Banks

3Q: Impact of higher rates on capital and credit quality in focus

Earnings Preview

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High Grade Credit
United States
Banks

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Bank spreads continue to underperform

Recent spread widening in regional banks of about 20-30 bps since 9/25 (vs. industrials +7 bp) has brought spreads back to June levels owing to concerns about the implication of higher long end rates on banks' capital and earnings (NIM). Going into 3Q, we expect investors' focus to center on this as well as on updates on credit quality trends, specifically in credit cards and commercial real estate (CRE). Other matters such as the Basel III end game and TLAC/LTD regulatory proposals and progress on cost savings efforts may be less of a focus. We continue to favor strong deposit franchises and diversified businesses, such as USB (Overweight), amid the uncertainty in the sector.

Higher rates and unrealized losses on securities

Concerns about rising rates and consequent impact on securities portfolios, unrealized losses, capital and net interest margins have resurfaced with the 55 bp increase in 10Y UST yield since Aug 31 and 73 bp increase in 3Q23 (up 8 bp in 4Q to date). However, we look for updates on strategic maneuvers and planning around securities portfolio restructurings to be in greater focus than in past quarters – especially as deposits stabilized in the quarter, defusing liquidity concerns for the sector overall. While long end rates have reached more attractive levels for banks to attempt to lock in higher rates, the cost of restructurings (i.e. the hit to capital) to execute such plans has also increased making it more challenging economically. Banks with non-core assets that can be sold at material gains are better positioned, all else equal, in our view. Separately on the capital front, credit-linked notes could become a more popular tool for banks to reduce RWA and improve capital ratios following updated guidance from the Federal Reserve in September.

TFC in talks to sell rest of Insurance; restructuring next?

According to media reports, Truist (TFC) is in talks with Stone Point to sell the remaining 80% stake in its insurance brokerage business for $10B. In September, TFC sized the potential capital uplift from selling the 80% stake at 200 bp (vs. ~30bp from selling the first 20% stake in 2Q), implying a possible $8.7B after tax gain on $435B RWA. It's unclear in our view if TFC would use the gain to restructure the AFS securities portfolio. TFC bonds were 4-6 bp tighter, in line with other regionals, whereas the stock outperformed +6.6% vs. KRE ETF +1.6%.

Credit quality deterioration in cards but well reserved

Increasing signs of a weakening consumer should show up in credit card portfolios via higher credit losses (Exhibit 4) as reported by the card-focused banks through August as well as strong card loan growth as consumers continue to spend. However, we note that banks are very well reserved in general for higher credit card losses at ~100% of annualized DFAST stressed scenario losses (i.e. for 1 year, not 9 quarters) and 2x pre-Covid levels. Commercial real estate reserves are 2% on average, above S&L 1 year loss peak of 1.8% but below GFC and DFAST losses of 2.5% and 3.9%, respectively. Rest of loan portfolios reserved at ~66% of annualized DFAST stress scenario losses and 5x pre-Covid losses between '16-'19. (Exhibits 1-3).

DFAST = Dodd-Frank Act Stress Tests

S&L = Savings & Loans

GFC = Global financial crisis

RWA = risk weighted assets

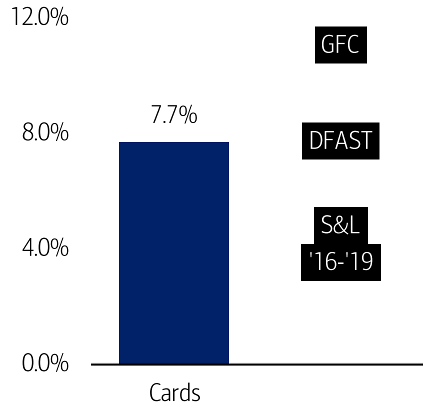
AFS = available for sale

TLAC = Total loss absorbing capacity

Current Loan Loss Reserves vs. Credit Losses in Past Cycles and DFAST Stressed Scenario

Exhibit 1: Credit Cards

Card loan loss reserves of 7.7% are similar to DFAST stress scenario losses (annualized)



Source: Company filings, FDIC and Federal Reserve (2022 DFAST Stress Scenario 18 bank average, annualized from 9 quarter loss rate). GFC = Global Financial Crisis '08-'11. S&L = savings and loans '91-'94. Median Credit Card loan loss reserve / loans among 19 banks

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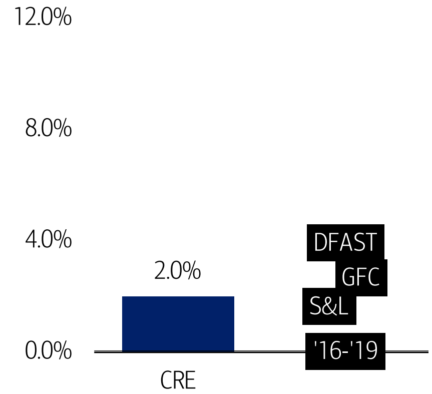
Exhibit 2: Commercial Real Estate

CRE loan loss reserves of 2.0% are similar to S&L crisis losses but less than GFC or DFAST



Source: Company filings, FDIC and Federal Reserve (2022 DFAST Stress Scenario 18 bank average, annualized from 9 quarter loss rate). GFC = Global Financial Crisis '08-'11. S&L = savings and loans '91-'94. Median Commercial Real Estate loan loss reserve / loans among 19 banks

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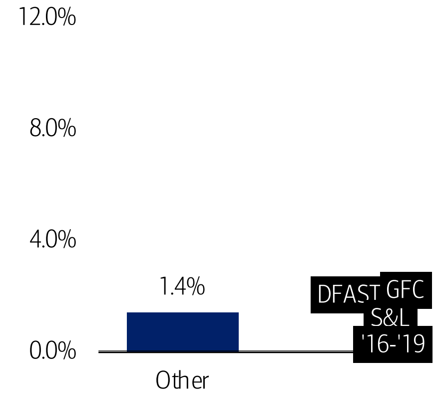
Exhibit 3: All Other Loans

Other loan loss reserves of 1.4% are similar to S&L crisis losses but less than GFC or DFAST



Source: Company filings, FDIC and Federal Reserve (2022 DFAST Stress Scenario 18 bank average, annualized from 9 quarter loss rate). GFC = Global Financial Crisis '08-'11. S&L = savings and loans '91-'94. Median Other loan loss reserve / loans among 19 banks

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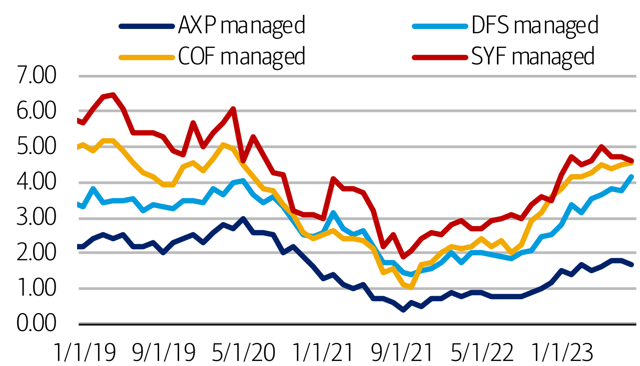
Exhibit 4: Monthly Credit Card Net Charge-off Ratios

Credit card losses continue to rise at 190bp YoY on average



Source: Company filings. AXP, COF, DFS and SYF account for approximately 40% of industry credit card loan balances and provide monthly updates on credit card trends

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Valuation & risk

Truist Financial (TFC)

We rate Truist Financial at Marketweight as we view the risk/reward from current spread levels as fair due to concerns about TFC's cost structure and pro forma regulatory capital levels due to unrealized losses on AFS and HTM securities.

Upside risks to our rating include achieving greater cost savings than targeted, sale of the remaining 80% stake in its insurance business at a premium, favorable moves in interest rates that improve deposit flows, funding costs and valuations on its securities portfolio, and a benign economic environment that reduces the outlook for rising credit losses. Downside risks include poor execution on cost savings plans, decision to not monetize its insurance business to improve capital ratios, further increase in interest rates that hurt valuations of its securities portfolio, a more severe economic downturn that drives higher credit losses, and a downgrade of TFC's credit ratings.

U.S. Bancorp (USB)

We rate U.S. Bancorp at Overweight as we see the risk/reward potential among the super regionals as the most favorable given spread underperformance since early March. We view the current level of capital as a temporary issue that will accrete back to its target CET1 capital ratio range of 8.5-9% given the strength, quality and diversification of USB's earnings power.

Risk to our rating include further substantial increase in interest rates across the curve that could drive further deposit outflows into higher yielding alternatives, which could hurt net interest margin and earnings, and greater unrealized losses on the AFS securities portfolio, which could impact tangible book value and pro forma regulatory capital ratios that currently do not include AOCI. Other risks include sensitivity to the economic backdrop, particularly with regard to asset quality of its loan book, integration risk of its recent acquisition of Union Bank, and potential downgrade of USB's credit ratings by the ratings agencies due to the aforementioned factors.

Analyst Certification

I, Tom Curcuruto, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Security/Loan pricing

Truist Financial / TFC

Security	Amt	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
5.9, Senior, USD, 2026:B	750	28-OCT-2026	A3-/A-/A	99.05	10-Oct-2023	6.40	141
6.047, Senior , USD, 2027:B	1,500	08-JUN-2027	A3/A-/A	98.74	10-Oct-2023	6.57	170
4.26, Senior , USD, 2026:B	1,500	28-JUL-2026	A3/A-/A	96.38	10-Oct-2023	6.42	137
4.873, Senior, USD, 2029:B	1,500	26-JAN-2029	A3/A-/A	93.24	10-Oct-2023	6.71	201
6.123, Senior, USD, 2033:B	750	28-OCT-2033	A3-/A-/A	94.91	10-Oct-2023	6.89	221
5.122, Senior, USD, 2034:B	1,500	26-JAN-2034	A3-/A-/A	88.15	10-Oct-2023	6.87	219
5.867, Senior, USD, 2034:B	1,750	08-JUN-2034	A3-/A-/A-	93.49	10-Oct-2023	6.80	210
4.916, Subordinated, USD, 2033:B	1,000	28-JUL-2033	A3-/A-/A-	83.73	10-Oct-2023	7.47	280
1.5, Senior, USD, 2025:B	1,250	10-MAR-2025	A2-/A/A+	93.53	10-Oct-2023	6.36	119
2.25, Subordinated, USD, 2030:B	1,250	11-MAR-2030	A2/A/A	75.63	10-Oct-2023	7.03	240

For pricing information refer to "Other Important Disclosures" below.
B=Bond; L=Loan; CS=Capital Security (Not including Equity Preferred); CDS=Credit Default Swap; EP=Equity Preferred

U.S. Bancorp / USB

Security	Amt	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
2.05, Senior, USD, 2025:B	1,000	21-Jan-2025	A2/A+/A+	95.05	10-Oct-2023	6.14	90
3, , USD, 2029:B	1,000	30-Jul-2029	A3/A-/A-	83.30	10-Oct-2023	6.50	186
4.967, , USD, 2033:B	1,300	22-Jul-2033	A3/A-/A-	85.66	10-Oct-2023	7.20	253
4.653, , USD, 2029:B	1,650	01-Feb-2029	A3/A/A	93.17	10-Oct-2023	6.49	180
4.839, , USD, 2034:B	2,000	01-Feb-2034	A3/A/A	87.38	10-Oct-2023	6.68	200
5.775, , USD, 2029:B	1,750	12-Jun-2029	A3/A/A	97.01	10-Oct-2023	6.53	185
5.836, , USD, 2034:B	1,750	12-Jun-2034	A3/A/A	93.93	10-Oct-2023	6.70	200
2.8, Senior, USD, 2025:B	1,000	27-Jan-2025	A2/A+/A+	95.96	10-Oct-2023	6.09	86

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Important Disclosures

Credit opinion history

Truist Financial / TFC

Company	Date[R1]	Action	Recommendation	
Truist Financial / TFC	23-Aug-2023	Initial	Marketweight	
Security	**Date[R1]**	**Action**	**Recommendation**	**Price**
5.9, Senior, USD, 2026:B	23-Aug-2023	Initial	Marketweight	99.50
6.047, Senior , USD, 2027:B	23-Aug-2023	Initial	Marketweight	99.38
4.26, Senior , USD, 2026:B	23-Aug-2023	Initial	Marketweight	96.36
4.873, Senior, USD, 2029:B	23-Aug-2023	Initial	Marketweight	95.07
6.123, Senior, USD, 2033:B	23-Aug-2023	Initial	Marketweight	98.68
5.122, Senior, USD, 2034:B	23-Aug-2023	Initial	Marketweight	91.63
5.867, Senior, USD, 2034:B	23-Aug-2023	Initial	Marketweight	96.82
4.916, Subordinated, USD, 2033:B	23-Aug-2023	Initial	Marketweight	87.50
1.5, Senior, USD, 2025:B	23-Aug-2023	Initial	Marketweight	92.95
2.25, Subordinated, USD, 2030:B	23-Aug-2023	Initial	Marketweight	77.91

Table reflects credit opinion history as of previous business day's close.[R1]First date of recommendation within the last 36 months, if for an issuer or within the last 12 months, if for a security or loan. The investment opinion system is contained at the end of the report under the heading "BofA Global Research Credit Opinion Key."
Pricing information in the table is provided for each action where available. In the case of bonds, loans, capital securities and equity preferreds, the price shown reflects the nominal cash price for the security; and in the case of CDS, the price shown reflects the spread, on the date of the relevant action.
B=Bond; L=Loan; CS=Capital Security (Not including Equity Preferred); EP=Equity Preferred; CDS=Credit Default Swap

U.S. Bancorp / USB

Company	Date[R2]	Action	Recommendation	
U.S. Bancorp / USB	23-Aug-2023	Initial	Overweight	
Security	**Date[R2]**	**Action**	**Recommendation**	**Price**
2.05, Senior, USD, 2025:B	23-Aug-2023	Initial	Overweight	94.80
3, , USD, 2029:B	23-Aug-2023	Initial	Overweight	84.34

U.S. Bancorp / USB

Company	Date[R2]	Action	Recommendation	
4.967, , USD, 2033:B	23-Aug-2023	Initial	Overweight	89.29
4.653, , USD, 2029:B	23-Aug-2023	Initial	Overweight	94.59
4.839, , USD, 2034:B	23-Aug-2023	Initial	Overweight	90.79
5.775, , USD, 2029:B	23-Aug-2023	Initial	Overweight	98.81
5.836, , USD, 2034:B	23-Aug-2023	Initial	Overweight	97.78
2.8, Senior, USD, 2025:B	23-Aug-2023	Initial	Overweight	95.74

Table reflects credit opinion history as of previous business day's close. [R2]First date of recommendation within the last 36 months, if for an issuer or within the last 12 months, if for a security or loan. The investment opinion system is contained at the end of the report under the heading "BofA Global Research Credit Opinion Key."
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Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

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Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
Sell Protection: Sell CDS, therefore going long credit risk.

Corporate Credit Issuer Investment Rating Distribution: Global Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R3]	Count	Percent
Buy	152	41.19%	Buy	125	82.24%
Hold	177	47.97%	Hold	150	84.75%
Sell	40	10.84%	Sell	29	72.50%

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