Strategic Report for
U.S. Bancorp

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Executive Summary

U.S. Bancorp is a bank holding company that recently ascended to a top 5 position in the commercial banking industry. U.S. Bancorp provides various kinds of financial services, encompassing commercial and wholesale banking, wealth management, payment processing service and treasury/corporate services. The recent credit crisis adversely affected the banking industry, resulting in the collapse of many small regional banks and a rise in merger and acquisition activities. U.S. Bancorp was no exception to this economic environment; it experienced a significant rise in expenses in recent years due to deteriorating credit quality. Additionally, in 2009, U.S. Bancorp's amount of non-performing loans, net charge-offs and provisions for loan loss expense all increased. However, compared with competitors Wells Fargo and Bank of America, U.S. Bancorp performed better during the economic downturn, giving the company a good image and a reputation for conservative operation. Moreover, U.S. Bancorp used the credit crisis as an opportunity to expand its market share by acquiring poorly capitalized small banks.

The company's recent significant deals include FDIC-assisted acquisitions of the banking operations of Downey Savings and Loan Associations, F.A. (DSL), PFF Bank and Trust (PFFB), and First Bank of Oak Park Corporation (FBOP). This enabled U.S. Bancorp to effectively expand in three key markets: California, Illinois, and Arizona. U.S. Bancorp announced its goals to continue market expansion through acquisitions and to be in the top 3 banks of those target markets.

Even though U.S. Bancorp presented relatively successful risk management and demonstrated faster recovery from the crisis relative to its competitors, the bank still faces various threats that could be detrimental to future profits. Given that U.S. Bancorp has been operating successfully, Vector Strategy Group has decided to focus on recognizing the risks facing the bank and providing strategic advice that seeks to prevent any future damage to the company. The risks include:

1) Commercial Real Estate (CRE): In next few years, the commercial real estate market is expected to collapse, following the burst of residential real estate bubble. This collapse will adversely affect the ability of CRE loan borrowers to make required payments. Therefore, U.S. Bancorp should perform thorough due diligence on CRE

loans maturing within a few years. Additionally, the bank should maintain contact with building owners and work with them to raise new capital, in order to prevent loan defaults at the maturity date. Also, the bank should not delay writing off CRE loans and realizing the corresponding losses, since failing to do so would lead to a surge in future expenses.

2) Mortgage Put-backs: After discovering underwriting flaws on loans comprising banks' portfolios, monoline insurers and investors expect demand to increase for loan put-backs to banks. Also, government-sponsored enterprises including Freddie Mac and Fannie Mae will force banks to repurchase more loans than they securitized in the past. Therefore, U.S. Bancorp should investigate previous loan issuance, particularly focusing on 2006 and 2007 mortgages, in order to precisely forecast the loss, while building sufficient reserves for possible losses from the repurchases.

3) Too-big-to fail (TBTF): After ascending to the position of the fifth largest bank in U.S., U.S. Bancorp is now regarded as a too-big-to-fail bank. Due to the significant role of too-big-to-fail banks in causing the recent credit crisis, various governmental regulations will be enacted soon to protect the economy. Therefore, U.S. Bancorp should be more cautious regarding its aggressive expansion strategy. Namely, the company should avoid excess dependence on complicated derivative contracts. The interconnectedness resulting from derivatives is one of the standards in determining whether a bank is TBTF, and thus should be limited.

Company Overview

Company History of U.S. Bancorp

The origin of US Bancorp traces back to the establishment of The United States National Bank of Portland (U.S. National) by a few wealthy businessmen in 1891. At the turn of the century, as the city of Portland developed economically, there was an increase in the number of national banks in Oregon from 27 to 75. Supported by the prosperous economy, U.S. National was actively involved in expanding its business through mergers and acquisitions during the first decade of the 1900s. In 1902, the company accepted a merger offer from U.S. National and Ainsworth National, the fourth largest bank. Shortly thereafter, U.S. National merged with Wells Fargo Company's Portland banks and another Portland bank called Lumbermens National. Through these mergers, the company became the second largest bank in the Pacific Northwest. The expansion of the company continued in 1920s following a merger with Ladd and Tilton in 1925. This merger caused U.S. National to be the second largest bank north of San Francisco and west of Minneapolis.

In the late 1940s, during the period of economic prosperity following the Great Depression and World War II, U.S National modified its business lines by strengthening the consumer credit department in order to target the profit from an increase in consumers' disposable income and consequent rise in their purchases. Also, from 1945 to 1960, the company actively expanded in the state of Oregon by adding 35 new banking units, mostly through acquisition and generated some new branches as well, reaching 100 branches in the state. Also, the bank's name was changed from United States National Bank of Portland to United States National Oregon.

In the late 1960s, as the range of products and services offered by commercial banks became more diverse, banking companies started to create holding companies in order to facilitate the acquisition of subsidiaries and to provide a broader range of services. As a result, on September 9, 1968, United States National Oregon also adapted this system, establishing U.S. Bancorp as a holding company. The 1970s were a time of re-organization for the company. During this period, subsidiaries like Bancorp Leasing Inc., a lease-financing company, U.S. Bancorp Financial Inc., an asset-based commercial

financing company, and Mound Hood Credit Life, an insurance company, were acquired by U.S. Bancorp.

During the 1980s, U.S. Bancorp expanded further by acquiring the State Finance and Thrift Company of Logan, Utah. In addition, through the establishment of Citizen's Industrial Bank in Littleton, Colorado, the company strengthened its presence in new geographic regions. Consequently, the territories under U.S. Bancorp's operation included California, Texas, Washington, Utah, Idaho, Colorado, Montana, and Oregon.

In the early 1990s U.S Bancorp changed its focus from aggressive acquisition to streamlining its operation process. Between 1992 and 1994, the company laid off almost a quarter of its employees, and focused on raising efficiency levels. However, after just two years of trimming its business lines, U.S. Bancorp boosted its growth once again through active takeovers, starting with the purchase of West One Bancorp of Idaho in May 1995, at a cost of $1.6 billion. U.S. Bancorp kept acquiring other banks and bolstering its presence; it acquired California Bancshares Inc., paying $327 million, and the company's recognition in northern California was further strengthened by the subsequent purchase of Business & Professional Bank in 1996.

In 1997, First Bank System acquired U.S. Bancorp for $8.8 billion and took the U.S. Bancorp name. First Bank's chief executive, John Grundhofer, assumed the position of CEO, while U.S. Bancorp's Gerry Cameron served as chairman. Through this acquisition, U.S. Bancorp doubled its assets to $70 billion and served 17 states in the Midwest and West. However, since the administrative functions were combined, the acquisition resulted in the lay-off of 4000 people mainly from the offices of U.S. Bancorp.

In late 1997, U.S. Bancorp continued to realize Grundhofer's ambition to expand as the company acquired Piper Jaffray Companies Inc., a securities firm, for $730 million. This deal enabled U.S. Bancorp to provide enhanced retail and institutional brokerage and investment banking services, adding $13 billion mutual fund assets and consequently increasing its assets to $65 billion.

Besides the acquisition by First Bank System, one of the most important events in U.S. Bancorp's history occurred in October 2000. At that time, Jerry A. Grundhofer, CEO of

the Firstar Corporation, acquired U.S. Bancorp, his younger brother's company, for $21 billion. Both companies agreed to retain U.S. Bancorp as the company name but to move the headquarters to Minneapolis since the Firstar Corporation had been based in Milwaukee. This acquisition helped to improve the weaknesses of both banks. Firstar's strength in retail business helped U.S. Bancorp reinforce its disappointing revenue from retail. The deal also increased the diversification in Firstar's lending by increasing the revenue generated by fee-based activities performed by U.S. Bancorp's subsidiaries such as Piper Jaffrary. This acquisition created the nation's eighth largest bank, holding more than $160 billion in assets.

In addition to these firms, U.S. Bancorp purchased the Nova Corporation, a credit card payment-processing firm for $2.1 billion in 2001. This made U.S. Bancorp the third-biggest processor of payments for merchants. In contrast to the acquisition, the company spun off its subsidiary, Piper Jaffrary, in 2003 by distributing Piper Jaffrary's stock to U.S. Bancorp's shareholders in the form of stock dividends.

By the end of 2006, U.S. Bancorp displayed solid profit growth due to low credit costs and a rise in revenue from fee-based products. However, the home mortgage slowdown and deteriorating credit quality in 2006 inevitably affected U.S. Bancorp's operations in subsequent years. In 2007, the company experienced a decline in net income of $500 million with an increase in the provision for credit loss by $248 million, a 45.6 % rise.

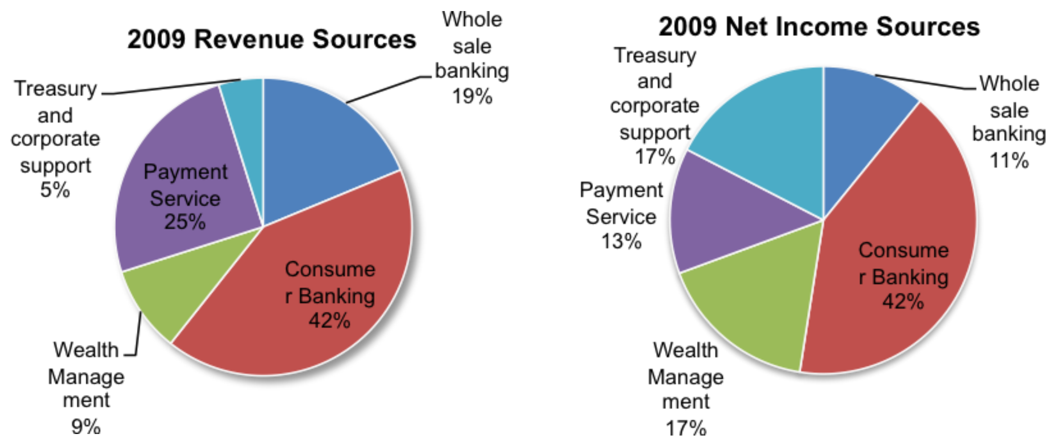
In 2008, U.S. Bancorp continued to suffer from falling housing prices and distress in the commercial and consumer lending markets. It recognized a fall in net income from $4.3 billion in 2007 to $2.9 billion in 2008. Moreover, the company announced that $1.3 billion of the provisions for credit losses were in excess of net charge-offs. Also in 2008, U.S Bancorp received $6.6 billion through the government bailout program, by selling $6 billion of preferred stock and 10 year warrants to U.S. Treasury. This program, also known as the Troubled Asset Relief Program (TARP), involved investing $250 billion in various banks in order to encourage more lending. In 2008, U.S. Bancorp contracted loss-sharing agreements with the FDIC, which shares the credit loss of certain loans and protects the firm from risk in asset yields.

However, relative to competitors in the banking industry like Wells Fargo & Co. and Bank of America Corp., U.S. Bancorp performed better in terms of risk management and benefited from its conservative operating strategy under the crisis. This is shown in its acquisition of banking operations in Downey Savings & Loan Association, F.A., PFF Bank & Trust in 2008 and FBOP in 2009. U.S. Bancorp returned its bailout money in June 2009, becoming the first large bank to complete the repayment. In addition, the stress test performed by regulators in February 2009 concluded that U.S. Bancorp does not need any additional capital to prepare for further economic downturn. In the fourth quarter of 2009, U.S. Bancorp reported a rise in profits from $330 million to $602 million, nearly doubling from the same period in last year.

In January 2010, U.S. Bancorp purchased $850 million in deposits and 14 branch locations from BB&T Corp., including branches in Las Vegas, Reno and other markets in northern Nevada. These braches will assume the U.S. Bancorp name. On April 3, 2010, U.S. Bancorp's stock price rose to $26.24, up from the 52-week low of $8.08. Overall, the banking industry has seen some improvement, with U.S. Bancorp exhibiting some of the healthiest signs of recovery.

Business Model

U.S. Bancorp is currently the fifth largest bank holding company. It oversees 20 subsidiaries and provides diverse financial services, holding $281 billion of assets, $183 billion of deposits and $195 billion of loans. It provides services to $17.2 million customers with 3,002 bank branches and 5,148 ATMs[1]. U.S. Bancorp's business can be categorized into five operating segments:



1. Wholesale Banking: This business includes the lending, equipment finance, small-ticket leasing that covers items up to $100,000 in value, treasury management, foreign exchange, international trade service, and other financial services targeting middle market and corporate or commercial real estate. U.S. Bancorp currently operates wholesale banking nationwide[1]. Based on the financial statements for 2009, wholesale banking accounts for 19 % of total revenue and 11 % of total income.

2. Consumer Banking: This business covers the wide range of services including community banking, metropolitan banking, in-store banking, small business banking, consumer lending, mortgage banking, consumer finance, workplace banking, student banking, and 24-hour banking. U.S. Bancorp provides the products and services of consumer banking to its regional markets through its banking offices, telephone and online services[1]. In 2009, it generated 41.9% of total revenue and 41.5% of total income from consumer banking.

3. Wealth Management and Securities services: This segment encompasses trust, private banking, financial advisory, investment management, insurance, retail brokerage and mutual fund services. Similar to consumer banking, this business also covers only regional markets[1]. This business comprised 9.3 % of U.S. Bancorp's total revenue and 17 % of total income for 2009.

4. Treasury and Corporate Support: This business includes U.S. Bancorp's investment portfolios, funding, management of recently acquired assets, capital management, asset securitization and interest rate risk management. This segment generated 5 % of revenue and 17 % of total income in 2009.

5. Payment Services: This business segment covers consumer and business credit cards, stored-value cards, debit cards, corporate and purchasing card services and merchant processing. U.S. Bancorp's market place includes North America, Europe and Mexico[1].

Following the consumer banking business, this is the second-largest revenue source to U.S. Bancorp; it generated 25 % of total revenue in 2009. However, this segment only accounts 13 % of net income, the second lowest element contributing to net income.

Competitive analysis

Industry Overview

Mergers and consolidation activities in the banking industry have prospered since the early 1990s, which makes it difficult to precisely define the industry of the large conglomerate banks. U.S. Bancorp currently operates in the National Commercial Banks industry with the SIC code 6021 and in the Commercial Banking industry with NAICS code 522110[2]. Although U.S. Bancorp's operations concentrate on commercial banking, it also has characteristics of a diversified financial services company. This industry is comprised of companies providing various kinds of financial services including lending businesses, international banking, insurance, securities, investment banking and trading, making the industry as a whole difficult to classify. While it is challenging to quantify the size and scope of the diversified financial services industry, it is easier to grasp the magnitude of the commercial banking industry, because the latter is closely supervised by regulators, and the FDIC regularly distributes aggregate industry data[4]. The U.S. commercial banking industry is highly fragmented and competitive; according to data published in September 2009, 8091 banks exist in the U.S. Among those banks, the FDIC currently insures 6911 commercial banks and 1180 savings institutions[3]. The companies that are positioned in both the diversified financial services industry and the banking industry include JPMorgan Chase, Citigroup, Bank of America, Wells Fargo, PNC Financial services, Bank of New York Mellon, SunTrust Banks, State Street, Capital One Financial, BB&T, Regions Financial and Fifth Third Bancorp.[3,4]

Porter's Five Forces Analysis:

Porter's five forces	Degree
Rivalry	High
Entry/ Exit Barrier	High/ Moderate
Power of Suppliers	Low
Power of Buyers	Low
Substitutes/ Complements	Moderate

Competitive Rivalry

As mentioned above, the banking industry is highly fragmented and competitive. The financial services industry has existed for hundreds of years and consumers requiring banking services are already using banks[5]. Therefore, in order to expand its market share, a bank must convince clients to switch from other banks.

Moreover, the commodity-like nature of financial services products intensifies the competition[6]. Since financial products cannot be copyrighted or patented, it is almost impossible to create highly differentiated products that other banks cannot instantly duplicate. Therefore, even if banks introduce new products, they are always confronted by the competition. In addition, non-financial companies can also provide services that are acceptable substitutes, further intensifying the competition in the banking industry.

The Gramm-Leach-Bliley Act of 1999 is one of the most important factors that led to an increase in the level of competition in the financial services industry[6]. This act allowed investment banks, insurance companies and commercial banks to enter each other's business lines. The act enabled banks to take advantage of economies of scale as a cost-cutting measure and resulted in many large consolidations in the industry. Currently, the recent financial crisis has resulted in many mergers and acquisitions, creating an abundance of large financial conglomerates. The industry is expected to consolidate

further in the future. Due to these factors, the diversified financial services industry is under harsh competition and strong rivalry.

Entry and Exit

In the general banking industry, it is difficult for an individual to start a bank or financial services company. First of all, a special bank license issued from the government is required before a company can begin operations. Moreover, after starting the business, financial services companies are subject to various regulations. In addition, economies of scale exist for these types of companies, meaning the industry tends to favor large firms. Larger companies offer diversified products, and therefore can obtain an advantage from their broader distribution systems to get the most products to the greatest amount of people in the most efficient manner[6]. It is also easier for large banks to widely advertise and strengthen brand name recognition. As a result, start-up banks, which are smaller than the existing mega-banks, have a disadvantage when competing with existing players, creating a barrier to new entrants.

Furthermore, even if there are new entrants, they are unlikely to pose a threat to existing banks. This is because the banking industry is already highly fragmented and competitive, implying that the significance of new entrants is immaterial.

However, the consolidation between different kinds of financial services firms can pose a threat to U.S. Bancorp and the other players. This is due to economies of scale, as mentioned above. As banks grow larger, they can operate more efficiently. Therefore, the threat to existing players comes from the emergence of consolidated mega-banks providing diverse financial services, rather than new entering firms.

However, exit is easier than entry in the banking industry due to the proliferation of mergers and acquisitions. Since the banking industry is highly saturated, banks must lure customers away from other firms in order to expand market share. In this

environment, mergers and acquisitions are the most convenient way to achieve rapid growth. Due to the current credit crisis, government organizations have intervened on multiple occasions to restructure the banking industry. Therefore, once a bank intends to exit the market in current circumstances, it is not especially difficult to find a company interested in purchasing the company.

Supplier Power

In the commercial banking industry, banks face three kinds of suppliers: depositors, the credit market, and the central bank[7]. These three groups supply funds to the bank. The first group, individual depositors, does not hold bargaining power. In general, banks offer a certain interest rate and prices, and depositors can choose to accept or reject these prices. Moreover, banks pay nothing for demand deposits.

Larger clients, such as corporations, government agencies, and wealthy individuals, possess higher levels of bargaining power. However, the bank is still the dominant party relative to these types of clients. Despite this, banks' bargaining power can be threatened when these large clients hold substantial amounts of deposits and decide to switch to another bank.

As a supplier of money, the credit market is always open to qualified banks, suggesting that it is unlikely for banks to be threatened by a credit market as a source of funding. The central bank is a lender of last resort, which will continue to supply liquidity to the banking system in virtually unlimited quantities at a reasonable cost. However, as displayed by the recent financial crisis, the central bank can impose stricter regulations and intervene in banks' operation in exchange for a supply of funds.

In contrast, human capital can pose a threat to banks[6]. The Federal Reserve Board recently issued a proposed supervisory guidance relating to incentive compensation policies for bank employees. Under this circumstance, talented individuals would be attracted by banks that are under less strict regulation and can provide better incentives.

Buyer power

In general, retail customers do not hold any bargaining power to banks. The classic banking wisdom says, "If you owe the bank $10,000, you have a problem. If you owe the bank $10,000,000, then the bank has a problem[7]." This statement suggests that the disparity in size and power of banks and customers is too large: in general, clients cannot have any bargaining power. Also, when a client uses multiple financial services at one particular bank, it is extremely difficult for the customer to switch to another bank. Due to banks' cross-selling and resulting high switching costs, buyers are not a substantial threat to banks.

Even though large corporate clients have higher bargaining power than any individual client, the power that these corporations can exercise is limited. Any negotiation of terms and conditions of a banking deal between a corporate client and a bank would be a win/win negotiation, where both sides are willing to develop a deal that is optimal for both participants. The deals would be structured in such a way that the corporate client can meet the requirements and banks can guarantee the repayment. Therefore, even though large corporations have a power to negotiate with a bank, usually this doesn't pose a threat to banks because the deal would be negotiated to be optimal to both parties. However, regardless of bargaining power, large corporations are high-margin clients, and losing such clients would affect banks' profitability.

Substitutes and Complements

Since U.S. Bancorp and the other diversified financial services companies already hold many subsidiaries that offer diverse financial services, it is difficult to find any true substitutes. However, in terms of commercial banking operations, competition arises from non-bank firms that can provide substitutable services.

The first example is a commercial firm that offers an essentially identical service to a bank as a source of credit[8]. One example is Paypal Inc.; a company that lets users hold an account that allows them to receive and pay bills and also withdraw cash from an ATM. Another example is mobile-phone companies offering pre-paid cards that can be used to pay for telecom services.

In addition, manufacturing companies can provide a substitute to banks' services by providing financing service to their customers. Sony Financing offers a deal that finances purchases of more than $399, and if it is paid within 24 months, requires no interest payment[9]. Similarly, General Motors and Microsoft all offer preferred financing to customers buying big-ticket items[5]. Therefore, financing services directly provided by retail companies can be considered substitutes to a bank's lending service.

One of the complements to the banking industry is derived from the improvement in technology. The advent of Internet banking and the development of technologically advanced ATMs make it much more convenient to use banking services. Also, more advanced technology helps banks to organize and share customers' information between its affiliates, which contributes to rises in profitability.

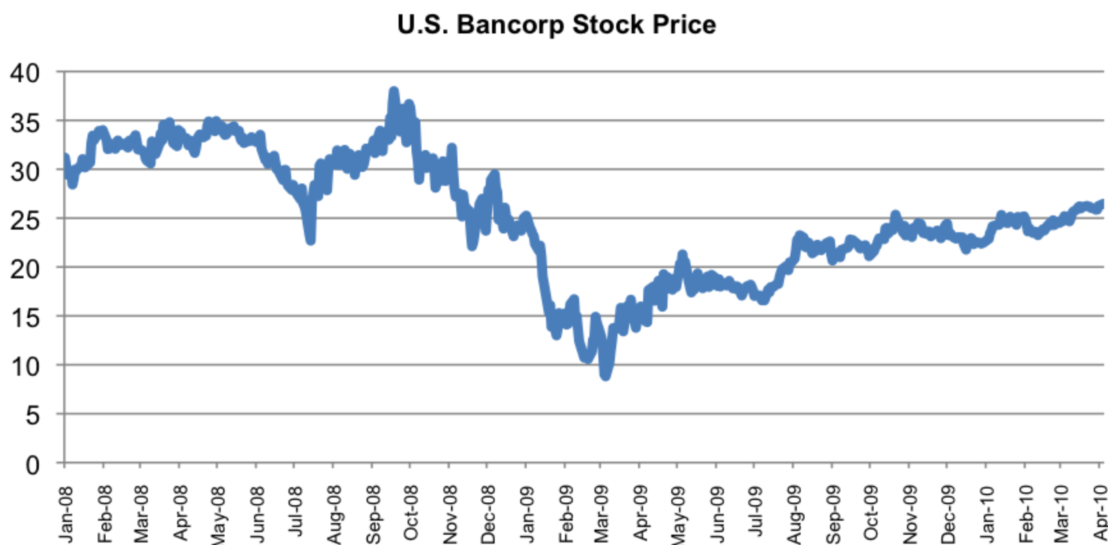
In addition to technology, the improving economic environment is another significant complement to the banking industry. The general economic upturn raises transaction volumes of a bank's services due to demand for an increased amount of investments. Lower interest rates during the economic growth also contribute to a rise in the demand

for bank's loans, while reducing the funding cost. Therefore, improving economy with easy monetary policy definitely generate the complementary effect to banking industry.

Financial Analysis

Stock price analysis

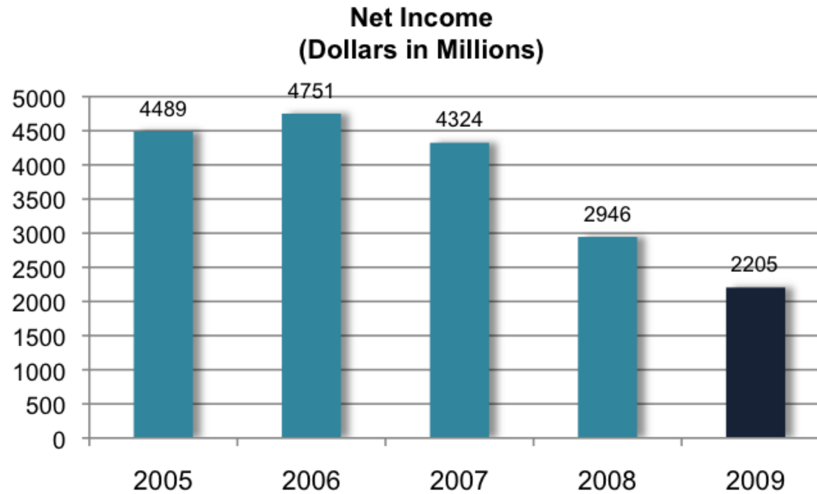
U.S. Bancorp's stock price reached its lowest level in a decade in March 2009, when it traded at $8.82. Since that time, the stock price has steadily risen. The rise in stock price in 2009 was primarily due to U.S. Bancorp's aggressive market expansion through acquisitions, its reputation for conservative operations, and less exposure to credit risk relative to the other large banks. The price-to-earnings (PE) ratio, which is the key measure of market valuation, was x27.05 based on the stock price of 26.24 on April 3, 2010 and earnings per share (EPS) in 2009. The estimated PE was x16.5 when we used the 2010 earnings estimated by Business Week with the stock price at the same date[10]. Compared to Wells Fargo's x19.72 and JPMorgan Chase's x15.06 PE ratio, we can conclude that U.S. Bancorp is currently valued as one of the strongest players in the banking industry and the market has confidence in U.S. Bancorp's long-term prospects[10].

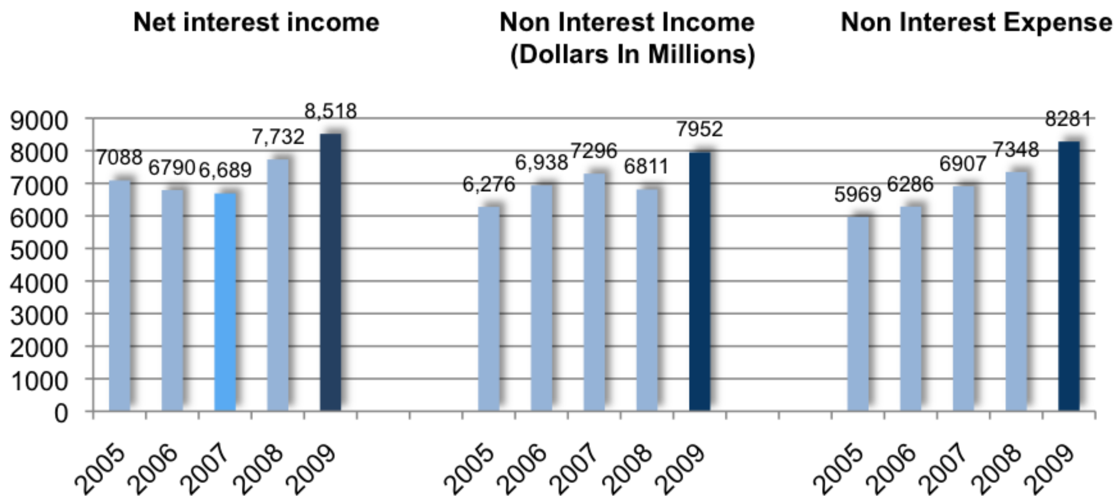


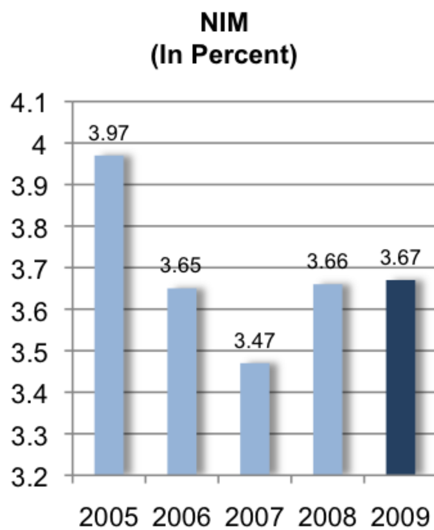
Source: Yahoo! Finance

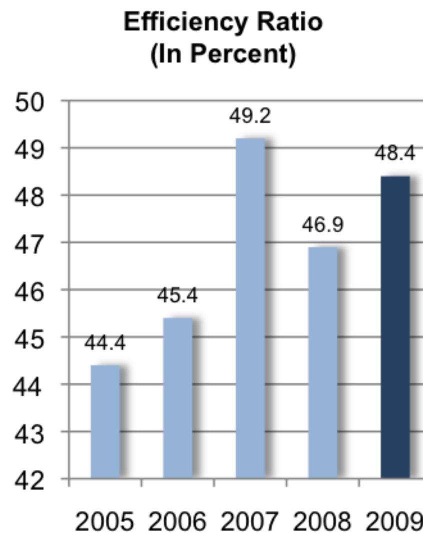
Profitability analysis:

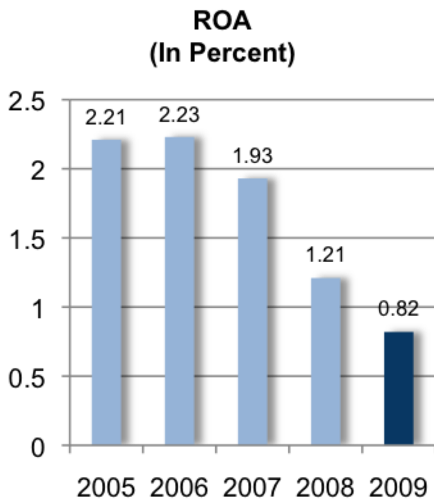
Banks	U.S. Bancorp			Wells Fargo & Co.			Bank of America Corp.		
	2009	2008	2007	2009	2008	2007	2009	2008	2007
NIM(%)	3.67	3.66	3.47	4.28	4.83	4.74	2.65	2.98	2.6
Efficiency Ratio(%)	48.4	46.9	49.2	55.3	54	57.6	55.16	56.14	54.71
ROA(%)	0.82	1.21	1.93	0.97	0.44	1.52	0.26	0.22	0.94
ROE(%)	8.2	13.9	21.3	9.88	4.79	17.22	3.2	1.8	11.08
Total Capital(%)	12.9	14.3	12.2	13.26	11.83	10.68	14.66	13	11.02
Tier 1 Capital(%)	9.6	10.6	8.3	9.25	7.84	7.59	10.4	9.15	6.87
TCE/TA	5.3	3.3	4.8	n/m	n/m	n/m	5.57	2.93	2.46
Loans to Deposit	1.06	1.16	1.19	0.93	1.08	1.09	0.91	1.06	1.07

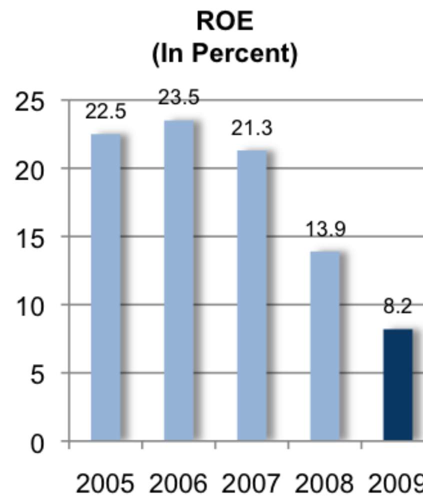












Net interest income and net interest margin:

U.S. Bancorp realized a rise in net interest income from $6.7 in 2007 and $7.7 billion in 2008 to $8.5 billion in 2009. This increase is attributed to the rise in average earning assets and lower cost core deposit funding in 2009.[11] Average earning assets rose to $237.3 billion in 2009 from $215.1 billion in 2008, which was mainly driven by a rise in loans through origination and acquisitions. U.S. Bancorp was also able to raise non-interest bearing deposits in 2008 and 2009 due to the company's positive reputation for conservative operations and flight to quality trend during the recent economic crisis.

Given that a high portion of U.S. Bancorp's revenue comes from traditional banking operations, the net interest margin (NIM) is a significant indicator of its profitability. The NIM that U.S Bancorp used in its annual report is expressed as a percentage of the difference between interest income and interest expense, divided by the bank's assets. NIM is generally affected by changes in the market interest rate and the bank's business model. An increase in the federal funds rate or the discount rate generally flattens the yield curve because short-term rate volatility typically outweighs long-term rate volatility. As a result, the flattened yield curve reduces the spread between the long-term rate that banks use to determine the rate they charges to borrowers, and the short-term rate that banks usually have to pay for deposits. This leads to a decrease in NIM. In addition to yield curve risk, banks are exposed to repricing risk because their business model, which uses short term liabilities for funding long term assets. Whereas a rise in interest rate will raise the funding cost, there is no effect on loan rates for a period of time, due to the shorter repricing period of liabilities. The rise in interest rate will reduce the demand for the loans, which contributes to lowering the NIM. However, a bank can use a range of various products, including derivatives such as interest rate swaps or forward rate agreements, adjustable loans, or zero interest deposits to insulate itself from market risk and secure a certain level of NIM.

U.S. Bancorp's NIM increased from 3.66% in 2008 and 3.47% in 2007 to 3.67% in 2009. The bank's ability to attract low cost deposits while raising loans contributed to the improvement in net interest margin. According to analysts, NIM will continue to increase to 3.78% in 2010 and 3.86% in 2011[12]. U.S. Bancorp generated a higher NIM than its competitor, Bank of America, but a lower NIM than Wells Fargo. Wells Fargo's NIM is 4.28% and Bank of America's NIM was 2.65%. When we consider that U.S. Bancorp is one of the most conservative banks, the company's profitability seems strong and healthy.

Non-interest income and business diversification:

U.S. Bancorp's non-interest income in 2009 was $8.0 billion, which is a 16.8 % rise from $6.8 billion in 2008. This improvement in non-interest income is attributable to a $765 million rise in mortgage banking revenue due to the low-interest environment and an increase in the valuation of mortgage service rights. Besides this enhanced performance of the mortgage banking business, a rise in revenue from ATM processing service, higher commercial loan products and related fee income, and smaller net securities losses also contributed to the increase in non-interest income. [11]

In 2009, non-interest income accounted for 40% of U.S. Bancorp's total revenue, which is below the industry average of 45%, based on 2008 data. According to an S&P industry trend report, larger banks tend to derive a greater proportion of their total income from non-interest bearing sources, which suggests larger banks are involved in more diversified businesses such as securities trading, trust services, mortgage banking, capital market activities, corporate finance, credit cards and other fee-based financial services[13]. The industry average percentage of non-interest income has been rising, suggesting that U.S. Bancorp's earnings depend more on traditional banking and compared with its competitors, it is not sufficiently diversified.

Non-interest expense and efficiency ratio

U.S. Bancorp's non-interest expense increased to $8.3 billion from $7.3 billion in 2008 from $6.9 billion in 2007. The compensation expense, net occupancy/equipment expense and professional services expense increased due to recently completed acquisitions and expansion initiatives. In addition, costs stemming from the introduction of new credit cards, marketing, and a rise in FDIC premiums contributed to the rise in non-interest expense[11].

U.S. Bancorp's efficiency ratio rose to 48.4 % in 2009 from 46.9 % in 2008. The rise in efficiency ratio implies that a larger portion of revenue is depleted from non-interest expenses. In the case of U.S. Bancorp, the rise in non-interest expense due to recently

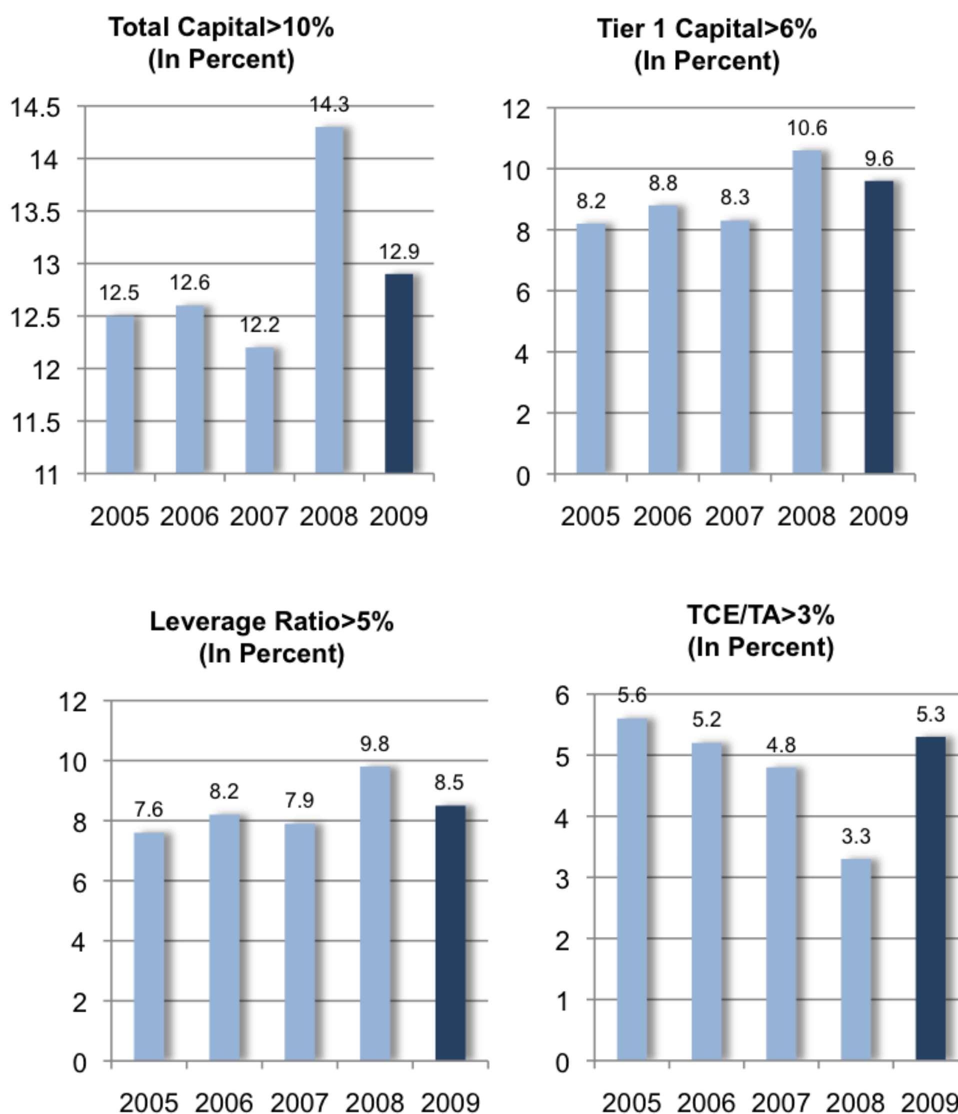
pursued acquisitions and higher FDIC expenses seems mainly attributable to its deteriorating efficiency ratio. Also, the efficiency ratio typically improves as a firm grows in size, due to economies of scale. U.S. Bancorp's acquisitions of DSL, PFFB and FBOP in 2008 and 2009 are expected to generate 4-5% accretive in U.S. Bancorp's revenue[12]. Therefore, the rise in revenue and improvement in economies of scale arising from U.S. Bancorp's growth would enable the company to achieve a better efficiency ratio in the future. Moreover, the typical range of this ratio is from 55% to 65% in banking industry; the efficiency ratios of Bank of America and Wells Fargo were 55.2% and 55.3% respectively, which indicates U.S. Bancorp is still relatively efficient.

ROE and ROA

U.S. Bancorp's return on average assets was 0.82% in 2009, a decline from 1.21% in 2008 and 1.93% in 2007. This is mainly due to a steep rise in the provision for loan loss in 2009, which increased from $3.1 billion to $5.5 billion and higher non-interest expense than non-interest income. As a result, U.S. Bancorp experienced a decrease in its net income by $780 million. Moreover, U.S. Bancorp's net loans increased by $10 billion, which mainly led to a $15 billion rise in assets in 2009. These two factors negatively influence the value of ROA. However, once U.S. Bancorp's market expansion through recent low-risk, attractively priced acquisitions starts to generate profits, its ROA is expected to rise to 2.04% in 2012[12]. The ROAs of Wells Fargo and Bank of America were 0.97% and 0.26%, respectively. Even though U.S. Bancorp was not able to exceed the ROA of Wells Fargo, it still performed much better than Bank of America.

U.S. Bancorp's return on average common equity was 8.2% in 2009, which also declined from 13.9% in 2008 and 21.9% in 2007. Similar to ROA, the decline in net income is the main factor that deteriorated ROE in 2009. According to analysts, however, ROE is estimated to grow up to 21.6% in 2012[12]. Compared with Wells Fargo's ROE of 9.7% and Bank of America's ROE of 3.2%, U.S. Bancorp's ratio suggests that its performance is similar to that of Wells Fargo, one of the strongest players in the industry.

Capital and Liquidity analysis:



Capital

U.S. Bancorp's capital ratios have consistently remained above the government standards for sufficient capital. To be well-capitalized under the FDICIA corrective action provisions, total capital, tier 1 capital ratio, and leverage ratio should be above 10%, 6% and 5%, respectively. Under these regulatory definitions, U.S. Bancorp is a well-capitalized bank; its total capital, tier 1 capital, and leverage ratio were 12.9%, 9.6% and 8.5%, respectively. This suggests not only that U.S. Bancorp maintains a sufficient

cushion for its liability obligations but also that it is able to grow through either internal means or acquisitions.

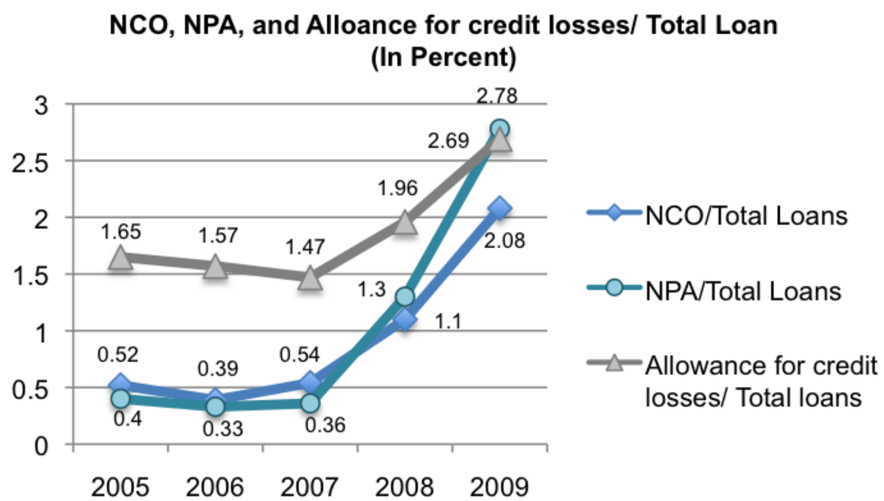
In addition to the capital ratios above, investors also consider the tangible common equity ratio in order to evaluate a bank's capital. This ratio was also used in the bank stress test conducted in 2009 to judge banks' financial health; banks with lower than 3% tangible common ratio were determined as having a lack of capital and required to supplement it. Tangible common equity indicates how much owners of common stock will receive when a bank is liquidated. Also, the ratio of tangible common equity over tangible assets reflects a bank's ability to absorb loss before becoming insolvent. U.S. Bancorp's tangible common equity ratio was 5.3 in 2009, which also illustrates the company's conservative capital management. Along with JP Morgan Chase, U.S. Bancorp was one of the rare banks that passed the U.S. stress test with zero required additional capital need.

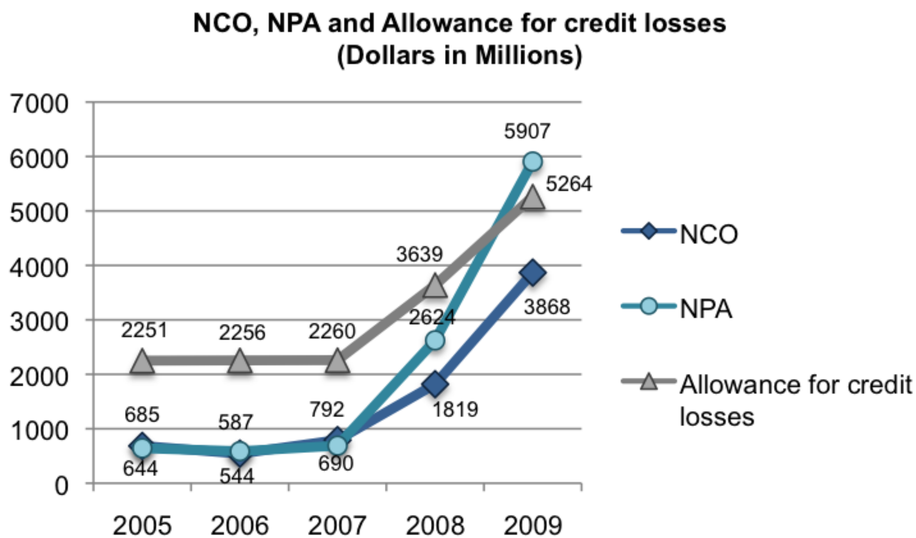
Liquidity

Because of the bank's operating model, which highly leverages its assets with interest-bearing deposits, liquidity is one of the important aspects that can prevent unexpected bank-runs. In the analysis of the banking industry, the ratio of loans to deposits is the most commonly used measure to evaluate a bank's liquidity. Loans are profitable but illiquid, and therefore, a high level of loans funded by deposits implies a higher exposure to illiquidity risk when depositors come to make a withdrawal. U.S. Bancorp's loan-to-deposit ratio was 1.06 in 2009, which slightly declined from 1.16 and 1.19 in 2008 and 2007. As the table above displays, the other key players have been more liquid compared to U.S. Bancorp. This suggests that U.S. Bancorp tends to invest its deposit funding in loans rather than other liquid assets. This is also illustrated in its loan-to-asset ratio, which was 67% in 2009. After excluding intangible assets, the actual liquid assets including cash and investment securities account for only 18% of assets. Even though a higher loan-to-deposit ratio implies higher profitability, U.S. Bancorp currently seems relatively illiquid.

The percentage of foreign deposit can also indicate banks' exposure to illiquidity risk. Since foreign deposits are known to be hypersensitive to reputational risk events, higher foreign deposits imply more exposure to unexpected bank run risk. U.S. Bancorp's percentage of foreign deposit is 12.1%, which is relatively higher than its competitors. Wells Fargo holds only 7%, while Bank of America holds 8.3% of foreign deposits in their total deposits. This suggests that U.S. Bancorp seems more exposed to a risk of high levels of deposit withdrawal.

Credit Quality Analysis:





The provision for loan losses and allowance for loan losses are important indicators of changes in the quality of loans. U.S Bancorp realized $5.6 billion of the provision for credit losses in 2009, which increased from $3.1 billion in 2008 and $792 million in 2007. The allowance of loan loss increased as well to $5.3 billion (3.04 % of total loans) in 2009, compared with 3.6 billion (1.96 % of total loans) in 2008. This rise in provision and allowance for loan losses was mainly driven by deterioration in residential home construction, residential mortgage portfolio, and the influence of the economic slowdown on commercial and consumer loans[11].

Due to the same reasons, U.S. Bancorp's non-performing assets increased to $5.9 billion in 2009, compared with $2.6 billion in 2008 and $690 million in 2007. Higher nonperforming loans not only reduce interest income but also reflect potential net charge-offs. The ratio of total nonperforming assets to total loans and other real estate was 3.02 % in 2009, which is higher than 1.42% in 2008 and 0.45% in 2007. However, according to an S&P industry report, the industry average level of nonperforming loans was 4.94% in 2009, 3.93% in 2008 and 1.39% in 2007[13]. Therefore, by examining the chart above, we can conclude that U.S. Bancorp has a conservative credit risk management. However, even though the provision for loan losses expects to decline in 2010, the net charge-off will continue to increase, because of the deteriorating commercial loan market.[11]

SWOT Analysis

Strengths

Growth Strategy through low-risk, in-market acquisitions:

- *Acquisition through FDIC and Loss Sharing Agreement:*

For the past two years, U.S. Bancorp has expanded its market share through low-risk, attractively priced acquisitions assisted by the FDIC. Following the acquisition of Mellon 1st Business Bank which added $3.4 billion in assets in November 2008, U.S. Bancorp acquired the banking operations of Downey Savings and Loan Associations, F.A. and PFF Bank and Trust from FDIC. Through these acquisitions, U.S. Bancorp obtained an additional $17.4 billion of assets and approximately $15.8 billion of liabilities. Although U.S. Bancorp embraced all bad assets that these two banks held, it is protected from credit loss through a loss sharing agreement with the FDIC, which will reimburse a portion of loan loss incurred due to the acquisitions. The FDIC would reimburse $2.4 billion of $4.7 billion of estimated losses from these two acquisitions[11].

In addition, U.S. Bancorp succeeded to acquire the banking operations of First Bank of Oak Park Corporation (FBOP), which was assisted by the FDIC as well. This acquisition added $18 billion of assets and $17.4 billion of liabilities, including $15.4 billion of deposits. This acquisition also includes a loss-sharing agreement with the FDIC, which will reimburse $1.9 billion of $2.8 billion of estimated losses[11].

- *Attractive acquisition targets:*

U.S. Bancorp set a goal to be in the top 3 banks for market share in key markets with high population growth rates: California, Illinois and Arizona[12]. In accordance with this strategy, recent acquisitions raised U.S. Bancorp's outlets in California to 677 branches, its market share of deposits from 1.7% to 4.3%, and its market rank from #8 to #6[12]. In addition, deposit market share in Illinois grew from 1.3% to 2.3% and its rank ascended

from 13 to 11[12]. The three FDIC-assisted deals augmented U.S. Bancorp's footprints by adding 361 new branches and increasing deposits by $25.4 billion, mainly in its target regions presenting higher population growth rate. As a result, USB's expected population growth rate of its national footprints rose from 3.95% to 4.1%.[12]

Weighted Avg. USB Pre-Acq.	3.95
WAVG USB Post-Acq	4.10
National Average	4.63

FDIC Assisted Transactions – Branch MSA Details

Recent acquisitions have allowed USB to increase its market share in higher growth MSA

Downey Acq. - Branch Analysis by MSA

MSA	Branch Count	Deposits ($000)	Est. Pop. Growth (%)
Bakersfield, CA	1	41,575	10.96
Lake Havasu City-Kingman, AZ	3	162,824	13.31
Los Angeles-Long Beach-Santa Ana, CA	86	4,669,818	3.44
Napa, CA	1	14,427	3.48
Oxnard-Thousand Oaks-Ventura, CA	6	137,321	3.54
Prescott, AZ	2	59,205	15.86
Riverside-San Bernardino-Ontario, CA	32	1,511,064	11.83
Sacramento-Arden-Arcade-Roseville, CA	3	184,329	8.14
San Diego-Carlsbad-San Marcos, CA	12	639,811	4.33
San Francisco-Oakland-Fremont, CA	5	339,844	2.58
San Jose-Sunnyvale-Santa Clara, CA	11	1,038,211	3.61
San Luis Obispo-Paso Robles, CA	6	163,923	3.80
Santa Barbara-Santa Maria-Goleta, CA	2	48,323	1.84
Santa Rosa-Petaluma, CA	2	99,441	1.77
Total DSL	172	9,110,116	5.25

PFFB Acq. - Branch Analysis by MSA

MSA	Branch Count	Deposits ($000)	Est. Pop. Growth (%)
Los Angeles-Long Beach-Santa Ana, CA	9	773,749	3.44
Riverside-San Bernardino-Ontario, CA	27	1,285,649	11.83
Total PFFB	36	2,059,398	8.68

Source: Morgan Stanley Analyst Report

FBOP Acquisition - Branch Analysis by MSA

MSA	Branch Count	Deposits ($000)	Est. Pop. Growth (%)
Chicago-Naperville-Joliet, IL-IN-WI	33	3,520,124	2.97
Houston-Sugar Land-Baytown, TX	2	271,954	11.45
Los Angeles-Long Beach-Santa Ana, CA	64	5,408,948	3.44
Napa, CA	1	53,933	3.48
Oxnard-Thousand Oaks-Ventura, CA	2	170,762	3.54
Phoenix-Mesa-Scottsdale, AZ	2	143,284	14.62
Riverside-San Bernardino-Ontario, CA	3	52,581	11.83
San Diego-Carlsbad-San Marcos, CA	27	2,842,745	4.33
San Francisco-Oakland-Fremont, CA	14	1,350,330	2.58
San Jose-Sunnyvale-Santa Clara, CA	2	155,568	3.61
Texas (no MSA)	3	274,933	4.03
Total FBOP	153	14,245,162	3.73

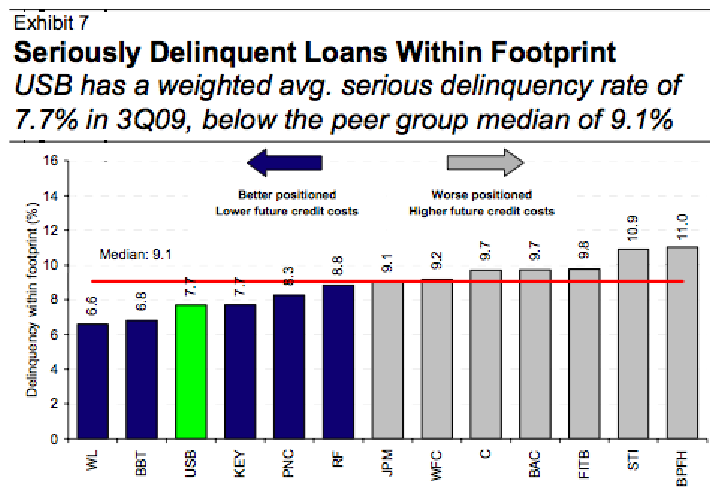
Source: Morgan Stanley Analyst Report

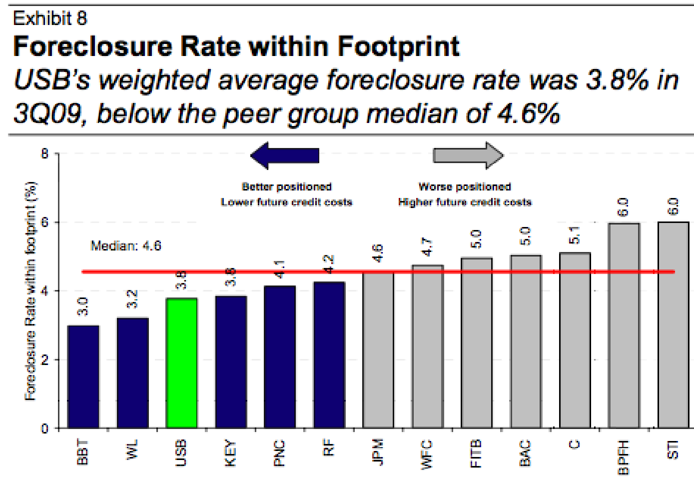
U.S. Bancorp's acquisition and growth strategy is definitely one of its key strengths. By selecting valuable branches in attractive markets, purchasing well-priced banks with assistance from the FDIC, and ensuring risk protection through the loss sharing agreement, U.S. Bancorp has followed a smart expansion plan.

Conservative, prudent risk management:

U.S. Bancorp is one of the most conservative banks in terms of underwriting and loan lending, which enables it to maintain higher credit quality than its peers. These conservative standards for asset underwriting led to U.S. Bancorp's outperformance relative to the industry during the recent economic downturn. The conservative point of view extends to U.S Bancorp's 2010 outlook as well. Projections for 2010 include a 10.5% of unemployment rate, decline in housing prices by 4-5%, GDP growth rate below 2% and no change in the interest rate[12]. This indicates that U.S. Bancorp will continue its conservative standard for underwriting and loan lending in 2010 as well.

U.S. Bancorp's prudent approach is reflected in the company's selection of the markets in which it has targeted to expand. U.S. Bancorp's footprints display relatively lower delinquency ratio and foreclosure rate than other large-cap banks[12].





Source: Morgan Stanley Analyst Report

Strong capital and liquidity:

U.S. Bancorp has maintained relatively high capital as a sufficient cushion for assets. According to the Bank Stress Test performed by the Federal Reserve in May 2009, which assessed the capital adequacy of large banks, U.S. Bancorp has sufficient capital to face a worst-case scenario. The bank proved its strength in capital by redeeming the $6.6 billion of preferred stock issued to U.S. Department of the Treasury under the TARP program in June 2009 and repurchased the $139 million of common stock warrant as well. Also, it demonstrated its ability to raise the capital and market acceptance of U.S. Bancorp's additional stocks by issuing $2.7 billion of common stock. Credit rating agencies valued U.S. Bancorp's debt as one of the highest-rated of its large domestic peers.

Banks	S&P	Moody's	Fitch	DBRS
1. U.S. Bancorp	**A+**	**Aa3 *-**	**AA-**	**AA**
2. JP Morgan Chase & Co.	A+ *-	Aa3 *-	AA-	AH
3. Wells Fargo & Co.	AA- *-	A1	AA-	AA
4. BB&T Corp.	A	A1 *-	A+ *-	AAL *-
5. Bank of America Corp.	A *-	A2	A+	A
6. PNC Financial Services Group	A	A3 *-	A+	AH
7. Keycorp	BBB+ *-	Baa1 *-	A- *-	AL *-
8. Suntrust Banks, Inc.	BBB	Baa1 *-	A- *-	A *-
9. Fifth Third Bancorp	BBB *-	Baa1 *-	A- *-	A *-
10. Regions Financial Corp.	BBB- *-	Baa3 *-	BBB+ *-	A: *-

*-indicates negative watch or outlook

*+ indicates positive watch or outlook

Accurate as of March 24, 2010

Source: U.S. Bancorp Fact Sheet

Focus on customer relationships:

U.S. Bancorp focuses on constantly improving its customer services and customer relationships. Through the Enterprise Revenue Office (ERO), US Bancorp communicates with customers and obtains more information about customer need. Its Wholesale Banking "Voice of the Customer" initiative gathers customer feedback of payment services and organizes Customer Roundtable discussions about the bank's payment services. This satisfies corporate customers and contributes to its deeper relationship with consumers.

U.S. Bancorp also started the "Build Deeper Relationships" initiative, which focused on appealing to corporate customers. This initiative resulted in growth in corporate banking relationships and corporate payments relationship with S&P Clients from 132 in 2007 to 148 and from 468 in 2007 to 474, respectively.[12]

Reputation for conservative standards:

U.S. Bancorp has a good reputation for its conservative strategy among investors and customers. Warren Buffet advised to buy U.S. Bancorp's stock and many other press outlets complimented U.S. Bancorp's outperformance during the economic downturn. Due to a good reputation for having conservative standards, U.S. Bancorp currently benefits from the "Flight to Quality Trend," in which customers seek safer banks.

Ability to provide integrated services:

Through its 20 subsidiaries U.S. Bancorp can offer integrated financial services, which helps the bank to attract corporate customers or even individual customers who need a broad range of financial services. This is illustrated in the recently entered contract with Athenahealth Inc., which promises the U.S. Bancorp's payment processing service through its subsidiaries, U.S. Bank and Elavon and additional wealth management service.[14]

Weaknesses

Conservative strategy in economic upswing:

U.S. Bancorp's conservative strategy that recently turned out to be its strength in economic downturn could lead to slower growth in the top line in better economic conditions. The banking industry is highly saturated and competitive. Therefore, as the toppled banks start to revive, U.S. Bancorp is expected to experience severe competition during the economic upturn. Under these circumstances, it is possible that U.S. Bancorp's conservative strategy will less efficiently generate the profit compared to its aggressive banking peers.

Emphasis on lending business:

U.S Bancorp's commercial lending accounts 97.14% of its business[15]. The company's emphasis on commercial lending leads to higher vulnerability to the risks of the main street economy. [15]

Opportunities

Potential market growth:

In 2010, acquisition opportunities are still expected to abound due to troubled smaller banks that are ready to be sold at low prices, and large banks that are trying to reorganizing their unprofitable branches. Given U.S. Bancorp's strong capital and conservative practices, the bank can expand its market share further through safe, well-priced acquisitions in 2010 as well. As previously mentioned, U.S. Bancorp is focused on expanding in California, Arizona, Nevada and Illinois. In the future, U.S. Bancorp will seek more FDIC assisted acquisitions in San Diego, Los Angeles, Riverside, and Sacramento in California, Reno and Las Vegas[12]. In terms of the large base of deposit, San Francisco, Chicago, San Jose and Phoenix would be attractive regions to seek acquisition opportunities[12]. Moreover, the company can expand its market through organic growth, supported by recently transacted acquisitions that are expected to increase revenue.

Revenue growth in Corporate/ Wholesale Banking and Wealth Management:

Corporate/ Wholesale bank and Wealth Management are expected to be in higher demand and generate higher revenue as the economy recovers. The acquisition of the mutual funds administration and accounting service division of Fiduciary Management in October 2009 put U.S. Bancorp in a better position to benefit from the economic upturn.

Corp. Trust Business:

Corp. Trust Business will exhibit better performance as the economy improves and investors start to more actively participate in financial investments. U.S. Bancorp also acquired the bond trustee business of First Citizens BancShares and AmeriServ recently, which will help the bank to generate higher income from trust businesses once the economy recovers. Also, it is expected that other large banks will spin off their under-sale

businesses over time, which will provide opportunities to acquire further trustee businesses.

Payment service business segment:
As the economy improves and store sales rise, payment processing services are expected to be a profitable business for U.S. Bancorp in the future. U.S. Bancorp can expand its payment processing services by improving mid-size regional co-brand business, debit card business, rewards programs for debit cards, and prepaid card programs.

Moreover, U.S. Bancorp's subsidiaries Elavon and Santander Bank launched a partnership for merchant services in the UK and expanded their alliance relationship to Mexico, which suggests higher growth in revenue from the payment service business[1]. As demonstrated in the alliance between Elavon and Santander Bank, U.S. Bancorp can achieve growth in the payment processing service business through expanding its relationship with international banks and international merchants in the emerging markets where domestic demand and store transactions will be rapidly growing.

Threats

Strict government regulations:
One of the main threats to U.S. Bancorp is a regulatory reform stemming from the recently passed H.R. 4173 (Wall Street Reform & Consumer Protection Act of 2009) from the House of Representatives and the Senate's expected Regulatory Restructuring legislation, which is likely to be finalized at some point during 2010[16]. The President recently proposed a Financial Crisis Responsibility Fee in the budget and new restrictions on the size and scope of financial institutions, which is called the 'Volcker Rule'[16]. According to the Volcker Rule, financial institutions must be broken up and their risk-taking activities limited by law.

In addition to these potential regulations in the future, the Federal Reserve prohibited banks from charging ATM and debit card overdraft fees unless customers are willing to pay for the fees in exchange for going through balance-busting transactions. This rule will take effect on July 1 2010, which could adversely affect U.S. Bancorp's fee income. Moreover, the FDIC insurance premium rose since the number of troubled banks is expected to keep rising in next few years.

Increasing interest rates:
Due to the longer repricing period of assets relative to liabilities and the flattening effect of the interest rate rise on the yield curve, if the Fed tightens in the form of an interest rate hike, the bank can experience an excessive amount of interest expense relative to interest income. In addition, if U.S. Bancorp holds non-interest income bearing assets that are sensitive to the interest rate, an increase in interest rate will deteriorate the value of its assets as well if U.S. Bancorp has not hedged the interest rate exposure.

Too-big-to-fail risk:
Through recently transacted acquisitions, U.S. Bancorp ascended to the fifth position in the commercial banking industry. As U.S. Bancorp expands, it will probably experience the moral hazard problem, which could motivate the company to become involved in riskier investments and to be imprudent in risk management. Becoming too big to fail also entails the risk that the government might impose stricter regulation on U.S. Bancorp.

Deteriorating commercial real estate values:
Investment properties in commercial real estate are expected to deteriorate in next two years as well. As a result, default in commercial real estate loans is supposed to spike in the near future. Besides commercial real estate loans, commercial mortgage backed securities will also be influenced by the deteriorating commercial real estate market.

Mortgage put-backs:

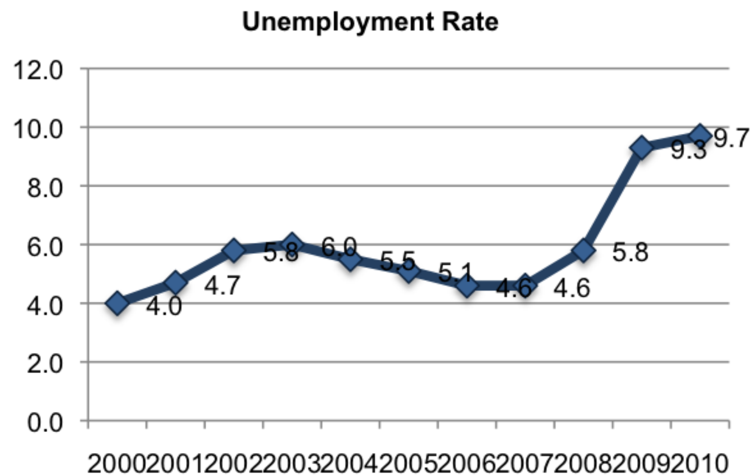
Due to the repurchase agreement between loan originators and the counterparty who purchased the loans for securitization, U.S. Bancorp might face a rise in mortgage repurchase demand in particular from the GREs. This will pose liquidity risk and require U.S. Bancorp to realize higher losses from writing off these returned mortgages.

Strategic Recommendations

Based on the analysis elaborated above, Vector Strategy Group concluded that the primary challenge for U.S. Bancorp is the various risks the company faces. In response to these risks, Vector has prepared strategic advice for U.S. Bancorp that intends to limit the company's exposure to future risk and provide a plan for the best way to prepare the company for the future. The risks that Vector will treat include commercial real estate risk, rising levels of mortgage put-backs from monoline insurers, and U.S. Bancorp's risk of becoming a too-big-to-fail bank.

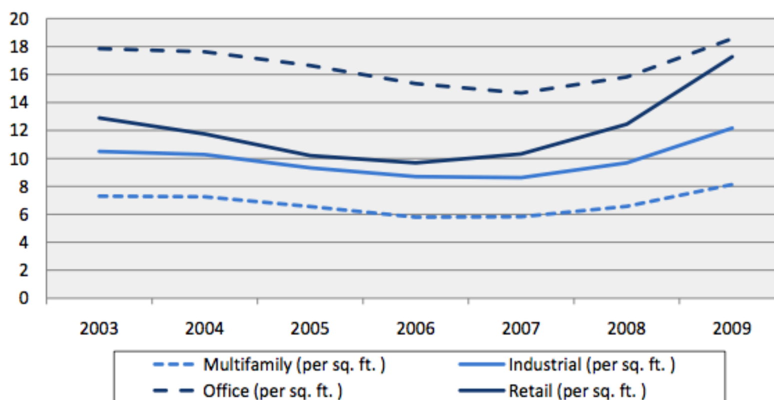
Commercial Real Estate Risk

Defaults on commercial real estate (CRE) loans are expected to rise due to the weak economic situation and consequently deteriorating CRE market fundamentals. According to the February Oversight Report issued by the Congressional Oversight Panel, the unemployment rate rose to a high level in 2009 despite the country's rise in GDP[17]. This high unemployment rate implies low consumer spending, which corresponds to lower demand for CRE utilization including commercial office space, retail stores and lodging spaces.



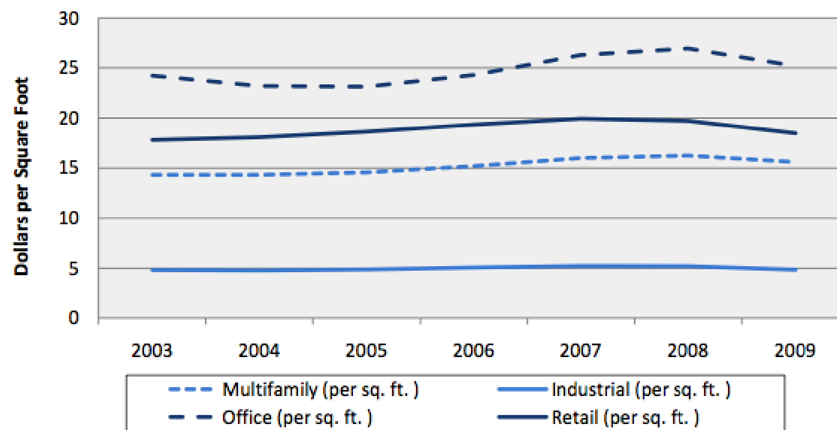
Source: Bureau of Labor Statistics

In addition, many commercial real estate loans were issued under loosened underwriting standards during the real estate bubble from 2002 to 2007. This resulted in the current oversupply of CRE. Due to lower demand for CRE utilization and oversupply, the vacancy ratio has been rising since mid-2007 and CRE rental prices for certain property types have declined sine mid-2008. Currently, rental prices have been buffered by leases held by many commercial properties[17]. However, once the leases are expired, the vacancy ratio is expected to rise, which will push the rental price further down. Altogether, the actual and projected cash flows will fall, affecting the ability of CRE loan borrowers to make required loan payments prior to the maturity date.



Source: Congressional Overnight Panel, February Oversight Report

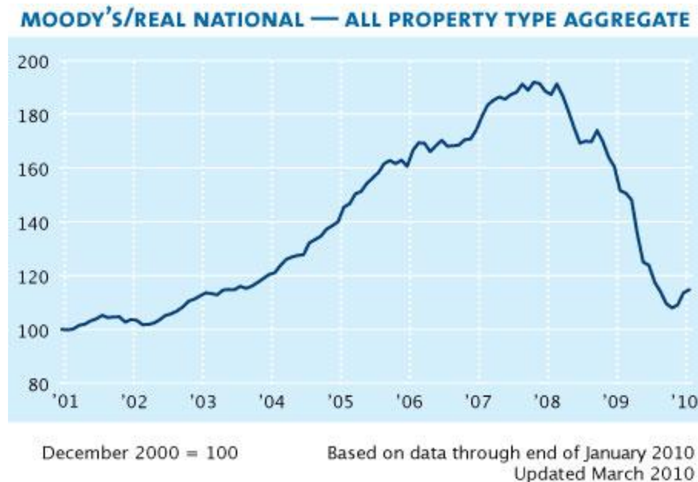
Commercial Real Estate Average Rental Prices by Property Type



Source: Congressional Overnight Panel, February Oversight Report

Also, commercial real estate loans typically don't amortize the full principal and instead, leave a large balloon payment at the maturity date[17]. Consequently, borrowers should refinance or apply for new loans at the maturity date if they are not able to prepare sufficient funds for the principal repayment. However, commercial real estate prices have fallen since 2007, which will cause some to be unable for refinancing due to a rise in loan–to-value ratio (LTV) and stricter underwriting standards. As a result, banks should consider the surge of defaults in CRE loans at maturity.

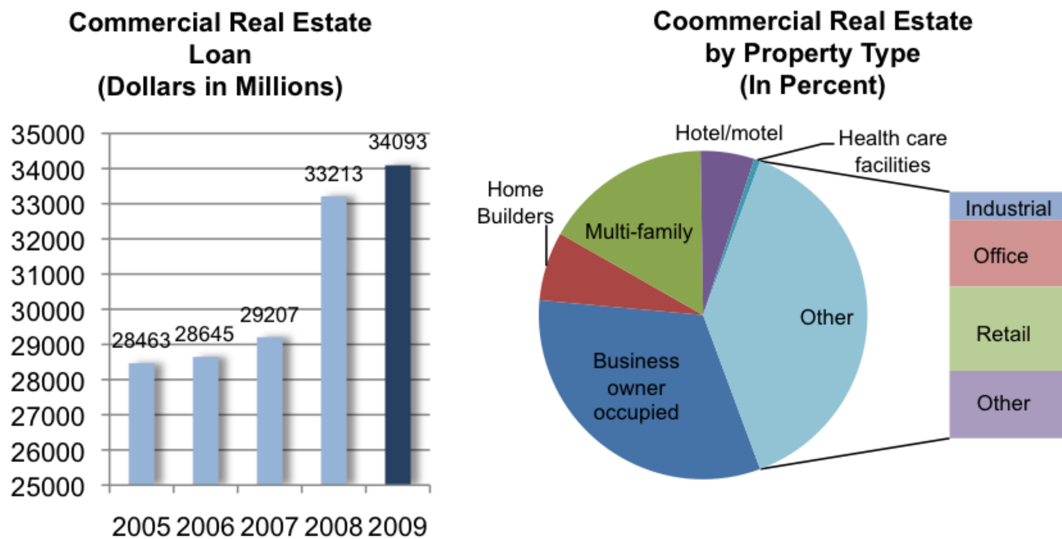
Commercial Real Estate Property Price Indices

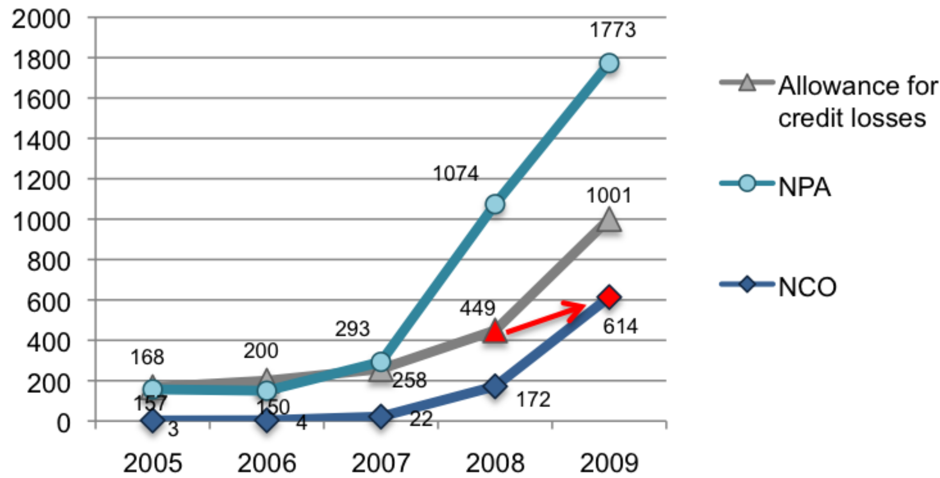


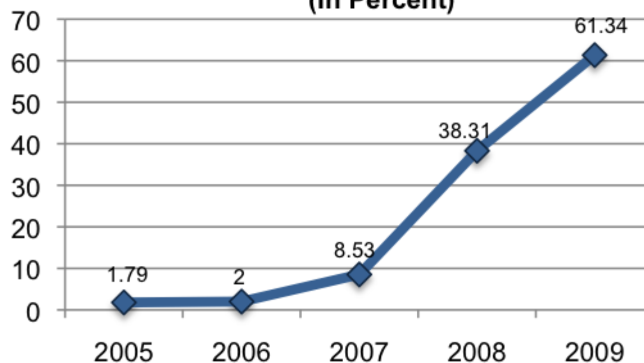
Source: Real Capital Analytics[25]

The current weak economic situation will affect the overaggressive issuance of CRE loans during the real estate bubble and also the healthy CRE loans. Therefore, the deteriorating CRE market poses a threat to U.S. Bancorp, despite the company's conservative underwriting standards.

In the case of U.S. Bancorp, CRE loans rose by 2.6 % from $33 billion to $34 billion and currently account for 17.5 % of total loans outstanding. Also, the percentage of loans that financed offices, retail and lodging spaces are 29 % in total. These property types are expected to be most detrimental to the banks[18]. As the chart below illustrates, non-performing CRE loans, the net charge-off of them and allowance for CRE loan loss increased by 65 %, 257 % and 123 %, respectively. The huge rise in all of nonperforming loans, net charge-offs and allowance for loan loss indicate that U.S. Bancorp is also exposed to CRE loan default risks.







When evaluating U.S. Bancorp's treatment of this problem, we can look at the company's net charge-off to allowance ratio, which rose from 38% in 2008 to 61% in 2009. As shown in the above chart, the steep rise in this ratio over the past few years indicates that U.S. Bancorp might not report the sufficient projected loss for future CRE loan default in the form of an allowance for loan loss. U.S. Bancorp's net charge-off for CRE loans was $614 million in 2009, and the allowance for CRE loan loss at the end of 2008 was $449 million. This rise suggests that U.S. Bancorp can experience a higher net charge-off than the allowance balance in 2010, and consequently realize unprepared credit losses. The commercial real estate loans that will mature within 1 year account for 33% and the loans that will mature in one to five years accounts for 47% of total CRE loans. CRE loan

holders will face difficulty when they have to refinance their CRE loans at the maturity date.

Due to U.S. Bancorp's reputation for conservative operations, Vector Strategy Group believes that the company has been reasonably writing off its default loans. However, due to U.S. Bancorp's exposure to the deteriorating CRE market, the bank should not be reluctant to report credit losses in CRE loans and foreclose these assets. More thorough due diligence in regards to CRE loan holders who will meet the maturity date within a few years, and better preparation for sufficient loan loss reserves are needed as well. Additionally, U.S. Bancorp should work with building owners to bring in new capital by helping them seek renters or buyers for their property. This will let building owners forecast higher cash flows and consequently, secure their credit, which will help them make required payments to U.S. Bancorp and refinance their loans. Otherwise, U.S. Bancorp can directly help CRE loan holders avoid default by restructuring existing loans when it is more profitable than foreclosing on real assets.

As the commercial real estate market deteriorates and affects small regional banks, small business loans will decline, hampering the economic recovery. U.S. Bancorp should consider the secondary impact of the CRE market on economic recovery and the default in consumer loans and credit card loans. In addition to the due diligence on CRE loans, U.S. Bancorp should thoroughly examine other types of loans that are particularly vulnerable to economic downturn. Also, when the credit market is tight for commercial real estate loans, U.S. Bancorp should use this period as an opportunity to attract healthy, profitable customers. Maintaining conservative underwriting standards, requiring stricter write-offs for CRE loans, and helping borrowers to raise capital are three key strategies that will reward U.S. Bancorp in long run.

Rise in mortgage put-backs and rescissions from monoline insurers and government-sponsored enterprises ("GSE")

Monoline financial guarantors and mortgage insurers expect to raise the amount of loan put-backs to mortgage originators in order to recover their losses from the rise in mortgage defaults. As the residential mortgage market has collapsed, financial guarantors have reviewed the underwriting practices for the loans composing its troubled residential mortgage backed securities (RMBS). If they find irregularities in the underwriting process, they can recover their loss in insured mortgage pools by forcing the loan originators to repurchase those defaulted loans at par, regardless of the current written-down value of those loans. It is estimated that financial guarantors reduced their losses by $4 billion through loan put-backs, accounting for 30 % of RMBS losses for the largest guarantors[19].

In addition, the mortgage insurers' rescission rate increased from the historical value of 7% to 20-25% in 2009 because of unreasonable underwriting practices[19]. According to Moody's estimates, mortgage insurers rescinded approximately $6 billion of the claims since 2008 and expect to rescind $2 to $4 billion of claims in the next few years[19].

In 2009, Fannie Mae and Freddie Mac requested an increased amount of loan put-backs to the loan originators. After suffering $202 billion in losses since 2007, these two government-sponsored enterprises (GSEs) tightened underwriting practices for the loans they guarantee. As a result, they succeeded in letting banks repurchase more than $8.4 billion loans at par and realize approximately $5 billion losses from impairing the buybacks in 2009[20]. Freddie Mac compelled the banks to buy $4.1 billion mortgages last year, and expects to demand another $4 billion in buybacks in the future[20]. According to the trade publication Insider Mortgage Finance, Fannie Mae forced banks to buy $4.3 billion of loans back during the first nine months of 2009[21]. It is anticipated that these two GSEs may demand the repurchasing of $21 billion of home loans to lenders including Bank of America, JPMorgan Chase, Wells Fargo and Citigroup Inc. The

mortgage repurchases expect this to affect banks' earnings through 2011 since the mortgages written in 2006 and 2007 contain the worst underwriting flaws[20].

Large banks are preparing for future losses from the expected rise in demand for loan repurchases. Bank of America reported $1.9 billion of "warranties expense" that reflects the past and future buybacks of those defected loans, representing a sevenfold increase since 2008. JPMorgan realized $1.6 billion in losses in 2009 due to loan repurchases and a rise in reserves for future write-offs, while Citigroup increased its repurchase reserves to $483 million, an amount six times higher than the previous year.

U.S. Bancorp didn't disclose details about loan put-backs in its balance sheets. However, the firm mentioned that its maximum payment arising from the guarantees in the form of asset buy-backs or make-whole provisions would be $780 million in 2009, which is an increase from $503 million in 2008[11].

U.S. Bancorp's much lower expense for past and future buyback guarantees seems due to its conservative underwriting and consequently higher amount of healthy mortgages. However, U.S. Bancorp still needs to thoroughly review the underwritings of 2006 and 2007 mortgages in particular, focusing on document type, loan type, credit scores and LTVs. After estimating which types of loans have the potential to default, the bank can estimate how much of the loans will end up in default and be forced to repurchase. Therefore, even if we believe the company is relatively less exposed to mortgage put-back risk due to its conservative underwriting, U.S. Bancorp should always be reasonable and strict in preparing its repurchase reserves. Also, in order to relieve investors' anxiety, the bank should disclose more details about its involvement in GSE or financial guarantors' repurchase demands in the financial statements.

Too-big-to-fail (TBTF)

After realizing the huge role too-big-to-fail banks had with respect to the recent economic contraction, the government has been devising stricter regulations in order to remove systemic risk. A failure of one financial institution can lead to the subsequent collapse of other participants in the financial system. As one of the programs that give disadvantage to TBTF banks, the financial crisis responsibility fee will go effect in June 30, 2010. This is a 0.15% additional tax on the liabilities of banks that hold more than $50 billion in assets. The government created this fee this to compensate for the $117 billion shortfall in the $700 billion bailout fund. The government expects that 60% of the revenue from this new fee will come from the ten largest banks and this fee will continue for the next ten years[22]. This suggests that the government attributes the consequence of the current crisis to TBTF banks and wants them to fill the shortfalls of the bailout funds. In addition to the new tax, The House of the Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 and is ready to be reconciled with the Regulatory Restructuring legislation proposed by the Senate. The provisions include the strengthened oversight, standard and regulation on systematically risky banks and establishment of orderly process for dismantling large, failing firms. Analysts expect that these will finalize at some point in 2010. Also, the Volcker Rule proposal calls for new restrictions on the size and scope of financial institutions. Therefore, as various kinds of regulations on TBTF banks are enacted over the next few years, becoming TBTF will result in barriers to profit growth.

In recent years, U.S. Bancorp accomplished many FDIC-assisted acquisitions, which helped the bank become the fifth largest bank in the U.S. This suggests that U.S. Bancorp can be regarded as a TBTF bank by the government and consequently, the company can expect to be subject to stricter regulations and supervision in the future. In “13 Bankers” published in March 2010, Johnson and Kwak specifically mention the six largest money center banks- Citigroup, JP Morgan Chase, Morgan Stanley, Goldman Sachs, Wells Fargo

and Bank of America- as the main targets to dismantle. The report also noted that Bank of New York Mellon, Freddie Mac, PNC and U.S Bank are banks that should be broken down as well[23].

Therefore, U.S. Bancorp should be more prudent in its aggressive expansion, which could strengthen its image as a TBTF bank and make regulators nervous about the possible moral hazard problem. In addition to size, the government will also consider how much a bank is interconnected to the other financial institutions because this is a main source of systematic risk, as the entire economy can be affected by one bank's default[24]. This interconnectedness mainly comes from derivative contracts between other financial institutions as proven in the recent credit crisis.

Therefore, U.S. Bancorp should limit its involvement in derivative contracts to hedging purposes. The company should avoid exotic derivatives and engage in exchange-traded derivatives as opposed to over-the-counter derivatives. Also, U.S. Bancorp should try to reduce counterparty risk by having an organization with extremely good credit act as an intermediary. When engaging in over-the-counter derivatives, U.S. Bancorp should insist on bilateral margins on equal terms, which protects against unexpected defaults by both parties. Additionally, U.S. Bancorp should work closely with regulators on derivative exposures in order to obtain information of the potential risks and new regulations in the derivative market. U.S. Bancorp should also support financial regulation that would require over-the-counter derivatives to be on an exchange, or go through a clearinghouse.

Also, in order to reduce investors' anxiety about U.S. Bancorp's exposure to derivatives and prove that it doesn't pose systemic risk, it would be better to more specifically disclose its current portfolio of derivative contracts in the company's balance sheet. By being more cautious about rapid expansion in its size and avoiding unnecessary derivative contracts, U.S. Bancorp can secure its image as a conservative bank and avoid the expected stricter government regulations that aim to break down TBTF banks.

End Notes:

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