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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-			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

Our negative outlook on HSBC Bank Bermuda (HBBM) reflects the possibility of a downgrade related to group support and bank-specific factors. If the strategic importance of the Bermuda bank to the parent were to change in our view, we could lower our ratings. We could also lower our ratings if the bank's stand-alone credit profile (SACP) were to weaken: For example, if higher-than-expected payouts were to result in the risk-adjusted capital (RAC) ratio staying below 15% on a sustained basis, or if the bank were to cede significant market share to its competitors. On the other hand, we could revise the outlook to stable, within two years, if we were to believe that HBBM's strategic importance to the parent is unlikely to materially change, if capital ratios were to remain close to current ranges, or if asset quality improvements were to continue at a faster pace and converge more closely with those of peers.

Rationale

We recognize the bank's dominant competitive position in Bermuda, particularly in serving the reinsurance sector. At the same time, we see downside risk if HBBM were to continue to cede market share to competitors (such as with the 2015 sale of its private banking and trust businesses). The bank's earnings have been robust in recent years and its capital ratios remain very strong (RAC ratio of 18% as of year-end 2017), but in several recent years, dividend payouts have exceeded net income. HBBM's loan performance has improved, but is still elevated relative to that of peers. At year-end 2017, adjusted nonperforming assets to customer loans and other real estate owned were 19%, and were somewhat lower if troubled debt restructurings are excluded (15%). Finally, the bank receives three notches of ratings uplift for group support that reflect our view of its strategic importance to its parent company, U.K.-incorporated bank holding company HSBC Holdings PLC (HSBC; A/Stable/A-1).

Anchor:

We rank the banking sector of Bermuda (A+/Positive/A-1) under our Banking Industry Country Risk Assessment (BICRA) methodology, in BICRA group '5'. S&P Global Ratings' criteria define the BICRA framework as one "designed to evaluate and compare global banking systems."

On May 11, 2018, we revised our economic risk trend on Bermuda to positive from stable, in line with our positive outlook on our sovereign rating on Bermuda, the latter also recently revised, from stable. We see encouraging recent economic indicators in Bermuda, including increased visitor traffic, length-of-stay, and spending, combined with a return to positive real growth in GDP in 2017. Concern 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 the insurers and reinsurers that comprise Bermuda's economic bedrock, although we expect consolidation in those sectors to gradually continue. Major construction projects (such as the airport renovation) are also providing a temporary boost to employment and income. We may improve our economic risk score for Bermuda if we become convinced that the current economic rebound will persist. We continue to view the trend for industry risk as stable.

Table 1

HSBC Bank Bermuda Ltd. -- Key Figures					
	--Year ended Dec. 31--				
(Mil. US$)	**2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	9,027	9,757	11,992	11,459	14,163
Customer loans (gross)	2,436	2,461	2,569	3,062	3,329
Adjusted common equity	757	828	1,004	1,063	1,055
Operating revenues	302	281	304	326	368
Noninterest expenses	139	166	175	184	192
Core earnings	162	96	93	77	49

Business position:

We assess HBBM's business position as adequate, largely driven by its status as the second-largest Bermuda-based 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 with the entire Bermudian banking system, of which HBBM constitutes a dominant share, with over $8.9 billion in total assets as of June 30, 2018.

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 55% in Bermuda—well more than any of its competitors. 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 due to the sell-off of some of the bank's subsidiaries. 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 year of the past decade.

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 industry consolidation. 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--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	9,027	9,757	11,992	11,459	14,163
Customer loans (gross)	2,436	2,461	2,569	3,062	3,329
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Operating revenues	302	281	304	326	368
Noninterest expenses	139	166	175	184	192
Core earnings	162	96	93	77	49
Return on average common equity	20.5	10.2	8.9	6.7	3.3

Capital and earnings:

HBBM's RAC ratio remains very strong (our highest category), at about 18.0%, as of Dec. 31, 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 the very high dividend payout ratio. HBBM's parent has set return on equity targets, which we regard as ambitious for Bermuda. We believe that in order for HBBM to meet these targets, 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, 2017, HBBM's Common Equity Tier 1 capital ratio and total capital ratio were 21.7% and 22.3%, respectively. The bank'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 2017, aided by gains from sales of investments and a decline in operating expenses and loan impairment charges. We expect earnings to benefit from higher interest rates and better expense control 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 3.12%, 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--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	64.4	67.4	61.0	59.3	58.8
Fee income/operating revenues	16.8	20.1	24.4	26.3	26.5
Market-sensitive income/operating revenues	18.6	12.2	14.4	14.1	14.4
Noninterest expenses/operating revenues	46.0	58.9	57.6	56.6	52.3
Preprovision operating income/average assets	1.7	1.1	1.1	1.1	1.3

Risk position:

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: by our measure, NPAs as a share of loans, for the Bermudian banking industry as a group were 15% in 2015, and 14% in 2016-2017; for HBBM, the comparable measure was 21% in 2015, 22% in 2016, and 19% in 2017. We expect net charge-offs to remain elevated through 2018, as prior credit impairment is resolved and the economy recovers at a slow pace.

The bank's customer loan portfolio is about 25% of its total assets as of Dec. 31, 2017, 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, 2017. 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 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--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(1.0)	(4.2)	(16.1)	(8.0)	(12.8)
New loan loss provisions/average customer loans	0.0	0.8	1.3	2.0	3.5
Net charge-offs/average customer loans	0.7	2.7	1.2	5.9	1.0
Gross nonperforming assets/customer loans + other real estate owned	19.4	22.1	20.6	18.8	22.7
Loan loss reserves/gross nonperforming assets	32.7	31.3	22.7	20.3	31.5

Funding and liquidity:

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 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. In addition, there is no Bermudian debt market, so any potential capital markets funding must come from abroad (accounted for via our BICRA).

As of year-end 2017, HBBM's stable funding ratio (S&P Global Ratings' calculation) is about 89%, in line with its peer average. In addition, the bank's deposit liabilities are typically extremely short term (as of Dec. 31, 2017, 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 40% of total assets, at Dec. 31, 2017) and high quality (all investment securities were investment-grade, as of Dec. 31, 2017, and 48% were rated 'AAA'). Broad liquid assets comfortably cover its short-term wholesale funding, by about 98x. 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--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	38.1	33.7	34.5	27.1	42.2
Customer loans (net)/customer deposits	73.6	77.4	76.8	106.4	56.5
Long-term funding ratio	43.4	39.4	40.9	34.0	46.6
Stable funding ratio	88.5	85.2	82.0	79.8	117.7
Short-term wholesale funding/funding base	0.6	9.0	1.0	0.7	0.4
Broad liquid assets/short-term wholesale funding (x)	97.9	6.8	74.0	93.5	149.5
Short-term wholesale funding/total wholesale funding	0.9	13.5	1.5	1.0	0.8

Support:
We view HBBM as a strategically important subsidiary of HSBC. 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.

Related Criteria

- General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- 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
- Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Banking Industry Country Risk Assessment: United Kingdom, Nov. 5, 2018
- Moderating Property Prices And Private Sector Leverage To Temper Economic Risk For Hong Kong Banks, Oct. 22, 2018
- Rearranged And Ready: U.K. Banks Are On Track For Ring-Fencing, Aug. 15, 2018
- Industry Report Card: U.K. Banks Keep Calm And Carry On Amid Brexit Uncertainty, Aug. 13, 2018

- HSBC Holdings 'A/A-1' Ratings Affirmed; Outlook Stable, July 4, 2018
- New Ring-Fenced Entity HSBC UK Bank PLC Assigned 'AA-/A-1+' Ratings; Outlook Stable, June 27, 2018
- Summary: HSBC Bank PLC, June 18, 2018
- Bulletin: HSBC Ratings Unaffected By Growth-Focused Strategy Update, June 11, 2018
- Bank of N.T. Butterfield & Son Upgraded To 'BBB+' On Improved Business Position; HSBC Bank Bermuda Affirmed At 'A-/A-2', May 11, 2018
- Bermuda Outlook Revised To Positive From Stable On Prospects Of Sustained Economic Growth And Improved Fiscal Outcomes, April 26, 2018

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 23, 2018)

HSBC Bank Bermuda Ltd.	
Issuer Credit Rating	A-/Negative/A-2
Issuer 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
Sovereign Rating	
Bermuda	A+/Positive/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.