HSBC Bank plc

Capital and Risk Management Pillar 3 Disclosures at 31 December 2011

HSBC

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Presentation of information

This document comprises the *Capital and Risk Management Pillar 3 Disclosures at 31 December 2011* (‘*Pillar 3 Disclosures 2011*’) for HSBC Bank plc (‘the bank’) and its subsidiary undertakings (together ‘the group’). References to either ‘HSBC’ or ‘the Group’ within this document mean HSBC Holdings plc together with its subsidiaries.

Cautionary statement regarding forward-looking statements

These *Pillar 3 Disclosures 2011* contain certain forward-looking statements with respect to the financial condition, results of operations and business of the group. Statements that are not historical facts, including statements about the group’s beliefs and expectations, are forward-looking statements. Words such as ‘expects’, ‘anticipates’, ‘intends’, ‘plans’, ‘believes’, ‘seeks’, ‘estimates’, ‘potential’ and ‘reasonably possible’, 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. The bank makes no commitment to revise or update any forward-looking statements to reflect events or circumstances occurring or existing after the date of any forward-looking statement.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ materially from those anticipated or implied in any forward-looking statement.

Frequency

In accordance with the Financial Services Authority of the United Kingdom (‘FSA’) requirements, the bank publishes its Pillar 3 disclosures annually.

Verification

The *Pillar 3 Disclosures 2011* have been verified internally but have not been audited by the group’s external auditor.

Media and location

The HSBC Holdings plc Pillar 3 Disclosures 2011 and other information on the Group are available on HSBC’s investor relations website: www.hsbc.com/investor-relations.

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Introduction

The bank is a subsidiary of HSBC Holdings plc. HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US$ 136 billion at 31 December 2011.

The group provides a comprehensive range of banking and related financial services and divides its activities into business segments: UK Retail Banking, Continental Europe Retail Banking, Global Banking and Markets, and Private Banking.

Further details of the group's principal activities can be found on page 4 of the HSBC Bank plc *Annual Report and Accounts 2011 ('2011 Accounts')*.

Basel II

The FSA supervises the group on a consolidated basis and therefore receives information on the capital adequacy of the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, including the FSA itself in certain circumstances (for example, the bank), who set and monitor their capital adequacy requirements.

At both group and bank level capital is calculated using the Basel II framework of the Basel Committee on Banking Supervision as implemented by the FSA. However, local regulators are at different stages of implementation and local reporting may still be on a Basel I basis in some places. In most jurisdictions, non-banking financial institutions are also subject to the supervision and capital requirements of local regulatory authorities.

Basel II is structured around three 'pillars': minimum capital requirements, supervisory review and market discipline. The Capital Requirements Directive ('CRD') implemented Basel II in the European Union ('EU') and the FSA then gave effect to CRD by including the requirements of CRD in its rulebooks.

Pillar 3 disclosures 2011

Pillar 3 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 and risk assessment processes, and hence the capital adequacy of the institution. Disclosures consist of both quantitative and qualitative information and are provided at the consolidated level.

Banks are required to disclose all their material risks as part of the pillar 3 framework. All material and non-proprietary information required by pillar 3 is included in the HSBC Holdings plc *Pillar 3 Disclosures 2011*. HSBC Bank plc, as a significant subsidiary of HSBC Holdings plc, is required to publish certain limited pillar 3 disclosures separately on a consolidated basis.

The FSA permits certain pillar 3 requirements to be satisfied by inclusion within a firm's financial statements. Where this is the case, this document provides page references to the relevant sections in the HSBC Bank plc *2011 Accounts* and HSBC Holdings plc *Annual Report and Accounts 2011*.

Principal changes to disclosures

The principal changes to the *Pillar 3 Disclosures 2011*, compared with the previous year, are those commonly known as Basel 2.5, implemented in the EU through CRD III. These changes have increased the capital requirements for resecuritisation exposures and market risk with effect from 31 December 2011.

Movement in risk-weighted assets in 2011

RWAs increased by £26bn or 13% in 2011, primarily as a result of Basel 2.5 implementation.

Market risk requirements increased by approximately £16bn, predominantly in the form of stressed VAR. Credit risk requirements increased by roughly £10bn, of which £5bn resulted from higher risk weights on resecuritisation exposures and the remainder largely reflected growth in the bank's Commercial Banking business.

The impact of these changes is visible in Tables 3 & 4 on pages 6-7 of these *Pillar 3 Disclosures 2011*.

Future Developments

The regulation and supervision of financial institutions continues to undergo significant change in response to the global financial crisis. In December 2010, the Basel Committee issued rules in two documents 'A global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring', which together are commonly referred to as 'Basel III'. In June 2011, the Basel Committee issued a revision to the former document setting out the finalised

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capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum common equity tier 1 requirement of 4.5% and an additional capital conservation buffer requirement of 2.5%, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a maximum level of 2.5% effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. The leverage ratio will be subject to a supervisory monitoring period, which commenced on 1 January 2011, and a parallel run period which will run from 1 January 2013 until 1 January 2017. Further calibration of the leverage ratio will be carried out in the first half of 2017, with a view to migrating to a pillar 1 requirement from 1 January 2018.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011, to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

In July 2011, the European Commission published proposals for a new regulation (COM 2011/452) and directive (COM 2011/453), known collectively as CRD IV, to give effect to the Basel III framework in the EU. The majority of the Basel III proposals are in the regulation, removing national discretion, with the exception of countercyclical and capital conservation buffers which are in the directive.

The Regulation additionally sets out provisions to harmonise regulatory reporting in the EU. In December 2011, the European Banking Authority published a consultative document, “Implementing Technical Standards on Supervisory Reporting Requirements”. The proposed measures specify uniform formats, frequencies and dates of prudential reporting to the regulator. The new requirements are due to take effect as of 1 January 2013.

The CRD IV measures are subject to agreement by the European Parliament, the Council and EU member states.

Table 1: Basel III phase-in arrangements

%	2013	2014	2015	2016	2017	2018	2019
Minimum common equity capital ratio	3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital conservation buffer	-	-	-	0.625	1.25	1.875	2.5
Minimum common equity capital ratio plus capital conservation buffer	3.5	4.0	4.5	5.125	5.75	6.375	7.0
Minimum tier 1 ratio	4.5	5.5	6.0	6.0	6.0	6.0	6.0
Minimum total capital ratio plus capital conservation buffer	8.0	8.0	8.0	8.625	9.25	9.875	10.5

In September 2011, the UK Independent Commission on Banking recommended measures on capital requirements for UK banking groups. For further details on these proposals see page 31 of the HSBC Bank plc *2011 Accounts*.

Comparison with the HSBC Bank plc *Annual Report and Accounts 2011*

The *Pillar 3 Disclosures 2011* have been prepared in accordance with regulatory capital adequacy concepts and rules, rather than in accordance with International Financial Reporting Standards (‘IFRSs’). Therefore, some information in the *Pillar 3 Disclosures 2011* is not directly comparable with the financial information in the HSBC Bank plc *2011 Accounts*. This is most pronounced for the credit risk disclosures, where credit exposure is defined as the amount estimated to be at risk under specified Basel II parameters. This differs from similar information in the HSBC Bank plc *2011 Accounts,* which is mainly reported at the balance sheet date and therefore does not reflect the likelihood of future drawings of committed credit lines.

Consolidation basis

The basis of consolidation for financial accounting purposes is described in *Note 1 - Basis of preparation* of the notes on the financial statements on page 99 of the HSBC Bank plc *2011 Accounts.* This differs from that used for regulatory purposes. Investments in banking associates are equity accounted in the financial accounting consolidation, whereas their exposures are proportionally consolidated for regulatory purposes. Subsidiaries and associates

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engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation does not include Special Purpose Entities ('SPEs') where significant risk has been transferred to third parties. Exposures to these SPEs are either risk-weighted as securitisation positions or deducted from capital for regulatory purposes.

Scope of Basel II permissions

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, trade finance and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holdings of debt and other securities.

Basel II applies three approaches of increasing sophistication to the calculation of minimum credit risk capital requirements. The most basic, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties, to group unrated counterparties into broad categories and to apply standardised risk weightings. 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 uses supervisory formulae and parameters to estimate exposure at default ('EAD') and loss given default ('LGD'). Finally, the IRB advanced approach allows banks to use their own internal assessment in both determining PD and quantifying EAD and LGD.

The capital resources requirement, which is intended to cover unexpected losses, is derived from formulae specified in the regulatory rules which incorporate these factors and other variables such as maturity and correlation. Expected losses under the IRB approaches are calculated by multiplying PD by EAD and LGD. Expected losses are deducted from capital to the extent that they exceed accounting impairment allowances on the IRB portfolios.

For credit risk, with the FSA's approval, the group has adopted the IRB advanced approach for the majority of its business, with the remainder on either IRB foundation or standardised approaches. A rollout plan is in place to extend coverage of the advanced approach over the next few years, leaving a residue of exposures on the standardised approach.

Counterparty credit risk

Counterparty credit risk is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. It arises on over the counter and securities financing transactions in both the trading and non-trading books.

Three methods for 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.

The group uses the mark-to-market and internal model methods to measure exposure for counterparty credit risk. Its longer-term aim is to migrate more positions to the internal model method.

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 group's income or the value of its portfolios. Market risk is measured using internal market risk models where approved by the FSA, or the FSA's standard market risk position risk requirement ('PRR') rules.

Following the implementation of CRD III, the bank's internal market risk models comprise models for Value at Risk ('VAR'), stressed VAR and the incremental risk charge.

The group uses both approaches for market risk. Its longer-term aim is to migrate more positions from standard market risk PRR rules to internal models based approaches.

Operational risk

Basel II 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 a bank's own statistical analysis and modelling of operational risk data to determine capital requirements.

The group has adopted the standardised approach in determining its operational risk capital requirements.

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Capital

Regulatory capital

Table 2 below sets out the composition of the group's regulatory capital and risk-weighted assets at 31 December 2011.

Table 2: Capital structure at 31 December

	2011	2010
Composition of regulatory capital (Audited)	**£m**	£m
Shareholders' equity [1]	**32,449**	31,379
Shareholders' equity per balance sheet	**31,090**	31,825
Preference shares & related premium	**(431)**	(431)
Other equity instruments	**-**	(1,750)
Deconsolidation of special purpose entities [2]	**1,790**	1,735
Non-controlling interests	**364**	382
Non-controlling interests per balance sheet	**514**	532
Of which representing non-controlling interests in preference shares	**(150)**	(150)
Regulatory adjustments to the accounting basis	**(1,032)**	748
Unrealised (gains)/losses on available-for-sale debt securities [3]	**1,261**	1,545
Own credit spread	**(706)**	(170)
Defined benefit pension fund adjustment [4, 5]	**(1,058)**	288
Cash flow hedging reserve	**(236)**	(190)
Reserves arising from revaluation of property & unrealised gains on available-for-sale equities	**(272)**	(373)
Other regulatory adjustments	**(21)**	(352)
Deductions	**(11,051)**	(11,428)
Goodwill capitalised & intangible assets	**(10,274)**	(10,436)
50% of securitisation positions	**(570)**	(679)
50% of excess expected losses over impairment allowances	**(286)**	(439)
50% of tax credit adjustment for excess expected losses	**79**	126
Core tier 1 capital	**20,730**	21,081
Other tier 1 capital before deductions	**2,377**	2,374
Preference shares & related premium	**581**	581
Hybrid capital securities	**1,796**	1,793
Deductions	**(368)**	(500)
Unconsolidated investments [6]	**(447)**	(626)
50% of tax credit adjustment for excess expected losses	**79**	126
Tier 1 capital	**22,739**	22,955
Total qualifying tier 2 capital before deductions	**11,837**	11,758
Reserves arising from unrealised gains on revaluation of property & available-for-sale equities	**272**	373
Collective impairment allowances [7]	**235**	338
Perpetual subordinated debt	**2,863**	2,762
Term subordinated debt	**8,467**	8,285
Total deductions other than from tier 1 capital	**(1,908)**	(2,302)
Unconsolidated investments [6]	**(1,045)**	(1,177)
50% of securitisation positions	**(570)**	(679)
50% of excess expected losses over impairment allowances	**(286)**	(439)
Other deductions	**(7)**	(7)
Total Regulatory capital	**32,668**	32,411
Risk-weighted assets (Unaudited)		
Credit and counterparty credit risk	**173,693**	164,372
Market risk	**28,605**	12,762
Operational risk	**25,381**	24,586
Total	**227,679**	201,720
Capital ratios (Unaudited)	**%**	%
Core tier 1 ratio	**9.1**	10.5
Tier 1 ratio	**10.0**	11.4
Total capital ratio	**14.4**	16.1

Notes (continues overleaf)

1 *Includes externally verified profits for the year to 31 December 2011. Does not include the interim dividend of £200m declared by the Board of Directors after 31 December 2011.*
2 *Mainly comprises unrealised losses on available-for-sale debt securities owned by deconsolidated special purpose entities.*
3 *Under FSA rules unrealised gains/losses on available-for-sale debt securities must be excluded from capital resources.*

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4 *FSA rules require banks to exclude from capital resources any surplus in a defined benefit pension scheme.*
5 *FSA rules permit banks to replace a liability in a defined benefit pension scheme by the additional funding that will be paid into the scheme over the following five year period.*
6 *Mainly comprise investments in insurance entities.*
7 *Under FSA rules collective impairment allowances on loan portfolios under the standardised approach may be included in tier 2 capital.*

Credit risk and market risk

Tables 3 & 4 below set out the group's credit and market risk-weighted assets and regulatory capital requirements at 31 December 2011.

Table 3: Credit risk capital requirements

	At 31 December 2011		At 31 December 2010	
	Capital required	**RWA**	Capital required	RWA
Total credit risk capital requirements	**£m**	**£m**	£m	£m
Credit risk	**12,360**	**154,497**	11,765	147,066
Counterparty credit risk [1]	**1,535**	**19,196**	1,385	17,306
Total	**13,895**	**173,693**	13,150	164,372
Credit risk analysis by exposure class				
Exposures under the IRB advanced approach	**7,726**	**96,572**	7,233	90,416
Retail:				
– secured on real estate property	**506**	**6,328**	646	8,081
– qualifying revolving retail	**506**	**6,320**	602	7,520
– small and medium-sized enterprises	**340**	**4,257**	356	4,454
– other retail	**464**	**5,797**	531	6,638
Total retail	**1,816**	**22,702**	2,135	26,693
Central governments and central banks	**216**	**2,698**	200	2,496
Institutions	**445**	**5,563**	503	6,287
Corporates	**3,744**	**46,795**	3,522	44,023
Securitisation positions [2, 3]	**1,477**	**18,466**	873	10,917
Equity [4]	**28**	**348**	-	-
Exposures under the foundation IRB approach	**316**	**3,949**	210	2,629
Corporates	**316**	**3,949**	210	2,629
Exposures under the Standardised approach	**4,318**	**53,976**	4,322	54,021
Institutions	**216**	**2,703**	894	11,180
Corporates	**2,807**	**35,092**	2,150	26,877
Retail	**243**	**3,037**	267	3,337
Secured on real estate property	**360**	**4,498**	365	4,566
Past due items	**46**	**575**	57	716
Collective investment undertakings	**9**	**107**	8	103
Equity – Institutions	**5**	**56**	7	85
Equity – Other	**68**	**854**	77	958
Other items [5]	**564**	**7,054**	497	6199
Total	**12,360**	**154,497**	11,765	147,066

Notes
1 *Includes counterparty credit risk on both trading book and non-trading book exposures.*
2 *Excludes securitisation positions deducted from capital (which would otherwise be risk-weighted at 1,250 per cent). Securitisation positions deducted from capital are shown in Table 2.*
3 *At the end of 2011, the implementation of CRD III resulted in increased capital requirements for resecuritisations.*
4 *An FSA rule change during 2011 allows banks to risk weight certain venture capital exposures using the equity IRB simple risk weight approach. These exposures were previously deducted from capital.*
5 *Primarily includes such items such as tangible fixed assets, prepayments and deferred taxation.*

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Table 4: Market risk capital requirements

	At 31 December 2011		At 31 December 2010	
Market risk analysis by approach	**Capital required £m**	**RWA £m**	Capital required £m	RWA £m
Internal models based requirements [1]	**2,127**	**26,586**	884	11,051
VAR	**410**	**5,122**	355	4,440
Stressed VAR	**913**	**11,415**	-	-
Incremental Risk Charge	**160**	**2,001**	231	2,882
VAR and stressed VAR from other CRD jurisdictions	**644**	**8,048**	298	3,729
Standard market risk position risk requirements [2]	**161**	**2,019**	137	1,711
Interest rate position risk requirement [3]	**146**	**1,832**	130	1,620
Equity position risk requirement	**1**	**9**	4	52
Commodity position risk requirement	**14**	**174**	3	39
Foreign exchange position risk requirement	**-**	**1**	-	-
CIU position risk requirement [4]	**-**	**3**	-	-
Total market risk capital requirement	**2,288**	**28,605**	1.021	12,762

Notes

1. *At the end of 2011, the implementation of CRD III resulted in increased capital requirements for market risk positions.*
2. *Calculated using FSA standard market risk PRR rules.*
3. *Includes securitisation positions held in the trading book.*
4. *The CIU position risk requirement at 31 December 2011 arises wholly from option exposures.*

Internal assessment of capital adequacy

The group assesses the adequacy of its capital by considering the resources necessary to cover unexpected losses arising from discretionary risks, being those which it chooses to accept (such as credit risk and market risk), and from non-discretionary risks, being those which arise by virtue of its operations (such as operational risk and business risk). The group's capital management and allocation policy is underpinned by its capital management framework. The capital management framework and related policies define the Internal Capital Adequacy Assessment Process by which the Board of Directors of HSBC Bank plc ('the Board') and senior management examine the risk profile from both regulatory and economic capital viewpoints to ensure that the group's level of capital:

- remains sufficient to support the group's risk profile and outstanding commitments;
- exceeds the group's formal minimum regulatory capital requirements by an agreed margin;
- is capable of withstanding a severe economic downturn stress scenario; and
- remains consistent with the group's strategic and operational goals, and shareholder and rating agency expectations.

The regulatory and economic capital assessments rely upon the use of models that are integrated into the group's management of risk.

Economic capital is the internally calculated capital requirement which the group deems necessary to support the risks to which it is exposed. Regulatory capital is the minimum level of capital which the group is required to hold in accordance with the rules set by the FSA (in the case of the bank and the consolidated group) and by local regulators (for individual subsidiary companies).

The economic capital assessment is the more risk-sensitive measure as it covers a wider range of risks and takes account of the substantial diversification of risk accruing from the group's operations. The group's economic capital models, based on those developed by HSBC, are calibrated to quantify the level of capital that is sufficient to absorb potential losses over a one-year time horizon to a 99.95 per cent level of confidence for its banking activities and to a 99.5 per cent level of confidence for its insurance activities and pension risks. The group's approach to capital management is aligned to its corporate structure, business model and strategic direction.

The group's discipline around capital allocation is maintained within established processes and benchmarks, in particular the approved annual group capital plan.

Regulatory and, increasingly, economic capital are the metrics by which risk is measured and linked to capital within the group's risk appetite framework. The framework expresses the types and quantum of risks to which the group wishes to be exposed. It is

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approved and monitored by the Board and senior management.

The group identifies and manages risk through a defined risk management framework and continuous monitoring of the risk environment. It assesses and manages certain of these risks via the capital planning process. Risks assessed via capital and those that are not are compared below.

Risks assessed via capital

Credit (including counterparty credit), market and operational risk

The group assesses economic capital requirements for these risk types utilising the embedded operational infrastructure used for the calculation of regulatory capital requirements, together with an additional suite of models that take into account, in particular:

- the increased level of confidence required to meet the group's strategic goals (99.95 per cent); and
- internal assessments of diversification or concentration of risks within the group's portfolios.

The group's economic capital assessment consistently demonstrates a substantially lower overall capital requirement for credit risk than the regulatory equivalent, evidencing the benefits of diversification. However, the group maintains a prudent stance on capital coverage, ensuring that any model risk is mitigated.

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.

This risk arises in such portfolios principally from mismatches between the 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 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. IRRBB economic capital is measured as the amount of capital necessary to cover an unexpected loss in the value of our non-trading products over one year to a 99.95% level of confidence. The group's management of this risk is also described on page 63 of the HSBC Bank plc *2011 Accounts.*

Insurance risk

The group operates a bancassurance model which provides insurance products for customers with whom the group has a banking relationship. Many of these insurance products are manufactured by group subsidiaries but, where the group considers it operationally more effective, third parties are engaged to manufacture and provide insurance products which the group sells through its banking network. The group works with a limited number of market-leading partners to provide these products. When manufacturing products, the group underwrites the insurance risk and retains the risks and rewards associated with writing insurance contracts. The group's risk management of insurance operations is described in more detail on pages 66-73 of the HSBC Bank plc *2011 Accounts.*

Risk-based capital methodologies are in use at the group's two principal life insurance subsidiaries and we continue to make progress towards implementing similar measures for the group's remaining insurance businesses.

Pension risk

The group operates a number of pension plans. Some of these are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme. In order to fund these benefits, sponsoring group companies (and in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the scheme's trustees (where relevant). In situations where a funding deficit emerges, sponsoring group companies agree to make additional contributions to the plans, to address the deficit over an appropriate repayment period. Further detail of these payments can be found in *Note 7 – Employee compensation and benefits* of the Notes on the Financial Statements on pages 124-132 of the HSBC Bank plc *2011 Accounts.* The group's management of pension risk is also described on pages 73-74 of the HSBC Bank plc *2011 Accounts.*

The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

Pension risk is the risk that a deficit may arise in a defined benefit plan from a number of factors, including:

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when

increases in long-term interest rates cause a fall in the value of fixed income securities held;

- the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and
- scheme members living longer than expected (known as longevity risk).

Pension risk is assessed by way of an economic capital model that takes into account potential variations in these factors, using a VAR methodology.

Residual risk

Residual risk is primarily the risk that mitigation techniques prove less effective than expected. This category also includes risks that arise from specific reputational or business events that give rise to exposures not deemed to be included in the major risk categories. The group conducts economic capital assessments of such risks on a regular, forward-looking basis to ensure that their impact is adequately covered by its capital base.

Risks not explicitly assessed via capital

Liquidity risk

Liquidity and funding risk management is described in detail on pages 57-60 of the HSBC Bank plc *2011 Accounts.*

The group uses cash-flow stress testing as part of its control processes to assess liquidity risk. The group does 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, the group recognises 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.

Structural foreign exchange risk

Structural foreign exchange risk is described in detail on pages 63-64 of the HSBC Bank plc *2011 Accounts.*

Structural foreign exchange risks arise from our net investments in subsidiaries, branches and associates, the functional currencies of which are other than the British Pound. Unrealised gains or losses due to revaluations of structural foreign exchange exposures are reflected in reserves, whereas other unrealised gains or losses arising from revaluations of foreign exchange positions are reflected in the income statement.

The group's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that the group's consolidated capital ratios and the capital ratios of the individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question. The group evaluates residual structural foreign exchange exposures using a VAR model, but typically does not assign any economic capital for these, since they are managed within appropriate economic capital buffers.

Reputational risk

Details of the group's management of reputational risk can be found on page 74 of the HSBC Bank plc *2011 Accounts.*

As a banking group, the group's reputation depends upon the way in which it conducts its business, but it can also be affected by the way in which clients to whom it provides financial services conduct themselves. The group's reputation is paramount and safeguarding it is the responsibility of all members of staff, supported by a global risk management structure, underpinned by relevant policies and practices, readily available guidance and regular training. A fresh emphasis in 2011 on values made these more explicit, to ensure the group meets the expectations of society, customers, regulators and investors.

Business risk

The FSA specifies that banks, as part of their internal assessment of capital adequacy process, should review their exposure to business risk.

Business risk is the potential negative impact on profits and capital as a result of the group not meeting its strategic objectives, as set out in the rolling operating plan, owing to unforeseen changes in the business and regulatory environment, exposure to economic cycles and technological changes. The group does not explicitly set aside capital against business risk as a distinct category.

Capital and Risk Management Pillar 3 Disclosures at 31 December 2011

Business risk is managed and mitigated through the business planning and stress testing processes, which ensure that the 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 the business plans are identified at an early stage so that mitigating actions can be taken proactively.

Scenario analysis and stress testing

Scenario analysis and stress testing are important mechanisms in understanding the sensitivities of the group's business and capital plans to the adverse effects of a range of plausible events of varying severity, some of which are extreme. As well as considering the potential financial impact upon plans, a key output of this tool is the consideration and establishment of management action plans for mitigating such events should they, or similar events, arise.

Regulatory capital supply is regularly assessed against demand under a range of stress scenarios, including projected global and local economic downturns. Qualitative and quantitative techniques are used to estimate the potential impact on the group's capital position under such scenarios. The group also participates, where appropriate, in standard scenario analyses requested by regulatory bodies.

As part of the group's risk appetite process, business and capital plans are supported by forecasts of the risk parameters that drive the group's capital requirements. The group carries out macro-economic stress tests which consider sensitivities of these drivers under a variety of potential economic forecasts in order to examine the possible capital positions that could arise. In any material economic downturn, proactive and structured intervention by management is both inevitable and necessary. Therefore, the group incorporates the effect of such management actions in determining whether or not it is likely to be able to withstand such an event.

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Terms and conditions of capital securities

All capital securities included in the regulatory capital base of the group have been issued in accordance with the rules and guidance in the FSA's General Prudential Sourcebook. For regulatory purposes, the group's capital base is divided into two categories, or tiers, depending on the degree of permanence and loss absorbance exhibited. These are tier 1 and tier 2.

The main features of capital securities issued by the group are described below. The balances disclosed in the tables below are the balance sheet carrying amounts under IFRSs from the HSBC Bank plc *2011 Accounts* and are not the amounts that the instruments contribute to regulatory capital. The regulatory treatment of these instruments and the accounting treatment under IFRSs differ, for example, in the treatment of issuance costs or regulatory amortisation. Therefore, the balances disclosed will not reconcile to other amounts disclosed in this document.

Tier 1 capital

Tier 1 capital is comprised of shareholders' equity and related non-controlling interests and qualifying capital instruments such as preference shares and hybrid capital securities, after the deduction of certain regulatory adjustments.

Ordinary shares

	At 31 December	
	2011	2010
Called up ordinary share capital	**£m**	£m
HSBC Bank plc ordinary shares (of nominal value £1 each)	**797**	797

Further details of the group's called up share capital can be found in *Note 36 – Called up share capital and other equity instruments* of the Notes on the Financial Statements on pages 189-190 of the HSBC Bank plc *2011 Accounts*.

Preference shares and related premium

Preference shares are securities which rank higher than ordinary shares for dividend payments and in the event of a winding-up, but generally carry no voting rights. To qualify as capital for regulatory purposes these instruments must have no stated maturity date but may be called and redeemed by the issuer, subject to prior notification to the FSA, and, where relevant, the consent of the local banking regulator. There must also be no obligation to pay a dividend, and (if not paid) the dividend may not cumulate. Dividends on floating rate preference shares are generally related to interbank offered rates. The following table lists the qualifying preference shares in issue at 31 December 2011 together with 31 December 2010 comparatives:

	At 31 December	
	2011	2010
Perpetual shares and related premium	**£m**	£m
HSBC Bank plc non-cumulative third dollar preference shares	**431**	431
Non-controlling interests in preference shares issued by a subsidiary of the bank	**150**	150
	581	581

Further details of the HSBC Bank plc non-cumulative third dollar preference share capital can be found in *Note 36 – Called up share capital and other equity instruments* of the Notes on the Financial Statements on pages 189-190 of the HSBC Bank plc *2011 Accounts*.

Capital and Risk Management Pillar 3 Disclosures at 31 December 2011

Hybrid capital securities

Hybrid capital securities are deeply subordinated securities with some equity features that can be included as tier 1 capital. Hybrid capital securities are issues of securities for which there is no obligation to pay a coupon and if not paid, the coupon is not cumulative. Such securities do not generally carry voting rights and rank higher than ordinary shares for coupon payments and in the event of a winding-up. The securities may be called and redeemed by the issuer, subject to prior notification to the FSA, and, where relevant, the consent of the local banking regulator. If not redeemed, coupons payable may step-up and become floating rate related to interbank offered rates. The following table lists the qualifying hybrid capital securities in issue at 31 December 2011 together with 31 December 2010 comparatives:

		At 31 December	
		2011	2010
	Hybrid Capital Securities	**£m**	£m
€900m	7.75% Non-cumulative Subordinated Notes 2040	**752**	775
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities	**700**	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities	**244**	279
		1,696	1,754

Further details of the terms of these instruments can be found in *Note 30 – Subordinated Liabilities* of the Notes on the Financial Statements on page 175 of the HSBC Bank plc *2011 Accounts*.

Tier 2 capital

Tier 2 capital comprises qualifying subordinated loan capital, related non-controlling interests, allowable collective impairment allowances, unrealised gains arising on the fair valuation of equity instruments held as available-for-sale and reserves arising from the revaluation of properties. Tier 2 capital is divided into two tiers: upper and lower tier 2.

Upper tier 2 capital

Upper tier 2 securities are subordinated loan capital that do not have a stated maturity date but may be called and redeemed by the issuer, subject to prior notification to the FSA, and, where relevant, the consent of the local banking regulator. Interest coupons on the floating rate upper tier 2 securities are generally related to interbank offered rates. Upper tier 2 capital may also include, for regulatory purposes, some preference share securities not meeting the full GENPRU requirements for inclusion in the tier 1 capital base. The following table lists the qualifying upper tier 2 securities in issue at 31 December 2011 together with 31 December 2010 comparatives:

		At 31 December	
		2011	2010
	Perpetual subordinated loan capital and other Upper Tier 2 instruments	**£m**	£m
US$2,862m	Perpetual Subordinated Debt [1]	**1,849**	-
US$750m	Undated Floating Rate Primary Capital Notes	**484**	483
US$500m	Undated Floating Rate Primary Capital Notes	**323**	322
US$300m	Undated Floating Rate Primary Capital Notes (Series 3)	**194**	193
£750m	7.884% Perpetual Subordinated Debt [2]	**-**	750
£500m	Perpetual Subordinated Debt [2]	**-**	500
£500m	Perpetual Subordinated Debt [2]	**-**	500
	Other perpetual subordinated loan capital	**13**	14
		2,863	2,762

Notes

1 *In March 2011 the bank issued US dollar denominated perpetual subordinated debt of US$2,862m to HSBC Holdings plc – this is classified as a subordinated liability under IFRSs.*

2 *In March 2011 the bank repaid to HSBC Holdings plc £1,750m of perpetual subordinated debt classified as equity under IFRSs.*

Further details of the terms of the instruments repaid in March 2011 can be found in *Note 36 – Called up share capital and other equity instruments* of the Notes on the Financial Statements on pages 189-190 of the HSBC Bank plc *2011 Accounts*. Further details of the group's other perpetual subordinated loan capital instruments can be found in *Note 30 – Subordinated Liabilities* of the Notes on the Financial Statements on page 175 of the HSBC Bank plc *2011 Accounts*.

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Lower tier 2 capital

Lower tier 2 capital comprises dated subordinated loan capital repayable at par on maturity which has an original maturity of at least five years. Some subordinated loan capital may be called and redeemed by the issuer, subject to prior notification to the FSA, and, where relevant, the consent of the local banking regulator. If not redeemed, interest coupons payable may step-up or become floating rate related to interbank offered rates. Lower tier 2 capital may also include, for regulatory purposes, some preference share or undated capital securities not meeting the full GENPRU requirements for inclusion in the capital base as either tier 1 or upper tier 2 capital. For regulatory purposes, it is a requirement that lower tier 2 securities be amortised on a straight-line basis in their final five years of maturity thus reducing the amount of capital that is recognised for regulatory purposes. The following table lists the qualifying lower tier 2 securities in issue at 31 December 2011 together with 31 December 2010 comparatives:

		At 31 December	
		2011	2010
	Term subordinated loan capital and other Lower Tier 2 instruments	**£m**	£m
US$1,450m	Floating Rate Subordinated Loan 2021	**937**	-
€1,000m	Floating Rate Subordinated Loan 2017	**835**	862
US$1,000m	Floating Rate Subordinated Loan 2020	**646**	644
US$977m	Floating Rate Subordinated Loan 2040	**631**	629
£600m	4.75% Subordinated Notes 2046	**592**	592
£500m	4.75% Callable Subordinated Notes 2020	**490**	499
£500m	5.375% Subordinated Notes 2033	**438**	469
£390m	6.9% Subordinated Loan 2033	**390**	390
€500m	Callable Subordinated Floating Rate Notes 2020	**355**	381
£350m	Callable Subordinated Variable Coupon Notes 2017	**355**	362
£350m	5% Callable Subordinated Notes 2023	**344**	353
£350m	5.375% Callable Subordinated Step-up Notes 2030	**318**	329
£300m	6.5% Subordinated Notes 2023	**299**	297
US$450m	Subordinated Floating Rate Notes 2021	**291**	-
US$300m	7.65% Subordinated Notes 2025	**242**	220
£225m	6.25% Subordinated Notes 2041	**224**	224
€250m	Floating Rate Subordinated Loan 2021	**209**	215
€800m	Callable Subordinated Floating Rate Notes 2016	**-**	689
€600m	4.25% Callable Subordinated Notes 2016	**-**	530
US$300m	6.95% Subordinated Notes 2011	**-**	200
	Other term subordinated loan capital instruments less than £100m	**479**	416
		8,075	8,301

Further details of the terms of these instruments can be found in *Note 30 – Subordinated Liabilities* of the Notes on the Financial Statements on page 175 of the HSBC Bank plc *2011 Accounts*.

Glossary

Terms	Definition
Available-for-sale financial assets	Those non-derivative financial assets that are in terms of IFRS not classified as a) loans and receivables b) held-to-maturity investments or c) financial assets at fair value through profit or loss.
Basel I	The capital adequacy framework issued by the Basel Committee on Banking Supervision in 1988 and subsequently updated until superseded by Basel II.
Basel II	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'.
Basel 2.5	The enhancements to the existing Basel II framework announced by the Basel Committee in April 2008 as an immediate response to the financial crisis. These enhancements mostly affect the definition of capital as well as the risk-weighting rules for credit, market risk and concentration risk.
Basel III	In December 2010, the Basel Committee issued final rules 'Basel III: A global regulatory framework for more resilient banks and banking systems' and 'Basel III: International framework for liquidity risk measurement, standards and monitoring'. Together these documents present the Basel Committee's reforms to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades. The Basel III requirements will be phased in starting 1 January 2013 with full implementation by 1 January 2019.
BIPRU	The FSA's rules, as set out in Prudential Sourcebook for Banks, Building Societies and Investment Firms.
Capital conservation buffer	A capital buffer, prescribed by regulators under Basel III, and designed to ensure banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. Should a bank's capital levels fall within the capital conservation buffer range, capital distributions will be constrained by the regulators.
Capital Requirements Directive ('CRD')	The European Union's capital adequacy rules (in directives 2006/48 and 2006/49) enacting the Basel II framework issued by the Basel Committee in June 2006.
CRD III	The enabling instrument by which the European Union has enacted the Basel 2.5 enhancements.
CRD IV	The European Commission's proposals for a new Regulation and Directive, published in July 2011, to give effect to the Basel III framework in the EU.
Common equity tier 1 capital and Common equity	The highest quality form of regulatory capital under Basel III. It comprises common shares issued and related share premium, retained earnings and other reserves excluding the cashflow hedging reserve, less specified regulatory adjustments.
Core tier 1 capital	The highest quality form of regulatory capital. It comprises total shareholders' equity and related non-controlling interests, less goodwill and intangible assets, and certain other regulatory adjustments.

Glossary

Terms	Definition
Countercyclical capital buffer	A capital buffer, prescribed by regulators under Basel III, which aims to ensure capital requirements take account of the macro-economic environment in which banks operate. The buffer will provide additional capital to protect the banking sector against the increased potential for future losses which arises when excess credit growth in the financial system as a whole is associated with an increase in system-wide risk.
Derivatives	Financial instruments whose value is based on the performance of one or more underlying assets, for example bonds or currencies.
ECAI	External Credit Assessment Institution, such as Moody's Investors Service, Standard & Poor's Ratings Group or Fitch Group.
Economic capital	The internally calculated capital requirement which is deemed necessary by the group to support the risks to which it is exposed at defined confidence levels.
Equity IRB simple risk weight approach	The simplest of 3 approaches prescribed for calculating risk weighted assets and expected loss on equity exposures under the IRB approach.
Expected loss ('EL') (regulatory)	A regulatory measure of the amount expected to be lost on an exposure using a 12 month time horizon and downturn loss estimates. EL is calculated by multiplying the Probability of Default (a percentage) by the Exposure at Default (an amount) and Loss Given Default (a percentage).
Exposure	A claim, contingent claim or position which carries a risk of financial loss.
Exposure at default ('EAD') and Exposure value	The amount expected to be outstanding after any credit risk mitigation, if and when a counterparty defaults. EAD reflects drawn balances as well as allowance for undrawn commitments and contingent exposures, and is usually measured over a 12 month horizon.
Fair value	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.
FSA	The Financial Services Authority of the United Kingdom.
GENPRU	The FSA's rules, as set out in the General Prudential Sourcebook.
Held-to-maturity	An accounting classification for investments acquired with the intention of being held until they mature.
Incremental risk charge	A measure of the direct and indirect losses that could occur on positions in the Trading Book as a result of the default of an issuer, or a change in its creditworthiness.
Institutions	Under the Standardised approach, Institutions are classified as credit institutions or investment firms. Under the IRB approach, Institutions also include regional governments and local authorities, public sector entities and multilateral development banks.
Insurance risk	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.
Internal Capital Adequacy Assessment Process	The group'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.
Internal ratings-based approach ('IRB')	A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters.

Glossary

Terms	Definition
IRB advanced approach	The IRB advanced approach is a method of calculating credit risk capital requirements using internal PD, LGD and EAD models.
IRB foundation approach	The IRB foundation approach is a method of calculating credit risk capital requirements using internal PD models but supervisory estimates of LGD and conversion factors for the calculation of EAD.
Leverage ratio	A measure, prescribed by regulators under Basel III, which is the ratio of tier 1 capital to total exposures. Total exposures include on-balance sheet items, off-balance sheet items and derivatives, and should generally follow the accounting measure of exposure. This supplementary measure to the risk based capital requirements is intended to constrain the build-up of excess leverage in the banking sector.
Liquidity risk	The risk that the bank 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.
Loss given default ('LGD')	The estimated ratio (percentage) of the economic loss on an exposure to the amount outstanding at default (EAD) upon default of a counterparty.
Probability of default ('PD')	The probability that an obligor will default within a one-year time horizon.
Qualifying revolving retail exposures	Retail IRB exposures not exceeding €100k that are revolving, unsecured, and (to the extent they are not drawn) immediately and unconditionally cancellable, such as credit cards.
Regulatory capital	The capital which the bank holds, determined in accordance with rules established by the FSA (in the case of the bank and the consolidated group) and by local regulators (for individual group companies).
Resecuritisation	A securitisation transaction where one or more of the underlying exposures is itself a securitisation exposure.
Retail IRB	Retail exposures that are treated under the IRB approach.
Risk appetite	An assessment of the types and quantum of risks to which the group wishes to be exposed.
Risk-weighted assets ('RWA')	Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure in accordance with the applicable rules.
Securitisation	In general, a transaction or scheme whereby the credit risk associated with an underlying exposure, or pool of exposures, is tranched and where payments to investors in the transaction or scheme are dependent upon the performance of the underlying exposure or pool of exposures. A traditional securitisation involves the transfer of the exposures being securitised to an SPE which issues securities. In a synthetic securitisation, the tranching is achieved by the use of credit derivatives and the exposures are not removed from the balance sheet of the originator. As a specific, defined regulatory term a securitisation differs from a resecuritisation in that none of the underlying exposure or exposures is itself a securitisation.
Special Purpose Entity ('SPE')	A corporation, trust or other non-bank entity, established for a narrowly defined purpose, including for carrying on securitisation activities. The structure of the entity and activities are intended to isolate the obligations of the SPE from those of the originator and the holders of the beneficial interests in the securitisation.

Glossary

Terms	Definition
Standardised approach	In relation to credit risk, a method for calculating credit risk capital requirements using ECAI ratings and supervisory risk weights. In relation to operational risk, a method of calculating the operational capital requirement by the application of defined percentage charges to the three year average gross income of eight specified business lines.
Standard market risk PRR rules	The FSA's rules regarding the calculation of market risk capital requirements for trading book exposures which are not subject to VAR model permissions. The rules divide risks into a number of standard types, within which risk is measured by the application of defined percentage charges to both net & gross exposures.
Stressed VAR	A measure of VAR using a specific, continuous, one-year period of stress for the trading portfolio.
Tier 1 capital	A component of regulatory capital, comprising core tier 1 capital and other tier 1 capital. Other Tier 1 capital includes qualifying hybrid capital instruments such as non-cumulative perpetual preference shares and innovative Tier 1 securities.
Tier 2 capital	A component of regulatory capital comprising qualifying subordinated loan capital, related non-controlling interests and allowable collective impairment allowances. Tier 2 capital also includes reserves arising from unrealised gains on the fair valuation of equity instruments held as available-for-sale and on the revaluation of properties.
Value at risk ('VAR')	In general, 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. As a specific, defined regulatory term VAR differs from Stressed VAR as follows: • VAR is calculated using the changes in relevant market factors observed during the specified time horizon; whereas, • Stressed VAR replaces these with movements from a specific, continuous one-year period of stress for the trading portfolio.

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