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## HSBC impairments surge and dividends slide

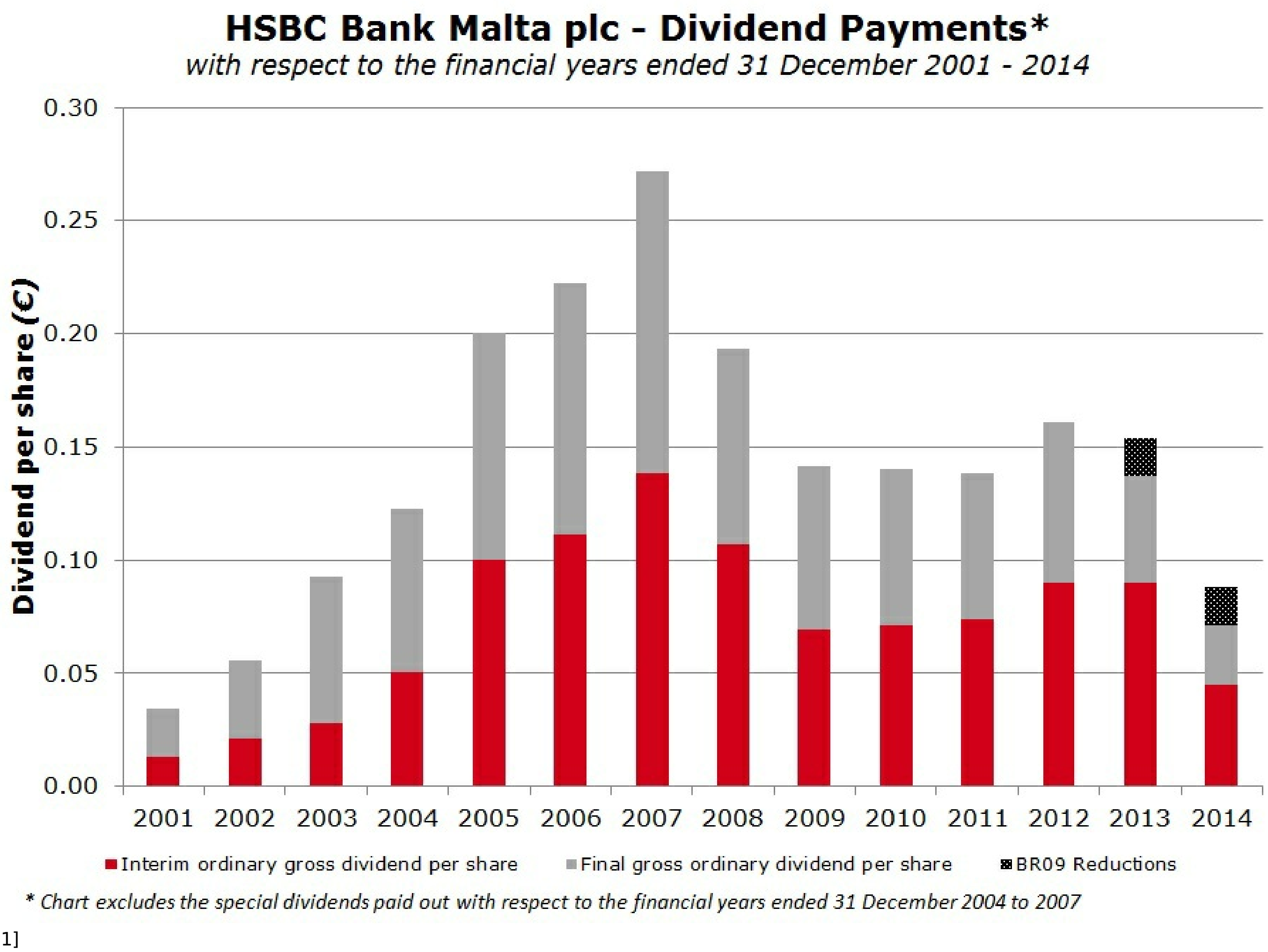
The financial reporting season commenced on a negative note as HSBC Bank Malta plc announced a 42% decline in pre-tax profits to €52.1 million – the weakest performance since 2002.

The single largest contributor to the drop in profits was the surge in impairments. During the financial year ended 31 December 2014, impairments increased by €19.3 million to €22.5 million. During the press conference last Monday afternoon, HSBC Malta's CEO Mr Mark Watkinson explained that the Board of Directors adopted a more cautious approach on a handful of long-outstanding non-performing loans. The CEO noted that fresh property valuations were conducted on the collateral held of these well-known problematic loans within the commercial real-estate sector and the results indicated lower values mainly due to the delay in the sales momentum over the years. Mr Watkinson said that despite the recognition of such impairments, the Bank will still vigorously pursue the recovery of these facilities which may possibly result in some write-backs in the future. When questioned whether this increased provisioning reflected the results of the Asset Quality Review performed by the European Central Bank during 2014, the CEO argued that the figure of €30.6 million in under-provisioning that was revealed by the ECB reflected the position as at 31 December 2013. Mr Watkinson noted that material loan repayments were made by the Bank's customers during 2014 which resulted in this under-provisioning being reduced to €14.7 million. As such, the actual impairments taken by HSBC during 2014 reflect a more conservative view than the findings of the AQR.

The level of impairments accounted for in the 2014 financial statements is a clear outlier compared to that in recent years when provisions ranged between a low of €1.9 million in 2008 and a high of €8.3 million in 2011. Prior to 2008, HSBC Malta had actually recognised recoveries between 2003 and 2006. While the high impairments of 2014 may therefore be regarded as a one-time exercise to bring the Bank in line with improved practices and recent recommendations by the regulators, HSBC's CEO indicated that the Bank will continue to behave in a more prudent manner going forward especially if the performance of certain sectors in the economy remains challenging.

Although the significant increase in impairments was the primary reason for the steep decline in profits, the financial statements also show that lower income was registered across all core business activities.

Net interest income dropped by 3.6% to €120.2 million (the lowest level since 2010) as overall net loans declined and interest earned on investments also decreased as higher yielding maturing bonds were reinvested at lower rates of interest. This is a reflection of the challenging interest rate environment for retail banks which is likely to remain unchanged over the next few years.

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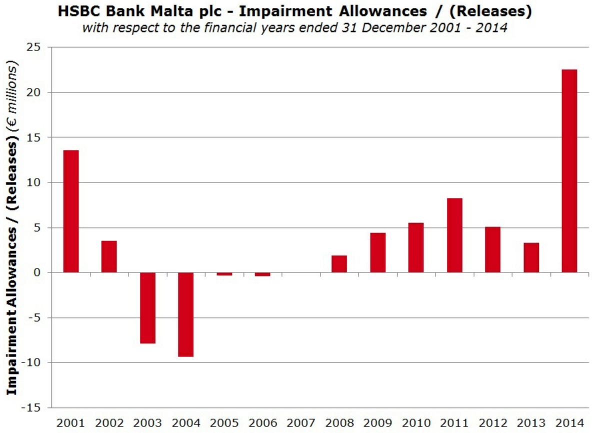
Non-interest income activities were also under pressure during 2014 with HSBC reporting the lowest level in the last 10 years largely due to the €4 million drop in pre-tax profits registered by the Group's life assurance subsidiary to €9 million reflecting the negative impact of the prevailing decline in yields and lower technical reserve releases which offset the 10% growth in new insurance business. Furthermore, net fee and commission income edged 3.7% lower to €28.5 million and trading profits related to foreign exchange activities dropped by 7.7% to €8.8 million. Additionally, the Bank reported a lower amount of gains on disposal of available for sale financial instruments at €1.7 million compared to €4.3 million in 2013.

While the reduction in revenue across most of the activities was a reflection of the current interest rate environment, some of this was also self-inflicted following the winding down of the fund administration and custody businesses in early 2014 which negatively impacted fee and commission income. The decision by HSBC Malta to discontinue these services reflected a revised group-wide policy on risk management practices.




Moreover, the performance of HSBC Malta in 2014 was also negatively hit by the higher cost base. Operating expenses increased by 5.4% to €95.4 million largely reflecting the additional compliance and regulatory costs (associated with the build-up of the internal compliance function, the ECB’s Comprehensive Assessment and higher regulatory fees) as well as a rise of €1 million in early voluntary retirement costs. In fact, excluding these extraordinary items, operating costs were flat as the cost savings from the simplification and re-engineering of processes counterbalanced the adverse impact of the annual increase in staff salaries, the impact of inflation and continued investment in technology. The cost to income ratio deteriorated to 56.8% in 2014 from 49.9% in 2013.

Due to the steep decline in profits, the Directors of HSBC recommended a final gross dividend of €0.026 per share representing a 44.4% decline from the previous years’ final dividend. In September 2014, HSBC Malta paid an interim dividend of €0.045 per share. Therefore, the total gross dividend in respect of the 2014 financial year amounts to €0.071 per share representing a 48.1% drop from the previous year’s total dividend and the lowest dividend distribution to shareholders since 2002. In fact, the gross dividend yield based on the current share price of €1.90 is only 3.74% compared to a significantly higher yield in previous years.

The reduction in dividends compared to 2013 and prior years is a combination of the lower profit levels registered during 2014 as well as the impact of the new Banking Rule 09 (BR09) which came into effect in December 2013. The amended rule requires banks to hold a ‘Reserve for General Banking Risk’ calculated as a percentage of non-performing loans. This reserve is required to be funded from planned dividends. To date HSBC have already set aside €7 million representing 85% of the currently estimated reserve and the remaining 15% will be set aside in 2015. In effect, the impact of BR09 will be significantly lower during the current financial year to 31 December 2015.

Last Monday, the Directors or HSBC Malta also recommended a bonus share issue of 1 new share for every 9 held. Shareholders as at close of trading on 27 April 2015 will be entitled to receive these additional shares subject to approval at the upcoming Annual General Meeting scheduled to take place on 22 April 2015. While this may be a good initiative for regulatory purposes due to the transfer of distributable reserves to non-distributable reserves, the impact for shareholders should be neutral since the additional shares should be reflected in an adjustment to the share price after the distribution of the new shares in April 2015. Unfortunately, many local retail investors still view a bonus share issue as an additional financial compensation apart from the dividend. However, this is incorrect and investors need to understand the overall implications of such corporate actions correctly.

***“…the impact of BR09 will be significantly lower during the current financial year to 31 December 2015.”***

HSBC’s CEO clearly stated at the start of last Monday’s press conference that the challenging interest rate environment and the negative implications of increased regulatory costs is “not a five minute event and will prolong into the medium-term”. Investors need to take stock of this new reality when reviewing their banking exposures in their portfolios especially in view of the upcoming quantitative easing programme of the European Central Bank which is expected to place further downward pressure on real interest rates thereby limiting investment opportunities further for the excess liquidity of the banks. Such an environment is not favourable for banks and HSBC’s announcement earlier this week is a clear indication that the dividends paid out in recent years may not be sustainable going forward given the various headwinds across the banking sector coupled with the regulatory restrictions on dividend payments by banks.



URLs in this post:

[1] Image: **http://rizzofarrugia.com/wp-content/uploads/Article-372_Chart-2.jpg**