

First Republic Bank Outlook Revised To Positive From Stable; 'BBB+' Rating Affirmed

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- First Republic has increased its capital levels, maintained near-pristine credit quality, and gained access to the public equity markets in the past year.
- We are changing our outlook to positive from stable and affirming our counterparty credit rating on the bank.
- We could upgrade First Republic if capital and credit quality remain strong and the bank further increases its fee income.

NEW YORK (Standard & Poor's) June 24, 2011—Standard & Poor's Ratings Services said today that it revised its outlook on San Francisco-based First Republic Bank to positive from stable. At the same time, we affirmed our 'BBB+' long-term counterparty credit rating on the company.

Since its sale from Bank of America Corp. (BofA) in July 2010, First Republic has increased its capital levels, maintained near-pristine credit quality, and gained access to the public equity markets. The bank's ratio of tangible common equity to tangible assets rose to 8.8% in first-quarter 2011 from 8.3% at the time of sale from BofA, and its nonperforming assets remain minimal. Its financial flexibility—or ability to access capital—improved with a December 2010 initial public offering.

“Our ratings on First Republic continue to reflect its strong core deposit base and the long and successful track record of its management team,” said Standard & Poor's credit analyst Brendan Browne. The bank's concentrated loan portfolio, limited geographic diversification, and improving but still fairly lackluster core earnings capacity partially offset these positive ratings factors.

First Republic's senior management team has largely been in place since the bank's early years or its founding in 1985. It has continued to run the institution even through

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mergers with Merrill Lynch in 2007 and BofA in 2008 and following its divestiture from BofA in 2010. The team has built the bank's risk profile conservatively while suffering relatively low credit and net losses. It has also developed a strong core deposit base and used a service-intensive business model to carve out a loyal base of affluent customers primarily on the West and East coasts of the U.S.

However, the bank's balance sheet and franchise reflect limited diversification. Single-family jumbo mortgages in a few select geographies—particularly the San Francisco Bay Area—dominate the loan portfolio. Furthermore, because of its wealthy customer base, First Republic tends to finance high-end homes. The bank ameliorates this exposure with conservative loan-to-value standards.

Although the bank has suffered few credit problems, its earnings historically have been fairly modest. Its pretax, preprovision core earnings have improved somewhat in the past year, but have typically lagged comparable banks', reflecting lower net interest margins and weak noninterest income generation. The bank earns less fee income from its customers with low levels of deposit service charges, and its fee income businesses have not yet generated significant earnings. In a hypothetical situation of distress, it would be more difficult for First Republic to build capital through earnings than for a bank with strong core earnings capacity. At the same time, from a risk perspective, we view the trade-off of lower net interest margins for consistently stronger credit quality as beneficial.

The positive outlook indicates that there is at least a one-in-three chance we could raise the rating within two years. We are likely to raise the rating if capital and credit quality remain strong and the company further builds its fee income businesses. The bank is currently working to expand its investment advisory, trust, and brokerage businesses. If those businesses or others were to drive the company's core profitability higher, perhaps with a core return on assets (ROA) of more than 1%, we could raise the rating. On an adjusted basis, we estimate that the bank reported an ROA of about 0.95% in first-quarter 2011. While less likely, we could lower the rating with a substantial deterioration in capital or credit quality.

RELATED CRITERIA AND RESEARCH

- U.S. Regional Banks Continued To Report Encouraging Results In First-Quarter 2011, May 18, 2011
- Bank Rating Analysis Methodology Profile, March 18, 2004

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