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15 February 2017

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Credit Suisse Group AG

Q4 2016 Results: One-off RMBS litigation charge leads to large loss while cost reductions continue to support results

Summary

In Q4 2016, Credit Suisse Group AG[1] reported a CHF 1.9 billion pre-tax loss. On a Moody's adjusted basis[2], pre-tax net income from continuing operations was a negative CHF 2.0 billion, excluding CHF 78 million in gains on the sale of real estate. The results were impacted by a $2.0 billion (CHF 2.1 billion) charge in relation to the settlement of legacy retail mortgage backed securities (RMBS) litigation with the US Department of Justice. Excluding this charge, CS's strong progress on cost reductions supported results in the fourth quarter. These results are in line with our expectation that Credit Suisse's profitability would be weak in 2016, reflecting challenges stemming from the restructuring exercise launched in October 2015.

Credit Suisse's adjusted operating expenses were down sharply (-16%) versus the prior year quarter, largely a result of ongoing cost reductions in Global Markets and lower expenses associated with the run-off of the legacy non-core book and, to a lesser extent, cost reductions achieved in other business divisions. In 2016, the group achieved net cost savings of CHF1.9 billion, above its target of CHF1.4 billion. The group targets further net cost savings of CHF2.4 billion by end-2018 to reach a cost-base of less than CHF 17 billion (CHF 19.4 billion in 2016). Apart from Asia Pacific, all main business divisions reported improved pre-tax profit in 4Q16 and all divisions apart from the Swiss Universal Bank reported improved revenues in comparison to 4Q15. In particular, fixed income related revenues were up in CS's two global capital markets divisions, however a sharp decline in fixed income revenues in Asia Pacific was the main contributor to a decline in the pre-tax profit for the Asia Pacific division.

During the earnings call, Credit Suisse reinforced its intention to pursue the minority IPO of its Swiss domestic subsidiary, Credit Suisse (Schweiz) AG, in the second half of 2017. However, management is also evaluating other possible actions and watching closely developments on the regulatory landscape.

Credit Suisse Group reported a 40 basis point decline in its BIS fully-applied common equity tier 1 (CET1) ratio to 11.6% in the quarter (see Exhibit 1). The negative impact of the RMBS settlement (circa 90 basis points) was partly offset by a 1% reduction in risk-weighted assets (RWA) to CHF268 billion, reflecting RWA reductions in the group's Global Markets and non-core unit.

Credit Suisse reported a Swiss SRB going concern leverage ratio of 4.5% on a fully-applied basis, a decline of 10 basis points (bps.) from 30 September 2016. The decline is largely

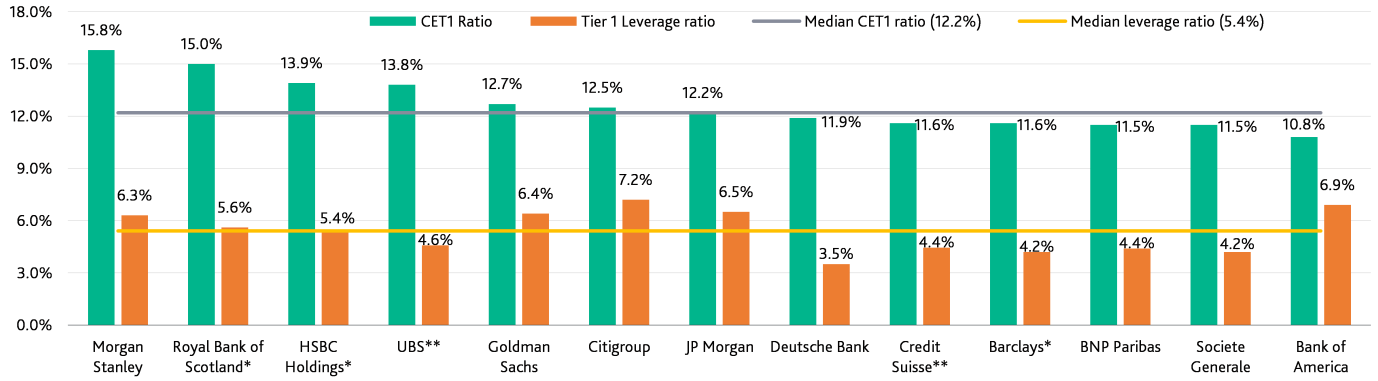
due to the impact of the RMBS settlement as leverage exposure remained broadly flat at CHF 951 billion. In 4Q16, Credit Suisse reported a 3.3% CET1 leverage ratio, a level which is slightly below the end-state requirement of 3.5% under Switzerland's Too-Big-To-Fail (TBTF) provisions due in end-2019. CS reported a 4.4% tier 1 leverage ratio on a fully applied basis. Relative to the other global investment banking firms we rate, Credit Suisse reported a CET1 ratio just below the median of peers and a tier 1 leverage ratio in-line with its European peers (see Exhibit 1).

To support the Swiss TBTF gone concern loss absorbing capital requirements, Credit Suisse will be required to issue further amounts of senior holding company bonds. Due to current and anticipated TLAC issuance, we recently upgraded the long-term debt ratings of Credit Suisse AG to A1 from A2 and those of Credit Suisse Group Funding (Guernsey) Limited to Baa2 from Baa3. Management expects additional funding costs from TLAC issuance to be offset by cost savings as they replace more expensive legacy junior instruments.

Credit Suisse reported an average Basel III Liquidity Coverage ratio (LCR) of 202% for 4Q16. The high LCR ratio reflected additional liquidity held around the time of the RMBS settlement in end-December and holdings of liquidity for local entity level requirements. CS management expects to reduce this measure to around 150% over the course of 2017 and this reduction should be met with a correspondent improvement in the leverage ratio as leverage exposures relating to high quality liquid assets are reduced.

Exhibit 1

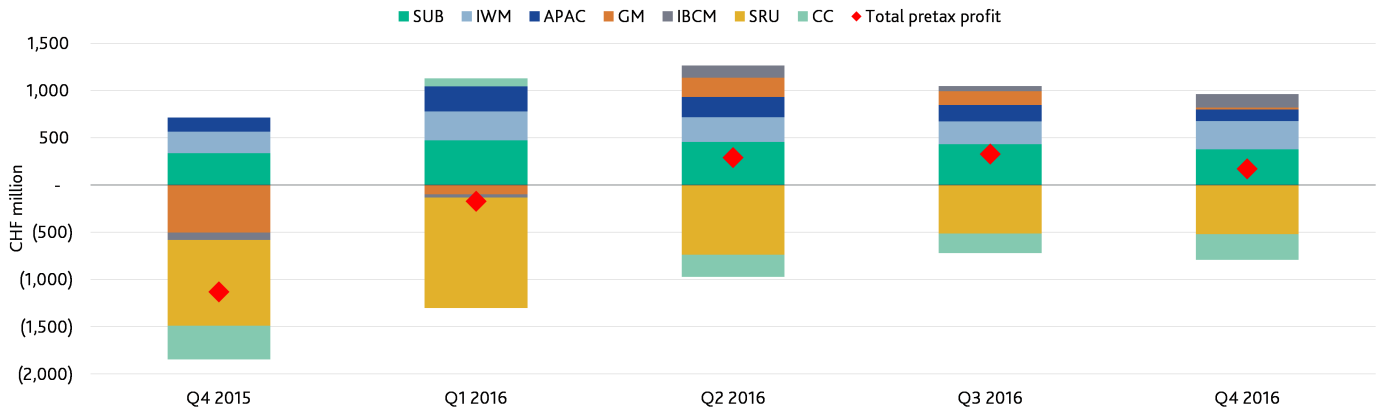
Common Equity Tier 1 (CET1) ratio and Tier 1 Leverage Ratio for Global Investment Banks, End-2016



*End-September 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-2016 for all but three banks which are due to report their fourth quarter 2016 results.
Source: Company results presentations and financials, Moody's

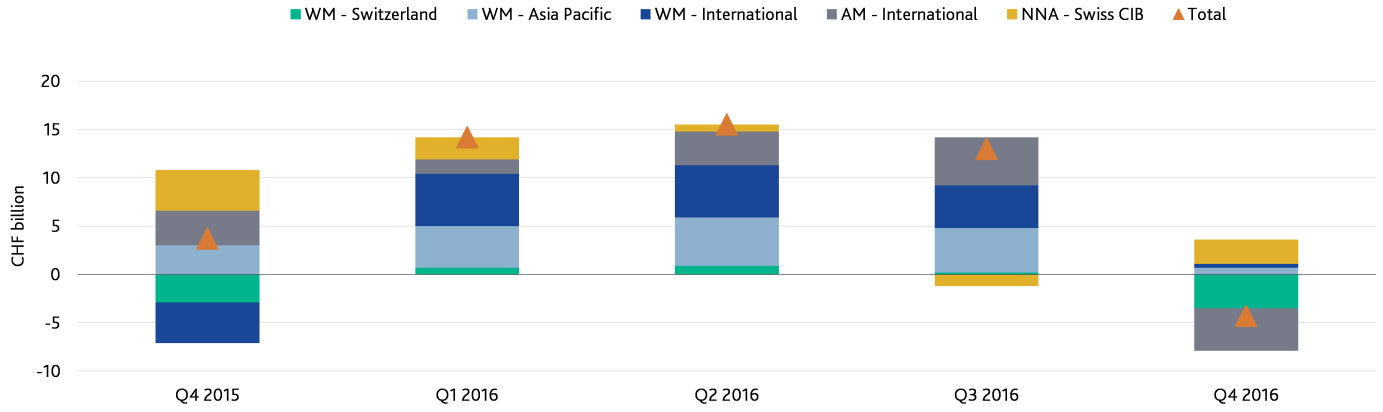
Within the business segments, key operating and financial trends were as follows:

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 (NNA) 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 378 million, up 12.5% versus the same quarter a year ago as expense reductions of 5% offset a revenue decline of 1.5%. SUB Private Banking's (PB) adjusted pre-tax profits improved 21%, as lower operating expenses (-10%) mitigated revenue declines (-5%), in comparison to the prior year period. Within Corporate and Institutional Banking (CIB), pre-tax profits increased 6%, as higher revenues (+4%) offset a rise in operating expenses (+5%). Swiss PB's adjusted net margin improved to 28 bps, from 23 bps in 4Q15, mainly due to lower operating expenses. These results underscore the progress the bank has made in reducing its cost base to boost profitability under the backdrop of the continued headwinds in Switzerland from negative interest rates and subdued client activity. For the last four quarters, SUB has consistently reported improved year-over-year pre-tax profits. Full year 2016 adjusted pre-tax profits amounted to CHF1.7 billion (CHF1.6 billion in 2015) and compare with the bank's 2018 target of CHF2.3 billion which CS reiterated in their December 2016 strategy update. CS plans to achieve this target through the combination of 3% per annum cost reductions and 1-3% per annum revenue growth. Assets under management (AUM) across SUB increased in the quarter by CHF 2.4 billion to CHF 531.5 billion, as net new asset (NNA) inflows in Swiss CIB and favourable exchange rate movements more than offset net new asset outflows of CHF3.5 billion in Swiss PB. Just over half of the Swiss PB NNA outflow related to client tax regularisation and exit of certain low margin asset management relationships.

International Wealth Management ("IWM") reported adjusted pre-tax profits of CHF 300 million for the quarter, up 31% from a year ago. Within IWM, Asset Management reported a particularly strong result with pre-tax profit up 177% to CHF 108 million on the back of cost reductions (-16%) and higher revenues (+4%). Private Banking adjusted pre-tax income in the quarter was up 1% to CHF192 million as higher net interest income (+28%) offset higher operating expenses (+8%). The rise in IWM PB net interest income reflected higher loan and deposit margins on both higher loan and deposit volumes. Full year 2016 adjusted pre-tax profits amounted to CHF1.1 billion (CHF1.0 billion in 2015) and compares with the 2018 target of CHF1.8 billion which CS reiterated in their December 2016 strategy update, and which CS plans to achieve largely through growth initiatives and management actions. IWM saw NNA outflows of CHF 4.0 billion during the quarter, primarily in relation to emerging markets. Across IWM, the division manages a total CHF 645 billion in assets under management, an increase of 1% versus 3Q15 as favourable exchange rate movements in the quarter more than offset the NNA outflows.

Asia Pacific ("APAC") reported adjusted pre-tax profits of CHF 122 million in the fourth quarter, an 18% decline compared to the prior year. Weak performance in Asia Investment Banking (IB) overshadowed improved results in Asia Private Banking (PB). Credit Suisse downgraded its growth ambitions for APAC IB in its December 2016 strategy update, with a revised 2018 pre-tax profit target of CHF 900 million from CHF1.4 billion. The decline in APAC IB profits was driven primarily by a decline in fixed income sales and trading (-49%), as client activity in rates products was subdued, and a decline in equity sales and trading (-10%). This was partly offset by an improved underwriting and advisory result (+43%). Operating expenses in APAC IB were up 2%, leading to a 94% cost-to-income ratio for the subdivision. APAC PB on the other hand reported a strongly improved performance with adjusted pre-tax profits up 76% as net interest income, recurring fees and commissions and transactional based revenues increased, more than offsetting higher operating expenses. Operating expenses were higher largely due to a higher relationship manager headcount (+10%) over the year. Risk-weighted assets increased by 7% in the quarter to CHF34.6 billion.

Global Markets ("GM") reported an adjusted pretax profit of $23 million for 4Q16 relative to a loss of $507 million in the same period last year. GM has now reported three consecutive quarters of adjusted pretax profit after recording pretax losses in 4Q15 and 1Q16 when it booked write-downs on inventory and CS subsequently announced a further de-risking and accelerated restructuring of the division. Within the business, Credit improved 66% versus the prior year which more than offset declines in Equities (-17%) and Solutions (-18%). Performance in credit was among the higher end of peers and reflected favourable markets, asset prices and volume movements, lower volatility and narrowed US high yield spreads in the quarter, which were supportive for client activity. Credit Suisse announced further cost reductions for GM in its December 2016 strategy update to improve the division's operational leverage, and set a 2018 cost base of below $4.8 billion relative to the full year 2016 target of $5.4 billion as it seeks to achieve a return on regulatory capital of between 10% and 15%. This compares with GM's full year 2016 adjusted operating expenses of $5.3 billion (meeting the 2016 target) and return on regulatory capital of 2%. RWAs fell in the quarter by 4% to $51 billion and leverage exposures by 6% to $278 billion.

Investment Banking and Capital Markets ("IBCM") reported adjusted pre-tax income of $142 million for 4Q16, relative to a pre-tax loss of $78 million for the prior year. The strong improvement in results reflected operational leverage from both improved revenues (+36%) and expense reductions (-14%), bringing the cost-income ratio to 75%. Within revenues, higher debt underwriting revenues (+63%) offset minor declines in equity underwriting (-2%) and advisory and other fees (-4%). The debt underwriting results reflected higher leveraged finance revenues and the comparison with 4Q15 is skewed as the prior period included inventory write-downs of an undisclosed amount. Total operating expenses decreased 14% and reflected broad based reductions across general and administrative expenses and lower deferred expenses in relation to prior year rewards.

The Strategic Resolution Unit ("SRU") reported a (unadjusted) pre-tax loss of CHF 2.6 billion in the quarter relative a pre-tax loss of CHF 1.3 billion for the same period last year. Excluding litigation expenses of CHF 2.1 billion (CHF 255 million last year) in 4Q16, 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. The majority of the increased in the litigation provisions reflected the RMBS settlement. In the quarter, Credit Suisse continued to make good progress in reducing its non-core exposures recording a CHF8 billion reduction (-15%) in risk-weighted assets in the quarter and a corresponding reduction in leverage exposures of CHF 9 billion (-8%). These reductions reflect the sale of some loan portfolios to external parties and further unwinds and compressions across its macro and credit derivative products. Credit Suisse guided that it expects the disposal cost per unit of risk-weighted assets to increase as it seeks to reduce its relatively more leverage-intensive exposures.

Corporate Centre reported a narrower pre-tax loss of CHF 271 million in the quarter, relative to a pre-tax loss of CHF 356 million (excluding fair value changes in own debt, which Credit Suisse reports in Other Comprehensive Income) in the same period last year. The narrower loss reflected lower operating expenses and lower negative net revenues.

Endnotes

1 Credit Suisse Group AG (LT senior unsecured Baa2 stable) is the parent holding company of Credit Suisse AG (LT deposits A1 stable, LT senior unsecured A1 stable, baa2 BCA). BCA: Baseline Credit Assessment

2 Unless indicated otherwise, figures are on a Credit Suisse adjusted basis. Moody's does not adjust for restructuring and litigation expenses whereas Credit Suisse's adjusted figures take out restructuring expenses and major litigation expenses.

REPORT NUMBER 1057324

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