

# The Hongkong and Shanghai Banking Corporation Limited

(Incorporated in Hong Kong SAR with limited liability)

## Basel II – Pillar 3 disclosures of India Branches

For the year ended 31 March 2011

### 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 entity in which the Bank has minority interests which is neither consolidated nor capital deducted is HSBC Professional Services (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

(i) *Composition of Tier 1 capital (Audited)*

(Rs '000)

	As at 31 March 2011
Capital	44,991,660
Reserves	65,512,810
Innovative instruments	-
Other capital instruments	-
Amounts deducted from Tier 1 capital	(6,398,801)
<b>Total Tier 1 capital</b>	<b>104,105,669</b>

(ii) *Tier 2 capital (Audited)*

The amount of Tier 2 capital (net of deductions) is Rs. 8,352,763 ('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 – Pillar 3 disclosures of India Branches (Continued)

For the year ended 31 March 2011

### 2 Capital Structure (Continued)

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

There is no amount outstanding in respect of subordinated debt as at 31 March 2011.

(v) *Other deductions from capital*

There are no other deductions from capital.

(vi) *Total eligible capital (Audited)*

The total eligible capital is Rs 112,458,432 ('000).

### 3 Capital Adequacy

The Bank's capital management framework is shaped by its 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 them, 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)

	As at 31 March 2011
Portfolios subject to standardised approach	39,110,150
Securitisation exposures	-
<b>Capital requirements for credit risk</b>	<b>39,110,150</b>

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 3 Capital Adequacy (Continued)

(ii) Capital requirements for market risk

(Rs '000)

	As at 31 March 2011
<b>Standardised Duration Approach</b>	
Interest rate risk	8,165,134
Foreign exchange risk	405,000
Equity risk	37,614
<b>Capital requirements for market risk</b>	<b>8,607,748</b>

(iii) Capital requirements for operational risk

The capital requirement for operational risk under the basic indicator approach is Rs. 8,417,420 ('000).

(iv) Capital ratios

	As at 31 March 2011
Consolidated total capital ratio	18.03%
Consolidated Tier 1 capital ratio	16.69%

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 derivative contracts 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 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.

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## **Basel II – Pillar 3 disclosures of the India Branches (*Continued*)**

*For the year ended 31 March 2011*

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

- 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 Chief Risk Officer 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.

#### **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.

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

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

#### Scope and nature of risk reporting and measurement (continued)

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

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

(Rs '000)

	As at 31 March 2011		
	Fund based <sup>Note 1</sup>	Non fund based <sup>Note 2</sup>	Total
	402,314,237	553,491,150	955,805,387

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.

#### (ii) Geographical distribution of exposures

(Rs '000)

	As at 31 March 2011		
	Fund based	Non fund based	Total
Overseas	-	-	-
Domestic	402,314,237	553,491,150	955,805,387
<b>Total</b>	<b>402,314,237</b>	<b>553,491,150</b>	<b>955,805,387</b>

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## Basel II – Pillar 3 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	-	2,110,700	2,110,700
Mining	442,834	186,464	629,298
Iron & Steel	2,491,793	9,985,685	12,477,478
Other Metals & Metal Products	6,791,566	11,671,555	18,463,121
All Engineering	15,787,277	21,846,102	37,633,379
Electricity (Gen & Trans.)	-	95	95
Cotton Textiles	4,492,858	565,827	5,058,685
Jute Textiles	266	-	266
Other Textiles	5,802,328	7,591,128	13,393,456
Sugar	479,396	147,164	626,560
Tea	196,073	1,843	197,916
Food Processing	4,541,943	489,608	5,031,551
Vegetable Oils (including Vanaspati)	1,610,270	349,076	1,959,346
Tobacco & Tobacco Products	2,675,262	940,547	3,615,809
Paper & Paper Products	3,901,736	3,139,067	7,040,803
Rubber & Rubber Products	1,960,134	910,891	2,871,025
Chemicals, Engineering and infrastructure	21,941,883	18,578,386	40,520,269
Cement	1,920,061	2,856,246	4,776,307
Leather and Leather Products	97,161	713	97,874
Gems and Jewellery	60,880	-	60,880
Construction	8,586,376	2,153,468	10,739,844
Petroleum	169,461	26,244,799	26,414,260
Automobiles including trucks	8,209,067	14,422,592	22,631,659
Computer Software	13,187,505	5,329,294	18,516,799
Infrastructure	35,215,688	33,902,777	69,118,465
Other Industries	99,243,185	116,288,843	215,532,028
NBFCs & Trading	21,375,572	2,024	21,377,596
Banking and Finance	81,240,140	272,039,244	353,279,384
Retail Advance	59,893,522	1,737,012	61,630,534
<b>Total</b>	<b>402,314,237</b>	<b>553,491,150</b>	<b>955,805,387</b>

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

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

(iv) Residual contractual maturity breakdown of total assets

(Rs '000)

	As at 31 March 2011
1 day	76,883,163
2 to 7 days	40,356,949
8 to 14 days	25,666,357
15 to 28 days	55,490,844
29 days & upto 3 months	156,226,037
Over 3 months & upto 6 months	131,696,131
Over 6 months & upto 1 year	110,571,790
Over 1 year & upto 3 years	149,182,986
Over 3 years & upto 5 years	84,965,905
Over 5 years	80,444,586
<b>Total</b>	<b>911,484,748</b>

(v) Amount of NPAs (Gross)

(Rs '000)

	As at 31 March 2011
Substandard	2,282,539
Doubtful 1	2,732,123
Doubtful 2	1,104,202
Doubtful 3	370,215
Loss	3,466,225
<b>Total (Audited)</b>	<b>9,955,304</b>

(vi) Net NPA (Audited)

The net NPA is Rs 2,487,432('000).

(vii) NPA ratios

	As at 31 March 2011
Gross NPAs to gross advances	3.54%
Net NPAs to net advances (Audited)	0.91%

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

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

(viii) Movement of NPAs (Audited)

	(Rs '000)		
	Gross NPA's	Provision	Net NPA
Opening balance	16,832,926	11,401,585	5,431,341
Additions during the period	2,775,803	2,806,743	(30,940)
Reductions during the period	(9,653,425)	(6,740,456)	(2,912,969)
Closing balance	<u>9,955,304</u>	<u>7,467,872</u>	<u>2,487,432</u>

(ix) Non performing investments (Audited)

Non performing investments as at 31 March 2011 are Rs. 4. This represents 3 equity share investments and 1 preference share investments which have each being written down to Re. 1.

(x) Movement of provisions for depreciation on investments (Audited)

	(Rs '000)
	For the year ended 31 March 2011
Opening balance	5,826,362
Provisions during the year	-
Write offs during the year	-
Write back of excess provisions during the year	(686,944)
Closing balance	<u>5,139,418</u>

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 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 1<sup>st</sup> July 2010.

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 – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 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 – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

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

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

(Rs '000)

	As at 31 March 2011
Below 100% risk weight	677,276,891
100% risk weight	225,105,067
Above 100% risk weight	39,246,041
Deductions*	(6,432,568)
Total	935,195,431
* Deduction represents amounts deducted from Capital Funds	

# The Hongkong and Shanghai Banking Corporation Limited

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## **Basel II – Pillar 3 disclosures of the India Branches (*Continued*)**

*For the year ended 31 March 2011*

### **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 ratio (LVR) for different types of properties. With effect from 01 April 2011, the maximum LVR offered to customers cannot exceed 80% 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 an 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 are 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 an equivalent credit rating of AA- or above by a rating agency recognised by the RBI for capital adequacy purposes.

#### 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*

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## **Basel II – Pillar 3 disclosures of the India Branches (*Continued*)**

*For the year ended 31 March 2011*

The total exposure (including non-funded post CCF) that is covered by eligible financial collateral, after the application of haircuts is Rs. 35,120,350 ('000).

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## **Basel II – Pillar 3 disclosures of the India Branches (Continued)**

*For the year ended 31 March 2011*

### **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.

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 – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 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 (Audited)

(Rs '000)

	Retail Loans	Corporate Loans
Total number of loan assets securitized	-	-
Total book value of loan assets securitized (Rs '000)	-	-
Sale consideration received for the securitised assets (Rs '000)	-	-
Gain on sale on account of securitisation (Rs '000)	-	-
Gain on securitisation recognised in Income Statement (Rs '000)	2,195	26,283
The unamortized gain as at 31 March 2011 (Rs '000)	5,567	2,157
Form and quantum (outstanding value) of services provided by way of Credit Enhancement (Rs '000)	40,025	-

Note:

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.

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## **Basel II – Pillar 3 disclosures of the India Branches (*Continued*)**

*For the year ended 31 March 2011*

### **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 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 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).

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 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.

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 total treasury 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 VAR 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)

	As at 31 March 2011
Interest rate risk	8,165,134
Foreign exchange risk	405,000
Equity position risk	37,614
Total	<u>8,607,748</u>

# The Hongkong and Shanghai Banking Corporation Limited

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

## **Basel II – Pillar 3 disclosures of the India Branches (*Continued*)**

*For the year ended 31 March 2011*

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

The banking book is defined as:

- i) Underlying value of assets and liabilities as well as off-balance sheet instruments that are managed (transferred) to Treasury via the Funds Transfer Pricing (FTP) mechanism.
- ii) Investments held in the available-for-sale (AFS) portfolio in line with general accounting principles.
- iii) Funding transactions to manage the liquidity of the bank.

Market risk in the banking book arises principally from structural mismatches in assets and liabilities and from off-balance sheet instruments arising from repricing risk, yield curve risk and basis risk.

Further, an analysis of these risks incorporates assumptions on optionality in certain products such as in 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 efficiently, interest rate risk in the banking book is transferred to the supervision of the Treasurer.

The transfer of market risk to the Treasury is achieved through a formal transfer pricing framework wherein a series of internal deals are executed between the business units and Treasury. In certain products, the interest rate risk behaviour may differ from the contractual nature thereby requiring a study to determine the correct approach in managing the risk. This is achieved through a behaviouralisation study that is periodically updated and placed before the Asset and Liability Committee (ALCO) for approval, along with any underlying assumptions.

In certain cases, the non-linear characteristics of products typified through customer behaviour, 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 rate 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.

#### **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. This monitoring process effectively builds on the level of interest rate risk that is commensurate with the capital held.

# The Hongkong and Shanghai Banking Corporation Limited

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## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

### 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 effectively identifies, measures, monitors and controls the interest rate 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 maximize the return commensurate with its capital base, without exposing the bank to undue risk arising from movements in market interest rates. This involves the use of money market and derivative instruments available in the interbank market, in order to achieve the economic perspective set by Management on 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	360.29	2.59	1.87	20.35	385.10

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	(360.29)	(2.59)	(1.87)	(20.35)	(385.10)

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 Hong Kong SAR with limited liability)

## Basel II – Pillar 3 disclosures of the India Branches (Continued)

For the year ended 31 March 2011

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

#### Impact on Earnings (NI)

*Parallel Movement in Yield curve*

INR Millions	Commercial Banking	ALCO Pool	Treasury	Sub-total	Intersegment Elimination	Total (Apr-11 to Mar-12)
+100 Bps	2,184	135	248	2,567	(611)	1,956
-100 Bps	(2,076)	(135)	(272)	(2,483)	716	(1,767)

*Ramp Movements in Yield Curve\**

INR Millions	Commercial Banking	ALCO Pool	Treasury	Sub-total	Intersegment Elimination	Total (Apr-11 to Mar-12)
+100 Bps	1,418	30	61	1,509	(391)	1,118
-100 Bps	(1,323)	(30)	(75)	(1,428)	403	(1,025)

\* 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 – Pillar 3 disclosures of the India Branches (Continued)**

*For the year ended 31 March 2011*

### **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 on a monthly basis, above the reporting threshold of INR 10,000 mandated by RBI. A regular report on operational losses is made to the Bank's senior management through the RMC. 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.