Research Update:

U.S. Bancorp Downgraded To 'A' From 'A+' On Narrower Outperformance Versus Peers; Outlook Stable

May 11, 2023

PRIMARY CREDIT ANALYST

Stuart Plesser
New York
+ 1 (212) 438 6870
stuart.plesser
@spglobal.com

SECONDARY CONTACT

Rian M Pressman, CFA
New York
+ 1 (212) 438 2574
rian.pressman
@spglobal.com

Overview

- Although U.S. Bancorp (USB) continues to generate higher earnings than its large regional bank peers, we believe its overall performance advantage has narrowed as those peers have gained market share and delivered stable results.
- In addition, USB's capital levels are lower than peers, and we believe the company will need to build capital ratios to meet possible regulatory requirements by earliest year-end 2024 should it move into a category II bank designation.
- We lowered our ratings on USB and its subsidiaries, including our long-term issuer credit and unsecured debt ratings on the holding company to 'A' from 'A+', and the issuer credit ratings on its operating subsidiary to 'A+' from 'AA-'.
- The stable outlook on USB and its operating subsidiaries reflects our expectation that the company will generate stable earnings, build capital, and maintain adequate asset quality and good balance sheet metrics.

Rating Action

On May 11, 2023, S&P Global Ratings lowered its long-term issuer credit ratings on U.S. Bancorp to 'A' from 'A+' and its issuer credit ratings on the bank's operating subsidiaries (including U.S. Bank N.A., MUFG Union Bank N.A., and Elavon Financial Services DAC) to 'A+' from 'AA-'. The outlook on the long-term issuer credit ratings is stable. We also lowered our short-term ratings on the operating subsidiaries to 'A-1' from 'A-1+'. At the same time, we lowered the ratings on the subordinated debt and preferred stock issued from the holding company to 'A-' and 'BBB' from 'A' and 'BBB+', respectively.

Rationale

The downgrade primarily reflects our view that USB's outperformance versus peers has narrowed. Although USB continues to perform well with respect to earnings, its results in a variety of metrics, such as risk-adjusted returns, indicate its performance advantage over large regional peers is no longer as outsize as it used to be. In the last few years, large regional bank peers, such as PNC and Truist Financial Corp., have closed the performance gap with USB through strategic acquisitions and building scale and efficiency. As a result, they've delivered consistent and stable results.

In addition, USB's capital levels are among the lowest of its large regional peers, with a common equity tier 1 (CET1) of 8.5% at the end of the first quarter versus a median of 10.6% among rated U.S. bank peers. Its risk-adjusted capital (RAC) ratio is also at the low end of peers, totaling 7.2% at year-end 2022, and at the lower end of our threshold to view it as adequate. As of the first quarter, its tangible common equity-to-tangible asset ratio, which includes unrealized losses in its securities portfolio, was a below-peer 4.8%.

The downgrade also reflects that while we think the acquisition of Union Bank in December 2022 complements USB's national strategy by adding market share and expanding its deposit base, it also adds integration risk and has increased USB's loan concentration in California.

We expect USB to build up its capital ratios from current low levels. Given its earnings power, we think USB will add about 20 bps-25 bps to its CET1 ratio per quarter going forward, largely by retaining earnings but also by optimizing risk-weighted assets and the maturity profile of its available-for-sale securities portfolio. We expect USB's CET1 ratio to reach 9.0% by year-end 2023, and to rise further to 10.0% by the end of 2024, excluding other comprehensive income (OCI). Management expects the bank will possibly fall into a category II designation under the Federal Reserve's tailoring rules at the earliest, end of 2024. Such a designation would necessitate that USB include OCI in its capital ratio. The rapid rise in interest rates resulted in negative OCI of $10.2 billion at the end of first-quarter 2023. If current OCI losses were incorporated in its CET1 ratio, it would reduce the ratio by about 200 bps.

Notwithstanding the capital we expect it to build to bolster regulatory ratios, in our view USB's funding and liquidity compare well with peers. Excluding an expected decline, deposits in the first quarter were down sequentially by about 1%, marginally lower than the 1.3 % median for rated U.S. bank peers. The cost of interest-bearing deposits rose only about 42 bps sequentially, better than most of USB's peers. About 51% of its deposits are uninsured, and they are made up largely of operational deposits, with a sizable portion linked to its trust business. While we expect deposit outflows to remain manageable, we believe USB has ample available liquidity to handle these potential declines. Its available liquidity, including cash, securities, and access to the Federal Home Loan Bank and Fed discount window, is roughly 126% of uninsured deposits.

Like peers, USB's asset quality remains good and charge-off levels remain well below historical ones. Commercial real estate (CRE) represents about 14% of loans, but offices only 2% of loans. However, USB's California exposure has increased and as of year-end 2022 was 40.0% of CRE loans, 47.0% of residential loans, and 17.5% of commercial loans. Given the strength of its earnings power, including its unique fee-generating businesses, we think USB should be able to build loan loss reserves without significantly hampering profitability if economic conditions worsen. This is reflected by its performance in the Fed's 2022 stress test, in which it had the lowest capital burndown of regional banks participating in the test.

Outlook

The stable outlook on USB and its operating subsidiaries reflects our expectation that although the uncertain regional banking conditions could create some challenges for USB, the company will continue to perform better than most regional bank peers, while navigating economic risks. We expect the company to generate peer-leading earnings, build capital, and maintain adequate asset quality and funding and liquidity metrics.

Downside scenario

We could lower the rating if:

- USB is unable to build capital to at least 150 bps above its projected CET1 required minimum;
- Profitability, risk profile, or balance sheet metrics start to converge with lower-rated peers;
- Asset quality deteriorates more than we expect;
- Deposit outflows are larger than we expect;
- Liquidity declines significantly;
- The company does not manage interest rate risk effectively; or
- Elevated risks arise from the acquisition of Union Bank, although we don't expect this.

Upside scenario

We are unlikely to raise the rating in the next two years, given the company's performance relative to peers and the elevated risks in the economy.

Ratings Score Snapshot

	To	From
Bank holding company rating	A/Stable/A-1	A+/Negative/A-1
Operating company rating	A+/Stable/A-1	AA-/Negative/A-1+
Group SACP	a+	aa-
Anchor	bbb+	bbb+
Business position	Very strong (+2)	Very strong (+2)
Capital and earnings	Adequate (0)	Adequate (0)
Risk position	Strong (+1)	Strong (+1)
Funding and liquidity	Adequate and adequate (0)	Adequate and adequate (0)
Comparable ratings analysis	0	+1
Support	0	0
ALAC support	0	0
GRE support	0	0
Group support	0	0

	To	From
Sovereign support	0	0
Additional factors	0	0

SACP--Stand-alone credit profile.

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions , March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology , Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions , Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- General Criteria: Group Rating Methodology , July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology , July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria , Oct. 21, 2016
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011

Ratings List

Downgraded

	To	From
U.S. Bancorp		
Senior Unsecured	A	A+
Subordinated	A-	A
Preferred Stock	BBB	BBB+
U.S. Bank N.A.		
Senior Unsecured	A+	AA-
Commercial Paper	A-1	A-1+
USB Capital IX		
Preferred Stock	BBB	BBB+

USB Realty Corp.		
Preferred Stock	BBB	BBB+
Downgraded; CreditWatch/Outlook Action		
	To	**From**
Elavon Financial Services DAC		
U.S. Bank Trust Co. N.A.		
U.S. Bank N.A.		
MUFG Union Bank, N.A.		
Issuer Credit Rating	A+/Stable/A-1	AA-/Negative/A-1+
Downgraded; CreditWatch/Outlook Action; Ratings Affirmed		
	To	**From**
U.S. Bancorp		
Issuer Credit Rating	A/Stable/A-1	A+/Negative/A-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.