

# The Hongkong and Shanghai Banking Corporation Limited

(Incorporated in the Hong Kong SAR with limited liability)

## Basel II disclosures of the India Branches

for the year ended 31 March 2010

### 1 Scope of Application

The capital adequacy framework applies to The Hongkong and Shanghai Banking Corporation Limited – India Branches “The Bank”. The Bank has a subsidiary, HSBC Agency (India) Private Limited, which is consolidated in line with AS 21 and full capital deduction is taken. The Bank does not have any other group company where a pro-rata consolidation is done or any deduction is taken. The group entities in which the Bank has minority interests which are neither consolidated nor capital deducted are HSBC Professional Services (India) Private Limited and HSBC Consumer Finance (India) Private Limited. The investments in these companies are appropriately risk weighted.

(i) *Capital deficiencies in all subsidiaries not included in the consolidation*

The aggregate amount of capital in HSBC Agency (India) Private Limited of Rs. 500 (000s) is not included in the consolidation and is deducted from capital.

(ii) *Banks total interest in insurance entities*

The Bank has no interests in any of the insurance entities of the group.

### 2 Capital Structure

In August 1999, the Bank raised a 10 year subordinated debt of Rs 2,000 million at 13.05% interest, which was fully subscribed through private placement. CRISIL assigned a rating of AAA/stable to the Subordinated debt. The subordinated debt matured in August 2009.

(i) *Composition of Tier 1 capital*

(from audited accounts)  
Rs '000

	<b>As at 31 March 2010</b>
Capital	44,991,660
Reserves	53,896,348
Innovative instruments	-
Other capital instruments	-
Amounts deducted from Tier 1 capital	(7,448,792)
<b>Total Tier 1 capital</b>	<b>91,439,216</b>

(ii) *Tier 2 capital*

The amount of Tier 2 capital (net of deductions) is Rs. 7,705,285 ('000).

(iii) *Debt capital instruments in upper Tier 2 capital*

No debt capital instruments are included in upper Tier 2 capital.

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 2 Capital Structure (Continued)

(iv) *Subordinated debt in lower Tier 2 capital*

There is no amount outstanding in respect of subordinated debt as at 31 March 2010.

(v) *Other deductions from capital*

There are no other deductions from capital.

(vi) *Total eligible capital*

The total eligible capital is Rs 99,144,501 ('000).

### 3 Capital Adequacy

The Bank's capital management framework is shaped by the structure, business model and strategic direction. There is a continuing need to focus on the effective management of risk, and commensurate capital to bear that risk. The Bank carefully assesses its growth opportunities relative to the capital available to support it, particularly in light of the economic environment and advent of Basel II.

The Bank maintains a strong discipline over capital allocation and ensuring that returns on investment cover capital costs.

(i) *Capital requirements for credit risk*

Rs '000

	<b>As at 31 March 2010</b>
Portfolios subject to standardised approach	32,923,578
Securitisation exposures	-
<b>Capital requirements for credit risk</b>	<b>32,923,578</b>

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 3 Capital Adequacy (Continued)

#### (ii) Capital requirements for market risk

Rs '000

	As at 31 March 2010
<b>Standardised Duration Approach</b>	
Interest rate risk	8,669,901
Foreign exchange risk	405,000
Equity risk	32,215
<b>Capital requirements for market risk</b>	<b>9,107,116</b>

#### (iii) Capital requirements for operational risk

The capital requirement for operational risk under the basic indicator approach is Rs. 7,463,036 ('000).

#### (iv) Capital ratios

	As at 31 March 2010
Consolidated total capital ratio	18.03%
Consolidated Tier 1 capital ratio	16.63%

There is no significant subsidiary for which the above disclosure is required.

### 4 Credit risk: general disclosures for all banks

Credit Risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance, marked-to-market exposure from derivatives contract and certain off-balance sheet products such as guarantees, and from the Bank's holdings of assets in the form of debt securities.

#### **Strategy and Processes (including credit risk management policy of the Bank)**

The HSBC Group Head Office "HSBC" formulates high-level risk management policies for the HSBC Group worldwide. The Bank has formulated local credit guidelines consistent with the HSBC policy. The Bank's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that all types of risk are systematically identified, measured, analyzed and actively managed.

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **4 Credit risk: general disclosures for all banks (*Continued*)**

The Bank has standards, policies and procedures dedicated to the monitoring and management of credit risk, which include the following:

- Establish and maintain the large credit exposure policy. This policy delineates the bank's maximum exposures to individual customers, customer groups and other risk concentrations. Ensure compliance with the lending guidelines to the specified market sectors and industries. Controlling exposures to the selected industries by imposing restrictions on new business, where required.
- Undertake independent review and objective assessment of the credit risk. All commercial non-bank credit facilities originated are subject to review prior to the facilities being committed to customers.
- Control exposures to banks and other financial institutions. The Group's credit and settlement risk limits to counterparties in the finance and government sectors are designed to optimise the use of credit availability and avoid excessive risk concentration.
- Manage exposures to debt securities by establishing controls in respect of the liquidity of securities held for trading and setting issuer limits for financial investments. Separate portfolio limits are established for asset-backed securities and similar instruments.
- Control cross-border exposures to manage country and cross-border risk through the imposition of country limits with sub-limits by maturity and type of business.
- Maintain and develop HSBC's risk rating framework and systems, in order to classify exposures meaningfully and facilitate focused management of the risks involved. Rating methodologies are based upon a wide range of financial analytics together with market data-based tools, which are core inputs to the assessment of customer risk. For larger facilities, while full use is made of automated risk rating processes, the ultimate responsibility for setting risk ratings rests with the final approving executive. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

#### **Structure and Organization**

Credit approval authorities are delegated from the Chief Risk Officer at the Regional Head Office in Hong Kong to the Chief Executive Officer, India. The Head of Risk Management in India maintains a strong functional reporting line to the Chief Risk Officer in Hong Kong.

The Risk Management function is responsible for the quality and performance of its credit portfolios and for monitoring and controlling all credit risks in its portfolios, including those subject to approval by the Regional Head Office in Hong Kong.

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 4 Credit risk: general disclosures for all banks (Continued)

#### Scope and nature of risk reporting and measurement

The Bank manages and directs credit risk management systems initiatives. HSBC has constructed a centralized database covering substantially all of the Group's direct lending exposures, to deliver an increasingly granular level of management reporting. An electronic credit application process for banks is operational throughout the Group and a similar corporate credit application system covers almost all Group corporate business by value.

The Bank is required to maintain regular reporting on credit risk portfolio, to include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

#### Non performing advances (NPAs)

Non performing advances are identified by periodic appraisals of the portfolio by management or in accordance with RBI guidelines, whichever is earlier.

Specific provisions are made on a case by case basis based on management's assessment of the degree of impairment of the advances (other than homogeneous retail loans, except mortgage loans), subject to the minimum provisioning levels prescribed by the RBI. Where there is no longer any realistic prospect of recovery, the outstanding advance is written off.

Special attention is paid to problem exposures, which are subject to more frequent and intensive review and reporting, in order to accelerate remedial action. The bank engages with customers closely to work out of distress situations. Where there is no longer any realistic prospect of recovery, the outstanding advance is written off.

Subject to the minimum provisioning levels prescribed by the RBI, provision on homogeneous loans relating to retail business (except mortgage loans) is assessed on a portfolio basis using the historical loss and/or net flow method.

#### (i) Total gross credit risk exposures

			<i>Rs '000</i>
			<b>As at 31 March 2010</b>
<b>Fund based</b> <sup>Note 1</sup>	<b>Non fund based</b> <sup>Note 2</sup>	<b>Total</b>	
375,653,662	461,121,851	<b>836,775,513</b>	

Note 1: Amount represents funded exposure before credit risk mitigants.

Note 2: Amount represents non-funded exposure after applying credit conversion factor and before credit risk mitigants.

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## Basel II disclosures of the India Branches (Continued)

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### 4 Credit risk: general disclosures for all banks (Continued)

(ii) Geographical distribution of exposures

Rs '000

	As at 31 March 2010		
	Fund based	Non fund based	Total
Overseas	-	-	-
Domestic	375,653,662	461,121,851	836,775,513
<b>Total</b>	<b>375,653,662</b>	<b>461,121,851</b>	<b>836,775,513</b>

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## Basel II disclosures of the India Branches (Continued)

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### 4 Credit risk: general disclosures for all banks (Continued)

(iii) Industry type distribution of exposures

Rs '000

Industry	Fund based	Non fund based	Total
Coal	550,548	698,519	1,249,067
Mining	312,207	188,099	500,306
Iron & Steel	1,778,254	3,820,572	5,598,826
Other Metals & Metal Products	6,522,275	10,389,197	16,911,472
All Engineering	9,264,406	19,248,133	28,512,539
Electricity (Gen & Trans.)	-	-	-
Cotton Textiles	4,243	-	4,243
Jute Textiles	-	-	-
Other Textiles	7,041,823	6,536,843	13,578,666
Sugar	158,546	9,083	167,629
Tea	282,903	2,161	285,064
Food Processing	3,444,143	1,595,572	5,039,715
Vegetable Oils (including Vanaspati)	629,434	200	629,634
Tobacco & Tobacco Products	3,730,553	2,169,390	5,899,943
Paper & Paper Products	2,868,902	3,478,799	6,347,701
Rubber & Rubber Products	472,586	200,350	672,936
Chemicals, Engineering and infrastructure	17,599,833	12,671,290	30,271,123
Cement	1,994,154	1,648,556	3,642,710
Leather and Leather Products	350,483	49,106	399,589
Gems and Jewellery	35,301	60	35,361
Construction	1,007,432	2,104,848	3,112,280
Petroleum	2,856,567	7,388,173	10,244,740
Automobiles including trucks	4,289,772	3,583,388	7,873,160
Computer Software	10,561,520	5,300,089	15,861,609
Infrastructure	12,808,920	39,136,043	51,944,963
Other Industries	115,185,567	109,548,872	224,734,439
NBFCs & Trading	17,850,717	2,024	17,852,741
Banking and Finance	80,545,769	228,278,102	308,823,871
Retail Advance	73,506,804	3,074,382	76,581,186
<b>Total</b>	<b>375,653,662</b>	<b>461,121,851</b>	<b>836,775,513</b>

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 4 Credit risk: general disclosures for all banks (Continued)

(iv) Residual contractual maturity breakdown of total assets

Rs '000

	<b>As at 31 March 2010</b>
1 day	22,930,234
2 to 7 days	38,411,151
8 to 14 days	11,999,045
15 to 28 days	48,538,600
29 days & upto 3 months	176,540,921
Over 3 months & upto 6 months	121,802,279
Over 6 months & upto 1 year	103,940,724
Over 1 year & upto 3 years	152,260,627
Over 3 years & upto 5 years	120,721,507
Over 5 years	107,108,836
<b>Total</b>	<b>904,253,924</b>

(v) Amount of NPAs (Gross)

Rs '000

	<b>As at 31 March 2010</b>
Substandard	11,571,850
Doubtful 1	2,789,001
Doubtful 2	662,165
Doubtful 3	239,436
Loss	1,570,474
<b>Total</b>	<b>16,832,926</b>

(vi) Net NPA:

The net NPA is Rs 5,431,341('000).

(vii) NPA ratios

	<b>As at 31 March 2010</b>
Gross NPAs to gross advances	6.84%
Net NPAs to net advances	2.31%

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 4 Credit risk: general disclosures for all banks (Continued)

(viii) Movement of NPAs

(from audited accounts)

Rs '000

	Gross NPA's	Provision	Net NPA
Opening balance	13,161,444	9,251,100	3,910,344
Additions	23,977,351	7,391,103	16,586,248
Reductions (including write back/write off of excess provisions)	(20,305,869)	(5,240,618)	(15,065,251)
Closing balance	<b>16,832,926</b>	<b>11,401,585</b>	<b>5,431,341</b>

(ix) Non performing investments

Non performing investments as at 31 March 2010 are Rs. 3. This represents three equity investments which have each been written down to Re. 1 each.

(x) Movement of provisions for depreciation on investments

(from audited accounts)

Rs '000

	For the year ended 31 March 2010
Opening balance	3,407,977
Provisions made during the period	2,418,385
Write Off	-
Write back of excess provisions	-
Closing balance	<b>5,826,362</b>

# The Hongkong and Shanghai Banking Corporation Limited

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for the year ended 31 March 2010

### 5 Credit risk: disclosures for portfolios under the standardised approach

The Bank uses the following External Credit Assessment Institutions (ECAIs) approved by RBI to calculate its capital adequacy requirements under the standardised approach to credit risk

Domestic ECAIs for external ratings of Indian Corporates:

- a) Credit Analysis and Research Limited;
- b) CRISIL Limited;
- c) FITCH India; and
- d) ICRA Limited.

The Bank used the issue-specific ratings (for both Long Term and Short Term facilities) of all the above domestic ECAIs to risk weight both funded as well as non-funded exposures on corporate customers.

The process has used by the Bank to transfer public issue ratings onto comparable assets in the banking book is in line with the provisions advised in the Reserve Bank of India's Prudential Guidelines on Capital Adequacy and Market Discipline issued on 27th April 2007.

The mapping of external credit ratings and risk weights for corporate exposures are provided in the grids below:

Risk weight mapping of long term corporate ratings

Long term ratings	Risk weights
AAA	20%
AA	30%
A	50%
BBB	100%
BB & Below	150%
Unrated	100%

Risk weight mapping of short term corporate ratings

CARE	Short Term Ratings			Risk weights
	CRISIL	FITCH	ICRA	
PR1+	P1+	F1+	A1+	20%
PR1	P1	F1	A1	30%
PR2	P2	F2	A2	50%
PR3	P3	F3	A3	100%
PR4 & PR5	P4 & P5	B, C, D	A4 & A5	150%
Unrated	Unrated	Unrated	Unrated	100%

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 5 Credit risk: disclosures for portfolios under the standardised approach (Continued)

The claims on banks incorporated in India and foreign banks branches in India, excluding investment in equity shares and other instruments eligible for capital status are risk weighted as under:

CRAR %	Scheduled Banks	Other Banks
> 9	20%	100%
6 to < 9	50%	150%
3 to < 6	100%	250%
0 < 3	150%	350%
Negative	625%	625%

International ECAs for external ratings of Foreign Banks, Foreign Sovereigns, Foreign Public Sector Entities and Non-Resident Corporates:

- Fitch
- Moodys
- Standard & Poor's

The process used by the Bank to transfer public issue ratings onto comparable assets in the banking book is in line with the provisions advised in Reserve Bank of India's Guidelines.

The mapping of external credit ratings and risk weights for the above entities are provided in the grids below:

Risk weight mapping of foreign banks

<b>S&amp;P and Fitch ratings</b>	AAA to AA	A	BBB	BB to B	Below B	Unrated
<b>Moody's rating</b>	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
<b>Risk weight</b>	20%	50%	50%	100%	150%	50%

Risk weight mapping of foreign sovereigns

<b>S&amp;P and Fitch ratings</b>	AAA to AA	A	BBB	BB to B	Below B	Unrated
<b>Moody's rating</b>	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
<b>Risk weight</b>	0%	20%	50%	100%	150%	100%

Risk weight mapping of foreign public sector entities

<b>S&amp;P and Fitch ratings</b>	AAA to AA	A	BBB	Below BB	Unrated
<b>Moody's rating</b>	Aaa to Aa	A	Baa to Ba	Below Ba	Unrated
<b>Risk weight</b>	20%	50%	100%	150%	100%

Risk weight mapping of non resident corporates

<b>S&amp;P and Fitch ratings</b>	AAA to AA	A	BBB	Below BB	Unrated
<b>Moody's rating</b>	Aaa to Aa	A	Baa to Ba	Below Ba	Unrated
<b>Risk weight</b>	20%	50%	100%	150%	100%

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## **Basel II disclosures of the India Branches (Continued)**

*for the year ended 31 March 2010*

### **5 Credit risk: disclosures for portfolios under the standardised approach (Continued)**

(i) *Amount outstanding under various risk buckets (post CRM)*

*Rs '000*

	<b>As at 31 March 2010</b>
Below 100% risk weight	666,964,584
100% risk weight	120,393,008
Above 100% risk weight	36,901,617
Deductions*	(7,481,267)
Total	<b>816,777,942</b>
<small>* Deduction represents amounts deducted from Capital Funds</small>	

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **6 Credit risk mitigation: disclosures for standardised approaches**

#### Policy for Collateral Valuation and Management

It is the Bank's policy that all corporate and institutional facilities be reviewed (and hence revalued) at least on an annual basis. All deeds of ownership/titles related to collateral are held in physical custody under control of executives independent of the business.

For mortgages, the credit policy clearly outlines the acceptable Loan to value (LVR) ratios for different types of properties. The maximum LVR offered to customers cannot exceed 90% of the mortgaged property, except if approved under a special lending authority. The valuation of the property is initiated through a bank-empanelled valuer who is an expert on the subject matter. Additionally, for loans exceeding INR 5 million, dual valuations are also initiated in order to have the benefit of a second opinion on the mortgaged property. The disbursal of the loan is handled through an empanelled lawyer who in exchange collects the security documents from the borrower. The property documents thus collected are attached to the credit file & sent to central archives where the same is stored in a secure manner.

In the absence of an all India property price index, it is a challenge to benchmark & update the marked-to-market valuations of the properties financed by the bank on an ongoing basis. However, should a loan become a NPA, a fresh valuation is initiated through the bank empanelled valuer & the provisions applicable are calculated accordingly.

#### Main Types of Collaterals taken by HSBC

The main types of recognised collateral taken by the Bank appear in the list of eligible financial collaterals advised in Section 7.3.5 of RBI's Prudential Guidelines on Capital Adequacy and Market Discipline, and include (but not limited to) cash on deposits, equities listed in a main index and/or a recognised exchange, units or shares in collective investment schemes and various recognised debt securities.

Further the main types of recognised collateral taken by the Bank for mortgages include plots of land and ready and under construction properties.

#### Main Types of Guarantor Counterparty and their Creditworthiness

As stated in Section 7.5 of the RBI's Prudential Guidelines on Capital Adequacy and Market Discipline, certain guarantees are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporates and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigant, it must have a credit rating of AA- or above by Standard & Poor's, Fitch and Moody's.

#### Information about (Market or Credit) Risk Concentrations within the mitigation taken

The quantum of the credit portfolio which benefits from financial collaterals and/or guarantees as credit risk mitigants is an insignificant portion of the customer advances of the Bank. Therefore the credit and/or market concentration risks are not material

#### *Eligible financial collateral*

The total exposure (including non-funded post CCF) that is covered by eligible financial collateral, after the application of haircuts is Rs. 34,657,410 ('000).

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **7 Securitisation: disclosure for standardised approach**

Where the Bank securitises corporate and retail loans it has originated, these are done by selling them to a Special Purpose Vehicle (SPV), mainly in order to diversify its sources of funding. The Bank has no investment in securities issued by any SPV. In case the loan is derecognised from the books, no capital needs to be maintained. However the Bank is required to make appropriate reduction from capital for credit enhancements provided in line with the RBI guidelines.

#### Corporate loan securitisations

The Bank primarily conducts securitisations related to corporate loan assets on a single name basis. In such transactions, the Bank sells all rights, titles and benefits in a single corporate loan to SPVs for cash, and the SPVs in turn issues pass through certificates (PTC) to investors. The loan is sold on an outright basis and with the entire credit risk of the underlying obligation transferred to the SPVs and in turn to the investors of the PTC. Upon the sale of the loan assets, the Bank does not provide any credit enhancement nor does it service the asset.

#### Retail loan securitisations

In retail loan securitisation transactions, the Bank sells all rights, titles and benefits in the identified portfolio of retail loans to the SPVs for cash, and the SPVs in turn issues pass through certificates to investors. Credit enhancements are used to obtain investment grade ratings on the debt issued by the SPVs. Other than the credit enhancement provided the Bank transfers the entire credit risk to the SPVs and in turn to the investors of the PTC. The Bank continues to service the retail assets securitised.

#### Key accounting Policies

Securitisation transactions are accounted for in accordance with the RBI guidelines on “Securitisation of Standard Assets” and other relevant guidelines/ notifications issued by the RBI from time to time and the Guidance Note on Accounting for Securitisation issued by the ICAI.

Securitized assets are derecognised upon sale if the Bank surrenders control over the contractual rights that comprise the financial asset. In respect of credit enhancements provided or recourse obligations accepted by the Bank, appropriate provision / disclosure is made at the time of sale in accordance with AS 29 – ‘Provisions, contingent liabilities and contingent assets’.

Gains on securitisations, being the excess of the consideration received over book value of the loans and provisions against expected costs including servicing costs and expected delinquencies are amortised over the life of the securities issued by the SPV. Losses are recognised immediately.

Sales and transfers that do not meet the criteria for surrender of control are accounted for as secured borrowings.

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 7 Securitisation: disclosure for standardised approach (Continued)

#### ECAI's used

The Bank uses one of the following ECAIs for all types of securitisation deals:

- a) CRISIL Limited;
- b) FITCH India; and
- c) ICRA Limited.

#### (i) Details of securitisation of standard assets

	<i>Rs '000</i>	
	<b>Retail Loans</b>	<b>Corporate Loans</b>
Total number of loan assets securitized		4
Total book value of loan assets securitised (Rs '000)		7,500,596
Sale consideration received for the securitised assets (Rs '000)		7,563,849
Gain on sale on account of securitisation (Rs '000) (1)		63,253
Gain on securitisation recognised in Income Statement (Rs '000)	5,306	188,850
The unamortized gain as at 31 March 2010 (Rs '000)	7,762	28,440
Form and quantum (outstanding value) of services provided by way of Credit Enhancement (Rs '000)	40,025	

Notes:

1. The gain on sale on account of securitisation for corporate loans represents the difference between the sale consideration and the book value. The gain on sale on account of securitisation on retail loans represents the discounted value of the excess interest strip retained by the Bank.

#### (ii) Securitisation of impaired/past due assets

The Bank has not securitized any impaired/past due assets.

#### (iii) Loss recognised on securitisation of assets

The Bank has not recognised any losses during the current period for any securitisation deal.

#### (iv) Securitisation exposures retained or purchased

The Bank has not purchased any securitisation exposures nor does it have any retained securitisation exposure.

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **8 Market risk in trading book**

The objective of HSBC's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Group's status as one of the world's largest banking and financial services.

Market risk is the risk that movements in foreign exchange rates, interest rates, or equity prices will result in profits or losses to the Bank. Market risk arises on financial instruments, which are measured at fair value in the trading book. It also arises on instruments carried at amortized cost but in the banking books. The objective of market risk management is to control market risk exposures to achieve an optimal return while maintaining risk at acceptable levels.

#### **Strategy and processes :**

The Bank separates exposures to market risk into trading and non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position taking and other marked-to-market positions so designated.

Non-trading portfolios (included in the banking book) include positions that arise from the interest rate management of the Bank's retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held-to-maturity.

The risk components apply equally to cash and to derivative instruments. All open market risk is subject to approved limits. Limits are established to control the level of market risk and are complementary to counterparty and credit limits.

The existence of a market risk trading limit does not confer any credit, counterparty, country or sovereign risk limit: they must be separately established through normal credit procedures.

The level of market risk limits set for each operation depends upon: the size, financial and capital resources of the business, the business plan, the experience and track record of the management, dealers and market environment as well as Group's appetite.

Market risk limits are reviewed annually.

#### **Structure and Organization of management of risk**

The Bank has an independent market risk management and control function within the treasury middle office, which is responsible for measuring market risk exposures in accordance with prescribed policies, and monitoring and reporting these exposures against the approved limits on a daily basis. The monitoring of the risks is against limits assigned to the Treasurer by the Chief Executive Officer (CEO). The Treasurer allocates limits down to desks by risk type (Interest Rate and FX).

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 8 Market risk in trading book (Continued)

#### Scope and nature of risk measurement, risk reporting and risk monitoring systems

Market risk in trading portfolios is monitored and controlled using a complementary set of techniques. These include Value at Risk “VAR” and, for interest rate risk, present value of a basis point (PVBP) movement in interest rates, net open positions for Foreign Exchange, vega limits for options, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Value at Risk “VAR” is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. VAR limits are also set for the Trading and Banking portfolios, although no separate limits are assigned for derivatives. The Bank calculates VAR using the historical simulation methodology over last two years’ market data and at 99% confidence level over a one-day holding period.

PVBP limits are set for the Bank for the Trading and Banking book. The Bank does not operate in gold, commodity or equity markets (except for certain strategic investments). Limits are set in terms of face value and/or tenor.

Stress limits/Disaster Limits are also set which, measure the sensitivity of the book to significant combined moves in the underlying interest rate/volatility/exchange rates. Limits are also set on FX Vega for the Fx Options portfolio. Daily and monthly stop loss limits are also set and monitored.

The limit structure facilitates the risk management of the individual market risks by setting limits for these risk types individually, via option scenario matrices and via appropriate stress scenarios, and the management of market risk on an overall basis by setting Value at Risk limits. These limits are established to control the level of market risk and are complementary to counterparty and credit limits.

(i) *Capital requirements for market risk*

Rs ‘000

	<b>As at 31 March 2010</b>
Interest rate risk	8,669,901
Foreign exchange risk	405,000
Equity position risk	32,215
Total	<u><u>9,107,116</u></u>

# The Hongkong and Shanghai Banking Corporation Limited

*(Incorporated in the Hong Kong SAR with limited liability)*

## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **9 Interest rate risk in the banking book (IRRBB)**

The banking book is defined as:

- i) Investments held in the available-for-sale (AFS) portfolio.
- ii) Risks transferred to treasury's books by the bank via the Funds Transfer Pricing (FTP) mechanism.
- iii) Funding transactions to manage the liquidity of the bank.

Market risk in non trading portfolio (banking book) arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes.

Analysis of this risk incorporates assumptions on optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts.

#### **Strategy and Process**

In order to manage this risk optimally, market risk in the banking book is transferred to a separate book managed under the supervision of the Treasurer

The transfer of market risk to the AFS books is usually achieved by a series of internal deals between the business units and these books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local Asset and Liability Committee ("ALCO") regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits.

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to alternative investment products and the precise prepayment speeds of mortgages will vary at different interest rate levels. In such circumstances, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in the ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

#### **Structure and Organisation**

The Bank has an independent market risk management and control function within the treasury mid office, which is responsible for measuring interest rate risk exposures in accordance with prescribed policies, monitoring and reporting these exposures against the approved limits on a daily basis.

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 9 Interest rate risk in the banking book (IRRBB) (Continued)

#### Scope/Nature of Risk reporting/measurement system and mitigation techniques

The Bank monitors the sensitivity of projected net interest income under varying interest rate scenarios. The Bank manages the market risk in the banking book, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The Bank manages the interest rate risk arising from commercial banking activities in order to maximise yield, without exposing the bank to undue risk arising from movements in market interest rates. This involves the use of cash and derivative instruments available in the interbank market, either to close or open positions, in order to achieve the above goals, through the effective expression of the Balance Sheet Management's view of future market rates and market liquidity.

#### (i) Sensitivity to upward shocks

IRRBB: Sensitivity to upwards 100 bps movement in INR crore					By currency	
Currency	INR	USD	EUR	GBP	Total	
Sensitivity	121.2	2.44	1.06	11.23	135.93	

Note: The above does not include investments and derivatives in the banking book as these are classified as held for trading for capital calculations.

#### (ii) Sensitivity to downward shocks

IRRBB: Sensitivity to downwards 100 bps movement in INR crore					By currency	
Currency	INR	USD	EUR	GBP	Total	
Sensitivity	(121.2)	(2.44)	(1.06)	(11.23)	(135.93)	

Note: The above does not include investments and derivatives in the banking book as these are classified as held for trading for capital calculations

# The Hongkong and Shanghai Banking Corporation Limited

(Incorporated in the Hong Kong SAR with limited liability)

## Basel II disclosures of the India Branches (Continued)

for the year ended 31 March 2010

### 9 Interest rate risk in the banking book (IRRBB) (Continued)

#### Impact on Earnings (NII)

##### *Parallel Movement in Yield curve*

<b>INR Millions</b>	<b>Commercial Banking</b>	<b>ALCO Pool</b>	<b>Treasury</b>	<b>Sub-total</b>	<b>Intersegment Elimination</b>	<b>Total (Apr-10 to Mar-11)</b>
+100 Bps	2,138	123	(324)	1,937	(717)	1,220
-100 Bps	(2,135)	(123)	329	(1,929)	717	(1,212)

##### *Ramp Movements in Yield Curve\**

<b>INR Millions</b>	<b>Commercial Banking</b>	<b>ALCO Pool</b>	<b>Treasury</b>	<b>Sub-total</b>	<b>Intersegment Elimination</b>	<b>Total (Apr-09 to Mar-10)</b>
+100 Bps	1,340	7	(179)	1,168	(471)	697
-100 Bps	(1,383)	(7)	179	(1,211)	471	(740)

\* rates are assumed to rise/fall in parallel by 25bps on the first day of each quarter.

Note: The earnings risk analysis is based on the management's internal method to assess risk on earnings to interest rate movements over the next year and factors in certain assumptions on business growth over the next twelve months.

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II disclosures of the India Branches (*Continued*)**

*for the year ended 31 March 2010*

### **10 Operational risk**

Operational risk is the risk of loss arising from fraud, unauthorised activities, error, omission, inefficiency, systems failure or external events. It is inherent in every business organisation and covers a wide spectrum of issues.

#### **Strategy and Process**

The Bank manages this risk within a control based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken by internal audit / internal Control, and by monitoring external operational risk events, which ensure that the Bank stays in line with industry best practice and takes account of learnings from publicised operational failures within the financial services industry.

#### **Structure and Organisation**

The operational risk management responsibility is assigned to senior officials within each business operation.

The operational risk loss data is collected and reported to the Bank's senior management on a monthly basis. Aggregate operational risk losses are recorded and details of incidents above the materiality threshold of RBI are reported to the HSBC Group's Audit Committee. A consolidated summary and scorecard of the operational loss incidents affecting the key businesses is shared with the Bank's senior management every quarter through the Operational Risk Management Committee (ORMG) and significant loss events, gaps, mitigants etc are discussed.

#### **Scope/Nature of Risk reporting/measurement system and mitigation techniques**

The Bank has codified its operational risk management process by a high level standard, supplemented by more detailed formal guidance. This explains how the Bank manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with RBI requirements.

Information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting.

Assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes.