

2010

The Hongkong and Shanghai Banking  
Corporation Limited, Bangkok Branch

Pillar 3 Disclosures  
as at 31 December 2010



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### **Cautionary statement regarding forward-looking statements**

The *Pillar 3 Disclosures 2010* contains certain forward-looking statements with respect to the financial condition of The Hongkong and Shanghai Banking Corporation Limited, Bangkok Branch ('the Bank'), results of operations and business.

Statements that are not historical facts, including statements about the Bank's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'seeks', 'estimates' and 'potential', variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them.

Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement. These factors include changes in general economic conditions in the markets in which we operate, changes in government policy and regulation and factors specific to the Bank.

## Introduction

In November 2008, the Bank of Thailand ('BoT') announced a capital adequacy framework based on the 'International Convergence of Capital Measurement and Capital Standards' (commonly known as 'Basel II') issued by the Basel Committee on Banking Supervision ('BCBS').

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, constitute a more comprehensive approach to addressing risks, and focus on internationally active banks. Basel II is structured around three 'pillars': pillar 1, 'minimum capital requirements', pillar 2, 'supervisory review' and pillar 3, 'market discipline'.

### Pillar 3 disclosures 2010

Pillar 3, market discipline, complements the minimum capital requirements and the supervisory review process. Its aim is to encourage market discipline by developing a set of disclosure requirements which 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. Disclosures consist of both quantitative and qualitative information.

#### Frequency

In accordance with the BoT's requirements, the Bank publishes comprehensive Pillar 3 disclosures annually with an update of certain quantitative capital requirement disclosures, including market risk information, at the half year.

#### Media and location

The Pillar 3 Disclosures 2010 of the Bank on a standalone basis are available on the Bank's website: [www.hsbc.co.th](http://www.hsbc.co.th), whereas the Pillar 3 Disclosures 2010 of HSBC Holdings and its subsidiaries ('HSBC' or 'Group') on a consolidated level and other information on HSBC are available on HSBC Group's website: [www.hsbc.com](http://www.hsbc.com).

#### Verification

The Pillar 3 Disclosures 2010 have been appropriately verified internally, but have not been audited by the external auditor.

### Scope of Basel II permissions

#### Credit risk

Basel II provides three approaches of increasing sophistication to the calculation of pillar 1 credit risk capital requirements. The most basic, the standardised approach ('SA'), requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties, group other counterparties into broad categories and apply standardised risk weightings to these categories. The next level, the internal ratings-based ('IRB') foundation approach, allows banks to calculate their credit risk capital requirements on the basis of their internal assessment of the probability that a counterparty will default ('PD'), but subjects their quantified estimates of exposure at default ('EAD') and loss given default ('LGD') to standard supervisory parameters. Finally, the IRB advanced approach allows banks to use their own internal assessment in both determining PD and quantifying EAD and LGD.

For credit risk, with the BoT's approval, the Bank has adopted the standardised approach.

Counterparty credit risk in both the trading and non-trading books is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. Three approaches to calculating counterparty credit risk and determining exposure values are defined by Basel II: standardised, mark-to-market and internal model method. These exposure values are used to determine capital requirements under one of the credit risk approaches; standardised, IRB foundation and IRB advanced.

Internally, the Bank uses the mark-to-market and internal model method approaches for managing and monitoring its counterparty credit risk.

*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 the Bank's income or the value of its portfolios.

The Bank has obtained approval from the BoT to apply a combined approach for market risk assessment to determine capital requirement. The standardised approach is used for Specific Interest Rate Risk and the Value at Risk ('VaR') model is used for general market, foreign exchange and interest rate risk.

*Operational risk*

Basel II also includes capital requirements for operational risk, again utilising three levels of sophistication. The capital required under the basic indicator approach is a simple percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Both these approaches use an average of the last three financial years' revenues. Finally, the advanced measurement approach uses banks' own statistical analysis and modelling of operational risk data to determine capital requirements.

The Bank has adopted the standardised approach in determining its operational risk capital requirement.

**Capital**

**Capital management and allocation**

Our approach to capital management is driven by our strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which we operate. It is our objective to maintain a strong capital base to support the development of our business and to meet regulatory capital requirements at all times. Our policy is underpinned by the capital management framework, which enables us to manage our capital in a consistent and aligned manner. The framework, which is approved by the Group Management Board ('GMB'), incorporates a number of different capital measures including market capitalisation, invested capital, economic capital and regulatory capital. Our strategy is to allocate capital to businesses based on their economic profit generation, regulatory and economic capital requirements and the cost of capital.

As at 31 December 2010 and 30 June 2010, the Bank has an allocated and registered capital fund with the BoT of Baht 10,349 million. The detail can be summarised as follows:

*Table 1 : The Bank's Capital Structure as at 31 December 2010 and 30 June 2010*

	31 December 2010 THBm	30 June 2010 THBm
Assets maintained under Section 32 .....	<u>10,855</u>	<u>10,907</u>
<b>Sum of net capital for maintenance of assets under Section 32 and net balance of inter-office accounts</b>		
Capital for maintenance of assets under Section 32 .....	10,349	10,349
Net balance of inter-office accounts where the branch is the debtor to the head office and other branches located in other countries, the parent company and subsidiaries of the head office .....	<u>18,508</u>	<u>12,427</u>
<b>Total</b> .....	<u>28,857</u>	<u>22,776</u>
<b>Total Capital Fund</b> .....	<u>10,349</u>	<u>10,349</u>

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**Pillar 3 Disclosures as at 31 December 2010 (continued)**

**Table 2 : The Bank's Capital Adequacy as at 31 December 2010 and 30 June 2010**

*Minimum capital requirement for credit risk classified by type of assets under the Standardised Approach*

	<b>31 December 2010 THBm</b>	<b>30 June 2010 THBm</b>
<b>Performing claims</b>		
Claims on sovereigns and central banks, and multilateral development banks (MDBs).....	20	7
Claims on financial institutions, non-central government public sector entities (PSEs) treated as claims on financial institutions, and securities firms.....	764	630
Claims on corporates, non-central government public sector entities (PSEs) treated as claims on corporates.....	3,477	3,302
Claims on retail portfolios.....	840	793
Claims on housing loans.....	86	77
Other assets.....	67	74
<b>Non-performing claims</b> .....	<b>60</b>	<b>88</b>
<b>Total minimum capital requirement for credit risk</b> .....	<b>5,314</b>	<b>4,971</b>

*Minimum capital requirement for market risk for positions in the trading book*

	<b>31 December 2010 THBm</b>	<b>30 June 2010 THBm</b>
Internal model approach.....	244	472
<b>Total minimum capital requirement for market risk</b> .....	<b>244</b>	<b>472</b>

*Remark:*

- *The Bank has approval from the Bank of Thailand to apply a combined approach for market risk. The standardised approach is applied for specific interest rate risk and the internal model approach is applied for interest rate risk and foreign exchange rate risk.*
- *Since the Bank holds only THB Government bonds and the total amount of the portfolio is less than the Bank's THB liability, a zero percent risk weight was applied according to the Bank of Thailand regulation. Therefore, there is no capital requirement for the specific interest rate risk under the standardised approach as at 31 December 2010 and 30 June 2010.*

*Minimum capital requirement for operational risk*

	<b>31 December 2010 THBm</b>	<b>30 June 2010 THBm</b>
Standardised approach.....	935	937
<b>Total minimum capital requirement for operational risk</b> .....	<b>935</b>	<b>937</b>

*The Bank's capital ratio*

	<b>31 December 2010 %</b>	<b>30 June 2010 %</b>
<b>Total capital to risk-weighted assets</b> .....	<b>12.0</b>	<b>12.2</b>

## **Risk exposure and assessment**

### **Risk management objectives and policies**

#### *Overview*

Our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risks or combinations of risks. The most important risk categories that the Group is exposed to are credit risk (including cross-border country risk), market risk, operational risk in various forms, liquidity risk, insurance risk, pension risk, residual value risk, reputational risk and sustainability (environmental and social) risk. Market risk includes foreign exchange, interest rate and equity price risks

The objective of risk management, shared across the organisation, is to support Group strategies to build sustainably profitable business in the best long-term interests of our shareholders and other stakeholders. Our approach is therefore to ensure that risk management is deeply and firmly embedded in how we run our business. This is achieved through:

- a historically strong risk culture, with personal accountability for decisions;
- a robust governance structure, with a clear, well understood framework of risk ownership, standards and policy;
- the alignment of risk and business objectives, and integration of risk appetite into business planning and capital management; and
- an independent, integrated and specialist global Risk function.

Our risk culture is a major strength of the Group, and fostering it is a key responsibility of senior executives assisted by the Risk function. All employees are held accountable for identifying, assessing and managing risks within the scope of their assigned responsibilities. A primary duty of the senior executive in each country in which we operate is to maintain an effective risk strategy to address all risks in the business they manage, and we have a system of personal, not collective, authorities for lending decisions. Personal accountability, reinforced by learning and development, helps sustain a disciplined and constructive culture of risk management and control throughout HSBC.

As risk is not static, the risk profiles of the Bank change continually as a result of changes in the scope and impact of a wide range of factors, from geopolitical to transactional. The risk environment requires continual monitoring and holistic assessment in order to understand and manage the complex risk interactions across the Bank.

The global Risk function, headed by the Group Chief Risk Officer ('GCRO'), provides an expert, integrated and independent assessment of risks across the Group:

- supporting our regions and global businesses in the development and achievement of strategic objectives;
- partnering the business in risk appetite planning and operation;
- carrying out central approvals, controls, risk systems leadership and the analysis and reporting of management information;
- fostering development of the Risk function and the Group's risk culture; and
- addressing risk issues in dealings with external stakeholders including regulators and analysts.

In addition to 'business as usual' operations, the Risk function engages fully in business development activities such as new product approval and post-implementation review, and acquisition due diligence.

In Thailand, the Bank has established a Risk Management Committee ('RMC') which is chaired by the Chief Executive Officer ('CEO') with membership made up of senior managers. The RMC is the Bank's senior designated risk management committee as defined by the HSBC Regional Office in Hong Kong which is responsible for setting risk appetite and approving definitive risk policies and controls.

The members of Risk Management Committee are the Chief Risk Officer, Chief Financial Officer, Chief Operating Officer, Treasurer, Head of Global Banking, Head of Commercial Banking, Head of PFS. The RMC meeting is chaired by CEO and convened on a monthly basis.

### ***Group policy***

Our risk management policies, encapsulated in the Group Standards Manual and cascaded through a hierarchy of policy manuals across the Group, are designed to support the formulation of risk appetite, guide employees and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management.

HSBC's risk management policies are designed to identify and analyse risks, to set appropriate risk limits and controls and to monitor the risks and adherence to limits by means of reliable and up-to-date administrative and information systems. The Bank regularly reviews and updates our risk management policies, systems and methodologies to reflect changes in law, regulation, markets, products and emerging best practice.

It is a prime responsibility of the Bank's management to identify, assess and manage the broad spectrum of risks to which the Bank is subject. All employees moreover are expected to manage risk within the scope of their assigned responsibilities. Personal accountability, reinforced by the Bank's governance structure and instilled by training and experience, helps to foster a disciplined and constructive culture of risk management and control.

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

The purpose of our risk measurement and reporting systems is to ensure that risks are comprehensively captured, with all the attributes necessary to support well-founded decisions, that those attributes are accurately assessed and that information is delivered in a timely way to the right points in the organisation for those risks to be successfully managed and mitigated.

Risk measurement and reporting systems are also subject to a robust governance framework, to ensure that their design is fit for purpose and that they are functioning properly. Group risk IT systems development is a key responsibility of the GCRO, while the operation and development of risk rating and management systems and processes are ultimately subject to the oversight of the Board.

We invest significant resources in information technology systems and processes in order to maintain and improve our risk management capabilities. Group policy promotes the deployment of preferred technology where practicable. Group standards govern the procurement and operation of systems used in the Group, processing risk information within business lines and risk functions. The measurement and monitoring of the major risks we encounter, including credit, market and operational risks, are increasingly delivered by central systems or, where this is not the case for sound business reasons, through structures and processes that support comprehensive oversight by senior management.

### **Internal assessment of capital adequacy**

We assess the adequacy of our capital by considering the resources necessary to cover unexpected losses arising from discretionary risks, such as credit risk and market risk, or non-discretionary risks, such as operational risk and reputational risk. The framework, together with related policies define the Internal Capital Adequacy Assessment Process ("the ICAAP") by which GMB examines our risk profile from both regulatory and economic capital viewpoints and ensures that our level of capital:

- remains sufficient to support our risk profile and outstanding commitments;
- exceeds our formal minimum regulatory capital requirements;
- is capable of withstanding a severe economic downturn stress scenario; and
- remains consistent with our strategic and operational goals.

We identify and manage the risks we face through defined internal control procedures and stress testing. We assess and manage certain risks outlined below via a capital planning process.

### ***Credit, market and operational risk***

We assess capital requirements for these risk types utilising the embedded operational infrastructure used for the pillar 1 capital calculation, together with an additional suite of models that take into account, in particular diversification of risks within our portfolios and, similarly, any concentrations of risk that arise.



Our capital assessment operates alongside the regulatory capital assessment and consistently demonstrates a lower overall capital requirement for credit risk than the regulatory equivalent, reflecting the benefits of global diversification. However, we maintain a prudent stance on capital coverage, ensuring that any model risk is mitigated. Capital requirements are used to monitor our risks against our risk appetite.

***Interest rate risk in the banking book***

Interest Rate Risk in the Banking Book ('IRRBB') is defined as the exposure of our non-trading products to interest rates. Non-trading portfolios include positions that primarily arise from the interest rate management of future yield on assets and their funding costs, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on optionality within certain product areas, such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

***Liquidity risk***

Liquidity risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

The objective of our liquidity and funding management framework is to ensure that all foreseeable funding commitments can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, we maintain a diversified funding base comprising core retail and corporate customer deposits and institution balances. We augment this with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable us to respond quickly and smoothly to unforeseen liquidity requirements.

We also use cash-flow stress testing as part of our control processes to assess liquidity risk. We do not manage liquidity through the explicit allocation of capital as, in common with standard industry practice, this is not considered to be an appropriate or adequate mechanism for managing these risks. However, we recognise that a strong capital base can help to mitigate liquidity risk both by providing a capital buffer to allow an entity to raise funds and deploy them in liquid positions and by serving to reduce the credit risk taken by providers of funds to the Group.

***Reputational risk***

As a banking group, our good reputation depends upon the way in which we conduct our business, but it can also be affected by the way in which clients to whom we provide financial services conduct themselves.

HSBC in Thailand manages and monitors our reputational risk via the RMC. The Public Affairs Department monitors reputational risk on a daily basis and informs local senior management in a timely manner if there are occurrences of any reputational risk events.

***Business risk***

Business risk is the potential negative impact on profits and capital as a result of the Bank not meeting our strategic objectives, as set out in the rolling operating plan, caused by unforeseen changes in the business and regulatory environment, exposure to economic cycles and technological changes.

We manage and mitigate business risk through our business planning and stress testing processes, which ensure that our business model and planned activities are appropriately resourced and capitalised consistent with the commercial, economic and risk environment in which the Group operates and that the potential vulnerability to our business plans are identified at an early stage so that mitigating actions can be taken proactively.

## Credit risk

### General information on credit risk exposure

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 products such as guarantees and credit derivatives. Of the risks in which we engage, credit risk generates the largest regulatory capital requirement. This includes a capital requirement for counterparty credit risk in the banking and trading books.

The objectives of credit risk management, underpinning sustainably profitable business, are principally:

- to maintain a strong culture of responsible lending, and a robust risk policy and control framework;
- to both partner and challenge our business in defining and implementing risk

appetite, continually re-evaluating under actual and stress scenario conditions; and

- to ensure independent, expert scrutiny and approval of credit risks, their costs and their mitigation.

The Bank uses the Standardised Approach to calculate capital requirement for credit risks. Non-performing claims represent assets/loans with overdue period more than 90 days. The specific provision has been provided for non-performing assets/loans based on the estimated losses which were calculated by discounting the expected future cash flows (inclusive of the value of security). The general provision has been calculated based on collective impairment for both corporate and retail loans portfolio for which historical loss rate experience, time value and economic factors have been taken into account.

The following tables set out credit risk exposure value according to regulatory requirement as at 31 December 2010 and 2009.

## Credit risk

### General information on credit risk exposure

Table 3 : Credit risk exposure of significant on-balance sheet and off-balance sheet exposures before recognised credit risk mitigation as at 31 December 2010 and 2009

	31 December 2010		31 December 2009	
	Average exposure value THBm	Exposure value THBm	Average exposure value THBm	Exposure value THBm
<b>On-balance sheet</b>				
Loans and advances, net .....	133,526	147,433	104,899	118,535
Investments in debt securities, net .....	28,575	22,849	22,451	26,061
Deposits (including accrued interest receivable) .....	1,912	857	1,518	590
<b>Total</b> .....	<b>164,013</b>	<b>171,139</b>	<b>128,868</b>	<b>145,186</b>
<b>Off-balance sheet</b>				
Aval, guarantees and letter of credit .....	3,711	3,952	2,429	2,805
OTC derivatives .....	2,405,530	2,730,571	1,752,072	1,932,097
Undrawn commitment .....	95,568	89,889	104,438	104,129
<b>Total</b> .....	<b>2,504,809</b>	<b>2,824,412</b>	<b>1,858,939</b>	<b>2,039,031</b>

Remark:

- Loans and advances represent loans to customers and interbank and money market placements including accrued interest receivable and net of deferred income and loan impairment allowances.
- Investments in debt securities are measured at fair value excluding accrued interest receivable and net of any loss on impairment.
- Off-balance sheet represents the notional amounts before the application of a credit conversion factor.

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Table 4 : Credit risk exposure of significant on-balance sheet and off-balance sheet exposures before recognised credit risk mitigation - analysis by country or geographical area as at 31 December 2010 and 2009

Exposure values are allocated to region based on the country of incorporation where the exposure was originated.

Country or geographical area	31 December 2010							
	On-balance sheet				Off-balance sheet			
	Total THBm	Loans and advances THBm	Investments in debt securities THBm	Deposits THBm	Total THBm	Aval, guarantees and letter of credit THBm	OTC derivatives THBm	Undrawn commitment THBm
Thailand	170,392	146,721	22,849	822	1,102,394	3,941	1,010,227	88,226
Asia Pacific (excluding Thailand)	220	216	-	4	1,076,639	8	1,076,128	503
North America and Latin America	215	210	-	5	161,476	3	160,549	924
Europe	312	286	-	26	483,903	-	483,667	236
<b>Total</b>	<b>171,139</b>	<b>147,433</b>	<b>22,849</b>	<b>857</b>	<b>2,824,412</b>	<b>3,952</b>	<b>2,730,571</b>	<b>89,889</b>

Country or geographical area	31 December 2009							
	On-balance sheet				Off-balance sheet			
	Total THBm	Loans and advances THBm	Investments in debt securities THBm	Deposits THBm	Total THBm	Aval, guarantees and letter of credit THBm	OTC derivatives THBm	Undrawn commitment THBm
Thailand	144,878	118,273	26,061	544	868,471	2,715	762,794	102,962
Asia Pacific (excluding Thailand)	60	55	-	5	753,659	90	753,142	427
North America and Latin America	120	117	-	3	108,908	-	108,392	516
Europe	128	90	-	38	307,993	-	307,769	224
<b>Total</b>	<b>145,186</b>	<b>118,535</b>	<b>26,061</b>	<b>590</b>	<b>2,039,031</b>	<b>2,805</b>	<b>1,932,097</b>	<b>104,129</b>

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**Table 5 : Credit risk exposure of significant on-balance sheet and off-balance sheet exposures before recognised credit risk mitigation – analysis by residual maturity as at 31 December 2010 and 2009**

	31 December 2010			31 December 2009		
	Less than 1 year THBm	Over 1 year THBm	Total THBm	Less than 1 year THBm	Over 1 year THBm	Total THBm
<b>On-balance sheet</b>						
Loans and advances, net.....	140,175	7,258	147,433	110,053	8,482	118,535
Investments in debt securities, net.....	16,025	6,824	22,849	12,172	13,889	26,061
Deposits (including accrued interest receivable).....	857	-	857	590	-	590
<b>Total</b> .....	<b>157,057</b>	<b>14,082</b>	<b>171,139</b>	<b>122,815</b>	<b>22,371</b>	<b>145,186</b>
<b>Off-balance sheet</b>						
Aval, guarantees and letter of credit.....	3,930	22	3,952	2,805	-	2,805
OTC derivatives.....	1,310,750	1,419,821	2,730,571	733,362	1,198,735	1,932,097
Undrawn commitment.....	87,168	2,721	89,889	102,391	1,738	104,129
<b>Total</b> .....	<b>1,401,848</b>	<b>1,422,564</b>	<b>2,824,412</b>	<b>838,558</b>	<b>1,200,473</b>	<b>2,039,031</b>

**Table 6 : Outstanding loans including accrued interest receivable and investments in debt securities classified as doubtful loss before recognised credit risk mitigation - analysis by country or geographical area and asset classification as prescribed by the Bank of Thailand as at 31 December 2010 and 2009**

Country or geographic area	31 December 2010						Investments in debt securities classified as doubtful loss THBm
	Normal THBm	Special mentioned THBm	Substandard THBm	Doubtful THBm	Doubtful loss THBm	Total THBm	
Thailand.....	144,941	1,969	166	448	775	148,299	69
Asia Pacific (excluding Thailand).....	219	-	-	-	-	219	-
North America and Latin America.....	212	-	-	-	-	212	-
Europe.....	289	-	-	-	-	289	-
<b>Total</b> .....	<b>145,661</b>	<b>1,969</b>	<b>166</b>	<b>448</b>	<b>775</b>	<b>149,019</b>	<b>69</b>

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Country or geographic area	31 December 2009						Investments in debt securities classified as doubtful loss THBm
	Loans including accrued interest receivable						
	Normal THBm	Special mentioned THBm	Substandard THBm	Doubtful THBm	Doubtful loss THBm	Total THBm	
Thailand.....	116,210	2,500	380	113	871	120,074	60
Asia Pacific (excluding Thailand).....	56	-	-	-	-	56	-
North America and Latin America.....	118	-	-	-	8	126	-
Europe.....	90	-	-	-	-	90	-
<b>Total.....</b>	<b>116,474</b>	<b>2,500</b>	<b>380</b>	<b>113</b>	<b>879</b>	<b>120,346</b>	<b>60</b>

Remark:

- Loans represent loans to customers, interbank and money market, including accrued interest receivable and net of deferred income.
- Investments in debt securities classified as doubtful loss represent unrealised losses on revaluation according to the definition of the BoT's Notification RE: Classification and Provision of the Financial Institutions.

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Table 7 : General provision, specific provision and bad debt written-off during the year against loans including accrued interest receivable and investments in debt securities - analysis by country or geographic area as at 31 December 2010 and 2009

Country or geographic area	31 December 2010			
	Loans including accrued interest receivable			Specific provision for investments in debt securities THBm
	General provision THBm	Specific provision THBm	Bad debt written-off during period THBm	
Thailand		805	836	69
Asia Pacific (excluding Thailand)		-	-	-
North America and Latin America		-	6	-
Europe		-	-	-
<b>Total</b>	<b>781</b>	<b>805</b>	<b>842</b>	<b>69</b>

Country or geographic area	31 December 2009			
	Loans including accrued interest receivable			Specific provision for investments in debt securities THBm
	General provision THBm	Specific provision THBm	Bad debt written-off during period THBm	
Thailand		789	1,330	60
Asia Pacific (excluding Thailand)		-	-	-
North America and Latin America		8	-	-
Europe		-	-	-
<b>Total</b>	<b>1,014</b>	<b>797</b>	<b>1,330</b>	<b>60</b>

Remark:

- The provisions of loans and advances represent only provisions against loans to customers as there were no provisions against interbank and money market transactions for the year ended 31 December 2010 and 2009.
- Specific provisions for investments in debt securities represent unrealised losses on the revaluation of debt securities at the year end.

Table 8 : Outstanding loans including accrued interest receivable before recognised credit risk mitigation - analysis by type of business and asset classification as prescribed by the Bank of Thailand as at 31 December 2010 and 2009

Type of business	31 December 2010					
	Normal THBm	Special mentioned THBm	Substandard THBm	Doubtful THBm	Doubtful loss THBm	Total THBm
Agriculture and mining	720	-	-	-	-	720
Financial sector	106,805	-	-	-	-	106,805
Manufacturing and commerce	18,138	1,496	-	432	722	20,788
Real estate business and construction	1,047	-	-	-	-	1,047
Public utilities and services	6,690	144	-	-	-	6,834
Housing loan	1,141	8	2	13	5	1,169
Others	11,120	321	164	3	48	11,656
<b>Total</b>	<b>145,661</b>	<b>1,969</b>	<b>166</b>	<b>448</b>	<b>775</b>	<b>149,019</b>

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Type of business	31 December 2009					
	Normal THBm	Special mentioned THBm	Substandard THBm	Doubtful THBm	Doubtful loss THBm	Total THBm
Agriculture and mining	714	-	-	-	-	714
Financial sector	81,986	-	-	-	-	81,986
Manufacturing and commerce	13,053	1,997	41	102	859	16,052
Real estate business and construction	1,182	-	-	-	8	1,190
Public utilities and services	7,816	65	-	-	-	7,881
Housing loan	812	1	-	11	11	835
Others	10,911	437	339	-	1	11,688
<b>Total</b>	<b>116,474</b>	<b>2,500</b>	<b>380</b>	<b>113</b>	<b>879</b>	<b>120,346</b>

Table 9 : General provision, specific provision and bad debt written-off during the year against loans including accrued interest receivable - analysis by type of business as at 31 December 2010 and 2009

Type of business	31 December 2010		
	General provision THBm	Specific provision THBm	Bad debt written-off during period THBm
Agriculture and mining	-	-	-
Financial sector	-	-	-
Manufacturing and commerce	-	801	-
Real estate business and construction	-	-	6
Public utilities and services	-	-	-
Housing loan	-	1	1
Others	-	3	835
<b>Total</b>	<b>781</b>	<b>805</b>	<b>842</b>

Type of business	31 December 2009		
	General provision THBm	Specific provision THBm	Bad debt written-off during period THBm
Agriculture and mining	-	-	-
Financial sector	-	-	-
Manufacturing and commerce	-	782	58
Real estate business and construction	-	8	-
Public utilities and services	-	-	-
Housing loan	-	6	7
Others	-	1	1,265
<b>Total</b>	<b>1,014</b>	<b>797</b>	<b>1,330</b>

Remark: Bad debt written off during the year ended 31 December 2010 of Baht 834 million (2009 : Baht 1,265 million) is in respect of the retail portfolio.

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**Table 10 : Reconciliation of the movement in the general provision and specific provision against loans including accrued interest receivable as at 31 December 2010 and 2009**

	31 December 2010		
	General provision THBm	Specific provision THBm	Total THBm
Provisions at the beginning of period	1,014	797	1,811
Bad debts written-off during the period	(834)	(8)	(842)
Provisions charge during the period	601	16	617
<b>Provisions at the end of period</b>	<b>781</b>	<b>805</b>	<b>1,586</b>

	31 December 2009		
	General provision THBm	Specific provision THBm	Total THBm
Provisions at the beginning of period	1,244	393	1,637
Bad debts written-off during the period	(1,264)	(66)	(1,330)
Provisions charge during the period	1,034	470	1,504
<b>Provisions at the end of period</b>	<b>1,014</b>	<b>797</b>	<b>1,811</b>

Remark: The above information also includes interbank and money market transactions.

**Table 11 : Net exposure of on-balance sheet and credit equivalent amount of off-balance sheet before recognised credit risk mitigation classified by type of assets under the Standardised Approach as at 31 December 2010 and 2009**

	31 December 2010		
	On-balance sheet THBm	Off-balance sheet THBm	Total THBm
<b>Performing claims</b>			
Claims on sovereigns and central banks, and MDBs	29,766	94,410	124,176
Claims on financial institutions, PSEs treated as claims on financial institutions, and securities firms	2,377	42,053	44,430
Claims on corporate, PSEs treated as claims on corporate	32,488	18,844	51,332
Claims on retail portfolios	11,269	-	11,269
Claims on housing loans	1,155	-	1,155
Other assets	33,453	-	33,453
<b>Non-performing claims</b>	622	57	679
<b>Total</b>	<b>111,130</b>	<b>155,364</b>	<b>266,494</b>

	31 December 2009		
	On-balance sheet THBm	Off-balance sheet THBm	Total THBm
<b>Performing claims</b>			
Claims on sovereigns and central banks, and MDBs	19,912	71,251	91,163
Claims on financial institutions, PSEs treated as claims on financial institutions, and securities firms	1,285	35,010	36,295
Claims on corporate, PSEs treated as claims on corporate	27,048	19,993	47,041
Claims on retail portfolios	11,198	4	11,202
Claims on housing loans	825	-	825
Other assets	27,804	-	27,804
<b>Non-performing claims</b>	639	133	772
<b>Total</b>	<b>88,711</b>	<b>126,391</b>	<b>215,102</b>

Remark:

- The above information has been presented net of specific provision.
- Off-balance sheet amounts have been adjusted by the credit conversion factor and also included repo style transactions.



***Ratings from External Credit Assessment Institutions***

Credit risk under the Standardised Approach has been calculated based on the external credit ratings from External Credit Assessment Institutions ('ECAI'). The Bank uses external credit ratings from the following ECAIs which are approved by the BoT.

- Standard & Poor's Ratings Service;
- Moody's Investors Services;
- Fitch Ratings;
- Fitch Ratings (Thailand);
- TRIS Rating

Data files of external ratings from the nominated ECAIs are matched with the customer records in the centralised credit database.

When calculating the risk-weighted value of any exposure, risk systems identify the customer in question and look up in the central database the available rating, according to the BoT's rating selection rules as prescribed in the appendix 4 of the BoT's guideline on Minimum Capital Requirement for Credit Risk under the Standardised Approach. The system then applies the BoT's prescribed credit quality step mapping to derive from the rating the relevant risk weight.

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Table 12 : Net exposure of on-balance sheet and credit equivalent amount of off-balance sheet after recognised credit risk mitigation for each type of assets, classified by risk weight under the Standardised Approach as at 31 December 2010 and 2009

31 December 2010											
Risk weight	Net exposures after recognised credit risk mitigation - Rated					Net exposures after recognised credit risk mitigation - Unrated					
	0% THBm	20% THBm	50% THBm	100% THBm	150% THBm	0% THBm	20% THBm	50% THBm	35% THBm	75% THBm	100% THBm
<b>Performing claims</b>											
Claims on sovereigns and central banks, and MDBs	123,656	-	520	-	-						-
Claims on financial institutions, PSEs treated as claims on financial institutions, and securities firms	-	30,854	1,144	3,460	-						-
Claims on corporate, PSEs treated as claims on corporate	-	268	3,935	2,004	1						42,326
Claims on retail portfolios											11,202
Claims on housing loans									6		1,149
Other assets						44,186	86				874
<b>Non-performing claims</b>											
			50% 3	100% 232	150% 374					75% -	
31 December 2009											
Risk weight	Net exposures after recognised credit risk mitigation - Rated					Net exposures after recognised credit risk mitigation - Unrated					
	0% THBm	20% THBm	50% THBm	100% THBm	150% THBm	0% THBm	20% THBm	50% THBm	35% THBm	75% THBm	100% THBm
<b>Performing claims</b>											
Claims on sovereigns and central banks, and MDBs	99,913	-	119	-	-						-
Claims on financial institutions, PSEs treated as claims on financial institutions, and securities firms	-	26,954	800	2,563	-						-
Claims on corporate, PSEs treated as claims on corporate	-	74	1,311	1,588	-						34,098
Claims on retail portfolios											11,108
Claims on housing loans									6		819
Other assets						33,223	537				943
<b>Non-performing claims</b>											
			50% 1	100% 232	150% 479					75% -	

Remark: Off-balance sheet represents the notional amounts after applied credit conversion factor.

### *Credit risk mitigation*

The Bank's approach when granting credit facilities is to do so on the basis of capacity to repay, rather than to place primary reliance on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided unsecured.

Mitigation of credit risk is nevertheless a key aspect of effective risk management and, in a diversified financial services organisation, takes many forms. There is no material concentration of credit risk mitigation held.

The Bank's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Specific, detailed policies cover the acceptability, structuring and terms of various types of business with regard to the availability of credit risk mitigation, for example in the form of collateral security, and these policies, together with the determination of suitable valuation parameters, are subject to regular review to ensure that they are supported by empirical evidence and continue to fulfil their intended purpose.

The most common method of mitigating credit risk is to take collateral. In residential and commercial real estate businesses, a mortgage over the property is usually taken to help secure claims. In the commercial and industrial sectors, charges are created over business assets such as premises, stock and debtors. Facilities to small and medium enterprises are commonly granted against guarantees given by their owners and/or directors. Guarantees from third parties can arise where the Bank extends facilities without the benefit of any alternative form of security, e.g. where it issues a bid or performance bond in favour of a non-customer at the request of another bank.

In the institutional sector, trading facilities are supported by charges over financial instruments such as cash, debt securities and equities. Financial collateral in the form of marketable securities is used in much of the Bank's over-the-counter ('OTC') derivatives activities and in its securities financing business (securities lending and borrowing or repos and reverse repos). Netting is extensively used and is a prominent feature of market standard documentation.

HSBC's Global Banking and Markets business utilises credit risk mitigation to actively manage the credit risk of its portfolios, with the

goal of reducing concentrations in individual names, sectors or portfolios. The techniques in use include credit default swaps, structured credit notes and securitisation structures. Buying credit protection creates credit exposure against the protection provider.

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt of cash, securities or equities. Daily settlement limits are established to cover the aggregate of our transactions with a counterparty on any single day. Settlement risk on many transactions can be further substantially mitigated by settling through assured payment systems or on a delivery-versus-payment basis.

Policies and procedures govern the protection of our position from the outset of a customer relationship, for instance in requiring standard terms and conditions or specifically agreed documentation permitting the offset of credit balances against debt obligations and through controls over the integrity, current valuation and, if necessary, realisation of collateral security.

The valuation of credit risk mitigants seeks to monitor and ensure that they will continue to provide the secure repayment source anticipated at the time they were taken. Where collateral is subject to high volatility, valuation is frequent; where stable, less so. Trading businesses typically carry out daily valuations. In the residential mortgage business, on the other hand, Group policy prescribes valuation at intervals of up to three years, or more frequently as the need may arise, at the discretion of the business line, by a variety of methods ranging from use of market indices to individual professional inspection.

For banking book exposures subject to the standardised approach – covered by eligible guarantees, non-financial collateral, or credit derivatives – the exposure is divided into covered and uncovered portions. The covered portion attracts the risk weight applicable to the credit quality step associated with the protection provider, while the uncovered portion attracts the risk weight associated with the credit quality step of the obligor. For trading book exposures fully or partially covered by eligible financial collateral, the value of the exposure is adjusted under the Financial Collateral Comprehensive Method

using supervisory volatility adjustments, including those arising from currency mismatch, which are determined by the specific type of collateral (and, in the case of eligible debt securities, their credit quality) and its liquidation period. The adjusted exposure value is subject to the risk weight associated with the credit quality step of the obligor.

Credit risk adjustment

HSBC incorporates counterparty creditworthiness in the fair value of OTC derivative transactions through adoption of a credit risk adjustment. The adjustment aims to calculate at each HSBC legal entity level some calibration, according to a set of formulae, of the potential loss arising from the portfolio of derivative transactions against each third party, based upon a modelled expected positive exposure profile, including allowance for credit risk mitigants such as netting agreements and credit support annexes. The scenario analyses used to generate the exposure profiles are consistent with the analysis tools and methodological approach used to generate the exposure profiles used by the Group's risk functions for exposure management purposes or, where applicable, as the basis for portfolios where exposures are calculated under the internal model method ('IMM').

Collateral arrangements

To calculate a counterparty's net risk position, for counterparty credit risk, HSBC revalues all financial instruments and associated collateral positions on a daily basis. A dedicated Collateral Management function independently monitors counterparties' associated collateral positions and manages a process which ensures that calls for collateral top-ups or exposure reductions are made promptly. Processes exist for the resolution of situations where the level of collateral is disputed or the collateral sought is not received.

Eligible collateral types are documented by a Credit Support Annex ('CSA') of the International Swaps and Derivatives Association ('ISDA') Master Agreement and are controlled under a policy which ensures the collateral agreed to be taken exhibits characteristics such as price transparency, price stability, liquidity, enforceability, independence, reusability and eligibility for regulatory purposes. A valuation 'haircut' policy reflects the fact that collateral may fall in value between the date the collateral was called and the date of liquidation or enforcement.

*Table 13 : Exposure value under the Standardised Approach covered by collateral classified by type of assets and collateral as at 31 December 2010 and 2009*

	31 December 2010		31 December 2009	
	Eligible financial collateral THBm	Guarantee and credit derivatives THBm	Eligible financial collateral THBm	Guarantee and credit derivatives THBm
<b>Performing claims</b>				
Claims on financial institutions, PSEs treated as claims on financial institutions, and securities firms	11,193	-	9,332	-
Claims on corporate, PSEs treated as claims on corporate	643	2,220	6,707	3,303
Claims on retail portfolios	57	10	61	33
<b>Non-performing claims</b>	15	57	1	59
<b>Total</b>	<b>11,908</b>	<b>2,287</b>	<b>16,101</b>	<b>3,395</b>

## Market risk

The objective of the Bank'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 organisations.

The Bank separates exposures to market risk into trading and non-trading portfolios. Trading portfolios include positions arising from market-making, position-taking and other designated as marked-to-market. Non-trading portfolios 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 management of market risk is principally undertaken in Global Banking and Markets using risk limits approved by the GMB. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk develops the Group's market risk management policies and measurement techniques. The Treasury Administration Department ('TAD'), an independent unit from Global Markets (risk taking unit), is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks which arise on each product in its business and to transfer these risks to either its local Global Markets unit for management, or to separate books managed under the supervision of the local Asset and Liability Management Committee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage such risks professionally.

The Bank uses a range of tools to monitor and limit market risk exposures. These include sensitivity analysis, VaR and stress testing.

## Sensitivity analysis

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, present value of a basis point movement in interest rates, for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

## Value at risk

VaR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VaR models used by the Bank are based on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used by the Bank incorporate the following features:

- potential market movements are calculated with reference to data from the past two years;
- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities; and
- VaR is calculated to a 99 percent confidence level and for a one-day holding period.

TAD is responsible for preparing the VaR report and submitting it to local senior management for their consideration on a daily basis. If there are exceptions, the exception report has to be sent to local senior management and also the regional market risk unit.

The Bank validates the accuracy of its VaR models by back-testing the actual daily profit and loss results, adjusted to remove non-modeled items such as fees and commissions, against the corresponding VaR numbers. The back-testing is performed by TAD on a daily basis. Statistically, the Bank would expect to see losses in excess of VaR only 1 percent of the time over a one-year period. The actual number of excesses over this period can

therefore, be used to gauge how well the models are performing.

Although a valuable guide to risk, VaR should always be viewed in the context of its limitations. For example;

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or the risk offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all position fully;
- the use of a 99 percent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore, does not necessarily reflect intra-day exposures; and
- VaR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

#### **Stress testing**

In recognition of VaR's limitations, the Bank augments it with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

The process is governed by the Stress Testing Review Group forum. This coordinates the Group's stress testing scenarios in conjunction with regional risk managers, considering actual market risk exposures and market events in determining the scenarios to be applied at portfolio and consolidated levels, as follows:

- sensitivity scenarios, which consider the impact of any single risk factor or set of factors that are unlikely to be captured within the VaR models, such as the break of a currency peg;
- technical scenarios, which consider the largest move in each risk factor, without consideration of any underlying market correlation;
- hypothetical scenarios, which consider potential macro economic events, for example, a global flu pandemic; and

- historical scenarios, which incorporate historical observations of market movements during previous periods of stress which would not be captured within VaR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the Bank's profit. The daily losses experienced during 2010 were within the stress loss scenarios reported to senior management.

In addition to Group's stress testing scenarios, the Bank also perform the stress testing using the scenarios as specified by the BoT, covering parallel and non-parallel shifts in interest rate yield curves and depreciation and appreciation in major currencies.

#### **Interest rate risk**

Interest rate risk arises within the trading portfolios, principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments.

HSBC aims, through its management of interest rate risk, to mitigate the effect of prospective interest rate movements which could reduce its net income, balanced against the cost of associated hedging activities.

Interest rate risk arising within the trading portfolios is measured, where practical, on a daily basis. HSBC uses a range of tools to monitor and limit interest rate risk exposures. These include the present value of a basis point movement in interest rates, VaR, stress testing and sensitivity analysis.

#### **Foreign exchange risk**

Foreign exchange risk arises as a result of movements in the relative value of currencies. In addition to VaR and stress testing, HSBC controls the foreign exchange risk within the trading portfolio by limiting the open exposure to individual currencies, and on an aggregate basis.

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**Specific issuer risk**

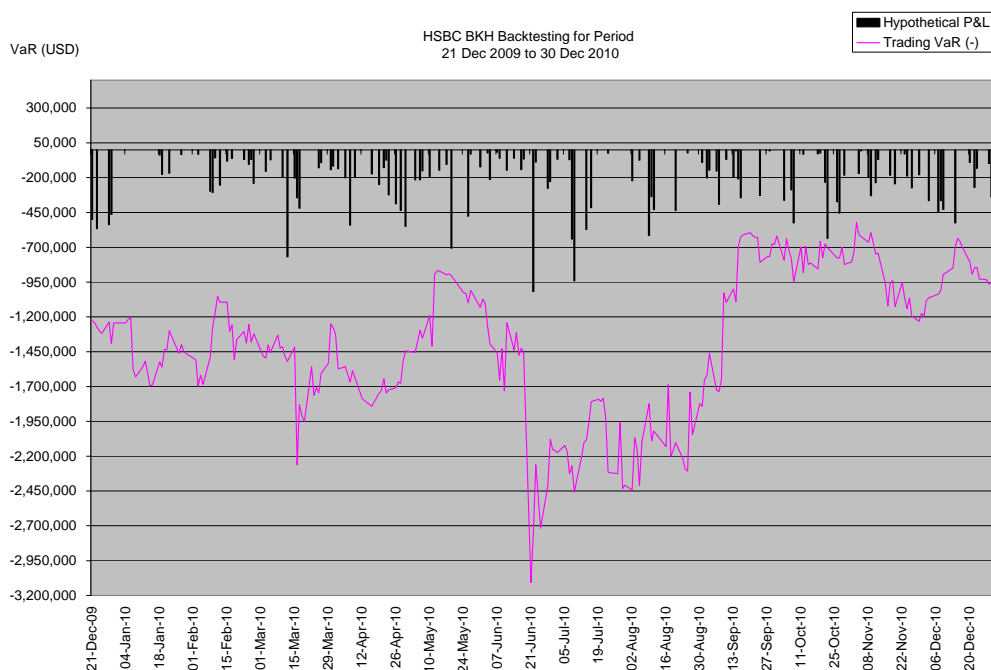
Specific issuer (credit spread) risk arises from a change in the value of debt instruments due to a perceived change in the credit quality of the issuer or underlying assets. As well as VaR and stress testing, HSBC manages the

exposure to credit spread movements within the trading portfolios through the use of limits referenced to the sensitivity of the present value of a basis point movement in credit spreads.

**Table 14 : Market risk information by Internal Model Approach as at 31 December 2010 and 30 June 2010**

	31 December 2010 THBm	30 June 2010 THBm
<b>Interest Rate Risk</b>		
Maximum VaR during the period.....	113	315
Average VaR during the period.....	83	156
Minimum VaR during the period.....	57	89
VaR at the end of the period.....	89	220
<b>Foreign Exchange Rate Risk</b>		
Maximum VaR during the period.....	26	44
Average VaR during the period.....	12	14
Minimum VaR during the period.....	5	2
VaR at the end of the period.....	23	3
<b>Total Market Risk</b>		
Maximum VaR during the period.....	118	319
Average VaR during the period.....	81	157
Minimum VaR during the period.....	50	89
VaR at the end of the period.....	87	221

**Table 15 : Backtesting result (considering loss side of Hypothetical P&L vs. VaR)**



Remark: There were no Backtesting exceptions for the period of 21 December 2009 to 30 December 2010.

### Interest rate risk in the banking book

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Banking and Markets or to separate books managed under the supervision of the local Asset and Liability Management Committee.

The transfer of market risk to books managed by Global Markets or supervised by Asset and Liability Management Committees is usually achieved by a series of internal deals between the business units and these books. When the behavioural characteristics of a product differ from its contractual characteristics, the

behavioural characteristics are assessed to determine the true underlying interest rate risk. Behavioural assumptions of a product are assessed with respect to each local market in which the product is offered. Local Asset and Liability Management Committees are required to regularly monitor all such behavioural assumptions and interest rate risk positions to ensure they comply with interest rate risk limits established by RMM.

The Bank aims, through its management of interest rate risk, to mitigate the effect of prospective interest rate movements which could reduce its future net interest income, balanced against the cost of associated hedging activities, on the current net revenue stream.

Interest rate risk arising within the trading portfolios and non-trading portfolios is measured, where practical, on a daily basis. HSBC uses a range of tools to monitor and limit interest rate risk exposures. These include the present value of a basis point movement in interest rates, VaR, stress testing and sensitivity analysis.

The table below sets out the effect on future net income of an incremental 100 basis points parallel rise in yield curves during the 12 months.

*Table 16 : The effect of changes in interest rates to net interest income in the banking book at 31 December 2010 and 2009*

Currency	Effect to net income	
	2010 THBm	2009 THBm
Baht .....	480	287
US Dollar .....	(142)	(134)
Euro .....	(6)	(5)
Others .....	(33)	(11)
<b>Total effect of changes in interest rates to net interest income .....</b>	<b>299</b>	<b>137</b>



### **Equity exposures in the banking book**

At 31 December 2010, the Bank had equity investments in the banking book of Baht 218 million (2009: Baht 218 million). These are classified as available-for-sale for accounting purposes and held for the purposes maintained as capital fund under Section 32. There are no realised gains or losses on equity securities recognised in the statements of income during the period. Unrealised gains on revaluation of available-for-sale securities as at 31 December

2010 of Baht 18 million (2009: Baht 18 million) were recognised directly in a separate component of Head Office's equity.

Details of the Bank's accounting policy for available-for-sale equity investments are detailed on pages 11, of the *Annual financial statements and Audit report of Certified Public Accountant 2010*.

*Table 17 : Equity exposures in the banking book as at 31 December 2010 and 2009*

	<b>At 31 December</b>	
	<b>2010</b>	<b>2009</b>
	<b>THBm</b>	<b>THBm</b>
Equity exposures		
Book value.....	200	200
Fair value.....	218	218
Unrealised gains on revaluation of available-for-sale equities.....	18	18
Minimum capital requirements for equity exposures on Standardised Approach.....	1	1

*Remark: As at 31 December 2010 and 2009, the Bank holds 200,000 units of The ABF Thailand Bond Index Fund with Net Asset Value of Baht 1,092.0883 per unit and Baht 1,092.9750 per unit, respectively.*

## **Operational risk**

Operational risk is defined as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk’.

Operational risk is relevant to every aspect of the Bank’s business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the definition of operational risk.

### **Objective**

The objective of HSBC’s operational risk management is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with the Group’s risk appetite, as defined by GMB.

### **Organisation and responsibilities**

Operational risk management is primarily the responsibility of employees and business management. The Group Operational Risk function and the operational risk management framework assist business management with discharging this responsibility. Designated Operational Risk Co-ordinators work within key business units and have responsibility for ensuring that the operational risk management framework is effectively implemented in their assigned business units.

### **Measurement and monitoring**

HSBC has codified its operational risk management framework in a high level standard, supplemented by detailed policies. The detailed policies explain HSBC’s approach to identifying, assessing, monitoring and controlling operational risk and give guidance on mitigating action to be taken when weaknesses are identified.

HSBC’s business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework helps managers to fulfil these responsibilities by defining a standard risk and control assessment

methodology and providing a tool for the systematic reporting of operational loss data.

Operational risk capital requirements are calculated under the Standardised Approach, as a percentage of the average of the last three financial years’ gross income.

### **Operational risk assessment approach**

Operational risk self assessments are performed by individual business units and functions. The risk assessment process is designed to support the management rather than total avoidance of risk. Each business and function carries out a risk identification and assessment process at least annually. Where risk is assessed as high, business management either proposes a cost-effective action plan to mitigate the risk or provide a rationale as to why the risk is acceptable at the current level.

All appropriate means of mitigation and controls are considered. These include:

- making specific changes to strengthen the internal control environment;
- investigating whether cost-effective insurance cover is available to mitigate the risk; and
- other means of protecting the Bank from loss.

### **Recording**

HSBC has established a centralised database (‘the Group Operational Risk Database’) to record the results of its operational risk management processes. Operational risk self-assessments as described above, comprising the identified risks, related scoring, action plans and proposed implementation dates, are inputted and maintained at business unit level in the Group Operational Risk Database. Business management and Operational Risk Business Co-ordinators monitor and follow up the progress of documented action plans.

### **Operational risk loss reporting**

To ensure that operational risk losses can be monitored at a Group level, all Group companies are required to report individual losses when the net loss is expected to exceed US\$10,000 and to aggregate all other operational risk losses under US\$10,000. Losses are entered into the Group Operational Risk Database and are reported to the Group Operational Risk function on a monthly basis.

**The Hongkong and Shanghai Banking Corporation Limited, Bangkok Branch**  
**Glossary**

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Abbreviation	Brief description
<b>A</b>	
<b>ALCO</b>	Assets and Liability Management Committee
<b>B</b>	
<b>Bank</b>	The Hongkong and Shanghai Banking Corporation Limited, Bangkok Branch
<b>BCBS</b>	The Basel Committee on Banking Supervision
<b>BoT</b>	The Bank of Thailand
<b>C</b>	
<b>CEO</b>	Chief Executive Officer
<b>CSA</b>	Credit Support Annex
<b>E</b>	
<b>EAD</b>	Exposure at Default
<b>ECAI</b>	External Credit Assessment Institution, such as Moody's Investors Services, Standard & Poor's Ratings Service, Fitch Ratings or TRIS Rating
<b>G</b>	
<b>GCRO</b>	Group Chief Risk Officer
<b>GMB</b>	Group management Board
<b>Group</b>	HSBC Holdings together with its subsidiary undertakings
<b>H</b>	
<b>HSBC</b>	HSBC Holdings together with its subsidiary undertakings
<b>I</b>	
<b>ICAAP</b>	Internal Capital Adequacy Assessment Process
<b>IMM</b>	Internal Model Method
<b>IRB</b>	Internal Ratings-Based
<b>IRRBB</b>	Interest Rate Risk in the Banking Book
<b>ISDA</b>	International Swaps and Derivatives Association
<b>L</b>	
<b>LGD</b>	Loss Given Default
<b>M</b>	
<b>MDB</b>	Multilateral Development Bank
<b>O</b>	
<b>OTC</b>	Over-the-Counter
<b>P</b>	
<b>PD</b>	Probability of Default
<b>PSE</b>	Public Sector Entities
<b>R</b>	
<b>Repo</b>	Sale and repurchase transaction
<b>Reverse repo</b>	Security purchased under commitments to sell
<b>RMC</b>	Risk Management Committee
<b>RMM</b>	Risk Management Meeting of the Group Management Board
<b>RWA</b>	Risk-Weighted Asset
<b>S</b>	
<b>SA</b>	Standardised Approach
<b>T</b>	
<b>TAD</b>	Treasury Administration Department
<b>V</b>	
<b>VaR</b>	Value at Risk

Term	Definition
<b>A</b>	
<b>Available-for-sale ('AFS') financial assets</b>	Those non-derivative financial assets that are designated as available for sale or are not classified as a) loans and receivables b) held-to-maturity investments or c) financial assets at fair value through profit or loss.
<b>B</b>	
<b>Back-testing</b>	A statistical technique used to monitor and assess the accuracy of a model, and how that model would have performed had it been applied in the past.
<b>Basel II</b>	The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
<b>C</b>	
<b>Commercial real estate</b>	Any real estate investment, comprising buildings or land, intended to generate a profit, either from capital gain or rental income.
<b>Credit default swap ('CDS')</b>	A derivative contract whereby a buyer pays a fee to a seller in return for receiving a payment in the event of a defined credit event (e.g. bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency) on an underlying obligation (which may or may not be held by the buyer).
<b>Credit quality step</b>	A step in the Bank of Thailand credit quality assessment scale which is based on the credit ratings of ECAIs. It is used to assign risk weights under the standardised approach.
<b>Credit risk</b>	Risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises mainly from direct lending and trade finance, but also from products such as guarantees, derivatives and debt securities.
<b>Credit risk adjustment</b>	An adjustment to the valuation of OTC derivative contracts to reflect the creditworthiness of OTC derivative counterparties.
<b>Credit risk mitigation</b>	A technique to reduce the credit risk associated with an exposure by application of credit risk mitigants such as collateral, guarantees and credit protection.
<b>Credit Support Annex ('CSA')</b>	A legal document that regulates credit support (collateral) for OTC derivative transactions between two parties.
<b>E</b>	
<b>Exposure</b>	A claim, contingent claim or position which carries a risk of financial loss.
<b>Exposure at default ('EAD')</b>	The amount expected to be outstanding after any credit risk mitigation, if and when the counterparty defaults. EAD reflects drawn balances as well as allowance for undrawn amounts of commitments and contingent exposures.
<b>F</b>	
<b>Fair value</b>	Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
<b>Funding risk</b>	A form of liquidity risk arising when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.
<b>G</b>	
<b>Global Markets</b>	HSBC's treasury and capital markets services in Global Banking and Markets.
<b>Group</b>	HSBC Holdings together with its subsidiary undertakings.

Term	Definition
<b>H</b>	
<b>Haircut</b>	With respect to credit risk mitigation, an adjustment to collateral value to reflect any currency or maturity mismatches between the credit risk mitigant and the underlying exposure to which it is being applied. Also a valuation adjustment to reflect any fall in value between the date the collateral was called and the date of liquidation or enforcement.
<b>I</b>	
<b>Impairment allowances</b>	Management's best estimate of losses incurred in the loan portfolios at the balance sheet date.
<b>Insurance risk</b>	A risk, other than financial risk, transferred from the holder of a contract to the insurance provider. The principal insurance risk is that, over time, the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income.
<b>Internal Capital Adequacy Assessment Process ('ICAAP')</b>	The Bank's own assessment of the levels of capital that it needs to hold through an examination of its risk profile from regulatory and economic capital viewpoints.
<b>Internal Model Method ('IMM')</b>	One of three approaches defined by Basel II to determine exposure values for counterparty credit risk.
<b>Internal ratings-based approach ('IRB')</b>	A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters.
<b>ISDA master agreement</b>	Standardised contract developed by ISDA used as an umbrella under which bilateral derivatives contracts are entered into.
<b>L</b>	
<b>Liquidity risk</b>	The risk that HSBC does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows.
<b>M</b>	
<b>Market risk</b>	The risk that movements in market risk factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce income or portfolio values.
<b>Mark-to-market approach</b>	One of three approaches defined by Basel II to determine exposure values for counterparty credit risk.
<b>N</b>	
<b>Net interest income</b>	The amount of interest received or receivable on assets net of interest paid or payable on liabilities.
<b>O</b>	
<b>Operational risk</b>	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including legal risk.
<b>Over-the-counter ('OTC')</b>	A bilateral transaction (e.g. derivatives) that is not exchange traded and that is valued using valuation models.
<b>R</b>	
<b>Regulatory capital</b>	The capital which the Bank holds, determined in accordance with rules established by the Bank of Thailand.
<b>Residual maturity</b>	The period outstanding from the reporting date to the maturity or end date of an exposure.
<b>Risk appetite</b>	An assessment of the types and quantum of risks to which HSBC wishes to be exposed.

Term	Definition
<b>Risk-weighted assets ('RWA's)</b>	Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure.
<b>S</b>	
<b>Specific issuer risk</b>	Specific issuer (credit spread) risk arises from a change in the value of debt instruments due to a perceived change in the credit quality of the issuer or underlying assets
<b>Standardised approach</b>	<p>In relation to credit risk, a method for calculating credit risk capital requirements using ECAI ratings and supervisory risk weights.</p> <p>In relation to operational risk, a method of calculating the operational capital requirement by the application of a supervisory defined percentage charge to the gross income of eight specified business lines.</p>
<b>V</b>	
<b>Value at risk ('VaR')</b>	A technique that measures the loss that could occur on risk positions as a result of adverse movements in market risk factors (e.g. rates, prices, volatilities) over a specified time horizon and to a given level of confidence