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HSBC Bank Bermuda Ltd.

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Table Of Contents

Major Rating Factors

Outlook

Rationale

Related Criteria

Related Research

HSBC Bank Bermuda Ltd.

SACP	bbb-		+	Support	+3	+	Additional Factors	0
Anchor	bbb-			ALAC Support	0		**Issuer Credit Rating**	
Business Position	Adequate	0		GRE Support	0		**A-/Negative/A-2**	
Capital and Earnings	Very Strong	+2		Group Support	+3			
Risk Position	Weak	-2		Sovereign Support	0			
Funding	Average	0						
Liquidity	Strong							

Major Rating Factors

Strengths:	Weaknesses:
• Strategically important subsidiary of HSBC Holdings PLC • Leading competitive position in Bermuda • Very strong capital ratios, albeit declining • Ample and high-quality liquidity assets	• Elevated nonperforming assets (NPAs) versus those of peers • Geographically concentrated loan portfolio, with large single-name exposures • Large recent capital returns to shareholders, in the context of relatively weak, albeit improving, loan performance

Outlook: Negative

The negative outlook on HSBC Bank Bermuda Ltd. (HBBM) primarily reflects the possibility the bank may significantly reduce its capital levels. 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 15% on a sustained basis. We could also lower the rating if we consider that the Bermudian market may become less important to the parent's long-term strategy.

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 second-largest bank in Bermuda, primarily reflect the bank's strategic importance to its parent company, U.K.-incorporated bank holding company HSBC Holdings PLC (HSBC), as well as its dominant competitive position in Bermuda. Among other factors, our assessment incorporates HBBM's significant proportion of fee income, partially offset by materially higher NPAs than peers'.

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 targets. Capital remains well above minimum regulatory requirements, but in several recent years, dividend payouts have exceeded net income. HBBM's loan performance improved in 2016, but remains very poor relative to peers'. HBBM's adjusted NPAs to customer loans, which have declined in recent years (18.8% in 2016 versus 20.6% in 2015), remain materially higher than those of peers. 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 Banking Industry Country Risk Assessment (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 that 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 have revised our trend for economic risk (ER) in the Bermudian banking industry to stable, from positive. We still see upside potential for ER to decrease (improve), relative to our base-case expectations, including the possibility that Bermuda benefits more than we currently expect from accelerating real growth in U.S. GDP. On the other hand, we see increased downside risk, compared with our previous assessment, including the implications of recent real quarterly declines in Bermudian GDP and real estate prices, combined with the risk that potential near-term U.S. tax-policy changes disrupt the business model of multinational financial services companies based in Bermuda.

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. $)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	9,316	9,757	11,992	11,459	14,163
Customer loans (gross)	2,360	2,363	2,569	3,062	3,329
Adjusted common equity	854	828	1,004	1,063	1,055
Operating revenues	137	281	304	326	368
Noninterest expenses	73	166	175	184	192
Core earnings	63	96	93	77	49

Business position: Dominant competitive position in Bermuda

We assess HBBM's business position as adequate (as our criteria define it), largely driven by its status as the second-largest bank with a leading competitive position in the jurisdiction. Despite HBBM's small size relative to its parent, HSBC, we believe that its business position greatly benefits from its ownership structure and globally recognized brand. The adequate business position stems from our comparison of HBBM to the entire Bermudian banking system, of which HBBM constitutes a dominant share, with over $9 billion in total assets as of June 30, 2017 (about half of the system's assets).

We believe the combination of the resources of the HSBC global network and the long-term local knowledge and well-established local presence of HBBM's predecessor (established in Bermuda in 1889) helps HBBM to maintain its dominance. We estimate that it has a deposit market share of approximately 43% in Bermuda--slightly less 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, which we view as less volatile compared to its lending and trading businesses, has declined in recent years. In May 2016, HBBM entered into an agreement to sell off Bermuda Trust Company Ltd. and its Private Banking Investment management operations in Bermuda to Bank of N.T. Butterfield & Son Ltd. As a result, the bank's fee income declined in 2016 and the first six months of 2017 to below 20% of overall revenues, as was expected. 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. Despite the 20% contraction in GDP since 2008, HBBM has not reported a loss in any of the fiscal years.

HBBM's customer loan portfolio (about 25% of its assets) is geographically concentrated in Bermuda, and has large single-name exposures. In comparison with banks that we view as having similar industry risk, such as those based in the U.S., HBBM is highly dependent on a single industry (global 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--			
(%)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Return on equity	15.02	12.72	8.39	4.54	3.38

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 20.2%, as of June 30, 2017. 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 relatively stable earnings and the continuation of its very high dividend payout ratio. HBBM's parent has set ROE targets, which we regard as ambitious for Bermuda. In order for HBBM to meet these targets, 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 in the range of 0.5% to 3%, based on its systemic importance to Bermuda's economy and banking sector. As of Dec. 31, 2016, HBBM's Common Equity Tier 1 capital ratio and total capital ratio were 22.6% and 23.4%, 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, in line with the bank's peers'.

Despite a significant decline in earnings since 2010, the bank is still profitable, partly because of strong earnings capacity before loan-loss provisions and strategic developments within the organization. HBBM reported strong earnings in 2016, aided by a decline in loan loss provisions and gain of $20 million on sale of the private banking division. Although fee income will likely be pressured due to the sale of the private banking business, we expect earnings to benefit from higher interest rates in the coming years as well as further reduction in loan loss provisions, assuming loan performance stabilizes. We expect HBBM's earnings quality to remain solid based on our projected three-year average earnings buffer of 1.87%, 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--			
(%)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	69.71	67.38	60.99	59.29	58.79
Fee income/operating revenues	18.57	20.13	24.36	26.32	26.53

Table 3

HSBC Bank Bermuda Ltd. -- Capital And Earnings (cont.)					
		--Year ended Dec. 31--			
(%)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Market-sensitive income/operating revenues	9.62	12.22	14.40	14.12	14.45
Noninterest expenses/operating revenues	53.15	58.90	57.61	56.61	52.34
Preprovision operating income/average assets	1.35	1.06	1.10	1.10	1.28

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. We view HBBM's asset quality as having performed substantially worse than its local bank peers' during the past few years, reflecting both Bermuda's weakening economy and challenges in the bank's commercial loan portfolio--including large, single-name exposures. 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, 13% in 2013, 11% in 2014, 9% in 2015, and 8.1% in 2016; for HBBM, the comparable measure moved from 1.8% in 2008 to 13% in 2011, 16% in 2012, 23% in 2013, 19% in 2014, 21% in 2015, and 18.88% in 2016. We expect net charge-offs to remain elevated through 2017, as prior credit impairment is resolved and the economy recovers at a slow pace.

The bank's customer loan portfolio is about 24.6% of its earning assets as of Dec. 31, 2016, providing some cushion to earnings and capital, despite relatively weak loan performance. The loan portfolio is largely concentrated in residential mortgages, which represented more than half of the bank's gross loans and advances to customers as of Dec. 31, 2016. We understand many residential mortgage borrowers rely 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 mortgage portfolio experienced large losses between 2012 and 2015 mainly due to the economic recession and origination practices from 2005 to 2010. 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--			
(%)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(0.25)	(8.02)	(16.09)	(8.04)	(12.84)
New loan loss provisions/average customer loans	0.09	0.78	1.28	2.01	3.51
Net charge-offs/average customer loans	0.85	2.72	1.18	5.88	1.04
Gross nonperforming assets/customer loans + other real estate owned	13.56	18.88	20.61	18.80	22.74
Loan loss reserves/gross nonperforming assets	19.69	16.24	22.72	20.34	31.55

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 insure the vast majority of Bermuda-dollar retail 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 second-quarter 2017, HBBM's stable funding ratio (S&P Global Ratings' calculation) is about 93.02%, in line with its peer average. Additionally, the bank's deposit liabilities are typically extremely short term (as of Dec. 31, 2016, 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 50% of total assets, at Dec. 31, 2016) and high quality (all investment securities were investment-grade, as of Dec. 31, 2016, and 40% were rated 'AAA'). Broad liquid assets comfortably cover its short-term wholesale funding, by about 0.71x. 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.

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 the 'bbb-' SACP on the bank and two notches below our 'a+' unsupported group credit profile on HSBC.

Table 5

HSBC Bank Bermuda Ltd. -- Funding And Liquidity					
		--Year ended Dec. 31--			
(%)	**Year to date June 2017**	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	36.54	33.71	34.51	27.14	42.25
Customer loans (net)/customer deposits	78.40	77.44	76.81	106.44	56.49
Long term funding ratio	42.65	39.42	40.93	34.02	46.60
Stable funding ratio	93.02	90.40	81.99	81.00	121.13
Short-term wholesale funding/funding base	0.71	8.95	1.01	0.70	0.45
Broad liquid assets/short-term wholesale funding (x)	92.03	7.09	73.99	94.49	152.22
Short-term wholesale funding/total wholesale funding	1.12	13.51	1.55	0.96	0.77

Additional rating factors: None

No additional factors affect this rating.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Bermuda, Aug. 4, 2017
- Research Update: Bermuda 'A+' Rating Affirmed On Effective Policymaking And High GDP Per Capita; Outlook Stable, April, 26, 2017.

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 November 14, 2017)	
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

Ratings Detail (As Of November 14, 2017) (cont.)	
Sovereign Rating	
Bermuda	A+/Stable/A-1

*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.