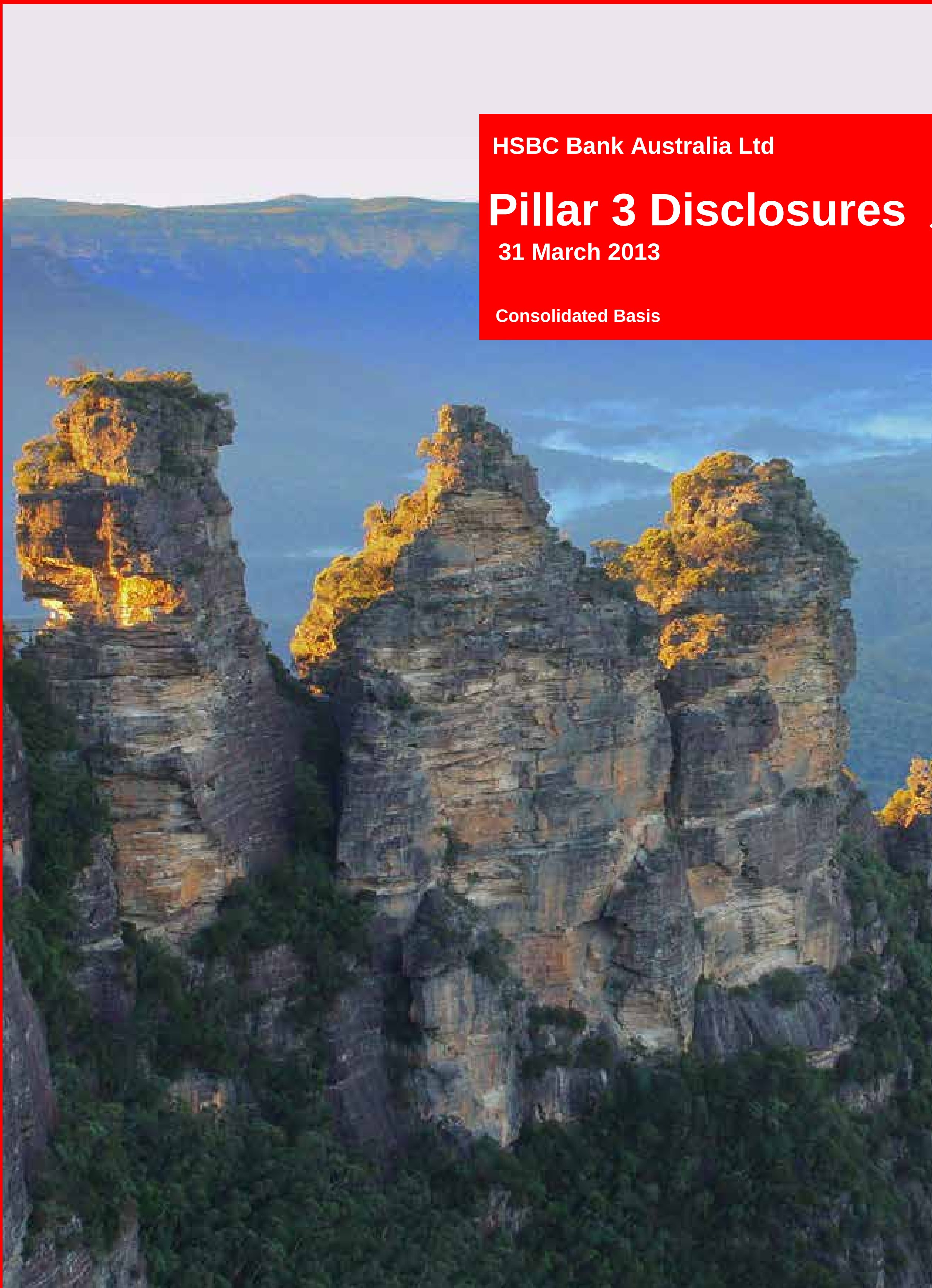
HSBC Bank Australia Ltd

Pillar 3 Disclosures

31 March 2013

Consolidated Basis



HSBC

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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 unforseen 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 current 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.

Basel III capital reforms require that existing capital instruments which do not meet the new capital eligibility criteria as detailed in Prudential Standard APS 111 must be de-recognised from 1st January 2013 or be formally approved by APRA to allow the application of transitional arrangements. HSBC Bank Australia Limited (HBAU) has a number of capital instruments which required consideration under these provisions:

· AUD $200m of subordinated unsecured floating rate Medium Term Notes (MTN), issued on 25th November 2010 and maturing on 25th November 2020, with an issuer call option exercisable on 26th November 2015. This tranche of lower Tier 2 capital does not meet the loss absorbency at the point of non-viability requirements detailed in Attachment J of APS 111 (January 2013) and is subject to transitional arrangements under which the level eligible for inclusion as Tier 2 capital will be amortised by 10% per annum from 1st January 2013.

· AUD $42m of subordinated unsecured floating rate MTN, issued on 14th March 2008 and maturing on 14th March 2018, with an issuer call option exercisable on 15th March 2013. This tranche of lower Tier 2 capital included a step-up provision coinciding with the call date and so did not meet the requirements of Attachment H of APS 111 (January 2013) and also did not meet the loss absorbency at the point of non-viability requirements detailed in Attachment J of APS 111 (January 2013) and so was de-recognised as Tier 2 capital from 1st January 2013.

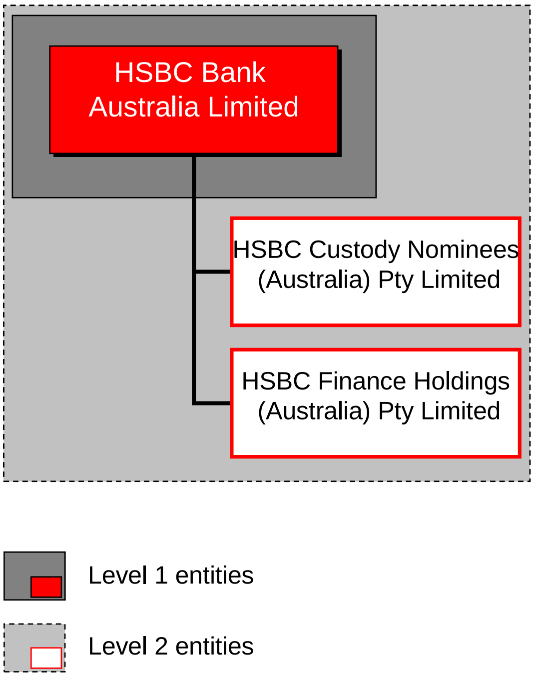
· AUD $60m in non-cumulative, non-redeemable preference shares. This Additional Tier 1 capital does not meet the loss absorbency at the point of non-viability requirements detailed in Attachment J of APS 111 (January 2013) and so was de-recognised from 1st January 2013. On 18th March 2013 these shares were cancelled and replaced with AUD 60m of ordinary shares.

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")

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.

4. HBAU Context

HSBC is one of the world's largest banking and financial services organisations 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

Kate Epworth
+61 2 9006 5682
+61 481 004 119
kateepworth@hsbc.com.au

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.

Table 16 - Capital Adequacy (Consolidated)

All figures in AUDm

Capital requirements (in terms of risk weighted assets) for credit risk by portfolio	March 2013	December 2012
· Corporate	6,083	5,931
· Government	-	-
· Bank	1,061	1,067
· Residential Mortgage	3,825	3,784
· Other Retail	1,367	1,367
· All Other	106	118
Risk weighted assets – Credit risk excluding securitisation	**12,443**	**12,267**
· Securitisation	-	1
Total credit risk weighted assets	**12,443**	**12,268**
Capital requirements (in terms of risk weighted assets) for Market risk	30	33
Capital requirements (in terms of risk weighted assets) for Operational risk	1,369	1,369
Total risk weighted assets	**13,842**	**13,670**

Capital Ratios	March 2013	December 2012
Total capital ratio for the consolidated banking group	11.0%	11.3%
Tier 1 capital ratio for the consolidated banking group	8.9%	8.9%

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'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 approach 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.

Table 17a – Credit risk (Consolidated)

All figures in AUDm

	March 2013		December 2012	
Exposure Type	**Total gross credit risk exposures**	**Average gross exposure over the period**	**Total gross credit risk exposures**	**Average gross exposure over the period**
· Cash and Liquid Assets	71	57	43	27
· Debt Securities	5,775	6,158	6,541	6,277
· Due from other Financial Institutions	918	708	497	832
· Loans and Advances	15,250	15,138	15,026	14,900
· Derivatives	109	117	124	133
· Contingent Liabilities, Commitments and other Off-Balance Sheet Exposures	5,454	5,330	5,205	5,491
· Other Assets	329	353	377	421
Total Exposures	**27,906**	**27,861**	**27,813**	**28,081**
Portfolio Type	**Total gross credit risk exposures**	**Average gross exposure over the period**	**Total gross credit risk exposures**	**Average gross exposure over the period**
· Corporate	6,609	6,568	6,526	6,627
· Government	2,769	3,110	3,450	3,195
· Bank	6,421	6,131	5,840	6,376
· Residential Mortgage	10,569	10,507	10,445	10,334
· Other Retail	1,424	1,425	1,425	1,397
· All Other	114	120	127	152
Total Exposures	**27,906**	**27,861**	**27,813**	**28,081**

Note: Total exposures are based on local APRA definitions.

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.

Table 17b – Credit risk (Consolidated)

All figures in AUDm

Financial Position

Portfolios subject to Standardised approach	March 2013 Impaired Loans	March 2013 Past due loans >90 days[1]	March 2013 Provisions[1]	December 2012 Impaired Loans	December 2012 Past due loans >90 days[1]	December 2012 Provisions[1]
· Corporate [2]	197.7	-	100.3	169.8	-	88.8
· Government	-	-	-	-	-	-
· Bank	13.6	-	11.6	13.7	-	11.6
· Residential Mortgage	9.3	55.9	2.7	20.7	43.9	7.2
· Other Retail	0.2	23.6	28.2	0.2	21.4	23.8
· All Other	-	-	-	-	-	-
Sub Total	**220.8**	**79.5**	**142.8**	**204.4**	**65.3**	**131.4**
Collective provision			30.1			28.1
Total Provisions			**172.9**			**159.5**

[1] Includes Individually and Portfolio Managed Facilities.
[2] Increase is due to a single corporate impairment with exposure of $26.0m and provision raised of $10.5m.

Financial Performance

Portfolios subject to Standardised approach [1]	March 2013 Charges for Provisions	March 2013 Write offs	March 2013 Recoveries	March 2013 Total
· Corporate	12.6	0.0	(3.2)	9.4
· Government	-	-	-	-
· Bank	-	-	-	-
· Residential Mortgage	-	-	(0.8)	(0.8)
· Other Retail	5.1	16.8	(3.3)	18.6
· All Other	-	-	-	-
Sub Total	**17.7**	**16.8**	**(7.3)**	**27.2**
Movement in collective provision (not included above)	2.0	-	-	2.0
Total loan impairment charges and other movement in credit risk provisions	**19.7**	**16.8**	**(7.3)**	**29.2**

[1] Year-to-Date figures.

Financial Performance

Portfolios subject to Standardised approach [1]	December 2012 Charges for Provisions	Write offs	Recoveries	Total
· Corporate	92.6	-	(25.4)	67.2
· Government	-	-	-	-
· Bank	-	-	-	-
· Residential Mortgage	3.8	-	(0.5)	3.3
· Other Retail	6.6	63.0	(15.3)	54.3
· All Other	-	-	-	-
Sub Total	**103.0**	**63.0**	**(41.2)**	**124.8**
Movement in collective provision (not included above)	9.9	-	-	9.9
Total loan impairment charges and other movement in credit risk provisions	**112.9**	**63.0**	**(41.2)**	**134.7**

[1] Year-to-Date figures.

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 compiled on the basis of expected losses on all exposures across the various risk portfolios.

The General Reserve consists of eligible Collective Impairment Provisions (CIP) raised under AIFRS, and Portfolio provisions. Any shortfall in the 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

	March 2013	December 2012
General Reserve for Credit Losses[1]	**100.1**	**87.3**

[1] Gross of deferred tax.

The quarterly increase in the General Reserve for Credit Losses is due to a deterioration in asset quality in the corporate book which has been reflected in the level of impaired loans and provisions as shown in Table 17b.

Securitisation

HBAU undertakes the following securitisation related activity in the normal course of business:

- Securitisations of own originated residential mortgages for funding, contingent liquidity and potentially capital purposes. Such activity can potentially result in investment in any class of notes issued by the securitisation special purpose entity (SPE), provision of swaps to the SPE, provision of liquidity facilities and provision of Servicer and Trust Manager services to the SPE.

- Securitisation is examined as part of the wider funding planning of the Bank and within the context of the HSBC Group's limited appetite for wholesale funding.

- Provision of interest rate swaps to third party securitisations.

HBAU does not invest in notes issued by third party securitisations in either Trading or Balance Sheet Management books.

Table 18 – Securitisation Exposures

a) No new securitisation or re-securitisation activity was undertaken during the March 2013 or December 2012 quarters relating to SPEs where the notes and receivables are owned by external parties.

b) Securitisation transactions in the December 2012 quarter were related to the transfer of an additional AUD 1.5 billion of residential mortgages into an existing SPE which HBAU continues to consolidate. All of the notes and receivables in this SPE are owned by HBAU and are held for contingent liquidity purposes.

c) There were no new on-balance sheet securitisation exposures retained or purchased during the March 2013 or December 2012 quarters. This excludes originated securitisation exposures for contingent liquidity purposes where no capital relief is sought. In such instance loans are retained for regulatory capital and risk weighted in accordance to APS 112. HSBC Bank Australia Limited has no re-securitisation exposure currently or in the prior quarter.

All figures in AUDm

	March 2013	December 2012
Off Balance Sheet [1]	**Exposure Amount**	**Exposure Amount**
· Derivatives	1.9	2.2
· Other	-	-
Total Off Balance Sheet	**1.9**	**2.2**

[1] Credit equivalent value