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Research Update:

HSBC Bank Bermuda Ltd. Outlook Revised To Stable From Negative On Encouraging Indicators; Ratings Affirmed

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Research Update:

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Overview

- We continue to see encouraging recent economic indicators in Bermuda, the principal jurisdiction of operations for HSBC Bank Bermuda (HBBM), one of two banks that control the vast majority of the local market.
- A strategy update by the bank's parent (HSBC Holdings PLC) appears to have concluded without meaningfully reducing HBBM's strategic importance to the group, lowering the likelihood of this downside risk.
- We believe the likelihood that future capital payouts to the parent are as high a share of annual net income as the amounts paid in 2016 and certain previous years is also lower.
- In light of this, we now view the probability of upside and downside movement in the ratings as approximately balanced.
- Therefore, we are revising our outlook on HBBM to stable from negative and affirming our 'A-/A-2' issuer credit ratings on the bank.

Rating Action

On Feb. 19, 2019, S&P Global Ratings revised its outlook on HSBC Bank Bermuda (HBBM) to stable from negative. At the same time, S&P Global Ratings affirmed its 'A-/A-2' issuer credit ratings on the bank.

Rationale

The outlook revision mainly reflects potential improvements in Bermuda's economy, the bank's maintenance of very high capital ratios, and no recent indication from its parent that it is less committed to doing business in Bermuda, all of which reduce the odds of a downgrade.

In line with our positive economic risk trend in our Banking Industry Country Risk Assessment (BICRA) for Bermuda, and our positive outlook on Bermuda, we continue to see encouraging recent indicators in the territory, including positive real growth in GDP in each quarter (quarter/quarter) since fourth-quarter 2017. Economic improvement, if persistent, should help stem further asset quality problems and perhaps help the bank more quickly work through its currently high levels of nonperforming assets (NPAs).

Risk regarding the negative competitive pressure on Bermuda (a low-tax jurisdiction) from the recent decrease in the U.S. corporate tax rate appears to be fading, and we do not expect en masse departures of insurers and reinsurers that constitute Bermuda's economic bedrock, although we expect consolidation in those sectors to continue gradually. Major construction projects (such as the airport renovation) are also boosting employment and income, temporarily.

Furthermore, a strategy update held by the bank's parent, HSBC Holdings PLC (A/Stable/A-1), appears to have concluded without meaningfully reducing the strategic importance of HBBM to the group. That lowers the likelihood of this downside risk to our ratings, since we include three notches of uplift in our ratings on HBBM for the likelihood of extraordinary group support. That is, we consider the bank strategically important to the group (although not core nor highly strategic) and likely to receive extraordinary group support if needed.

The bank's earnings have been robust in recent years and its capital ratios remain very strong (risk-adjusted capital ratio [RAC] of 18% as of year-end 2017, and regulatory common equity tier 1 ratios of 23.3% at June 30, 2018--exceeding the regulatory requirement by 15.3%--and 21.7% at Dec. 31, 2017). We believe that capital payouts to the parent in the coming two years, although exceeding net income in each of the past five years, are most likely to be substantially less, as a share of annual net income, than the large amounts paid in 2016 (equal to 240% of that year's earnings) and certain previous years. We estimate that even if the company were to pay out substantially all of its projected annual earnings as dividends to the parent in the coming two years, our RAC would most likely remain above our 15% threshold for a very strong assessment. Therefore, we now believe the risk that our RAC for HBBM might fall so far as to lead us to downgrade the bank, while not eliminated, is likewise lower.

Nevertheless, the stable outlook reflects our view that we cannot dismiss the possibility that the parent might decide to again require capital payouts substantially exceeding net income, both because HBBM's current capitalization exceeds its regulatory requirements and because this would help the bank achieve its targeted return on equity.

Our stand-alone analysis of HBBM recognizes the bank's dominant competitive position in Bermuda, particularly in serving the reinsurance sector, the mainstay of the Bermudian economy and its highest-income segment. At the same time, we see downside risk if HBBM were to continue to cede market share to competitors (such as with the 2016 sale of its private banking and trust businesses).

Our assessment of the bank's risk position is unchanged. The bank's loan performance has improved, but NPAs are still elevated relative to those of peers. At year-end 2017 (most-recent reported financial results), adjusted NPAs to customer loans and other real estate owned were 19%, though somewhat lower if troubled debt restructurings are excluded (15%). NPAs as a share of loans by both measures remain substantially higher than those of HBBM's closest competitor in Bermuda (Bank of N.T. Butterfield & Son Ltd., BBB+/Positive/A-2), with the latter's equivalent measures at 3.0% and 1.5%, respectively, as of the same date (we believe part of the difference results from the latter's better-performing exposures outside the territory).

We continue to view HBBM's funding profile as average for a Bermudian bank, but its liquidity profile as strong (better than the average Bermudian bank), given substantial holdings of highly liquid assets (almost half were rated 'AAA') and very little short-term wholesale funding (less than 1% of its funding base), at Dec. 31, 2017.

Although we do not believe Bermuda to be one of HSBC's priority growth markets, and HBBM is small as a share of the group, the bank is wholly owned by its parent, uses its parent's branding, and has a leading market position within Bermuda. Moreover, we think customers' belief that HSBC stands behind its subsidiaries is important to the parent's global franchise.

Outlook

The stable outlook implies upside and downside risks of similar likelihood during the coming two years. Our base-case expectation is that the group's proclivity to provide extraordinary support to its Bermudian subsidiary will not meaningfully weaken during that period, and it will not extract capital from the bank that causes our RAC to fall below 15%. We also expect the bank to maintain good profitability and make gradual progress in reducing its NPAs as a share of loans. In an alternate scenario, we view the chance of strengthening positive momentum in the Bermudian economy and the risk that the parent could extract so much capital that our RAC could fall below 15% as roughly offsetting.

We could raise our ratings on HBBM if we believe that signs of nascent recovery in the local economy will persist, leading to an improvement in the economic risk score in our BICRA assessment and a revision in our anchor for bank ratings in Bermuda to 'bbb' from 'bbb-'. However, we are unlikely to raise the ratings unless we believe that capital payouts to the parent will not increase, in those circumstances, sufficiently to bring our RAC significantly below 15%, asset quality improves significantly, or there is some further sign that the group is more committed to Bermuda.

We could lower the ratings if we believe the group's proclivity to support its Bermudian operations will soon meaningfully decline, it extracts dividends from the bank that cause its RAC to fall below 15% regardless of domestic economic conditions, or the bank's asset quality or market share in Bermuda weaken further.

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- 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: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Ratings List

Ratings Affirmed; Outlook Action

	To	From
HSBC Bank Bermuda Ltd.		
Issuer Credit Rating	A-/Stable/A-2	A-/Negative/A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.