

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 2012

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. 200 (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 2012
Capital	44,991,660
Reserves	74,937,775
Innovative instruments	-
Other capital instruments	-
Amounts deducted from Tier 1 capital	(5,569,168)
Total Tier 1 capital	114,360,266

(ii) *Tier 2 capital (Audited)*

The amount of Tier 2 capital (net of deductions) is Rs. 9,345,641 ('000).

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

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



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

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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 2012.

(v) Other deductions from capital

There are no other deductions from capital.

(vi) Total eligible capital (Audited)

The total eligible capital is Rs 123,705,907 ('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 2012
Portfolios subject to standardised approach	49,801,501
Securitisation exposures	-
Capital requirements for credit risk	49,801,501



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3 Capital Adequacy (Continued)

(ii) Capital requirements for market risk

	(Rs '000)
	As at
Standardised Duration Approach	31 March 2012
Interest rate risk	10,999,486
Foreign exchange risk	99,000
Equity risk	56,742
Capital requirements for market risk	11,155,228

(iii) Capital requirements for operational risk

The capital requirement for operational risk under the basic indicator approach is Rs. 8,438,792 ('000).

(iv) Capital ratios

	As at
	31 March 2012
Consolidated total capital ratio	16.04%
Consolidated Tier 1 capital ratio	14.83%

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

4 Credit risk:

a. General

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

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. The Bank has formulated local credit guidelines consistent with HSBC policy and RBI guidelines. 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, analysed and actively managed.

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

- Establish a separate Risk Management unit independent of business with a matrix of delegated approval authorities for the approval of credit risks.



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4 Credit risk: (Continued)

- Establish and maintain the exposure norms policy. This policy delineates the bank's maximum exposures to individual customers, customer groups and other risk concentrations. This policy also ensures compliance with the ceilings and lending guidelines relating to specific market sectors and industries.
- Establish and maintain the Country Risk Plan, which is reviewed and revised at least annually, and more frequently if required. This contains the credit appetite in terms of grow / maintain and shrink sectors and minimum criteria that must be met by new customers.
- Constitute a Risk Management Committee ("RMC") consisting of senior executives, which reviews overall portfolio risks and key risks facing the Bank in India.
- 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.



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

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4 Credit risk: (Continued)

Structure and Organisation

Credit approval authorities are delegated from the Chief Risk Officer at the Regional Head Office in Hong Kong to the Chief Executive Officer, India and the Chief Risk 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, measurement, monitoring and mitigation

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.

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 unsecured retail loans), subject to the minimum provisioning levels prescribed by the RBI. When 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.

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



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4 Credit risk: (Continued)

b. 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 for Corporate, Bank and Sovereign counterparties.

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 ratings issued by the ECAIs (for both Long Term and Short Term facilities) to risk weight both funded as well as non-funded exposures on corporate customers.

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 the Reserve Bank of India's Prudential Guidelines on Capital Adequacy and Market Discipline issued on 1st July 2011.

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

Short Term Ratings				Risk weights
CARE	CRISIL	FITCH	ICRA	
CARE A1	CRISIL A1	FITCH A1	ICRA A1	30%
CARE A2	CRISIL A2	FITCH A2	ICRA A2	50%
CARE A3	CRISIL A3	FITCH A3	ICRA A3	100%
CARE A4	CRISIL A4	FITCH A4	ICRA A4	150%
CARE D	CRISIL D	FITCH D	ICRA D	150%
Unrated	Unrated	Unrated	Unrated	100%



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4b 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:

- a) Fitch;
- b) Moodys; and
- c) 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

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

Risk weight mapping of foreign sovereigns

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

Risk weight mapping of foreign public sector entities

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

Risk weight mapping of non resident corporates

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



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

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 disbursement 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 and 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 and 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 and 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.

The total exposure (including non-funded post CCF) that is covered by eligible financial collateral, after the application of haircuts is Rs. 59,400,092 ('000).



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

(i) Total gross credit risk exposures

(Rs '000)

	Fund based ^{Note 1}	Non fund based ^{Note 2}	As at 31 March 2012 Total
	518,733,716	613,473,880	1,132,207,596

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)

	Fund based	Non fund based	As at 31 March 2012 Total
Overseas	-	-	-
Domestic	518,733,716	613,473,880	1,132,207,596
Total	518,733,716	613,473,880	1,132,207,596



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

(iii) Industry type distribution of exposures

(Rs '000)

Industry	Fund based	Non fund based	Total
Coal	-	996,746	996,746
Mining	150,025	568,174	718,199
Iron & Steel	2,246,480	5,601,863	7,848,343
Other Metals & Metal Products	8,767,305	14,816,283	23,583,588
All Engineering	12,770,247	25,165,695	37,935,942
Electricity (Gen & Trans.)	1,896,141	89,809	1,985,950
Cotton Textiles	7,506,214	-	7,506,214
Jute Textiles	1,064	-	1,064
Other Textiles	5,605,351	7,405,126	13,010,477
Sugar	811,375	-	811,375
Tea	267,381	-	267,381
Food Processing	4,875,115	882,125	5,757,240
Vegetable Oils (including Vanaspati)	3,186,827	26,251	3,213,078
Tobacco & Tobacco Products	1,253,788	89,831	1,343,619
Paper & Paper Products	5,722,428	4,403,988	10,126,416
Rubber & Rubber Products	2,769,577	1,430,719	4,200,296
Chemicals, Engineering and infrastructure	21,992,020	37,248,233	59,240,253
Cement	2,538,830	3,468,860	6,007,690
Leather and Leather Products	177,905	31,854	209,759
Gems and Jewellery	199,135	3,500	202,635
Construction	24,960,892	4,466,532	29,427,424
Petroleum	21,865,981	34,048,022	55,914,003
Automobiles including trucks	15,334,114	13,592,679	28,926,793
Computer Software	7,307,075	7,002,998	14,310,073
Infrastructure	51,897,160	32,961,779	84,858,939
Other Industries	112,413,247	154,494,113	266,907,360
NBFCs & Trading	27,527,992	3,051,837	30,579,829
Banking and Finance	115,135,085	255,548,685	370,683,770
Retail Advance	59,554,962	6,078,178	65,633,140
Total	518,733,716	613,473,880	1,132,207,596



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

(iv) Residual contractual maturity breakdown of total assets

(Rs '000)

	As at 31 March 2012
1 day	206,919,579
2 to 7 days	23,468,169
8 to 14 days	28,749,916
15 to 28 days	60,823,364
29 days & up to 3 months	183,785,972
Over 3 months & up to 6 months	129,101,743
Over 6 months & up to 1 year	138,229,400
Over 1 year & up to 3 years	140,502,759
Over 3 years & up to 5 years	75,377,050
Over 5 years	105,284,823
Total	1,092,242,775

(v) Amount of NPAs (Gross)

(Rs '000)

	As at 31 March 2012
Substandard	3,224,301
Doubtful 1	1,714,595
Doubtful 2	1,444,608
Doubtful 3	347,259
Loss	470,341
Total (Audited)	7,201,104

(vi) Net NPA (Audited)

The net NPA is Rs 2,203,435('000).



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

(vii) NPA ratios

	As at 31 March 2012
Gross NPAs to gross advances	2.00%
Net NPAs to net advances (Audited)	0.62%

(viii) Movement of NPAs (Audited)

	(Rs '000)		
	Gross NPA's	Provision	Net NPA
Opening balance as at 1 April 2011	9,955,304	7,467,872	2,487,432
Additions during the period	4,722,760	2,406,531	2,316,229
Reductions during the period	(7,476,960)	(4,876,734)	(2,600,226)
Closing balance as at 31 March 2012	7,201,104	4,997,669	2,203,435

(ix) Non performing investments (Audited)

Non performing investments as at 31 March 2012 are Rs. 5. This represents 3 equity share investments and 2 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 2012
Opening balance	5,139,418
Provisions during the year	-
Write offs during the year	-
Write back of excess provisions during the year	(1,621,331)
Closing balance	3,518,087



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4b Credit risk: disclosures for portfolios under the standardised approach (Continued)

(xi) Exposure under various risk buckets (post CRM)

(Rs '000)

	As at 31 March 2012
Below 100% risk weight	791,084,110
100% risk weight	282,713,721
Above 100% risk weight	46,092,559
Deductions*	(5,604,133)
Total	1,114,286,257
* Deduction represents amounts deducted from Capital Funds	



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4c. Securitisation: disclosure for standardised approach

Where the Bank securitises advances 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. The bank has not securitised any loans during the current financial year. For accounting policy followed by the bank in respect of securitisation, refer to the 'Significant Accounting Policies' disclosed in the financial statements of the Bank.

ECAI's used

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

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

(i) *Details of securitisation of standard assets (Audited)*

	Retail Loans	Corporate Loans
Total number of loan assets securitised during the year	-	-
Total book value of loan assets securitised during the year (Rs '000)	-	-
Sale consideration received for the securitised assets (Rs '000)	-	-
Gain on sale on account of securitisation during the year (Rs '000)	-	-
Gain on securitisation recognised in Income Statement (Rs '000)	1,586	2,157
The unamortised gain as at 31 March 2012 (Rs '000)	3,981	-
Outstanding value of services provided by way of Credit Enhancement (Rs '000)	40,025	-

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 securitised 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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5 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 institutions.

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 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 are established separately 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 the Group's appetite.

Market risk limits are reviewed annually.

Structure and Organisation 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. The Treasurer allocates limits down to desks by risk type (Interest Rate and FX).



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5 Market risk in trading book (Continued)

Scope and nature of risk measurement, reporting and monitoring

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. The Bank does not operate in gold or commodity markets. Certain strategic equity investments are held by the Bank, otherwise it does not operate in the equity markets.

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. The Bank calculates VAR using the historical simulation methodology over last two years' market data, at 99% confidence level for a one-day holding period. VAR limits are set for the Trading and Total treasury portfolios.

PVBP limits are set for the Bank for the Trading and Banking book. 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 and exchange rates. Limits are also set on FX Vega for the FX Options portfolio. The Bank sets and monitors daily and monthly stop loss limits.

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 2012
Interest rate risk	10,999,486
Foreign exchange risk	99,000
Equity position risk	56,742
Total	<u>11,155,228</u>



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6 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk. 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 and internal control departments, and continuous reviews by Concurrent Audit 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 RMC of the Bank, constituted by the senior most executives, is responsible for the Operational Risk management of the Bank. The RMC meets monthly, or more frequently if required, to assess and monitor operational risks and, where appropriate, authorise mitigating actions. The RMC is supported by an independent Operational Risk Management team within the Risk function. Furthermore, senior representatives from each business and function are tasked with responsibility for ongoing operational risk management. The RMC is also supported by the Operational Risk Management Committee ("ORMC"), which is constituted by the Chief Risk Officer, Chief Financial Officer and the senior representatives of the businesses and functions responsible for operational risk management, which meets to discuss operational risk issues and operationalise mitigating actions authorized by the RMC.

Scope and Nature of Risk reporting, monitoring and mitigation

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 businesses and the risks inherent in its processes, activities and products. Risk and Control Assessment is done on a regular basis.

The operational risk loss data is collected on a monthly basis, above the reporting threshold of Rs 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 on a bi-monthly basis and significant loss events, gaps, mitigants etc are discussed.



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 2012

7. 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 mechanism.
- ii) Investments held in the available-for-sale 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.

IRRBB does not incur a capital charge. It is monitored as part of the Bank's Internal Capital Adequacy Assessment Process.

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 for approval, along with 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.



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7 Interest rate risk in the banking book (IRRBB) (Continued)

Scope and nature of Risk reporting, measurement, monitoring and mitigation

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 maximise 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

(Rs crore)

IRRBB: Sensitivity to upwards 100 bps movement in interest rates by currency				As at 31 March 2012	
Currency	INR	USD	EUR	Other FCY	Total
Sensitivity	(121)	(7)	0.1	(3)	(130)

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

(Rs crore)

IRRBB: Sensitivity to downwards 100 bps movement in interest rates by currency				As at 31 March 2012	
Currency	INR	USD	EUR	Other FCY	Total
Sensitivity	(65)	(4)	(0.1)	(5)	(75)

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



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7. Interest rate risk in the banking book (IRRBB) (Continued)

(iii) Impact on Earnings (NII)

Parallel Movement in Yield curve

INR Millions	Commercial Banking	ALCO Pool	Treasury	Sub-total	Intersegment Elimination	For the year ended 31 March 2012
+100 Bps	2,445	309	(299)	2,455	(1,118)	1,337
-100 Bps	(2,219)	(307)	217	(2,309)	1,158	(1,151)

Ramp Movements in Yield Curve*

INR Millions	Commercial Banking	ALCO Pool	Treasury	Sub-total	Intersegment Elimination	For the year ended 31 March 2012
+100 Bps	1,502	166	(170)	1,498	(729)	769
-100 Bps	(1,340)	(85)	(17)	(1,442)	741	(701)

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

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.

