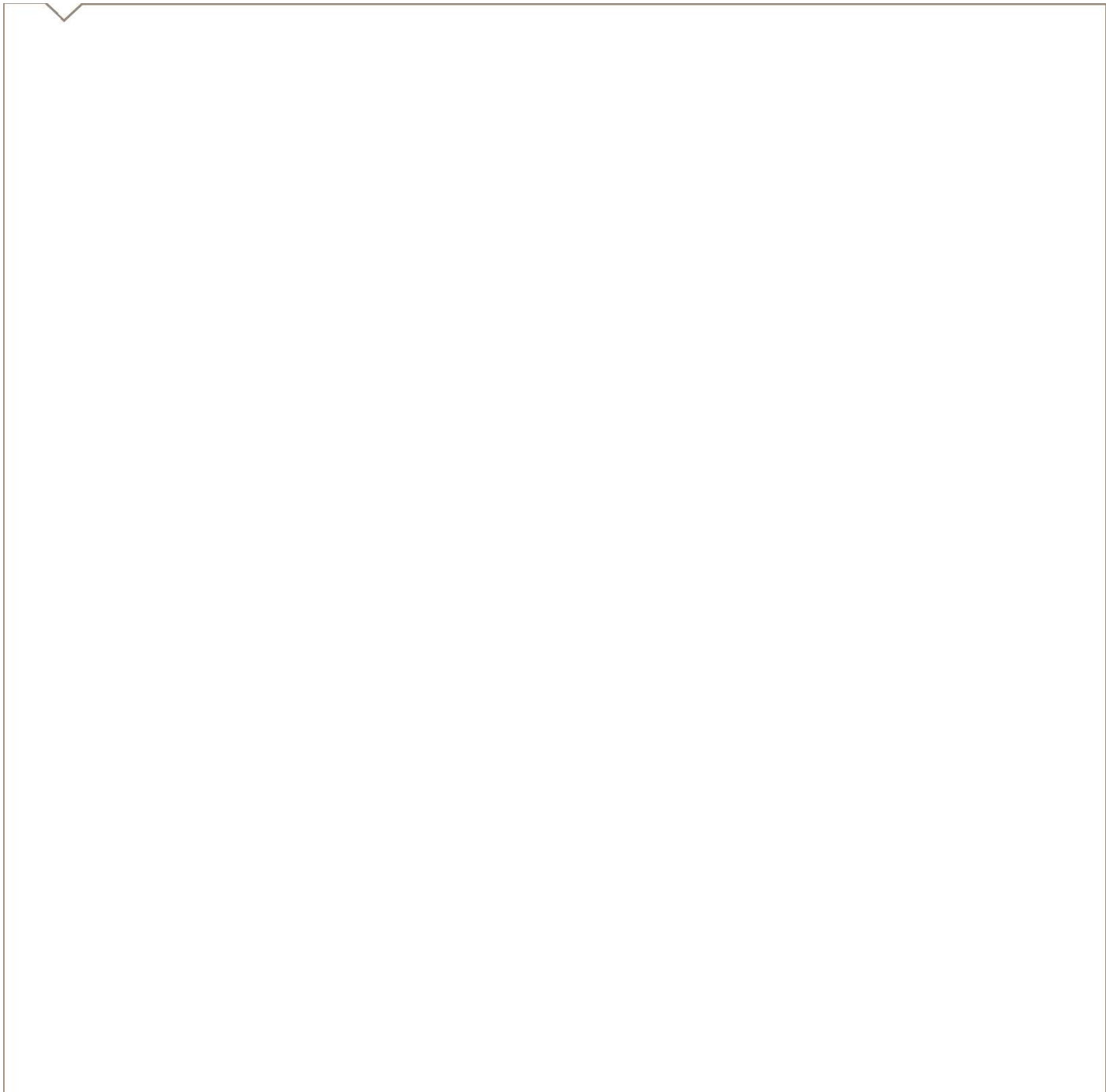


2011

HSBC Bank Bermuda Limited

Capital and Risk Management
Interim Pillar 3 Disclosures as at 30 June 2011



Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011

Certain defined terms

Unless the context requires otherwise, 'Bank' or 'HSBC Bermuda' means HSBC Bank Bermuda Limited (*formerly* The Bank of Bermuda Limited), 'Group' means the Bank together with its subsidiaries, 'HSBC Holdings' means HSBC Holdings plc and 'HSBC' or 'HSBC Group' means HSBC Holdings together with its subsidiaries. The abbreviation 'US\$m' represents millions of US dollars.

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Cautionary statement regarding forward-looking statements

The *Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011* ('*Interim Pillar 3 Disclosures 2011*') contains certain forward-looking statements with respect to Group's financial condition, results of operations and business.

Statements that are not historical facts, including statements about 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, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Written and/or oral forward-looking statements may also be made in the periodic reports to the Bermuda Monetary Authority ('BMA'), summary financial statements to HSBC Holdings, offering circulars and prospectuses, press releases and other written materials, and in oral statements made by the Bank's Directors, officers or employees to third parties, including financial analysts.

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.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Introduction

HSBC Bermuda is a leading financial services company providing retail and corporate banking, investment, trust, custody and fund administration services to international and local clients. Founded in 1889, the Bank became a member of the HSBC Group in 2004.

Basel II

The BMA supervises HSBC Bermuda both on an unconsolidated and consolidated basis, and therefore receives information on the capital adequacy of, and sets individual capital guidance for, both the solo bank and the Group as a whole. Other individual banking subsidiaries in the Group are directly regulated by their local regulators, who set and monitor their capital adequacy requirements.

Basel II is structured around three 'pillars': minimum capital requirements, supervisory review process and market discipline. The BMA implemented Basel II in Bermuda from 1 January 2009 and its rules are set out in *The Revised Framework for Regulatory Capital Assessment ('BMA Framework')*.

Interim pillar 3 disclosures 2011

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 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.

The BMA permits certain pillar 3 requirements to be satisfied by inclusion within the financial statements. Where this is the case, page references are provided to the relevant sections in the audited *Consolidated Financial Statements of HSBC Bank Bermuda Limited and its subsidiaries for the financial year ended 31 December 2010 ('Consolidated Financial Statements 2010')*.

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 final 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'.

The minimum common equity tier 1 requirement of 4.5% and additional capital conservation buffer requirement of 2.5%, will 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, in parallel with the capital conservation buffer 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.

On 1 June 2011, the Basel Committee issued a revised version of *A global regulatory framework for more resilient banks and banking systems* that set out the finalised capital treatment for counterparty credit risk in bilateral trades.

On 13 January 2011, the Basel Committee issued further minimum requirements 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.

The Basel Committee issued a consultative document on 19 July 2011, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*. It sets out the assessment methodology for global systemically important banks ('G-SIBs') which is based on an indicator-based approach and comprises five broad categories: size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. Those banks designated as G-SIBs will be required to hold a minimum amount of loss absorbency capital depending on their relative systemic importance. This requirement ranges from 1% to 2.5% and will be met with common equity tier 1 capital. An additional 1% surcharge will be applied to banks, if any, exceeding a certain level of

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

systemic importance relative to their peers, as a disincentive to materially grow their operations further. These requirements will be phased-in in parallel with the capital conservation and countercyclical capital buffers between 1 January 2016 and 31 December 2018, becoming fully effective on 1 January 2019.

Impact of Basel III

The estimated impact of Basel III remains unclear at this stage and will crystallise as the regulators develop their requirements around the practical application and interpretation of the new rules. Further uncertainty remains regarding any capital requirements which may be imposed by the BMA.

Frequency

In accordance with BMA requirements, Group intends to publish comprehensive pillar 3 disclosures annually. Quantitative disclosures such as capital structure, capital requirements and capital ratios are disclosed at the half year in the *Interim Pillar 3 Disclosures*.

Media and location

The *Interim Pillar 3 Disclosures 2011* and other information on Group are available in the *About us* section on the Bank's website: www.hsbc.bm.

Comparison with the Consolidated Financial Statements 2010

The *Interim 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 ('IFRS's). Therefore, some information in the *Interim Pillar 3 Disclosure 2011* is not directly comparable with the financial information in the *Consolidated Financial Statements 2010*. This is most pronounced for the credit risk disclosures, where credit exposure is defined as the maximum loss the Group has estimated under specific Basel II parameters. This differs from similar information in the *Consolidated Financial Statements 2010*, which is mainly reported as at the balance sheet date and, therefore, does not reflect the likelihood of future drawings of committed credit lines.

Verification

The *Interim Pillar 3 Disclosures 2011* have been appropriately verified internally, but have not been and are not required to be audited by the Group's external auditors.

Consolidation basis

The basis of consolidation for financial accounting purposes and a list of entities within the Group that are fully consolidated are described on page 8 and page 35 of the *Consolidated Financial Statements 2010*. The basis of consolidation for regulatory purposes differed from that used for the financial consolidation in that the holding in the captive insurance entity, namely HSBC Insurance (Bermuda) Limited, was removed from the consolidation process and deducted from regulatory capital at cost up to its disposal to an HSBC affiliated entity on 1 July 2010. Holdings in non-financial entities are risk-weighted, subject to certain overall limits above which a deduction from regulatory capital is required.

Scope of Basel II permissions

Credit risk

Basel II applies three approaches of increasing sophistication to the calculation of Pillar 1 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 and 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, the Group has adopted the standardised approach for consolidated reporting.

Market risk

Market risk is the risk that movements in market risk factors, including foreign exchange, commodity prices, interest rates, credit spread and equity prices will reduce Group's income or the value of its portfolios.

Group is not required to report under market risk methodologies as its trading book does not exceed the De Minimis threshold, resulting in an exemption as defined in the BMA Framework.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)***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 the banks' own statistical analysis and modelling of operational risk data to determine capital requirements.

Group has adopted the standardised approach in determining its consolidated operational risk capital requirement.

Future plans to implement advanced methodologies of Basel II

Group's plan to implement the "Advanced Measurement Approach" to operational risk is described on page 47 of the *Consolidated Financial Statements 2010*.

Group has no immediate plans to transition from the standardised approach to the advanced IRB approach for credit risk and will remain on the standardised approach under Basel II until the definition of local regulations and model approval become crystallised.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Capital

Table 1: Consolidated capital structure

	At 30 June 2011	At 31 December 2010
	US\$m	US\$m
Composition of regulatory capital		
Tier 1 capital	1,635	1,624
Ordinary share capital ¹	30	30
Share premium ¹	389	389
Retained earnings	1,415	1,425
Less goodwill and other intangibles assets	(199)	(220)
Tier 2 capital	6	6
Collective impairment allowances	6	6
Capital deductions	(454)	(6)
Investments in capital of other banks and associates	(454)	(6)
Total regulatory capital	1,187	1,624

	At 30 June 2011		At 31 December 2010	
	RWAs	Capital required ²	RWAs	Capital required ²
	US\$m	US\$m	US\$m	US\$m
Credit risk	4,508	360	4,400	352
Operational risk	896	72	896	72
Total	5,404	432	5,296	424

	At 30 June 2011	At 31 December 2010
	%	%
Capital ratios		
Tier 1 ratio	30.3	30.7
Total capital ratio	22.0	30.7

¹ The terms and conditions of ordinary share capital and share premium can be found on page 52 of the Consolidated Financial Statements 2010.

² Calculated as 8 per cent of risk-weighted assets ('RWA's').

Table 2: Capital ratio of significant bank subsidiaries

	At 30 June 2011		At 31 December 2010	
	HSBC Bermuda	HSBC Cayman ¹	HSBC Bermuda	HSBC Cayman ¹
	%	%	%	%
Capital ratios				
Tier 1 ratio	20.6	21.9	22.3	22.5
Total capital ratio	16.8	24.5	17.8	22.3

¹ As at 30 June 2011, HSBC Bank (Cayman) Limited is supervised under Basel II by the Cayman Island Monetary Authority ('CIMA'). The transition to Basel II reporting came into effect on 1 January 2011.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Capital management and allocation

The objectives of the Bank's internal capital management policies are to maintain creditor and market confidence and to sustain future development of the business. In addition, these objectives are designed to:

- maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times;
- maximise the financial resources of the Bank so that it can be a source of strength to all of its subsidiaries;
- ensure that sufficient income is generated to pay dividends;
- minimise any structural impediments to the free flow of capital resources, so that capital can be deployed in those businesses offering the best returns to the Bank.

To meet these objectives, the Bank develops capital plans which identify future capital requirements and/or surpluses. Capital plans are part of the 3-year strategic business framework, also known as the Medium Term Outlook ('MTO') and the annual Rolling Operating Plan ('ROP') process, and are used to ensure that Group and the Bank continue to be adequately capitalised. The capital plans contain actual data and quarterly forecasts. In addition, supporting commentary, where applicable, is included:

- projected timing of any forthcoming dividend payment(s);
- any known (or possible) requests for capital in addition to previously submitted capital plans;
- explanation for any material changes in current or projected risk-weighted assets;
- any plans, including amounts and timing, for local capital issuance;
- any plans with respect to repayment or refinancing of maturing capital;
- any other information or assumptions considered relevant from an HSBC Group perspective.

On an annual basis or more frequently as required, capital plans for the following year are reviewed by the Board of Directors and the Audit and Risk Committee.

The responsibility for global capital allocation principles and decisions rests with the HSBC Group

Management Board ('GMB'). Through its structured internal governance processes, HSBC maintains discipline over its investment and capital allocation decisions, seeking to ensure that returns on investment are adequate after taking account of capital costs. HSBC's strategy is to allocate capital to businesses on the basis of their economic profit generation, regulatory and economic capital requirements and cost of capital.

Transferability of capital within the Group

Each subsidiary manages its own capital required to support planned business growth and meet its local regulatory requirements within the context of the approved annual Group capital plan. In accordance with HSBC's Capital Management Framework, capital generated by subsidiaries in excess of planned requirements is returned to HSBC, normally by way of dividends. However, capital cannot be transferred from a subsidiary if the transfer would cause the subsidiary to no longer have capital to cover its minimum capital requirement. Own funds in excess of the minimum capital requirement are potentially transferable as long as there is no current or foreseeable material practical or legal impediment to the prompt transfer of funds.

The Bank holds investments in subsidiaries in Bermuda and other jurisdictions. There are no legal constraints on the transfer of profits, royalties or fees from these jurisdictions, or on the repatriation of invested capital.

In addition, the Bank does not hold assets that are normally subject to restrictions such as:

- funds that are dedicated to policyholders;
- funds subject to local exchange controls or other national restrictions;
- subordinated debt or other hybrid instruments that legally constitute liabilities of the issuing entity hence not fully transferable;
- minority interests;

As a consequence of this, there is no material practical or legal impediment to the transfer of capital. Nevertheless, the Bank's assessment of its levels of surplus capital includes, but is not limited to, the following factors:

- capital adequacy standards of local and external regulatory authority/authorities;
- capital needs for approved planned business expansion;

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

- capital effects of any approved acquisition/divestment or other exceptional corporate action;
- the level of distributable reserves;
- tax efficiency of dividend distributions.

Finally, transferability of capital under stressed conditions is assessed as part of the stress testing process.

Internal assessment of capital adequacy

The Group assesses the adequacy of 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 Capital Assessment and Risk Profile ('CARP') process by which Group examines the risk profile from both regulatory and economic capital view points and ensures that the level of capital:

- remains sufficient to support Group's risk profile and outstanding commitments;
- exceeds the formal minimum regulatory capital requirements by an internally determined margin;
- is capable of withstanding a severe economic downturn stress scenario; and
- maintains the Bank's target credit ratings.

The minimum regulatory capital that Group is required to hold is determined by the rules established by the BMA for the consolidated Group and by local regulators for individual banking subsidiaries within the Group.

The Group has reviewed and determined via the annual capital plan a minimum internal capital target in excess of the minimum regulatory capital requirement agreed between the Group and the BMA at the completion of the Pillar 2 supervisory assessment process annually.

Scenario analysis and stress testing

Scenario analysis and stress testing are important mechanisms in understanding the sensitivities of Group's capital to the adverse effects of extreme, but plausible, events. While considering the potential financial effects on business plans, a key output of this tool is the consideration and establishment of management actions to mitigate such events should they, or similar events, occur.

Group Risk and Group Finance regularly assess regulatory capital supply against demand under a range of stress scenarios. Qualitative and quantitative techniques are used to estimate the potential impact on capital position under such scenarios. The Bank also participates in the Standardised Stress Test required by the BMA as part of the Pillar 2 CARP process.

In addition to macro-economic analysis, several specific stress testing scenarios, including market risk, liquidity and funding risk, and interest rate risk, are regularly formulated and analysed in detail, ensuring that management has considered the potential impact, and what actions would be necessary, should a range of risks materialise.

As part of the overall HSBC risk appetite process, business and capital plans are supported by forecasts of the risk parameters that drive Group's capital requirements. Group considers 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 an inevitable and necessary consequence. Therefore, Group incorporates the impact of such management actions in determining whether or not Group is likely to be able to withstand such an event.

Risk management objectives and policies

Overview

All of Group's activities – whether lending, payment transmission, trading business to support clients and markets, or maintenance of infrastructure for delivering financial services – involve to varying degrees the measurement, evaluation, acceptance and management of risks.

The objective of risk management is to support Group strategies to build sustainably profitable business in the best long-term interests of shareholder and stakeholders. Risk management objectives are integrated into the balanced scorecards of heads of regions, global businesses and key functions from HSBC GMB down, and cascaded through the Group. The objectives of the Risk function as such are also fully aligned in this process with strategic business objectives.

Group's approach to risk appetite, explained in further detail on page 10 in this report, reinforces the integration of risk considerations into key business

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

goals and planning processes. Preserving the strong capital position remains a key priority for the Group, and the level of integration of risk and capital management helps to optimise response to business demand for regulatory and economic capital.

As risk is not static, Group's risk profile continually alters as a result of change 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 its complex interactions across the Group.

Organisation and responsibilities

A well established risk governance and ownership structure ensures oversight of, and accountability for, the effective management of risk at Group, customer group and operating entity levels.

The Board of Directors ('Board')

The primary responsibility of the Board of Directors is to ensure the Group's success by directing and monitoring its management and performance and serving the interests of all its stakeholders, including its shareholder, depositors, creditors, customers, and employees. The Board aligns its standards, processes, committee structures and policy direction with those of HSBC Group. The Board implements its strategy and policies through the delegation of powers to a number of committees. It approves the Group's overall risk appetite, ensures adherence to the Group's guiding principles, approves the Group's control framework and monitors the Group's risk profile.

Audit and Risk Committee

The Audit and Risk Committee, a committee of the Board, is accountable to the Board and assists the Board in meeting its responsibilities to ensure an effective system of risk management, internal control and compliance. One of the responsibilities of the Committee is to review the Group's financial controls and its internal control and risk management systems. Executive Management and senior representatives of the external and internal auditors attend all quarterly Committee meetings. The responsibilities of the Audit and Risk Committee are set out in its terms of reference which are approved by the Board.

Executive Management Committee ('EXCO')

The Board has delegated to the EXCO accountability for the day to day management of the Group. The responsibilities of EXCO are clearly set out in its

terms of reference which are approved by the Board and include its primary responsibility for developing and implementing the Group's operating and strategic plans.

In addition, a number of management committees have been established. The following are the principal committees discharging duties and responsibilities for the risk management framework:

Senior Management Committee ('SMC')

The primary responsibility of the SMC is to exchange information on matters pertaining to the management of the Group and to refer any proposals requiring approvals to EXCO.

Risk Management Committee ('RMC')

RMC provides strategic and tactical direction to risk management of all risks within the Bank, including but not limited to: credit, market, operational, reputational, and compliance risks. The RMC serves as the primary governance body of Bank's risk management framework and is chaired by the Chief Risk Officer ('CRO').

Operational Risk and Internal Control Committee ('ORIC')

The objective of ORIC is to provide RMC, the Audit and Risk Committee and the Board with reasonable assurance that through implementation of the operational risk framework and adherence to policies and procedures, operational risks are being effectively identified, assessed, managed and controlled so as to minimise loss and damage to reputation. One of the many responsibilities of ORIC is to challenge the operational risk management profile of the Bank, primarily through analysis of risk and control assessment results and loss incident reports.

Asset and Liability Management Committee ('ALCO')

One of the specific responsibilities of ALCO is to review all balance sheet risks on a systematic basis to ensure that adequate controls exist and that the related returns fully reflect these risks and that adequate capital is allocated to support these risks. ALCO is also responsible for ensuring prudent management of the following balance sheet risks: interest rate risk, liquidity and funding risk, foreign exchange risk, and credit risk. The Bank's risk limit mandate is approved annually.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Valuation and Hedging Committee ('VALCO')

The purpose of VALCO is to enhance and streamline existing financial controls concerning valuation of the Bank's Investment Portfolio on a non-consolidated basis by providing independent review and approval of methodologies and assumptions used to assign value to outstanding market positions held in the Investment Portfolio and to help ensure consistency in philosophies, methodologies and practices across the HSBC Group.

Credit Policy Committee ('CPC')

CPC is the committee responsible for considering credit-related policies and issues for the Bank. One of the specific responsibilities of CPC is to establish credit policies and guidelines, defining acceptable levels and types of credit exposure.

Basel II & Scenario Analysis Committee ('Basel II/SCANCO')

Basel II/SCANCO serves as a central resource to the Bank, providing oversight and support for the preparation of Basel II Accord reports, Pillar 2 requirements, and CARP. The Committee also ensures that the planning and capital management process is supported by a clearly articulated stress testing and scenario framework which ensures that P&L and capital volatility tolerance to stress events are clearly defined and approved.

The risk management framework also includes other committees such as Business Continuity Steering Committee and Health and Safety Committee.

Group policy

HSBC's risk management policies are encapsulated in the Group Standards Manual ('GSM') and cascaded in a hierarchy of policy manuals throughout HSBC to communicate standards, instructions and guidance to employees. They support the formation of risk appetite and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management. HSBC regularly reviews and updates its risk management policies, systems and methodologies to reflect changes in law, regulation, markets, products and emerging best practice. Functional Instruction Manuals ('FIM') are the vehicles by which HSBC policies on risk and capital governance are articulated and indeed are the operating platforms for HSBC. All employees are required to have read and adhere to GSM and relevant FIMs.

Each business area is responsible for creating and maintaining its own business-specific procedures. Staffs are trained using the procedures which are reviewed on a regular basis. The Internal Control department performs independent regular reviews and highlights any procedure gaps. In addition, HSBC Group Audit conducts periodic audits of functions and businesses.

Risk appetite

Group's risk appetite framework describes the quantum and types of risk Group is prepared to take in executing its strategy. It is central to an integrated approach to risk, capital and business management and supports Group in achieving its return on equity objectives, as well as being a key element of meeting Group's obligations under the supervisory review process of Basel II.

The formulation of risk appetite considers Group's risk capacity, its financial position, the strength of its core earnings and the resilience of its reputation and brand. It is expressed both qualitatively, describing which risks are taken and why, and quantitatively. SMC reviews the progress against quantitative metrics on a monthly basis to ensure that:

- underlying business activity may be guided and controlled so it continues to accord with Risk appetite;
- key assumptions underpinning Risk appetite can be monitored and, as necessary, adjusted through subsequent business planning cycles;
- mitigating business decisions are flagged and acted upon promptly.

The risk appetite framework covers both the beneficial and adverse aspects of risk. It is used as the basis for risk evaluation, capital ratio monitoring and performance measurement for the Group and across customer groups. Risk appetite is executed through the operational limits that control the levels of risk run by Group and customer groups and is measured using risk-adjusted performance metrics.

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 counterparty risk guarantees and credit derivatives, and from holdings of debt securities. Of the risks in which Group engages, credit risk generates the largest regulatory capital requirement.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Objectives

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 businesses in defining and implementing risk appetite, continually re-evaluating it under actual and stress scenario conditions; and
- to ensure independent, expert scrutiny and approval of credit risks, their costs and their mitigation.

Organisation and responsibilities

HSBC is responsible for the formulation of high-level credit policies. It also reviews the application of HSBC's universal credit risk rating system. HSBC's credit risk limits to counterparties in the financial and government sectors are managed centrally to optimise the use of credit availability and to avoid excessive risk concentration.

Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions

with counterparties in higher risk countries are considered on a case-by-case basis.

Measurement and monitoring

Within the overall framework of the HSBC policy, Group has an established risk management process encompassing credit approvals, control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual and a portfolio basis.

Group management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products. Special attention is paid to the management of problematic loans. Where deemed appropriate, specialist units are established to provide intensive management and control to maximise recoveries of assets, which show early signs of potential impairment.

The following pages set out credit risk exposures, RWAs and regulatory capital requirements as at 30 June 2011 together with 31 December 2010 comparatives.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Table 3: Credit risk exposure – exposure and average exposure analysis

	Average exposure ¹ US\$m	Exposure before credit risk mitigation US\$m	Exposure after credit risk mitigation US\$m	Risk weighted assets US\$m	Capital required ² US\$m
At 30 June 2011					
Standardised approach					
Cash	32	32	32	-	-
Claims on sovereigns ³	515	576	576	-	-
Claims on public sector entities	30	88	88	18	1
Claims on corporates	471	430	430	301	24
Claims on banks and securities firms ³	7,301	8,015	8,015	1,752	140
Retail loans	339	322	322	255	20
Residential mortgages	1,649	1,669	1,669	615	49
Commercial mortgages	601	639	639	639	51
Past due loans	130	140	140	168	13
Other balance sheet exposures ⁴	366	354	354	357	30
Non-market related off balance sheet credit exposures	556	560	560	379	30
Market-related off balance sheet credit exposures	34	41	41	24	2
Total	12,024	12,866	12,866	4,508	360
At 31 December 2010					
Standardised approach					
Cash	31	30	30	-	-
Claims on sovereigns ³	426	433	433	-	-
Claims on public sector entities	-	-	-	-	-
Claims on corporates	529	551	551	423	34
Claims on banks and securities firms ³	6,712	7,547	7,547	1,704	136
Retail loans	365	345	345	273	22
Residential mortgages	1,606	1,645	1,645	606	48
Commercial mortgages	547	564	564	564	45
Past due loans	95	118	118	144	12
Other balance sheet exposures ⁴	399	346	346	350	28
Non-market related off balance sheet credit exposures	426	509	509	325	26
Market-related off balance sheet credit exposures	32	18	18	11	1
Total	11,168	12,106	12,106	4,400	352

¹ Average exposure after credit risk mitigation is calculated based on the four most current quarter ends.

² Calculated as 8 per cent of risk-weighted assets ('RWA's).

³ Credit risk mitigation is applied to claims on banks fully guaranteed by sovereigns.

⁴ Includes such items as fixed assets, prepayments and accruals.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Exposures are allocated to a region based on the country of incorporation of the Group subsidiary where the exposure was originated.

Table 4: Credit risk exposure – analysis by geographical region

	Exposure value			Total US\$m
	Bermuda US\$m	Cayman US\$m	Rest of the world US\$m	
At 30 June 2011				
Standardised approach				
Cash	30	2	-	32
Claims on sovereigns	556	20	-	576
Claims on public sector entities	88	-	-	88
Claims on corporates	417	13	-	430
Claims on banks and securities firms	7,743	74	198	8,015
Retail loans	318	4	-	322
Residential mortgages	1,556	113	-	1,669
Commercial mortgages	566	73	-	639
Past due loans	129	11	-	140
Other balance sheet exposures	314	11	29	354
Non-market related off balance sheet credit exposures	560	-	-	560
Market-related off balance sheet credit exposures	41	-	-	41
Total	12,318	321	227	12,866
At 31 December 2010				
Standardised approach				
Cash	28	2	-	30
Claims on sovereigns	413	20	-	433
Claims on public sector entities	-	-	-	-
Claims on corporates	459	92	-	551
Claims on banks and securities firms	6,857	72	618	7,547
Retail loans	345	-	-	345
Residential mortgages	1,547	98	-	1,645
Commercial mortgages	564	-	-	564
Past due loans	118	-	-	118
Other balance sheet exposures	286	10	50	346
Non-market related off balance sheet credit exposures	509	-	-	509
Market-related off balance sheet credit exposures	18	-	-	18
Total	11,144	294	668	12,106

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

The following is an analysis of exposures by period outstanding from the reporting date to the maturity date. The full exposure is allocated to a residual maturity band based on contractual end date.

Table 5: Credit risk exposure – analysis by residual maturity

	Exposure value				
	Less than 1 year US\$m	1 – 5 years US\$m	More than 5 years US\$m	Undated US\$m	Total US\$m
At 30 June 2011					
Standardised approach					
Cash	32	-	-	-	32
Claims on sovereigns	283	278	15	-	576
Claims on public sector entities	-	88	-	-	88
Claims on corporates	70	226	134	-	430
Claims on banks and securities firms	6,688	1,045	282	-	8,015
Retail loans	78	77	167	-	322
Residential mortgages	83	217	1,369	-	1,669
Commercial mortgages	281	269	89	-	639
Past due loans	27	32	81	-	140
Other balance sheet exposures	-	-	-	354	354
Non-market related off balance sheet credit exposures	395	149	16	-	560
Market-related off balance sheet credit exposures	40	1	-	-	41
Total	7,977	2,382	2,153	354	12,866
At 31 December 2010					
Standardised approach					
Cash	30	-	-	-	30
Claims on sovereigns	-	418	15	-	433
Claims on public sector entities	-	-	-	-	-
Claims on corporates	112	255	184	-	551
Claims on banks and securities firms	6,046	1,155	346	-	7,547
Retail loans	72	86	187	-	345
Residential mortgages	66	214	1,365	-	1,645
Commercial mortgages	283	281	-	-	564
Past due loans	28	31	59	-	118
Other balance sheet exposures	-	-	-	346	346
Non-market related off balance sheet credit exposures	305	106	98	-	509
Market-related off balance sheet credit exposures	17	1	-	-	18
Total	6,959	2,547	2,254	346	12,106

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)**Application of the standardised approach for credit risk**

The standardised approach requires banks to use risk assessments prepared by External Credit Assessment Institutions ('ECAIs') or Export Credit Agencies to determine the risk weightings applied to rated counterparties. ECAI risk assessments are used as part of the determination of the risk weightings for the following classes of exposure:

- sovereigns;
- corporates; and
- banks and securities firms.

All other exposure classes are assigned risk weightings according to rules prescribed in the BMA Framework.

For the purpose of Pillar 1 reporting to the regulator, Group has nominated Standard & Poor's Rating Group as the BMA-recognised ECAI. Credit assessments of Moody's Investors Services and Fitch Group are subject to regular internal review but do not form the basis for local regulatory reporting. BMA approval will be sought prior to any future

nomination of Moody's and/or Fitch. Group has not nominated any Export Credit Agencies.

Data files of external ratings from the nominated ECAI are matched with customer records in the Group's centralised credit database. When calculating the risk-weighted value of any exposure under the standardised approach, the customer in question is identified and matched to a rating, according to the BMA's rating selection rules. The relevant risk rate is then derived using the BMA's prescribed credit quality step mapping.

Credit quality step	Moody's assessments	S&P's assessments	Fitch assessments
1	Aaa to Aa3	AAA to AA-	AAA to AA-
2	A1 to A3	A+ to A-	A+ to A-
3	Baa1 to Baa3	BBB+ to BBB-	BBB+ to BBB-
4	Ba1 to Ba3	BB+ to BB-	BB+ to BB-
5	B1 to B3	B+ to B-	B+ to B-
6	Caa1 and below	CCC+ and below	CCC+ and below

The table below sets out the distribution of standardised exposures across credit quality steps for all exposures to sovereigns, corporates, and banks and securities firms.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Table 6: Standardised approach exposure – credit quality step analysis

	Exposure before credit risk mitigation US\$m	Exposure after credit risk mitigation US\$m	Risk weight %	Risk weighted assets US\$m
At 30 June 2011				
Sovereigns				
Credit quality step 1	576	576	0%	-
	576	576		-
Public sector entities				
Credit quality step 1	88	88	20%	18
	88	88		18
Corporates				
Credit quality step 1	-	-	20%	-
Credit quality step 2	163	163	50%	81
Credit quality step 3 ²	67	67	0% / 100%	20
Credit quality step unrated	200	200	100%	200
	430	430		301
Banks and securities firms ¹				
Credit quality step 1 ²	4,401	4,401	0% / 20%	805
Credit quality step 2	3,046	3,046	20% / 50%	775
Credit quality step 3 ²	303	303	0% / 20% / 50%	131
Credit quality step unrated ²	265	265	0% / 20% / 50%	41
	8,015	8,015		1,752
At 31 December 2010				
Sovereigns				
Credit quality step 1	433	433	0%	-
	433	433		-
Public sector entities				
Credit quality step 1	-	-	20%	-
	-	-		-
Corporates				
Credit quality step 1	-	-	20%	-
Credit quality step 2	163	163	50%	82
Credit quality step 3	75	75	0% / 100%	28
Credit quality step unrated	313	313	100%	313
	551	551		423
Banks and securities firms				
Credit quality step 1	4,071	4,071	0% / 20%	771
Credit quality step 2	2,967	2,967	20% / 50%	759
Credit quality step 3	283	283	0% / 20% / 50%	128
Credit quality step unrated	226	226	0% / 20% / 50%	46
	7,547	7,547		1,704

¹ For claims on banks and securities firms, risk weight for credit quality step 2 and 3 is 20% where maturity is less than three months and 50% where maturity is more than three months.

² Risk weight of 0% is applied to the exposures where CRM technique is used to reduce or transfer credit risk through the use of guarantees by sovereigns.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Credit risk mitigation ('CRM')

CRM techniques that are currently applied by the Group reduce or transfer credit risk primarily by affecting the risk weightings through collateralisation or the use of guarantees.

The most common method of mitigating credit risk is to take collateral. In the residential and commercial real estate businesses, a mortgage over the property is usually taken to help secure claims. Physical collateral is also typically taken in vehicle financing. In the commercial and industrial sectors, charges are created over business assets such as premises, stock and debtors. Loans to private banking clients may be made against the pledge of eligible marketable securities or cash. 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 Group 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.

The most commonly used collateral for off balance sheet exposures include cash and fixed deposit accounts held with the Bank, investment in HSBC Corporate Money Fund or other investment portfolios and guarantees.

For exposures subject to the standardised approach – covered by eligible guarantee, non-financial collateral, or credit derivatives – the exposure is divided into covered and uncovered portions. The covered portion, determined by applying an appropriate 'haircut' for currency mismatch (and for omission of restructuring clauses for credit derivatives where appropriate) to the amount of protection provided, 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 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.

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. 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.

Past due and impaired loans

Loans are classified in accordance with the BMA Framework. The approach followed for specific and collective allowances and statistical methods can be found on pages 10 and 11 of the *Consolidated Financial Statements 2010*. Details of allowances for loan impairment as at 30 June 2011 are set out in the table below. Comparatives as at 31 December 2010 can be found on page 31 of the *Consolidated Financial Statements 2010*. An analysis by geographical region shows that the majority of the loan impairment is provided for loans in Bermuda.

Table 7: Reconciliation of changes in the allowance for loan impairment

	At 30 June 2011		
	Specific provision US\$m	General provision US\$m	Total US\$m
Allowance for loan impairment			
Opening balance at 1 January 2011	12	6	18
Uncollectible amounts written off during the period	(1)	(3)	(4)
Net impairment charges during the period	15	3	18
Closing balance at 30 June 2011	26	6	32

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Further details of loans that are past due up to 90 days and more than 90 days by counterparty type are set out in the table below.

Table 8: Past due loans and allowance for loan impairment by counterparty type

	Residential mortgages US\$m	Commercial mortgages US\$m	Retail and other US\$m	Total US\$m
At 30 June 2011				
Past due loans (past due up to 90 days)	76	14	37	127
Impaired loans (past due more than 90 days).....	78	74	14	166
Individual and collective allowance for loan impairment	(7)	(21)	(4)	(32)
At 31 December 2010				
Past due loans (past due up to 90 days)	132	59	42	233
Impaired loans (past due more than 90 days).....	63	69	11	143
Individual and collective allowance for loan impairment	(3)	(12)	(3)	(18)

Market risk

Market risk is the risk that changes in interest rates, credit spreads, foreign exchange rates or equity and commodity prices will affect Group's income or the value of its holdings of financial instruments.

Objectives

The objectives of Group's market risk management are to manage and control market risk exposures in order to optimise return within the Group's risk appetite.

Organisation and responsibilities

Group manages market risk through risk limits assigned by HSBC. Traded Markets Development and Risk ('TMR'), a division within HSBC, develops risk management policies and measurement techniques and reviews limit utilisation on a daily basis. HSBC global risk limits are approved by TMR. Limits are set by product and risk type, using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level.

Group assesses the structural interest rate risks which arise in the businesses and transfers these risks to Group's balance sheet management team. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the appropriate underlying interest rate risk. ALCO regularly monitors all such behavioural assumptions and interest rate risk positions to ensure they comply with established interest rate risk limits.

Measurement and monitoring

In the course of managing interest rate risk, quantitative techniques and simulation models are used where appropriate to identify the potential net interest income and market value effects of these interest rate positions under different scenarios. The primary objective of such interest rate risk management is to limit potential adverse effects of interest rate movements on net interest income whilst balancing the effect on the current net operating income stream and unrealised mark-to-market positions.

A principal part of Group's management of market risk is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). Group aims to mitigate the effect of prospective interest rate movements, which could reduce future net interest income, while balancing the cost of such hedging activities on the current net operating income stream.

The models measure the effect on net interest income due to parallel and ramp movements of plus or minus 100 basis points in all yield curves. The results represent the effect of the pro-forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile, and can be found on page 46 of the *Consolidated Financial Statements 2010*.

Group's foreign exchange exposure comprises trading exposures and structural foreign currency translation exposure. Structural currency risk exists for Group in holding subsidiary company investments whose functional currencies are not the US dollar or Bermuda dollar.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

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 Group’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.

Objectives

The objective of Group’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.

Organisation and responsibilities

Operational risk management is primarily the responsibility of employees and business management. Local management within the Group is responsible for implementing HSBC standards on operational risk throughout their operations. Where deficiencies are evident, these are required to be rectified within a reasonable timeframe.

Measurement and monitoring

Group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by Internal Control as well as an independent programme of periodic reviews undertaken by Internal Audit, and by monitoring external operational risk events, which ensures that Group

adheres to best practice and actively learns from the publicised operational failures within the financial services industry.

Group has adopted the HSBC operational risk management process with annual compliance certification. The HSBC standards explain how the Group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The process undertaken to manage operational risk is determined by reference to the scale and nature of each business operation. The HSBC standard covers the following:

- operational risk management responsibility is assigned at a senior management level within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- operational risks are identified by risk assessments covering operational risks facing each business and risks inherent in processes, activities and products. Risk assessment incorporates a regular review of risks identified to monitor significant changes;
- operational risk loss data is collected and reported to senior management. This report covers aggregate operational risk losses and details of incidents above a materiality threshold;
- risk mitigation, including insurance, is considered where this is cost-effective.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Glossary

Term	Definition
B	
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 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. The new requirement will be phased in starting 1 January 2013 with full implementation by 1 January 2019.
BMA	Bermuda Monetary Authority ('BMA') is the regulator of financial institutions in Bermuda.
C	
CARP	Capital assessment and risk profile ('CARP') is the Group's own annual assessment of the levels of capital that it needs to hold through an examination of its risk profile from a regulatory view point.
Commercial real estate	Any real estate investment, comprising buildings or land, intended to generate a profit, either from capital gain or rental income.
Credit quality step	A step in the BMA credit quality assessment scale which is based on the credit ratings of External Credit Assessment Institutions ('ECAIs'). It is used to assign risk weights under the standardised approach.
Credit risk	Risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises mainly from direct lending, trade finance and leasing business, but also from products such as guarantees, derivatives and debt securities.
Credit risk mitigation	A technique to reduce the credit risk associated with an exposure by application of credit risk mitigants such as collateral, guarantees and credit protection.
E	
ECAI	External Credit Assessment Institution, such as Moody's Investors Service, Standard & Poor's Ratings Group or Fitch Group.
Economic profit	The difference between the return on financial capital invested by shareholders ('return on invested capital') and the cost of that capital. Economic profit may be expressed as a whole number or as a percentage.
Exposure	A claim, contingent claim or position which carries a risk of financial loss.
H	
Haircut	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.
HSBC Cayman	HSBC Bank (Cayman) Limited, a wholly owned subsidiary of HSBC Bank Bermuda Limited.
I	
Impairment allowances	Management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

Internal ratings-based approach ('IRB')	A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters.
Invested capital	Equity capital invested by the shareholder.
IRB advanced approach	A method of calculating credit risk capital requirements using internal probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD') models.
M	
Market risk	The risk that changes in interest rates, credit spreads, foreign exchange rates or equity and commodity prices will affect income or the value of holdings of financial instruments.
N	
Net interest income	The amount of interest received or receivable on assets net of interest paid or payable on liabilities.
O	
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.
R	
Regulatory capital	The capital which the Bank and/or Group holds, determined in accordance with rules established by the BMA.
Residual maturity	The period outstanding from the reporting date to the maturity or end date of an exposure.
Risk appetite	An assessment of the types and quantum of risks to which the Bank and/or Group wishes to be exposed.
Risk-weighted asset ('RWA')	Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure in accordance with the applicable standardised approach rules.
S	
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 a supervisory defined percentage charge to the gross income of eight specified business lines.
T	
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 hybrid capital securities.
Tier 2 capital	A component of regulatory capital, comprising qualifying subordinated loan capital, related non-controlling interests, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

Capital and Risk Management Interim Pillar 3 Disclosures as at 30 June 2011 (continued)

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