Asia Credit Research

BREXIT: Isolating the noise on HSBC and Standard Chartered

Monday, 23 May 2016

Summary / Key credit considerations

- With exactly a month to go, uncertainty remains as the BREXIT referendum date approaches. This it seems is the only certainty at the moment.
- The sector that stands to lose the most from (or is most exposed to) a potential BREXIT is the UK's financial services sector for a variety of reasons.
- Considering this, we have looked at the operating statistics of HSBC Holdings Ltd (HSBC) and Standard Chartered PLC (SCB), to see if vulnerabilities exist and which one could be relatively better placed.
- Our conclusion is that the credit profiles of HSBC and SCB, while not immune to the volatility that such uncertainty will generate, should be relatively sheltered from the BREXIT vote considering their large diversified businesses and relatively lower reliance on wholesale funding.

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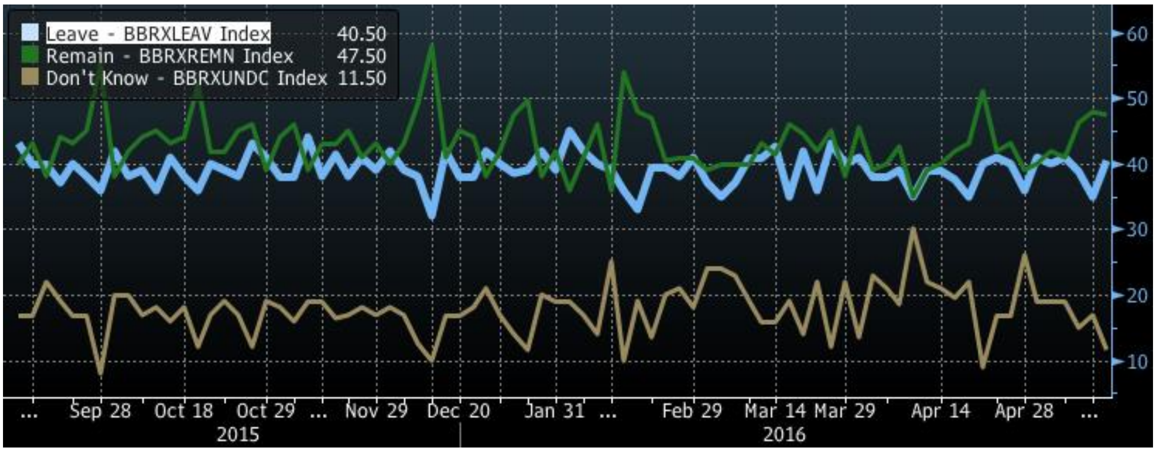
The Rollercoaster is just beginning

The shadow of BREXIT has been looming and the shadow is getting larger as the June 23rd referendum date approaches. While there appeared to be greater clarity of voter intentions to remain in the EU just a few days ago, sentiments have now turned more negative making the outlook a little hazy. According to Bloomberg's Composite EU Referendum Poll Tracker[1], an equal number of respondents (41%) voted to remain or leave the EU as recent as early May. This contrasted with a month ago when 51.5% of respondents preferred to remain in the EU while 40% voted to leave. During this time, voters who were unsure rose from 8.5% to 19%. While unsure voters have now dropped to 11.5%, we've seen more volatility in opinions of late indicating just how difficult it could be to predict the outcome based on polls. This is despite an acknowledgement by respondents that that there are almost as many risks of leaving the EU as there are benefits and there is increasing lobbying by politicians of the negative consequences of an exit on the UK economy. Rather than making people's minds clearer, it seems uncertainty is increasing. This is about the only thing that people are certain of for the coming weeks.



Source: Bloomberg, 23 May 2016

[1] **The Bloomberg Composite EU Referendum Poll Tracker takes the average of poll data from surveys done by market research firms including BMG Research, ComRes, ICM Research, Ipsos, MORI, ORB International, Survation, and YouGov. The survey asks "Should the United Kingdom remain a member of the European Union or leave the European Union?"**

Financial Services Likely To Be Most Impacted

While uncertainty remains on the outcome as well as the potential impact of BREXIT (both short term and long term), it seems clear that the one sector most exposed to the referendum is the financial services sector. This is because of the sector's strong contribution to the UK economy (around 10% of GDP including banking, insurance, fund management and securities dealing[2]) and London's status as a financial hub for Europe. The sector benefits from a relatively high level of foreign direct investment which could be under threat in the event of a BREXIT. This is because the UK leaving the EU invites high uncertainty regarding the future provision of financial services into and out of the UK and Europe including the status of passporting rights for the provision of financial services by UK banks into the EU. Indeed, it's been well documented that a BREXIT is likely to pose multiple challenges for UK banks including:

1. The shifting of operations and certain services out of London and into the EU which will impact business volumes. According to Standard & Poor's[3], 40% of net earnings in the financial services sector comes from trade with the EU;
2. Exposure to a slower UK Economy for domestically focused UK banks which could impact profitability, loan quality and asset prices. Demand for credit is also expected to slow in the lead up to the referendum as risk aversion increases towards the referendum date and potentially following the referendum on the expectation of a prolonged period of uncertainty;
3. Weaker prospects for export oriented sectors in the UK that could experience a drop in demand for UK exports to the EU due to possible imposition of tariffs which would make its goods more costly or impact its profit margins if it were to absorb the tariffs. The long-term impact is less certain as a likely weaker GBP against the EUR would make UK goods competitive;
4. A rise in wholesale funding costs reflecting market volatility and an expectation of weaker credit metrics for UK Banks going forward. Moody's[4] recently opined that the Bank of England's Credit Conditions Survey indicated an increase in wholesale funding spreads for UK banks during the first quarter of 2016. Moody's also commented that CDS for large UK banks had widened more than CDS for global systemically important banks headquartered in Europe outside the UK;
5. Diminution of values for UK non-core assets that are targeted for sale in restructuring plans. For instance, SCB identified USD20bn of risk weighted assets for sale as part of its strategic plan announced in November 2015;
6. Potentially longer period of low interest rates should the UK economy need priming due to an anticipated slowdown; and
7. Likely pressure on capital raising activities which could increase given potential challenges to internally generating capital.

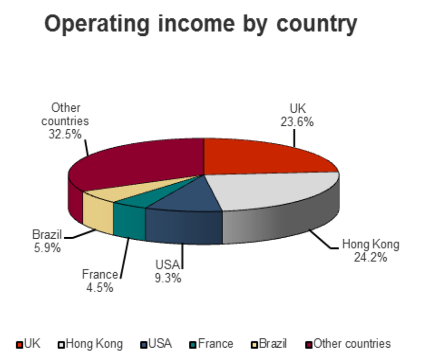
With the above in mind, we have taken a look at two banks that have entities with Singapore dollar issues that are domiciled in the UK to see if vulnerabilities to the above risks exist in their businesses. The first is HSBC Holdings Ltd although we note that the issuer of the SGD bonds is The Hongkong and Shanghai Banking Corp. Ltd., the group's Asia-Pacific subsidiary with operations mainly in Hong Kong (63% of FY2015 net operating income), China (10%) and Singapore (5%). As such, this entity is not directly impacted by the events in Europe although could be indirectly impacted as a key subsidiary of the HSBC Group. The other is Standard Chartered PLC, the holding company for the group which includes subsidiaries Standard Chartered Bank and Standard Chartered Bank (Hong Kong) Ltd. All three entities have issued SGD bonds but our data is at the hold co level.

We used the following parameters to assess potential vulnerabilities:
1. Business segment breakdown for presence of retail banking and capital market activities;
2. Geographic exposure for domestic against international (in particular EU) exposure;
3. Loans by Industry to assess exposure to UK based export oriented sectors. Industries potentially affected include machinery manufacturing, automotive, precious metals and pharmaceuticals which were the top exports out of the UK in the past few years;
4. Reliance on wholesale funding; and
5. Capital levels.

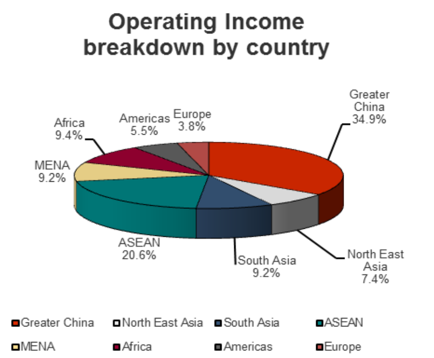
[2] City of London – economics research and Information
[3] Brexit Risk For The U.K. And Its Financial Services Sector: It's Complicated, June 23rd, 2015
[4] Brexit Vote Risks Include Higher Funding Costs, Challenges to Operating Models, May 5th, 2016

Geographic Breakdown:

HSBC Holdings Ltd (HSBC)



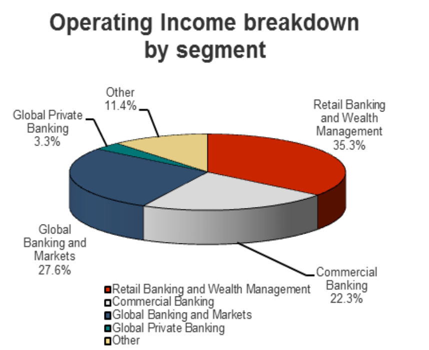
Standard Chartered PLC (SCB)



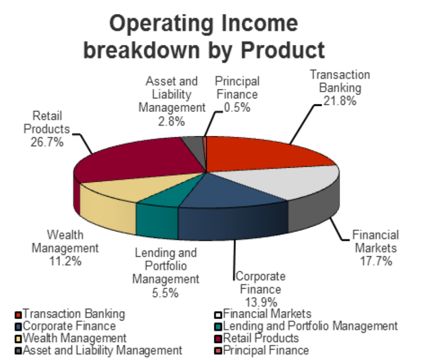
Both banks have geographically diverse businesses with HSBC having the higher exposure to the UK by operating income at 23.6% as at December 2015. However HSBC's strong market positions in its other markets, in particular Hong Kong, is expected to mitigate operating conditions in the UK and Europe. In particular, HSBC has a highly diversified exposure to stronger operating environments which contributes to earnings stability. On the other hand, SCB has a lower reliance on the UK and the EU than HSBC. That said, its credit profile is weighed down more by higher exposure to emerging markets with challenging operating conditions including MENA and India. This has seen profitability hit by rising credit costs and restructuring charges. In summary, UK and EU exposure is not a vulnerability for either bank in our view.

Business segment breakdown

HSBC Holdings Ltd (HSBC)



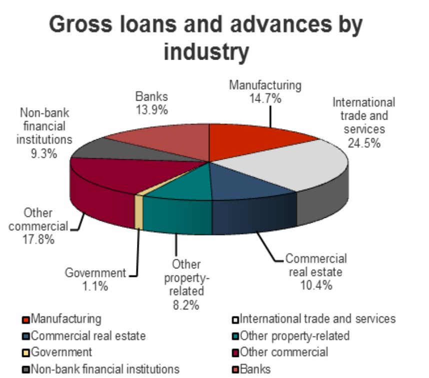
Standard Chartered PLC (SCB)



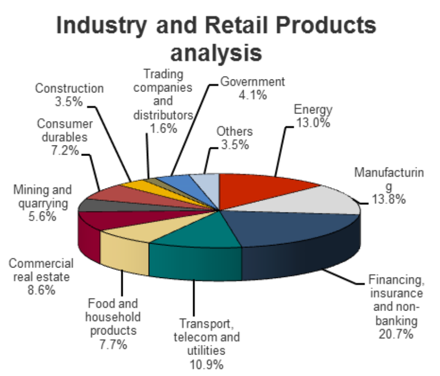
HSBC and SCB both have diversified business models which include capital market activities as part of Global Banking and Markets (GBM) for HSBC and Financial Markets for SCB. GBM is a relatively large contributor to operating income and consolidated PBT for HSBC at 28% and 42% respectively as at December 2015. By region however, GBM from UK contributes 2% to total consolidated PBT. In SCB's case, financial markets is the third largest contributor by segment at 18% of consolidated operating income. This business segment however is unlikely to impact the consolidated credit profile in BREXIT given the small contribution of Europe to the overall operating income. An additional mitigant to volatility in capital market activities in the event of BREXIT is the relatively high contribution of retail banking which is a more resilient and stable business model. In summary, the bank's diversified business segments should mitigate the loss of any markets related businesses.

Loans by Industry

HSBC Holdings Ltd (HSBC)

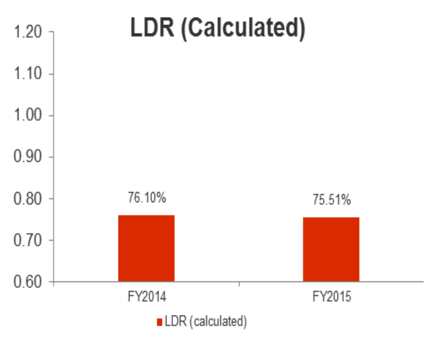
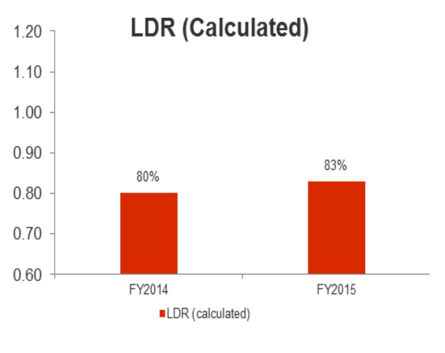


Standard Chartered PLC (SCB)

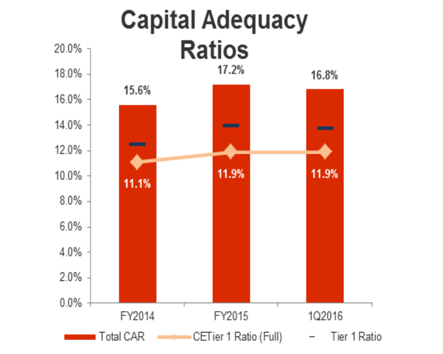
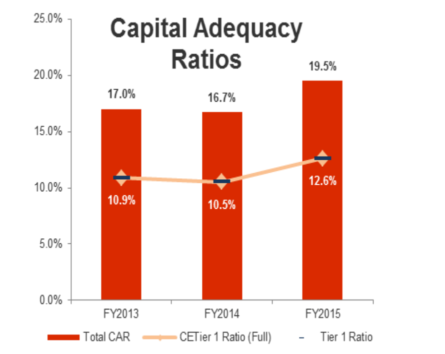


Given HSBC's strong retail franchise, personal loans comprise 37% of total gross loans and advances at 31 December 2015 with corporate and commercial loans at 49%. We put the maximum potential vulnerable loans to a slowdown at around 13% which comprises EU loans in manufacturing, international trade and services, commercial real estate and other property-related loans. These loans are not further broken down between EU and UK. For Standard Chartered, we estimate loans exposed to BREXIT impact at around 2% of total loans and advances. These loans are located in Europe and are in manufacturing, commercial real estate, consumer durables, construction and trading. Again, these loans are not further broken down between EU and UK therefore it is difficult to judge for both banks where most of this exposure resides.

Reliance on wholesale funding

HSBC Holdings Ltd (HSBC)	Standard Chartered PLC (SCB)	
		We measure reliance on wholesale funding by the loan to deposit ratio which was calculated using loans and advances to banks and customers over deposits by banks and customer accounts as at FY2015. While there is some reliance on wholesale funding, in general both banks benefit from their solid retail franchises, particularly in Asia. As such, reliance on wholesale funding is less compared to some of their European peers (in particular the Netherlands and France) which have loan to deposit ratios above 100%. Given this, a rise in wholesale funding costs should have a containable impact on HSBC's and SCB's credit profile.

Impact on Capital Issuance plans

HSBC Holdings Ltd (HSBC)	Standard Chartered PLC (SCB)	
		Capital requirements for UK banks are somewhat stringent with banks having to meet multiple capital requirements including Pillar 1 (minimum capital level to cover credit, market and operational risks), Pillar 2A (additional capital to cover all other risks), Pillar 2B (capital buffer for stress scenarios) as well as additional discretionary capital. Having said that, there still remains uncertainty on exact future capital requirements given some capital bucket levels are finalized and fully implemented, some are finalized but in transition and others are uncertain with only ranges disclosed. Both HSBC and SCB have estimated their capital requirements based

on current capital guidelines and disclosed them in their most recent annual reports. HSBC has estimated its overall capital requirements at 1 January 2019 at 15.5% (of which we estimate CET1 to comprise around 11%). SCB has similarly estimated its CET1 capital requirements for 2019 at 9.1% (we estimate this translates to overall capital requirements of around 13.3%). Based on these levels, both banks are above the expected minimum requirements for 2019 reflecting pro-active measures to strengthen capital levels to meet somewhat challenging operating conditions. SCB completed a USD5.1bn rights issue in December 2015 and is seeking to reduce its risk weighted assets to combat weak profitability while HSBC's capital levels remain supported by relatively stable earnings generation as well as lower costs and asset sales as part of its 10 strategic priorities announced in June 2015.

Conclusion

In summary, we think the credit profiles of these banks are not overly exposed to BREXIT. As noise volume possibly begins to rise as the BREXIT vote approaches, we think volatility in bond prices for HSBC or SCB may be overdone, especially if fundamentals remain more or less unchanged. Possible impacts from a BREXIT will also likely not happen overnight and take some time as regulators and legislators work out the details. An additional softener to impacts are supportive comments from the Bank of England that they will remain supportive of UK banks during any period of instability through provision of liquidity if needed around the referendum.

Bond	Moody's Bond rating	Coupon	Last Price	Average Price*	Maturity / Call Date
HSBC Float '30	Aa2	2.48% (SOR6m+80bps)	101.32	92.20	04/09/30
HSBC Float '25	Aa2	2.91% (SOR6m+128bps)	104.10	99.49	09/09/25
STANLN 4.4%'26	A3	4.40%	102.75	102.75	23/01/21
STANLN 4.15'21	A2	4.15%	102.88	102.88	28/10/16
STANLN 5.25% '23	A3	5.25%	103.38	103.35	10/04/18

*** Average prices cover period from 1 Jan 2016 to 20 May 2016**

Source: Bloomberg, 23 May 2016