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HSBC Bank Bermuda Ltd.

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HSBC Bank Bermuda Ltd.

SACP	bbb-		+	Support	+3	+	Additional Factors	0

Anchor	bbb-	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Weak	-2
Funding	Average	0
Liquidity	Strong	

ALAC Support	0
GRE Support	0
Group Support	+3
Sovereign Support	0

Issuer Credit Rating
A-/Negative/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Strategically important subsidiary of HSBC Holdings PLC • Leading competitive position in Bermuda • Very strong capital ratios • Ample and high-quality liquidity assets	• Very poor loan quality relative to peers, despite an improvement in 2015 • Geographically concentrated loan portfolio, with large single-name exposures • Return on equity targets set by the parent company may imply pressure to meaningfully adjust its capital levels

Outlook: Negative

The negative outlook on HSBC Bank Bermuda Ltd. (HBBM) primarily reflects the possibility the bank may significantly reduce its capital levels, which more than offsets the likelihood of an improvement stemming from a potential upturn in Bermudian economic risk (see "Various Rating Actions Taken On Bermuda Banks On Potential Upside In Bermuda's Economy," June 30, 2016). We might lower the stand-alone credit profile (SACP), and therefore, the rating, within two years, if a capital decline were to drive the S&P Global Ratings risk-adjusted capital (RAC) ratio below 10% on a sustained basis. On the other hand, we could revise the outlook to stable, within two years, if we were to become convinced that any potential capital withdrawal, by the parent, will be fully offset by improving operating conditions in Bermuda.

Rationale

The ratings on HBBM, the largest bank in Bermuda, primarily reflect the bank's strategic importance to its parent company, U.K.-incorporated bank holding company HSBC Holdings PLC, as well as its leading competitive position in Bermuda. Among other factors, our assessment incorporates HBBM's strong share of the Bermuda market and high proportion of fee income, partially offset by materially higher NPAs than peers', which we suspect may reflect weaker underwriting on some loans, in the past.

The bank's RAC ratio remains in our highest category (more than 15%). However, while we expect it to remain in the very strong range over the next 18 to 24 months, we believe that the return on equity (ROE) targets set by the parent company may imply pressure to meaningfully reduce its capital levels in order to meet these hurdles. Capital remains well above minimum regulatory requirements, but in several recent years, dividend payouts have exceeded net income. HBBM's loan performance improved in 2015, but remains very poor relative to peers' and its adjusted nonperforming assets (NPAs) to customer loans have ticked up since 2014 (20.6% in 2015 versus 18.8% in 2014). We view the bank's geographic concentration of its loans and operations negatively in our business risk assessment.

The long-term issuer credit rating also reflects our view of HBBM's strategic importance to its parent. The 'A-' long-term rating on HBBM is three notches above the 'bbb-' SACP on the bank.

Anchor: A small,exceptionally high-income economy, almost entirely dependent on two industries

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor SACP, the starting point in assigning an issuer credit rating. The combination of a '6' economic risk score and a '3' industry risk score for Bermuda results in a 'bbb-' anchor SACP for a bank operating in Bermuda.

Regarding economic risk, Bermuda is a very small and largely open economy with exceptionally high-income but almost complete dependence on two industries: international financial services (primarily provision of insurance and reinsurance), the main driver, and a much smaller and struggling tourism industry. We believe political risk is low, although macroeconomic policy flexibility is hampered by political and competitive constraints on fiscal policy, and a fixed exchange-rate regime which precludes independent monetary policy, leading us to categorize economic resilience as "intermediate risk". We continue to view Bermuda as in an extended (decade-long) correction phase to previously built-up economic imbalances, principally concerning local real estate valuations (residential and commercial). We also see this as the riskiest feature of the banking industry in Bermuda. We now believe, however, that a substantial majority of these have been realized, as NPAs, as a share of total loans, have decreased in each quarter since 2013. Indeed, we think economic risks may be improving, and we view the trend as positive. Combined with a potentially stronger boost to economic activity than we currently expect from Bermuda's preparation for the 2017 America's Cup, if credit losses continue to outperform our expectations, we may revise our assessment of economic imbalances to "high impact", from "very high impact". If it were to occur, this improvement would lead, other factors unchanged, to our improving our overall score for economic risk to '5', from '6', and improving our overall BICRA on Bermuda to '4', from '5'. In turn, this would result in our raising our anchor SACP for a bank operating in Bermuda to 'bbb' (other things unchanged).

Regarding industry risk, we view the risks resulting from Bermudian regulation and supervision, governance, and transparency as "intermediate", reflecting both a stable regulatory regime, consistent with international standards, and also the difficulties experienced by Bermuda's banks in recent years. We view Bermuda's banking industry as highly concentrated and well-entrenched, with "low" risk as far as competitive dynamics. We view Bermuda's systemwide funding as "intermediate" risk, balancing a lack of lender of last resort against abundant and relatively stable core deposits, and a general lack of either wholesale or external funding needs. We view the trend for industry risk as stable.

Table 1

HSBC Bank Bermuda Ltd. -- Key Figures					
	--Year ended Dec. 31--				
(Mil. $)	**2015**	**2014**	**2013**	**2012**	**2011**
Adjusted assets	11,992	11,459	14,163	13,227	14,851
Customer loans (gross)	2,569	3,062	3,329	3,820	3,646
Adjusted common equity	1,004	1,063	1,055	1,594	1,664
Operating revenues	304	326	368	397	428
Noninterest expenses	175	184	192	204	237
Core earnings	93	77	49	28	151

Business position: A leading competitive position in Bermuda

We assess HBBM's business position as adequate (as our criteria define it), largely driven by its status as the largest bank with a leading competitive position in the jurisdiction. The adequate business position stems from our comparison of HBBM to the entire Bermudian banking system, of which HBBM constitutes a dominant share, with about $12 billion in total assets as of Dec. 31, 2015 (about half of the system's assets).

We believe the combination of the resources of the HSBC global network with the long-term local knowledge and well-established local presence of HBBM's predecessor (established in Bermuda in 1889) help HBBM to maintain its dominance. Moreover, HBBM provides a full suite of banking services, including retail and corporate banking, global markets, investment and wealth management, trust, custody, and insurance services. We estimate that it has a deposit market share of approximately 43% in Bermuda--slightly more than its nearest competitor. Despite its dominant competitive position, our assessment is tempered by the substantial geographic concentration of the bank's lending portfolio and increasing reliance on more volatile spread income.

HBBM's fee income (about 24% of total revenues in 2015 versus almost 30% in 2011), which we view as less volatile compared to its lending and trading businesses, has been hurt in recent years. In October 2015, HBBM entered into an agreement to sell Bermuda Trust Company Ltd. and its Private Banking Investment management operations in Bermuda to Bank of N.T. Butterfield & Son Ltd. As a result, we expect the bank's fee income to further decline in 2016 to below 20% of overall revenues. However, we acknowledge management's re-focus on the bank's core, and better performing businesses in Bermuda, including Retail Banking Wealth Management, Commercial Banking, and Global Banking and Markets.

HBBM's customer loan portfolio (about 21% of its assets) is geographically concentrated in Bermuda, and has large single-name exposures. However, this concentration is slightly mitigated by HBBM's geographically diversified loans to banks (about 21%) and securities held (about 58%), and its well-diversified business lines. In comparison with banks that we view as having similar industry risk by virtue of the countries they are based in (such as those based in the

U.S.), HBBM is highly dependent on a single industry (global reinsurance, and more narrowly, on those reinsurers who focus on Bermudian specialties, such as catastrophe reinsurance). Moreover, the Bermudian reinsurance industry has shown noticeable volatility, in terms of employment and income, in the past decade, and we believe pricing pressure has led to significant consolidation in this industry. Many U.S. regional banks have more broadly diversified clients by industry, and often by geography, as well.

Table 2

HSBC Bank Bermuda Ltd. -- Business Position					
	--Year ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Return on equity	8.39	4.54	3.38	1.23	8.49

Capital and earnings: Risk-adjusted capital ratio remains very strong, but we expect at least some decline, and see a possibility of more significant decline, via dividends

HBBM's RAC ratio remains very strong (our highest category), at about 19%, as of Dec. 31, 2015. The ratio has improved significantly from 17.3% at year-end 2014 because of reduction in credit risk-weighted assets stemming from a decline in corporate and past due exposures. We expect the RAC ratio to decline somewhat over the next 18-24 months, but remain in the very strong category, as a result of dividends to the parent. Our forecast assumes modest loan growth and the continuation of its very high dividend payout ratio (the bank pays roughly all of its earnings in dividends). HBBM's parent company, U.K.-incorporated bank holding company HSBC Holdings PLC, has set return on equity targets, which we regard as ambitious for Bermuda. In order for HBBM to meet these hurdles, we believe the bank will at least somewhat reduce its capital levels, and see a possibility of a more significant decline, possibly putting our RAC ratio in a lower category, within the coming two years. This is a key reason for our negative outlook.

Effective Jan. 1, 2015, HBBM became subject to higher capital requirements under the Basel III final rules, which include imposition of a capital surcharge for Domestic Systemically Important Banks. As a result, HBBM is subject to a capital surcharge somewhere in the range of 0.5% to 3%, based on its systemic importance to Bermuda's economy and banking sector. As of Dec. 31, 2015, HBBM's Common Equity Tier 1 capital ratio and total capital ratio were 21.8% and 22.4%, respectively. HBBM's adjusted common equity, which is our definition of core capital that eliminates components that we classify as relatively weaker than common equity, represents 100% of its total adjusted capital, better than the bank's peer average of about 89%. However, the bank's more limited geographic and borrower diversification relative to that of some other banks somewhat tempers our very positive view of its capital. Separately, HBBM's payment of a large, discretionary dividend payment (resulting in a one-third decline in equity) to its parent in 2013, despite significant deterioration in loan performance in the same year, leads us to be somewhat skeptical of the relative priority HBBM and HSBC place on risk mitigation, versus return.

Despite a significant decline in earnings since 2010, the bank is still profitable, partly because of strong earnings capacity before loan-loss provisions and reduced noninterest expenses. HBBM reported strong earnings in 2015, aided by a decline in loan loss provisions. We expect earnings will benefit from higher interest rates in 2016 and further reduction in loan loss provisions, assuming loan performance stabilizes. Fee income will likely be pressured due to the sale of the private banking business. We expect HBBM's earnings quality to remain solid based on our projected three-year average earnings buffer of 1.95%, which indicates that the bank has adequate earnings to cover our estimate of normalized loan losses through the cycle.

Table 3

HSBC Bank Bermuda Ltd. -- Capital And Earnings					
	--Year ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	60.99	59.29	58.79	62.38	61.80
Noninterest expenses/operating revenues	57.61	56.61	52.34	51.46	55.30
Core earnings/average managed assets	0.79	0.60	0.36	0.20	1.13

Risk position: We expect loan performance to stabilize somewhat, but NPAs to remain elevated versus those of peers

HBBM's risk position is weak, in our opinion. The bank's loan performance has deteriorated significantly in recent years, reflecting both Bermuda's weakening economy and challenges in the bank's commercial loan portfolio--including large, single-name exposures. We view HBBM's asset quality as having performed substantially worse than its local bank peers' during the past few years. For example: NPAs as a share of loans, for the Bermudian banking industry as a group, moved from 1.4% in 2008 to 8% in 2011, 11% in 2012, 12% in 2013, 11% in 2014, and 9% in 2015; for HBBM, the comparable measure moved from 1.8% in 2008 to 13% in 2011, 16% in 2012, 23% in 2013, 19% in 2014, and 21% in 2015. We suspect the divergence may reflect weaker underwriting on some loans, compared with Bermudian peers, among other factors—although we believe HBBM's underwriting standards have since tightened. We expect NCOs to remain elevated through 2017, as prior credit impairment is resolved and the economy recovers at a slow pace.

The loan portfolio is largely concentrated in residential mortgages, which represented nearly half of the bank's gross loans and advances to customers as of Dec. 31, 2015. We understand loan losses had been extremely low before 2009. After five years of unbroken recession, however, residential repossessions, which we understand had also been extremely rare in Bermuda before 2009, have risen materially. We understand many residential mortgage borrowers relied on rental income from non-Bermudian workers (ownership of real estate below a price-threshold is restricted to Bermudians), and rental income has suffered as local economic deterioration has reduced both employment and related incomes. The bank's customer loan portfolio is only about 22% of its earning assets as of Dec. 31, 2015, providing some cushion to earnings and capital, despite deteriorating loan performance. HBBM is also exposed to credit risk through its investments in securities portfolios and loans to banks. However, these portfolios are well-diversified by geography and are highly rated.

Table 4

HSBC Bank Bermuda Ltd. -- Risk Position					
	--Year ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Growth in customer loans	(16.09)	(8.04)	(12.84)	4.77	11.97
New loan loss provisions/average customer loans	1.28	2.01	3.51	4.34	1.10
Net charge-offs/average customer loans	1.18	5.88	1.04	1.53	0.24
Gross nonperforming assets/customer loans + other real estate owned	20.61	18.80	22.74	15.74	12.93

Table 4

HSBC Bank Bermuda Ltd. -- Risk Position (cont.)					
	--Year ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Loan loss reserves/gross nonperforming assets	22.72	20.34	31.55	25.17	10.00

Funding and liquidity: Average and strong, the latter reflecting an exceptionally large share of balance sheet devoted to high-quality, liquid assets

The bank's funding profile is average, for a Bermudian bank, in our opinion. This acknowledges the advantage provided by deposits, which are generally plentiful (comprising almost HBBM's entire funding base), thus obviating the need for fickle capital markets funding. Historically, Bermudian banks have realized the need to maintain more conservative funding and liquidity profiles than they otherwise might because Bermuda has no lender of last resort and has had no deposit insurance. However, the local authorities have implemented the latter in August 2016. Although coverage is very limited at only B$25,000 per insured depositor for Bermuda-based depositors, we understand this is sufficient to fully insure the vast majority of Bermuda-dollar accounts. Additionally, there is no Bermudian debt market, so any potential capital markets funding must come from abroad (accounted for via our BICRA).

As of fourth-quarter 2015, HBBM's stable funding ratio (S&P Global Ratings' calculation) is about 74.5%, at the low end of the range relative to peers'. A ratio of more than 100% denotes that a bank has adequate long-term funding for its business model. Additionally, HBBM's deposit liabilities are typically extremely short term (as of Dec. 31, 2015, almost all were to mature within one month, and the majority were non-core, according to our methodology).

Nevertheless, HBBM maintains liquid assets that are both ample in size (more than 75% of total assets, at Dec. 31, 2015) and high quality (all investment securities were investment-grade, as of Dec. 31, 2015, and 63% were rated 'AAA'; likewise, almost all banks with whom funds were placed were investment-grade, and three-fourths rated 'AA-' or better). Broad liquid assets comfortably cover its short-term wholesale funding about 74x, well above peers. Although we believe there is a greater need for liquidity in Bermuda than in some other jurisdictions, we view HBBM's liquidity as strong, even for a Bermudian bank.

Table 5

HSBC Bank Bermuda Ltd. -- Funding And Liquidity					
	--Year ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Core deposits/funding base	30.20	17.25	17.51	17.56	49.18
Customer loans (net)/customer deposits	87.77	167.53	136.27	182.80	56.26
Long-term funding ratio	54.94	27.65	23.73	25.06	37.05
Stable funding ratio	74.50	60.30	63.57	63.87	N.A.
Short-term wholesale funding/funding base	1.01	0.70	0.45	0.56	0.58
Broad liquid assets/short-term wholesale funding (x)	74.20	95.20	154.99	120.34	N.A.
Short-term wholesale funding/total wholesale funding	1.45	0.67	0.54	0.67	1.13

N.A.--Not available.

External support: Uplift for strategic importance to parent company

We view HBBM as a strategically important subsidiary of HSBC, under our group methodology criteria. Supporting factors include that HBBM is a wholly owned subsidiary of HSBC (purchased on Feb. 18, 2004); it has a leading market position within Bermuda; it changed its legal name in 2010 to include HSBC; and we think customers' belief that HSBC stands behind its subsidiaries is important to HSBC's global franchise. On the other hand, HBBM is not in one of the group's priority growth markets; its connectivity with the rest of the group appears more limited than for subsidiaries in larger exporting economies; and it is relatively small, representing only about 1% of group capital. All things considered, we do not assume HBBM is among those subsidiaries most important to HSBC, but we do believe it to have strategically important group status. As a result, the 'A-' rating on HBBM is three notches above our SACP on the bank and three notches below our 'aa-' supported group credit profile on HSBC's core operating subsidiaries.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009
- Commercial Paper I: Banks, March 23, 2004

Related Research

- Banking Industry Country Risk Analysis: Bermuda, Aug. 8, 2016
- Various Rating Actions Taken On Bermuda Banks On Potential Upside In Bermuda's Economy, June 30, 2016

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	**6**	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	**bbb-**	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of October 3, 2016)

HSBC Bank Bermuda Ltd.	
Counterparty Credit Rating	A-/Negative/A-2
Counterparty Credit Ratings History	
01-Jul-2014	A-/Negative/A-2
11-Mar-2014	A/Watch Neg/A-1
26-Sep-2013	A/Negative/A-1
23-Aug-2012	A+/Negative/A-1
29-Nov-2011	A+/Stable/A-1
13-Oct-2011	AA-/Negative/A-1+
Sovereign Rating	
Bermuda	A+/Stable/A-1
Related Entities	
HSBC Bank PLC	
Issuer Credit Rating	AA-/Negative/A-1+
Commercial Paper	A-1+
Junior Subordinated	BBB+
Senior Unsecured	AA-
Short-Term Debt	A-1+
Subordinated	A-
HSBC Holdings PLC	
Issuer Credit Rating	A/Negative/A-1
Junior Subordinated	BBB-
Preference Stock	BBB-
Senior Unsecured	A
Senior Unsecured	AA-
Short-Term Debt	A-1
Subordinated	BBB+

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Ratings Detail (As Of October 3, 2016) (cont.)

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.