Management (Private Banking), AM: Asset Management, Swiss CIB: Swiss Corporate and Institutional Banking

Sources: Company financials, Moody's Investors Service

Segmental results commentary

Swiss Universal Bank (SUB) reported adjusted pre-tax profits of CHF554 million, up 15% year-over-year. Driven by two individual cases, credit loss expenses increased CHF24 million versus the prior-year quarter. With adjusted net revenues up 3% year-over-year, SUB managed to improve its year-over-year pre-tax profit, strongly supported by a 6% decrease in adjusted operating expenses. Assets under management (AuM) across SUB decreased slightly during the quarter to CHF559 billion, largely reflective of market performance.

International Wealth Management (IWM) reported adjusted pre-tax profits of CHF474 million for the quarter, up 45% from a year ago. Within IWM, Private Banking adjusted pre-tax income in the quarter was up 46% to CHF382 million, with yet another positive contribution from transaction and performance based revenues. The resulting revenue growth in the segment (+18%) clearly offset only slightly higher operating expenses (+1%).

IWM saw solid net new asset (NNA) inflows of CHF5.5 billion during the quarter and grew the adjusted gross margin to 110 basis points (bps) in Private Banking (Q1 2017: 108bps). With record invested assets of CHF370 billion in Private Banking and CHF391 billion in Asset Management, future fee generation will support recurring fee revenues.

Asia Pacific (APAC) reported adjusted pre-tax profits of CHF288 million in the quarter, up 73% year-over-year. APAC Markets performance recovered amid continued reshuffling and re-alignment; and further improved results in APAC Wealth Management and Connected (WM&C) boosted the segment's pre-tax profits.

APAC WM&C saw adjusted pre-tax profits jump 25% to CHF256 million, as significantly higher year-over-year recurring fee as well as transaction-based revenues (+23% and +20%, respectively) more than offset the decline in net interest income (-5%). Advisory, underwriting and financing revenues also grew by 17%. Still, and despite the very strong revenue generation in the quarter (+13% overall, unadjusted), operating expenses grew 17% (unadjusted), the latter being driven by higher litigation provisions as well as higher compensation and benefits.

Global Markets (GM) reported an unchanged pre-tax profit of CHF337 million in Q1 2018. Net revenues declined 4% while operating expenses fell 5%. Within the business, largely flat revenues from equity as well as fixed income sales and trading could not offset weaker underwriting (-8%). CS's equities and fixed income businesses benefitted from solid equity derivative revenues as a result of higher market volatility and improved client activity, as well as continued strength in securitized products revenues and leveraged finance share gain, which helped offset weakness in emerging market trading.

RWAs declined slightly in the quarter (to CHF58 billion from CHF59 billion in Q4 2017). Global Markets continues to operate around its leverage exposure cap ($290 billion), and its $60 billion RWA ceiling. It will therefore remain paramount to grow revenues without additional risk taking in GM, and to show that the division can be kept profitable on a sustained basis.

Investment Banking and Capital Markets (IBCM) reported adjusted pre-tax income of CHF89 million, a decline of 41% relative to the prior year. The decline was driven by lower advisory fees (-21%) as well as lower debt underwriting revenues (-12%) while equity underwriting revenues were flat. Muted client activity, and fewer M&A closings overshadowed increased IPO activity.

The **Strategic Resolution Unit (SRU)** reported an (unadjusted) pre-tax loss of CHF409 million versus CHF539 million in Q1 2017. CS continued reducing its non-core exposures, and at a faster-than-anticipated pace during the quarter, recording a CHF11.4 billion reduction (-34%) in RWAs to CHF22.2 billion, supported by a corresponding CHF16.8 billion reduction in leverage exposures (-28%) to CHF43.2 billion. The decline in RWAs was largely driven by the aforementioned operational risk RWAs re-allocation towards the segments (post regulatory discussions), which reduced operational risk RWAs by CHF8.9 billion in the SRU. Reduced liquidity requirements, the continued reduction in exposures to derivatives, as well as the sale of emerging markets loans and residual illiquid asset management exposures helped reduce leverage exposures. This has put CS in a strong position towards reaching its SRU targets on RWA and leverage exposures, including CHF11 billion of RWAs expected to relate to non-operational risks by year-end 2018 when the remaining SRU portfolio is expected to be folded back into the core businesses. The **Corporate Centre** reported a pre-tax loss of CHF171 million in the quarter relative to a loss of CHF75 million in the in the same period last year.

Moody's related publications

Credit Opinion

» Credit Suisse Group AG, April 2018

Issuer Comments

» Morgan Stanley: Q1 2018: Strong profitability aided by favorable markets and lower tax rate, but institutional loan growth accelerated, April 2018

» JPMorgan Chase & Co.: Q1 2018 commentary, April 2018

» Bank of America Corporation: Q1 2018 results: Positive operating leverage and a lower tax rate boosted profitability, April 2018

» The Goldman Sachs Group, Inc.: Q1 2018 results: Favorable market environment boosted net revenues in all business segments, April 2018

» Citigroup Inc.: Q1 2018 commentary, April 2018

» Q4 2017 results: Solid wealth management and lower legacy losses largely offset weaker capital markets results, February 2018

» Credit Suisse's de-risking and cost-cutting progress will support profitability, December 2017

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» UBS Group AG and Credit Suisse Group AG: Review of UBS's ratings for upgrade reflects its lower capital markets risk and more predictable earnings, April 2018

» Global Investment Banks - 2018 Outlook, December 2017

» Global Investment Banks - Europe: Q4 2017 Update: Weak capital markets results constrain revenue, but lower charges provide lift, April 2018

» Barclays, Credit Suisse, Deutsche Bank, Royal Bank of Scotland and UBS; Risks from remaining legacy assets will continue to weigh on standalone credit profiles, September 2017

» Global Investment Banks: Legacy litigation risks recede, July 2017

» Global Investment Banks: Indicators of Capital Markets Risk for the Moody's GIB Peer Group, June 2017

» Barclays, Credit Suisse, Deutsche Bank, Royal Bank of Scotland and UBS: De-risking Will Slow with Heightened Market Uncertainty, October 2016

» Credit Suisse and UBS: Swiss TLAC Regulation Drives Issuance of Loss-Absorbing Debt, Increasing Protection for Senior Creditors, December 2016

Rating Action

» Moody's places UBS Group AG's ratings on review for upgrade, maintains stable outlook on Credit Suisse Group AG, April 2018

Rating Methodology

» Banks, September 2017

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Endnotes

1 All figures in this report relate to Q1 2018 and comparisons are made to Q1 2017, unless otherwise indicated.

2 The rating shown is Credit Suisse Group AG's long-term senior unsecured debt rating and outlook.

3 The ratings shown are Credit Suisse AG's long-term deposit rating and outlook, its long-term senior unsecured debt rating and outlook and its Baseline Credit Assessment (BCA).

4 Unless indicated otherwise, figures displayed in this report are on a Credit Suisse Group AG adjusted basis. Our adjustments do not take into account restructuring and litigation expenses whereas Credit Suisse's adjusted figures take out restructuring and major litigation expenses.

5 Comparisons versus Q1 2017 are difficult because of the transfer of the systemic market making group to IWM from the Global Markets (GM) division and Asia Pacific Markets division in Q1 2017.

6 Combined revenues include capital markets revenues from CS's Global Markets (GM), Investment Banking & Capital Markets (IBCM) and Asia Pacific (APAC Markets) operations, in $, year-over-year.

7 These include Bank of America Corporation, Citigroup, The Goldman Sachs Group, JP Morgan Chase &Co. and Morgan Stanley.

8 These include Bank of America Corporation, The Goldman Sachs Group, JP Morgan Chase &Co. and Morgan Stanley.

9 These include Bank of America Corporation, Citigroup, The Goldman Sachs Group, JP Morgan Chase &Co. and Morgan Stanley.

10 RWAs = Risk-weighted assets.

11 CS continues to expect a 5% year-over-year decline in 2018 total operating expenses to below CHF17 billion from CHF21.2 billion in 2015 (and CHF18.0 billion in 2017), when it started its three-year restructuring program.

12 CS expects the SRU to be less of a drag on earnings in 2019, once the remainder of the unit is re-integrated into the group's core divisions. CS forecasts that the segment will produce a $500 million pre-tax loss during 2019, down significantly from around CHF1.85 billion in 2017 and CHF1.4 billion forecasted for 2018.

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