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Measured reactions to regulatory costs follow First Republic's 'huge surprise'

By Kiah Lau Haslett

First Republic Bank shares stumbled after the surprise announcement that noninterest expense would increase in response to heightened regulations, but the Street believes that the bank can recover from the hit and that fundamentals remain strong.

First Republic management kicked off its second-quarter earnings call with a detailed explanation of the investments and expense outlay needed to prepare for the heightened regulatory expectations associated with growing above $50 billion in assets — a threshold the bank expects to hit within six quarters. Shares began to fall, sinking throughout the July 16 call and losing 15.09% to $46.70 by the close of the day. One day later, industry observers show a more measured, optimistic response, while posing questions about how much the bank plans to spend and how it envisions itself performing as a larger bank.

Management's warning that the efficiency ratio would jump to an adjusted range of 59% to 62% was a "huge surprise," FIG Partners analyst Timothy Coffey told SNL. He noted that a spike in the efficiency ratio would also reduce the return on assets. The market reaction to the expense increase could also relate to concerns that the bank is not as internally prepared as they should be, Coffey said. But he credited management for demonstrating how little internal risk has changed inside the bank in a decade, with similar geographies and asset mix but more capital. Coffey believes the bank has plenty of lead time to fully strengthen its infrastructure and compliance programs.

First Republic Chairman and founding CEO James Herbert II said during the call that the bank currently has initiatives to enhance areas such as enterprise risk management, Bank Secrecy Act and anti-money laundering efforts, capital and liquidity stress testing, compliance, resolution planning, and the pending liquidity-coverage ratio. Analysts still struggled to contextualize the expenses and questioned the progress that the bank has already made. Goldman Sachs analyst Ryan Nash asked during the question-and-answer session what regulators found lacking. "Where are the areas where regulators felt you didn't have the right infrastructure and how long is maybe the time frame on each of those?"

Morgan Stanley analyst Ken Zerbe pressed management for details, bluntly stating, "[I]t feels like last quarter, things were fine and I think at times, you had addressed that you were spending to comply with the $50 billion asset crossing. But it's almost like something very material happened — in terms of your thinking, in terms of what you've been asked to do — that led to such a dramatic shift from last quarter to this quarter, in terms of what the ultimate regulatory expense is going to be."

Management said the bank has the proper infrastructure in place, and explained that the outlay is a response to indications that yielded greater clarity as to what the bank will need. It is directing most of its funds toward enhancing BSA/AML efforts and ERM, though improvements will run across the board. First Republic declined SNL's request for additional comment.

Coffey told SNL that few, if any, sell-siders had anticipated such a large future expense growth. He wrote in a July 17 report that he expects the majority of new expenses to be implemented in the next two quarters, which could add $45 million more in 2014 expenses than he had previously estimated.

Other reactions were also measured. First Republic's investment opportunity remains "quite strong," but the company needs to provide answers about what sort of efficiency ratio it thinks it can achieve in the long term as a larger bank, said Sean Stannard-Stockton. Stannard-Stockton is director of investments at Ensemble Capital Management, which he said has a "material position" in First Republic. He said the company believes the bank has a superior franchise directed toward a wealthy clientele and is managed in a "very straightforward, frankly, traditional way."

Stannard-Stockton listened to the second-quarter earnings call and said that while management's warning about future expense growth was "an abrupt change" in communication, the costs make sense. He reiterated Herbert's point that the investments will further the bank's future growth beyond $50 billion, and up toward $60 billion.

"You invest in First Republic because of the growth story, and they've been executing on that very well," he said. "That being said, they could have done more to communicate how those expenses were going to flow into their income statement over time."

A number of analysts saw silver linings in the front-loaded expenses and were optimistic about the efficiency ratio in reports the day after the call. Sandler O'Neill analyst Aaron Deer wrote that First Republic's expense acceleration makes sense given its growth has meant the threshold has approached faster than expected and that deposit flows can be unpredictable. Front-loading the expenses for an aggressive build-out will allow regulators more time to become comfortable with its systems, policies, procedures, technology and personnel, he wrote. Additionally, there might be variable elements embedded in the expenses that could peak and wane through early 2015, creating a favorable earnings ramp for 2015 and 2016.

Keefe Bruyette & Woods analyst Julianna Balicka wrote that First Republic used to have an efficiency ratio in the mid-60% to 70% range. Balicka pointed out in a July 17 report that management's recently updated outlook is a "positive improvement" and reflects increased scale and improving profitability from a more diversified bank.

"[I]n the medium term, with increased growth and a little bit of help from interest rates, we see [the efficiency ratio issue] resolving itself," she wrote.

Herbert did his part to reassure analysts and investors during the call. "[W]e don't find any of this particularly threatening, it's just work that needs to get done and systems and procedures that need to be improved," he said. "You can stretch it out or you can get it out. You can establish those new procedures and systems and personnel level quickly; we have chosen to do the latter."

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