

HSBC Bank Australia Ltd

Pillar 3 Disclosures

30 September 2011

Consolidated Basis



HSBC 

The world's local bank

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Basel II Pillar 3 – Capital Adequacy and Risk Disclosures as at 30 September 2011

1. Introduction

Purpose

The Basel II regime is based around three "Pillars"; Pillar 1, minimum capital requirements, Pillar 2, supervisory review and Pillar 3, market discipline.

Its aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess certain specified information on the scope of application of Basel II, capital, particular risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

Background

Capital is a cornerstone of an authorised deposit-taking institution's (ADI) strength. It provides a buffer to absorb unanticipated losses from an ADI's activities and, in the event of unforeseen events, enables the ADI to continue operating while those issues are addressed or resolved.

In June 2004, the Basel Committee on Banking Supervision introduced a new capital adequacy framework to replace the 1988 Basel Capital Accord in the form of a new Accord (commonly known as 'Basel II').

The new capital adequacy framework under the Basel II regime, implemented since 1 January 2008 in Australia, seeks to promote regulatory capital requirements that are more comprehensive and sensitive to risk and therefore, more aligned to the risk appetites of individual banks.

The supervisory objectives of Basel II are to promote safety and soundness in the financial system and maintain an appropriate level of capital in the system, enhance competitive equality, and establish a more comprehensive approach to addressing risks.

The application of Pillar 3 aims to enhance transparency in Australian financial markets by setting minimum requirements for the public disclosure of information on the capital adequacy of locally incorporated ADIs.

As outlined in Australian Prudential Standard (APS) 330, the Australian Prudential Regulation Authority (APRA) has adopted a proportional approach to Pillar 3 to ensure disclosure of information by banks is appropriate to the nature, scope and complexity of their activities, distinguishing clearly between banks adopting the Basel II Advanced Approaches and those adopting the Standardised Approach.

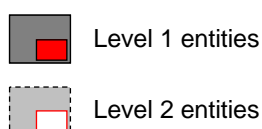
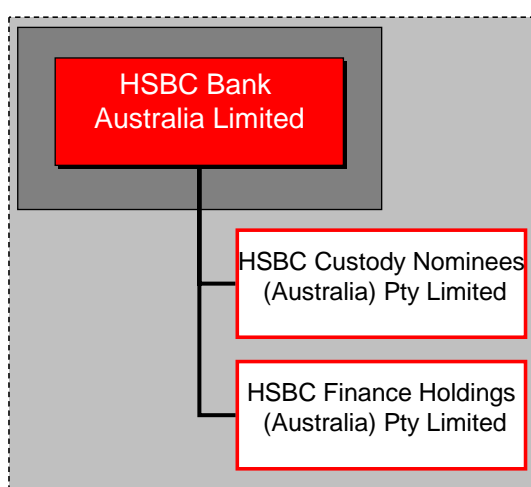
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2. Scope of Application

For regulatory (APRA) reporting purposes, HSBC Bank Australia Limited (HBAU) establishes two levels of reporting; Level one, which is HSBC Bank Australia Limited only, and Level two, which is the consolidation of HSBC Bank Australia Limited and all its financial subsidiaries.

- Level 1 – Stand alone basis (“Solo”)
- Level 2 – The consolidation of the Bank and all its subsidiary entities other than non-consolidated subsidiaries (“Consolidated entity”)

The Pillar 3 disclosures are based on Level 2 - Consolidated basis.



3. Verification

The Pillar 3 Disclosures have been appropriately verified internally but have not been audited by the external auditor.

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4. HBAU Context

HSBC is a global international bank and therefore deals with multiple regulators in multiple jurisdictions around the world. HSBC Holdings plc, regulated by the Financial Services Authority (FSA) in the UK, operates under the Advanced Internal Ratings Based Approach (IRB-A) for the majority of its Credit risk, the Standardised Approach for Operational risk and a mix of the Value at Risk (VaR) Approach and the Standardised Approach for Market risk (since 1 January 2008).

The Hongkong and Shanghai Banking Corporation Limited (HBAP), regulated by the Hong Kong Monetary Authority (HKMA) in Hong Kong, has adopted the IRB-A approach for Credit risk, the Standardised approach for Operational risk and both the Internal Models and Standardised approach for Market risk as of 1 January 2009.

HBAU has adopted the APRA Standardised approach to Credit, Market and Operational risk as of 1 January 2008.

Regulator	Institution	Credit risk	Operational risk	Market risk
APRA	HBAU	STD	STD (ASA)	STD
HKMA	HBAP	IRB-A	STD	IMM/STD
FSA	HSBC Holdings plc	IRB-A	STD	VAR/STD

IRB-A	=	Internal Ratings Based – Advanced approach for Credit risk
IMM	=	Internal Models approach for Market risk
VAR	=	Value at Risk for Market Risk
STD	=	Basel II Standardised approach for either Credit, Market or Operational risk
STD (ASA)	=	Standardised approach (Alternative Standardised Approach) for Operational risk

5. Frequency

This report will be released on a quarterly basis, comprising the Capital Adequacy (Table 16) and the Credit risk exposures (Tables 17a and b). The Capital Structure (Table 15) will be available annually only (Dec).

6. Enquiries

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Risk Definitions

Credit risk

Credit risk is the risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract. It arises principally from direct lending and trade finance, but also from off-balance sheet exposures such as market and non-market related transactions, and from HBAU's holdings of debt securities. Among the risks HBAU engages in, credit risk generates the largest regulatory capital requirement.

Market risk

Market risk is the risk that movements in market risk factors, including foreign exchange rates, commodity prices, interest rates, credit spreads and equity prices, will reduce HBAU's income or the value of its portfolios. HBAU 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 primarily arise from the interest rate management of HBAU's retail and commercial banking assets and liabilities and financial investments classified as available-for-sale and held-to-maturity.

Operational risk

Operational risk is the risk of loss arising through fraud, unauthorised activities, errors, omissions, inefficiencies, systems failures or from external events. It is inherent in every business organization and covers a wide spectrum of issues. The terms error, omission and inefficiency include process failures, systems/machine failures and human error.

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Table 16 - Capital Adequacy (Consolidated entity)

All figures in AUDm

	Sept 2011	Sept 2010
Risk weighted assets – Credit risk ¹		
• Corporate	5,750	4,938
• Government	-	-
• Bank	923	653
• Residential Mortgage	3,405	2,930
• Other Retail	1,268	1,128
• All Other	91	83
Risk weighted assets – Credit risk excluding securitisation	11,437	9,732
• Securitisation	-	1
Total Risk weighted assets – Credit risk	11,437	9,733
Risk weighted assets – Market risk	68	115
Risk weighted assets – Operational risk	1,299	1,216
Total Risk weighted assets	12,804	11,064

¹ Excludes securitisation

Capital Ratios	Sept 11	Jun 11	Mar 11	Dec 10	Sept 10
• Total Capital Ratio	10.8%	11.1%	12.8%	12.5%	11.4%
• Tier 1 Ratio	8.5%	8.7%	8.7%	8.4%	8.7%

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Credit Risk Management

Within Group Head Office, a specialised function, global Risk, is mandated to provide high-level centralised management of credit risk for HSBC worldwide, including to the consolidated entity. The global Risk function, headed by the Group Chief Risk Officer ('GCRO'), provides an expert, integrated and independent assessment of risks across the Group. Global Risk management's responsibilities include the following:

- Formulating Group credit policies and monitoring compliance with them. These policies are embodied in HSBC's Group Standards Manual;
- Issuing policy guidelines on the Group's attitude toward, and appetite for, credit risk exposure to specified market sectors, activities and banking products;
- Undertaking an independent review and objective assessment of risk. Global Risk management assesses all commercial non-bank credit facilities and exposures above designated limits – including those embedded in derivatives;
- Monitoring the performance and management of retail portfolios across the Group and reviewing whether any adverse trends are being managed appropriately by Group businesses;
- Controlling centrally exposures to sovereign entities, banks and other financial institutions. HSBC's credit and settlement risk limits to counterparties in these sectors are approved centrally and globally managed by a dedicated unit within Global Risk management, to optimise the use of credit availability and avoid excessive risk concentration;
- Maintaining HSBC's policy on large credit exposures, controlling these to ensure that exposure to any individual counterparty or group of closely related counterparties, or to individual geographic areas or industry sectors, does not become excessive in relation to the Group's capital base and is kept within internal and regulatory limits. A dedicated unit within Global Risk management manages this process, and also monitors HSBC's intra-Group exposures to ensure that they are maintained within regulatory limits;
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be high risk are considered on a case by case basis;
- Maintaining and developing HSBC's Global Risk rating systems in order to categorise exposures meaningfully and to facilitate management oversight of the attendant risks;
- Reviewing the performance and effectiveness of operating companies' credit approval processes, and of their specialised Credit Review and Risk Investigation teams;
- Reporting to senior executives on aspects of HSBC's credit risk portfolio;
- Managing and directing credit risk management systems initiatives. HSBC has a centralised database covering substantially all the Group's direct lending exposures, to deliver an increasingly granular level of management reporting. A systems-based credit application process for bank lending is operational throughout the Group and an electronic corporate credit application system is deployed in all the Group's major businesses;
- Providing advice and guidance to HSBC's operating companies in order to promote best practice throughout the Group on credit-related matters such as:
 - ▶ regulatory developments;
 - ▶ implementing environmental and social responsibility policies;
 - ▶ risk modelling;
 - ▶ collective impairment allowances;
 - ▶ new products due diligence;
 - ▶ training courses; and
 - ▶ credit risk reporting.

HSBC's consolidated entity operating in Australia is required to implement credit policies, procedures and lending guidelines which conform to HSBC Group standards, with credit approval authorities delegated from the Board of Directors of the consolidated entity to the Chief Executive Officer. The management of the consolidated entity includes a Chief Risk Officer who reports to the local Chief Executive Officer on credit-related issues and has a functional reporting line to the HBAP Chief Risk Officer for the Asia Pacific Region. The consolidated entity 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 central approval by global Risk management. This includes managing its own risk concentrations by market sector, geography and product. Local systems are in place to enable the consolidated entity to control and monitor exposures by customer and retail product segments.

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Table 17a – Credit risk (Consolidated entity)

All figures in AUDm

Exposure Type	Gross Credit Risk Exposure	
	Sept 2011	Quarter Average ¹
• Cash and Liquid Assets	39	22
• Debt Securities	5,114	4,731
• Due from other Financial Institutions	980	698
• Loans and Advances	13,964	13,741
• Derivatives	235	207
• Contingent Liabilities, Commitments and other Off-Balance Sheet Exposures	5,723	6,219
• Other Assets	317	231
Total Exposures	26,372	25,849

Portfolios subject to Standardised approach	Gross Credit Risk Exposure	
	Sept 2011	Quarter Average ¹
• Corporate	6,503	6,396
• Government	2,605	2,445
• Bank ²	6,448	6,277
• Residential Mortgage	9,390	9,309
• Other Retail	1,325	1,315
• All Other	101	107
Total Exposures	26,372	25,849

Note: Total exposures are based on local APRA definitions.

¹ Average throughout the Quarter

² Includes Repo exposures

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Exposures

Impairment of loans and advances

It is the consolidated entity's policy that each operating company will recognise losses for impaired loans promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the established Group guidelines. There are two basic methods of calculating impairment losses: those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

- Individually assessed loans
 - ▶ impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The consolidated entity assesses at each balance sheet date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant
- Collectively assessed loans
 - ▶ in respect of losses which have been incurred but have not yet been identified on loans subject to individual assessment for impairment; and
 - ▶ for homogeneous groups of loans that are not considered individually significant.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

Provisions for liabilities and charges

A provision is recognised in the balance sheet when the consolidated entity has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

A provision for restructuring is recognised when the consolidated entity has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been announced publicly. Future operating costs are not provided for.

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Table 17b – Credit risk (Consolidated entity)

All figures in AUDm

Financial Position

Portfolios subject to Standardised approach	As at September 2011			As at June 2011		
	Impaired Loans	Past due loans >90 days ¹	Provisions ¹	Impaired Loans	Past due loans >90 days ¹	Provisions ¹
• Corporate	111.6	-	35.6	122.6	-	35.5
• Government	-	-	-	-	-	-
• Bank	14.6	-	12.4	13.2	-	11.3
• Residential Mortgage	21.7	42.0	5.5	21.3	40.8	3.9
• Other Retail	0.6	18.5	18.9	0.6	20.5	23.9
• All Other	-	-	-	-	-	-
Total Exposures	148.5	60.5	72.4	157.7	61.3	74.6
Collective impairment provision (not included above)			16.7			14.2
Total Provisions			89.1			88.8

¹ Includes Individually and Portfolio Managed Facilities.

Financial Performance

Portfolios subject to Standardised approach	September 2011 ²			
	Charges for Provisions ²	Write offs ²	Recoveries ²	Total ²
• Corporate	18.7	0.5	(1.2)	18.0
• Government	-	-	-	-
• Bank	-	-	-	-
• Residential Mortgage	3.2	0.1	(0.5)	2.8
• Other Retail	(2.0)	46.3	(10.5)	33.8
• All Other	-	-	-	-
Sub Total	19.9	46.9	(12.2)	54.6
Collective provision not included	4.8	-	-	4.8
Total loan impairment charges and other credit risk provisions	24.7	46.9	(12.2)	59.4

² Year-to-Date figures.

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General Reserve for Credit Losses

The Bank maintains a level of General Reserves for Credit Losses, in addition to specific allowance, in order to absorb existing and potential future credit losses. A prudent level of General Reserves is dependent on the credit profile and business circumstances at the time and is benchmarked at 0.50% of total Credit Risk Weighted Assets, gross of deferred tax.

Composition of the General Reserve consists of eligible Collective Impairment Provisions (CIP) raised under AIFRS, and Portfolio provisions. Any shortfall to the benchmark level of the General Reserve for Credit Losses is deducted from retained earnings (Tier 1).

The General Reserve for Credit Losses is included in Upper Tier 2 Capital net of deferred tax.

All figures in AUDm

	<u>Balance¹</u>
General reserve for credit losses¹	<u>67.8</u>

¹ Gross of deferred Tax.