



HONG KONG MONETARY AUTHORITY
香港金融管理局

ANNUAL REPORT 2010

Hong Kong Monetary Authority

The Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability.

The HKMA's policy objectives are

- to maintain currency stability within the framework of the Linked Exchange Rate system
- to promote the stability and integrity of the financial system, including the banking system
- to help maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure
- to manage the Exchange Fund.

The HKMA is part of the Hong Kong Special Administrative Region Government but operates with a high degree of autonomy, complemented by a high degree of accountability and transparency. The HKMA is accountable to the people of Hong Kong through the Financial Secretary and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee.

The HKMA's offices are at

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Central,
Hong Kong
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The HKMA Information Centre is located at 55/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong and is open from 10:00 a.m. to 6:00 p.m. Monday to Friday and 10:00 a.m. to 1:00 p.m. on Saturday (except public holidays). The Centre consists of an exhibition area and a library containing materials on Hong Kong's monetary, banking and financial affairs and central banking topics.

The HKMA's bilingual website (www.hkma.gov.hk) provides comprehensive information about the HKMA including its main publications and many other materials.

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The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2010 submitted by the Monetary Authority to the Financial Secretary in accordance with section 9 of the Banking Ordinance.

The full text of this Report is available on the HKMA website.

All amounts in this Report are in Hong Kong dollars unless otherwise stated.

Highlights of 2010

Economic and Financial Environment

Hong Kong enjoys a broad-based recovery, with real GDP rising by 6.8%.

Both domestic and external demands recover strongly in 2010, with the former underpinned by improved labour market conditions and the latter bolstered by strong economic performance on the Mainland and in other emerging market economies.

Monetary Stability

The Linked Exchange Rate system continues to function smoothly.

The HKMA strengthens communications with stakeholders to help reinforce confidence in the Link and keep the market stable amid turbulent global fund flows and massive fund raising activities.

Banking Stability

The banking sector remains resilient despite heightened concerns about Europe's sovereign debt problems. Asset quality improves and capital positions remain robust.

The HKMA introduces prudential measures to improve risk management on property lending and strengthen regulatory requirements on investor and consumer protection.

International Financial Centre

Hong Kong enjoys rapid growth in the development of offshore renminbi businesses.

Standard & Poor's upgrades Hong Kong's rating to the highest AAA category, the highest sovereign rating ever assigned to Hong Kong.

The HKMA develops an implementation framework on regulation of over-the-counter derivatives, including the project of establishing a local trade repository.

Reserves Management

The Exchange Fund records an investment income of \$79.4 billion, a return of 3.6%.

Total assets of the Exchange Fund reach \$2,345.0 billion at the end of 2010.

Chief Executive's Statement



2010 was a very unique year filled with uncertainties, challenges and opportunities for the HKMA.

Towards the end of 2009, there was widespread view that the worst of the Global Financial Crisis was behind us and the world was back on track to a sustained recovery, thanks to the unprecedented and unconventional monetary and fiscal measures pursued by the advanced economies and some key Emerging Market Economies. However, this view was soon proved to be overly optimistic. In January 2010, the eruption of the sovereign debt crisis in Europe unsettled the global financial markets. By the middle of last year, the US seemed to be losing steam on its economic recovery, which aroused renewed concerns and volatility in the financial markets. It was not until late August when the US Federal Reserve Chairman Bernanke announced in Jackson Hole the Fed's preparedness to undertake further quantitative easing (QE2) that public sentiment and the equities in the US began to pick up again.

In this uncertain and turbulent time, the most important challenge for Hong Kong was the risk arising from the very low interest rates in the US and other advanced economies and the excess global liquidity resulting therefrom. With domestic interest rates at near zero since early 2009 and rising inflation, the risk of a credit fuelled housing bubble in Hong Kong intensified in 2010, notwithstanding the launch of the first round of tightening on mortgage lending in late October 2009.

In order to safeguard banking stability, the HKMA undertook two further rounds of tightening on the underwriting standards of mortgage lending by banks in August and November last year. I would like to stress that the purpose of these measures, sometimes known as macro-prudential or countercyclical measures, is not to target specific price level or transaction volume of the property market. There are many factors other than the supply and price of credit that affect the conditions of the property market and investors' expectations on property prices in the future. What the HKMA seeks to achieve is to reduce the speed and/or scale of the up-swing in a boom phase by requiring home buyers to put down higher down-payments and to prove that they have sufficient income to repay the mortgage loans. As these are countercyclical measures, they have to be forward looking, and be deployed and adjusted as and when the cycle of the property market evolves. These measures would not serve any useful purpose if we had waited too long, e.g. after the market has turned or when losses in the mortgage loan portfolio have started to rise.

If there is only one lesson that we can learn from the Global Financial Crisis, it is how important it is to maintain financial stability. We have witnessed how devastating it can become if an economy loses financial stability. No one can and should take financial stability and economic prosperity for granted: they require very hard work over many years, if not decades, and constant vigilance by all concerned to guard against complacency.

2010 was also a year of opportunities for Hong Kong. During this year, Hong Kong made very encouraging progress in strengthening its position as the International Financial Centre of Asia. Clearly the rapid development of Hong Kong as the RMB Offshore Centre tops the list of accomplishments in this regard.

With the strong support from the Central Government, the HKMA has worked closely with the People's Bank of China and other Mainland authorities to broaden and deepen the use of RMB for cross border trade settlement. Over 70% of all trade settled in RMB in 2010 was conducted through Hong Kong and our RMB deposits, which grew sharply from just over RMB62 billion in January to RMB315 billion in December, created the largest RMB liquidity pool outside Mainland China. This rapidly expanding liquidity pool, together with an efficient financial infrastructure, made it possible for 16 issuers to tap, with great success, the RMB bond market in Hong Kong, with a total issuance amounting to RMB36 billion in 2010, more than doubling the amount issued in 2009. The rapid development of Hong Kong as the offshore RMB centre has, once again, underscored Hong Kong's importance as the gateway and springboard for the trade and investment links between the Mainland and the rest of the world.

Meanwhile, the upgrading by Standard & Poor's of Hong Kong's rating to the highest level of AAA in December last year was a clear demonstration of the international recognition of the financial strength and resilience of Hong Kong. Globally, Hong Kong was the only economy receiving an upgrading to AAA rating in 2010.

On the performance of the Exchange Fund, a total profit of HK\$79.4 billion or an investment return of 3.6% was recorded in 2010. The first half of 2010 was a turbulent period in which the global equity markets were affected by the eruption of the European sovereign debt crisis. This led to a small negative return of HK\$1.0 billion as at the end of June 2010. The European debt crisis subsided in the second half of the year, with a significant rebound of the equity markets in the US and Europe following the Jackson Hole pre-announcement of QE2 in late August. In assessing the investment performance of the Exchange Fund in 2010, it should be borne in mind that about half of the Exchange Fund comprised the Backing Portfolio, which under the Currency Board regime must be held in highly liquid and short-term US papers of the highest credit quality. The holding of such a large Backing Portfolio, which was at least HK\$640 billion more than the normal level due to the net inflow into Hong Kong dollars in late 2008 and 2009, had inevitably brought down the overall investment return of the Exchange Fund. Not counting the Backing Portfolio, the Investment Portfolio, which accounted for HK\$1.1 trillion, achieved a much higher return of 6% in 2010.

Looking forward in the year 2011, the macro imbalances in the global financial system are unlikely to be fully redressed and will thus remain a source of tensions and volatilities. There still exist considerable uncertainties that affect the global economy and financial markets. Just to name a few examples: the sustainability of the advanced economies in their economic recovery and their ability to continue with excessively accommodating monetary policies without causing a pick up in inflationary pressure, the ability of the Emerging Market Economies to achieve a soft landing in their combat against inflation and asset price bubbles, the aftermath of the earthquake, tsunami and radiation leak in Japan and the geopolitical tensions in the Middle East and North African area. The list can go on and on. The crucial issue for Hong Kong is that we cannot afford to become complacent and the HKMA will do what it can to help identify and mitigate risks that may threaten the systemic stability of Hong Kong's banking and financial systems. At the same time, we must not allow unique opportunities that can make Hong Kong a more competitive and attractive centre of business and finance to slip through our fingers. All of us must work extra hard if we wish to fulfil our aspirations to stay ahead in this highly uncertain and yet fiercely competitive environment.



Norman T.L. CHAN
Chief Executive

About the HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining currency stability within the framework of the Linked Exchange Rate system; promoting the stability and integrity of the financial system, including the banking system; helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure; and managing the Exchange Fund.

THE HKMA'S LEGAL MANDATE

The HKMA was established on 1 April 1993 after the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance, the Banking Ordinance, the Deposit Protection Scheme Ordinance, the Clearing and Settlement Systems Ordinance and other relevant Ordinances. The division of functions and responsibilities in monetary and financial affairs between the Financial Secretary and the Monetary Authority is set out in an Exchange of Letters between them dated 25 June 2003. This Exchange of Letters also discloses the delegations made by the Financial Secretary to the Monetary Authority under these Ordinances. The letters are public documents and may be found on the HKMA website.

The Exchange Fund Ordinance establishes the Exchange Fund under the control of the Financial Secretary. According to the Ordinance, the Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar. It may also be used for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre.

The Monetary Authority is appointed under the Exchange Fund Ordinance to assist the Financial Secretary in performing his functions under the Exchange Fund Ordinance and to perform such other functions as are assigned by other Ordinances or by the Financial Secretary. The office of the Monetary Authority is known as the HKMA, and the Monetary Authority is the Chief Executive of the HKMA.

The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. Under the Ordinance, the Monetary Authority is responsible for the authorization of licensed banks, restricted licence banks and deposit-taking companies in Hong Kong.

The Clearing and Settlement Systems Ordinance provides a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre.

Under the Deposit Protection Scheme Ordinance, the Monetary Authority is charged with implementing the decisions of the Hong Kong Deposit Protection Board, such as deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

The HKMA is an integral part of the Hong Kong Government, but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. The Chief Executive of the HKMA and his staff are public officers. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong: a letter from the Financial Secretary to the Monetary Authority dated 25 June 2003 specifies that these should be currency stability defined as a stable exchange value at around HK\$7.80 to one US dollar maintained by Currency Board arrangements. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of

Hong Kong's financial system and the status of Hong Kong as an international financial centre. In support of these policies, the Monetary Authority's responsibilities include

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the development of payment, clearing and settlement systems and, where appropriate, the operation of these systems
- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

The Exchange Fund is under the control of the Financial Secretary. The Monetary Authority, under delegation from the Financial Secretary, is responsible to the Financial Secretary for the use of the Exchange Fund, and for the investment management of the Fund.

About the HKMA

ACCOUNTABILITY AND TRANSPARENCY

The autonomy given to the HKMA in its day-to-day operations, and in the methods it uses to pursue policy objectives determined by the Government, is complemented by a high degree of accountability and transparency.

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing and overseeing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being. The HKMA must have the confidence of the community if it is to perform its duties well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address any concerns within the community relevant to the HKMA's responsibilities.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues

a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries a large number of HKMA publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. The HKMA maintains an Information Centre at its offices, consisting of a library and an exhibition area, which is open to the public six days a week. The HKMA also organises public education programmes to inform the public, and in particular students, about the work of the HKMA through seminars and guided tours at the Information Centre. Further information on the HKMA's media work, publications and public education programmes is contained in the chapter on Corporate Functions.

Over the years the HKMA has progressively increased the detail and frequency of its disclosure of information on the Exchange Fund and Currency Board Accounts. Since 1999 the HKMA has participated in the International Monetary Fund's Special Data Dissemination Standard project for central banks. The HKMA publishes records of meetings of the Currency Board Sub-Committee of the Exchange Fund Advisory Committee and the reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

The relations between the HKMA and the Legislative Council play an important part in promoting accountability and transparency. There is a formal commitment from the Chief Executive of the HKMA to appear before the Panel on Financial Affairs of the Legislative Council three times a year to brief Members and to answer questions on the HKMA's work. Representatives from the HKMA attend Legislative Council Panel meetings from time to time to explain and discuss particular issues, and committee meetings to assist Members in their scrutiny of draft legislation.

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio Chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong Special Administrative Region. Members of EFAC are appointed for the expertise and experience that they can bring to the committee. Such expertise and experience include knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC advises the Financial Secretary on investment policies and strategies for the Fund and on projects, such as the development of financial infrastructure, that are charged to the Fund. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the Financial Secretary on the HKMA's annual administration budget and on the terms and conditions of service of HKMA staff. EFAC meets regularly and on other occasions when particular advice is being sought.

About the HKMA

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six meetings in 2010 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met six times in 2010 to consider a range of subjects including the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the *HKMA Annual Report*, and strategic planning matters. The Sub-Committee also received regular reports on the work of the HKMA.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. None of the members of the Sub-Committee performs any executive functions in the HKMA. The Sub-Committee met twice in 2010 and received reports on the work of the Internal Audit Division.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted to the Sub-Committee are published. In 2010 the Sub-Committee met four times.

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held six meetings during 2010.

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure. In 2010 the Sub-Committee met twice and received regular reports on development of financial infrastructure.

Brief biographies of EFAC Members and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members, is available for public inspection from 9:00 a.m. to 5:00 p.m. Monday to Friday (except public holidays) at the HKMA offices.

Banking Advisory Committee

The Banking Advisory Committee is established under section 4(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong Special Administrative Region on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong Special Administrative Region.

Deposit-Taking Companies Advisory Committee

The Deposit-Taking Companies Advisory Committee is established under section 5(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong Special Administrative Region on matters relating to the Banking Ordinance, in particular matters relating to deposit-taking companies and restricted licence banks and the carrying on of a business of taking deposits by them. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong Special Administrative Region.

Chief Executive's Committee

The Chief Executive's Committee comprises the Chief Executive of the HKMA, who chairs the Committee, the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets weekly to report to the Chief Executive on the progress of major tasks being undertaken by the various departments of the HKMA and to advise him on policy matters relating to the operations of the HKMA.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman



The Honourable John TSANG Chun-wah, GBM, JP
The Financial Secretary

Members



Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority



Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited



Mr HE Guangbei, JP
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited



Dr Patrick FUNG Yuk-bun, JP
Chairman and Chief Executive
Wing Hang Bank Limited



Professor the Honourable Lawrence J. LAU, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong



Mr David SUN Tak-kei, BBS, JP



Dr John CHAN Cho-chak, GBS, JP



Mr Benjamin HUNG Pi-cheng
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited



Mr Peter WONG Tung-shun, JP
Chief Executive
The Hongkong and Shanghai Banking Corporation Limited
(from 1 February 2010)



Professor CHAN Yuk-shee, BBS, JP
President
Lingnan University of Hong Kong
(from 1 March 2010)



Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.
(from 1 March 2010)



Ms Teresa KO Yuk-yin, JP
China Managing Partner
Freshfields Bruckhaus Deringer
(from 1 March 2010)



Mr PANG Yiu-kai, SBS, JP
Chief Executive
Hongkong Land Holdings Limited
(from 1 March 2010)



Mr Carlson TONG, JP
Chairman
KPMG Asia Pacific and KPMG China
(from 1 March 2010)

Advisory Committees



Mr Henry FAN Hung-ling, SBS, JP
(until 30 April 2010)



Mr Simon IP Sik-on, JP
(until 30 April 2010)



Mr Thomas KWOK Pink-kwong, SBS, JP
Vice Chairman and Managing Director
Sun Hung Kai Properties Limited
(until 30 April 2010)



Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited
(until 31 January 2010)

Secretary

Mr Trevor KEEN

(until 31 January 2010)

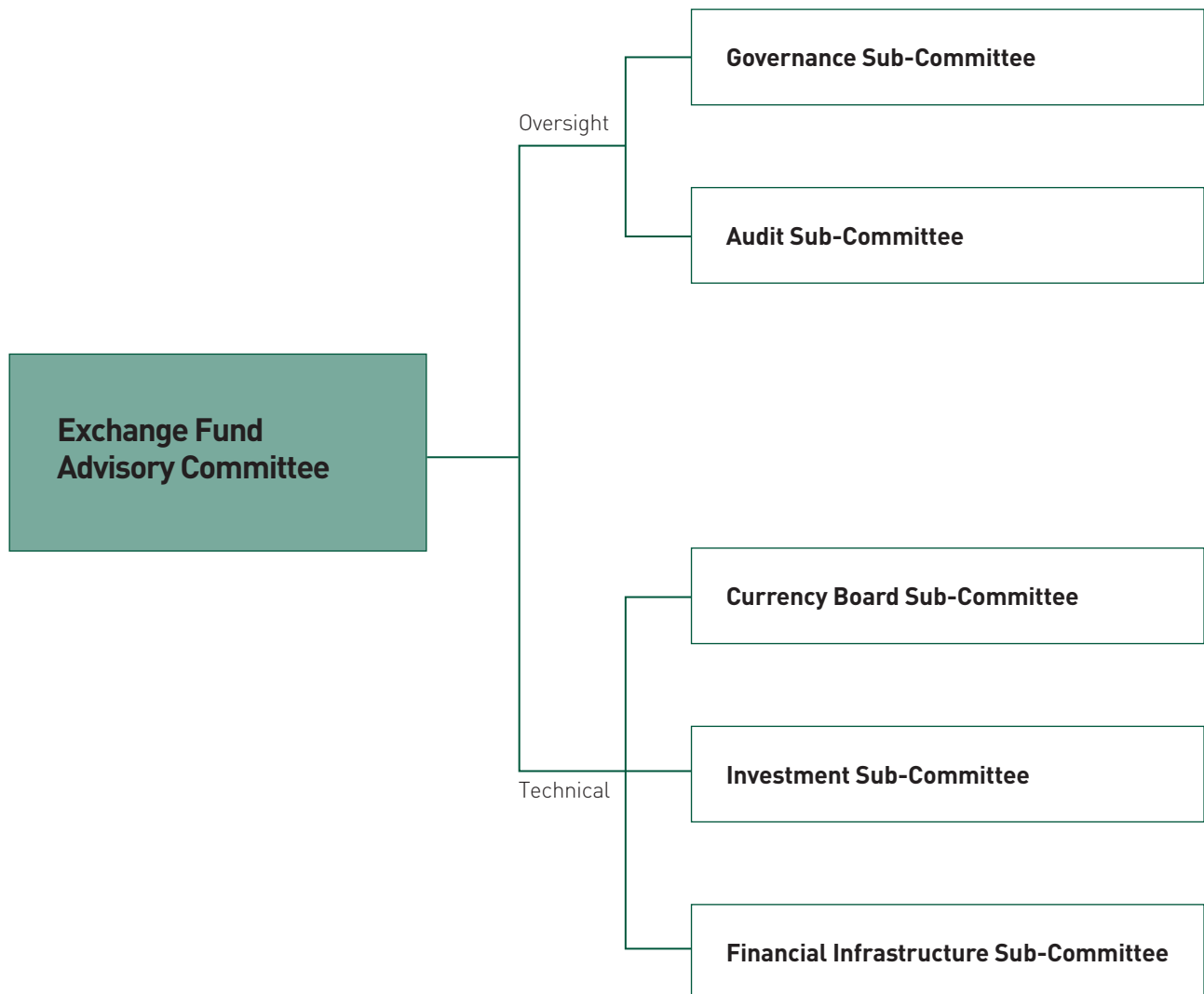
Mr Howard LEE

(1 February to 22 August 2010)

Mr Alan AU

(from 23 August 2010)

THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited

Members

Professor the Honourable Lawrence J. LAU, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Dr John CHAN Cho-chak, GBS, JP

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.
(from 1 March 2010)

Mr PANG Yiu-kai, SBS, JP
Chief Executive
Hongkong Land Holdings Limited
(from 1 March 2010)

Mr Simon IP Sik-on, JP
(until 30 April 2010)

Secretary

Mr Trevor KEEN
(until 31 January 2010)

Mr Howard LEE
(1 February to 22 August 2010)

Mr Alan AU
(from 23 August 2010)

Mr David SUN Tak-kei, BBS, JP

Professor CHAN Yuk-shee, BBS, JP
President
Lingnan University of Hong Kong
(from 1 March 2010)

Ms Teresa KO Yuk-yin, JP
China Managing Partner
Freshfields Bruckhaus Deringer
(from 1 March 2010)

Mr Carlson TONG, JP
Chairman
KPMG Asia Pacific and KPMG China
(from 1 March 2010)

Mr Thomas KWOK Ping-kwong, SBS, JP
Vice Chairman and Managing Director
Sun Hung Kai Properties Limited
(until 30 April 2010)

Terms of reference

- (1) To monitor the performance of the HKMA in carrying out its functions and responsibilities and in its use of resources, and to formulate recommendations to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC) on
 - (a) the remuneration and human resources policies of the HKMA;
 - (b) remuneration for HKMA staff, taking account of the Sub-Committee's assessment of the quality and effectiveness of the HKMA's work; and
 - (c) the use of resources of the HKMA, including its annual administrative budget.
- (2) To consider recommendations and provide advice to the Financial Secretary on the appointment and dismissal of staff at the level of Executive Director and above.
- (3) To keep under review the governance arrangements for the HKMA and to make recommendations to the Financial Secretary through EFAC as appropriate.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman

Mr David SUN Tak-kei, BBS, JP

Members

Mr HE Guangbei, JP

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP

Chief Executive
The Hongkong and Shanghai Banking Corporation Limited
(from 1 February 2010)

Mr Simon IP Sik-on, JP

(until 30 April 2010)

Mr Benjamin HUNG Pi-cheng

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Carlson TONG, JP

Chairman
KPMG Asia Pacific and KPMG China
(from 1 March 2010)

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited
(until 31 January 2010)

Secretary

Mr Trevor KEEN

(until 31 January 2010)

Mr Howard LEE

[1 February to 22 August 2010]

Mr Alan AU

(from 23 August 2010)

Terms of reference

(1) The objectives of the Audit Sub-Committee are as follows:

- (a) to help Members of the Exchange Fund Advisory Committee to discharge their responsibilities for ensuring the proper and smooth running of the HKMA operations and management of the Exchange Fund;
- (b) to consider any matters relating to the financial affairs of the HKMA and the internal and external audit of the HKMA's financial statements as the Sub-Committee may think necessary or desirable;
- (c) to encourage higher quality accounting and audit and provide more credible and objective financial reporting of the HKMA; and
- (d) to consider any other matters referred to it by the Committee; and to report on all such matters to the Committee.

(2) The functions of the Sub-Committee include, but are not restricted to, the following:

- (a) reviewing the HKMA's financial statements, the composition and accounting principles adopted in such statements, whether these are intended to be audited or published or not;
- (b) advising on the form and content of the financial statements of the HKMA;
- (c) examining and reviewing with both the external and internal auditors the scope and results of their audits;

(d) reviewing the findings, recommendations or criticisms of the auditors, including their annual management letter and management's response;

(e) reviewing the HKMA's management procedures to ensure the effectiveness of internal systems of accounting and control, and management's efforts to correct deficiencies discovered in audits; and

(f) initiating investigations or audit reviews into any activities of the HKMA which may be of concern or interest to the Sub-Committee.

(3) Authority

The Sub-Committee shall be entitled to obtain any information it requires from any member or employee of the HKMA, and all such members and employees shall be instructed to assist the Sub-Committee to the fullest extent possible. The Sub-Committee may also take such independent legal or other professional advice as it considers necessary. The Sub-Committee shall have no executive powers as regards its findings and recommendations.

(4) Meetings

The Sub-Committee shall meet at least twice a year. The Secretary to the Exchange Fund Advisory Committee shall attend its meetings and take minutes, copies of which shall be circulated to the Committee. The Chief Executive of the HKMA shall be entitled to attend the Sub-Committee's meetings. In all other respects, the Sub-Committee shall decide its own procedures.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Mr Peter PANG, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Arthur YUEN, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Professor TSANG Shu-ki
Senior Research Fellow
Institute for Enterprise Development
School of Business
Hong Kong Baptist University

Mr Benjamin HUNG Pi-cheng
Chairman
The Hong Kong Association of Banks

Mr Eddie YUE, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Dr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

Professor the Honourable Lawrence J. LAU, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Secretary

Mr Trevor KEEN
(until 31 January 2010)

Mr Howard LEE
(1 February to 22 August 2010)

Mr Alan AU
(from 23 August 2010)

Terms of reference

- (1) To ensure that the operation of the Currency Board arrangements in Hong Kong is in accordance with the policies determined by the Financial Secretary in consultation with the Exchange Fund Advisory Committee.
- (2) To report to the Financial Secretary through the Exchange Fund Advisory Committee on the operation of the Currency Board arrangements in Hong Kong.
- (3) To recommend, where appropriate, to the Financial Secretary through the Exchange Fund Advisory Committee, measures to enhance the robustness and effectiveness of the Currency Board arrangements in Hong Kong.
- (4) To ensure a high degree of transparency in the operation of the Currency Board arrangements in Hong Kong through the publication of relevant information on the operation of such arrangements.
- (5) To promote a better understanding of the Currency Board arrangements in Hong Kong.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

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(until 31 January 2010)

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(until 31 January 2010)

Mr Howard LEE
(1 February to 22 August 2010)

Mr Alan AU
(from 23 August 2010)

Terms of reference

- (1) To monitor the investment management work of the HKMA.
- (2) To make recommendations to the Financial Secretary, through the Exchange Fund Advisory Committee, on
 - (a) the investment benchmark for the Exchange Fund;
 - (b) the investment policy and risk management of the Fund;
 - (c) the investment strategy for the Fund; and
 - (d) any other matters referred to the Sub-Committee in connection with the investment management of the Exchange Fund.

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(from 1 February 2010)

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Terms of reference

- (1) To monitor the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong.
- (2) To recommend to the Financial Secretary through the Exchange Fund Advisory Committee
 - (a) measures to promote the safety and efficiency of the financial infrastructure in Hong Kong, particularly payment and settlement arrangements; and
 - (b) initiatives for the HKMA, in discharging its responsibilities for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, to promote the development of the financial infrastructure in Hong Kong with a view to maintaining Hong Kong's status as an international financial centre and helping to strengthen the international competitiveness of Hong Kong's financial services.

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Representing Securities and Futures Commission

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Industrial and Commercial Bank of China (Asia) Limited

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Representing Bank of China (Hong Kong) Limited

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Representing The Hongkong and Shanghai Banking Corporation Limited
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Executive Officer, Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch
(from 1 December 2010)

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Head of North and East Asia
BNP Paribas
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The Bank of Tokyo-Mitsubishi UFJ, Limited
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Ms Miranda KWOK

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China Construction Bank (Asia) Finance Limited
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Ms Theresa KWAN

(until 18 May 2010)

Ms Jasmin FUNG

(from 19 May 2010)

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Arthur YUEN, JP
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Raymond LI, JP
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Executive Director (Corporate Services)
(until 23 April 2010)



Francis CHU, JP
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Esmond LEE, JP
Executive Director (Financial Infrastructure)



Karen KEMP, JP
Executive Director (Banking Policy)



Nelson MAN, JP
Executive Director (Banking Supervision)

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Dong HE, JP
Executive Director (Research)



Meena DATWANI
Executive Director (Banking Conduct)
(from 1 April 2010)



Carmen CHU
Executive Director (External)
(from 1 April 2010)



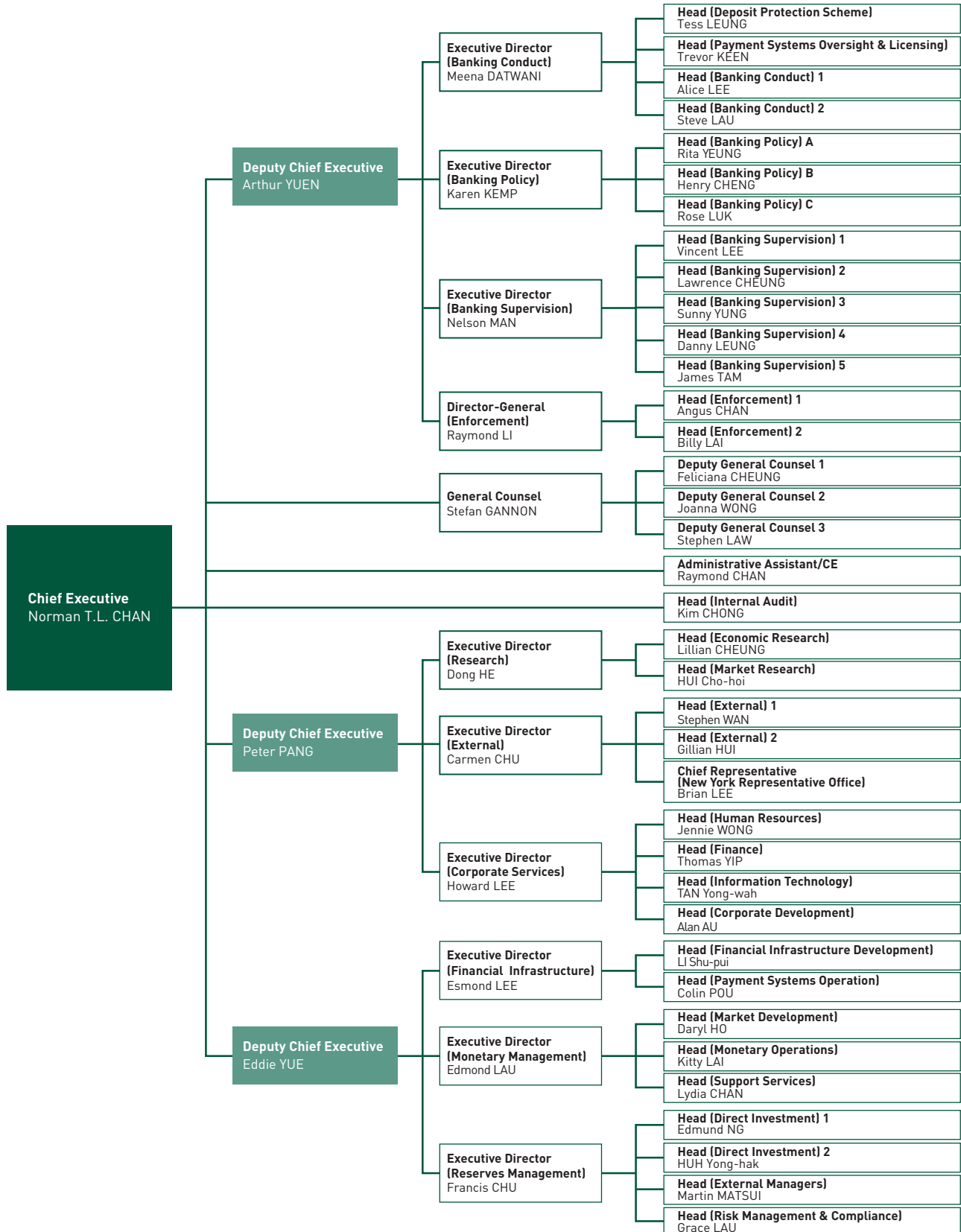
Howard LEE
Executive Director (Corporate Services)
(from 26 April 2010)



James H LAU Jr, JP
Chief Executive Officer
Hong Kong Mortgage Corporation

HKMA Organisation Chart

1 April 2011



Economic and Financial Environment

The Hong Kong economy experienced a broad-based recovery in 2010. The outlook for 2011 remains favourable, but consumer price inflation is likely to rise.

THE ECONOMY IN REVIEW

Overview

The recovery in Hong Kong's economy from the global financial crisis was broad-based, with real GDP rising by 6.8%. Supported mainly by private consumption, government investment and net exports, the economy maintained a solid, albeit slowing, pace of growth over the year as the inventory cycle had run its course (Table 1). Labour market conditions continued to improve on the back of buoyant economic activity. Following some moderation in earlier months, consumer price inflation revived in the fourth quarter due mainly to surging food prices and rental costs. While equity markets gained some momentum in the latter part of the year, the property market remained buoyant throughout 2010.

Monetary conditions were expansionary in 2010 with interest rates staying at historically low levels and domestic credit experiencing rapid growth. The Monetary Base changed little during the year, with the Aggregate Balance, a measure of interbank liquidity, staying at a high level. Monetary aggregates rose gradually during

the second half following a largely flat path in the first half. While short-term interbank rates remained low, the Hong Kong dollar spot exchange rate fluctuated on the strong-side of the Convertibility Zone for most of the year without triggering the Convertibility Undertaking. Major developments in renminbi business since the beginning of the year set off a surge in renminbi deposits. Despite this, Hong Kong dollar deposits as a share of total deposits remained largely unchanged over the year.

Domestic demand

Domestic demand recovered strongly in 2010. Private consumption growth gathered pace and registered 5.8%, underpinned by solid consumer confidence and continued improvement in labour market conditions. Government consumption also grew steadily by 2.7% (Chart 1). Inventory accumulation contributed substantially to output growth in the earlier part of the year, but weakened in the second and third quarters before picking up again in the latter part of the year in anticipation of stronger domestic demand. Private investment increased in the first half, but reversed its course in the second half amid slower building and construction activities. Overall fixed capital formation increased by 8.1% as public fixed investment expanded notably due to large-scale infrastructure projects in the pipeline.

Table 1 Real GDP growth by expenditure component (quarter on quarter)

[% quarter-on-quarter seasonally adjusted, unless otherwise specified]	2010				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gross Domestic Product	1.8	1.7	0.9	1.5	-3.6	3.6	0.4	2.2
(year-on-year growth)	8.1	6.4	6.7	6.2	-7.9	-3.4	-2.1	2.5
Private consumption expenditure	0.5	1.3	1.6	3.2	-0.9	4.9	0.4	1.6
Government consumption expenditure	0.9	0.7	0.9	-0.7	-0.4	1.6	0.4	0.4
Exports								
Exports of goods	6.2	3.8	1.8	-3.4	-14.2	5.7	0.2	7.9
Exports of services	4.1	2.4	2.1	0.4	-3.5	2.8	4.1	6.1
Imports								
Imports of goods	7.3	3.7	-1.0	-2.2	-12.5	7.2	4.7	5.6
Imports of services	2.5	2.9	0.7	1.3	-4.8	1.3	2.3	5.0
Overall trade balance (% of GDP)	2.7	-0.9	12.7	8.3	11.2	6.7	5.0	7.3

Source: Census and Statistics Department.

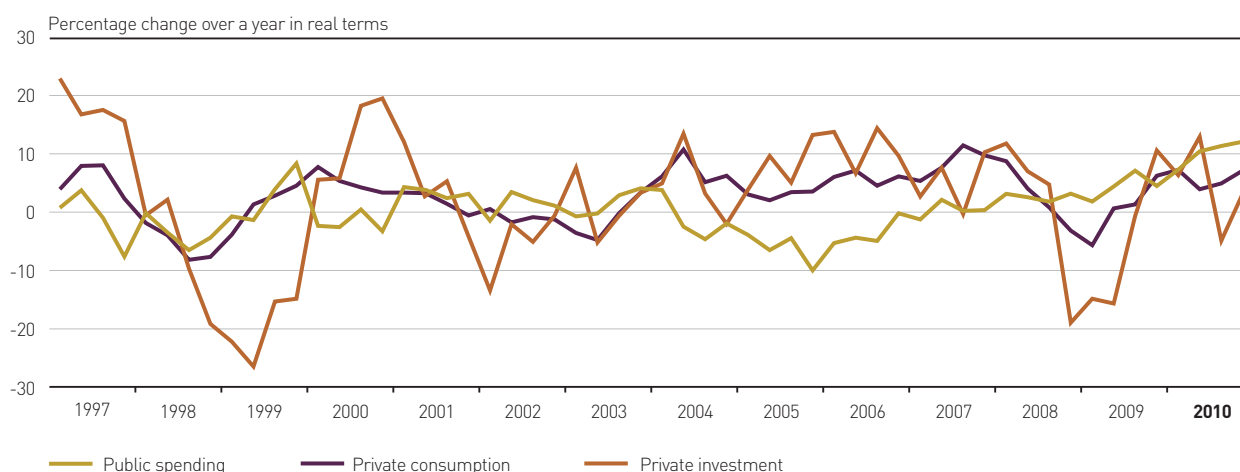
Economic and Financial Environment

External demand

External demand recovered in 2010, bolstered by strong economic performance in Mainland China and other emerging market economies, as well as the gradual recovery in advanced economies. Following solid growth in the first half, merchandise exports expanded at a slower pace in the second half due to the lingering uncertainties over the European sovereign debt crisis and increasing volatilities in the exchange rates of major currencies. For 2010 as a whole, merchandise exports grew by 22.8% in

value terms (Table 2). Exports of services also experienced a strong growth of 24.6% in value terms. In particular, exports of travel services expanded strongly due to thriving inbound tourism, while exports of transportation services, which are closely connected to merchandise trade, also grew at a firm pace. Imports of goods and services rose in value terms by 25.0% and 16.5% respectively as domestic demand strengthened. The trade surplus amounted to 6.0% of GDP, compared with 7.5% of GDP in 2009 (Chart 2).

Chart 1 Domestic demand



Source: Census and Statistics Department.

Table 2 Merchandise exports across major destinations¹

	Share %	2010					2009				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	53	40	26	31	14	27	-24	-5	-8	4	-8
United States	11	4	21	23	15	16	-21	-21	-24	-16	-21
European Union	11	-1	12	21	8	10	-18	-22	-26	-15	-20
Japan	4	13	27	18	13	17	-13	-18	-8	-2	-10
ASEAN5 ² + Korea	7	33	33	23	17	26	-32	-25	-18	-3	-20
Taiwan	2	72	30	18	3	25	-26	-6	3	25	-1
Others	12	19	27	33	25	26	-17	-18	-18	0	-13
Total	100	26	24	28	14	23	-22	-13	-14	-2	-13

¹ Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

² ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

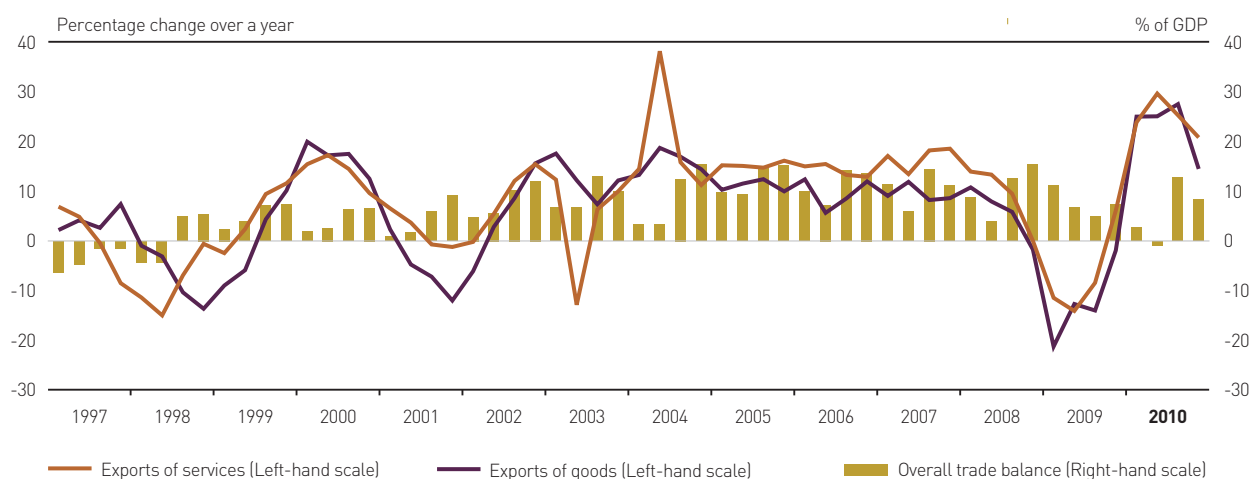
Source: Census and Statistics Department.

Inflation

Inflationary pressures increased in 2010, particularly in the fourth quarter, as food prices and rental costs rose gradually. Netting out the effects of government relief measures, the three-month-on-three-month annualised underlying inflation rate reached 2.7% in the earlier part of the year before tapering off to 1.4% in July, largely following the fluctuations in basic food prices and other non-housing prices. After staying flat in the third quarter,

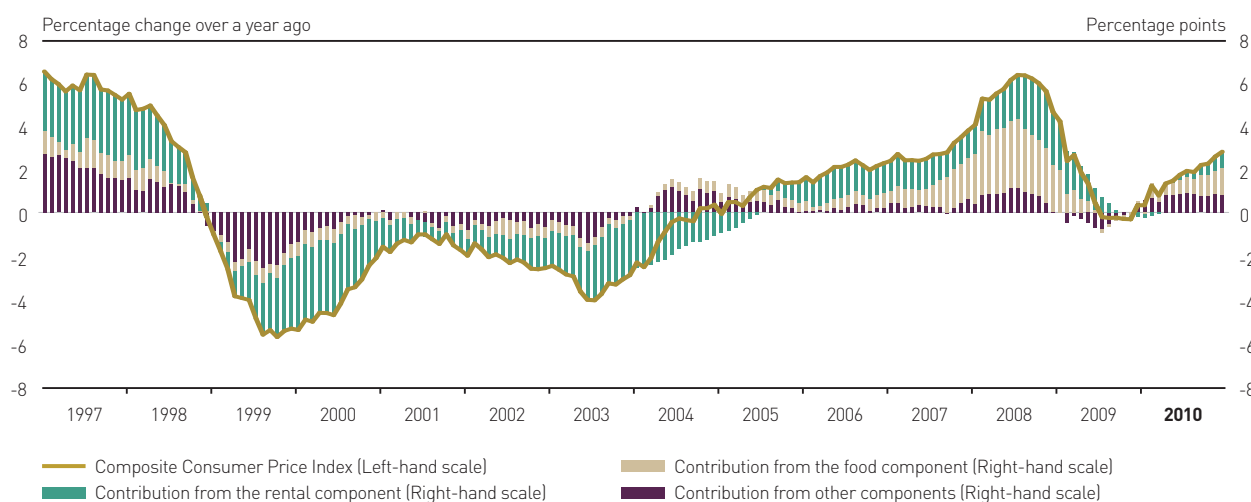
the inflation rate picked up again and touched a recent high of 4.3% at the end of the year, reflecting the rise in basic food prices and the filter-through of private housing rental costs. The year-on-year underlying inflation rate trended up throughout the year, reaching 2.8% in December and registered 1.7% for 2010 as a whole, compared with 1.0% in 2009. The headline CCPI inflation also rose to 2.4% from 0.5% a year earlier (Chart 3).

Chart 2 Overall trade balance and export growth (in nominal terms)



Source: Census and Statistics Department.

Chart 3 Consumer prices¹



¹ The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Sources: Census and Statistics Department, and staff estimates.

Economic and Financial Environment

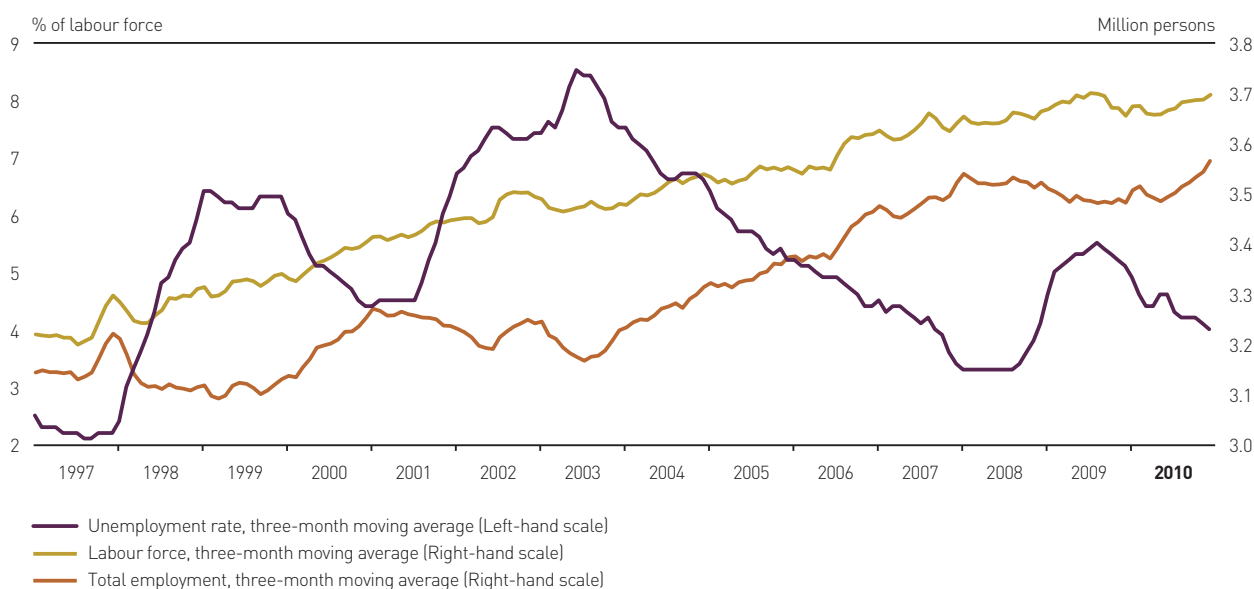
Labour market

Labour market conditions improved further in 2010, supported by strong economic activities. Following a downward trend in the second half of 2009, the seasonally adjusted three-month moving average unemployment rate declined further to 4.4% in March 2010. Heightened concerns over the European sovereign debt crisis had a short-lived impact on the demand for labour in the second quarter. Labour markets resumed improving in the second half underpinned by strong domestic demand and positive business sentiment, with the unemployment rate dropping from 4.6% in June to a two-year low of 4.0% in December (Chart 4). A sectoral breakdown indicated a broad-based improvement in labour market conditions, with manufacturing, construction, and retail, accommodation and food services sectors experiencing significant declines in unemployment rates. Total employment also turned around in June after a slowdown in hiring since February, and rose progressively in the second half to a historical high of 3,563,700 at the end of the year, with gains broadly observed among service sectors.

Stock market

The local stock market had an extended period of consolidation in the earlier part of 2010 amid the bumpy economic recovery of the advanced economies, concerns over sovereign debt problems in Europe and policy tightening on the Mainland. It was not until September that market activities revived visibly, due in large part to the expectation of an appreciation in the renminbi exchange rate, further quantitative easing in the US and solid corporate earnings of blue chip companies listed in Hong Kong. Investor sentiment, however, largely remained cautious throughout the year. At the close of 2010, the Hang Seng Index rose by 5.3% from a year earlier to 23,036. Stock trading picked up, with the average daily turnover increasing by 10.9% to \$69.1 billion. Fund raising activities were quiet in the earlier part of the year, but revived later, particularly with the listing of a major Mainland financial institution and a leading pan-Asia life insurer. Equity capital raised through new share floatation and post-listing arrangements on the local stock market reached \$858.7 billion in 2010.

Chart 4 Labour market conditions



Source: Census and Statistics Department.

Property market

The residential property market boom continued with housing prices rising rapidly by 20.9%. The rise was more notable for flats in the mass market than their luxury counterparts. Residential property trading was highly active, up 18.0% in terms of transaction agreements lodged with the Land Registry. Speculative activities also picked up, as suggested by a surge in re-sale within a short horizon. Mortgage lending also increased rapidly. Although interest rates remained low, housing affordability deteriorated due to a much faster increase in flat prices than household income. Against this background, the Government introduced a series of policy measures to stabilise the residential property market, while the HKMA also deployed a series of macro-prudential measures to protect banking stability and reduce the risk of a credit-asset price cycle. These policy measures have had some effect in preventing excessive mortgage lending and discouraging property speculation.

OUTLOOK FOR THE ECONOMY

Economic environment

The domestic economic environment is expected to remain favourable in 2011. Private consumption growth will continue to be supported by improving labour market conditions, advances in asset prices and solid consumer confidence. Gross fixed investment is expected to strengthen further, underscored by large-scale infrastructure projects in the pipeline and capacity expansion in the private sector amid bright business prospects. For the external environment, the waning global inventory re-building cycle will lead to a moderation in Hong Kong's export growth. Overall, Hong Kong's economic growth is expected to gradually revert to its trend rate. The market consensus in March pointed to real GDP growth of 5.2% in 2011, with the projections of the International Monetary Fund and the Asian Development Bank being 5.0 – 5.5% and 4.3% respectively.

Inflation and the labour market

Inflationary pressures are expected to build up further in 2011. The sharp rises in property prices and market rentals since early 2009 will continue to feed through to

the housing component of the Consumer Price Index. Upward pressures from food prices and local costs (such as utilities, education and transportation services) will also likely remain. The mean of the consensus forecasts in March suggested the headline CPI inflation may reach 4.3% for 2011 as a whole. Labour market conditions will continue to improve with the economy on track for healthy growth. Stronger corporate hiring sentiment will drive more job creation with the unemployment rate projected to fall to an average 3.8% in 2011 according to the consensus forecasts.

Uncertainties and risks

The largely favourable outlook for the Hong Kong economy is subject to a number of uncertainties and risks. The predominant external uncertainties include the effectiveness of the US quantitative easing in supporting its recovery, developments in the European sovereign debt crisis that could heighten financial market volatilities and, in a broader context, the speed and strength of recovery in the advanced economies. Any significant adverse developments in these factors could have spill-over effects on Hong Kong through both trade and financial channels. In addition, further macro-tightening in Mainland China to contain inflationary pressures and stabilise the property market could affect market sentiment in Hong Kong and increase asset market volatilities.

Domestically, the risk of overheating in the property market remains a concern. While the measures launched by the authorities over the past few months have had some impact, factors conducive to the formation of asset bubbles remain given the still low interest rate environment. Meanwhile, Hong Kong dollar flows will likely be volatile as interest rate cycles may start turning in the major advanced economies in the period ahead. While the brisk credit growth already poses some risks to local financial stability, the fickle nature of capital flows may increase interest-rate and liquidity risks in the domestic banking system. The rise in property prices and rentals for fresh leases together with increasing food prices will eventually feed through to inflationary pressures in the economy, further strengthening the demand for real assets as a hedge against inflation.

Economic and Financial Environment

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient in 2010, despite heightened concerns about sovereign debt in Europe. The strength in loan growth and improved asset quality reflected the favourable global economic and financial conditions. The capital position of locally incorporated AIs also remained robust.

Interest rate trends

Prompted by concerns over European sovereign debt, Hong Kong dollar interbank interest rates spiked briefly in the second quarter before stabilising at a low level for the remainder of the year, due largely to the accommodative monetary policy adopted by central banks in major developed countries. The composite interest rate, which reflects the average cost of funds of retail banks, remained low (Chart 5).

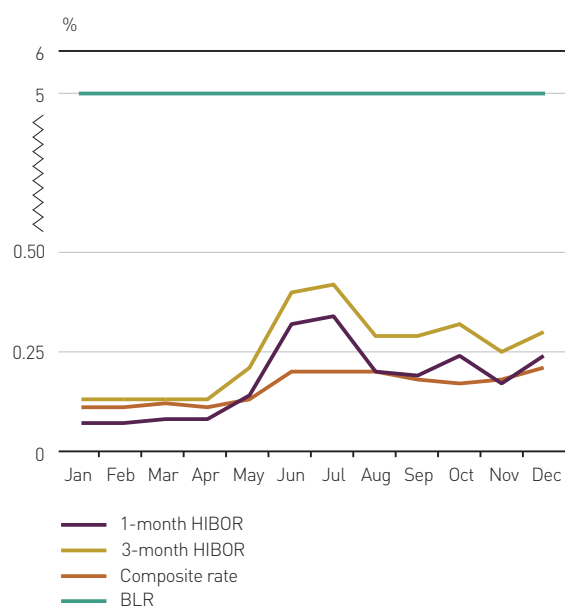
Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 10.4% in 2010, while the post-tax return on average assets also edged up to 1.01% from 0.97% in 2009 (Chart 6). Growth in income from fees and commissions and lower debt provisioning levels were the two key drivers for the growth, while net interest income dropped slightly, despite the fast pace of loan growth.

Underpinned by buoyant stock market activities, income from fees and commissions in 2010 increased by 10.3%. The proportion of non-interest income to total income of retail banks rose correspondingly to 47.9% from 45.2% in 2009.

The net interest margin of retail banks narrowed further in 2010 to a yearly average of 1.32%, compared with 1.48% in 2009, due to the persistently low interest rate environment

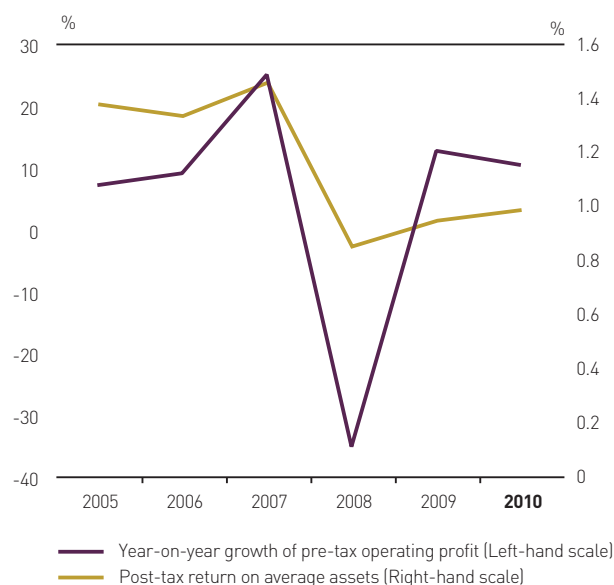
Chart 5 HIBORs, composite rate and BLR



Notes:

- 1 BLR refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited (monthly averages).
- 2 HIBORs are monthly averages.

Chart 6 Retail banks' performance



and intense competition for credit business (Chart 7). Net interest income dropped by 1.9% during the year, with the impact of thinner margins being somewhat offset by the strong growth in loans.

Increases in staff and rental expenses pushed up the operating costs of retail banks by 3.5% in 2010. The cost-to-income ratio edged up to 49.8% from 49.7% in 2009 (Chart 8).

Chart 7 Retail banks' net interest margin (yearly)

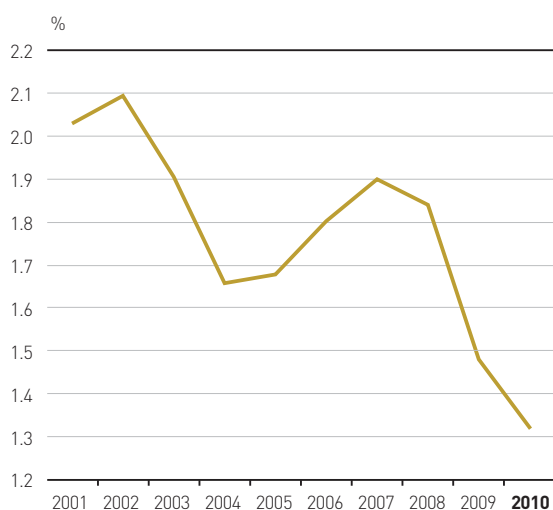
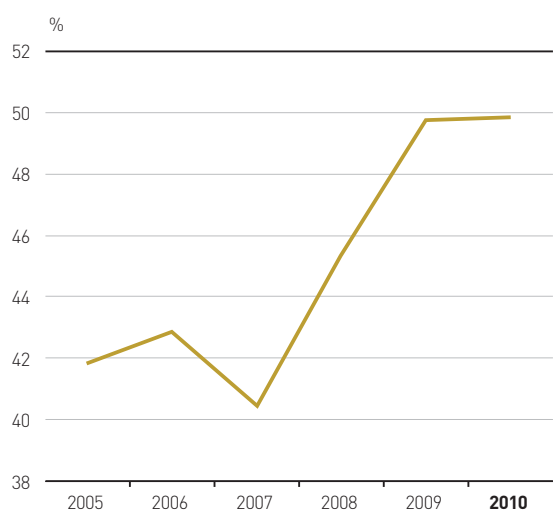


Chart 8 Retail banks' cost-to-income ratio

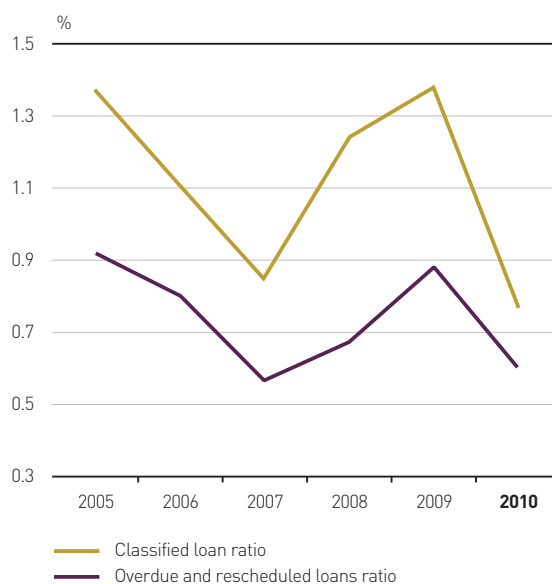


The net charge for debt provisions fell to \$1.8 billion from \$6.8 billion a year ago, as improved loan quality reduced the loan impairment charges.

Asset quality

The asset quality of retail banks improved as the Hong Kong economy remained robust and global recovery gained some traction. The classified loan ratio fell to 0.77% at the end of 2010 from 1.38% a year earlier (Chart 9). The combined ratio of overdue and rescheduled loans was also lower at 0.60% compared with 0.88% at the end of 2009.

Chart 9 Asset quality of retail banks

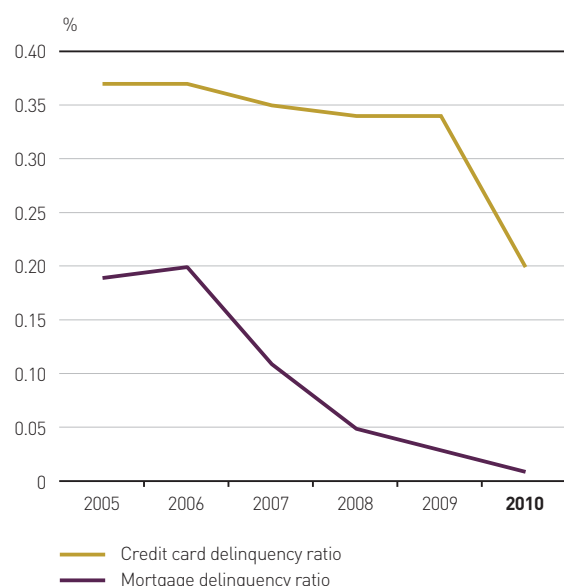


Economic and Financial Environment

The quality of surveyed institutions' residential mortgage lending remained sound. The delinquency ratio edged lower to 0.01% from 0.03% in 2009 (Chart 10). The rescheduled loan ratio declined to 0.04% from 0.09% in 2009. Higher property prices reduced the outstanding number of residential mortgage loans in negative equity to 118 cases at the end of 2010 from 466 a year ago.

The quality of credit card portfolios also improved, with the delinquency ratio declining to 0.20% at the end of 2010 from 0.34% a year ago (Chart 10). Similarly, the combined delinquent and rescheduled ratio dropped to 0.28% from 0.46% last year and the charge-off ratio fell to 1.91% from 3.71% in 2009.

Chart 10 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

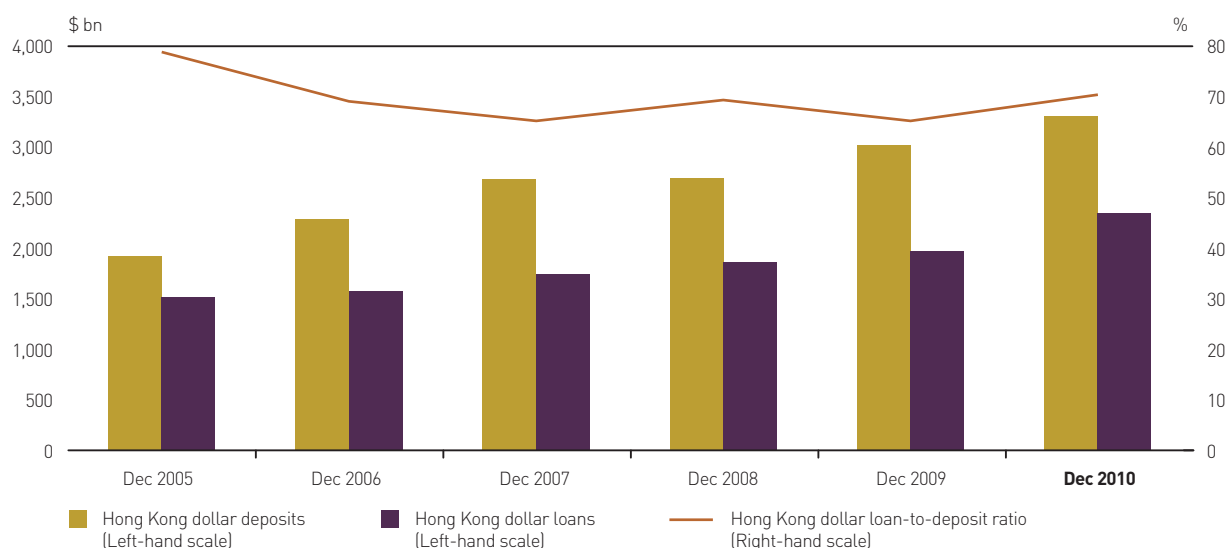


Balance sheet trends

Total loans and advances by retail banks surged by 26.6% in 2010, while total customer deposits grew by 11.0%. The overall loan-to-deposit ratio of retail banks increased to 52.8% from 46.3% in 2009. The Hong Kong dollar loan-to-deposit ratio also rose to 70.5% from 65.2% a year ago (Chart 11).

Growth in domestic lending was broad-based, which essentially reflected the robust recovery of the local economy. Remarkably strong credit growth was noted in the trade financing and wholesale and retail sectors, and this merits close observation from a supervisory perspective. Property lending also grew strongly, reflecting the buoyancy of the Hong Kong property market. To ensure the resilience of the banking sector, the HKMA introduced two rounds of countercyclical prudential measures on residential mortgage lending in August and November 2010.

Chart 11 Retail banks' Hong Kong dollar loans and customer deposits



Retail banks' total non-bank China exposures¹ rose to \$1,183 billion at the end of 2010 from \$772 billion a year ago. For the banking sector as a whole, non-bank China exposures increased to \$1,642 billion from \$1,014 billion in 2009.

Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit increased by 4.8% in 2010. However, the strong growth in loans lowered the share of total holdings of NDIs relative to total assets to 26% from about 28% in 2009. Among the holdings of NDIs, 42% were government-issued (44% in 2009), 36% were issued by non-bank corporates (35% in 2009), and 22% were issued by banks (21% in 2009) (Chart 12).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. Largely due to strong loan growth, the consolidated total and Tier 1 capital adequacy ratios of all locally incorporated AIs edged down to 15.9% and 12.3% respectively at the end of 2010, compared with 16.8% and 12.9% a year ago (Chart 13).

Chart 12 Retail banks' holdings of negotiable debt instruments at the end of 2010 (counterparty breakdown)

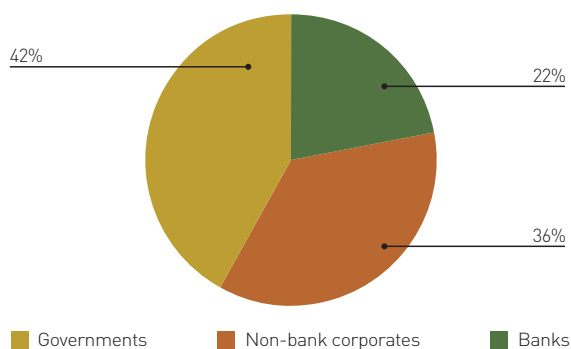
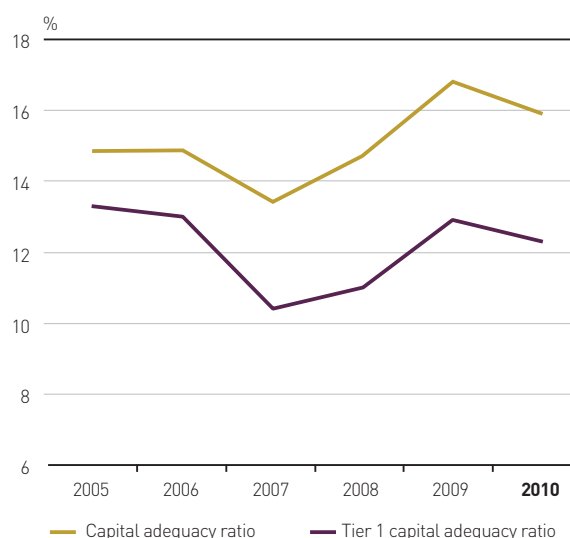


Chart 13 Consolidated capital adequacy ratio of locally incorporated AIs

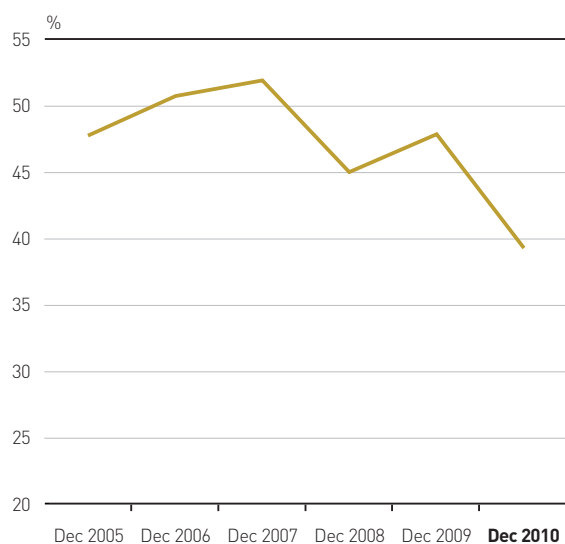


¹ Including exposures booked in retail banks' banking subsidiaries in Mainland China.

Economic and Financial Environment

With a larger loan book, which is usually less liquid than debt securities and bank placements, the average liquidity ratio of retail banks declined to 39.3% in the final quarter of 2010, down from 47.8% in the same quarter last year, but has remained well above the statutory minimum of 25% (Chart 14).

Chart 14 Retail banks' liquidity ratio (quarterly average)



PROSPECTS FOR 2011

The pace of economic recovery in 2010 varied significantly between different countries. The recovery in emerging economies has been much stronger than that of the advanced economies, reigniting concerns over global imbalances. In 2011, vigilance will be needed to address possible tensions created by diverging fiscal and monetary policies across different economies, which may have significant implications for cross-border fund flows, currency exchange rates and asset prices. In addition, the spill-over effect of the European sovereign debt crisis has been manageable so far. However, if the problems spread to other European sovereigns, the potential contagion risk could be significant on a macro-prudential level.

Against this background, it is important for AIs to ensure they are sufficiently resilient to weather unexpected changes in market conditions, such as deterioration in market liquidity or a sharp rise in funding costs. AIs should take account of the inherent pro-cyclicality of the credit cycle. In particular, AIs are expected to assess credit risks vigilantly by analysing carefully the possible impact on asset quality of a sudden reversal in credit growth and a decline in collateral values.

The banking sector should also be alert to the risks associated with an abrupt reversal of the prevailing low interest rate environment triggered by, for instance, capital outflows or an earlier-than-expected change of monetary policy in the US. An unexpected spike in interest rates could create distress for some overstretched borrowers, resulting in higher delinquency rates. Such a spike may also adversely affect the banks' own financial positions as a result of deteriorating market liquidity and mark-to-market losses on debt securities. Banks are advised to remain vigilant and maintain an adequate cushion of capital and liquidity to safeguard against these systemic risks.

Monetary Stability

The Linked Exchange Rate system – a cornerstone of Hong Kong's monetary and financial stability – continued to function smoothly and effectively in 2010. The Hong Kong Government is fully committed to the maintenance of the system.

OBJECTIVES

The overriding objective of Hong Kong's monetary policy is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, in terms of its exchange rate in the foreign-exchange market against the US dollar, within a band of HK\$7.75 - 7.85 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Monetary Base to be at least 100% backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100% matched by corresponding changes in US dollar reserves.

The Monetary Base (Table 1) comprises

- Certificates of Indebtedness, which provide full backing to the banknotes issued by the three note-issuing banks
- Government-issued notes and coins in circulation
- the Aggregate Balance, which is the sum of clearing account balances of banks kept with the HKMA
- Exchange Fund Bills and Notes issued by the HKMA on behalf of the Government.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for Hong Kong dollars is greater than the supply and the market exchange rate strengthens to the strong-side CU of HK\$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. Conversely, if the supply of Hong Kong dollars is greater than the demand and the market exchange rate weakens to the weak-side CU of HK\$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

Table 1 Monetary Base

\$ million	31 Dec 2010	31 Dec 2009
Certificates of Indebtedness ¹	226,705	200,185
Government-issued currency notes and coins in circulation ¹	8,929	8,477
Balance of the banking system	148,702	264,567
Exchange Fund Bills and Notes (EFBN) issued ²	655,220	537,429
Total	1,039,556	1,010,658

¹ The Certificates of Indebtedness and the government-issued notes and coins in circulation shown here are stated at Hong Kong dollar face values. The corresponding items shown in the balance sheet of the Exchange Fund in this Annual Report are in Hong Kong dollars equivalent to the US dollar amounts required for their redemption at the prevailing exchange rates on the balance sheet date. This arrangement is in accordance with the accounting principles generally accepted in Hong Kong.

² The amount of EFBN shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet.

Monetary Stability

REVIEW OF 2010

Exchange-rate stability

Despite the European sovereign debt crisis, volatile international capital flows and buoyant fund raising activities in the local equity market, currency stability was well maintained during the year (Chart 1). As concerns over European sovereign debt problems intensified in May, the Hong Kong dollar market exchange rate weakened to around 7.80. Between June and October, the exchange rate strengthened towards 7.75, supported by equity-related demand associated with initial public offerings and a buoyant stock market. Partly reflecting the repatriation of funds raised in the equity market, the exchange rate weakened in November and December. Overall, the exchange rate moved within a narrow range between 7.7511 and 7.8034 during the year.

Activities in the local foreign-exchange market were generally orderly. The market remained calm when signs of additional monetary easing in the US emerged in early August and when the US Federal Reserve announced on 3 November a second round of quantitative easing through large-scale Treasury bond purchases (widely known as QE2). On the Mainland, the People's Bank of China announced on 19 June that it would proceed with the reform of the renminbi exchange rate regime and enhance the exchange-rate flexibility. Although the renminbi faced renewed appreciation pressures, the Hong Kong dollar forward discounts traded within a narrow range during the year, with their movements broadly in line with HIBOR-LIBOR differentials.

Chart 1 Market exchange rate in 2010



Money market

The money market was stable in a low interest rate environment. Underpinned by low US dollar interest rates and ample interbank liquidity locally, HIBORs generally stayed below 1% during the year (Chart 2). Term HIBORs increased slightly in May and June following upward movements in their US dollar counterparts. The temporary rise in US dollar interbank rates partly reflected the concerns about the exposure of European banks to the debt-ridden countries in the Euro area. HIBORs rose occasionally in the second half of the year due to increased demand for equity funds.

While there were signs of capital flows from slowly recovering economies, including the US, to economies in the region with higher growth, the CUs were not triggered and the HKMA did not conduct any foreign-exchange operations within the Convertibility Zone during the year. In response to market demand, the HKMA issued additional Exchange Fund Bills in the first five months of the year, bringing the total additional supply since September 2008 to \$502.4 billion (Table 2). The Aggregate Balance contracted accordingly from \$264.6 billion on 4 January to \$148.6 billion on 12 May, and stabilised at around this level for the remainder of the year (Chart 3). These market operations were consistent with Currency Board principles and had little impact on the exchange rate and interest rates.

Chart 2 Hong Kong dollar interest rates in 2010

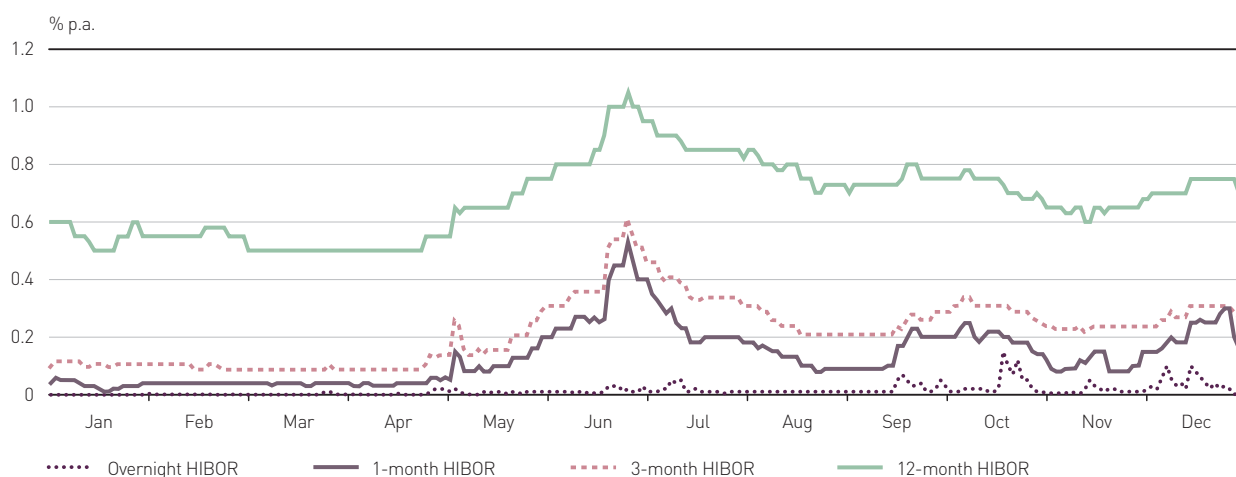
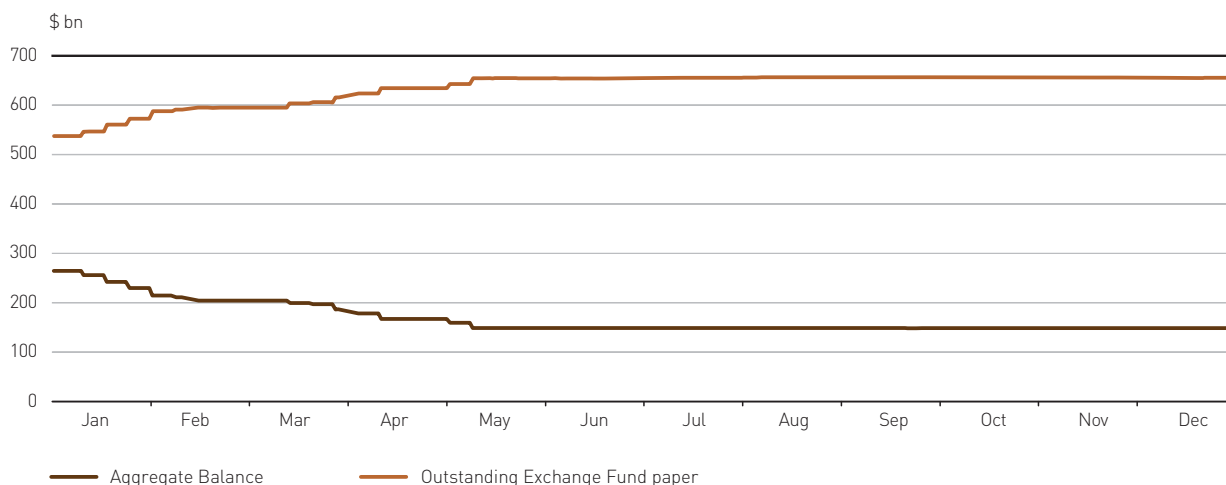


Table 2 Additional issuance of Exchange Fund Bills since September 2008

	\$ billion
September – December 2008	12.0
January – December 2009	374.4
January – May 2010	116.0
Total	502.4

Monetary Stability

Chart 3 Aggregate Balance and Exchange Fund paper in 2010



The markets also reacted calmly when the temporary Full Deposit Guarantee and the Contingent Bank Capital Facility provided by the Exchange Fund expired at the end of the year as scheduled. This indicated the HKMA's exit strategies over the past two years were successful.¹ As an example, the Deposit Protection Scheme (Amendment) Ordinance 2010 was passed on 30 June 2010 and an enhanced Deposit Protection Scheme came into effect on 1 January 2011. Under the enhanced scheme, the protection limit has been raised from \$100,000 to \$500,000, which will be able to fully cover about 90% of bank depositors.

The Linked Exchange Rate system

In the face of a volatile and complex external environment, the Linked Exchange Rate system continued to serve as an anchor for Hong Kong's highly externally oriented economy and as a cornerstone of its monetary and financial stability. However, against the backdrop of additional quantitative easing in the US and the increased use of the renminbi in Hong Kong, there was renewed discussion about the suitability of the Hong Kong dollar peg to the US dollar. The Hong Kong Government has reiterated its commitment to the Linked Exchange Rate system. Stability in the foreign-exchange and money markets suggests the market showed strong confidence in the Government's commitment.

¹ For more details on the HKMA's exit strategies, see *HKMA Annual Report 2009*, pages 45 – 47.

A sound banking system is a crucial condition for the normal functioning of the Linked Exchange Rate system. To guard against the risk of a credit-fuelled property market bubble in Hong Kong that would threaten banking and financial stability, the HKMA stepped up its supervisory efforts on residential mortgage lending during the year by introducing a series of measures to help the banks manage related risks. The measures include lowering the loan-to-value ratio for residential mortgages; assessing thoroughly the repayment ability of borrowers by computing debt servicing ratio prudently; and stress testing borrowers' repayment ability by assuming that interest rates would increase by at least two percentage points.

Over the years, the structure of the Currency Board has become stronger and more transparent. In view of potential changes to the long-term framework for monetary policy implementation in the US, the suitability of the existing formula for determining the Base Rate was reviewed in 2010. The review concluded that the formula for determining the Base Rate continues to be appropriate. Throughout 2010, the HKMA Base Rate remained unchanged at 0.5% (50 basis points above the lower boundary of the target range of the US Federal Funds Target Rate) according to the modified formula announced on 26 March 2009. To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved within a tight range of 107 – 108.5% during the year, without touching either the Upper or Lower Trigger Level. The ratio closed at 107.81% on 31 December (Chart 4).

Chart 4 Daily movement of the Backing Ratio in 2010



Monetary Stability

EFAC Currency Board Sub-Committee

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2010, the Sub-Committee considered issues including the renminbi exchange rate and its implications for inflation in Hong Kong; Hong Kong as an offshore renminbi centre and its implications for the Hong Kong dollar; external demand for Hong Kong dollar currency; and the development of, and prospects for, the real exchange rate of the Hong Kong dollar. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee are published on the HKMA website.

Hong Kong Institute for Monetary Research

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. In 2010, the Institute hosted 28 research fellows and five post-doctoral fellows. It also published 31 working papers.

The Institute organised a number of international conferences. In January, the First Annual International Conference on the Chinese Economy was held with the theme "China and the Global Economy: Macro, Trade and Financial Linkages". It covered topics ranging from China's savings rate, trade structure and productivity growth, to exchange-rate policies and capital account liberalisation. In July, the Institute, together with the Bank for International Settlements, held the "Financial Stability: Towards a Macroprudential Approach" conference, which dealt with theoretical and empirical issues related to the macroprudential approach to financial stability. Other programmes included a five-day Macroeconomic Modelling Seminar with the International Monetary Fund on the Global Integrated Monetary and Fiscal Model and the Global Projection Model; the Eighth Annual Summer Workshop, which focused on recent developments in exchange rate economics; a workshop with the Boyuan

Foundation on "The Development of Hong Kong as an Offshore Renminbi Centre"; and the Eighth HKIMR workshop on the Mainland economy with the theme "The Role of Property Markets in Macroeconomic Fluctuations in China". Forty public seminars were organised during the year covering a broad range of economic and monetary issues.

Notes and Coins

At the end of 2010, the total value of banknotes in circulation was \$226.7 billion, an increase of 13% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to \$8.7 billion, up 5% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$3 billion, an increase of 10% from 2009.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2010

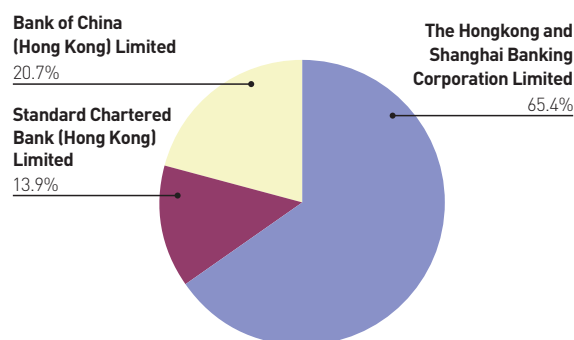
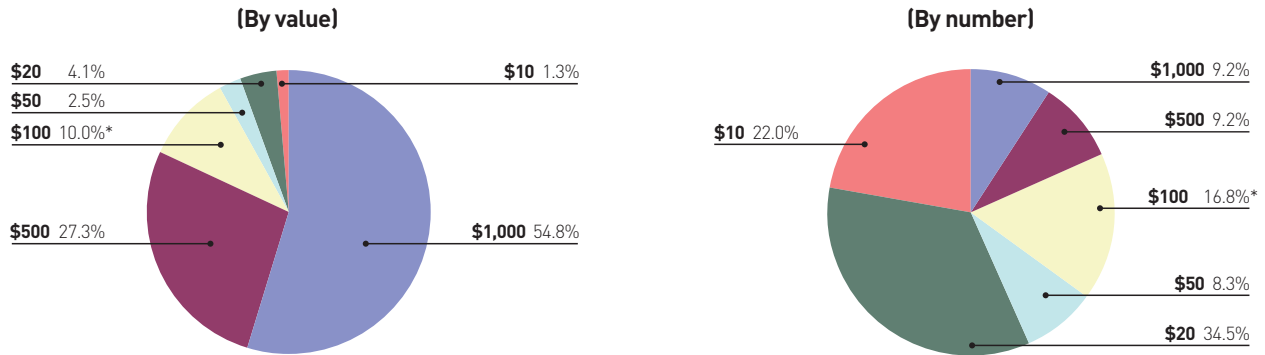


Chart 6 Distribution of banknotes in circulation at the end of 2010



* Includes 0.1 percentage points contributed by \$150 banknote.

Chart 7 Banknotes in circulation at the end of 2010

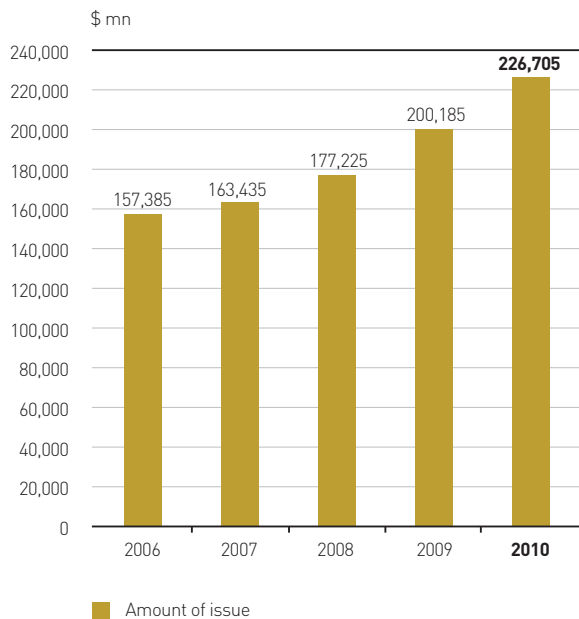


Chart 8 Government-issued notes and coins in circulation at the end of 2010

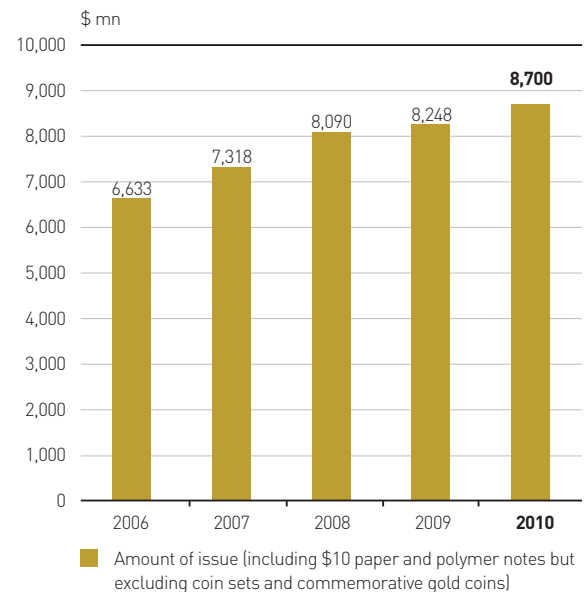
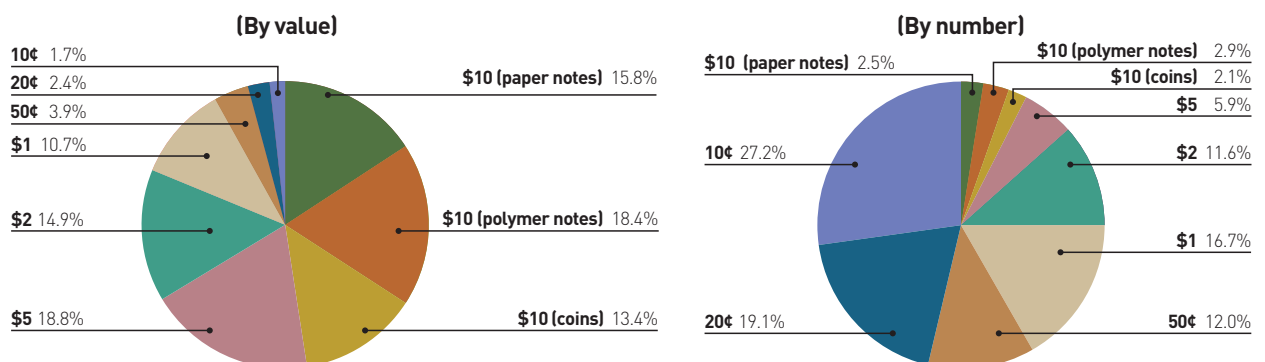


Chart 9 Government-issued notes and coins in circulation at the end of 2010



Monetary Stability

New series Hong Kong banknotes

The HKMA and the three note-issuing banks announced in July the issue of a new series of banknotes which carry state-of-the-art security features to stay ahead of counterfeiting and additional accessibility features for the visually impaired. New \$1,000 banknotes were put into circulation in December and the remaining four denominations of banknotes, \$500, \$100, \$50 and \$20, will go into circulation between 2011 and 2012.

The new security features are effective and easy to recognise, including the dynamic colour-changing pattern, colour-changing windowed metallic thread, enhanced watermark, fluorescent see-through pattern and fluorescent serial number.

For the first time, Braille and tactile lines have been embossed on Hong Kong banknotes to help the visually impaired differentiate between the denominations. A new note-measuring template has also been made available to the visually impaired through related organisations.

An extensive publicity campaign was launched to raise public awareness of the new banknotes. In all, 65 seminars were conducted for over 5,000 participants, including bank tellers, retailers, money changers, the visually impaired, the elderly, teachers and students. Roving exhibitions were held in six districts to enable people to view and feel the new banknotes, and student ambassadors visited major shopping centres to distribute educational leaflets to retailers.

\$10 polymer note

About 160 million polymer notes were in circulation at the end of 2010, representing 54% of the \$10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 17 million coins removed from circulation in 2010.



Norman Chan (third from left), Chief Executive of the HKMA, and the chief executives of the three note-issuing banks unveil the designs of the new series Hong Kong banknotes.



Roving exhibitions attract keen public interest in the new banknotes.

Exchange Fund Bills and Notes

Since the strong-side CU was not triggered in 2010, banks' demand for short-dated Exchange Fund paper eased compared with 2009. Against this background, the HKMA gradually slowed down the pace of issuing additional Exchange Fund Bills. An additional \$116 billion of 91- and 182-day Exchange Fund Bills were issued during the year, resulting in a corresponding decrease in the Aggregate Balance. By the end of 2010, the amount of outstanding Exchange Fund paper stood at \$653 billion (Table 3). During the year, the HKMA continued to fine-tune the maturity mix of the Exchange Fund Bills and Notes with increased issuance of 5-, 10- and 15-year Exchange Fund Notes.

PLANS FOR 2011 AND BEYOND

The macro-financial environment remains highly challenging in 2011. Financial stability could be vulnerable to the sovereign debt problems in Europe and geopolitical tensions in the Middle East and North Africa. Domestically, rising inflationary pressures, rapid growth in credit and the still buoyant property market will pose risks to monetary and financial stability.

The HKMA will closely monitor risks and vulnerabilities in the domestic and external environment and study issues affecting the economy in its research programme for the coming year. The EFAC Currency Board Sub-Committee will continue to examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.

Table 3 Outstanding issues of Exchange Fund Bills and Notes

\$ million	2010	2009
Exchange Fund Bills (by original maturity)		
91 days	346,038	299,162
182 days	195,000	123,000
364 days	42,200	42,200
Sub-total	583,238	464,362
Exchange Fund Notes (by remaining tenor)		
1 year or below	17,000	16,200
Over 1 year and up to 3 years	29,200	29,200
Over 3 years and up to 5 years	11,500	13,600
Over 5 years and up to 10 years	8,000	7,700
Over 10 years	4,200	3,000
Sub-total	69,900	69,700
Total	653,138	534,062

Banking Stability

The HKMA strengthened its supervisory activities in the aftermath of the global financial crisis; implemented new prudential measures to improve risk-management standards and practices for mortgage business; and introduced enhanced regulatory requirements to protect investors. Monitoring of Hong Kong banks' exposure to Eurozone sovereign debt indicates no significant risk to the soundness of banks in Hong Kong.

REVIEW OF 2010

Risk-based supervision

Following the global financial crisis, and the significant growth in loan portfolios and rapid expansion of the Mainland operations of authorized institutions (AIs), the HKMA has stepped up its monitoring and surveillance of AIs' asset quality, credit risk management, market risk and treasury activities and other areas of supervisory concern. As a result, 216 on-site examinations were conducted in 2010 compared with 142 in 2009. This was made possible by the release of supervisory staff resources previously redeployed to handle complaints on the sale of Lehman Brothers-related investment products by banks.

The HKMA conducted 49 risk-based examinations and 20 overseas examinations, of which 14 were related to AIs' Mainland operations. Areas of high supervisory priority were the subject of 74 focused thematic examinations covering asset quality; residential mortgage lending; trade financing activities; lending to small and medium-sized enterprises under the Government Loan Guarantee Scheme; compliance with the Representation Rules under the Deposit Protection Scheme and Guideline on Representation on Full Deposit Guarantee; and compliance with the regulatory requirements on renminbi business for personal and corporate customers.

The HKMA's specialist teams carried out 59 examinations of risk-management controls covering AIs' treasury and derivatives activities; sales of investment and insurance products and securities business; anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls; Internet banking and technology risk management and practice; customer data protection and operational risk management; and business continuity planning. Reviews were also performed for selected AIs that have adopted the internal ratings-based (IRB) approach for credit risk or the internal models (IMM) approach for general market risk under Basel II to ensure their compliance with the relevant requirements and the effectiveness of their IT systems in supporting the implementation of the IRB approach.

During the year, 190 off-site reviews were conducted while 12 tripartite meetings among the HKMA, AIs and their external auditors were held. Other duties included regular analysis of prudential returns and the handling of non-compliance with guidelines or statutory requirements. Supervisory teams met the boards or members of the board-level committees of seven AIs. In addition, the Banking Supervision Review Committee considered five cases relating to the licensing of AIs in 2010. As part of the off-site surveillance, the HKMA also conducted a round of reviews on the liquidity strategy of selected retail banks and the effectiveness of their liquidity contingency arrangements prior to the expiry of the Full Deposit Guarantee. The reviews included cash-flow analysis and assessment of the banks' liquidity conditions under stress scenarios. Details of the operational supervisory work performed in 2010 are set out in Table 1.

Banking Stability

Table 1 Operational supervision

	2010	2009
1 On-site examinations	216	142
<i>Regular examinations</i>	69	32
– risk-based	49	29
– overseas	20	3
<i>Basel II – IRB and IMM reviews</i>	14	9
– IRB initial recognition assessment and follow-up examinations	10	6
– IRB IT aspects	3	–
– IMM internal model recognition assessment and review	1	3
<i>Credit risk management and asset quality</i>	49	26
<i>Market risk and treasury activities</i>	15	6
<i>Securities, investment and insurance products-related conduct examinations</i>	11*	17
<i>Compliance with the Deposit Protection Scheme Representation Rules and Guideline on Representation on Full Deposit Guarantee</i>	19**	19
<i>AML/CFT controls</i>	14	18
<i>IT, Internet banking and operational risk</i>	19	12
<i>Renminbi business</i>	6	3
2 Off-site reviews and prudential interviews	190	193
3 Tripartite meetings	12	16
4 Meetings with board of directors or board-level committees of AIs	7	6
5 Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	241	269
6 Reports commissioned under section 59(2) of the Banking Ordinance	3	16
7 Cases considered by the Banking Supervision Review Committee	5	10
8 AIs that were subject to the exercise of powers under section 52 of the Banking Ordinance	1	3

* Apart from these 11 examinations by the specialist team, four regular examinations also covered this aspect.

** Included one examination on a non-Scheme member's compliance with the Guideline on Representation on Full Deposit Guarantee only.

Three reports were commissioned under section 59(2) of the Banking Ordinance to require three AIs to appoint external auditors to review internal controls and report their findings to the HKMA. One of the reports was related to a review of the processes and practices for handling Octopus cardholders' personal data. The other two reports were related to internal control systems for compilation of banking returns and liquidity risk management of an AI, and the AML/CFT controls of the other.

In 2010 no AI breached the requirements of the Banking Ordinance relating to capital adequacy. There was one breach of requirements under section 102 relating to liquidity ratios, two breaches of requirements under section 81 relating to large exposures, one under section 83 on connected lending, and three under section 85 on lending to AIs' employees. All of the breaches were assessed to be unintentional. They were rectified promptly by the relevant AIs and did not affect the interests of depositors.

Powers under section 52 of the Banking Ordinance

Only one AI, Melli Bank Plc, was subject to the exercise of powers under section 52 of the Banking Ordinance. The restrictions imposed by the Monetary Authority on 25 June 2008 under section 52(1)(A) of the Banking Ordinance on the affairs, business and property of the Hong Kong Branch of Melli Bank Plc remained in force during 2010. The HKMA continued to communicate regularly with the relevant authorities to monitor developments related to the branch and its Head Office in the United Kingdom, and to review the supervisory measures taken to protect the interests of the AI's depositors.

CAMEL rating review

Meetings of the CAMEL Approval Committee were held during the year to review and determine the composite CAMEL¹ rating of 192 AIs. The AIs were notified of the ratings and were given the opportunity to request a review, although none did so in 2010.

The CAMEL ratings of licensed banks on 20 October 2010 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by Scheme members in 2011 under the Deposit Protection Scheme.

¹ Comprising the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity components.

Specialised supervisory work

Supervision of technology risk and operational risk

Internet banking, technology risk management and business continuity management

The use of Internet banking services continued to grow in 2010 with 63 AIs offering the facility in Hong Kong: the number of personal Internet banking accounts increased to 7.0 million (from 6.2 million in 2009), and there were 573,000 corporate Internet banking accounts (up from 477,000 in 2009). Fifty-three AIs, including all of the 37 that offer high-risk transactions (such as fund transfers to unregistered third-party accounts) through Internet banking, have implemented two-factor authentication and some 3.6 million customers have registered for this service.

The HKMA continued to work with various parties to promote public security awareness of Internet banking. This included organising a "Hong Kong Clean PC Day 2010" in conjunction with the Hong Kong Police Force, the Hong Kong Association of Banks (HKAB), the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Co-ordination Centre. The HKMA also worked with HKAB to launch an educational leaflet providing safety tips on the use of Automatic Teller Machines (ATMs).

The HKMA issued a circular on 22 June to remind AIs of the need for appropriate management capability and procedures to respond effectively to significant incidents. The circular set out the principles that AIs should follow in any public communications dealing with such incidents. In view of growing customer demand for the Internet banking account aggregation service, the HKMA also issued a circular on 16 July setting out the required risk-management controls that AIs should implement when introducing this service to their customers.

A Task Force on ATM Fraud Prevention, comprising representatives from HKAB, Joint Electronic Teller Services Limited (JETCO), the Hong Kong Police Force and the HKMA, was established in May 2010 to strengthen ATM security in Hong Kong. After detailed discussions, it was agreed that AIs should adopt chip-based technology

to strengthen ATM security. The HKMA is working with the banking industry on the details of implementation.

The HKMA conducted regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning, and extended coverage of the supervisory control self-assessment process to 73 AIs (70 in 2009). These issues were also covered in the International Information Technology Supervisors Conference in which the HKMA is a regular participant.

Operational risk management

In 2010 the HKMA further strengthened its monitoring of AIs' operational risk and related risk management. The annual self-assessment exercise on operational risk management was extended to cover 76 AIs (52 in 2009), including all locally incorporated licensed banks and other selected AIs. The scope of the exercise was also expanded to collect more operational risk-related information to facilitate continued assessment and monitoring of individual AIs' risk profiles. The results of the self-assessments indicated the selected AIs were generally able to establish an operational risk management framework in line with the supervisory requirements. In addition, the operational risk management specialist team conducted on-site examinations on four AIs to review their policies and controls of operational risk.

Supervision of securities, insurance and Mandatory Provident Fund-related businesses

To increase regulatory focus on conduct issues and to step up the supervision of AIs' conduct of securities, insurance and Mandatory Provident Fund (MPF) intermediary activities, the HKMA centralised the supervisory resources dedicated to these activities into a specialised department with expanded manpower in April 2010.

Throughout the year, the HKMA co-operated closely with the Securities and Futures Commission (SFC), the Insurance Authority (IA) and the Mandatory Provident Fund Schemes Authority (MPFA) on the supervision of AIs' securities, insurance and MPF-related businesses. Regular contact was maintained through bilateral and multilateral meetings, and under the auspices of the Financial Stability Committee and the Council of Financial Regulators.

Banking Stability

The HKMA and SFC jointly instituted a mystery-shopper programme, engaging a service provider to assess intermediaries' compliance with the regulatory requirements on selling unlisted investment products, including structured deposits for the banking sector.

Since 2010, the HKMA has required all retail banks to submit quarterly surveys on the sale of investment products to retail banking customers to further strengthen off-site surveillance and risk-based supervision. The HKMA also continues to collect and analyse half-yearly returns on Als' securities and insurance activities. These returns provide a general overview and industry trends of the securities and insurance activities carried out by Als.

After detailed discussions with the banking industry, the HKMA issued a circular on 20 May requiring all Als to implement by 1 January 2011 a Pre-Investment Cooling-Off Period for the sale of unlisted derivative products to less sophisticated retail customers. This arrangement further enhances investor protection by reinforcing Als' procedures for giving customers sufficient time to consider their proposed investment. In addition, a number of circulars, including "Synthetic Exchange-Traded Funds and Related Products", "Selling of Renminbi Deposit, Investment and Insurance Products" and "Selling of Accumulators", were issued in 2010 to enhance and reiterate the regulatory requirements to protect the interests of investors and provide guidance to Als on the expected standards. The HKMA worked with the SFC and the banking industry on the implementation of the SFC's new regulatory measures for better investor protection.

Because of the simple product structure of plain vanilla renminbi bonds, which is easily understood by investors, the HKMA, in collaboration with the banking industry, launched a pilot scheme to streamline their selling arrangements.

In December 2010, the HKMA started discussions with the banking industry on a proposal to enhance the regulatory requirements for selling investment-linked assurance scheme (ILAS) products, in view of the features and risks (including the substantial long-term investment element) of these products. The HKMA also co-operated with the Government and the IA on the regulatory measures for the sale of eligible ILAS under the Capital Investment Entrant Scheme and on the proposal to establish an independent IA.

During the year, the HKMA conducted 11 thematic on-site examinations related to securities, insurance and investment products, covering the sales of ILAS and accumulators, the sponsor activities of initial public offerings, and compliance with the enhanced regulatory requirements for the selling of investment products. Four regular on-site examinations also covered this area.

The HKMA processed five applications for registration to become registered institutions (RIs) and five applications from RIs to engage in additional regulated activities. It also granted consent to 226 Executive Officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 9,297 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

During the year, the HKMA worked with the Government and the MPFA in preparation for the implementation of the Employee Choice Arrangement and the proposal to enhance the regulatory regime of the MPF intermediaries.

Supervision of treasury activities

Apart from treasury examinations covering Als' control framework for managing risks arising from their treasury and derivatives activities, thematic examinations focusing on new-product approval processes were also conducted in 2010. Altogether 11 treasury examinations were conducted with a primary focus on assessing the Als' senior management oversight and market risk, as well as the counterparty credit risk (CCR) control framework for treasury and derivatives activities. Four product thematic examinations were also conducted during the year, mainly to assess Als' new product approval processes and their control framework. The results of both treasury and product thematic examinations indicated there was room for certain Als to strengthen their risk identification and management processes.

Credit risk management and asset quality

Prudential supervision of mortgage loans

With the exceptionally low interest rate environment and quantitative easing measures pursued by major economies, excess liquidity has pushed up asset prices in emerging markets, including Hong Kong. This has increased the risk of asset price bubbles in Hong Kong's property market. Since mortgage loans constitute a significant part of Als' loan portfolio, the HKMA issued two circulars to Als on 13 August and 19 November respectively introducing prudential measures to strengthen risk-management standards and practices for mortgage business. These measures included:

- (1) lowering the maximum loan-to-value ratios for residential properties with a value at or above \$12 million to 50%; residential properties with a value at or above \$8 million and below \$12 million to 60%; and non-owner-occupied residential properties, properties held by companies, and industrial and commercial properties, regardless of their values, to 50%; and

- (2) standardising the maximum debt servicing ratio (DSR) for mortgage applicants at 50%, instead of the former range of 50% to 60%. In addition, banks are required to stress-test mortgage applicants' ability to withstand mortgage rate rises of at least 200 basis points, and limit the stressed DSR to 60%.

Credit growth

The banking sector's total lending grew by 29% during the year amid the low interest rate environment. Strong growth was noted in property-related lending, trade financing and lending to the wholesale and retail sector. In addition, corporate borrowers with Mainland background have been borrowing in Hong Kong, resulting in a strong growth in non-bank China exposures. To improve monitoring of Als' credit risk management procedures, the HKMA held meetings with Chief Risk Officers or relevant business heads of Als with significant loan growth to understand their business strategies and risk-management procedures. The HKMA is also studying necessary changes to banking returns in order to obtain more detailed information for prudential analysis.

Global financial crisis

Following concerns over sovereign debt issued by some Eurozone countries, which led to renewed financial turbulence and increased risks to the global economic outlook, the HKMA stepped up its monitoring of Als' exposures to these countries. The information collected revealed that the local banks' exposures accounted for less than 1% of their total assets, and the sovereign debt crisis in Europe did not pose significant risks to the safety and soundness of Hong Kong's banks. Nevertheless, the HKMA will continue to monitor major developments in financial markets in both the US and Europe to assess any ongoing potential impact on the local banking system.

Banking Stability

Mainland-related business

Renminbi banking business

The HKMA issued a circular to Als on 11 February 2010 to clarify the supervisory principles and operational arrangements for renminbi business in Hong Kong. There are two guiding principles: first, that cross-border flows of renminbi funds into and out of the Mainland should comply with the Mainland's requirements and this will be verified by the relevant Mainland authorities and banks; secondly, Als may develop renminbi business based on the regulatory requirements and market conditions in Hong Kong provided it does not entail the flow of renminbi funds back to the Mainland. Following the expansion of the renminbi cross-border trade settlement pilot scheme and the amendment to the renminbi clearing agreement, the HKMA issued another circular in July setting out the scope of renminbi business for corporate customers and the associated supervisory measures. Among other things, Als are reminded to carry out adequate know-your-customer procedures and are required to observe a simplified risk-management limit by placing 25% of their total renminbi deposits with the Renminbi Clearing Bank or holding them in cash. In its supervision, the HKMA will also assess the renminbi funding structure of an AI engaged in renminbi business, particularly whether there is over-reliance on a single source of wholesale renminbi funds if the AI does not have a retail deposit base.

A further circular was issued to Als in December enhancing the cross-border trade settlement pilot scheme. Als are required to provide trade-related renminbi conversion services for their corporate customers only in relation to transactions due for settlement within the next three months or renminbi trade proceeds received in the past three months, if the resulting position is to be squared with the Renminbi Clearing Bank. Such renminbi trade position squaring should be conducted on a net basis. As a standing arrangement, Als can approach the HKMA, subject to certain conditions, for renminbi funding to support their cross-border trade settlement activities. Since the renminbi is not a freely convertible currency, the HKMA also requires all Als to maintain a net renminbi open position that does not go beyond 10% of the size of their renminbi balance sheet.

The HKMA continued to conduct on-site examinations during the year of Als' renminbi banking business. A revised prudential return was introduced in September to capture additional data arising from the substantial development in the business.

Tapping the Mainland market

Thirteen locally incorporated banks maintained business operations on the Mainland during the year, of which eight were operating through subsidiary banks incorporated on the Mainland. They continued to expand their branch network, maintaining over 300 Mainland branches or sub-branches, either directly or through subsidiary banks.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK\$1,410.6 billion at the end of 2010, or 10.1% of total assets. These included exposures of HK\$428.4 billion booked in Mainland subsidiaries of Hong Kong banks. Compared with 2009, the aggregate exposures grew by 63.7%. With the increasing importance of the Mainland market to Als, the HKMA continued to maintain close contacts with the China Banking Regulatory Commission (CBRC) to ensure effective cross-border supervisory co-operation and co-ordination. A Supplemental Memorandum of Understanding was signed with the CBRC during the year to enhance co-operation in banking crisis management. The HKMA also conducted on-site examinations of the Mainland operations of Hong Kong banks.

Prevention of money laundering and terrorist financing

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Bill, which seeks to improve Hong Kong's anti-money laundering regime, was gazetted on 29 October 2010. The Bill is expected to come into effect on 1 April 2012. It codifies customer-due-diligence and record-keeping requirements, providing for supervisory and criminal sanctions for contravention of the statutory requirements, and establishes a licensing regime for money service operators.

After consulting HKAB and The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies), the HKMA issued a revised *Guideline on Prevention of Money Laundering and Supplement to the Guideline on Prevention of Money Laundering* in July to address issues raised in the Financial Action Task Force's 2008 Mutual Evaluation Report on Hong Kong and to better reflect international standards. To monitor AIs' compliance with the HKMA's *Guideline and Supplement*, the HKMA's AML/CFT specialist teams completed 13 Tier 2 on-site examinations and one thematic examination focusing on the AI's business relationship with overseas money services businesses.

Co-operation with overseas supervisors

During the year the HKMA participated in college-of-supervisors meetings organised by the home supervisors of 11 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including market trends, capital adequacy, stress-testing and liquidity risk management. As a member of the Cross-Border Crisis Management Working Group under the Financial Stability Board (FSB), the HKMA was involved in the Group's various meetings as well as the crisis management groups established for three banking groups to make advanced preparations for dealing with possible future financial and banking crises.

Bilateral meetings were held in Hong Kong and abroad with banking supervisory authorities from Australia, France, Japan, South Korea, Macau, Mainland, the Philippines, Singapore, Thailand, the UK and the US. There were also regular exchanges with overseas banking supervisory authorities on institution-specific issues and developments in financial markets.

The HKMA is also a member of the FSB Working Group on Data Gaps and Systemic Linkages and chairs one of the Group's work-streams responsible for addressing the legal and confidentiality constraints in any enhanced cross-border data-sharing arrangements. Enhanced data sharing, if effectively implemented, will help regulatory authorities better measure and understand the risks to the international system arising from increasingly integrated economies and financial markets and take early measures to mitigate the risk of contagion. The Working Group is expected to submit its report and recommendations to the FSB in early 2011.

Minibonds

As set out in the settlement agreement between the 16 distributing banks of Minibonds and the regulators under section 201 of the Securities and Futures Ordinance, the banks are required to engage independent firms to review their internal control systems and complaint-handling procedures relating to the sale of structured investment products. The exercise was completed during the year and, as part of its supervision, the HKMA has been monitoring the banks' progress in implementing the recommendations in the review reports. The HKMA is also following up on the work of the receivers appointed for the Minibonds in redeeming the underlying collateral.

BIS triennial FX survey

In April, the HKMA participated together with 52 other countries and financial centres in the Bank for International Settlements' Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity. The result of the survey showed that Hong Kong remained the sixth largest foreign exchange centre (the seventh largest when over-the-counter (OTC) derivatives were included).

Banking Stability

Basel II

Enhancements to Basel II

The HKMA collaborated with the Financial Services and the Treasury Bureau and the Department of Justice in developing legislative amendments to the Banking (Capital) Rules (BCR) and the Banking (Disclosure) Rules (BDR) necessary for implementing the recommendations for proposed enhancements made in the Basel Committee on Banking Supervision papers *Revisions to the Basel II Market Risk Framework*, *Guidelines for Computing Capital for Incremental Risk in the Trading Book*, and *Enhancements to the Basel II Framework* issued in July 2009.

In June, the Basel Committee announced certain adjustments to the document *Revisions to the Basel II Market Risk Framework* and a new co-ordinated starting date for implementing the revisions of no later than 31 December 2011. The HKMA has informed the industry associations that it proposes to incorporate the market risk adjustments into the BCR, and follow the Basel Committee's revised timetable in implementing all enhancements to the credit risk and market risk capital frameworks. The opportunity has also been taken to clarify some existing provisions within the Rules and address some issues observed in the implementation of the Rules since their introduction in 2007.

As part of its July 2009 reform package, the Basel Committee issued supplemental Pillar 2 guidance to address major flaws in the governance and risk-management practices of financial institutions revealed by the global financial crisis. The guidance promotes firm-wide governance and risk management, and addresses a variety of risk-management issues relating to off-balance sheet and securitisation exposures, valuation of financial instruments, stress-testing and remuneration practices. In the light of this guidance, the HKMA updated and refined its Pillar 2 supervisory framework and guideline, which came into effect on 4 June 2010.

Implementation of advanced approaches

During the year the HKMA granted approval to three Als to adopt the IRB approach under the credit risk framework of the BCR, after assessing the robustness of the Als' internal rating systems and their compliance with the requirements set out in the Rules.

The HKMA conducted a benchmarking exercise in which the risk estimates used by different Als adopting the IRB approach to calculate their capital requirements for credit risk exposures with similar or identical risk characteristics were compared. The exercise found that the risk estimates used by the Als adopting the IRB approach were prudent on the whole, although a few outliers were observed. The HKMA has shared the results of the exercise with the participating Als adopting the IRB approach to enable them to make suitable improvements to their systems.

The HKMA conducted follow-up reviews of selected Als which had previously obtained the HKMA's approval to use the IRB approach for credit risk and the IMM approach for market risk. These follow-up reviews were designed to ascertain the Als' continuing compliance with the requirements for the use of these approaches. The results were in general satisfactory.

Supervisory review process

The Supervisory review process (SRP) provides the HKMA with a comprehensive framework for assessing locally incorporated Als' capital levels and risks, including non-credit risks such as interest rate risk in the banking book, liquidity risk, and reputation and strategic risks.

During the year the HKMA completed a round of SRP assessments on Hong Kong-incorporated AIs, including a review of their progress in establishing their own capital adequacy assessment processes (CAAPs). The SRP Approval Committee within the HKMA then reviewed the assessment results to consider the appropriate minimum capital adequacy ratios (CARs) for the AIs and whether there were other supervisory issues requiring attention. The AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so in 2010.

CAAP is an internal process whereby AIs assess whether their overall capital adequacy is commensurate with the risk profile of their operations and formulate a strategy for maintaining adequate capital levels. Since the implementation of Basel II, some AIs have already substantially established their CAAPs and have been regularly submitting the results to the HKMA for review. Notable progress has also been observed for some of the other AIs in that their policies and procedures for their CAAPs are now largely in place, although some of the methodologies for calculating the capital adequacy are still being finalised.

Basel III

On 16 December 2010 the Basel Committee issued the Basel III rules text, setting out the details of the new global regulatory standards on bank capital adequacy and liquidity designed to strengthen the resilience of the global banking system and reduce the probability and severity of future banking crises. This followed the release in December 2009 of two consultative papers *Strengthening the Resilience of the Banking Sector* and *International Framework for Liquidity Risk Measurement, Standards and Monitoring*, and a subsequent comprehensive quantitative impact study (QIS) on the consultation proposals. Basel III was endorsed by the Group of Twenty (G-20) leaders at their Seoul Summit in November and represents a significant contribution to the banking reform agenda set by the G-20 a year earlier at their Pittsburgh Summit.

Key aspects of Basel III

Strengthening the global capital framework

The quality of the regulatory capital base will be enhanced by:

- simplifying the categories of regulatory capital by removing the class of Tier 3 capital and creating a single class of Tier 2 capital
- introducing more stringent definitions of, and qualifying criteria for, Tier 1 and Tier 2 capital, including the removal of incentives to redeem and the

inclusion of a requirement that the contractual terms of non-common equity capital instruments must allow them to be written-off or converted to common shares in the event that a bank is unable to support itself in the private market (as set out in the Basel Committee's August 2010 consultative document, *Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-viability*)

- harmonising regulatory adjustments and providing that in most cases these should be deducted from common equity.

The minimum regulatory capital requirements in relation to risk-weighted assets will be increased with:

- the common equity requirement rising from 2% (before the application of regulatory adjustments) to 4.5% (after the application of stricter regulatory adjustments)
- Tier 1 capital requirement rising from 4% to 6%
- the total minimum capital requirement remaining unchanged at 8%.

The transparency of the capital base will be improved, with all elements of capital being required to be disclosed along with a detailed reconciliation to the reported accounts.

Basel III (continued)

Reducing pro-cyclicality

In "normal" times, outside of periods of financial and economic stress, banks should hold buffers of capital above the regulatory minimum capital requirement. For this purpose, Basel III establishes a capital conservation buffer of 2.5% made up of common equity (after the application of regulatory adjustments). Restraints will be imposed on earning distributions by a bank when its capital levels fall into the conservation range. The range of the capital conservation buffer will be adjusted when there are indications of excessive aggregate credit growth. This additional "countercyclical capital buffer" may range from 0% in normal times up to 2.5% during periods of excessive credit availability.

The countercyclical buffer aims to achieve the broader macro-prudential goal of protecting the banking sector from the build-up of systemic risk during periods of excessive aggregate credit growth. Both the countercyclical buffer and the capital conservation buffer are designed to be drawn down in periods of stress, thus enabling banks to absorb losses while continuing to lend and conduct their usual business. The HKMA is developing policies and procedures to implement this framework in Hong Kong.

The Basel Committee is also addressing pro-cyclicality by promoting more forward-looking provisioning through advocating a change in the accounting standards and working with the International Accounting Standards Board (IASB) towards an expected loss provisioning approach.

Supplementing the risk-based capital requirement with a leverage ratio

The Basel III proposals include the introduction of a simple leverage ratio to constrain the build-up of excessive leverage in the banking sector. The leverage ratio also provides additional safeguards against model risk and measurement error in the risk-based capital adequacy calculation.

Enhancing risk coverage

The capital requirements for CCR exposures from banks' derivatives, repo and securities financing activities will be strengthened. The minimum capital required to back these exposures will be raised through the imposition of capital charges for mark-to-market losses, the use of stressed inputs in the calculation, and the application of a multiplier in the calculation for exposures to large regulated financial institutions and unregulated financial institutions to reflect the higher degree of correlation between these exposures and the higher level of "interconnectedness" of such institutions. The Basel Committee is also strengthening risk-management standards for model validation, stress-testing, collateral management and margining requirements.

To address systemic risk and improve transparency in OTC derivatives markets, the Basel Committee is finalising a new framework for capitalising banks' exposures to central counterparties (CCPs), which includes incentives for banks to clear their OTC derivative transactions using CCPs and trade on exchanges where required or practicable. The details of this framework were issued in December 2010 for consultation.

Addressing systemic risk and interconnectedness

Systemically important banks should have loss-absorbing capacity beyond the minimum standards, and work continues at the Basel Committee and the FSB to develop a well-integrated approach to these institutions. This could include combinations of capital or liquidity surcharges, the use of contingent capital or bail-in debt, enhanced resolution regimes and more intensive supervision.

Basel III (continued)

Introducing a global liquidity standard

Basel III sets two minimum standards for funding liquidity and introduces a number of monitoring metrics for strengthening and promoting global consistency in liquidity risk supervision. The liquidity standards and monitoring metrics are intended to reinforce the application of the Basel Committee's *Principles for Sound Liquidity Risk Management and Supervision (Liquidity Sound Principles)* issued in September 2008.

The two minimum standards are:

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is designed to promote banks' short-term liquidity resilience by ensuring that they have a sufficient stock of high-quality liquid assets to meet contingent liquidity needs and survive for at least 30 days under a supervisor-defined scenario which combines an idiosyncratic and market-wide shock.

Net stable funding ratio

The net stable funding ratio (NSFR) complements the LCR by promoting banks' use of more stable and longer term funding sources to support their activities. This ratio compares an estimate of reliable funding sources to an estimate of required stable funding over a one-year time horizon under conditions of extended stress.

HKMA's participation in the shaping of Basel III

The HKMA supports Basel III in strengthening the resilience of the global banking system. It is a member of the Basel Committee and participates in several of the Committee's working groups (such as the Working Group on Liquidity and the Definition of Capital Sub-Group), which were instrumental in developing the Basel III proposals.

During the consultation period, the HKMA encouraged the industry associations to formulate co-ordinated responses to the Basel Committee. HKAB recognises the merit of improving the banking sector's ability to absorb financial and economic shocks. However, it

raised a number of specific concerns on the reform proposals, including the uncertain potential cumulative impact of the various constituent parts of the proposals on the banking sector in Hong Kong. Following discussions with the banking industry and others on the potential implications for Hong Kong and the East Asian region more generally, the HKMA submitted a paper to the Basel Committee in April 2010 contributing some further thoughts on the proposals.

A particular issue potentially affecting the implementation of the LCR in some jurisdictions (including Hong Kong) is the limited supply of eligible high-quality liquid assets denominated in the local currency to cover banks' liquidity needs. Sovereign or central bank debt is the main source of high-quality liquid assets for banks under the LCR and these jurisdictions do not have sufficient government debt in issue. As such, the HKMA contributed to the development of alternative options for these jurisdictions, and the proposed options are under review by the Basel Committee. The HKMA will continue to participate in developing proposals to address this issue.

Comprehensive quantitative impact study

Appropriate calibration of the Basel III reform package is pivotal to strengthening the resilience of the banking sector while fostering sustainable long-term economic growth. The Basel Committee undertook a comprehensive QIS during 2010 to assess how the Basel III standards would affect the capital and liquidity positions of banks. The QIS was complemented by other high-level assessments on the macroeconomic costs of the transition to Basel III and the long-term impact of the standards on the overall economy. In addition to participating in the Basel Committee's comprehensive QIS, the HKMA conducted its own local QIS on a broader sample of AIs to better assess the impact of the new standards on the local banking sector and to formulate its strategy for implementing the standards in Hong Kong.

Basel III (continued)

Impact of Basel III on Als

Hong Kong banks should have little difficulty in meeting the higher capital requirements as they are well capitalised and place more reliance than their peers in other jurisdictions on common equity to meet regulatory capital requirements. In addition, most of the Basel III regulatory adjustments are already required to be deducted from Tier 1 capital under Hong Kong's existing capital rules. Similarly the HKMA does not expect any major problem for banks in Hong Kong to comply with the new liquidity standards, although some may need to adjust their liquidity profiles or the composition of their pool of liquid assets.

Transitional arrangements for implementation

The Basel III framework will be phased in gradually to enable the banking sector to move to the higher capital and new liquidity standards while continuing to support economic activities through lending and other banking business. National implementation by Basel Committee member jurisdictions will begin on 1 January 2013 with full implementation by 1 January 2019.

The transitional arrangements include:

- phasing in minimum common equity and Tier 1 requirements between 2013 and 2015, in annual half-percentage-point increments
- phasing in the capital conservation buffer between 2016 and 2018, to reach a final level of 2.5% of risk-weighted assets on 1 January 2019
- phasing out capital instruments that no longer qualify as non-common equity Tier 1 or Tier 2 capital over a 10-year horizon from 2013 (instruments that do not meet the criteria for inclusion as common equity Tier 1 will be excluded from 1 January 2013)
- phasing out instruments with an incentive to redeem on their effective maturity date
- supervisory monitoring for the leverage ratio to commence on 1 January 2011; with a parallel-run period from 2013 to 2017. Disclosure of the leverage ratio (and its components) will start on 1 January 2015 and the ratio will migrate to a Pillar 1 treatment on 1 January 2018
- the observation period for LCR and NSFR to begin in 2011 to enable the impact of the liquidity standards to be monitored and any unintended consequences addressed, before formal implementation on 1 January 2015 and 1 January 2018 respectively.

Improving the supervisory policy framework

Revision of liquidity regime

During the year, the HKMA consulted the industry on a phased approach to strengthening the local liquidity regime to bring it into line with the latest international standards and address issues revealed from the recent crisis. As part of this process, the HKMA developed a new supervisory guideline "Sound Systems and Controls for Liquidity Risk Management" to implement the Basel Committee's 2008 *Liquidity Sound Principles*. Als are expected to upgrade their liquidity risk management process and build up their liquidity position, where necessary, to comply with the requirements of the guideline, based on a sound implementation plan to be agreed with the HKMA. The HKMA also assessed the adequacy of its liquidity risk supervisory framework against the supervisory principles set out in the *Liquidity Sound Principles*. While the framework largely reflects the *Principles*, an action plan has been devised to strengthen areas where improvements can be made.

Following finalisation of the Basel III liquidity standards and monitoring tools in December 2010, the HKMA will consider the most appropriate approach for implementing them in Hong Kong and will begin enhancing the liquidity reporting framework to facilitate supervisory monitoring of Als' liquidity risk profiles and positions.

A benchmark review of industry practice in liquidity risk management and stress-testing was conducted in the fourth quarter of 2010, covering over 20 selected Als. The review was aimed at identifying good practices to share with the industry.

Compensation practices

In March 2010, the HKMA finalised its "Guideline on a Sound Remuneration System", after addressing a variety of comments received from the industry and other interested parties. The Guideline was designed to reflect the FSB's *Principles for Sound Compensation Practices* and accompanying *Implementation Standards (Principles and Standards)*. It provides guidance for the development and operation of Als' remuneration systems to ensure they are consistent with, and

promote, effective risk management. All Als were expected to bring their remuneration systems into line with the Guideline from the end of 2010.

In monitoring this progress, the HKMA provided Als in July with a template for conducting a self-assessment on their level of compliance. The results indicated the major locally incorporated Als already broadly complied with the Guideline and the majority of foreign bank branches were close to being fully compliant.

Internationally, the FSB conducted a peer review on the implementation of the *Principles and Standards* by its member jurisdictions in December 2009. The review report, published on 30 March 2010, indicated there were differences in the approach and pace of implementation, and that a sustained and co-operative effort would be required from supervisors and financial institutions to fully implement the *Principles and Standards* by the end of 2010. A follow-up review will be undertaken by the FSB in the second quarter of 2011 to assess the effectiveness of measures put in place in individual jurisdictions and the progress in industry compliance with the *Principles and Standards* and with respective national rules. The HKMA will conduct its own thematic examinations in the first quarter of 2011 to ensure Als' proper implementation of the Guideline and continue to monitor Als' progress as recommended by the FSB. The HKMA will also take into account any potential risks that may arise from Als' remuneration systems as part of its risk-based supervisory process.

Stress-testing

To further enhance Als' stress-testing frameworks, the HKMA updated its supervisory guidance incorporating the *Principles for Sound Stress Testing Practices and Supervision* issued by the Basel Committee in May 2009. The guidance includes recommendations and observations made by other international organisations and industry groups to address stress-testing deficiencies revealed by the global financial crisis. The draft revised guidance was issued for industry consultation in February 2011.

Improving the supervisory policy framework (continued)

General risk management controls

The existing guideline "General Risk Management Controls" was revised to reflect changes in international standards and practices in response to the crisis. The changes mainly relate to issues that have firm-wide implications, including, for example, the lack of a comprehensive approach to managing firm-wide risks; ineffective risk management oversight by the Board of Directors and senior management for risk identification, analysis and monitoring; and inadequate information and system infrastructure to support the broad management of financial risks. The revised guideline was formally issued on 31 December 2010, after addressing industry comments.

Prudent valuation

The Basel Committee issued a paper on *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices* in April 2009. This emphasised

the critical importance of robust risk-management and control processes around the measurement of fair values and their reliability, including the specific assessment of valuation uncertainty and the making of valuation adjustments to reflect appropriate risks. The accounting and auditing standard-setters also issued guidance to address the valuation challenges and risks faced by financial institutions when markets were no longer active during the global financial crisis. In the light of these developments, the HKMA reviewed the module "Use of the Fair Value Option for Financial Instruments" in its Supervisory Policy Manual (SPM), and issued an enhanced version "Guidance on Financial Instrument Fair Value Practices" for consultation with the industry associations and the Hong Kong Institute of Certified Public Accountants (HKICPA) in March 2010. The final text is expected to be released in the first half of 2011 after addressing the comments received from the consultation.

Accounting and disclosure

Provisioning standards

In 2010 the IASB continued its review of the impairment rules for financial instruments, as part of a more comprehensive review of international accounting standards *Financial Instruments: Recognition and Measurement*. The review aims to address concerns about pro-cyclicality under the current incurred-loss provisioning model, which does not permit anticipation of possible or probable future loan losses, resulting in loan-loss provisioning levels varying significantly through the economic cycle. The IASB issued an Exposure Draft on the amortised cost measurement and impairment of financial instruments in November 2009, which proposed a move from the incurred-loss model to an expected cash-flow approach. While strongly supportive of this initiative, the Basel Committee made some recommendations to

improve the operational feasibility, including practical expedients for the easier recognition of expected credit losses.

The IASB is expected to publish a refined proposal in the first quarter of 2011 for public comment. The HKMA will monitor developments on this accounting standard and will assess the levels of the regulatory reserve required to be maintained by Als.² In 2010 Hong Kong experienced rapid loan growth amid relatively benign economic conditions and Als' estimates of loan impairment during this period using the incurred-loss approach are likely to be much lower than the inherent credit losses that could eventually materialise during any subsequent economic downturn. Therefore, the HKMA will continue to require the maintenance of an adequate regulatory reserve by Als in addition to their accounting provisions to cater for expected, but not yet incurred future losses.

² The regulatory reserve is a non-distributable reserve, earmarked against retained earnings, which was introduced in 2005 to reduce the impact of changes in accounting standards on provisioning levels.

Dialogue with the HKICPA Banking Expert Panel

The HKMA has discussed a variety of accounting issues and key supervisory policy developments as part of its regular bilateral meetings with the HKICPA Banking Expert Panel. This process is critical to gaining a mutual understanding of each party's main concerns on the development of global accounting standards and their implications for Als' financial reporting and the HKMA's regulatory framework. HKAB members have also helped the HKMA assess the implications by sharing their concerns.

Thematic review on risk disclosures

Recognising the importance to market confidence of reliable valuation and timely disclosure of the risks that are most relevant to prevailing market conditions, the April 2008 FSB Report on *Enhancing Market and Institutional Resilience* proposed improved disclosure of banks' exposures to securitised and structured products. The FSB initiated a peer review in June 2010 to consider the implementation of these recommendations by supervisors and banks in its member jurisdictions. Hong Kong's response was co-ordinated among the HKMA, the SFC and the IA. The HKMA is also participating as a member of the review team, which intends to finalise its report by the end of the first quarter of 2011.

Macro-prudential surveillance

The HKMA has strengthened its internal communications on macro-prudential issues through a cross-departmental working group, with representatives from the Banking, Research and other relevant departments. This provides a platform for discussion of evolving market trends and financial product developments to identify any warning signals of emerging systemic risk.

A division tasked with increased focus and responsibility for macro-prudential surveillance has been closely monitoring the development of new financial products by analysing the associated risks and fund flow implications for banks and investors. The division has also improved

its data analysis techniques at a macro level to better understand risk-transfer mechanisms and the fund flow patterns within the banking sector, across different areas and across borders.

A review of the HKMA's supervisory data requirements and data analysis techniques was initiated in 2010 as a result of the global financial crisis, evolving regulatory requirements and financial conditions. The review should help further improve the quality of supervisory analysis and ensure compliance with new international regulatory requirements.

Consumer protection

Code of Banking Practice

In the industry's self-assessment covering the period from June 2008 to December 2009, all Als reported full compliance or almost full compliance³, with the Code of Banking Practice.

The HKMA strengthened its monitoring of Als' compliance with the Code of Banking Practice by revising the reporting template for the annual self-assessments to obtain more detailed information, and introducing an exception reporting requirement and a "mystery shopper exercise". The exercise was introduced as a proactive approach to assess compliance from the consumers' perspective.

During the year, the HKMA studied the latest developments and trends in major credit card markets, including the US and the UK. It was concluded that some of the enhancement measures should be introduced in Hong Kong to ensure customers are treated fairly. After detailed discussions between the HKMA and the industry, HKAB announced in January 2011 the implementation of 11 such measures before the end of March 2011, covering practices in relation to interest rates, fees and charges, increase in credit limit, disclosure, billing, underage customers and responsible lending. The implementation of other enhancement measures would be further studied.

³ With five or fewer instances of non-compliance.

Banking Stability

Improving transparency of credit card instalment payment plans

The HKMA issued a circular to all AIs in August setting out the requirements they should follow when marketing through third parties instalment payment plans (IPPs) involving pre-payment for goods or services. The action followed several cases where consumers, who had pre-paid for services using credit card IPPs, suffered losses because merchants went out of business. Under the new arrangement, AIs are required to ensure that consumers are given the necessary information in an easily readable form to ensure they are fully aware of the nature of the IPPs and their obligations when entering into such agreements.

Data privacy issues

Following public concerns over data privacy raised by the Octopus incident and an Administrative Appeals Board (AAB) decision involving an AI, the HKMA issued three circulars in August, September and October to remind AIs of the need to comply with the latest recommendations and guidance issued by the Privacy Commissioner. AIs are also required to review their practices on handling customers' personal data taking into account the Privacy Commissioner's reports and guidance on the collection and use of personal data in direct marketing, as well as the AAB decision.

Proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre

During 2010, the HKMA provided advice to the proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre and participated in a working group set up by the Government to discuss implementation issues relating to the latter.

Credit data sharing

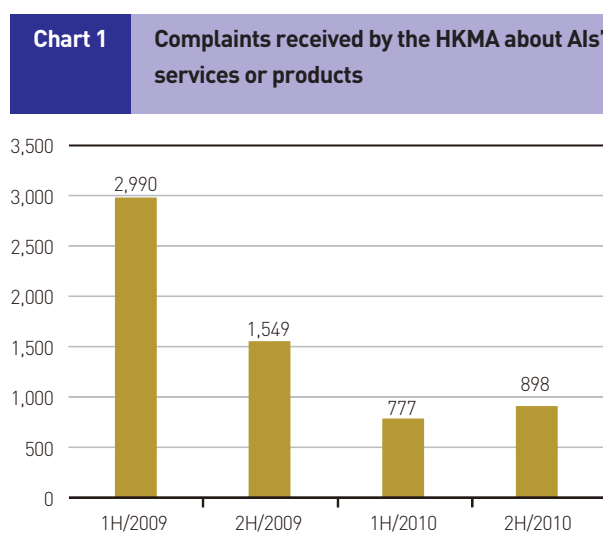
At the end of 2010, 116 AIs were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 112,900 business enterprises, about 18% of which

were sole proprietorships and partnerships. The continued development of the CCRA has helped to strengthen the credit risk management capacity of AIs and improve the access to credit by small and medium-sized enterprises.

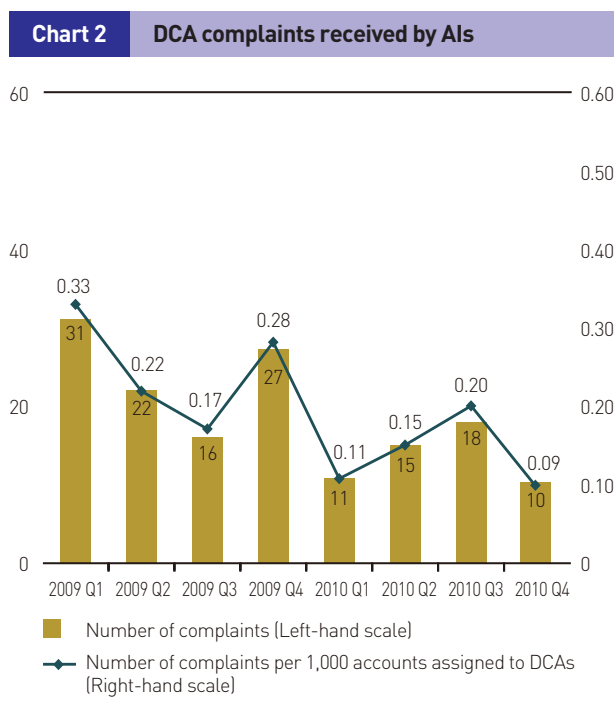
During the year, the HKMA worked with the industry and the Office of the Privacy Commissioner for Personal Data on a proposal to expand consumer credit data sharing arrangements to include positive mortgage data. Such a move among lenders will improve credit risk management by allowing lenders to have access to limited information on whether applicants for credit have outstanding property mortgages. The proposal will enhance the overall stability of Hong Kong's banking system. If adopted, the proposal will require an amendment to the Code of Practice on Consumer Credit Data issued by the Privacy Commissioner. On 5 January 2011, the Commissioner issued a document on sharing mortgage data for credit assessment for public consultation until 8 February 2011.

Customer complaints

The HKMA received 1,675 complaints about services provided, or products sold, by AIs in 2010, compared with 4,539 a year earlier (Chart 1). The fall reflected a reduction in the number of complaints received for investment products sold by AIs.



Complaints received by AIs against their debt collection agents (DCAs) also decreased to 54 from 96 in 2009 (Chart 2). The HKMA will continue to review the situation to ensure AIs remain vigilant in monitoring the performance of the DCAs that they use.



Enforcement

The HKMA has a shared responsibility with the SFC for enforcing the rules and regulations on RIs and their Executive Officers and Relevant Individuals in the conduct of regulated activities. In April, the HKMA strengthened its enforcement arm by forming a stand-alone department to take over the responsibility for securities enforcement and complaint-handling functions.

Lehman-related investigation

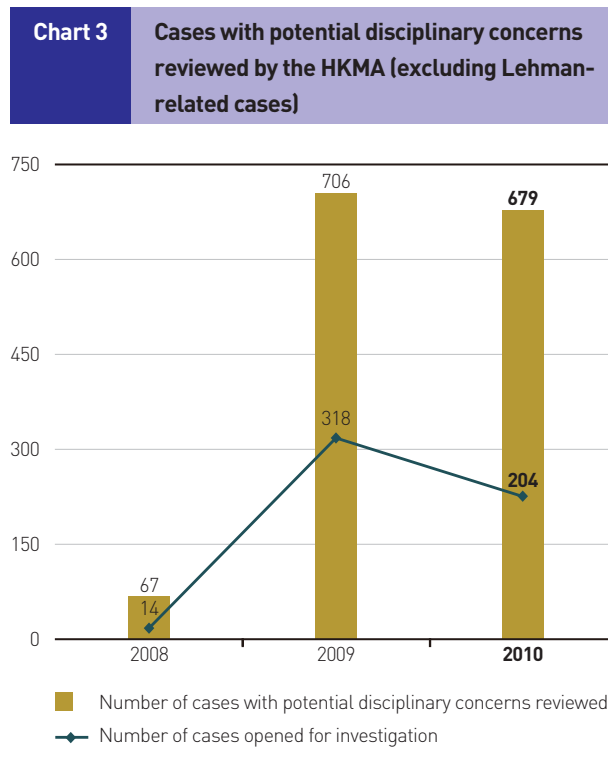
By the end of March, investigations had been completed in over 99% of Lehman-related complaints. And, by the end of 2010, over 77% of the complaints had been resolved by the settlement agreements under section 201 of the Securities and Futures Ordinance (SFO) (14,369 cases) or through the banks' enhanced complaint-handling procedures (2,551 cases).

The SFC and the HKMA reached a settlement agreement with a bank during the year in relation to its distribution of Lehman-related credit-linked notes, enabling more than 2,100 eligible customers to recover their principal plus interest.

Ninety-six remaining Lehman-related complaints were being investigated by the HKMA at the end of 2010. Working in close collaboration with the SFC, the disciplinary proceedings of 1,542 cases were also being processed.

Non-Lehman-related investigation

During the year, the HKMA reviewed 679 cases involving products not related to Lehman. Among them, 204 cases were opened for investigation (Chart 3). Investigations of 105 cases were completed by the end of 2010. As a result, the HKMA commenced its own disciplinary proceedings, or recommended the SFC to commence disciplinary proceedings, in five cases. On the basis of the HKMA's recommendations, the SFC banned two former Relevant Individuals from re-entering the industry for a specified period by exercising its sanctioning power under the SFO.



Banking Stability

Deposit Protection Scheme

The enhanced Deposit Protection Scheme (DPS) providing a higher protection limit of HK\$500,000 came into operation on 1 January 2011. The new DPS ensures that bank deposits continue to be protected up to this level following the expiry of the Government's Full Deposit Guarantee on 31 December 2010. The Full Deposit Guarantee was a contingency measure introduced at the onset of the global financial crisis in late 2008 to reinforce confidence in Hong Kong's banking system.

To ensure the enhancements to the DPS would take effect at the beginning of 2011, the Hong Kong Deposit Protection Board, with the assistance of the HKMA, completed the necessary legislative amendments in June. In addition to the new HK\$500,000 limit per depositor per bank, the coverage of the DPS was expanded to include deposits pledged as security for banking services. Measures were also introduced to improve payout efficiency. Requirements for Scheme members to make enhanced representations for their DPS membership and the protection status of their financial products also took effect at the same time.

To raise public awareness of the changes, a comprehensive multi-media campaign was launched in the second half of 2010. Close collaboration with banks was maintained to ensure timely adjustments were made to their systems and business flows to prepare for the transition. The Board also worked with the HKMA to remind AIs to make proper representations on the expiry of the Full Deposit Guarantee and its potential impact on their customers.

During the past two years, the HKMA had completed 37 compliance examinations relating to the representation requirements, with results showing Scheme members had generally established proper policies and procedures to ensure compliance with the requirements.

Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial

centre. The purpose of the CSSO is to promote the general safety and efficiency of the designated systems: the Central Moneymarkets Unit (CMU), Hong Kong dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS, Renminbi CHATS and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews, continuous monitoring, on-site examinations and meetings with management. Oversight of the CLS System is described in the next section.

All designated systems continued to comply with the safety and efficiency requirements under the CSSO in 2010. In July, all local designated systems successfully migrated to the SWIFTNet infrastructure.

In addition to complying with CSSO requirements, the systems are encouraged to comply with internationally recognised standards for payment and settlement. During the year, the HKMA assessed the Hong Kong dollar CHATS against the *Core Principles for Systemically Important Payment Systems* issued by the Bank for International Settlements (BIS). The assessment report, which was published on the HKMA website, concluded the Hong Kong dollar CHATS complied with all the ten *Core Principles*.

Co-operative oversight arrangements

The CLS System is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA, through the CLS Oversight Committee, participates in the international co-operative oversight of the CLS System.

The HKMA also co-operates with other central banks in the oversight of foreign currency payment systems in Hong Kong. In particular, the HKMA held bilateral meetings with officials from the European Central Bank and the People's Bank of China to discuss matters concerning the Euro CHATS and Renminbi CHATS during the year. Co-operative oversight arrangements are also maintained with other central banks for payment-versus-payment (PvP) links established between payment and settlement systems in Hong Kong and those in other jurisdictions. Such arrangements are in place for the US dollar/Malaysian Ringgit PvP link and the US dollar/Indonesian Rupiah PvP link.

Independent tribunal and committee

An independent Clearing and Settlement Systems Appeals Tribunal was established in 2004 to hear appeals by any party aggrieved by a decision of the Monetary Authority on designation and related matters under the CSSO. There has been no appeal since the establishment of the Tribunal.

An independent Process Review Committee reviews processes and procedures adopted by the HKMA in applying standards set under the CSSO to systems in which the HKMA has a legal or beneficial interest. The Committee evaluates the designated systems' compliance with the oversight standards and assesses whether the HKMA has applied the same set of procedures to all designated systems. The Committee held two meetings in 2010 and reviewed four regular reports and 22 accompanying oversight activities management reports of the designated systems, and concluded it was not aware of any case where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. Under its terms of reference, the Committee submitted its annual report to the Financial Secretary and published the report on the HKMA website.

Informal oversight of retail payment systems

Compared with large-value interbank payment systems, the retail payment systems generally carry minimal systemic risks and, at this stage, the HKMA considers they are not systemically significant enough to be designated under the CSSO. However, the HKMA encourages the retail payment industry to adopt a self-regulatory approach by issuing codes of practice to promote safety and efficiency.

The HKMA is responsible for monitoring the compliance of Octopus Cards Limited (OCL) with the Code of Practice for Multi-purpose Stored Value Card Operation issued by OCL and endorsed by the HKMA in 2005. In 2010 OCL completed its fifth annual self-assessment against the Code and reported its full compliance.

The Code of Practice for Payment Card Scheme Operators, issued by eight credit and debit card scheme operators and endorsed by the HKMA in 2006, sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA monitors the

operators' compliance with the Code and all operators are required to perform an annual self-assessment and report to the HKMA any incident which may have material and adverse impact on Hong Kong cardholders. In the third annual self-assessment report covering 2009, the eight card scheme operators reported full compliance with the Code. Since June 2010, the HKMA has published quarterly aggregate payment card data collected from the card operators to promote transparency of the payment card industry.

Licensing

At the end of 2010, Hong Kong had 146 licensed banks, 21 restricted licence banks, 26 deposit-taking companies and 16 approved money brokers. During the year the HKMA granted banking licences to four foreign banks. Three licensed banks, five restricted licence banks and two deposit-taking companies revoked their authorization during the year.

International co-operation

The HKMA continues its participation in various international and regional forums for banking supervisors. The HKMA is currently a member of both the Basel Committee and its governing body, the Group of Central Bank Governors and Heads of Supervision. The HKMA also participates in various Basel Committee initiatives through its membership of the Committee's working groups, including the Liquidity Working Group, the Definition of Capital Sub-Group and the Standards Implementation Group. The HKMA is a member of the FSB's Standing Committees on Supervisory and Regulatory Cooperation and Assessment of Vulnerabilities. Regionally, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and completed its term as chairman of the EMEAP Working Group on Banking Supervision (WGBS) in July. The HKMA remains the leader of the EMEAP WGBS Interest Group on Liquidity. The HKMA is also a member of the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

On payment systems oversight, the HKMA participates regularly in meetings of the committees and working groups under the BIS and EMEAP. The HKMA is a member of the joint working group under the BIS Committee on Payment and Settlement Systems and International Organization of Securities Commissions (IOSCO) and

Banking Stability

participated in the review of the existing core standards for financial market infrastructures (large-value payment systems, securities settlement systems and central counterparties). It also contributes in areas related to operational risk and governance.

PLANS FOR 2011 AND BEYOND

Supervisory focus

Credit risk management and asset quality

Prudential supervision of mortgage loans

The HKMA will continue to monitor closely developments in the property and mortgage markets, and may introduce appropriate prudential measures for mortgage loans to safeguard banking stability. In the first half of 2011, the HKMA will conduct thematic on-site examinations to ensure Als' compliance with the new prudential measures for mortgage loans specified in its circulars.

Credit growth

Supervisors need to address difficulties arising from the pro-cyclicality of the existing supervisory regime; for example, risk factors such as delinquency and default rates are likely to decline when credit growth and asset prices are on the rise, rendering the introduction of more forward-looking supervisory requirements difficult. To guard against this, the HKMA will devote more regulatory resources in 2011 to tackle the risks arising from the significant loan growth in 2010. In addition to the supervisory focus on property mortgage lending, the HKMA has scheduled a round of on-site examinations to assess Als' compliance with prudent underwriting standards. Macro-prudential surveillance will continue to keep track of the situation and facilitate forward-looking prudential analysis. Contacts with Als' senior management teams will be strengthened to ensure they take timely and appropriate measures to address the possible build-up of systemic risks.

Supervision of technology risk and operational risk

Internet banking, technology risk management and business continuity management

A round of thematic examinations on Als' controls over the development of critical business systems running

on end-user computer workstations is planned for 2011. Examinations are also planned to cover Als' controls over their processes for managing IT problems and changes.

Efforts to strengthen ATM security will continue in conjunction with the banking industry, in particular on the introduction of ATM chip-based technology as soon as practicable. In view of the growing popularity of mobile devices with web-browsing capability, the HKMA is monitoring these developments and, where applicable, will strengthen the relevant regulatory requirements for mobile and Internet banking.

Operational risk management

Through on-site examinations and off-site reviews, the HKMA's operational risk management specialist team will identify and address Als' emerging operational risks. To facilitate this, the existing operational risk profiling system, under which information gathered by the HKMA from the annual self-assessment exercise is analysed, will be further enhanced.

Supervision of securities, insurance and MPF-related business

The HKMA will continue to co-operate with the SFC and the banking industry on implementation of the SFC's new investor protection measures. The HKMA is also working with the banking industry on improving the regulatory requirements for the sale of investment and insurance products and on the possible streamlining of the selling process for relatively simple investment products.

With additional resources allocated, on-site examinations focusing on Als' sale of investment and insurance products will be ramped up in 2011. The HKMA also plans to launch another mystery shopper exercise on the sale of unlisted investment and insurance products.

The HKMA will continue its co-operation with the Government and other financial regulators on improving the regulatory regimes for insurance and MPF-related intermediary activities in Hong Kong.

Supervision of treasury activities

On-site examinations of Als' treasury and derivatives activities will be conducted, and resources will be strengthened to include stress-testing and liquidity

management as part of the HKMA's efforts to enhance the supervision of enterprise-wide stress-testing and liquidity management.

Mainland-related business

With the rapid growth in Mainland operations of Hong Kong banks, the HKMA will strengthen its surveillance to ensure that any associated risks will be assessed thoroughly and well-managed in the supervisory process. This will involve enhanced data collection through regular surveys for off-site review and increased on-site examinations of the Mainland operations. The HKMA will also liaise closely with the CBRC to ensure effective home-host supervisory co-operation.

As the increase in Als' non-bank exposures to Mainland China accounted for a significant proportion of the growth in credit in 2010, the need to maintain robust credit risk management will be emphasised in the HKMA's on-site examinations. Consideration will also be given to collecting more prudential data for analytical purposes. In addition, with the substantial development of renminbi banking business during 2010, supervisory monitoring on the way Als manage the risks arising from this line of business will be enhanced.

Remuneration practices

The HKMA expects to complete the on-site examinations of Als' compliance with the "Guideline on a Sound Remuneration System" during the first quarter of 2011. Depending on the examination findings, the HKMA may, where appropriate, develop a set of best practices for sharing with the relevant institutions. The findings, together with the results of the Als' self-assessment exercise, will form part of the HKMA's response to the FSB's follow-up peer review on remuneration to be conducted in the second quarter of 2011.

Prevention of money laundering and terrorist financing

The HKMA will assist the Government in the legislative process in relation to the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Bill, and participate in drafting a guideline to support the implementation of the new regime. The HKMA will undertake institution-specific and thematic examinations

to ensure Als remain vigilant against money laundering and terrorist financing.

International co-operation

The recent global financial crisis has underscored the importance of effective cross-border co-operation among regulators. The HKMA is committed to playing its part in various colleges of supervisors and crisis management groups. Participation in international financial forums will be a priority in keeping abreast of developments and ensuring Hong Kong's views and concerns are properly reflected at these forums. This will facilitate implementation of initiatives to improve the supervision of banks that are regarded as Systemically Important Financial Institutions.

In 2011, the FSB proposes to conduct peer reviews on the FSB's Principles and Implementation Standards on compensation and new capital and liquidity rules as well as policy measures regarding global systemically important financial institutions and deposit insurance. The HKMA will participate in these reviews.

Basel II

Amendments to Banking (Capital) Rules and Banking (Disclosure) Rules

In order to implement in Hong Kong the Basel Committee's July 2009 enhancements to the Basel II framework, the HKMA aims to conduct the required statutory consultation on the proposed amendments to the BCR and BDR in June 2011, pursuant to sections 98A and 60A of the Banking Ordinance. The final amended Rules are expected to be submitted to the Legislative Council in October 2011 for negative vetting and to take effect on 1 January 2012.

The regulatory return on capital adequacy and the relevant modules of the SPM will need to be amended to reflect the revisions to the BCR and BDR. This will be pursued in the first half of 2011 in consultation with the industry.

Implementation of advanced approaches

Market risk

The HKMA will conduct reviews of Als currently using the IMM approach for market risk to ascertain their

Banking Stability

compliance with the additional requirements (for example, calculation of stressed value-at-risk) under the revised market risk framework. Subject to Als' compliance with the requirements set out in the amended BCR, the HKMA will grant approval for these Als to continue using the IMM approach under the revised framework.

Operational risk

Locally incorporated Als in Hong Kong currently adopt either the Basic Indicator Approach or the Standardised Approach for measuring their capital charge for operational risk under the BCR. However, to further enhance their systems, some Als are planning to progressively adopt risk-management practices aligning with the Basel Committee's advanced measurement approaches for operational risk. To encourage Als to adopt more robust systems for managing operational risk, the HKMA will monitor the development of these practices and devise a policy framework for the introduction of the Basel Committee's advanced measurement approaches, where appropriate.

Capital Adequacy Assessment Process

Hong Kong-incorporated Als have made significant progress in developing their CAAP capability. In addition to its regular SRP reviews, in which individual Als' progress in establishing their CAAPs is considered, the HKMA plans to conduct a round of more focused thematic examinations to assess Als' compliance with the CAAP supervisory standards having regard to their risk profile and the level of sophistication of their operations. Based on the examination results, the HKMA will identify best practices and potential issues and, where necessary, provide further guidance to assist Als in enhancing and developing their existing systems to implement the CAAP standards.

Revision of liquidity supervisory framework

After the release of the new supervisory guideline "Sound Systems and Controls for Liquidity Risk Management", the HKMA's focus will be on monitoring progress and working with the industry towards compliance with the enhanced risk management standards in the guideline. Specific reviews and thematic on-site examinations will be conducted on individual Als to assess their compliance, and supplementary guidance will be issued where appropriate, taking into account implementation experience and further international developments.

Preparatory work on enhancing other areas of the liquidity supervisory framework, including the minimum liquidity standards and the reporting framework, will continue. The HKMA will in due course issue its proposals on these areas for industry consultation.

Basel III

The HKMA will devise a programme and timeline for the implementation of the Basel III standards in Hong Kong, having regard to the phase-in arrangements announced by the Basel Committee. The programme is expected to be released for initial consultation in the first half of 2011.

Given both the novelty and complexity of the proposed liquidity framework and the likelihood that the standards will be subject to change during the Basel Committee's observation period, the HKMA will consider the optimal approach, with the appropriate degree of flexibility, for implementing the framework.

Legislative amendments to the Banking Ordinance, BCR and BDR will be required to implement Basel III in Hong Kong. The HKMA aims to complete the legislative amendment process in the 2011 – 2012 legislative session to allow sufficient time for the development of supervisory guidelines and for Als to introduce necessary system improvements.

Consultation on capitalisation of bank exposures to central counterparties

On 20 December 2010, the Basel Committee issued a consultative paper *Capitalisation of Bank Exposures to Central Counterparties*, setting out proposals for the capital treatment of banks' exposures to central counterparties (CCPs), including both trade and default fund exposures. The proposals aim to ensure that while providing incentives for banks to increase the use of CCPs to clear OTC derivatives trades, the risk arising from banks' exposures to CCPs is adequately capitalised. The consultation ended in February 2011 and the Basel Committee is in the process of refining the standards with a view to finalising them for implementation internationally by January 2013 as part of the enhanced capital treatment for banks' CCR exposures. The HKMA will work with the industry to adopt these standards in Hong Kong.

Transitional arrangements

As the leverage ratio and liquidity standards are newly developed, the Basel Committee has provided as part of the transitional arrangements an observation period to monitor their operation and effects before they are confirmed and formally implemented. The Committee will put in place robust data reporting and assessment processes to monitor the effect of the new leverage ratio

and liquidity standards and to facilitate consideration, during the observation periods, of whether further adjustments to their design and calibration are required. The HKMA will monitor the development of the transitional reporting arrangements and consider the scope and approach for implementing those arrangements in Hong Kong. This may entail additional QIS-like reporting exercises or more formal regulatory reporting.

Development of supervisory policy

Competence and ethical behaviour

The past few years have seen a period of rapid innovation in Als' business, product lines and markets. Coupled with this has been the need to adopt more advanced approaches to the measurement and management of the risk inherent in Als' activities. These developments have posed considerable challenges in ensuring that the competency levels of Als' staff keep pace with changes. Against this backdrop and the increasing supervisory focus on the competency of individuals within the banking industry in overseas jurisdictions, driven to some degree by the global financial crisis, the HKMA has developed a new module in its SPM to provide guidance on the measures Als are expected to adopt in monitoring and maintaining competence and ethical behaviour. The guidance, entitled "Competence and Ethical Behaviour", was issued for industry consultation in the first quarter of 2011.

Corporate governance

The global financial crisis has focused attention on the importance of effective corporate governance and risk management in the prevention of loss and failure in the financial system. Drawing on the lessons learned from the crisis, the Basel Committee issued a set of *Principles for Enhancing Corporate Governance* in October setting out best practices for banking organisations. As an update to the Basel Committee's corporate governance principles issued in 2006, the 2010 guidance has strengthened areas such as the role of the board; the qualifications and composition of the board; the importance of monitoring risks on an ongoing firm-wide and individual entity basis; the board's oversight of remuneration systems; and the board and senior management's understanding of the bank's operational

structure and risks. In December 2010, Hong Kong Exchanges and Clearing Limited (HKEx) also published a consultation paper on proposed changes to the Code on Corporate Governance Practices and certain Listing Rules relating to corporate governance to promote the development of higher corporate governance standards.

The HKMA plans to update its existing SPM module CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions", which was issued in 2001, to bring it into line with the Basel Committee's enhanced principles and other developments in best practice. The enhanced guidance is proposed to be released for industry consultation within the first half of 2011.

Credit risk transfer

One of the weaknesses exposed by the financial crisis was inadequate risk management relating to securitisation exposures and other aspects of credit risk transfer activities. As a result, international standard-setters (including the FSB, the Joint Forum, the Basel Committee and IOSCO) and regulators in major financial centres have put forward a number of proposals to refine regulatory regimes and strengthen banks' risk management systems and practices. While Als' exposures to credit risk transfer activities are in general immaterial, the HKMA is reviewing its existing guidance on securitisation and credit derivatives to bring them into line with the latest international standards. This will require Als, for example, to conduct their own analysis of the credit and other risks of structured products and to avoid over-reliance on external credit ratings. Industry consultation on the enhanced guidance is expected to take place in the first half of 2011.

Development of supervisory policy (continued)

Stress-testing

The HKMA intends to finalise the revised supervisory guidance on stress-testing in the first half of 2011, taking into account the comments received from the industry consultation.

Central counterparty clearing and reporting to trade depositories for OTC derivatives transactions

The implementation in Hong Kong of the recommendations in the FSB's report *Implementing OTC Derivatives Market Reforms* released in October 2010 will entail infrastructural improvements through the establishment of a central counterparty clearing facility by HKEx and a trade repository by the HKMA. A supervisory guideline setting out the clearing and reporting requirements for AIs is currently being

developed by the HKMA. This work is progressing in collaboration with the SFC and the market through a number of joint agency and industry forums. The HKMA plans to formally consult the industry on the proposed regulatory framework as soon as practicable in 2011, with the aim of implementing the requirements by the international deadline of 2012.

Market risk management

To bolster AIs' market risk management standards following the global financial crisis, the HKMA will incorporate into a new supervisory guideline the latest international developments on market risk management. The draft guidance is expected to be issued for industry consultation in the second half of 2011.

Accounting and disclosure standards

The IASB is expected to finalise in 2011 a number of key accounting standards, such as those relating to fair value measurement, hedge accounting, revenue recognition and leases. The HKMA and the banking industry will continue to monitor these developments and contribute to the standard-setting process in conjunction with the HKICPA.

The HKMA will promote greater transparency on AIs' securitisation and market risk exposures, capital adequacy and liquidity through its implementation of the disclosure requirements relating to the Basel Committee's July 2009 enhancements to Basel II and the Basel III framework. The Basel Committee also issued for consultation in December 2010 a set of Pillar 3 requirements relating to disclosure on remuneration. The HKMA has encouraged the industry associations to respond to the consultation. The adoption of these global standards will further promote greater convergence and consistency of disclosures by AIs and hence more effective market discipline. The HKMA will continue discussions with the banking industry on further developments in the area of disclosure and assessing their implications on AIs' financial reporting and the regulatory framework for possible implementation of any new international standards.

Stress-testing

The HKMA will continue to review and refine its stress-testing framework in the light of evolving market conditions as well as international developments on stress-testing techniques.

Macro-prudential surveillance

Up-to-date and risk-focused supervisory information is essential for the formulation of timely and effective supervisory responses to emerging systemic risks. Priority is being given to further enhance the HKMA's management information system for banking supervision, including the development of techniques that will allow the construction of more comprehensive scenarios for use in its regular internal stress-testing exercise for AIs. The stress parameters employed will be regularly reviewed in the light of market developments.

As part of the Basel III reforms, priority will also be given to developing policies and procedures to implement the countercyclical capital buffer in Hong Kong.

Consumer protection

The HKMA will work to improve the standards of banking practices through participation in the Code of Banking Practice Committee, and will monitor Als' compliance with the Code through regular self-assessments, mystery shopper exercises and the handling of complaints about services and products provided by Als. On-site examinations of banks will also be conducted to supplement the self-assessments in an effort to improve consumer protection.

Credit card practices are one of the areas being pursued as part of the HKMA's initiative to promote the fair treatment of consumers. It will continue to discuss with the industry relevant developments and trends overseas, with a view to adopting measures applicable to the Hong Kong credit card market that will help foster fairness and transparency.

In relation to the proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre, the HKMA will work with the Financial Services and the Treasury Bureau, the SFC and the industry to prepare for their establishment.

Credit data sharing

Another priority for the HKMA in 2011 will be to work with the industry and the Privacy Commissioner to implement an appropriate regime for positive mortgage data sharing based on the public consultation results and decisions made by the Privacy Commissioner.

Enforcement

The HKMA and the SFC will continue disciplinary proceedings against implicated banks and individuals (Executive Officers and Relevant Individuals) arising from the completion of the Lehman-related investigation.

In view of the experience gained in handling an unprecedented number of complaints after the collapse of Lehman Brothers, the HKMA will

- enhance its complaint handling and investigation process by streamlining its internal procedures, simplifying the gathering of information from complainants, and introducing video and audio interview facilities
- revise its supervisory guideline "IC-4 Complaint Handling Procedures" to take account of recent developments
- assist the Government in reviewing the present regulatory framework governing the sale of investment products to retail investors and developing the financial dispute resolution mechanism.

Deposit protection

The HKMA will assist the Hong Kong Deposit Protection Board in implementing and operating the enhanced DPS. The Board will focus on further streamlining the DPS operation, and the HKMA will assist the Board to monitor Scheme members' compliance with the representation requirements, mainly through a series of on-site examinations. Advertising campaigns and other outreach programmes will be held throughout 2011 to maintain peoples' awareness of the DPS and reinforce their understanding of the Scheme's main features. Simulation tests, compliance reviews and payout rehearsals will be conducted by the Board to ensure the operational readiness of the DPS.

Payment systems oversight

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting and ensuring the safety and efficiency of these systems; and will continue to monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice, keep abreast of global trends and improve the current regime where necessary.

International Financial Centre

The world economic recovery gathered pace in 2010, following concerted efforts by policymakers to restore confidence in the global financial system. Nevertheless, challenges remain in supporting a more balanced global growth and maintaining financial stability. The HKMA has actively participated in international discussions on reforms to the global financial system; and has strengthened regional surveillance and co-operation to promote financial stability. Renminbi business has grown rapidly, enabling Hong Kong's development as an offshore renminbi business centre. Global credit rating agencies have upgraded their Hong Kong ratings, including an AAA from Standard & Poor's, the highest rating assigned by the agency.

OVERVIEW

Global economic and financial market conditions improved further in 2010. However, uncertainties remain with a still fragile recovery and deepening debt crisis in advanced economies. Emerging markets continued to recover strongly. The unprecedented loose monetary conditions in the advanced economies and better growth prospects in developing economies have attracted capital flows into the region, giving rise to asset price inflation and upward pressure on consumer prices. All these challenges call for action and co-operation to build more resilient financial systems and markets worldwide.

The HKMA actively participates in international discussions and exchanges views with the international community on issues of significance to the global and regional financial stability. In 2010, it hosted the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)¹ Deputies' Meeting and Monetary and Financial Stability Committee (MFSC) Meeting, and continued to co-ordinate the macro-surveillance work for the EMEAP MFSC. The HKMA also took part in meetings and forums of multilateral organisations, notably the Financial Stability Board (FSB)², which plays a key role in the reform of the international financial system. In addition, Hong Kong, through the HKMA, joined the Chiang Mai Initiative Multilateralisation (CMIM) – a new regional joint-defence mechanism against financial instability established under the aegis of ASEAN + 3.³ CMIM is a mutual assistance framework which provides short-term US dollar support to participants facing liquidity shortages.

¹ EMEAP is a co-operative forum of 11 central banks and monetary authorities in the East Asia and Pacific region comprising the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Japan, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, the Monetary Authority of Singapore and the Bank of Thailand.

² The FSB was established in April 2009 as the successor to the Financial Stability Forum to address vulnerabilities in global financial systems, and to develop and implement effective regulatory, supervisory and other policies in the interest of financial stability. Its membership comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions, standard-setting bodies, and committees of central bank experts.

³ ASEAN + 3 comprises the 10 ASEAN member countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam), together with China, Japan and Korea.

To enhance the status of Hong Kong as an international financial centre and to contribute to the Mainland's financial reform and liberalisation, the HKMA further strengthened cross-border financial co-operation with Mainland authorities. Various policy initiatives were also taken to further develop renminbi business in Hong Kong, including the expansion of the renminbi trade settlement scheme and renminbi bond issuance. Clarification of the supervisory principles and the refinement to the clearing arrangements have made it easier for individuals and companies to conduct renminbi activities. These initiatives have provided the right environment for the development of a renminbi interbank market in Hong Kong. Financial institutions have also seized the opportunity to introduce a variety of renminbi-denominated investment products in Hong Kong to meet the growing market demand, while expanding their business on the Mainland. The HKMA continued to maintain close contact with the Mainland authorities to enhance Hong Kong's role in promoting the wider use of the renminbi outside the Mainland.

Other initiatives to strengthen Hong Kong's international financial status include enhancing the robustness, efficiency and competitiveness of its financial infrastructure. During the year, the migration of the Real Time Gross Settlement (RTGS) systems and Central Moneymarkets Unit (CMU) (the debt securities clearing and settlement system operated by the HKMA) from a proprietary platform to the global SWIFTNet open platform was completed, which has removed the operational barrier for overseas financial institutions to join the RTGS systems. Enhancements were made to the renminbi RTGS system to cope with new business opportunities; and the HKMA embarked on a project to develop a local trade repository (TR) for over-the-counter (OTC) derivatives trades to help improve market transparency and bring Hong Kong's financial regulatory regime into line with evolving global standards.

International Financial Centre

REVIEW OF 2010

International and regional co-operation

With increasing globalisation, and closer economic and financial integration in Asia, the HKMA organises and participates in international and regional initiatives and discussions on a wide range of issues. It attended meetings of the Asia-Pacific Economic Co-operation (APEC), the FSB and the Bank for International Settlements (BIS). In 2010, much of the work of the international financial community continued to focus on promoting strong, sustainable and balanced global growth, and strengthening and reforming the international financial system. The initiatives, led principally by the Group of Twenty (G-20), have achieved significant progress.⁴ Hong Kong is involved in implementing the G-20's initiatives and recommendations through different channels, including the HKMA's participation in the FSB Plenary, and Standing Committees on Assessment of Vulnerabilities and on Supervisory and Regulatory Co-operation. Since 2009, the HKMA has been a member of the Basel Committee on Banking Supervision, the leading international forum for co-operation on banking supervisory matters, and contributed to initiatives such as enhancing Basel II and formulating the Basel III rules endorsed by the G-20 leaders in November 2010.

As a member of the BIS, the HKMA hosted the Committee on the Global Financial System (CGFS)⁵ roundtable on bank debt markets in August 2010, discussing banks' funding challenges, investors' behaviour towards bank debts and the impact of regulatory reforms on bank funding. In contributing to the reform of the international financial system, the HKMA is pursuing the implementation in Hong Kong of the relevant recommendations and best practices that are appropriate to local circumstances. Additional information on the HKMA's role in international co-operation can be found in the Chapter on Banking Stability.

⁴ Hong Kong participates in the G-20 as a member of the China delegation.

⁵ The CGFS is a central bank forum under the BIS for monitoring and examining broad issues relating to financial markets and the global financial system.

Promoting monetary and financial stability in Asia

The 39th EMEAP Deputies' Meeting and the 8th EMEAP MFSC Meeting were hosted by the HKMA in November. As co-ordinator of MFSC's macro-surveillance, the HKMA conducted analyses and prepared the Committee's bi-annual Macro-Monitoring Report to assess the region's risks and vulnerabilities, in particular those associated with the global growth outlook, sovereign debt crisis in advanced economies and strong capital flows into the region. As the chair of the EMEAP Working Group on Banking Supervision, the HKMA led the studies on the reform package of the Basel Committee and provided comments to the Basel Committee to allow the region's collective point of view to be taken into account in the development of the international standards. A tripartite working group established by the HKMA, Bank Negara Malaysia and the Monetary Authority of Singapore mapped out a co-ordinated strategy for the smooth exit from the full deposit guarantees in their respective jurisdictions at the end of 2010.

On 24 March, the Finance Ministers and Central Bank Governors of the ASEAN + 3 countries and the Monetary Authority announced the implementation of the CMIM Agreement – an advanced framework for regional emergency liquidity support. With access of up to US\$120 billion, the CMIM can supplement existing international financial arrangements and help guard against financial contagion in the region. Hong Kong's participation in this initiative is a demonstration of its autonomy in international financial affairs under the "One Country, Two Systems" principle, and has substantial practical and symbolic importance to Hong Kong's financial stability.

As one of the deputy chairs of the EMEAP Working Group on Payment and Settlement Systems, the HKMA has been working closely with the People's Bank of China (PBoC) and Bank Indonesia (the chair and another deputy chair respectively) to co-ordinate the Group's effort in sharing experiences and exchanging information on developments in domestic and cross-border payment and settlement systems. A new sub-group on cross-border co-operation and development was formed, with the HKMA taking the lead role.

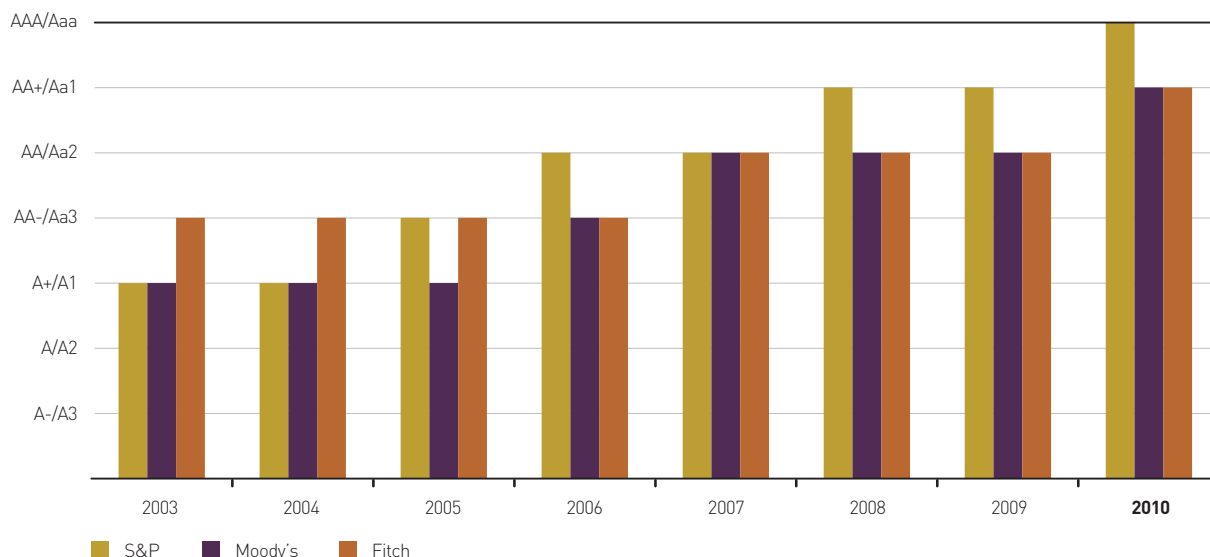
The HKMA participated in the Basel Committee on Banking Supervision – Committee on Payment and Settlement Systems Working Group on Intraday Liquidity Management to develop indicators for supervisors to monitor banks' management of their intraday liquidity risks, and assist in the review of the implementation of principles relating to banks' payment and settlement activities. The HKMA hosted a meeting of the Working Group in December, and was also involved in other international forums including the Asian Bond Market Initiatives.

Hong Kong's sovereign credit ratings

Since July 2003, the HKMA has played a pivotal role in the adoption of a more proactive approach towards major international credit rating agencies – Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch) – on Hong Kong's sovereign credit ratings. The HKMA works closely with the Government to present a balanced assessment of Hong Kong's

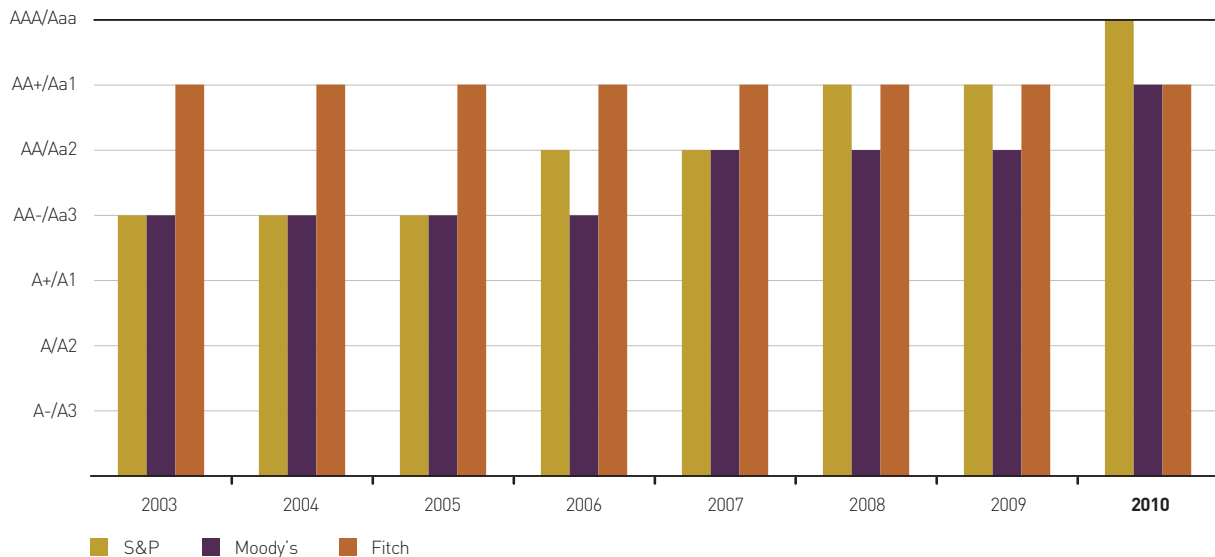
economic and financial developments to the agencies, which has assisted them in better understanding the strengths of the economy. This has led to a series of upgrades to Hong Kong's sovereign ratings over the past several years (Charts 1 and 2). A higher sovereign credit rating helps lower funding costs for Hong Kong debt issuers and strengthens Hong Kong's status as an international financial centre.

Chart 1 Hong Kong's sovereign foreign currency ratings



Hong Kong's sovereign credit ratings (continued)

Chart 2 Hong Kong's sovereign local currency ratings



In 2010, discussions with credit rating agencies focused on the strong and speedy recovery of the Hong Kong economy from the global financial crisis. Comparative analyses showed that Hong Kong continued to possess triple-A (that is, AAA/Aaa) credit qualities and outperform the triple-A median economy in key rating variables, notably in fiscal and external positions. Hong Kong's outperformance of some triple-A economies had further widened as a number of advanced economies were battered by the global financial crisis and escalating sovereign debt challenges. Quantitative analyses also showed that Hong Kong would continue to benefit from robust economic growth on the Mainland and that potential risks originating from the Mainland were low and manageable.

These efforts contributed to further upgrades in Hong Kong's sovereign credit ratings by all major international credit rating agencies in 2010. S&P upgraded Hong Kong's ratings to AAA, the agency's highest rating category and the highest sovereign rating ever assigned to Hong Kong. It reflected the agency's recognition of Hong Kong's large net external creditor position, solid fiscal strength and above-average growth potential for a high-income economy. Moody's and Fitch both upgraded Hong Kong's ratings to Aa1 and AA+ respectively, just one notch below triple-A. Moody's also assigned a "Positive" outlook to Hong Kong's ratings, an indication that an upgrade to Aaa was likely.

Financial co-operation with the Mainland

2010 was an eventful year for the development of renminbi business in Hong Kong. Significant growth and progress was seen in various areas, including cross-border trade settlement, deposits, bond issuance and the introduction of financial and wealth management products.

The renminbi trade settlement scheme, introduced in July 2009, was expanded further in June and December 2010, with companies in 20 provinces and cities on the

Mainland having the option of settling their current account transactions with any other economy in renminbi. As a result, the amount of trade transactions settled through banks in Hong Kong increased substantially from a monthly average of RMB4.5 billion in the first half of the year to over RMB57.0 billion a month in the second half of the year. Supported by the increasing volume of trade transactions, renminbi deposits in Hong Kong grew from just over RMB62 billion at the end of 2009 to about RMB315 billion at the end of 2010.

Following the expansion of the renminbi trade settlement scheme, the HKMA and the PBoC signed a memorandum in July to strengthen co-operation and facilitate the wider use of renminbi outside the Mainland. At the same time, the PBoC and Bank of China (Hong Kong) Limited, the Renminbi Clearing Bank, also signed a revised Settlement Agreement on the Clearing of Renminbi Businesses. The revision of the agreement effectively permits all companies, including securities firms, asset management companies and insurance companies to open renminbi bank accounts and removes the restrictions on renminbi interbank transfers between personal accounts and corporate accounts. Market players were quick to respond to these developments, with the launch of a wide range of renminbi financial and wealth management products, such as renminbi-denominated insurance policies and investment funds.

The growing pool of renminbi liquidity has enabled the development of Hong Kong as an offshore renminbi financing platform. In 2010, 16 renminbi bonds were issued in Hong Kong involving some RMB36 billion. The issuers ranged from private companies to multinational financial institutions, indicating their appetite for using Hong Kong's comprehensive and multi-currency financial platform to raise renminbi funds. In addition, the Finance Department of the Ministry of Finance successfully issued RMB5 billion of renminbi sovereign bonds to institutional investors by using the CMU's tendering platform, after signing a Co-operation Memorandum with the HKMA. This manifests a deepening of financial co-operation between the Mainland and Hong Kong, and is expected to open the door wider for the issuance of renminbi sovereign bonds.

On 17 August, the PBoC promulgated a notice on a pilot scheme for the Renminbi Clearing Bank and Participating Banks outside the Mainland to invest in the Mainland's interbank bond market. The scheme has opened up a channel for the holders of renminbi funds and financial

institutions in Hong Kong to invest in the Mainland market, which will further promote the development of renminbi trade settlement and enhance the attractiveness of renminbi offshore business in Hong Kong. More importantly, it provides a pathway for the circulation and capital preservation of renminbi funds in Hong Kong. By the end of 2010, four Hong Kong banks had received approval, and applications from a number of other banks were being processed by Mainland authorities.

At the beginning of 2011, the PBoC announced a pilot scheme to allow Mainland enterprises to use renminbi in conducting overseas direct investment (ODI). Banks in Hong Kong may obtain ODI-related renminbi funds from their counterparts on the Mainland to facilitate and finance ODI transactions through the Hong Kong platform. This will further improve the circulation of renminbi funds for trade and investment activities between Hong Kong and the Mainland.

Overall, the development of renminbi business in Hong Kong has been encouraging. During the year, the HKMA issued guidance to authorized institutions (AIs) setting out the principles and operational arrangements for renminbi business, the scope of this business in relation to corporate customers and the associated supervisory measures, for the cross-border trade settlement pilot scheme. To further promote the potential of this offshore business, the HKMA is preparing overseas road shows focusing on locations which have strong and growing trade and investment flows with the Mainland.

A further liberalisation of the Closer Economic Partnership Arrangement (CEPA) has been added under the Seventh Supplement relaxing the requirements for Hong Kong banks serving Hong Kong enterprises operating on the Mainland. It allows the banks to extend renminbi banking services to their corporate clients with a business presence on the Mainland.

Milestones in renminbi business development in Hong Kong

January 2004

Personal renminbi business commences, including deposit-taking, exchange and remittance services.

July 2007

The launch of the first issue of renminbi bonds in Hong Kong.

July 2009

The pilot scheme for cross-border trade settlement in renminbi commences operation.

September 2009

The first renminbi sovereign bonds by the Ministry of Finance is launched in Hong Kong.

February 2010

The HKMA issues a circular to streamline operations of AIs in renminbi cross-border trade settlement.

June 2010

The geographical coverage of the renminbi trade settlement scheme is expanded.

July 2010

The Clearing Agreement on renminbi business is amended.

August 2010

Announcement of a pilot scheme for the Renminbi Clearing Bank and other eligible institutions outside the Mainland to invest in the Mainland's interbank bond market.

November 2010

Renminbi sovereign bonds are issued through the CMU.

December 2010

The number of eligible Mainland enterprises that can settle merchandise exports in renminbi expands by 184 times from 365 to 67,359.

January 2011

Mainland enterprises are allowed to conduct and settle ODI in renminbi, and Hong Kong banks can provide renminbi funds to facilitate such transactions.

Strengthening research on Mainland economic and financial issues

The growing financial integration with the Mainland and the expansion in the scope of offshore renminbi business have important implications for Hong Kong as an international financial centre. To fully develop this intermediary role of Hong Kong in facilitating financial reforms on the Mainland, the HKMA has undertaken studies to explore potential new areas of financial co-operation, and the use of Hong Kong as a platform for promoting the use of renminbi and contributing to policy formulation to strengthen cross-border economic and financial ties.

The HKMA also has frequent meetings and seminars with Mainland authorities, scholars and private-sector economists to keep abreast of the latest developments on the Mainland. More information on the HKMA's activities relating to renminbi business in Hong Kong and the Mainland business of locally incorporated AIs can be found in the Chapter on Banking Stability.

Training

Training programmes for officials of the PBoC and the China Banking Regulatory Commission held in Hong Kong and on the Mainland continued to expand. During the year, 2,064 officials from the Mainland attended 22 courses (5,304 man-days) covering monetary policy; financial stability; banking supervision; management of human resources, accounting and internal control; macroeconomic analysis; financial risk management; payment and clearing systems; and prevention of money laundering. The HKMA also organised a regional course on risk management and internal controls under the APEC financial regulators' training initiative, and other courses for Mainland commercial banks for 170 participants.

Debt-market development

Proposed refinements to the Qualifying Debt Instruments Programme, announced by the Financial Secretary in his 2010 – 11 Budget Speech, will be implemented through legislative amendments. These refinements will enhance the tax concessions for qualifying debt securities under the Programme to further develop the local debt market. The HKMA has been providing substantial assistance in the legislative process. A bill to amend the Inland Revenue Ordinance was passed by the Legislative Council in March 2011.

Government Bond Programme

The HKMA has also provided assistance in implementing the Government Bond Programme, which consists of both institutional and retail bond issuances. A total of seven tenders for the Institutional Programme, involving tenors of 2, 5 and 10 years, was completed in 2010. The bonds were well-received, attracting a diversified group of investors. The amount of institutional bonds outstanding at the end of 2010 was \$24 billion. The HKMA will maintain close contact with market players and consider measures to enhance the Institutional Programme.

In addition, necessary preparatory work has been completed to achieve maximum readiness for the launch of the Retail Programme. The HKMA will take into account the advice of the co-arranger banks – the Bank of China (Hong Kong)-HSBC consortium, and prevailing market conditions in drawing up the timing and details of the retail issues.

International Financial Centre

Development of Islamic finance

The HKMA continued to work closely with other agencies and the private sector to promote the development of Islamic finance in Hong Kong in four broad areas:

- establishing market infrastructure
- enhancing Hong Kong's profile as an emerging Islamic finance centre
- promoting market knowledge of Islamic finance
- encouraging product development.

To nurture a larger pool of talent for the local Islamic financial industry, the HKMA organised a series of educational workshops and seminars on Islamic finance for market practitioners and university students in collaboration with local industry associations, such as the Treasury Markets Association (TMA), and various international organisations including the Islamic Financial Services Board. Response from the market has been positive. A legislative proposal to level the taxation playing field between common types of Islamic bonds (sukuk) and their conventional counterparts is being prepared. Moreover, the HKMA participated in a range of international Islamic finance forums to promote Hong Kong's Islamic financial platform, and strengthened co-operation with other Islamic financial centres like Malaysia. During the year, a global sukuk issue out of Malaysia was listed in Hong Kong.

Promotion of asset management business

To promote Hong Kong's asset management industry and reinforce its position as a leading asset management centre, the HKMA, together with other agencies, has been looking at ways to improve the international competitiveness of Hong Kong's financial markets and provide a more favourable tax and regulatory environment for such businesses. In conjunction with other agencies, the HKMA also took part in a joint promotional road show to London to highlight the strengths of Hong Kong's financial platform, focusing on its advantages in the process of the Mainland's gradual financial liberalisation and the wider external use of the renminbi.

OTC derivatives market regulation

In an effort to minimise systemic risk and promote transparency in the OTC derivatives market, the HKMA liaised with Hong Kong Exchanges and Clearing Limited (HKEx) to assess the feasibility of developing a local central counterparty (CCP) in Hong Kong. In December, the HKMA announced its plan to establish a local TR as a new service under the CMU to receive reports on OTC derivatives transactions, while HKEx also decided to develop the CCP. As a centralised registry that maintains an electronic database of records of OTC derivatives transactions, the TR will support regulatory authorities in performing their surveillance responsibilities.

This initiative will bring the local financial infrastructure into line with international standards recommended by the G-20 leaders at their 2010 Toronto Summit. Meanwhile, the HKMA monitored closely international regulatory developments for the OTC derivatives market and participated in various international forums, including the OTC Derivatives Working Group established under the FSB and the OTC Derivatives Regulators' Forum. As a member of the FSB OTC Derivatives Working Group, the HKMA helped prepare a report on Implementing OTC Derivatives Market Reforms, which developed recommendations to address issues that authorities may encounter when implementing the G-20's policy objectives in reforming the OTC derivatives market.

Treasury Markets Association

The HKMA worked closely with the market and provided strategic support to the TMA, whose mission is to further promote the professionalism and competitiveness of Hong Kong's treasury markets. The Association has 1,588 individual and 76 institutional members from banks, investment houses, insurance companies, money brokers and large corporations. Currently chaired by the HKMA's Deputy Chief Executive, Eddie Yue, the TMA achieved encouraging results in 2010:

- A thorough review was undertaken of the TMA's professional qualification framework and drafting began on its Code of Conduct and Practice to establish a new benchmark for market practitioners. The new professional qualification framework and Code will be implemented in 2011.

- A number of professional training courses were launched in collaboration with various universities, including the Professional Certificate in Treasury Markets (Derivatives and Structured Products), the Professional Course in Back Office Operations of Treasury Markets, and Treasury Markets Certificate and Model Code Examination organised for the Associate Member Upgrading Scheme. A series of e-learning programmes was also launched to promote distance learning and to enhance the Association's educational capacity on the Mainland and in Asia. More than 80 individuals took part in the professional courses and examinations launched by the TMA.
- About 50 seminars, workshops and talks were organised during the year for individual members and staff of institutional members to keep them abreast of market trends and developments.
- The TMA and the HKMA jointly organised the Treasury Markets Summit in Beijing in October to provide a forum for Mainland and Hong Kong market participants to understand more about the key themes driving the development of treasury markets in the current challenging environment. The TMA also supported a number of high-level international events, such as the Asian Financial Forum.

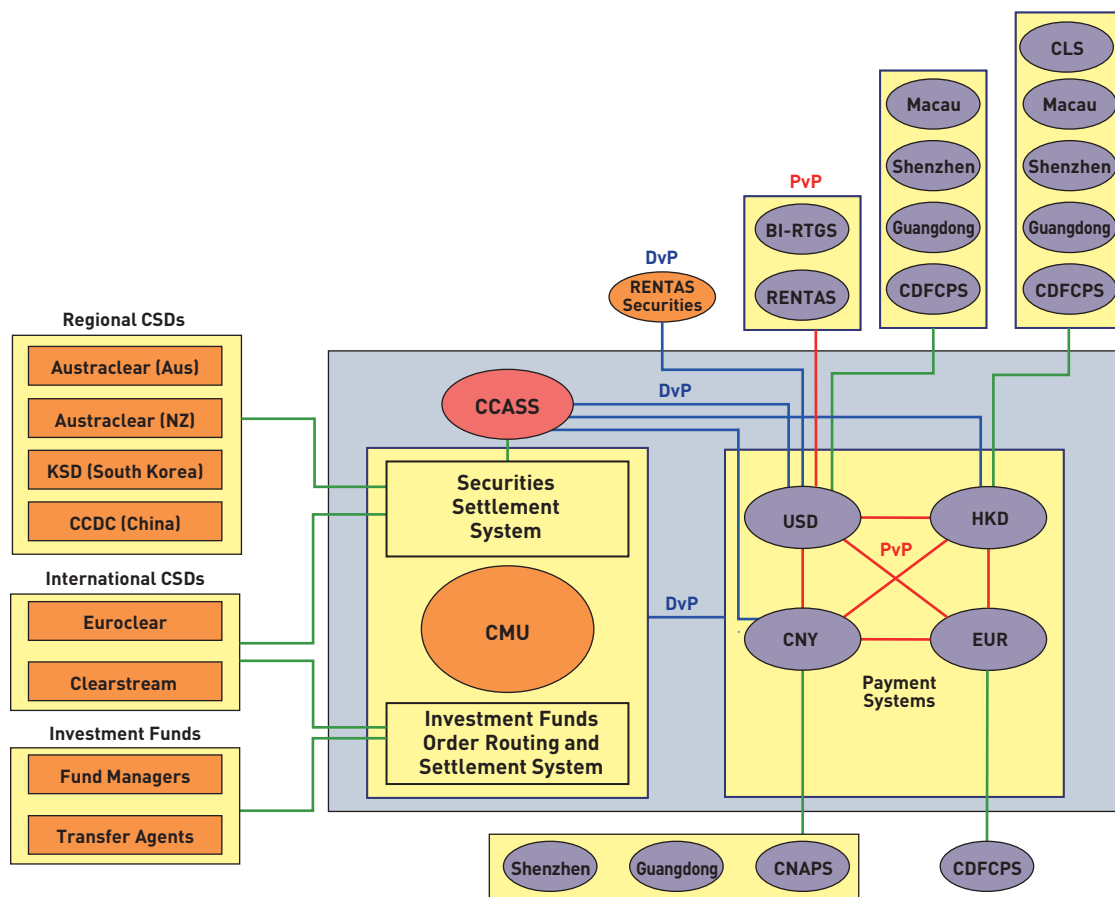
International Financial Centre

Hong Kong's financial infrastructure

The HKMA plays a major role in developing Hong Kong's financial infrastructure to reinforce its status as a regional hub for payment and settlement of funds and securities. Over the years, continuous effort and resources have been devoted to building a robust and efficient multi-currency, multi-dimensional platform, with extensive domestic and overseas system linkages (Chart 3).

Key achievements include the establishment of RTGS systems for the Hong Kong dollar, the US dollar, the euro and the renminbi, and developing bilateral links between the CMU and many regional and international central securities depositories (CSDs), such as Euroclear, Clearstream, and the depositories in Australia, New Zealand, South Korea and the Mainland.

Chart 3 Hong Kong's multi-currency payment and settlement infrastructure



- | | |
|---|---------------------------------|
| BI-RTGS - Bank Indonesia Real Time Gross Settlement (Indonesia's rupiah RTGS system) | — Delivery versus Payment (DvP) |
| CCASS - Central Clearing and Settlement System | — Payment versus Payment (PvP) |
| CCDC - China Central Depository and Clearing | — System linkages |
| CDFPCS - China's Domestic Foreign Currency Payment System | |
| CLS - Continuous Linked Settlement | |
| CMU - Central Money Markets Unit | |
| CNAPS - China National Advanced Payment System | |
| KSD - Korean Securities Depository | |
| RENTAS - Real Time Electronic Transfer of Funds and Securities (Malaysia's ringgit RTGS system) | |

Hong Kong dollar RTGS system

The Hong Kong dollar Clearing House Automated Transfer System (CHATS), which operates on an RTGS basis, is responsible for clearing all Hong Kong dollar interbank payments, and continues to run smoothly and efficiently. It has a direct link with the CMU to provide both real-time and end-of-day delivery-versus-payment (DvP) settlement services. Hong Kong Interbank Clearing Limited (HKICL), the operator of the RTGS systems, was established in 1995 and is owned equally by the HKMA and the Hong Kong Association of Banks. In 2010, HKICL processed a daily average of \$545 billion in CHATS transactions (21,510 items), up 4% from 2009, probably reflecting the recovery in economic and financial activities.

In addition to settling large-value payments, CHATS also handles daily bulk clearings of stock market transactions, credit card transactions, cheques, small-value bulk electronic payment items (EPS, auto-credit and auto-debit transactions) and ATM transfers (Chart 4).

Banks can use their Exchange Fund Bills and Notes (EFBN) to obtain interest-free intraday liquidity through intraday repurchase agreements with the HKMA to settle their interbank payments.

Foreign currency RTGS systems in Hong Kong

The US dollar, euro and renminbi RTGS systems have been operating smoothly since their launch. The average daily turnover value of the US dollar and renminbi RTGS systems grew in 2010. In particular, the turnover of the renminbi RTGS system increased substantially amid a surge in renminbi cross-border trade settlement and payment-versus-payment (PvP) transactions, and an increase in renminbi bond issuance activities in Hong Kong (Charts 5 – 7). The average daily turnover and other details of the foreign currency RTGS systems are listed in Table 1.

Chart 4 Hong Kong dollar RTGS system average daily turnover

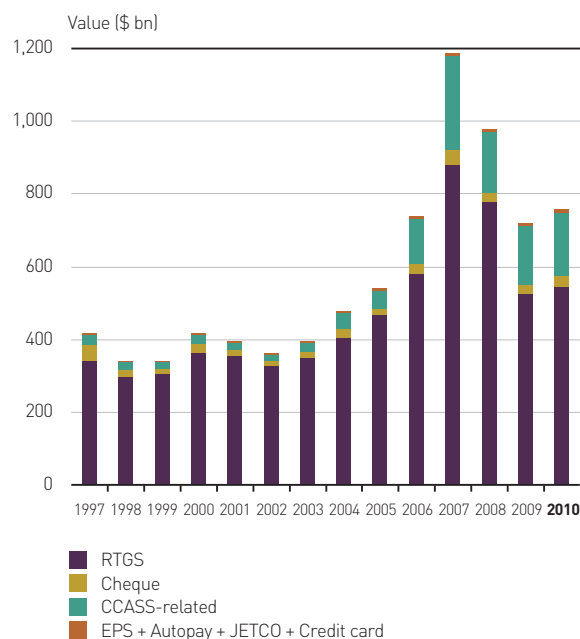
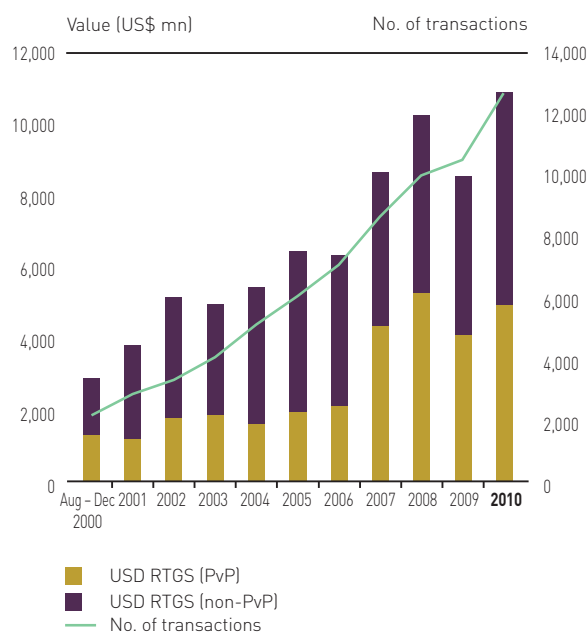


Chart 5 US dollar RTGS system average daily turnover



International Financial Centre

Chart 6 Euro RTGS system average daily turnover

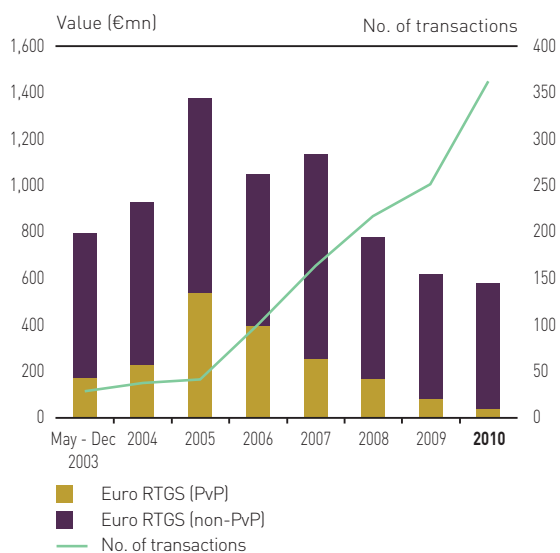


Chart 7 Renminbi RTGS system average daily turnover

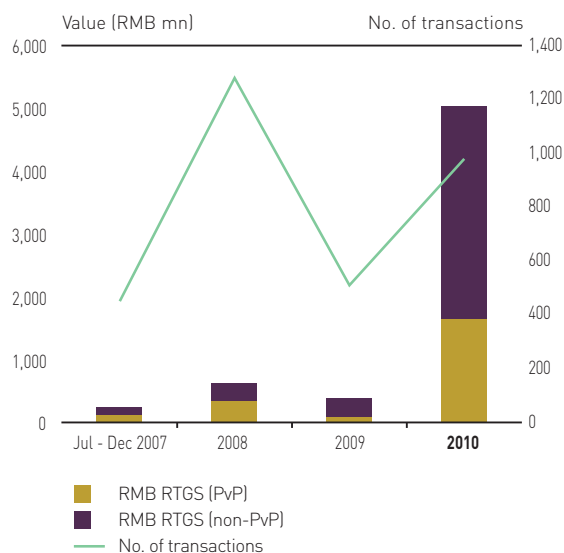


Table 1 Foreign currency RTGS systems

RTGS systems	Launch date	Settlement institution or Clearing Bank	Number of participants at the end of 2010	Average daily turnover in 2010	Average daily transactions in 2010
US dollar RTGS system	August 2000	The Hongkong and Shanghai Banking Corporation Limited	Direct: 81 Indirect: 143	US\$10.9 billion	12,637
Euro RTGS system	April 2003	Standard Chartered Bank (Hong Kong) Limited	Direct: 31 Indirect: 19	€580.7 million	362
Renminbi RTGS system	June 2007	Bank of China (Hong Kong) Limited	Direct: 96	RMB 5.0 billion	976

Payment-versus-payment

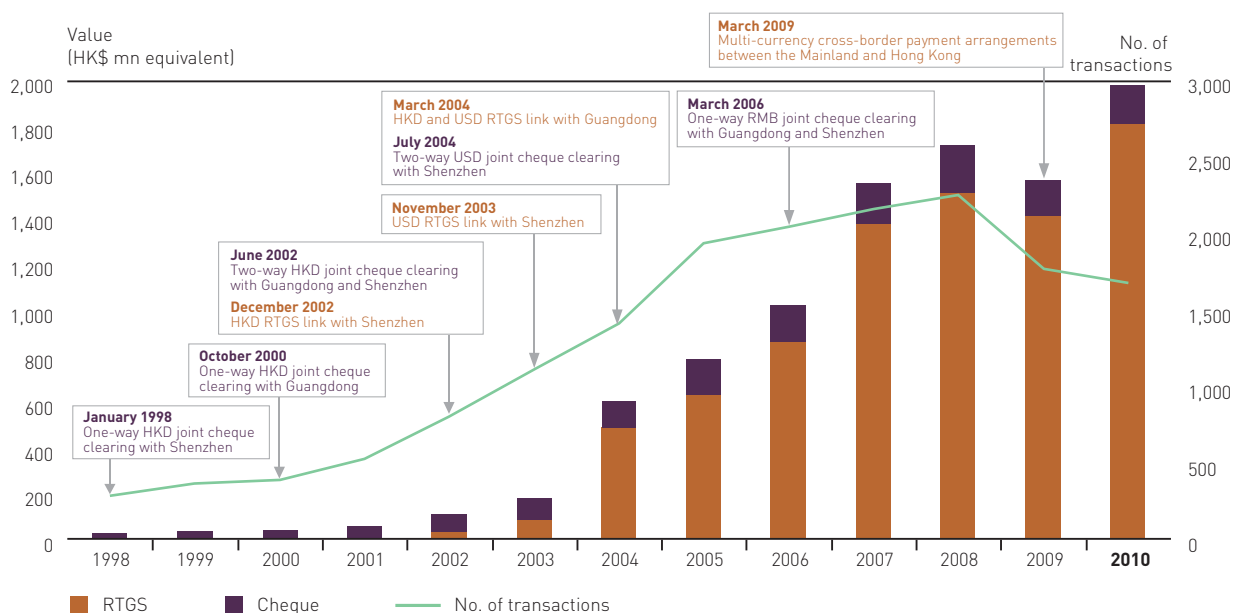
PvP is a mechanism for settling a foreign-exchange transaction to ensure that payments in the two currencies involved are settled simultaneously. Within Hong Kong, six cross-currency PvP links have been established among the Hong Kong dollar, US dollar, euro and renminbi RTGS systems. Hong Kong's US dollar RTGS system has also established two cross-border PvP links, with Malaysia's ringgit RTGS system in November 2006 and Indonesia's rupiah RTGS system in January 2010. PvP greatly improves settlement efficiency and eliminates settlement risk arising from time lags in settlements and from time-zone differences (known as Herstatt risk). In 2010, the transaction value of Hong Kong dollar, US dollar, euro and

renminbi-related PvP transactions amounted to about \$5,020 billion, US\$1,229 billion, €10 billion and RMB409 billion respectively.

Payment links with the Mainland

The HKMA continues to work closely with Mainland authorities in providing efficient cross-border payment links to meet growing demands. The use of these services has risen gradually over the years. In 2010, the average daily turnover handled by the various system links was equivalent to around \$2 billion, including the RTGS cross-border links with the Mainland's Domestic Foreign Currency Payment Systems launched in March 2009 (Chart 8).

Chart 8 Average daily turnover in cross-border links with the Mainland



International Financial Centre

The RTGS system links with Shenzhen and Guangdong handled more than 21,000 transactions during the year, with a total value equivalent to \$427 billion. The system allows cross-border payments in Hong Kong dollars and US dollars to be settled efficiently and safely between banks in Hong Kong and their counterparts in Shenzhen and Guangdong.

The two-way joint cheque-clearing facilities processed about 372,000 Hong Kong dollar and US dollar cheques in 2010, with a value equivalent to \$41 billion. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong and presented in Shenzhen and Guangdong, and for cheques drawn on banks in Shenzhen and Guangdong and presented in Hong Kong. Since March 2006, the joint cheque-clearing facilities have been expanded to cover renminbi cheques drawn on banks in Hong Kong, and presented in Shenzhen and Guangdong for consumer spending. In 2010, renminbi cheques with a total value equivalent to around \$40 million were cleared.

Payment links with Macau

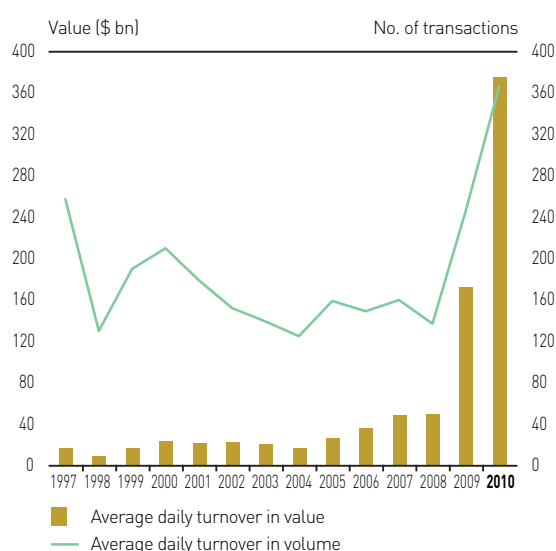
The one-way joint clearing facility for Hong Kong dollar cheques between Hong Kong and Macau was launched in August 2007 and a similar facility for US dollar cheques was launched in June 2008. The facilities have reduced the time required for clearing Hong Kong dollar and US dollar cheques issued by banks in Hong Kong and presented in Macau from four or five days to two. In 2010, Hong Kong dollar cheques with a total value of over \$17 billion and US dollar cheques with a total value of over US\$14 million were cleared.

Debt settlement systems

The CMU provides an efficient, one-stop clearing, settlement and depository service for Hong Kong dollar and foreign currency-denominated debt securities issued in Hong Kong. Through the linkages between the CMU and international and regional CSDs, overseas investors can hold and settle securities lodged with the CMU. They also help Hong Kong investors to hold and settle foreign securities held with overseas CSDs.

In 2010, the CMU processed an average daily value of \$375 billion (365 transactions) in secondary market transactions (Chart 9). Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of EFBN was \$653 billion and the total amount of other securities was equivalent to \$347 billion.

Chart 9 CMU secondary market turnover



Development of financial infrastructure in 2010

The HKMA completed a number of projects to promote the safety and efficiency of the financial infrastructure, and captured new business opportunities to further develop Hong Kong as a regional payment and settlement hub.

Payment-versus-payment link with Indonesia

A PvP link between Hong Kong's US dollar RTGS system and Indonesia's rupiah RTGS system was launched in January allowing simultaneous settlement of foreign-exchange transactions in US dollars and Indonesian rupiah in the Asian time zone, thereby enhancing settlement efficiency and eliminating Herstatt risk.

SWIFTNet migration project

The proprietary platform of the RTGS systems and CMU in Hong Kong was replaced with the open SWIFTNet platform after the launch of Phase 2 of the SWIFTNet migration project in July. It has improved real-time interactive user interfaces and greatly enhanced interoperability between domestic and international messages for payment instructions. The migration to SWIFTNet has removed barriers for overseas institutions to join the RTGS systems in Hong Kong, thus reinforcing its status as an international financial centre.

CMU fund order routing and settlement

The CMU Fund Order Routing and Settlement system became SWIFT compatible in April, opening up a new channel for straight-through processing of investment fund orders.

Same-day settlement of EPSCO and JETCO payment items

An afternoon bulk settlement run was introduced to the Hong Kong dollar RTGS system in September to enable same-day settlement of the small-value electronic payment items from EPS Company (Hong Kong) Limited (EPSCO) and Joint Electronic Teller Services Limited (JETCO), adding to the existing morning bulk settlement run for the previous day's items.

Hong Kong/Shenzhen cross-border one-way joint direct debit transfer

The Hong Kong/Shenzhen cross-border one-way joint direct debit transfer arrangement was implemented in phases to provide a more efficient means for Hong Kong residents to make recurring payments, such as property management fees and utilities bills, to Shenzhen merchants. Phases 1 and 2 of the project were launched in August and September respectively to allow holders of Hong Kong dollar and renminbi China UnionPay (CUP) credit cards and Hong Kong dollar CUP debit cards issued in Hong Kong to make cross-border payments. Phase 3 for making payments through renminbi CUP debit cards is scheduled for launch in 2011.

Enhancement of the renminbi RTGS system

Improvements to the renminbi RTGS system were introduced in 2010 to capture new opportunities from the significant expansion of renminbi business in Hong Kong. This was given greater impetus with the implementation in July of the revised Settlement Agreement on the Clearing of Renminbi Businesses between the PBoC and the Clearing Bank of the renminbi RTGS system. The enhancements include:

- introducing bulk settlement runs and real-time DvP functions to the renminbi RTGS system in September and November respectively to support money settlement for the potential listing and trading of renminbi-denominated securities on the Stock Exchange of Hong Kong, and subsequent dividend distributions

International Financial Centre

- a Regional CHATS Payment Service (RCPS), launched in the renminbi RTGS system in December, adds to the RCPS available in the Hong Kong dollar, US dollar and euro RTGS systems in Hong Kong. The RCPS leverages the extensive correspondent banking network of the participating banks to facilitate cross-border multi-currency payments using Hong Kong's RTGS systems. With the inclusion of the renminbi, the RCPS can outreach to Mainland markets, thus reinforcing Hong Kong's role as a regional payment hub
- implementing the RTGS Liquidity Optimiser (RLO) in December to enhance efficiency of the renminbi RTGS system by allowing interbank payments to be settled periodically on a multilateral basis. The RLO is a liquidity saving device that helps reduce the intraday liquidity needs of banks and clear gridlocks of payment instructions.

Promoting Hong Kong's financial infrastructure

Strengthening Hong Kong's position as a regional payment hub, leveraging the renminbi advantage, and ensuring that the financial infrastructure keeps pace with new developments in technology and standards were the major business development areas pursued during the year.

Strengthening Hong Kong as a regional payment hub

In 2010, the HKMA continued to lead the Pan-Asian CSDs' alliance project, which aims to develop a common post-trade processing infrastructure for Asian debt securities. A White Paper was published in June setting out the long-term vision of the Common Platform Model as well as the proposed launch of a Pilot Platform in the first half of 2011. Meetings were held with stakeholders, including central banks, finance ministries and CSDs in the region, global custodian banks and infrastructure platform providers to enable a better understanding of the White Paper initiatives and to obtain wider support. The task force on the Common Platform Model also convened two meetings to consider matters vital to the implementation of the Pilot Platform by mid-2011 and the gradual migration to the Model.

Leveraging the renminbi advantage

Hong Kong made solid progress in its development as a renminbi offshore centre. Encouraging growth was recorded in transactions and amounts cleared and settled in the renminbi RTGS system, with the average daily PVP transactions growing from a negligible amount to around RMB6.4 billion a day at the end of the year. The bulk of the renminbi transactions were against the US dollar with the remainder against the Hong Kong dollar. The number of direct participating banks in Hong Kong's renminbi RTGS system more than doubled to 96 in 2010 from 46 a year ago. These developments indicate an increasingly active offshore foreign-exchange market in renminbi. The impressive results are due partly to the HKMA's intense marketing campaigns, including promotional programmes organised in partnership with the Bank of China (Hong Kong) Limited and other major banks promoting Hong Kong's RCPS and cross-border renminbi trade settlement infrastructure. The HKMA attended or arranged 67 seminars and 260 marketing calls in various cities on the Mainland as well as in the Asia-Pacific region, Europe and North America.

Keeping pace with new developments

One way to strengthen Hong Kong's status as an international financial centre is to ensure that the existing financial infrastructure is in line with the latest developments in technology and standards. In response to the call by the BIS Committee on Payment and Settlement Systems to improve resilience in the repo market infrastructure and efforts by major banks to seek safer alternatives to unsecured interbank lending, a project was initiated to upgrade the CMU's bank-to-bank repo infrastructure to help the industry develop an active bank repo market in Hong Kong. A consultation exercise in June resulted in support from key market players. The enhanced CMU bank-to-bank repo platform, expected to be launched by the end of 2011, will take into account requirements and feedback collected from the primary dealer community in Hong Kong.

PLANS FOR 2011 AND BEYOND

The expectation of a slow recovery in the global economy and concerns about debt sustainability in the advanced economies will continue to cloud global financial markets in 2011. Capital inflows into the region arising from excess global liquidity also increase the risk of financial instability. All these highlight the importance of co-operation for improving financial stability and surveillance. The HKMA will continue to spearhead the macro-surveillance work for the EMEAP MFSC. Participation in central banking and international financial forums remains a priority of the HKMA to ensure Hong Kong's views are heard, and to keep abreast of the latest developments. Following the achievement of an AAA credit rating from S&P, the HKMA will pursue further upgrades of Hong Kong's credit ratings by other major international credit rating agencies.

Strengthening financial co-operation with the Mainland is important to enhancing Hong Kong's competitiveness as an international financial centre. The HKMA will discuss and liaise with Mainland authorities on issues related to the continued development of renminbi business in Hong Kong, and to expand CEPA to increase the financial integration between Hong Kong and the Mainland. Following expansion of the use of renminbi for trade settlement and ODI, other initiatives will be pursued to enhance the fuller circulation of renminbi funds, including the use of renminbi to conduct foreign direct investment on the Mainland. To help promote the wider use of renminbi outside the Mainland and to extend the outreach of Hong Kong's renminbi trading platform to the international community, the HKMA is preparing a series of road shows to introduce the renminbi services provided by Hong Kong to overseas investors, companies and financial institutions in 2011.

The renminbi RTGS system will be further improved to enable Hong Kong to tap into new business opportunities likely to result from the revised Settlement Agreement on the Clearing of Renminbi Businesses. Additional steps will also be taken to capitalise on the increasing demand in intra-regional trade denominated in Asian currencies (particularly the renminbi), cross-border/cross-currency transactions, and retail payments by electronic means. This includes working with central banks and CSDs in the Asia-Pacific region and Euroclear to launch a pilot platform for cross-border bond transactions in mid-2011 and, in conjunction with banking and related service providers, to enhance the electronic retail payment infrastructure in Hong Kong.

The HKMA will continue to support the Government's initiatives in further developing the local debt market and the Islamic finance sector, and in implementing the Government Bond Programme to broaden its investor base and establish a liquid and representative yield curve.

To meet international standards and to ensure the smooth implementation of reforms to the OTC derivatives market by the end of 2012, the HKMA will work with other agencies to facilitate the development of regulatory framework for the OTC derivatives market in Hong Kong, in terms of introducing clearing and reporting requirements on OTC derivatives transactions. The HKMA will maintain close contact with market participants to collect opinion on issues related to the development of the regulatory framework for the OTC derivatives market in Hong Kong. Subject to the timely establishment of the relevant international standards, the bulk of the system development work for the local TR for OTC derivatives is expected to be completed during the year.

Finally, the HKMA will work closely with other agencies and the private sector to consider and implement initiatives that will reinforce the competitiveness of Hong Kong's financial markets to strengthen its position as an international financial centre.

Reserves Management

The Exchange Fund recorded an investment return of 3.6% in 2010. This was achieved in an uncertain and difficult investment environment.

THE EXCHANGE FUND

The Exchange Fund's primary objective, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. The Fund may also be used to maintain the stability and integrity of Hong Kong's monetary and financial systems to help maintain Hong Kong as an international financial centre. The Exchange Fund is under the control of the Financial Secretary and may be invested in any securities or other assets he considers appropriate, after consulting the Exchange Fund Advisory Committee (EFAC).

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and benchmark

EFAC has set the following investment objectives for the Exchange Fund:

- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar-denominated securities;
- (c) to ensure that sufficient liquidity will be available for the purposes of maintaining monetary and financial stability; and
- (d) subject to (a) – (c), to achieve an investment return that will help preserve the long-term purchasing power of the Fund.

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the investment benchmark of the Fund, which guides its long-term strategic asset allocation. Currently the target bond-to-equity ratio of the benchmark is 75:25. In terms of target currency mix, 82% of the benchmark is allocated to the US dollar and the Hong Kong dollar and the remaining 18% to other currencies.

The Exchange Fund is managed as two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated assets to provide full backing to the Monetary Base as required under the Currency Board arrangements. The Investment Portfolio is invested primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of the assets. In an effort to better manage risk and enhance long-term returns, the Fund has started, in a cautious and modest manner, to explore opportunities for diversification of investment.

In 2007 a Strategic Portfolio was established to hold shares in Hong Kong Exchanges and Clearing Limited acquired by the Government for the account of the Exchange Fund for strategic purposes. Because of the unique nature of this Portfolio, it is not included in the assessment of the investment performance of the Exchange Fund.

Reserves Management

The investment process

The investment process of the Exchange Fund is underpinned by decisions on two types of asset allocation – the strategic asset allocation and the tactical asset allocation. The strategic asset allocation, reflected in the investment benchmark, represents the long-term optimal asset allocation given the investment objectives of the Exchange Fund. Guided by the strategic allocation, assets are tactically allocated in an attempt to achieve an excess return over the benchmark. This often means the actual allocation is different from the benchmark, or strategic, allocation. The differences between the actual and the benchmark allocations are known as “tactical deviations”. While the benchmark and the limits for tactical deviations are determined by the Financial Secretary in consultation with EFAC, tactical decisions are made by the HKMA under delegated authority. Within the limits allowed for tactical deviations, portfolio managers may take positions to take advantage of short-term market movements.

Investment management

Direct Investment

HKMA staff in the Reserves Management Department directly manage the investment of about 80% of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio is a multi-currency portfolio invested in the major fixed-income markets. The staff also manage positions in financial derivatives to implement investment strategies or control the risks of the Fund.

Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers based in over a dozen international financial centres to manage about 20% of the Exchange Fund’s assets, including all of its equity portfolios and other specialised assets. The purpose of appointing external managers is to tap the best investment expertise available in the market, capturing a diverse mix of investment styles and to transfer knowledge and information from the market to in-house professionals.

Expenditures relating to the use of external managers include fund management and custodian fees, transaction costs and withholding and other taxes. They are determined by market factors, and may fluctuate from year to year.

Risk management and compliance

The high volatility of financial markets in recent years has highlighted the importance of risk management. Stringent controls and investment guidelines have been established for both internally and externally managed portfolios, and compliance with guidelines and regulations is closely monitored. Risk-control tools are deployed to assess market risks under both normal and adverse market conditions. The HKMA also conducts detailed performance attribution analyses to make the best use of the investment skills of both internal and external managers.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2010

The global investment environment in 2010 remained difficult and volatile. Investor sentiment was shaken by the European sovereign debt crisis in the first half of the year, leading to a decline in the global equity markets. Following the speech by the US Federal Reserve Chairman in August to provide additional monetary accommodation if it proved necessary, global equity markets rebounded sharply.

Bond markets also remained volatile with global yields edging lower in the first half as major central banks

continued to pursue an accommodative monetary policy to provide support for their economies. However, bond yields rebounded towards the end of 2010. On currency markets, the euro weakened substantially in the first half as the European sovereign debt crisis deepened, but recovered most of the losses when the situation stabilised in the second half. For 2010 as a whole, the euro fell by 6.5%, while the yen gained more than 14% against the US dollar.

The performance of major currency, bond and equity markets in 2010 are shown in Table 1.

Table 1 2010 market returns

Currencies	
Appreciation (+)/depreciation (-) against the US dollar	
Euro	-6.5%
Yen	+14.8%
Bond markets	
Relevant US Government Bond (1 - 3 years) Index	+2.5%
Equity markets	
Standard & Poor's 500 Index	+12.8%
Hang Seng Index	+5.3%

Reserves Management

The Exchange Fund's performance

The Exchange Fund recorded an investment income of \$79.4 billion in 2010, comprising gains from Hong Kong and foreign equities of \$11.6 billion and \$27.1 billion respectively, valuation gains from bonds and other investments held by the investment holding subsidiaries of the Fund of \$42.1 billion and \$1.7 billion respectively, and a loss of \$3.1 billion from foreign-exchange revaluation. Apart from this \$79.4 billion investment income, the valuation gain and dividend income of the Strategic Portfolio amounted to \$2.6 billion.

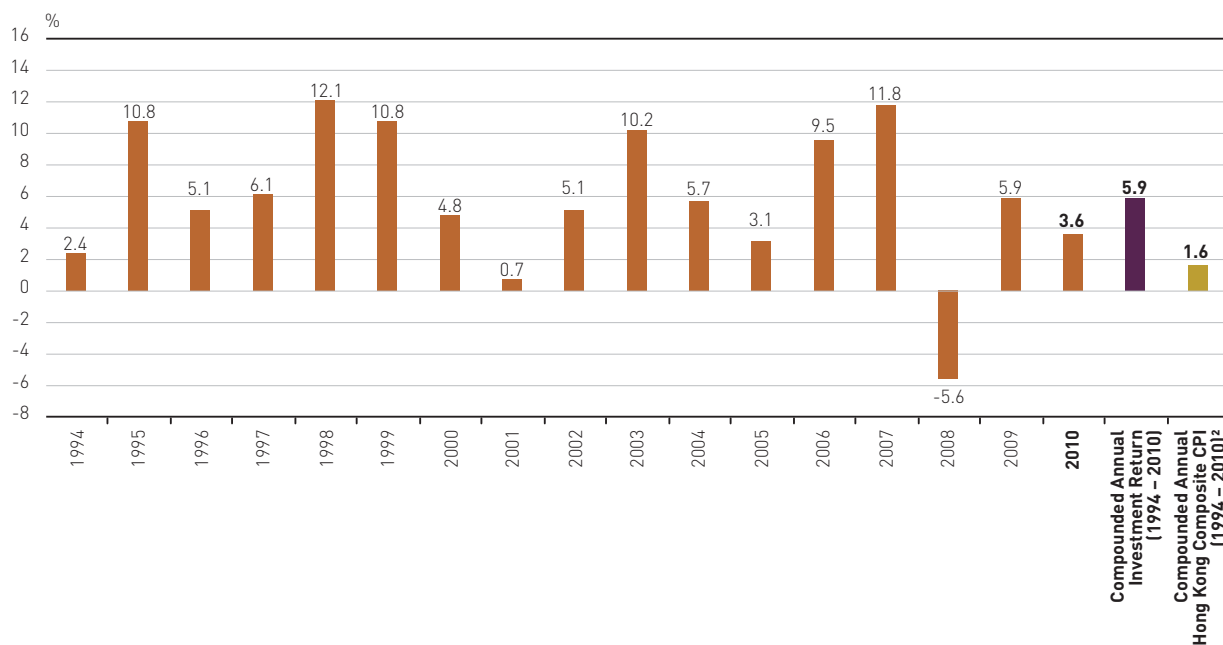
The overall investment return of the Exchange Fund (excluding Strategic Portfolio) is 3.6%. The return takes into account contribution from both the Backing Portfolio and the Investment Portfolio. On the back of the significant inflow of funds into the Hong Kong dollar in late 2008 and 2009 leading to an expansion in the Monetary Base by over \$600 billion, the Backing Portfolio has also grown in size by an equivalent amount. As the Backing Portfolio can

only be invested in high quality, short-term and liquid US dollar assets to provide full backing to the Monetary Base, its return has been stable but low. The increasing share of the Backing Portfolio, coupled with its relatively low rate of return, affects the overall return of the Exchange Fund. Excluding the investment return of the Backing Portfolio, the return on the Investment Portfolio is 6%.

The annual return of the Fund from 1994 to 2010 is set out in Chart 1. Table 2 shows the 2010 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 1.2% over the last three years, 4.9% over the last five and 10 years and 5.9% since 1994.¹ Table 3 shows the currency mix of the Fund's assets on 31 December 2010.

¹ Averages over different time horizons are calculated on an annually compounded basis.

Chart 1 Investment return of the Exchange Fund (1994 – 2010) ¹



¹ Investment return calculation excludes the holdings in the Strategic Portfolio.

² Composite Consumer Price Index is calculated based on the 2004/2005-based series.

Table 2 Investment return of the Exchange Fund in Hong Kong dollar terms ¹

	Investment return ^{2&3}
2010	3.6%
3-year average (2008 – 2010)	1.2%
5-year average (2006 – 2010)	4.9%
10-year average (2001 – 2010)	4.9%
Average since 1994	5.9%

¹ The investment returns for 2001 to 2003 are in US dollar terms.

² Investment return calculation excludes the holdings in the Strategic Portfolio.

³ Averages over different time horizons are calculated on an annually compounded basis.

Table 3 Currency mix of the Exchange Fund's assets on 31 December 2010 (including forward transactions)

	HK\$ billion	%
US dollar	1,853.0	79.0
Hong Kong dollar	217.0	9.3
Others ¹	275.0	11.7
Total	2,345.0	100.0

¹ Including mainly euro, yen, sterling, Australian dollar, Canadian dollar, Singapore dollar, Swiss franc, Swedish krona, Norwegian krone and Danish krone.

Corporate Functions

The HKMA strengthened communications with the media and the community at large, and continued to enhance its robust organisational structure to meet the evolving challenges in maintaining Hong Kong's banking and monetary stability.

CORPORATE DEVELOPMENT

Media relations

The HKMA attaches great importance to maintaining effective and timely communications with the media to provide transparency and accessibility to its operations. Initiatives were taken in 2010 to strengthen this relationship and improve the understanding of the HKMA's policies and work by the media and the public. During the year, 68 open press events comprising 19 press conferences and forums, 15 stand-up interviews and 34 other public functions were held, and 39 media interviews were given. Altogether 324 bilingual press releases were issued and staff handled a large volume of media enquiries each day.

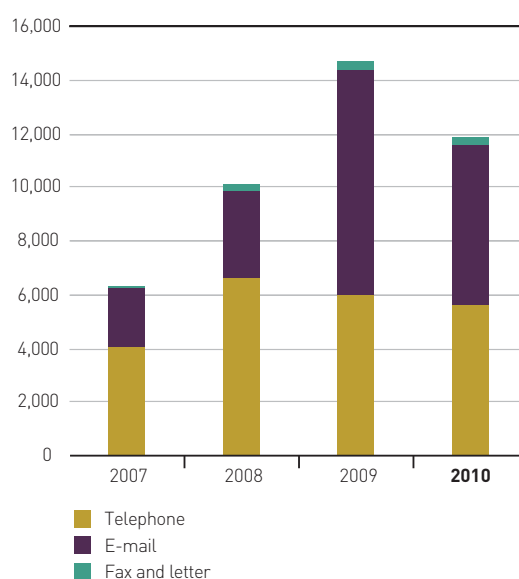
In addition, 26 media briefings were organised covering a wide range of topics to facilitate better understanding of the HKMA's operations and initiatives. These included investment performance of the Exchange Fund, currency board operations, banking policies and regulations, prudential measures for mortgage lending, consumer data privacy, 2010 series banknotes, Hong Kong's credit ratings, financial infrastructure and renminbi business development.

Public enquiries

The Public Enquiry Service received 11,908 enquiries in 2010, reflecting the intense public interest in the HKMA's work since the onset of the global financial crisis in late 2008.

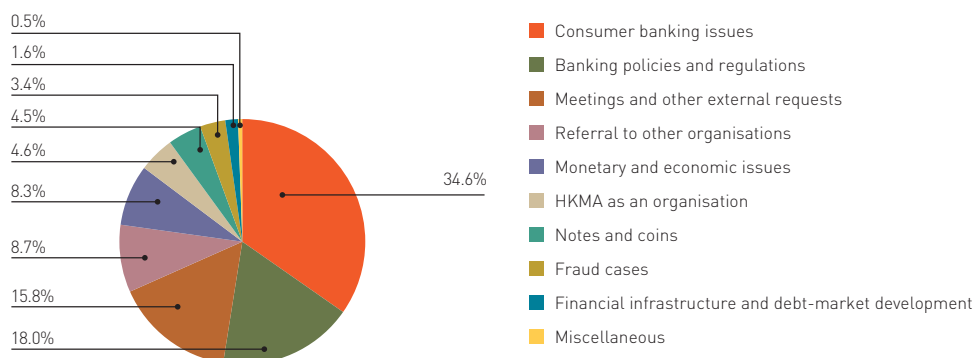
About half the enquiries were on banking policies and regulations, and consumer banking issues. Notable examples were prudential measures on residential mortgage loans and the enhanced Deposit Protection Scheme (DPS). With the rapid development of renminbi businesses in Hong Kong, the number of enquiries on this subject also surged. Chart 1 shows the number of enquiries received since 2007, while Chart 2 breaks down the enquiries in 2010 by type.

Chart 1 Total number of public enquiries



Corporate Functions

Chart 2 Enquiries received by nature in 2010



Publications

The *HKMA Annual Report*, *Half-Yearly Monetary and Financial Stability Report*, *Quarterly Bulletin* and *Monthly Statistical Bulletin* are the major sources of information on monetary, banking and economic issues in Hong Kong. The HKMA has also published five background briefs introducing its work on maintaining monetary and banking stability.

The *HKMA Annual Report 2009* received a Bronze award in the Hong Kong Management Association's 2010 Best Annual Reports Awards.

The HKMA website

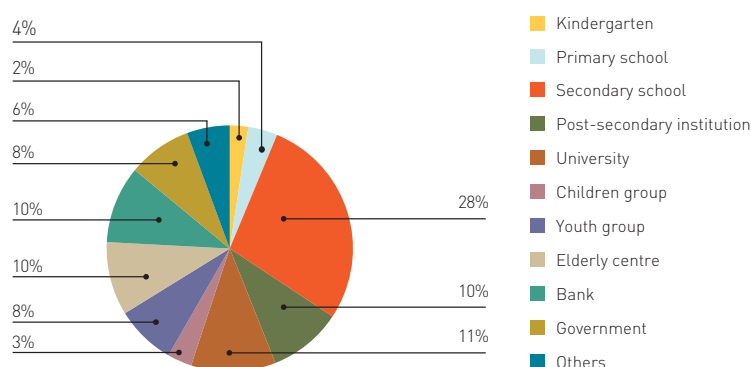
The HKMA website (www.hkma.gov.hk) provides comprehensive and accessible news and information about the HKMA, including its main publications.

Public education programme

The Information Centre on the 55th Floor of Two International Finance Centre is an important resource for introducing the HKMA's work to the community and promoting public awareness of monetary and banking matters.

The Centre consists of an exhibition area and library, and is open to the public six days a week. It presents a survey of the history of money and banking in Hong Kong and the key policy objectives of the HKMA, and provides information on Hong Kong banknotes, Internet banking security, the payment systems and deposit protection in Hong Kong. Daily guided tours are organised for visitors. During the year, more than 46,000 people visited the Centre and over 600 guided tours were organised for schools and other groups (Chart 3). The Centre has received some 334,000 visitors since it opened in December 2003.

Chart 3 Type of group visits to the Information Centre



The Library, situated next to the Exhibition Area, contains materials for detailed study of Hong Kong's monetary, banking and financial affairs and of central banking topics. It houses an electronic register of authorized institutions in Hong Kong maintained under section 20 of the Banking Ordinance.

The HKMA continued to organise public education seminars on topics relevant to its work. In 2010, three seminars with the Linked Exchange Rate system as the main theme were organised for more than 2,000 students, teachers and members of the public. Since the launch of the education programme in 1998, more than 44,000 people have participated in the seminars.

During the year, the HKMA invited primary school students to participate in an art competition to show their creativity through the use of images of coins currently or previously in circulation in Hong Kong. Over 3,000 students participated and the winning drawings were displayed in the HKMA Information Centre.



Norman Chan, Chief Executive, and Miss Lee Yim-kam, the champion of the art competition, admire the winning artwork.

HUMAN RESOURCES

The HKMA needs to recruit, develop and maintain a highly professional workforce to support its policy objectives and respond flexibly to changing work priorities. While the HKMA is an integral part of the Government, it is able to employ staff on terms different to those of the civil service to attract personnel of the right experience and expertise. As a public organisation, the HKMA aims to maintain a lean and flexible structure and to redeploy staff resources to meet new and increased workloads whenever possible.

Organisational changes

In April 2010, the responsibilities of the banking departments were re-distributed to cope with an increasingly heavy and demanding workload. The Enforcement Department was created to focus on securities enforcement and complaint handling issues. The re-organisation also involves

- the Banking Development Department being renamed the Banking Conduct Department (BCD)
- the BCD taking over from the Banking Supervision Department (BSD) and the Banking Policy Department (BPD) all supervisory and development functions relating to the business conduct of AIs, in addition to its original responsibilities for payment systems oversight, licensing, deposit protection and settlement
- the BPD taking over from BSD the responsibilities for treasury and operational risk supervision, in addition to its original responsibilities for Hong Kong's participation in international forums, translating new international standards into local practice and monitoring systemic risks
- the BSD focusing on prudential supervision.

Corporate Functions

Staffing

The establishment of the HKMA at the beginning of 2010 was 711. During the year, the workload arising from the investigation of complaints about the sale by banks of investment products related to Lehman Brothers continued to be shouldered by about 180 people, mostly temporary staff hired on contract. To build a core team of experienced permanent staff for enforcement and to handle banking complaints, 30 temporary positions were converted to permanent posts in October. At the end of 2010, the establishment of the HKMA was 741.

The aftermath of the global financial crisis and the new challenges posed by the exceptionally low interest rate environment and unprecedented fund flows created considerable strains within the HKMA to meet new and increased demands on various fronts. Additional resources were necessary to implement several major initiatives to address potential risk areas and capture the limited window of opportunity to enhance Hong Kong's status as a premier financial hub. While efforts had been made to cope using existing and temporary resources as much as possible, 34 new posts were needed. They were created in January 2011 to enable the effective discharge of essential functions, bringing the total establishment to 775 (an increase of 4.6%). The new posts will be deployed in a number of key areas:

- (a) **Enhancing macroeconomic and market surveillance** – While the Hong Kong banking sector has remained largely unscathed during the global financial crisis, a high level of vigilance is required to guard against future risks. Different departments will increase cross-sector surveillance, macro-prudential analysis and global market monitoring.
- (b) **Enhancing investor protection** – In the light of more diverse investment products being distributed by banks to customers with varied background, new posts are deployed to
- establish a dedicated investor protection team to supervise Als' sale of securities products
 - enhance supervisory work on other consumer issues, including Als' compliance with the Code of Banking Practice, monitoring international trends in consumer affairs, introducing additional regulatory requirements, and monitoring compliance and incident handling
- establish a new team for on-site examinations of Als' compliance with the representation and disclosure requirements for the enhanced DPS, which came into effect on 1 January 2011.
- (c) **Enhancing supervisory capability in response to the expansion of Mainland operations by Hong Kong banks, and ensuring the development and safety of Hong Kong as a major cross-border financial services hub in Asia** – The rapid increase in the number of local Als having operations on the Mainland and the growing size of Mainland assets of local Als have called for enhanced supervisory arrangements. Resources will be deployed for expanding the scope of thematic examinations of Als to cover risk management and stress testing, and for improving on-site examinations on prevention of money laundering.
- (d) **Promoting Hong Kong as a leading financial services hub** – Additional support will be provided for the work of the Treasury Markets Association and the further development of the treasury markets in Hong Kong.
- (e) **Exploring and developing opportunities to improve returns and diversify risks in managing the Exchange Fund** – Manpower will be deployed to help execute investments in renminbi-denominated assets, such as those under the Qualified Foreign Institutional Investors scheme and the Mainland's interbank bond investment programme.
- (f) **Enhancing internal control and risk management** – In addition to expanding internal audit coverage, more resources will be devoted to upgrading credit risk control for the Exchange Fund. A pricing unit will be established to oversee the setting and applying of prices for revaluating the Fund's investment holdings, and to provide more robust business continuity support.
- (g) **Strengthening professional and support functions** – With a range of new and expanded activities, additional professional and support resources are required in various offices, including legal, accounting and administration.

Table 1 gives a breakdown of the establishment and strength of the HKMA.

Table 1 Establishment and strength of the HKMA on 1 January 2011

Department	Functions	Senior staff		Others	
		Establishment	Strength*	Establishment	Strength*
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	8	8
Banking Conduct	To focus on payment systems oversight, licensing, deposit protection and settlement, and all supervisory and development functions relating to the business conduct of authorized institutions.	1	1	97	78
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	47	45
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	147	139
Enforcement	To focus on securities enforcement and complaint handling functions.	–	1	50	41
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through participation in the international central banking and financial community.	1	1	50	49
Financial Infrastructure	To develop and enhance the financial market infrastructure important for maintaining and strengthening Hong Kong as an international financial centre.	1	1	25	28
Monetary Management	To maintain currency stability through monitoring of market operations and development issues, and to ensure adequate supply of banknotes and coins.	1	1	34	33
Research	To conduct research and analysis on economic and international financial market developments in Hong Kong and other economies.	1	1	36	34
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	81	73
Office of the General Counsel	To provide in-house legal support and advice.	1	1	20	18
Corporate Services	To provide support services in the form of administrative, finance, HR, IT and secretariat services, and to handle media and community relations.	1	1	157	148
Internal Audit	To provide audit services through assisting management in controlling risks, monitoring compliance and improving the efficiency of internal control systems and procedures.	–	–	9	8
Total		14	15	761	702

* Inclusive of permanent staff deployed on positions under project votes.

Corporate Functions

Temporary resources will also be deployed to meet a number of other work demands, including

- formulating a strategy and marketing plan to promote the further development of Hong Kong as an international financial centre
- maintaining a constructive presence of Hong Kong in international forums, and establishing a banking policy “research and development” team to monitor policy development in various areas, collate and analyse policy options, and support structured policy formulation
- strengthening Hong Kong’s financial market infrastructure to enhance transparency and reducing systemic risks pursuant to the recommendations of the Group of Twenty and the Financial Stability Board
- enhancing the supervision of Als’ insurance intermediary and Mandatory Provident Fund businesses pending development of the proposed reform of their regulatory regime.

The HKMA second staff to other international or local organisations, such as the International Monetary Fund and the Hong Kong Interbank Clearing Limited to help co-ordinate activities or policy initiatives in which Hong Kong or the HKMA has an interest. Staff are also redeployed full-time or part-time to provide operational support to the Hong Kong Deposit Protection Board and the Treasury Markets Association.

Remuneration policies and pay review mechanism

The Financial Secretary determines the pay and conditions of service for HKMA staff on the advice of EFAC and its Governance Sub-Committee (GSC) taking into account the prevailing market rates and practices. The HKMA remuneration comprises a total cash package and a Provident Fund Scheme, with minimal benefits in kind. The cash package consists of two elements: Fixed Pay, which is payable monthly, and Variable Pay, which may be awarded to individual staff members as a lump sum once a year depending on performance.

Pay for HKMA staff is reviewed annually by the Financial Secretary in the light of recommendations made to him by the GSC through EFAC, taking into account the findings of independent consultants on pay trends and pay levels in the financial sector, the GSC’s assessment of the performance of the HKMA during the preceding year, and other appropriate factors. The performance of individual staff is considered in distributing any approved overall pay awards.

Remuneration of senior staff

The remuneration packages of the senior staff in 2010 are shown in Table 2.

Table 2 Remuneration packages of HKMA senior staff in 2010¹

\$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff ²	1	4	13
Annualised pay			
Fixed pay	6,000	4,969	3,124
Variable pay	1,500	1,324	600
Other benefits ³	868	440	302

Notes:

- 1 Except for annual leave accrued, the actual remuneration received by staff during 2010 but not serving a full year is annualised for the purpose of calculating the average annual package for the rank.
- 2 The number of staff in this table at the Deputy Chief Executive and Executive Director ranks reflects staff movements during the year and includes, among the Executive Directors, the Chief Executive Officer of the Hong Kong Mortgage Corporation.
- 3 Other benefits include provident funds, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.

Training and development

The HKMA emphasises the training and development of staff, and during the year 2,799 training days were provided, compared with 2,772 in 2009. These included 1,007 days of horizontal training in general skills and 1,792 days of vertical training in job-specific issues. Each staff member received an average of 4.1 days of training.

As part of the horizontal training programme, courses on central banking and the work of the HKMA were organised for new staff. A course on English writing skills was conducted for Assistant Managers, and training sessions on PC skills were organised for staff from various ranks. Putonghua classes were provided according to staff operational needs. Workshops on communications and media training were conducted for staff in the Communications Unit, while managerial staff attended workshops on coaching, conflict management, team-building, decision-making, interviewing skills, performance management and staff communication. Training sessions attended by senior staff included a central banking course in New York organised by the Federal Reserve Bank of New York, an advanced national studies course arranged for Hong Kong senior government officials conducted by the Chinese Academy of Governance in Beijing, and a seminar on global financial issues organised by the Salzburg Global Seminar.

Other training courses were organised throughout the year to cover the latest developments on specific topics of interest for staff in the banking departments, including updates on renminbi business, the enhanced DPS, a sound remuneration system, trade financing, supervision of securities business and complaints handling.

In addition to formal training, briefings were conducted by senior executives to keep staff informed on a range of topics about the HKMA's work.

The HKMA runs a Training Sponsorship Scheme for the pursuit by staff of degree or diploma studies, professional qualifications or other short courses relevant to the work of the HKMA. Partial reimbursement of membership dues of relevant professional bodies is also provided.

FINANCE

Annual budget

In drawing up the annual budget, the HKMA takes into account both its continuing operations and its strategic development set out in a three-year plan approved by the Financial Secretary on the advice of EFAC. In the budget process, departments are required to assess their needs for the coming year and to consider where savings in staffing and expenditure can be achieved. This requires departments to critically assess each year the value of existing services and the cost-effectiveness of different methods of delivering them. The Finance Division scrutinises all budget requests and discusses them with individual departments before submitting a consolidated draft budget for scrutiny by senior management. The GSC of EFAC then deliberates on the budget and recommends any changes it believes are necessary, before putting it through EFAC to the Financial Secretary for approval.

After the budget is approved, all expenditure is subject to stringent financial controls through procurement rules and guidelines. Compliance with these guidelines and procedures is subject to internal audit and is reviewed by independent auditors during the annual audit of the Exchange Fund. Expenses are analysed and reported to senior management every month.

Corporate Functions

The administrative expenditure in 2010 and the budgeted expenditure for core activities in 2011 are shown in Table 3. The difference between the 2010 actual expenditure and the 2011 budget arises mainly from an increase in staff costs, reflecting the full-year effect of staff increases in 2010 and the increase of 34 posts approved for 2011 by the Financial Secretary on the advice of EFAC.

In 2010, expenditure relating to the handling of complaints about banking services, mostly for hiring external professional staff and renting the necessary office accommodation, amounted to \$119 million. With the progressive completion of outstanding complaints, operational expenditure in 2011 is projected to be \$125 million, mostly for the continued employment of contract staff and related operational support. This expenditure will be limited to the period necessary for completion of outstanding investigations. This budget is shown separately in Table 4.

Expenses related to premises for international organisations, whose presence in Hong Kong reflects its status as an international financial centre, are expected to remain stable in 2011. Expenditure continued in 2010 on the programme to upgrade Hong Kong's financial infrastructure, including the migration of the Real Time Gross Settlement systems and the Central Moneymarkets Unit to the SWIFTNet platform. Spending on financial infrastructure is not related to the HKMA's own operations, but to providing and expanding payment and other systems to enable markets to function efficiently. These expenses are shown in Table 5. The HKMA also provides operational support to the Hong Kong Deposit Protection Board in the areas of investment, accounting and settlement on a cost-recovery basis as endorsed by the Financial Secretary according to section 6 of the DPS Ordinance.

In addition to investment income from managing the Exchange Fund, the HKMA earns revenue mainly through licence fees paid by AIs, and custodian and transaction fees from users of the Central Moneymarkets Unit. The HKMA also received reimbursement from the Hong Kong Deposit Protection Board for providing operational support to the Board according to section 6 of the DPS Ordinance. In 2011, licence fees are estimated at \$131 million (\$134 million in 2010) and the other income components (excluding investment income) at \$67 million (\$56 million in 2010).

Financial disclosure

The HKMA adopts best practices in financial disclosure as far as these are consistent with central banking operations. These standards include the reporting requirements laid down by the International Monetary Fund's Special Data Dissemination Standard. In the absence of specific reporting requirements applying to central banking institutions, the HKMA adopts the disclosure requirements applicable to commercial entities as far as possible to achieve a high level of transparency. Working with the external auditor and other accounting professionals, the Finance Division prepares and presents the group financial statements in accordance with the Hong Kong Financial Reporting Standards applicable to central banking operations. The *HKMA Annual Report* compares favourably with those of other central banking institutions and monetary authorities: it contains detailed disclosure and thorough analyses of a wide range of expense items and budgetary information.

Table 3 Administrative expenditure (2010 and 2011 budgeted)

\$ million	2010 Budget*	2010 Actual	2011 Budget*
Staff costs	698		802
Salaries and other staff costs		611	
Retirement benefit costs		51	
Premises expenses			
Operating lease charges	8	8	9
Other premises expenses (including utility charges and management fees)	40	37	39
General operating costs			
Maintenance of office and computer equipment	41	38	45
Financial information and communication services (including trading, dealing terminals and data link charges)	41	35	43
External relations (including international meetings)	30	23	46
Professional and other services	25	17	28
Training	9	6	9
Others	6	5	6
Total HKMA administrative expenditure	898	831	1,027

* Includes supplementary budget and relevant provisions in project budgets for the year.

Table 4 Expenses related to investigation of complaints about banking services (2010 and 2011 budgeted)

\$ million	2010 Budget	2010 Actual	2011 Budget
Handling of complaints about banking services			
Staff costs	95	88	84
Premises expenses	17	12	10
General operating costs			
Communication services	3	1	2
Professional and other services	31	18	26
Others	3	–	3
Total	149	119	125

Table 5 Additional expenses (2010 and 2011 budgeted)

\$ million	2010 Budget*	2010 Actual	2011 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	19	17	20
Premises expenses of international financial organisations in Hong Kong	29	29	31
Service fees for financial infrastructure	55	27	72

* Includes supplementary budget and relevant provisions in project budgets for the year.

Corporate Functions

General administration

The HKMA continued to streamline its work to improve efficiency and cost-effectiveness to cope with the increasing workload. Business continuity plans are reviewed constantly, and drills on evacuation and the activation of the backup office are held annually.

An environmental policy is in place to promote staff awareness of protecting the environment. The HKMA supports and encourages recycling, organising regular campaigns to collect unwanted clothes, toys and other reusable items from staff for donation to charities. Waste paper and used printer cartridges are also collected for recycling. As a result of staff awareness in various green office measures, the consumption of electricity per staff at the HKMA main office decreased by 3% and the total paper consumption decreased by 14% in 2010.

During 2010, HKMA staff teams participated in a number of charity fund-raising events, winning the Corporate Cup of the Sowers Action Charity Marathon and taking second place in the Bank Category of the Green Power Hike. Staff also took part in the Oxfam Trailwalker, Blood Donation Day, the Community Chest's Dress Special Day and Love Teeth Day, and the HKMA Volunteer Team gave more than 100 hours of free time to voluntary services. Team members visited the New Life Building Long Stay Care Home, provided translation services for International Volunteer Day and assisted in the training camp organised by TREATS. The HKMA procured office supplies from a workshop operated by people with physical disabilities. In recognition of its commitment to corporate citizenship, the Hong Kong Council of Social Service awarded the 5 Consecutive Years Caring Organisation Logo to the HKMA.

INFORMATION TECHNOLOGY

The IT Division maintained 100% operational uptime in 2010 for all critical systems. It also completed expansion of the computer centre at Two IFC as part of the upgrade of the HKMA's IT infrastructure and the new application systems. In December, an annual organisation-wide business continuity drill was conducted and the recovery times of the IT systems met the required targets. To promote IT security awareness, the Division conducted an IT security quiz for staff in the summer of 2010. The Division continued to support the Hong Kong Deposit Protection Board in enhancing the payout system.

SETTLEMENT SERVICES

The Settlement Section provides settlement and operational support to ensure efficient and reliable transfers of funds or assets of the Exchange Fund arising from reserves management, monetary operations and other activities of the HKMA. In keeping with the Settlement Section's adherence to best market practices, an external consultant was engaged to review settlement operations in 2010. The review confirmed the Section provides professional settlement and operational services to support the investment and monetary operations of the Exchange Fund.

The Settlement Section is put under the Banking Conduct Department, which is separated from the monetary operations and reserves management functions of the HKMA. This arrangement achieves a segregation of duties and helps avoid potential conflicts of interest.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel (OGC) is responsible for providing legal advice to the HKMA on all aspects of its functions and activities. It comprises 13 lawyers who assist the HKMA in maintaining Hong Kong's banking and monetary stability, enhancing its financial infrastructure, maintaining its status as an international financial centre, and ensuring the effective management of the Exchange Fund.

In addition to providing legal support to the operation of each line department within the HKMA, the OGC assists in the planning and implementation of projects, initiatives and operations, most of which involve complex issues of commercial, regulatory and administrative law. Examples include

- preparation of proposed legislative amendments to the Banking (Capital) Rules and the Banking (Disclosure) Rules called for by the Basel Committee on Banking Supervision's enhancements to the Basel II framework
 - preparation of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Bill
 - implementation of the Government Bond Programme and proposed establishment of the China Bond Index Fund under the second phase of the Asian Bond Fund Programme
 - negotiation for Hong Kong's participation in the new arrangement to borrow with the International Monetary Fund and in the Note Purchase Agreement
 - continued development of the renminbi business in Hong Kong, including amending the Renminbi Clearing Agreement and Settlement Agreement as a result of the expansion in the scope of the renminbi business
 - deliberation of ways to strengthen the cross-border resolution regime for financial institutions and the Government's review of the legislative proposal on the Corporate Rescue Procedure
- implementation of the mystery shopper programme to ensure compliance with the Code of Banking Practice and enhance protection to bank customers
 - promotion of Islamic finance initiatives
 - negotiations on the formulation of global settlement agreements with the SFC and a number of distributing banks on Lehman Brothers-related and other financial products.

The OGC manages HKMA litigation matters and provides comments to government bureaux on significant legislative proposals, such as the Companies Bill and the Competition Bill. OGC's lawyers participate in the Financial Stability Board Steering and Working Groups and other meetings and conferences for central bankers, financial regulators and the banking community to keep abreast of topical developments in major international financial centres; and to discuss and resolve issues of current legal concern.

INTERNAL AUDIT

The Internal Audit Division performs independent assessments of the adequacy and effectiveness of risk management and control, and advises on opportunities for improvement. The Division reports directly to the Chief Executive of the HKMA and the Audit Sub-Committee of EFAC.

During the year it co-ordinated the annual organisation-wide risk assessment exercise and reported the results to the Risk Committee. Using a risk-based approach, operational audits and system security reviews were conducted to cover all the significant risks facing the HKMA. The Division advised on major system development projects and responded to management requests on internal-control matters, as well as advising senior executives on issues with control implications.

Corporate Functions

To keep abreast of developments in practices in the profession and other central banks, the Division attended the Heads of Audit Forum organised by the Bank of England to exchange views and experiences in risk management and audit matters. It also contributed to the Asian Chief Audit Executives Leadership Forum organised by the Asian Confederation of Institutes of Internal Auditors. In addition, professional staff attend seminars and training courses on the latest risk-management practices and audit techniques.

RISK MANAGEMENT

One of the most important tasks of the HKMA is to manage risks to the monetary and banking systems. Risk management is undertaken both at a working level in the day-to-day operations of the HKMA and at a higher level through strategic planning.

The Chief Executive chairs a high-level Risk Committee established to

- identify potential risks and threats to the organisation and the monetary and financial systems more broadly, and devise strategies to reduce the impact of these risks and threats
- review the existing systems for managing risks across different departments to identify possible gaps and significant risks, and ensure the adequacy of measures to address them
- harmonise the criteria and methods of risk management and prioritise the resource management of risks identified
- encourage a stronger risk-management culture, which promotes the proper levels of authorisation and controls.

The Committee meets regularly to review the risk assessments made by the business units and the adequacy of controls, and to identify potential or emerging risks and devise mitigating strategies.

EXTERNAL AUDITOR

In accordance with section 7 of the Exchange Fund Ordinance, the Audit Commission of the Government of the Hong Kong Special Administrative Region audits the financial statements of the Exchange Fund. The Commission does not charge for this service.

The Exchange Fund

- Report of the Director of Audit
- Exchange Fund – Income and Expenditure Account
- Exchange Fund – Statement of Comprehensive Income
- Exchange Fund – Balance Sheet
- Exchange Fund – Statement of Changes in Equity
- Exchange Fund – Statement of Cash Flows
- Exchange Fund – Notes to the Financial Statements

Report of the Director of Audit



Audit Commission
The Government of the Hong Kong Special Administrative Region

Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 120 to 201, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2010, and their income and expenditure accounts, statements of comprehensive income, statements of changes in equity and statements of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Monetary Authority's Responsibility for the Financial Statements

The Monetary Authority is responsible for the preparation of financial statements that give a true and fair view in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) and Hong Kong Financial Reporting Standards, and for such internal control as the Monetary Authority determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Monetary Authority, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Report of the Director of Audit (continued)

Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Exchange Fund and of the Group as at 31 December 2010, and of their financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Benjamin Tang
Director of Audit

29 March 2011

Audit Commission
26th Floor
Immigration Tower
7 Gloucester Road
Wanchai, Hong Kong

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
INCOME					
Interest income		20,524	22,628	19,231	21,303
Dividend income		8,433	7,181	8,614	7,379
Net realised and revaluation gains		55,871	72,810	55,547	72,777
Net exchange gains/(losses)		(3,026)	9,762	(3,074)	9,772
Investment income	4(a)	81,802	112,381	80,318	111,231
Bank licence fees		134	134	134	134
Other income		626	388	74	127
TOTAL INCOME		82,562	112,903	80,526	111,492
EXPENDITURE					
Interest expense	4(b)	(39,833)	(36,063)	(39,663)	(35,784)
Operating expenses	4(c)	(2,781)	(2,622)	(2,529)	(2,403)
Note and coin expenses	4(d)	(288)	(333)	(288)	(333)
Write back of impairment losses on loans		17	37	-	-
TOTAL EXPENDITURE		(42,885)	(38,981)	(42,480)	(38,520)
SURPLUS BEFORE SHARE OF PROFIT/(LOSS) OF ASSOCIATE AND JOINT VENTURES					
		39,677	73,922	38,046	72,972
Share of profit/(loss) of associate and joint ventures, net of tax		(154)	2	-	-
SURPLUS BEFORE TAXATION		39,523	73,924	38,046	72,972
Income tax		(178)	(150)	-	-
SURPLUS FOR THE YEAR		39,345	73,774	38,046	72,972
ATTRIBUTABLE TO:					
Owner of the Fund		39,333	73,759	38,046	72,972
Non-controlling interests		12	15	-	-
		39,345	73,774	38,046	72,972

The notes on pages 126 to 201 form part of these financial statements.

Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
SURPLUS FOR THE YEAR		39,345	73,774	38,046	72,972
OTHER COMPREHENSIVE INCOME					
Available-for-sale securities					
fair value changes taken to equity	27	1,248	973	-	-
fair value changes on disposal transferred to income and expenditure account	27	(40)	(4)	-	-
tax effect	27	(17)	(37)	-	-
Cash flow hedges					
fair value changes taken to equity	27	26	25	-	-
tax effect	27	(4)	(4)	-	-
Exchange difference on translation of financial statements of overseas subsidiaries and joint ventures	27	48	2	-	-
OTHER COMPREHENSIVE INCOME FOR THE YEAR, NET OF TAX		1,261	955	-	-
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		40,606	74,729	38,046	72,972
TOTAL COMPREHENSIVE INCOME FOR THE YEAR ATTRIBUTABLE TO:					
Owner of the Fund		40,594	74,714	38,046	72,972
Non-controlling interests		12	15	-	-
		40,606	74,729	38,046	72,972

The notes on pages 126 to 201 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2010

	Note	Group		Fund	
		2010	2009	2010	2009
(Expressed in millions of Hong Kong dollars)					
ASSETS					
Cash and money at call	6	49,579	17,736	48,911	17,658
Placements with banks and other financial institutions	7	155,455	112,732	149,478	108,636
Derivative financial instruments	8(a)	3,299	5,565	1,902	4,247
Financial assets designated at fair value	9	2,108,964	1,995,464	2,104,562	1,995,464
Available-for-sale securities	10	12,326	7,678	493	493
Held-to-maturity securities	11	8,108	5,883	–	–
Loan portfolio	12	35,259	43,789	–	–
Gold	13	732	572	732	572
Other assets	14	19,772	15,063	18,770	14,007
Investments in subsidiaries	15	–	–	16,828	4,947
Interests in associate and joint ventures	16	3,461	160	–	–
Property, plant and equipment	17(a)	3,501	3,603	3,308	3,374
TOTAL ASSETS		2,400,456	2,208,245	2,344,984	2,149,398
LIABILITIES AND EQUITY					
Certificates of Indebtedness	18	225,939	199,006	225,939	199,006
Government-issued currency notes and coins in circulation	18	8,899	8,427	8,899	8,427
Balance of the banking system	19	148,702	264,567	148,702	264,567
Derivative financial instruments	8(a)	2,473	1,031	2,429	873
Placements by banks and other financial institutions	20	23,187	28,311	23,187	28,311
Placements by Fiscal Reserves	21	592,282	504,123	592,282	504,123
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	22	76,760	41,836	76,760	41,836
Exchange Fund Bills and Notes issued	23	653,721	536,429	654,221	536,429
Other debt securities issued	24	39,100	44,459	–	–
Mortgage-backed securities issued	25	1,530	2,021	–	–
Other liabilities	26	27,919	18,753	21,062	12,369
Total liabilities		1,800,512	1,648,963	1,753,481	1,595,941
Accumulated surplus	27	597,553	558,220	591,503	553,457
Other reserves	27	2,119	858	–	–
Total equity attributable to owner of the Fund		599,672	559,078	591,503	553,457
Non-controlling interests	27	272	204	–	–
Total equity		599,944	559,282	591,503	553,457
TOTAL LIABILITIES AND EQUITY		2,400,456	2,208,245	2,344,984	2,149,398

Norman T.L. Chan

Monetary Authority
29 March 2011

The notes on pages 126 to 201 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
Attributable to owner of the Fund					
Accumulated surplus					
At 1 January		558,220	484,461	553,457	480,485
Surplus for the year	27	39,333	73,759	38,046	72,972
At 31 December		597,553	558,220	591,503	553,457
Other reserves					
Revaluation reserve					
At 1 January		865	(88)	-	-
Other comprehensive income for the year	27	1,213	953	-	-
At 31 December		2,078	865	-	-
Translation reserve					
At 1 January		(7)	(9)	-	-
Other comprehensive income for the year	27	48	2	-	-
At 31 December		41	(7)	-	-
		2,119	858	-	-
Total equity attributable to owner of the Fund at 31 December		599,672	559,078	591,503	553,457
Non-controlling interests					
At 1 January		204	191	-	-
Total comprehensive income for the year	27	12	15	-	-
Capital injection by non-controlling interests	27	67	11	-	-
Dividends paid to non-controlling interests	27	(11)	(13)	-	-
At 31 December		272	204	-	-
Total equity at 31 December		599,944	559,282	591,503	553,457

The notes on pages 126 to 201 form part of these financial statements.

Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
Cash flows from operating activities					
Surplus before share of profit/(loss) of associate and joint ventures		39,677	73,922	38,046	72,972
Adjustments for:					
Interest income	4(a)	(20,524)	(22,628)	(19,231)	(21,303)
Dividend income	4(a)	(8,433)	(7,181)	(8,614)	(7,379)
Net gains on available-for-sale securities	4(a)	(167)	(20)	-	-
Interest expense	4(b)	39,833	36,063	39,663	35,784
Depreciation	4(c)	148	140	110	106
Elimination of exchange differences and other non-cash items		(556)	(976)	(556)	(938)
Interest received		20,636	23,934	19,396	22,590
Interest paid		(39,798)	(36,063)	(39,729)	(35,811)
Dividends received		8,427	7,214	8,095	7,150
Income tax paid		(174)	(64)	-	-
		39,069	74,341	37,180	73,171
Change in fair value of derivatives and other debt securities issued		3,959	451	3,927	390
Change in placements with banks and other financial institutions		(361)	(879)	753	(931)
Change in financial assets designated at fair value		(183,361)	(592,838)	(178,959)	(592,838)
Change in loan portfolio		8,542	7,008	-	-
Change in gold		(160)	(124)	(160)	(124)
Change in other assets		(4,814)	3,181	(4,928)	2,492
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		27,405	23,074	27,405	23,074
Change in balance of the banking system		(115,865)	106,529	(115,865)	106,529
Change in placements by banks and other financial institutions		(5,124)	14,698	(5,124)	14,698
Change in placements by Fiscal Reserves		88,159	(27,247)	88,159	(27,247)
Change in placements by Hong Kong Special Administrative Region government funds and statutory bodies		34,924	41,762	34,924	41,762
Change in Exchange Fund Bills and Notes issued		117,292	373,875	117,792	373,875
Change in other liabilities		9,144	(12,874)	8,739	(13,509)
Net cash from operating activities		18,809	10,957	13,843	1,342

Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
Cash flows from investing activities					
Loans to subsidiaries		-	-	(11,881)	(2,802)
Loan repayments received from a subsidiary		-	-	-	8,000
(Increase)/Decrease in investment in joint ventures		(3,443)	2	-	-
Proceeds from sale or redemption of available-for-sale securities		4,944	1,845	-	-
Purchase of available-for-sale securities		(8,215)	(5,982)	-	-
Proceeds from redemption of held-to-maturity securities		2,152	2,817	-	-
Purchase of held-to-maturity securities		(4,375)	(2,978)	-	-
Proceeds from disposal of property, plant and equipment		3	-	-	-
Purchase of property, plant and equipment		(57)	(95)	(44)	(32)
Dividends received from subsidiaries		-	-	513	266
Net cash from/(used in) investing activities		(8,991)	(4,391)	(11,412)	5,432
Cash flows from financing activities					
Proceeds from issue of other debt securities		8,193	22,061	-	-
Redemption of other debt securities issued		(13,831)	(19,652)	-	-
Redemption of mortgage-backed securities issued		(470)	(1,172)	-	-
Capital injection by non-controlling interests		67	11	-	-
Dividends paid to non-controlling interests		(11)	(13)	-	-
Net cash from/(used in) financing activities		(6,052)	1,235	-	-
Net increase in cash and cash equivalents		3,766	7,801	2,431	6,774
Cash and cash equivalents at 1 January		208,120	199,380	204,249	196,537
Effect of foreign exchange rate changes		578	939	556	938
Cash and cash equivalents at 31 December	28	212,464	208,120	207,236	204,249

The notes on pages 126 to 201 form part of these financial statements.

Exchange Fund – Notes to the Financial Statements

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

1 PRINCIPAL ACTIVITIES

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance (Cap. 66). The principal activities of the Fund are safeguarding the exchange value of the currency of Hong Kong and maintaining the stability and integrity of Hong Kong's monetary and financial systems.

The assets of the Fund are managed as three distinct portfolios: the Backing Portfolio, the Investment Portfolio and the Strategic Portfolio. The assets of the Backing Portfolio fully match the Monetary Base, under Hong Kong's Currency Board system. The Strategic Portfolio holds shares in Hong Kong Exchanges and Clearing Limited acquired by the Hong Kong Special Administrative Region (HKSAR) Government for the account of the Fund for strategic purposes. The balance of the Fund's assets constitutes the Investment Portfolio. Operating segment information is set out in note 29.

2 SIGNIFICANT ACCOUNTING POLICIES

2.1 Statement of compliance

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs) and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), and accounting principles generally accepted in Hong Kong. A summary of the significant accounting policies adopted by the Fund and its subsidiaries (together referred to as the Group) is set out below.

The HKICPA has issued certain new and revised HKFRSs that are effective for the current accounting period. Note 3 provides information on the changes in accounting policies resulting from initial adoption of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these financial statements.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

2.2 Basis of preparation of the financial statements

The Group's financial statements include the financial statements of the Group as well as the Group's interests in an associate and joint ventures. The principal activities of the principal subsidiaries, the associate and the joint ventures are shown in notes 15 and 16.

The measurement basis used in the preparation of the financial statements is historical cost except that the following assets and liabilities are stated at their fair value as explained in the accounting policies set out below:

- trading financial instruments (note 2.5.2.1);
- financial assets and financial liabilities designated at fair value (note 2.5.2.2);
- available-for-sale securities (note 2.5.2.5); and
- gold (note 2.10).

The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and the reported amounts of assets, liabilities, income and expenditure. The estimates and associated assumptions are based on experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Note 35 contains information about the assumptions relating to fair value estimation of financial instruments. There are no critical accounting judgements involved in the application of the Group's accounting policies except for the valuation of certain financial instruments as set out in note 2.5.3.

2.3 Subsidiaries

A subsidiary is an entity controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that are presently exercisable are taken into account.

An investment in a subsidiary is consolidated into the Group financial statements from the date that control commences until the date that control ceases.

Intra-group balances and transactions together with any unrealised profits and losses arising from intra-group transactions are eliminated in full in preparing the Group financial statements.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

Non-controlling interests represent the equity in a subsidiary not attributable directly or indirectly to the Fund, and in respect of which the Group has not agreed any additional terms with the holders of those interests which would result in the Group as a whole having a contractual obligation in respect of those interests that meets the definition of a financial liability. Non-controlling interests are presented in the Group balance sheet within equity, separately from equity attributable to the owner of the Fund. Non-controlling interests in the results of the Group are presented on the face of the Group income and expenditure account and the Group statement of comprehensive income as an allocation of the surplus or deficit and total comprehensive income or loss for the year between non-controlling interests and the owner of the Fund.

In the balance sheet of the Fund, its investments in subsidiaries are stated at cost less impairment losses, if any [note 2.12].

2.4 Associate and joint ventures

An associate is an entity in which the Group has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

A joint venture is an entity which operates under a contractual arrangement between the Group and other parties, where the contractual arrangement establishes that the Group and one or more of the other parties share joint control over the economic activity of the entity.

Investment in an associate or a joint venture is accounted for in the Group financial statements under the equity method and is initially recorded at cost, adjusted for any excess of the Group's share of the acquisition-date fair values of the investee's identifiable net assets over the cost of the investment (if any). Thereafter, the investment is adjusted for the post acquisition change in the Group's share of the net assets of the associate or the joint venture and any impairment loss relating to the investment.

The Group income and expenditure account includes the Group's share of the post-tax results of the associate and the joint ventures for the year. Unrealised profits and losses resulting from transactions between the Group and its associate and joint ventures are eliminated to the extent of the Group's interests in the associate or the joint ventures.

In the balance sheet of the Fund, its investments in associate and joint ventures are stated at cost less impairment losses, if any [note 2.12].

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.5 Financial assets and financial liabilities

2.5.1 Initial recognition

The Group classifies its financial assets and financial liabilities into different categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred. The categories are: trading financial instruments, financial assets and financial liabilities designated at fair value, loans and receivables, held-to-maturity securities, available-for-sale securities and other financial liabilities.

A reconciliation of the categories of financial assets and financial liabilities to the balance sheet captions is set out in note 5.

Financial assets and financial liabilities are measured initially at fair values, which normally equal to the transaction prices plus transaction costs for loans and receivables, held-to-maturity securities, available-for-sale securities and other financial liabilities that are directly attributable to the acquisition of the financial assets or the issue of the financial liabilities. Transaction costs on trading financial instruments and financial assets and financial liabilities designated at fair value are expensed immediately.

The Group recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instrument. Purchases or sales of derivative financial instruments are recognised using trade date accounting. Purchases or sales of trading liabilities and financial assets and financial liabilities designated at fair value, which are settled within the time frame established generally by regulation or convention in the market place concerned, are also recognised using trade date accounting. Other financial assets and financial liabilities are recognised using settlement date accounting.

2.5.2 Categorisation

2.5.2.1 Trading financial instruments

The Group does not engage in active trading of financial instruments. However, derivative financial instruments that do not qualify for hedge accounting (note 2.8) and short positions in Exchange Fund Bills and Notes (EFBN) are categorised as “trading” under HKAS 39, Financial Instruments: Recognition and Measurement.

Trading financial instruments are carried at fair value. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.5.2.2 Financial assets and financial liabilities designated at fair value

Financial assets and financial liabilities designated at fair value primarily consist of:

- financial assets and financial liabilities that are managed, evaluated and reported internally on a fair value basis; and
- other debt securities issued by the Group through a subsidiary, The Hong Kong Mortgage Corporation Limited (HKMC), which contain embedded derivatives that significantly modify the cash flows that would otherwise be required under the contracts.

Financial assets and financial liabilities under this category are carried at fair value. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

2.5.2.3 Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and which the Group has no intention of trading, other than those that the Group, upon initial recognition, designates as at fair value or as available-for-sale. This category includes placements with banks and other financial institutions, cash and money at call, and the loan portfolio purchased by the Group through the HKMC.

Loans and receivables are carried at amortised cost using the effective interest method less impairment losses, if any (note 2.9).

2.5.2.4 Held-to-maturity securities

Held-to-maturity securities are non-derivative financial assets with fixed or determinable payments and fixed maturity which the Group has the positive intention and ability to hold to maturity, other than (a) those that the Group, upon initial recognition, designates as at fair value or as available-for-sale; and (b) those that meet the definition of loans and receivables.

Held-to-maturity securities are carried at amortised cost using the effective interest method less impairment losses, if any (note 2.9).

2.5.2.5 Available-for-sale securities

Available-for-sale securities are non-derivative securities that are designated as available-for-sale or are not classified in any of the other categories above. They include securities intended to be held for an indefinite period of time, but which may be sold in response to needs for liquidity or changes in the market environment.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Available-for-sale securities are carried at fair value. Unrealised gains and losses arising from changes in the fair value are recognised in other comprehensive income and accumulated separately in the revaluation reserve, except for impairment losses, if any (note 2.9). Foreign exchange gains and losses on monetary items are recognised in the income and expenditure account.

The investment by the Fund in shares of the Bank for International Settlements is held in order to participate in it on a long-term basis. As these shares do not have a quoted market price in an active market and the fair value cannot be reliably measured, they are carried at cost less impairment losses, if any (note 2.9).

When available-for-sale securities are sold, gains or losses on disposal include the difference between the net sale proceeds and the carrying amount, and the accumulated fair value adjustments which are released from equity to the income and expenditure account.

2.5.2.6 Other financial liabilities

Other financial liabilities are financial liabilities other than trading liabilities and those designated at fair value. Certificates of Indebtedness and government-issued currency notes and coins in circulation (note 2.5.2.7), the balance of the banking system, placements by Fiscal Reserves and placements by HKSAR government funds and statutory bodies are stated at the principal amount payable.

Other financial liabilities with a fixed maturity and a predetermined rate are carried at amortised cost using the effective interest method. These include placements by banks and other financial institutions and other debt securities (other than those which contain embedded derivatives) issued by the Group through the HKMC.

2.5.2.7 Certificates of Indebtedness and government-issued currency notes and coins in circulation

As backing for the banknote issues, each note-issuing bank is required to hold a non-interest-bearing Certificate of Indebtedness issued by the Financial Secretary, which is redeemable on demand. Payments for the issue and redemption of banknotes against these Certificates are made in US dollars at the fixed exchange rate of US\$1 = HK\$7.80. Consistent with the requirement for backing banknote issues with US dollars, the issue and redemption of government-issued currency notes and coins are conducted with an agent bank against US dollars at the fixed exchange rate of US\$1 = HK\$7.80.

The Group's liabilities in respect of Certificates of Indebtedness represent the US dollars payable to the note-issuing banks on redemption of the Certificates. The Group's liabilities in respect of government-issued currency notes and coins represent the US dollars payable to the agent bank when they are redeemed. Certificates of Indebtedness in issue and government-issued currency notes and coins in circulation are stated in the financial statements at the Hong Kong dollars equivalent of the US dollars required for their redemption at the closing exchange rate at the balance sheet date.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.5.3 Fair value measurement principles

The fair value of financial instruments is based on their quoted market prices at the balance sheet date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices.

If there is no publicly available latest traded price nor a quoted market price on a recognised stock exchange or a price from a broker/dealer for non-exchange-traded financial instruments, or if the market for it is not active, the fair value of that financial asset or financial liability is estimated using valuation techniques that provide a reliable estimate of prices which could be obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market rate at the balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date.

The Group's investments in unlisted investment funds and unlisted equity securities, except for the holding of unlisted shares in the Bank for International Settlements (note 10), are stated at fair value by making reference to valuation reports provided by investment managers. These fair values approximate the net asset values of the investments. The net asset values of the investments are computed based on valuation methods and techniques generally recognised within the industry. The Group regularly assesses the appropriateness of assumptions, methods and techniques applied by the investment managers for determining the most suitable and consistent model for valuation.

2.5.4 Derecognition

A financial asset is derecognised when the contractual rights to receive the cash flows from the financial asset expire, or where the financial asset together with substantially all the risks and rewards of ownership have been transferred.

The Group uses the weighted average method to determine realised gains and losses to be recognised in the income and expenditure account on derecognition.

A financial liability is derecognised when the obligation specified in the contract is discharged, is cancelled or expires.

Liabilities for EFBN in issue are derecognised when they are repurchased as a result of market making activities. The repurchase is considered a redemption of the debt.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

2.5.5 Offsetting

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet where there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the assets and settle the liabilities simultaneously.

2.5.6 Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that includes both the derivative and a host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An embedded derivative is separated from the host contract and accounted for as a derivative when (a) the economic characteristics and risks of the embedded derivative are not closely related to the host contract; and (b) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the income and expenditure account.

Where the embedded derivative is separated, the host contract is accounted for according to its category (note 2.5.2).

2.6 Repurchase and reverse repurchase transactions

Securities sold subject to a simultaneous agreement to repurchase these securities at a certain later date at a fixed price (repurchase agreements) are retained on the balance sheet and measured in accordance with the measurement principles as stated in note 2.5.2.2. The proceeds from the sale are reported as liabilities in “placements by banks and other financial institutions” and are carried at amortised cost.

Conversely, securities purchased under agreements to resell (reverse repurchase agreements) are reported not as purchases of the securities, but as receivables in “placements with banks and other financial institutions” and are carried in the balance sheet at amortised cost.

Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements are recognised as interest income and interest expense respectively, over the life of each agreement using the effective interest method.

2.7 Securities lending agreements

Where securities are loaned with the receipt of cash or securities as collateral, they are retained on the balance sheet and measured in accordance with the measurement principles as stated in note 2.5.2.2. Where cash collateral is received, a liability is recorded in respect of the cash received in “placements by banks and other financial institutions”. Securities received as collateral are not recognised in the financial statements.

Exchange Fund – Notes to the Financial Statements *(continued)*

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

2.8 Hedging

Hedge accounting recognises the offsetting effects on income and expenditure of changes in the fair values of the hedging instrument and the hedged item.

The Group documents, at the inception of the transaction, the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

2.8.1 Fair value hedge

A fair value hedge seeks to offset risks of changes in the fair value of a recognised asset or liability that will give rise to a gain or loss being recognised in the income and expenditure account.

Derivatives that are designated and qualified as fair value hedges are measured at fair value, with fair value changes recognised in the income and expenditure account, together with any changes in the fair value of the hedged item attributable to the risk being hedged.

When (a) a hedging instrument expires or is sold, terminated or exercised; (b) a hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes designation of the hedge relationship, any adjustment to the carrying amount of a hedged item for which the effective interest method is used, is amortised to the income and expenditure account over the period to maturity.

2.8.2 Cash flow hedge

Where a derivative is designated as a hedge of the variability in cash flows of a recognised asset or liability or a highly probable forecast transaction, the effective portion of any gain or loss from remeasurement of the derivative to fair value is recognised in other comprehensive income and accumulated separately in equity. The ineffective portion of any gain or loss is recognised immediately in the income and expenditure account.

Amounts previously recognised in other comprehensive income and accumulated in equity are recycled to the income and expenditure account in the periods in which the hedged item will affect the income and expenditure account.

When (a) a hedging instrument expires or is sold, terminated or exercised; (b) a hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes designation of the hedge relationship, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income and expenditure account. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was recognised in equity is immediately transferred to the income and expenditure account.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.9 Impairment of financial assets

The carrying amounts of loans and receivables, held-to-maturity securities and available-for-sale securities are reviewed at each balance sheet date to determine whether there is objective evidence of impairment.

For loans and receivables and held-to-maturity securities, if any such evidence exists, an impairment loss is recognised in the income and expenditure account as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If in a subsequent period the amount of such impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income and expenditure account. A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years.

For available-for-sale securities carried at fair value, the cumulative loss – measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that financial asset previously recognised in the income and expenditure account – is removed from equity and recognised in the income and expenditure account. Impairment losses for debt securities are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses in such circumstances are recognised in the income and expenditure account. Impairment losses for equity securities are not reversed through the income and expenditure account. Any subsequent increase in the fair value of such assets is recognised in other comprehensive income.

For available-for-sale equity securities carried at cost, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar instrument. Such impairment losses are not reversed.

2.10 Gold

Gold is carried at market value. Changes in the market value of gold are included in the income and expenditure account in the period in which they arise.

2.11 Property, plant and equipment

The following items of property, plant and equipment are stated in the balance sheet at cost less accumulated depreciation and any impairment losses (note 2.12):

- a building held for own use situated on freehold land;
- land classified as held under a finance lease and building held for own use situated thereon;
- plant and equipment, including plant, machinery, furniture, fixtures, equipment, motor vehicles and personal computers; and
- computer software licences and system development costs.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Depreciation is calculated to write off the cost of items of property, plant and equipment, less their estimated residual value, if any, on a straight-line basis over their estimated useful lives as follows:

- freehold land not depreciated
- leasehold land classified as held under a finance lease depreciated over the unexpired term of lease
- building situated on freehold land 39 years
- buildings situated on leasehold land depreciated over the shorter of the unexpired term of lease and their estimated useful lives
- plant and equipment 2 to 15 years
- computer software licences and system development costs 3 to 5 years

Gain or loss arising from the disposal of an item of property, plant and equipment is determined as the difference between the net disposal proceeds and the carrying amount of the asset and is recognised in the income and expenditure account on the date of disposal.

2.12 Impairment of other assets

The carrying amounts of other assets, including investments in subsidiaries, investments in associate and joint ventures, and property, plant and equipment, are reviewed at each balance sheet date to identify any indication of impairment.

If any such indication exists, an impairment loss is recognised in the income and expenditure account whenever the carrying amount of an asset exceeds its recoverable amount. The recoverable amount of an asset is the greater of its fair value less costs to sell and value in use.

2.13 Cash and cash equivalents

Cash and cash equivalents comprise cash and money at call, placements with banks and other financial institutions and short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant risk of changes in value, having been within three months of maturity when placed or acquired.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.14 Revenue and expenditure recognition

2.14.1 Interest income and expense

Interest on the majority of the placements by Fiscal Reserves, placements by HKSAR government funds and statutory bodies is payable at a fixed rate determined annually (notes 21 and 22). Interest on these placements is recognised daily in the income and expenditure account on an accrual basis, using the effective interest method.

Interest income and expense for all other interest-bearing financial assets and financial liabilities is recognised in the income and expenditure account on an accrual basis, using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

2.14.2 Net realised and revaluation gains/(losses)

Realised gains or losses on financial instruments are recognised in the income and expenditure account when the financial instruments are derecognised.

Changes in fair value of trading financial instruments and financial assets and financial liabilities designated at fair value are recognised as revaluation gains or losses in the income and expenditure account in the period in which they arise.

2.14.3 Dividend and other income

Dividend income from listed equity securities is recognised in the income and expenditure account when the share price is quoted ex-dividend. Dividend income from unlisted equity securities is recognised when the shareholder's right to receive payment is established.

Bank licence fees are fees receivable from authorized institutions under the Banking Ordinance (Cap. 155) and are accounted for in the period when the fees become receivable.

Other income includes rental income, income from the sale of withdrawn coins, Central Moneymarkets Unit fee income and net insurance premiums earned from mortgage insurance business of the HKMC. Rental income is recognised on a straight-line basis over the lease term. Other income is accounted for in the period when it becomes receivable.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.14.4 Contributions to staff retirement schemes

The Group operates several defined contribution schemes, including the Mandatory Provident Fund Scheme. Under these schemes, contributions payable each year are charged to the income and expenditure account. The assets of the staff retirement schemes are held separately from those of the Group.

2.14.5 Rental payments under operating leases

Leases where substantially all the rewards and risks of ownership remain with the leasing company are classified as operating leases. Rental payments made under operating leases are charged to the income and expenditure account on a straight-line basis over the period of the relevant leases.

2.14.6 Income tax

Income tax payable on profits of subsidiaries is recognised as an expense in the period in which profits arise.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the assets can be utilised. Deferred tax liabilities are provided in full.

2.15 Foreign currency translation

The financial statements are presented in Hong Kong dollars, which is the Fund's functional currency.

Foreign currency transactions during the year are translated into Hong Kong dollars using the spot exchange rates at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars using the closing exchange rate at the balance sheet date.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into Hong Kong dollars using the spot exchange rates at the transaction dates. Non-monetary assets and liabilities that are measured at fair value in a foreign currency are translated into Hong Kong dollars using the closing exchange rates at the dates when the fair value is determined.

All foreign currency translation differences are presented in aggregate as "net exchange gains/(losses)" in the income and expenditure account. Although it is not practicable to disclose separately the net exchange gains/(losses) on financial assets and financial liabilities designated at fair value or on trading financial instruments, the majority of the exchange gains/(losses) relate to these two categories of financial instruments.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.16 Related parties

For the purposes of these financial statements, a party is considered to be related to the Group if:

- (a) the party has the ability, directly or indirectly, to control the Group or exercise significant influence over the Group in making financial and operating policy decisions, or has joint control over the Group;
- (b) the Group and the party are subject to common control;
- (c) the party is an associate of the Group or a joint venture in which the Group is a venturer;
- (d) the party is a member of key management personnel of the Group, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;
- (e) the party is a close family member of a party referred to in (a) or is an entity under the control, joint control or significant influence of such individuals; or
- (f) the party is a post-employment benefit plan which is for the benefit of employees of the Group or of any entity that is a related party of the Group.

Close family members of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity.

2.17 Operating segments

Operating segments are reported in a manner consistent with the internal management reports provided to the chief operating decision maker. The Group comprises the following operating segments:

- management of funds under the Currency Board Operations, including the Backing Portfolio;
- management of funds representing the general reserve assets of the Fund, including the Investment Portfolio and the Strategic Portfolio; and
- maintaining the stability and integrity of monetary and financial systems of Hong Kong, which includes banking supervision and monetary management, and the activities of the Hong Kong Mortgage Corporation Limited and the Hong Kong Note Printing Limited.

Details of the operating segments of the Group are set out in note 29.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

3 CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued certain new and revised HKFRSs that are effective for the current accounting period. There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments. However, as a result of adopting Amendment to HKAS 17, Leases, there are changes to the classification of a leasehold land interest in the financial statements.

The Group has not applied any new standard that is not yet effective for the current accounting period (note 37).

3.1 HKAS 27 (Revised), Consolidated and Separate Financial Statements

The revised standard requires the effects of all equity transactions with non-controlling interests to be recorded in equity if control is retained and these transactions will not result in goodwill or gains or losses. The standard also specifies the accounting when control is lost. Any remaining interest in the entity is re-measured at fair value, and a gain or loss is recognised in income and expenditure account. HKAS 27 (Revised) does not have any impact on the financial statements as there were no equity transactions related to non-controlling interests.

3.2 Amendment to HKAS 39, Financial Instruments: Recognition and Measurement – Cash Flow Hedge Accounting

The amendment, which is part of the improvement to HKFRSs (2009), clarifies that gains or losses should be reclassified from equity to income and expenditure account in the period in which the hedged forecast cash flow affects investment income. There is no material impact to the financial statements of the Group as a result of this amendment.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

3.3 Amendment to HKAS 17, Leases – Classification of Leases of Land and Buildings

The amendment, which is part of the improvement to HKFRSs (2009), removes the requirement that interests in leasehold land should be classified as an operating lease unless the lessee acquires legal title at the end of the lease. The amendment requires the classification of leasehold land to be based on the general principles set out in HKAS 17, that are based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

As a result of this amendment, the Group has re-evaluated the classification of its interest in leasehold land as to whether in the Group's judgement, the lease transfer significantly all the risks and rewards of ownership of the land such that the Group is in a position economically similar to that of a purchaser. The Group has concluded that its interest in leasehold land, which is registered and located in the Hong Kong Special Administrative Region, should no longer be classified as operating leases. Instead, such interests of leasehold land should be reclassified as finance leases. As a result, split of the land and buildings elements is no longer necessary as both of them are under finance lease. Operating land lease prepayment of the Group and the Fund has been reclassified to property, plant and equipment (note 17) and amortisation of the land element has been reclassified to depreciation retrospectively.

The adjustments that have been made in accordance with the amendment to each of the line items in the balance sheet as previously reported as at 1 January 2009 and 31 December 2009 are set out below. Such reclassification had no impact on the income and expenditure account.

The presentation of "Property, plant and equipment" (note 17(a)) has been changed to include computer software licences and system development costs which were shown as "Intangible assets" in the 2009 balance sheet.

3.3.1 Effect on the balance sheet as at 1 January 2009

	Group			Fund		
	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)
ASSETS						
Property, plant and equipment	786	2,849	3,635	584	2,849	3,433
Operating land lease prepayment	2,849	(2,849)	-	2,849	(2,849)	-
	3,635	-	3,635	3,433	-	3,433
Intangible assets	15	-	15	15	-	15
	3,650	-	3,650	3,448	-	3,448

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

3.3.2 Effect on the balance sheet as at 31 December 2009 and 1 January 2010

	Group			Fund		
	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)
ASSETS						
Property, plant and equipment	812	2,775	3,587	583	2,775	3,358
Operating land lease prepayment	2,775	(2,775)	-	2,775	(2,775)	-
	3,587	-	3,587	3,358	-	3,358
Intangible assets	16	-	16	16	-	16
	3,603	-	3,603	3,374	-	3,374

4 INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2010	2009	2010	2009
Interest income:				
– from derivative financial instruments	395	293	395	293
– from financial assets designated at fair value	18,581	20,637	18,454	20,637
– from other financial assets	1,548	1,698	382	373
	20,524	22,628	19,231	21,303
Dividend income:				
– from financial assets designated at fair value	8,067	7,102	8,067	7,102
– from other financial assets	366	79	35	14
– from subsidiaries	-	-	512	263
	8,433	7,181	8,614	7,379
Net realised and revaluation gains:				
– on derivative financial instruments	777	5,390	578	6,204
– on financial assets and financial liabilities designated at fair value	54,927	67,400	54,969	66,573
– on disposal of available-for-sale securities	167	20	-	-
	55,871	72,810	55,547	72,777
Net exchange gains/(losses)	(3,026)	9,762	(3,074)	9,772
TOTAL	81,802	112,381	80,318	111,231

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Interest expense

	Group		Fund	
	2010	2009	2010	2009
Interest expense on derivative financial instruments	194	94	194	94
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value and trading liabilities	1,984	1,166	1,817	940
Interest expense on other financial liabilities	37,655	34,803	37,652	34,750
TOTAL	39,833	36,063	39,663	35,784
Comprises:				
Interest on placements by Fiscal Reserves:				
– at a fixed rate determined annually	33,765	33,486	33,765	33,486
– at market-based rates	1	1	1	1
Interest on placements by HKSAR government funds and statutory bodies:				
– at a fixed rate determined annually	3,863	1,245	3,863	1,245
Interest on Exchange Fund Bills and Notes issued	1,814	940	1,815	940
Other interest expense	390	391	219	112
	39,833	36,063	39,663	35,784

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(c) Operating expenses

	Group		Fund	
	2010	2009	2010	2009
Staff costs				
Salaries and other staff costs	843	785	697	645
Retirement benefit costs	61	57	53	50
Premises and equipment expenses				
Depreciation	148	140	110	106
Rental expenses under operating leases	44	37	42	36
Other premises expenses	53	51	44	42
General operating costs				
Maintenance of office and computer equipment	45	46	38	39
Financial information and communication services	41	39	36	34
External relations	25	19	23	17
Service fees for financial infrastructure	27	40	27	40
Other professional services	54	58	35	45
Training	6	6	6	5
Others	23	18	22	21
Investment management and custodian fees				
Management and custodian fees	789	688	777	688
Transaction costs	178	239	175	236
Withholding tax	427	382	427	382
Others	17	17	17	17
TOTAL	2,781	2,622	2,529	2,403

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

The aggregate emoluments of senior staff (Executive Directors and above) of the Group were as follows:

	Group	
	2010	2009
Fixed pay	57.2	58.3
Variable pay	10.3	14.5
Other benefits	5.7	6.8
	73.2	79.6

Other benefits shown above included provident funds, medical and life insurance, gratuity and annual leave accrued during the year. There were no other allowances or benefits-in-kind.

The numbers of senior staff (Executive Directors and above) of the Group whose emoluments fell within the following bands were:

HK\$	Group	
	2010	2009
500,000 or below	1	–
1,000,001 to 1,500,000	–	1
1,500,001 to 2,000,000	1	1
2,000,001 to 2,500,000	3	–
3,000,001 to 3,500,000	2	2
3,500,001 to 4,000,000	1	3
4,000,001 to 4,500,000	4	5
4,500,001 to 5,000,000	1	–
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	1	–
6,500,001 to 7,000,000	2	1
7,000,001 to 7,500,000	–	1
7,500,001 to 8,000,000	1	1
10,000,001 to 10,500,000	–	1
	18	17

(d) Note and coin expenses

These represent reimbursements to the note-issuing banks in respect of note-issuing expenses and expenses incurred directly by the Fund in issuing government-issued currency notes and coins.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

	Note	Total	Group – 2010					
			Trading financial instruments and hedging instruments	Financial assets and liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	49,579	-	-	49,579	-	-	-
Placements with banks and other financial institutions	7	155,455	-	-	155,455	-	-	-
Derivative financial instruments	8(a)	3,299	3,299	-	-	-	-	-
Financial assets designated at fair value	9	2,108,964	-	2,108,964	-	-	-	-
Available-for-sale securities	10	12,326	-	-	-	-	12,326	-
Held-to-maturity securities	11	8,108	-	-	-	8,108	-	-
Loan portfolio	12	35,259	-	-	35,259	-	-	-
Other assets	14	19,772	-	-	19,772	-	-	-
FINANCIAL ASSETS		2,392,762	3,299	2,108,964	260,065	8,108	12,326	-
Certificates of Indebtedness	18	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	18	8,899	-	-	-	-	-	8,899
Balance of the banking system	19	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,473	2,473	-	-	-	-	-
Placements by banks and other financial institutions	20	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	21	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	22	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	23	653,721	-	653,721	-	-	-	-
Other debt securities issued	24	39,100	-	1,937	-	-	-	37,163
Mortgage-backed securities issued	25	1,530	-	-	-	-	-	1,530
Other liabilities	26	27,919	-	-	-	-	-	27,919
FINANCIAL LIABILITIES		1,800,512	2,473	655,658	-	-	-	1,142,381

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Note	Total	Group – 2009					
			Trading financial instruments and hedging instruments	Financial assets and financial liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	17,736	-	-	17,736	-	-	-
Placements with banks and other financial institutions	7	112,732	-	-	112,732	-	-	-
Derivative financial instruments	8(a)	5,565	5,565	-	-	-	-	-
Financial assets designated at fair value	9	1,995,464	-	1,995,464	-	-	-	-
Available-for-sale securities	10	7,678	-	-	-	-	7,678	-
Held-to-maturity securities	11	5,883	-	-	-	5,883	-	-
Loan portfolio	12	43,789	-	-	43,789	-	-	-
Other assets	14	15,063	-	-	15,063	-	-	-
FINANCIAL ASSETS		2,203,910	5,565	1,995,464	189,320	5,883	7,678	-
Certificates of Indebtedness	18	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	18	8,427	-	-	-	-	-	8,427
Balance of the banking system	19	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	1,031	1,031	-	-	-	-	-
Placements by banks and other financial institutions	20	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	21	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	22	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	23	536,429	-	536,429	-	-	-	-
Other debt securities issued	24	44,459	-	2,846	-	-	-	41,613
Mortgage-backed securities issued	25	2,021	-	-	-	-	-	2,021
Other liabilities	26	18,753	-	-	-	-	-	18,753
FINANCIAL LIABILITIES		1,648,963	1,031	539,275	-	-	-	1,108,657

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

	Note	Fund – 2010						
		Total	Trading financial instruments	Financial assets and liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	48,911	-	-	48,911	-	-	-
Placements with banks and other financial institutions	7	149,478	-	-	149,478	-	-	-
Derivative financial instruments	8(a)	1,902	1,902	-	-	-	-	-
Financial assets designated at fair value	9	2,104,562	-	2,104,562	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	18,770	-	-	18,770	-	-	-
FINANCIAL ASSETS		2,324,116	1,902	2,104,562	217,159	-	493	-
Certificates of Indebtedness	18	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	18	8,899	-	-	-	-	-	8,899
Balance of the banking system	19	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,429	2,429	-	-	-	-	-
Placements by banks and other financial institutions	20	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	21	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	22	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	23	654,221	-	654,221	-	-	-	-
Other liabilities	26	21,062	-	-	-	-	-	21,062
FINANCIAL LIABILITIES		1,753,481	2,429	654,221	-	-	-	1,096,831

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Note	Total	Fund – 2009					
			Trading financial instruments	Financial assets and liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	17,658	-	-	17,658	-	-	-
Placements with banks and other financial institutions	7	108,636	-	-	108,636	-	-	-
Derivative financial instruments	8(a)	4,247	4,247	-	-	-	-	-
Financial assets designated at fair value	9	1,995,464	-	1,995,464	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	14,007	-	-	14,007	-	-	-
FINANCIAL ASSETS		2,140,505	4,247	1,995,464	140,301	-	493	-
Certificates of Indebtedness	18	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	18	8,427	-	-	-	-	-	8,427
Balance of the banking system	19	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	873	873	-	-	-	-	-
Placements by banks and other financial institutions	20	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	21	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	22	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	23	536,429	-	536,429	-	-	-	-
Other liabilities	26	12,369	-	-	-	-	-	12,369
FINANCIAL LIABILITIES		1,595,941	873	536,429	-	-	-	1,058,639

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

6 CASH AND MONEY AT CALL

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
Balance with central banks	24,212	1,339	24,212	1,339
Balance with banks	25,367	16,397	24,699	16,319
TOTAL	49,579	17,736	48,911	17,658

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
Placements in respect of reverse repurchase agreements:				
– with central banks	38,897	38,795	38,897	38,795
– with banks and other financial institutions	5,018	1,916	5,018	1,916
Other placements with banks	111,540	72,021	105,563	67,925
TOTAL	155,455	112,732	149,478	108,636

8 DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments refer to financial contracts whose value depends on the value of one or more underlying assets or indices with settlement at a future date.

The Group uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies. The principal derivative financial instruments used are interest rate and currency swap contracts, forward foreign exchange contracts, and currency and bond options contracts, which are primarily over-the-counter derivatives, as well as exchange-traded futures contracts.

Market risk arising from derivative financial instruments is included as part of the overall market risk exposure. The credit risk arising from these transactions is marked against the overall credit exposure to individual counterparties. The financial risk management approaches are outlined in note 34.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

(a) Fair values of derivative financial instruments

An analysis of the fair values of derivative financial instruments held by product type is set out below:

	Group				Fund			
	2010		2009		2010		2009	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	647	226	812	308	582	199	685	201
Interest rate futures contracts	1	-	6	-	1	-	6	-
Equity index swaps	-	8	-	-	-	8	-	-
Currency derivatives								
Forward foreign exchange contracts	1,292	1,937	3,550	483	1,279	1,929	3,550	482
Others								
Stock index futures contracts	13	279	-	161	13	279	-	161
Bond futures contracts	27	14	6	6	27	14	6	6
Bond options contracts	-	-	-	23	-	-	-	23
	1,980	2,464	4,374	981	1,902	2,429	4,247	873
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	1,029	3	1,035	3	-	-	-	-
Currency derivatives								
Currency swap contracts	290	2	134	40	-	-	-	-
	1,319	5	1,169	43	-	-	-	-
Derivatives designated as hedging instruments in cash flow hedges								
Currency derivatives								
Currency swap contracts	-	4	22	7	-	-	-	-
TOTAL	3,299	2,473	5,565	1,031	1,902	2,429	4,247	873

The fair value hedges consist of currency and interest rate swap contracts that are used to protect against changes in the fair value of certain fixed-rate securities due to movements in market interest rates.

The cash flow hedges consist of currency swap contracts that are used to hedge the currency risk arising from foreign currency loan portfolios.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Notional amounts of derivative financial instruments

An analysis of the notional amounts of derivative financial instruments held at the balance sheet date based on the remaining periods to settlement is set out below. The notional amounts of these instruments indicate the volume of outstanding transactions and do not represent the amounts at risk.

	Group									
	Notional amounts with remaining life of									
	Total	2010				Total	2009			
3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	23,650	200	5,809	9,362	8,279	63,366	3,382	11,171	39,834	8,979
Interest rate futures contracts	2,909	638	1,919	352	-	12,724	601	11,525	598	-
Equity index swaps	520	-	520	-	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	187,985	159,440	23,187	5,358	-	161,442	156,198	5,244	-	-
Others										
Stock index futures contracts	32,664	32,664	-	-	-	17,029	17,029	-	-	-
Bond futures contracts	7,818	7,818	-	-	-	5,923	5,923	-	-	-
Bond options contracts	-	-	-	-	-	3,102	3,102	-	-	-
	255,546	200,760	31,435	15,072	8,279	263,586	186,235	27,940	40,432	8,979
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	27,331	3,868	7,695	11,493	4,275	31,373	2,968	5,724	18,406	4,275
Currency derivatives										
Currency swap contracts	7,488	1,091	1,865	4,532	-	8,629	740	876	7,013	-
	34,819	4,959	9,560	16,025	4,275	40,002	3,708	6,600	25,419	4,275
Derivatives designated as hedging instruments in cash flow hedges										
Currency derivatives										
Currency swap contracts	2,354	-	-	2,354	-	11,761	861	-	10,900	-
TOTAL	292,719	205,719	40,995	33,451	12,554	315,349	190,804	34,540	76,751	13,254

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

	Fund									
	Notional amounts with remaining life of									
	Total	2010				Total	2009			
3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	16,206	-	1,000	7,241	7,965	42,629	-	-	33,853	8,776
Interest rate futures contracts	2,909	638	1,919	352	-	12,724	601	11,525	598	-
Equity index swaps	520	-	520	-	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	180,643	157,456	23,187	-	-	160,540	155,989	4,551	-	-
Others										
Stock index futures contracts	32,664	32,664	-	-	-	17,029	17,029	-	-	-
Bond futures contracts	7,818	7,818	-	-	-	5,923	5,923	-	-	-
Bond options contracts	-	-	-	-	-	3,102	3,102	-	-	-
TOTAL	240,760	198,576	26,626	7,593	7,965	241,947	182,644	16,076	34,451	8,776

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Fund	
	2010	2009	2010	2009
At fair value				
Debt securities				
Treasury bills and commercial paper				
Listed outside Hong Kong	44	3,324	44	3,324
Unlisted	846,014	873,782	846,014	873,782
Other debt securities				
Listed outside Hong Kong	486,515	403,258	485,184	403,258
Unlisted	378,484	357,240	375,413	357,240
Total debt securities	1,711,057	1,637,604	1,706,655	1,637,604
Equity securities				
Listed in Hong Kong	152,572	142,939	152,572	142,939
Listed outside Hong Kong	190,880	168,180	190,880	168,180
Unlisted	54,455	46,741	54,455	46,741
Total equity securities	397,907	357,860	397,907	357,860
TOTAL	2,108,964	1,995,464	2,104,562	1,995,464

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

10 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2010	2009	2010	2009
Debt securities, at fair value				
Listed in Hong Kong	-	78	-	-
Listed outside Hong Kong	-	57	-	-
Unlisted	1,435	2,452	-	-
	1,435	2,587	-	-
Equity securities				
Listed in Hong Kong, at fair value	1,469	1,026	-	-
Unlisted, at cost	493	493	493	493
	1,962	1,519	493	493
Investment funds, at fair value				
Unlisted	8,929	3,572	-	-
TOTAL	12,326	7,678	493	493

The Group's investment in unlisted equity securities as at 31 December 2010 represents a holding of 4,285 shares (2009: 4,285 shares) in the Bank for International Settlements. The nominal value of each share is 5,000 Special Drawing Rights and is 25% paid up (also note 32(a)). Fair value has not been ascertained for these shares as they are not freely transferable.

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
Debt securities				
Listed in Hong Kong	1,014	1,167	-	-
Listed outside Hong Kong	3,025	2,244	-	-
Unlisted	4,069	2,472	-	-
TOTAL	8,108	5,883	-	-

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

12 LOAN PORTFOLIO

	Group		Fund	
	2010	2009	2010	2009
Mortgage loans, at amortised cost	34,711	42,736	-	-
Non-mortgage loans, at amortised cost	550	1,067	-	-
Allowance for loan impairment	(2)	(14)	-	-
TOTAL	35,259	43,789	-	-

13 GOLD

	Group and Fund	
	2010	2009
Gold, at market value 66,798 ounces (2009: 66,798 ounces)	732	572

14 OTHER ASSETS

	Group		Fund	
	2010	2009	2010	2009
Interest and dividends receivable	9,896	9,996	9,158	9,323
Unsettled sales and redemption of securities	7,782	3,698	7,782	3,698
Prepayments, receivables and other assets	1,906	1,122	1,642	739
Staff housing loans	188	247	188	247
TOTAL	19,772	15,063	18,770	14,007

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2010	2009
Unlisted shares, at cost	2,145	2,145
Loans to subsidiaries	14,683	2,802
TOTAL	16,828	4,947

The following is a list of the principal subsidiaries as at 31 December 2010:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Group's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Banknote printing	HK\$255,000,000	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages and loans, mortgage securitisation and guarantee	HK\$2,000,000,000	100%
Bauhinia HKMC Corporation Limited	People's Republic of China	Mortgage guarantee business	RMB100,000,000	90%
Eight Finance Investment Company Limited	Hong Kong	Investment holding	HK\$1	100%
Drawbridge Investment Limited	Hong Kong	Investment holding	HK\$1	100%
Debt Capital Solutions Company Limited	Hong Kong	Investment holding	HK\$1	100%
Real Gate Investment Company Limited	Hong Kong	Investment properties holding	HK\$1	100%

The Hong Kong Mortgage Corporation Limited has unissued authorised share capital of HK\$1 billion (2009: HK\$1 billion), which is callable from the Fund.

Loans to subsidiaries with principal activities for holding investment including properties are unsecured, interest-free loans and repayable on demand.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

16 INTERESTS IN ASSOCIATE AND JOINT VENTURES

	Group		Fund	
	2010	2009	2010	2009
Associate				
Unlisted shares, at cost	-	-	-	-
Share of net assets	47	45	-	-
	47	45	-	-
Joint ventures				
Unlisted shares, at cost	120	120	-	-
Due from joint ventures	3,443	-	-	-
Share of net assets	(154)	2	-	-
Foreign currency translation differences	5	(7)	-	-
	3,414	115	-	-
TOTAL	3,461	160	-	-

The Fund holds directly an associate incorporated in Hong Kong (issued share capital: HK\$10,000) which provides interbank clearing services. The Fund holds 50% (2009: 50%) of equity interest.

The Group holds investments in joint ventures through the following subsidiaries:

- the HKMC which holds a joint venture incorporated outside Hong Kong for providing mortgage guarantee coverage to banks. The HKMC holds 50% (2009: 50%) of equity interest; and
- Real Gate Investment Company Limited (RG) which holds two joint ventures incorporated outside Hong Kong for holding overseas investment properties. RG holds 51% (2009: Nil) and 74% (2009: Nil) of equity interests in these joint ventures respectively.

The Group's share of the joint ventures is summarised below:

	Group	
	2010	2009
Current assets	455	116
Non-current assets	7,996	-
Current liabilities	84	1
Non-current liabilities	4,953	-
Share of income	31	3
Share of expenses	187	1

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

17 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group			Total (restated)
	Premises (restated)	Plant and equipment	Computer software licences and system development costs	
Cost				
At 1 January 2009	3,855	666	246	4,767
Additions	–	89	6	95
Disposals	(3)	(7)	–	(10)
At 31 December 2009	3,852	748	252	4,852
At 1 January 2010	3,852	748	252	4,852
Additions	–	47	10	57
Disposals	–	(34)	–	(34)
At 31 December 2010	3,852	761	262	4,875
Accumulated depreciation				
At 1 January 2009	457	429	231	1,117
Charge for the year	88	47	5	140
Written back on disposal	(1)	(7)	–	(8)
At 31 December 2009	544	469	236	1,249
At 1 January 2010	544	469	236	1,249
Charge for the year	89	55	4	148
Written back on disposal	–	(23)	–	(23)
At 31 December 2010	633	501	240	1,374
Net book value				
At 31 December 2010	3,219	260	22	3,501
At 31 December 2009	3,308	279	16	3,603

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund			
	Premises (restated)	Plant and equipment	Computer software licences and system development costs	Total (restated)
Cost				
At 1 January 2009	3,843	224	246	4,313
Additions	–	26	6	32
Disposals	–	(6)	–	(6)
At 31 December 2009	3,843	244	252	4,339
At 1 January 2010	3,843	244	252	4,339
Additions	–	34	10	44
Disposals	–	(10)	–	(10)
At 31 December 2010	3,843	268	262	4,373
Accumulated depreciation				
At 1 January 2009	453	181	231	865
Charge for the year	88	13	5	106
Written back on disposal	–	(6)	–	(6)
At 31 December 2009	541	188	236	965
At 1 January 2010	541	188	236	965
Charge for the year	88	18	4	110
Written back on disposal	–	(10)	–	(10)
At 31 December 2010	629	196	240	1,065
Net book value				
At 31 December 2010	3,214	72	22	3,308
At 31 December 2009	3,302	56	16	3,374

(b) The net book value of premises comprises:

	Group		Fund	
	2010	2009 (restated)	2010	2009 (restated)
In Hong Kong				
Leasehold land and the building situated thereon (leasehold between 10 and 50 years)	3,196	3,285	3,191	3,279
Outside Hong Kong				
Freehold land and the building situated thereon	23	23	23	23
TOTAL	3,219	3,308	3,214	3,302

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

18 CERTIFICATES OF INDEBTEDNESS, GOVERNMENT-ISSUED CURRENCY NOTES AND COINS IN CIRCULATION

	Group and Fund			
	Certificates of Indebtedness		Government-issued currency notes and coins in circulation	
	2010	2009	2010	2009
Carrying amount	225,939	199,006	8,899	8,427
Reconciliation with face value:				
Hong Kong dollar face value	226,705	200,185	8,929	8,477
Linked exchange rate for calculating the US dollars required for redemption	US\$1 = HK\$7.80	US\$1 = HK\$7.80	US\$1 = HK\$7.80	US\$1 = HK\$7.80
US dollars required for redemption	US\$29,065 million	US\$25,665 million	US\$1,145 million	US\$1,087 million
Market exchange rate for translation into Hong Kong dollars	US\$1 = HK\$7.77365	US\$1 = HK\$7.75405	US\$1 = HK\$7.77365	US\$1 = HK\$7.75405
Carrying amount	225,939	199,006	8,899	8,427

19 BALANCE OF THE BANKING SYSTEM

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the Hong Kong Monetary Authority (HKMA) for the account of the Fund. The aggregate amount in these clearing accounts, which must not have a negative balance, represents the total level of liquidity in the interbank market.

Under the weak-side Convertibility Undertaking, the HKMA undertakes to convert Hong Kong dollars in these clearing accounts into US dollars at the fixed exchange rate of US\$1 = HK\$7.85. Likewise, under the strong-side Convertibility Undertaking, licensed banks can convert US dollars into Hong Kong dollars in these accounts, as the HKMA undertakes to buy US dollars at the fixed exchange rate of US\$1 = HK\$7.75. Within the Convertibility Zone bounded by the two Convertibility Undertakings, the HKMA may choose to conduct market operations in a manner consistent with Currency Board principles. Such operations can result in matching changes in the balances of these accounts.

The balance of the banking system is repayable on demand, non-interest-bearing and is shown at its Hong Kong dollar amount.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

20 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2010	2009
At amortised cost		
Placements by central banks	23,187	–
Placements by banks	–	28,311
TOTAL	23,187	28,311

21 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2010	2009
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	309,168	269,867
Land Fund	186,925	175,846
Capital Works Reserve Fund	56,859	22,026
Civil Service Pension Reserve Fund	22,994	21,631
Disaster Relief Fund	47	22
Innovation and Technology Fund	3,444	3,971
Lotteries Fund	8,459	7,832
Capital Investment Fund	2,163	820
Loan Fund	2,071	1,821
	592,130	503,836
Placements with interest payable at market-based rates		
General Revenue Account	152	276
Capital Works Reserve Fund	–	11
	152	287
TOTAL	592,282	504,123

Placements by Fiscal Reserves are repayable on demand. Interest on the majority of the placements by Fiscal Reserves is payable at a fixed rate determined every January. The rate is the average annual investment return of the Fund's Investment Portfolio for the past six years or the average annual yield of three-year Exchange Fund Notes for the previous year subject to a minimum of zero percent, whichever is the higher. This rate has been fixed at 6.3% per annum for 2010 (2009: 6.8%).

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

22 PLACEMENTS BY HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT FUNDS AND STATUTORY BODIES

	Group and Fund	
	2010	2009
Placements with interest payable at a fixed rate determined annually		
Research Endowment Fund	19,451	15,805
Bond Fund	25,088	5,631
Housing Authority	21,620	20,339
West Kowloon Cultural District Authority	10,503	–
	76,662	41,775
Placements with interest payable at market-based rates		
Deposit Protection Scheme Fund	98	61
TOTAL	76,760	41,836

The fixed rate arrangement related to the placements by Fiscal Reserves is also applied to certain HKSAR government funds and statutory bodies. This rate has been fixed at 6.3% per annum for 2010 (2009: 6.8%).

23 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group		Fund	
	2010	2009	2010	2009
At fair value				
Exchange Fund Bills and Notes issued				
Exchange Fund Bills	582,967	464,304	582,967	464,304
Exchange Fund Notes	72,253	73,125	72,253	73,125
	655,220	537,429	655,220	537,429
Exchange Fund Bills held	(1,499)	(1,000)	(999)	(1,000)
TOTAL	653,721	536,429	654,221	536,429

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

EFBN issued are unsecured obligations of the Fund and are one of the components of the Monetary Base in the Currency Board Account. Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year, 10-year and 15-year maturities. EFBN issued are valued at offer prices derived from the “HKMA EFBN Closing Reference” adjusted by observed market spreads.

EFBN held by the Fund as a result of market making activities are considered as redemption of the EFBN issued and are derecognised.

The analysis of the nominal value of EFBN issued at the beginning and the end of year is set out below:

	Group				Fund			
	2010		2009		2010		2009	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Issued by Currency Board Operations segment								
Nominal value at 1 January	464,362	69,700	90,753	66,900	464,362	69,700	90,753	66,900
Issuance	1,800,352	16,400	1,031,328	16,400	1,800,352	16,400	1,031,328	16,400
Redemption	(1,681,476)	(16,200)	(657,719)	(13,600)	(1,681,476)	(16,200)	(657,719)	(13,600)
Nominal value at 31 December	583,238	69,900	464,362	69,700	583,238	69,900	464,362	69,700
Long positions held by Financial Stability and Other Activities segment								
Nominal value at 31 December	(1,500)	-	(1,000)	-	(1,000)	-	(1,000)	-
Total nominal value	581,738	69,900	463,362	69,700	582,238	69,900	463,362	69,700
Carrying amount, at fair value	581,468	72,253	463,304	73,125	581,968	72,253	463,304	73,125
Difference	270	(2,353)	58	(3,425)	270	(2,353)	58	(3,425)

The fair value changes of EFBN issued are attributable to changes in benchmark interest rates.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

24 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2010	2009	2010	2009
Debt securities issued, carried at amortised cost	4,119	4,218	-	-
Debt securities issued, designated as fair value hedge	33,044	37,395	-	-
Debt securities issued, designated at fair value	1,937	2,846	-	-
TOTAL	39,100	44,459	-	-

The analysis of the nominal value of other debt securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2010	2009	2010	2009
Total debt securities issued				
Nominal value at 1 January	43,989	40,939	-	-
Issuance	8,280	22,689	-	-
Redemption	(13,831)	(19,652)	-	-
Foreign currency translation difference	5	13	-	-
Nominal value at 31 December	38,443	43,989	-	-
Carrying amount	39,100	44,459	-	-
Difference	(657)	(470)	-	-
Debt securities issued, designated at fair value				
Nominal value	2,549	3,427	-	-
Carrying amount, at fair value	1,937	2,846	-	-
Difference	612	581	-	-

The fair value changes of debt securities issued designated at fair value are attributable to changes in benchmark interest rates.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

25 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2010	2009	2010	2009
Mortgage-backed securities issued, carried at amortised cost	806	1,051	-	-
Mortgage-backed securities issued, designated as fair value hedge	724	970	-	-
TOTAL	1,530	2,021	-	-

The analysis of the nominal value of mortgage-backed securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2010	2009	2010	2009
Total mortgage-backed securities issued				
Nominal value at 1 January	1,976	3,148	-	-
Redemption	(470)	(1,172)	-	-
Nominal value at 31 December	1,506	1,976	-	-
Carrying amount	1,530	2,021	-	-
Difference	(24)	(45)	-	-

26 OTHER LIABILITIES

	Group		Fund	
	2010	2009	2010	2009
Unsettled purchases of securities	20,284	11,428	20,284	11,428
Accrued charges and other liabilities	6,608	6,321	451	568
Interest payable	821	819	327	373
Tax payable	142	138	-	-
Deferred tax liabilities	64	47	-	-
TOTAL	27,919	18,753	21,062	12,369

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

27 EQUITY

	Group		Fund	
	2010	2009	2010	2009
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	558,220	484,461	553,457	480,485
Surplus for the year	39,333	73,759	38,046	72,972
At 31 December	597,553	558,220	591,503	553,457
Other reserves				
Revaluation reserve				
At 1 January	865	(88)	-	-
Fair value changes on available-for-sale securities:				
– revaluation	1,248	973	-	-
– realisation on disposal	(40)	(4)	-	-
– tax effect	(17)	(37)	-	-
Cash flow hedges:				
– revaluation	26	25	-	-
– tax effect	(4)	(4)	-	-
At 31 December	2,078	865	-	-
Translation reserve				
At 1 January	(7)	(9)	-	-
Currency translation differences:				
– subsidiaries and joint ventures	48	2	-	-
At 31 December	41	(7)	-	-
	2,119	858	-	-
	599,672	559,078	591,503	553,457
Non-controlling interests				
At 1 January	204	191	-	-
Total comprehensive income for the year	12	15	-	-
Capital injection by non-controlling interests	67	11	-	-
Dividends paid to non-controlling interests	(11)	(13)	-	-
At 31 December	272	204	-	-
TOTAL	599,944	559,282	591,503	553,457

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

28 ANALYSIS OF CASH AND CASH EQUIVALENTS IN THE STATEMENT OF CASH FLOWS

	Group		Fund	
	2010	2009	2010	2009
Cash and money at call	49,579	17,736	48,911	17,658
Placements with banks and other financial institutions	153,260	110,898	148,700	107,105
Treasury bills and commercial paper	9,625	79,486	9,625	79,486
TOTAL	212,464	208,120	207,236	204,249

Reconciliation with the balance sheet

	Note	Group		Fund	
		2010	2009	2010	2009
Amounts shown in the balance sheet					
Cash and money at call	6	49,579	17,736	48,911	17,658
Placements with banks and other financial institutions	7	155,455	112,732	149,478	108,636
Financial assets designated at fair value					
Treasury bills and commercial paper	9	846,058	877,106	846,058	877,106
		1,051,092	1,007,574	1,044,447	1,003,400
Less: Amounts with original maturity beyond 3 months		(838,628)	(799,454)	(837,211)	(799,151)
Cash and cash equivalents in the statement of cash flows		212,464	208,120	207,236	204,249

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

29 OPERATING SEGMENT INFORMATION

The Group determines its operating segments based on the reports reviewed by the chief operating decision maker. As a central banking institution, the HKMA is responsible for managing the Exchange Fund, maintaining the monetary and banking stability of Hong Kong. The Group comprises operating segments as stated in note 2.17.

	Group									
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
Income/(Loss)	12,555	(1,441)	67,931	112,404	80,486	110,963	2,076	1,940	82,562	112,903
Expenditure										
Interest expense	1,815	940	37,846	34,844	39,661	35,784	172	279	39,833	36,063
Other expenses (note 29(b))	-	-	-	-	1,548	1,447	1,504	1,471	3,052	2,918
	1,815	940	37,846	34,844	41,209	37,231	1,676	1,750	42,885	38,981
Surplus/(Deficit) before share of profit/(loss) of associate and joint ventures	10,740	(2,381)	30,085	77,560	39,277	73,732	400	190	39,677	73,922
Share of profit/(loss) of associate and joint ventures, net of tax	-	-	(158)	-	(158)	-	4	2	(154)	2
Surplus/(Deficit) before taxation	10,740	(2,381)	29,927	77,560	39,119	73,732	404	192	39,523	73,924
Income tax	-	-	-	-	-	-	(178)	(150)	(178)	(150)
Surplus/(Deficit) for the year	10,740	(2,381)	29,927	77,560	39,119	73,732	226	42	39,345	73,774
Attributable to:										
Owner of the Fund	10,740	(2,381)	29,930	77,560	39,122	73,732	211	27	39,333	73,759
Non-controlling interests	-	-	(3)	-	(3)	-	15	15	12	15
	10,740	(2,381)	29,927	77,560	39,119	73,732	226	42	39,345	73,774

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 29(c) & (d))		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
Assets												
Backing Assets												
Investment in designated US dollar assets	1,119,691	1,079,351	-	-	1,119,691	1,079,351	-	-	-	-	1,119,691	1,079,351
Interest receivable on designated US dollar assets	1,404	1,738	-	-	1,404	1,738	-	-	-	-	1,404	1,738
Other investments	-	-	1,142,354	1,043,672	1,142,354	1,043,672	113,338	61,991	(1,499)	(1,000)	1,254,193	1,104,663
Other assets	-	-	18,526	15,742	18,526	15,742	6,101	6,279	541	472	25,168	22,493
TOTAL ASSETS	1,121,095	1,081,089	1,160,880	1,059,414	2,281,975	2,140,503	119,439	68,270	(958)	(528)	2,400,456	2,208,245
Liabilities												
Monetary Base												
Certificates of Indebtedness	225,939	199,006	-	-	225,939	199,006	-	-	-	-	225,939	199,006
Government-issued currency notes and coins in circulation	8,899	8,427	-	-	8,899	8,427	-	-	-	-	8,899	8,427
Balance of the banking system	148,702	264,567	-	-	148,702	264,567	-	-	-	-	148,702	264,567
Exchange Fund Bills and Notes issued	655,220	537,429	-	-	655,220	537,429	-	-	(1,499)	(1,000)	653,721	536,429
Interest payable on Exchange Fund Notes	327	373	-	-	327	373	-	-	-	-	327	373
Net accounts (receivable)/payable	(355)	(336)	-	-	(355)	(336)	-	-	541	472	186	136
Other debt securities issued	-	-	-	-	-	-	39,100	44,459	-	-	39,100	44,459
Mortgage-backed securities issued	-	-	-	-	-	-	1,530	2,021	-	-	1,530	2,021
Placements by banks and other financial institutions	-	-	-	28,311	-	28,311	23,187	-	-	-	23,187	28,311
Placements by Fiscal Reserves	-	-	592,282	504,123	592,282	504,123	-	-	-	-	592,282	504,123
Placements by HKSAR government funds and statutory bodies	-	-	76,662	41,775	76,662	41,775	98	61	-	-	76,760	41,836
Other liabilities	-	-	22,495	12,615	22,495	12,615	7,384	6,660	-	-	29,879	19,275
Total liabilities	1,038,732	1,009,466	691,439	586,824	1,730,171	1,596,290	71,299	53,201	(958)	(528)	1,800,512	1,648,963

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 29(c) & (d))		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
Accumulated surplus												
At 1 January	71,623	49,207	471,847	408,352	543,470	457,559	14,750	26,902	-	-	558,220	484,461
Surplus/(Deficit) for the year attributable to owner of the Fund	10,740	(2,381)	29,930	77,560	39,122	73,732	211	27	-	-	39,333	73,759
Transfer between Currency Board Operations and general reserves (note 29(e))	-	24,797	(34,278)	(14,065)	(32,730)	12,179	32,730	(12,179)	-	-	-	-
At 31 December	82,363	71,623	467,499	471,847	549,862	543,470	47,691	14,750	-	-	597,553	558,220
Other reserves	-	-	1,878	743	1,878	743	241	115	-	-	2,119	858
Non-controlling interests	-	-	64	-	64	-	208	204	-	-	272	204
Total equity	82,363	71,623	469,441	472,590	551,804	544,213	48,140	15,069	-	-	599,944	559,282
TOTAL LIABILITIES AND EQUITY	1,121,095	1,081,089	1,160,880	1,059,414	2,281,975	2,140,503	119,439	68,270	(958)	(528)	2,400,456	2,208,245

(a) Currency Board Operations

Starting from 1 October 1998, specific US dollar assets of the Fund have been designated to back the Monetary Base, which comprises Certificates of Indebtedness, government-issued currency notes and coins in circulation, the balance of the banking system and EFBN issued. While specific assets of the Fund have been earmarked for backing the Monetary Base, all the Fund's assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the Linked Exchange Rate system.

(b) Other expenses

Other expenses of the Currency Board Operations segment and the Reserves Management segment are aggregated as there is no meaningful basis to allocate such expenses between these two segments.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(c) Re-allocation of assets and liabilities

For the purpose of the Currency Board Operations segment, certain liabilities of the Fund are deducted from the Backing Assets and certain assets are deducted from the Monetary Base in order to allow proper computation of the Backing Ratio. This re-allocation adjustment adds back these items in order to reconcile the segmental information to the Group balance sheet.

As at 31 December 2010, deductions from the Monetary Base comprised “other assets” of HK\$541 million (2009: HK\$472 million). As Hong Kong dollar interest rate swaps have been used as a means to manage the cost of issuing Exchange Fund Notes, interest receivable of HK\$22 million (2009: HK\$19 million) and revaluation gains of HK\$519 million (2009: HK\$453 million) on these interest rate swaps are included in “net accounts (receivable)/ payable” to reduce the Monetary Base.

(d) EFBN held by the Financial Stability and Other Activities segment are treated as redemption of EFBN issued in the Currency Board Operations segment.

(e) In accordance with an arrangement approved by the Financial Secretary in January 2000, assets can be transferred between the Backing Portfolio and general reserves when the Backing Ratio reaches either the upper trigger point (112.5%) or the lower trigger point (105%). This arrangement allows transfer of excess assets out of the Backing Portfolio to maximise their earning potential while ensuring that there are sufficient liquid assets in the Backing Portfolio.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

30 PLEDGED ASSETS

Assets are pledged as margin for stock index and bond futures contracts as well as securities lending agreements, and as securities for issuing mortgage-backed securities. Securities lent do not include EFBN in issue. There are no financial assets pledged against contingent liabilities.

	Note	Group		Fund	
		2010	2009	2010	2009
Secured liabilities					
Stock index futures contracts – notional amount	8(b)	32,664	17,029	32,664	17,029
Bond futures contracts – notional amount	8(b)	7,818	5,923	7,818	5,923
Interest rate futures contracts – notional amount	8(b)	2,909	12,724	2,909	12,724
Mortgage-backed securities issued	25	1,530	2,021	–	–
Assets pledged					
Financial assets designated at fair value		3,385	2,457	3,385	2,457
Held-to-maturity securities		278	–	–	–
Placements with banks		28	34	–	–
Mortgage loans		1,185	1,906	–	–

During the year, the Group entered into collateralised reverse repurchase agreements, repurchase agreements and securities lending transactions that may result in credit exposure in the event that the counterparty to the transaction is unable to fulfil its contractual obligations. The Group controls credit risk associated with these activities by monitoring counterparty credit exposure and collateral values on a daily basis and requiring additional collateral to be deposited with or returned to the Group when deemed necessary.

These transactions are conducted under terms that are usual and customary to standard lending, and securities borrowing and lending activities.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

31 COMMITMENTS

(a) Capital commitments

Capital expenditure authorised but not provided for in the financial statements at the balance sheet date was as follows:

	Group		Fund	
	2010	2009	2010	2009
Contracted for	1	8	1	8
Authorised but not yet contracted for	156	161	135	136
	157	169	136	144

(b) Credit facility to the International Monetary Fund

The Fund has participated in the New Arrangements to Borrow (NAB), a standby credit facility provided to the International Monetary Fund (IMF) for the purpose of managing instability in the international monetary system. As at 31 December 2010, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,070 million equivalent (2009: HK\$4,133 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2010, there was no outstanding balance due from the IMF under this NAB facility (2009: Nil).

(c) Credit facility to the Hong Kong Deposit Protection Board

The Fund has provided the Hong Kong Deposit Protection Board (HKDPB) with a standby credit facility of HK\$40 billion (2009: HK\$40 billion) at prevailing market interest rates for meeting the necessary liquidity required for payment of compensation in the event of a bank failure. As at 31 December 2010, there was no outstanding balance due from the HKDPB under this facility (2009: Nil). The standby credit facility has been increased to HK\$120 billion since 1 January 2011.

(d) Credit facility to The Hong Kong Mortgage Corporation Limited

The Fund has provided the HKMC with a revolving credit facility of HK\$30 billion (2009: HK\$30 billion) at prevailing market interest rates. As at 31 December 2010, there was no outstanding balance due from the HKMC under this facility (2009: Nil).

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

(e) Repurchase agreements with other central banks

The Fund has entered into bilateral repurchase agreements with various central banks in Asia and Australasia amounting up to HK\$44,699 million equivalent (2009: HK\$44,586 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2010, there was no outstanding transaction with any central bank under this arrangement (2009: Nil).

(f) Chiang Mai Initiative Multilateralisation Agreement

Chiang Mai Initiative Multilateralisation (CMIM) Agreement came into effect on 24 March 2010. With a total size of US\$120 billion, the CMIM was established under the aegis of the 10 Association of Southeast Asian Nations (ASEAN) member countries together with China, Japan and Korea (ASEAN + 3) to provide short-term US dollars through currency swap transactions to participants facing balance-of-payments and liquidity difficulties. Hong Kong, through the HKMA, participates in the CMIM and has undertaken to commit up to US\$4.2 billion out of the Fund. Hong Kong has the right to request liquidity support up to US\$2.1 billion from the CMIM in case of emergency. Up to 31 December 2010, there had been no request to activate the CMIM.

(g) Bilateral swap agreement

The HKMA and the People's Bank of China (PBoC) entered into a bilateral swap agreement in January 2009 to provide short-term liquidity support to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need, and to promote the development of renminbi-denominated trade transactions between Hong Kong and the Mainland. This currency swap agreement has a term of three years and expires in January 2012, which can be extended upon agreement by both parties. It can provide liquidity support up to RMB200 billion/HK\$227 billion. The HKMA activated the currency swap agreement with the PBoC in 2010 for facilitating trade settlement business. The bilateral swap outstanding as at 31 December 2010 was RMB20 billion (2009: Nil).

(h) Investment commitments

The Group's subsidiaries with principal activities for holding investment including properties had investment commitment of HK\$23,273 million equivalent as at 31 December 2010 (2009: HK\$9,351 million equivalent).

(i) Lease commitments

As at 31 December 2010, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

	Group		Fund	
	2010	2009	2010	2009
Within one year	34	37	33	35
After one year but not later than five years	35	64	35	64
TOTAL	69	101	68	99

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

32 CONTINGENT LIABILITIES

The Group has the following contingent liabilities:

- (a) as at 31 December 2010, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$192 million equivalent (2009: 16.1 million Special Drawing Rights or HK\$195 million equivalent), in respect of the uncalled portion of its 4,285 shares (2009: 4,285 shares) in the Bank for International Settlements (note 10); and
- (b) to further strengthen confidence in Hong Kong's banking system, the Financial Secretary announced on 14 October 2008 the use of the Fund to guarantee the repayment of all customer deposits held with all authorized institutions in Hong Kong. This guarantee covered all protected deposits as defined in the Deposit Protection Scheme Ordinance (Cap. 581), were the Ordinance to apply to all authorized institutions including licensed banks, restricted licence banks and deposit-taking companies. It covered the amount of deposits in excess of the protection limit under the Deposit Protection Scheme Ordinance. This guarantee expired at the end of 2010 and had not been activated since its introduction in 2008. From 2011 onwards, the protection limit provided under the Deposit Protection Scheme Ordinance is HK\$0.5 million per depositor per bank.

33 MATERIAL RELATED PARTY TRANSACTIONS

Transactions with related parties are conducted at rates determined by the Monetary Authority taking into account the nature of each transaction on a case-by-case basis.

In addition to the transactions and balances disclosed elsewhere in these financial statements, during the year, the Group, through the HKMC, purchased HK\$154 million (2009: HK\$173 million) of mortgage loans from the HKSAR Government.

The Exchange Fund Advisory Committee (EFAC) through its Sub-Committees advises the Financial Secretary in his control of the Fund. Members of the EFAC and its Sub-Committees are appointed in a personal capacity by the Financial Secretary for the expertise and experience that they can bring to the Committees. It is not appropriate to disclose details of transactions with companies related to Committee members as all such transactions have been conducted as a normal part of the operation of the Group and on terms consistent with its ongoing operations.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

34 FINANCIAL RISK MANAGEMENT

This note presents information about the nature and extent of risks to which the Group is exposed, in particular those arising from financial instruments, and the risk management framework of the Group. The principal financial risks the Group is exposed to are credit risk, market risk and liquidity risk.

34.1 Governance

The Financial Secretary is advised by the EFAC in his control of the Fund. The EFAC is established under section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Fund. Members of the EFAC are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the HKSAR for the expertise and experience that they can bring to the Committee. Such expertise and experience include knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

The EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through the EFAC.

Among these Sub-Committees, the Investment Sub-Committee (ISC) monitors the HKMA's investment management activities and makes recommendations on the investment policy and strategy of the Fund and on risk management and other related matters. Operating within the policies and guidelines endorsed by the EFAC, the Reserves Management Department of the HKMA conducts the day-to-day investment management and risk management of the Fund.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

34.2 Investment management and control

Investment activities of the Fund are conducted in accordance with the investment benchmark derived from the Fund's investment objectives. The investment benchmark directs the strategic asset allocation of the Fund and is reviewed on a regular basis to ensure that it consistently meets the investment objectives. Changes to the investment benchmark, if required, must be endorsed by the EFAC.

The Fund's target asset and currency mix were as follows:

	2010	2009
Asset type		
Bonds	75%	75%
Equities and related investments	25%	25%
	100%	100%
Currency¹		
US dollar and other currencies	–	86%
Euro, yen, sterling and other currencies	–	14%
US dollar and Hong Kong dollar	82%	–
Others ²	18%	–
	100%	100%

¹ Investments denominated in Australian dollar, Canadian dollar and Singapore dollar which were grouped under "US dollar and other currencies" in 2009 have been re-categorised under "Others" in 2010.

² These included investments denominated mainly in Australian dollar, Canadian dollar, Danish krone, euro, Norwegian krone, Singapore dollar, sterling, Swedish krona, Swiss franc and yen.

In addition to the investment benchmark, the EFAC determines the tactical deviation limits governing the extent to which the Fund's asset and currency mix may deviate from the investment benchmark. The tactical deviation limits are used to guide the medium term investments for the Fund. The tactical deviation limits are derived from a risk-based approach, taking into account the risk tolerance level set by the EFAC and risk contributions of the asset classes and markets that the Fund is allowed to invest in. These risk contributions reflect the neutral allocations of asset markets within the investment benchmark, and the volatility of and correlation across asset markets. Authority to take medium term investment decisions is delegated to senior management of the HKMA down to the Executive Director level.

The Risk Management and Compliance Division (RMC) of the Reserves Management Department is responsible for risk management and compliance monitoring regarding the investments of the Fund. The RMC monitors the risk exposure of the Fund, checks compliance of investment activities against established guidelines and reports and follows up any identified breaches.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

34.3 Credit risk

Credit risk is the risk of financial loss when a counterparty or a borrower fails to meet its contractual obligations. It arises principally from the investments of the Fund.

34.3.1 Management of credit risk

The HKMA maintains effective credit risk management over the investments of the Fund. Based on the delegated authority of the EFAC, the Credit Review and Compliance Committee (CRCC) was established within the HKMA with the following responsibilities: (i) to establish and maintain the Credit Exposure Policy to govern the investments of the Fund; (ii) to review the adequacy of the existing credit risk management practices and, where necessary, formulate proposals for amendments; (iii) to conduct analysis of credit risk issues; (iv) to establish and review credit limits for the approved issuers and counterparties; and (v) to monitor the compliance of the investments of the Fund with the established policies and limits, and report and follow up any identified breaches. The CRCC is chaired by the Deputy Chief Executive (Monetary) whose responsibilities are independent of the day-to-day investment activities of the Fund, and includes representatives from both the Reserves Management Department and the Monetary Management Department of the HKMA.

In light of the increased volatility in financial markets, the HKMA will remain vigilant in monitoring and controlling the Fund's credit risk exposure, and will sustain the impetus for better credit risk management practices to support the investment activities of the Fund.

Credit limits are established in accordance with in-house methodologies as set out in the Exchange Fund Investment Policy and Credit Exposure Policy to control the exposures to counterparty, issuer and country risks arising from the investments of the Fund.

(a) Counterparty risk

The Fund selects its counterparties in lending, placement, derivatives and trading transactions prudently and objectively. Since the Fund will conduct transactions with a counterparty for a range of financial instruments, credit limits are established to control the overall exposure to each authorised counterparty based on its credit ratings, financial strength, the size of its total assets and capital, and other relevant information.

Counterparty credit exposures are measured according to the risk nature of financial products involved in the transaction. Counterparty credit exposures of derivatives include an estimate for the potential future credit exposure of the derivative contracts, in addition to their positive mark-to-market replacement value.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

(b) Issuer risk

Issuer risk arises from investments in debt securities. Credit limits for approved issuers are set on an individual and group level to control the risk of loss caused by the default of debt securities issuers and to prevent undue risk concentration.

Moreover, to be qualified as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Fund.

(c) Country risk

Country risk is broadly defined to include both the transfer risk and the sovereign risk. Under the existing framework, country limits are established to control the Fund's overall credit risk exposures to the countries endorsed by the EFAC. These country limits are set to reflect the status of a country's sovereign credit quality and the risks of default of the debt issued by its government.

The above credit limits are reviewed regularly. Credit exposure is monitored against these limits on a daily basis. To ensure prompt identification, proper approval and consistent monitoring of credit risk, the Fund has implemented a unified automated credit monitoring system which provides fully-integrated straight-through-processing linking the front, middle and back office functions. The pre-deal checking takes place in the front office prior to the commitment of any transaction to ensure that the intended transaction will not exceed the credit limits. The end-of-day compliance checking further verifies that the Fund complies with the established credit policies and procedures.

Any breaches of credit limits are reported to the CRCC, the ISC and the EFAC, and are followed up by the RMC in a timely manner. The approval authorities to sanction these breaches are set out in the Credit Exposure Policy.

To manage the exposure to credit risk arising from the loan portfolio and mortgage insurance business, a four-pronged approach is established for (i) selecting Approved Sellers carefully, (ii) adopting prudent mortgage purchasing criteria and insurance eligibility criteria, (iii) conducting effective due diligence reviews and (iv) ensuring adequate protection for higher-risk mortgages.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

34.3.2 Exposure to credit risk

The maximum exposure to credit risk at the balance sheet date without taking into account any collateral held or other credit enhancements is shown below:

	Note	Group		Fund	
		2010	2009	2010	2009
Cash and money at call	6	49,579	17,736	48,911	17,658
Placements with banks and other financial institutions	7	155,455	112,732	149,478	108,636
Derivative financial instruments	8(a)	3,299	5,565	1,902	4,247
Debt securities designated at fair value	9	1,711,057	1,637,604	1,706,655	1,637,604
Available-for-sale debt securities	10	1,435	2,587	–	–
Held-to-maturity securities	11	8,108	5,883	–	–
Loan portfolio	12	35,259	43,789	–	–
Other assets	14	19,772	15,063	18,770	14,007
Loans to subsidiaries	15	–	–	14,683	2,802
Due from joint ventures	16	3,443	–	–	–
Mortgage insurance risk in force	34.6	17,630	14,921	–	–
Loan commitments and other credit related commitments		144,691	88,719	151,418	118,719
TOTAL		2,149,728	1,944,599	2,091,817	1,903,673

The loan portfolio is secured by mortgages on properties. Reserve funds and deferred considerations are also used as an additional form of credit enhancement.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

34.3.3 Credit quality

The Group predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. As at 31 December 2010, approximately 92% (2009: 95%) of the debt securities held by the Group were rated “triple-A” by rating agencies Moody’s or Standard & Poor’s. The credit quality of major financial assets is analysed below:

	Group		Fund	
	2010	2009	2010	2009
Cash and money at call, placements with banks and other financial institutions, by credit rating¹				
AAA	39,487	40,107	39,487	40,107
AA – to AA +	69,720	32,035	68,800	28,083
A – to A +	71,024	57,411	65,591	57,191
Lower than A– or un-rated ²	24,803	915	24,511	913
	205,034	130,468	198,389	126,294
Debt securities, by credit rating¹				
AAA	1,590,105	1,563,347	1,586,920	1,562,078
AA – to AA +	59,139	28,629	53,154	22,273
A – to A +	12,752	5,561	12,379	4,716
Lower than A– or un-rated ²	58,604	48,537	54,202	48,537
	1,720,600	1,646,074	1,706,655	1,637,604
Loan portfolio				
Neither past due nor impaired (note 34.3.3(a))	34,648	42,855	–	–
Past due but not impaired (note 34.3.3(b))	613	943	–	–
Impaired (note 34.3.3(c))	–	5	–	–
Allowance for loan impairment	(2)	(14)	–	–
	35,259	43,789	–	–
TOTAL	1,960,893	1,820,331	1,905,044	1,763,898

¹ This is the lower of ratings designated by Moody’s and Standard & Poor’s.

² These include mainly balance with central banks and debt securities issued by the Bank for International Settlements which are not rated.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(a) Loans that are neither past due nor impaired

An internal rating system is used for assessing the credit quality of the loan portfolio. Grades 1 to 5 are loans that are neither past due nor impaired. Grades 1 to 3 include loans with no past due experience and with different levels of credit enhancements in addition to the collateral. Grade 4 includes loans with past due experience and with different levels of credit enhancements in addition to the collateral. Grade 5 includes loans with past due experience and collateral but without further credit enhancement. The credit quality of loans that were neither past due nor impaired at the balance sheet date is analysed below:

	Group		Fund	
	2010	2009	2010	2009
Grades				
1 to 3	34,621	42,794	-	-
4	-	-	-	-
5	27	61	-	-
TOTAL	34,648	42,855	-	-

(b) Loans that are past due but not impaired

These are loans where contractual interest or principal payments are past due but the Group believes that recognising an impairment loss is not appropriate on the basis of the level of collateral held. The loans that were past due but not impaired at the balance sheet date are analysed below:

	Group		Fund	
	2010	2009	2010	2009
Loans that were past due				
90 days or less	610	933	-	-
91 to 180 days	2	5	-	-
over 180 days	1	5	-	-
TOTAL	613	943	-	-
Fair value of collateral and other credit enhancements	2,529	2,753	-	-

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

(c) Impaired loans

These are loans where the Group determines on an individual basis that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan agreements. As at 31 December 2010, the fair value of related collateral held and credit enhancement was HK\$0.4 million (2009: HK\$9 million).

34.3.4 Concentration of credit risk

The Group has no significant concentration of credit risk. Credit risk of the Group is spread over a large number of counterparties and countries. The maximum credit risk exposure (note 34.3.2) by industry groups is analysed below:

	Group		Fund	
	2010	2009	2010	2009
Governments and government agencies ¹	1,677,684	1,631,417	1,676,894	1,631,104
Supra-nationals	82,472	42,012	82,449	41,967
States, provinces and public-sector entities ²	73,105	41,764	102,241	70,913
Financial institutions	152,899	103,125	139,144	92,559
Others	163,568	126,281	91,089	67,130
TOTAL	2,149,728	1,944,599	2,091,817	1,903,673

¹ These include debt securities guaranteed by governments.

² These include debt securities guaranteed by states.

34.4 Market risk

Market risk is the risk that changes in market variables such as interest rates, equity prices and exchange rates may affect the fair value or cash flows of a financial instrument.

34.4.1 Types of market risk

(a) Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in market interest rates. This can be further classified into fair value interest rate risk and cash flow interest rate risk.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Fair value interest rate risk is the risk that the fair value of a financial instrument will fluctuate because of changes in market interest rates. The Group is exposed to fair value interest rate risk since a substantial portion of its investments is in fixed-rate debt securities. These securities are subject to interest rate risk as their fair values will fall when market interest rates increase. Other significant financial assets and financial liabilities with a fixed interest rate and therefore subject to interest rate risk include placements with banks and other financial institutions and EFBN issued.

Cash flow interest rate risk is the risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Because the Group has no significant floating-rate investments and liabilities, the Group's future cash flows are not materially affected by potential changes in market interest rates.

(b) Currency risk

Currency risk is the risk of loss arising from changes in foreign exchange rates. A large portion of the Group's foreign currency assets is held in US dollars with the remaining in other major international currencies. When the exchange rates of the relevant foreign currencies against the Hong Kong dollar fluctuate, the value of these foreign currency assets expressed in Hong Kong dollar will vary accordingly.

Due to the linked exchange rate of the US dollar relative to the Hong Kong dollar, the Group's currency risk principally arises from its assets and liabilities denominated in foreign currencies other than the US dollar.

(c) Equity price risk

Equity price risk is the risk of loss arising from changes in equity prices. The Group's equity investments are subject to equity price risk since the value of these investments will decline if equity prices fall.

The majority of the equity securities held by the Group are constituent stocks of major stock market indexes and companies with large market capitalisation.

34.4.2 Management of market risk

The market risk of the Fund as a whole is regularly measured and monitored to prevent excessive risk exposure. The investment benchmark and tactical deviation limits of the Fund govern the asset allocation strategies. This, together with the volatility of asset markets, will affect the Fund's market risk exposure. The Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies. The market risk of the Fund is mainly measured and monitored using the Value-at-Risk (VaR) methodology.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

VaR is calculated using the parametric approach based on a 95% confidence level and one-month time horizon. The result represents the maximum expected loss of the Fund over a one-month period under normal market conditions, with a 5% chance that the actual loss may exceed the calculated VaR. The Fund's absolute VaR and the relative VaR (i.e. the VaR of the Fund relative to its investment benchmark), expressed in dollar amounts, are measured by the RMC and reported to management, the ISC and the EFAC on a regular basis.

The relative VaR of the Fund is also used to calculate the actual tracking error of the Fund against its investment benchmark. This is regularly monitored against the tracking error limit endorsed by the EFAC to ensure that the market risk exposure of the Fund is within its limit. The tracking error of a portfolio indicates how well the portfolio tracks its investment benchmark. The smaller the tracking error, the better the portfolio tracks its benchmark. The tracking error limit is established to prevent the Fund from taking unduly large market risk with respect to its investment benchmark. The actual tracking error of the Fund is regularly reported to the ISC and the EFAC, and any breach of the limit is followed up in a timely manner.

VaR is a widely accepted measure of market risk within the financial services industry. It provides users with a single amount to measure market risk and takes into account multiple risks. VaR should however be assessed in the context of some of its inherent limitations. The calculation of VaR involves a number of assumptions that may or may not be valid in a real life scenario, in particular in extreme market conditions. The calculation of VaR assumes that future events can be predicted by historical data, and that changes in risk factors follow a normal distribution. The end-of-day basis does not reflect intraday exposures. In addition, the confidence level on which calculation of VaR is based needs to be taken into account as it indicates the possibility that a larger loss could be realised.

To compensate for some of the limitations of VaR, the HKMA also conducts stress tests to estimate the potential losses under extremely adverse market conditions. This serves to identify the major attributes of market risk under extreme market conditions, and helps to prevent the Fund from being exposed to excessive market risk. The results of the stress tests are also reported to the ISC and the EFAC on a regular basis.

In addition, to manage the interest rate risk arising from the fixed-rate debt securities issued by the Group to fund the purchase of portfolios of loans, a major portion of the risk is hedged using fair value hedges in the form of interest rate swaps by swapping into floating-rate funding to better match the floating-rate assets.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

34.4.3 Exposure to market risk

(a) Interest rate risk

The interest rate gap position in respect of the Group's major interest-bearing assets and liabilities, including the net repricing effect of interest rate derivatives is shown below. The assets and liabilities are stated at carrying amounts at the balance sheet date and categorised by the earlier of contractual repricing dates or maturity dates.

	Group – 2010							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	Total	
Assets								
Cash and money at call	25,826	-	-	-	-	-	25,826	23,753
Placements with banks and other financial institutions	153,942	1,214	299	-	-	-	155,455	-
Financial assets designated at fair value	166,953	288,766	472,154	412,025	220,360	146,118	1,706,376	402,588
Available-for-sale securities	490	945	-	-	-	-	1,435	10,891
Held-to-maturity securities	349	77	719	4,282	2,681	-	8,108	-
Loan portfolio	25,697	9,346	141	54	21	-	35,259	-
Interest-bearing assets	373,257	300,348	473,313	416,361	223,062	146,118	1,932,459	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates ¹	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,239	318,415	147,091	42,440	8,368	4,168	653,721	-
Other debt securities issued	6,863	4,863	9,276	13,052	3,776	1,270	39,100	-
Mortgage-backed securities issued	806	724	-	-	-	-	1,530	-
Interest-bearing liabilities	141,158	324,002	156,367	55,492	12,144	5,438	694,601	
Interest rate derivatives (net position, notional amounts)	(12,049)	(23,868)	12,428	11,250	8,892	3,600	253	
Interest rate sensitivity gap	220,050	(47,522)	329,374	372,119	219,810	144,280	1,238,111	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Group – 2009							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	Total	
Assets								
Cash and money at call	17,635	-	-	-	-	-	17,635	101
Placements with banks and other financial institutions	111,509	1,135	69	-	-	-	112,713	19
Financial assets designated at fair value	138,840	268,546	553,705	307,874	215,276	149,793	1,634,034	361,430
Available-for-sale securities	1,201	931	455	-	-	-	2,587	5,091
Held-to-maturity securities	502	1,000	763	3,142	476	-	5,883	-
Loan portfolio	36,615	6,978	124	57	15	-	43,789	-
Interest-bearing assets	306,302	278,590	555,116	311,073	215,767	149,793	1,816,641	
Liabilities								
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-
Placements by Fiscal Reserves with interest payable at market-based rates ¹	287	-	-	-	-	-	287	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	61	-	-	-	-	-	61	-
Exchange Fund Bills and Notes issued	89,312	268,167	122,334	45,203	8,257	3,156	536,429	-
Other debt securities issued	6,043	6,294	6,658	19,659	4,003	1,802	44,459	-
Mortgage-backed securities issued	1,051	-	229	741	-	-	2,021	-
Interest-bearing liabilities	125,065	274,461	129,221	65,603	12,260	4,958	611,568	
Interest rate derivatives (net position, notional amounts)	(13,406)	11,476	2,617	(6,976)	3,983	2,400	94	
Interest rate sensitivity gap	167,831	15,605	428,512	238,494	207,490	147,235	1,205,167	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

	Fund – 2010							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	Total	
Assets								
Cash and money at call	25,210	-	-	-	-	-	25,210	23,701
Placements with banks and other financial institutions	148,700	778	-	-	-	-	149,478	-
Financial assets designated at fair value	165,398	288,078	472,115	411,480	219,589	146,103	1,702,763	401,799
Interest-bearing assets	339,308	288,856	472,115	411,480	219,589	146,103	1,877,451	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates ¹	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,739	318,415	147,091	42,440	8,368	4,168	654,221	-
Interest-bearing liabilities	133,989	318,415	147,091	42,440	8,368	4,168	654,471	
Interest rate derivatives (net position, notional amounts)	-	(10,045)	3,321	(1,241)	4,365	3,600	-	
Interest rate sensitivity gap	205,319	(39,604)	328,345	367,799	215,586	145,535	1,222,980	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund – 2009							Total	Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments								
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years			
Assets									
Cash and money at call	17,603	-	-	-	-	-	17,603	55	
Placements with banks and other financial institutions	107,860	776	-	-	-	-	108,636	-	
Financial assets designated at fair value	138,840	268,546	553,705	307,874	215,276	149,793	1,634,034	361,430	
Interest-bearing assets	264,303	269,322	553,705	307,874	215,276	149,793	1,760,273		
Liabilities									
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-	
Placements by Fiscal Reserves with interest payable at market-based rates ¹	287	-	-	-	-	-	287	-	
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	61	-	-	-	-	-	61	-	
Exchange Fund Bills and Notes issued	89,312	268,167	122,334	45,203	8,257	3,156	536,429	-	
Interest-bearing liabilities	117,971	268,167	122,334	45,203	8,257	3,156	565,088		
Interest rate derivatives (net position, notional amounts)	-	24,930	(99)	(25,853)	(1,378)	2,400	-		
Interest rate sensitivity gap	146,332	26,085	431,272	236,818	205,641	149,037	1,195,185		

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Currency risk

The currency exposure of the Group is summarised below:

	Group			
	2010		2009	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion) (restated)	Liabilities (in HK\$ billion) (restated)
Hong Kong dollar	238.0	1,533.4	187.5	1,418.5
US dollar ¹	1,879.5	261.3	1,772.9	226.0
Others ²	283.0	5.8	247.9	4.5
TOTAL	2,400.5	1,800.5	2,208.3	1,649.0

	Fund			
	2010		2009	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion) (restated)	Liabilities (in HK\$ billion) (restated)
Hong Kong dollar	217.0	1,496.1	150.2	1,376.0
US dollar ¹	1,853.0	253.1	1,754.0	217.4
Others ²	275.0	4.3	245.2	2.5
TOTAL	2,345.0	1,753.5	2,149.4	1,595.9

¹ Assets and liabilities denominated in Australian dollar, Canadian dollar and Singapore dollar which were grouped under "US dollar and other currencies" in 2009 have been re-categorised under "Others" in 2010.

² These included assets and liabilities denominated mainly in Australian dollar, Canadian dollar, Danish krone, euro, Norwegian krone, Singapore dollar, sterling, Swedish krona, Swiss franc and yen.

(c) Equity price risk

As at 31 December 2010 and 2009, the majority of equity investments were reported as "financial assets designated at fair value" as shown in note 9.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

34.4.4 Sensitivity analysis

The VaR positions of the Fund at 31 December and during the year, based on a 95% confidence level and one-month time horizon, were as follows:

	Fund	
	2010	2009
VaR		
At 31 December	34,854	30,324
During the year		
Average	30,996	41,435
Maximum	37,573	64,131
Minimum	26,203	30,324

34.5 Liquidity risk

Liquidity risk refers to the risk that the Group may not have sufficient funds available to meet its liabilities as they fall due. In addition, the Group may not be able to liquidate its financial assets at a price close to fair value within a short period of time.

34.5.1 Management of liquidity risk

To ensure sufficient liquidity to meet liabilities and the ability to raise funds to meet exceptional needs, the Group invests primarily in liquid financial markets and instruments that are readily saleable to meet liquidity needs. There are internal investment restrictions to prevent undue concentrations in individual debt securities issues, debt securities issuers, and groups of closely related debt securities issuers. Such restrictions are derived based on various factors such as the nature or maturity of the securities. There are also limitations on the maximum proportion of assets that can be placed in fixed term deposits, and requirements regarding the ability to convert foreign currency assets into cash. All these restrictions and limits are designed to promote the liquidity of assets and consequently minimise the liquidity risk. Compliance with these limits is monitored by the RMC and any breaches are reported to the ISC and the EFAC and are promptly followed up.

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

34.5.2 Exposure to liquidity risk

The remaining contractual maturities at the balance sheet date of major financial liabilities, commitments and derivative financial liabilities, which are based on contractual undiscounted cash flows and the earliest date on which the Group can be required to pay, are shown below.

	Group – 2010						Total
	Remaining maturity						
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	8,899	-	-	-	-	-	8,899
Balance of the banking system	148,702	-	-	-	-	-	148,702
Placements by banks and other financial institutions	-	-	23,187	-	-	-	23,187
Placements by Fiscal Reserves	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	29,210	-	-	35,000	12,550	-	76,760
Exchange Fund Bills and Notes issued	133,243	318,914	148,486	44,047	9,215	4,605	658,510
Other debt securities issued	3,048	4,277	10,978	18,139	3,987	1,424	41,853
Mortgage-backed securities issued	28	49	1,297	166	-	-	1,540
Other liabilities	26,783	239	12	-	-	-	27,034
Loan commitments and other credit related commitments	144,691	-	-	-	-	-	144,691
TOTAL	1,312,825	323,479	183,960	97,352	25,752	6,029	1,949,397
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	292	(3)	(62)	(26)	335	101	637
- on gross basis							
Total outflows	37,684	31,766	28,388	9,668	-	-	107,506
Total inflows	(36,707)	(31,205)	(28,000)	(9,669)	-	-	(105,581)
TOTAL	1,269	558	326	(27)	335	101	2,562

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Group – 2009						Total
	Remaining maturity						
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	8,427	-	-	-	-	-	8,427
Balance of the banking system	264,567	-	-	-	-	-	264,567
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	6,836	-	-	-	35,000	-	41,836
Exchange Fund Bills and Notes issued	89,311	268,625	123,823	46,712	8,825	3,344	540,640
Other debt securities issued	1,119	3,715	7,910	28,055	4,604	2,896	48,299
Mortgage-backed securities issued	49	30	402	1,612	-	-	2,093
Other liabilities	17,421	243	223	-	-	-	17,887
Loan commitments and other credit related commitments	88,719	-	-	-	-	-	88,719
TOTAL	1,207,889	272,613	132,358	76,379	48,429	6,240	1,743,908
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	179	(10)	102	66	176	54	567
- on gross basis							
Total outflows	24,128	7,053	8,768	15,798	614	-	56,361
Total inflows	(23,714)	(7,010)	(8,741)	(15,793)	(608)	-	(55,866)
TOTAL	593	33	129	71	182	54	1,062

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund – 2010						Total
	Remaining maturity						
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	8,899	-	-	-	-	-	8,899
Balance of the banking system	148,702	-	-	-	-	-	148,702
Placements by banks and other financial institutions	-	-	23,187	-	-	-	23,187
Placements by Fiscal Reserves	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	29,210	-	-	35,000	12,550	-	76,760
Exchange Fund Bills and Notes issued	133,743	318,914	148,486	44,047	9,215	4,605	659,010
Other liabilities	20,484	239	12	-	-	-	20,735
Loan commitments and other credit related commitments	151,418	-	-	-	-	-	151,418
TOTAL	1,310,677	319,153	171,685	79,047	21,765	4,605	1,906,932
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	294	(13)	(65)	(45)	335	101	607
- on gross basis							
Total outflows	35,961	29,533	23,593	-	-	-	89,087
Total inflows	(34,987)	(28,970)	(23,187)	-	-	-	(87,144)
TOTAL	1,268	550	341	(45)	335	101	2,550

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund – 2009						Total
	Remaining maturity						
	1 month or less	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	8,427	-	-	-	-	-	8,427
Balance of the banking system	264,567	-	-	-	-	-	264,567
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	6,836	-	-	-	35,000	-	41,836
Exchange Fund Bills and Notes issued	89,311	268,625	123,823	46,712	8,825	3,344	540,640
Other liabilities	11,530	243	223	-	-	-	11,996
Loan commitments and other credit related commitments	118,719	-	-	-	-	-	118,719
TOTAL	1,230,830	268,868	124,046	46,712	43,825	3,344	1,717,625
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	167	(16)	18	34	169	54	426
- on gross basis							
Total outflows	22,764	5,777	4,583	-	-	-	33,124
Total inflows	(22,356)	(5,728)	(4,554)	-	-	-	(32,638)
TOTAL	575	33	47	34	169	54	912

34.6 Mortgage insurance risk

In providing mortgage insurance cover to authorized institutions in respect of mortgage loans originated by such authorized institutions and secured by residential properties, the Group faces insurance risk of the uncertainty of the insured event occurring and the uncertainty of the amount of the resulting claim.

Under the Mortgage Insurance Programme, the Group, through the HKMC, offers mortgage insurance that covers approved sellers for credit losses of up to 25% to 30% of the value of properties financed under mortgage loans with loan-to-value ratio below 90% at origination. The Group reinsures the exposure with approved reinsurers. As at 31 December 2010, the total risk-in-force was HK\$17.6 billion (2009: HK\$14.9 billion), of which HK\$15.2 billion (2009: HK\$11.6 billion) was retained by the Group after reinsurance.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the Group faces under its insurance contracts is that the actual claims exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims is greater than estimated. The actual number and amount of claims and benefits will vary year to year from the estimate established using statistical techniques.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

Experience shows that the larger the portfolio of similar insurance contracts, the smaller the relative variability about the expected outcome will be. In addition, a more diversified portfolio is less likely to be affected across the board by a change in any subset of the portfolio. The Group has developed a business strategy to diversify the type of mortgage insurance risks accepted and within each of the key categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome.

The frequency and severity of claims can be affected by several factors which cause collateral values fall below the outstanding balance of the mortgage loans. The most significant are a downturn in the economy and a decline in local property values. Economic downturn, which may cause a rise in defaults, affects the frequency of claims.

The Group manages these risks by adopting a set of prudent insurance eligibility criteria. To ensure sufficient provision is set aside for meeting future claim payments, the Group calculates technical reserves on prudent liability valuation assumptions and the methods prescribed in the regulatory guidelines. The Group also takes out quota-share reinsurance from its approved mortgage reinsurers in an effort to limit its risk exposure. The reinsurers are selected according to prudent criteria and their credit ratings are reviewed regularly.

34.7 Operational risk

Operational risk is the risk of direct and indirect loss arising from a wide variety of causes associated with the Group's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements. Operational risks arise from all of the Group's operations and are faced by all business segments.

The Group's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Group's reputation with overall cost-effectiveness and to avoid control procedures that restrict initiative.

The primary responsibility for the development and implementation of controls to address operational risk rests with an internal high-level Risk Committee. The Committee is chaired by the Chief Executive of the HKMA and the three Deputy Chief Executives serve as members. The Risk Committee provides direction and guidance for management in managing operational risk.

The HKMA's operational risk management is supported by a formal risk assessment process. This is conducted on an annual basis and requires each division to assess and rank the potential impact and likelihood of occurrence of financial and operational risks. It also requires the relevant divisions to review the procedures and measures in place to address the identified risks. The assessment and ranking is reviewed by Internal Audit for consistency and reasonableness before being submitted to the Risk Committee, which has the responsibility for ensuring that the identified risks are properly addressed. This risk assessment forms an important basis for the annual Internal Audit plan. Internal Audit will audit the risk areas at various frequencies depending on the levels of risks and the results of past audits.

Internal Audit reports its findings to the EFAC Audit Sub-Committee and the Chief Executive of the HKMA. It also follows up on outstanding issues to ensure that they are resolved in a proper manner.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

35 FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair values of financial instruments traded in active markets are based on quoted market prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date. The fair values of unlisted investment funds and unlisted equity securities are estimated by investment managers. These fair values approximate the net asset values of the investments. Depending on the redemption and liquidity features of the investments, the fair values may not necessarily represent the amounts that can be ultimately realised by the Group.

- (a) The fair values of held-to-maturity securities, other debt securities and mortgage-backed securities issued that were not designated at fair value are shown below:

	Note	Group			
		Carrying value		Fair value	
		2010	2009	2010	2009
Financial assets					
Held-to-maturity securities	11	8,108	5,883	8,259	6,001
Financial liabilities					
Other debt securities issued, not designated at fair value	24	37,163	41,613	37,165	41,619
Mortgage-backed securities issued, not designated at fair value	25	1,530	2,021	1,525	2,011

All other financial instruments of the Group and the Fund are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2010 and 2009.

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

- (b) The carrying value of financial instruments measured at fair value at the balance sheet date across the three levels of the fair value hierarchy is shown below:

	Group – 2010			Total
	Level 1	Level 2	Level 3	
Assets				
Derivative financial instruments	41	3,258	–	3,299
Financial assets designated at fair value	1,719,068	369,122	20,774	2,108,964
Available-for-sale securities	1,469	1,435	8,929	11,833
	1,720,578	373,815	29,703	2,124,096
Liabilities				
Derivative financial instruments	293	2,180	–	2,473
Exchange Fund Bills and Notes issued	–	653,721	–	653,721
Other debt securities issued, designated at fair value	–	1,937	–	1,937
	293	657,838	–	658,131

	Group – 2009			Total
	Level 1	Level 2	Level 3	
Assets				
Derivative financial instruments	12	5,553	–	5,565
Financial assets designated at fair value	1,729,460	238,740	27,264	1,995,464
Available-for-sale securities	1,104	2,509	3,572	7,185
	1,730,576	246,802	30,836	2,008,214
Liabilities				
Derivative financial instruments	167	864	–	1,031
Exchange Fund Bills and Notes issued	–	536,429	–	536,429
Other debt securities issued, designated at fair value	–	2,846	–	2,846
	167	540,139	–	540,306

Exchange Fund – Notes to the Financial Statements (continued)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund – 2010			
	Level 1	Level 2	Level 3	Total
Assets				
Derivative financial instruments	41	1,861	–	1,902
Financial assets designated at fair value	1,719,068	365,783	19,711	2,104,562
	1,719,109	367,644	19,711	2,106,464
Liabilities				
Derivative financial instruments	293	2,136	–	2,429
Exchange Fund Bills and Notes issued	–	654,221	–	654,221
	293	656,357	–	656,650

	Fund – 2009			
	Level 1	Level 2	Level 3	Total
Assets				
Derivative financial instruments	12	4,235	–	4,247
Financial assets designated at fair value	1,729,460	238,740	27,264	1,995,464
	1,729,472	242,975	27,264	1,999,711
Liabilities				
Derivative financial instruments	167	706	–	873
Exchange Fund Bills and Notes issued	–	536,429	–	536,429
	167	537,135	–	537,302

The three levels of the fair value hierarchy are:

Level 1 – fair values of financial instruments are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 – fair values of financial instruments are determined involving inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices); and

Level 3 – fair values of financial instruments are determined with inputs that are not based on observable market data (unobservable inputs).

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

An analysis of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs, is shown below:

	Group			
	Designated at fair value		Available-for-sale	
	2010	2009	2010	2009
At 1 January	27,264	18,704	3,572	–
Net gains recognised in the income and expenditure account	866	3,583	–	–
Net gains recognised in other comprehensive income	–	–	1,103	743
Purchases	7,525	13,337	4,452	2,848
Sales	(5,269)	(7,460)	(198)	(19)
Transfers into Level 3	7,163	–	–	–
Transfers out of Level 3	(16,775)	(900)	–	–
At 31 December	20,774	27,264	8,929	3,572
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	1,300	3,123	–	–

	Fund			
	Designated at fair value		Available-for-sale	
	2010	2009	2010	2009
At 1 January	27,264	18,704	–	–
Net gains recognised in the income and expenditure account	869	3,583	–	–
Purchases	6,459	13,337	–	–
Sales	(5,269)	(7,460)	–	–
Transfers into Level 3	7,163	–	–	–
Transfers out of Level 3	(16,775)	(900)	–	–
At 31 December	19,711	27,264	–	–
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	1,303	3,123	–	–

Exchange Fund – Notes to the Financial Statements (continued)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

During the year, certain financial instruments were transferred between Level 2 and Level 3, reflecting changes in transparency of observable market data for these instruments.

For financial instruments classified under Level 3 of the fair value hierarchy, if the prices of investments were increased/decreased by 10%, these would have resulted in an increase/decrease in the Group's surplus for the year of HK\$2,077 million (2009: HK\$2,726 million) and in other comprehensive income of HK\$893 million (2009: HK\$357 million).

36 COMPARATIVE FIGURES

As a result of adopting Amendment to HKAS 17, certain comparative figures have been reclassified and restated to conform with changes in presentations in the current year and to show separately comparative amount in respect of item disclosed (note 3.3).

37 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010

Up to the date of issue of the financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2010 and which have not been early adopted in the financial statements.

The Group is in the process of making an assessment of what the impact of these amendments, new standards and interpretations is expected to be in the period of initial adoption. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position.

The following developments may result in new or revised disclosures in future financial statements:

	Effective for accounting periods beginning on or after
Amendments to HKFRS 7, Financial Instruments: Disclosures	
– Disclosures - Transfers of Financial Assets	1 July 2011
HKFRS 9, Financial Instruments	1 January 2013
Amendments to HKAS 12, Income Taxes	
– Deferred Tax: Recovery of Underlying Assets	1 January 2012
HKAS 24 (Revised), Related Party Disclosures	1 January 2011
Amendment to HKAS 32, Financial Instruments: Presentation	
– Classification of Rights Issues	1 February 2010

38 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 29 March 2011.

Calendar of Events 2010

25 January

The HKMA and Bank Indonesia jointly launch a new cross-border payment-versus-payment link between Hong Kong's US-dollar and Indonesia's Rupiah real time gross settlement systems.

11 February

The HKMA provides an elucidation of the supervisory principles and operational arrangements regarding renminbi business in Hong Kong.

24 March

The Finance Ministers and Central Bank Governors of ASEAN + 3 and the Monetary Authority of Hong Kong announce the implementation of the Chiang Mai Initiative Multilateralisation Agreement.

22 June

The People's Bank of China (PBoC) and relevant authorities in Mainland China announce an expansion of the geographical coverage of the renminbi trade settlement scheme.

30 June

The Legislative Council passes the Deposit Protection Scheme (Amendment) Ordinance 2010 to provide for the implementation of the enhanced Deposit Protection Scheme on 1 January 2011, including the increase in the protection limit from HK\$100,000 to HK\$500,000.

14 July

The Securities and Futures Commission and the HKMA reach a settlement agreement with a bank in relation to its distribution of the Lehman Brothers-related Constellation Notes.

19 July

The HKMA and the PBoC sign a Supplementary Memorandum of Co-operation on the expansion of the renminbi trade settlement scheme. The PBoC and the Renminbi Clearing Bank also sign a revised Settlement Agreement on the Clearing of Renminbi Businesses.

20 July

The HKMA and the three note-issuing banks announce the issue of the 2010 new series Hong Kong banknotes.

13 August

The HKMA introduces further prudential measures on residential mortgage loans.

17 August

The PBoC promulgates a notice on a pilot scheme for the Renminbi Clearing Bank and Participating Banks outside the Mainland to invest in the Mainland's interbank bond market.

1 September

The Bank for International Settlements announces the results of the triennial survey on foreign exchange and derivatives market turnover – Hong Kong continues to rank sixth in the global foreign-exchange market.

10 November

Moody's upgrades Hong Kong's government bond ratings to "Aa1" from "Aa2", with "Positive" outlook.

19 November

The HKMA introduces further prudential measures on property mortgage loans.

22 November

The Ministry of Finance signs a Memorandum of Co-operation with the HKMA on using Central Moneymarkets Unit for Issuance of Renminbi Sovereign Bonds. It also announces the issuance of renminbi sovereign bonds totalling RMB5 billion to institutional investors through the Central Moneymarkets Unit.

25 November

Fitch Ratings upgrades Hong Kong's long-term foreign-currency sovereign rating to "AA+" from "AA", with "Stable" outlook.

3 December

The International Monetary Fund releases its Staff Report on Hong Kong, welcoming the Government's efforts in maintaining financial stability and reiterating its support for the Linked Exchange Rate system.

6 December

The PBoC and the relevant Mainland authorities announce a substantial expansion of the number of eligible Mainland enterprises that can settle merchandise exports in renminbi.

10 December

The HKMA announces the development of a local trade repository for over-the-counter derivatives trades in Hong Kong.

16 December

Standard & Poor's upgrades Hong Kong's long-term foreign-currency and local-currency ratings to "AAA" from "AA+", with "Stable" outlook.

23 December

The HKMA announces the introduction of refinements to the Participating Banks' renminbi conversion arrangements with their customers for renminbi cross-border trade settlement transactions.

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Annex Authorized Institutions and Local Representative Offices

at 31 December 2010

LICENSED BANKS

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited	Dah Sing Bank Limited	PUBLIC BANK (HONG KONG) LIMITED
Bank of East Asia, Limited (The)	DBS BANK (HONG KONG) LIMITED	Shanghai Commercial Bank Limited
China Construction Bank (Asia) Corporation Limited	FUBON BANK (HONG KONG) LIMITED	Standard Bank Asia Limited
Chiyu Banking Corporation Limited	Hang Seng Bank, Limited	Standard Chartered Bank (Hong Kong) Limited
Chong Hing Bank Limited	Hongkong & Shanghai Banking Corporation Limited (The)	Tai Sang Bank Limited
CITIBANK (HONG KONG) LIMITED	Industrial and Commercial Bank of China (Asia) Limited	Tai Yau Bank, Limited
CITIC Bank International Limited (formerly known as CITIC Ka Wah Bank Limited)	MEVAS Bank Limited	WING HANG BANK, LIMITED
	Nanyang Commercial Bank, Limited	Wing Lung Bank Limited

Incorporated outside Hong Kong

ABN AMRO Bank N.V.#	BANK OF TAIWAN	Commerzbank AG
AGRICULTURAL BANK OF CHINA LIMITED	Bank of Tokyo-Mitsubishi UFJ, Ltd. (The)	Commonwealth Bank of Australia
Allahabad Bank	Bank Julius Baer & Co. Ltd.#	Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.
Australia and New Zealand Banking Group Limited	Bank Sarasin & Cie AG	CREDIT AGRICOLE CORPORATE AND INVESTMENT BANK (formerly known as CALYON)
Axis Bank Limited	BANK SINOPAC	Credit Suisse AG
Banca Monte dei Paschi di Siena S.p.A.	Barclays Bank PLC	DBS BANK LTD.
Banco Bilbao Vizcaya Argentaria S.A.	BNP PARIBAS	Deutsche Bank Aktiengesellschaft
BANCO DE ORO UNIBANK, INC.	BNP PARIBAS SECURITIES SERVICES	DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main
BANCO SANTANDER, S.A.	BNP PARIBAS WEALTH MANAGEMENT	E.Sun Commercial Bank, Ltd.
Bangkok Bank Public Company Limited	Canadian Imperial Bank of Commerce	EAST WEST BANK
Bank of America, National Association	CANARA BANK	EFG Bank AG also known as: EFG Bank SA EFG Bank Ltd
Bank of Baroda	CATHAY BANK	ERSTE GROUP BANK AG
Bank of China Limited	CATHAY UNITED BANK COMPANY, LIMITED	Falcon Private Bank AG also known as: Falcon Private Bank Ltd. Falcon Private Bank SA
Bank of Communications Co., Ltd.	Chang Hwa Commercial Bank Ltd.	FAR EASTERN INTERNATIONAL BANK
Bank of India	Chiba Bank, Ltd. (The)	First Commercial Bank, Ltd.
Bank of Montreal	China Construction Bank Corporation	
BANK OF NEW YORK MELLON (THE)	CHINA DEVELOPMENT BANK CORPORATION	
Bank of Nova Scotia (The)	China Merchants Bank Co., Ltd.	
BANK OF SINGAPORE LIMITED (formerly known as ING ASIA PRIVATE BANK LTD)	Chinatrust Commercial Bank, Ltd.	
	Chugoku Bank, Ltd. (The)	
	Citibank, N.A.	

Addition in 2010

Annex Authorized Institutions and Local Representative Offices

at 31 December 2010 (continued)

Fortis Bank	National Australia Bank, Limited	TAIPEI FUBON COMMERCIAL BANK CO., LTD.
Hachijuni Bank, Ltd. (The)	NATIONAL BANK OF ABU DHABI	TAISHIN INTERNATIONAL BANK CO., LTD
HANA BANK	National Bank of Pakistan	Taiwan Business Bank
HDFC BANK LIMITED	NATIXIS	Taiwan Cooperative Bank, Ltd.
HONG LEONG BANK BERHAD	NEWEDGE GROUP	Taiwan Shin Kong Commercial Bank Co., Ltd.#
HSBC BANK INTERNATIONAL LIMITED	Oversea-Chinese Banking Corporation Limited	Toronto-Dominion Bank
HSBC Bank plc	Philippine National Bank	UBS AG
HSBC Bank USA, National Association	PT. Bank Negara Indonesia (Persero) Tbk.	also known as:
HSBC Private Bank (Suisse) SA	Punjab National Bank	UBS SA
Hua Nan Commercial Bank, Ltd.	RBS Coutts Bank AG	UBS Ltd
ICICI BANK LIMITED	also known as:	UCO Bank
Indian Overseas Bank	RBS Coutts Bank SA	UniCredit Bank AG
Industrial and Commercial Bank of China Limited	RBS Coutts Bank Ltd	(formerly known as Bayerische Hypo- und Vereinsbank Aktiengesellschaft)
Industrial Bank of Korea	Royal Bank of Canada	UNICREDIT, SOCIETA' PER AZIONI
Industrial Bank of Taiwan Co., Ltd.	Royal Bank of Scotland N.V. (The) (formerly known as ABN AMRO Bank N.V.)	Union Bank of India
ING Bank N.V.	Royal Bank of Scotland public limited company (The)	United Overseas Bank Ltd.
INTESA SANPAOLO SPA	Shanghai Commercial & Savings Bank, Ltd. (The)	Wells Fargo Bank, National Association
Iyo Bank, Ltd. (The)	Shiga Bank, Ltd. (The)	WestLB AG
JPMorgan Chase Bank, National Association	Shinhan Bank	Westpac Banking Corporation
KBC Bank N.V.	Shizuoka Bank, Ltd. (The)	Woori Bank
Korea Exchange Bank	Societe Generale	
Land Bank of Taiwan Co., Ltd.	SOCIETE GENERALE BANK & TRUST	Deletion in 2010
LLOYDS TSB BANK plc#	Standard Chartered Bank	Bank of Scotland plc
Malayan Banking Berhad	State Bank of India	Bayerische Landesbank
MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD.	State Street Bank and Trust Company	UNITED COMMERCIAL BANK
MELLI BANK PLC	Sumitomo Mitsui Banking Corporation	
Mitsubishi UFJ Trust and Banking Corporation	Svenska Handelsbanken AB (publ)	
Mizuho Corporate Bank, Ltd.		

Addition in 2010

Annex Authorized Institutions and Local Representative Offices

at 31 December 2010 (continued)

RESTRICTED LICENCE BANKS

Incorporated in Hong Kong

ALLIED BANKING CORPORATION
(HONG KONG) LIMITED
Banc of America Securities Asia
Limited
Bank of China International Limited
CHINA CONSTRUCTION BANK (ASIA)
FINANCE LIMITED
Citicorp International Limited
J.P. MORGAN SECURITIES (ASIA)
PACIFIC) LIMITED

KDB Asia Limited
KOOKMIN BANK HONG KONG
LIMITED
ORIX ASIA LIMITED
SCOTIABANK (HONG KONG) LIMITED
Societe Generale Asia Limited
UBAF (Hong Kong) Limited

Deletion in 2010

GE Capital (Hong Kong) Limited
Mitsubishi UFJ Securities (HK)
Capital, Limited

Incorporated outside Hong Kong

Bank of Ayudhya Public Company
Limited
Credit Agricole (Suisse) SA
EUROCLEAR BANK
Mashreq Bank - Public Shareholding
Company
also known as Mashreqbank psc
PT. BANK MANDIRI (PERSERO) Tbk

RBC Dexia Investor Services Bank S.A.
Siam Commercial Bank Public
Company Limited (The)
Thanakharn Kasikorn Thai Chamkat
(Mahachon)
also known as
KASIKORNBANK PUBLIC
COMPANY LIMITED
TMB Bank Public Company Limited

Deletion in 2010

CIMB BANK BERHAD
LLOYDS TSB BANK plc
Wachovia Bank, National Association

Annex Authorized Institutions and Local Representative Offices

at 31 December 2010 (continued)

DEPOSIT-TAKING COMPANIES

Incorporated in Hong Kong

BCOM Finance (Hong Kong) Limited
BPI International Finance Limited
Chau's Brothers Finance Company Limited
Chong Hing Finance Limited
Commonwealth Finance Corporation Limited
Corporate Finance (D.T.C.) Limited
FUBON CREDIT (HONG KONG) LIMITED
Gunma Finance (Hong Kong) Limited
Habib Finance International Limited
Hachijuni Asia Limited
HBZ Finance Limited
Henderson International Finance Limited
HKCB Finance Limited

Hung Kai Finance Company Limited
Inchroy Credit Corporation Limited
KEB Asia Finance Limited
KEXIM ASIA LIMITED
OCTOPUS CARDS LIMITED
ORIENT FIRST CAPITAL LIMITED
PrimeCredit Limited
PUBLIC FINANCE LIMITED
SHINHAN ASIA LIMITED
Sumitomo Trust Finance (H.K.) Limited (The)
Vietnam Finance Company Limited
Wing Hang Finance Company Limited
WOORI GLOBAL MARKETS ASIA LIMITED

Deletion in 2010

AGRO ENTERPRISES COMPANY LIMITED
Wing Lung Finance Limited

Incorporated outside Hong Kong

NIL

Annex Authorized Institutions and Local Representative Offices

at 31 December 2010 (continued)

LOCAL REPRESENTATIVE OFFICES

ANTWERPSE DIAMANTBANK NV also known as ANTWERP DIAMOND BANK NV	Credit Industriel et Commercial Credito Bergamasco S.p.A.	Raiffeisen Bank International AG (formerly known as Raiffeisen Zentralbank Osterreich AG)
BANCA POPOLARE COMMERCIO E INDUSTRIA SPA	D.A.H. Hambros Bank (Channel Islands) Limited	Resona Bank, Limited
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Fiduciary Trust Company International	Rothschild Bank AG
Banca Popolare di Ancona Societa' per azioni	GUANGDONG DEVELOPMENT BANK CO., LTD.	Schroder & Co Bank AG also known as: Schroder & Co Banque SA Schroder & Co Banca SA Schroder & Co Bank Ltd Schroder & Co Banco SA
Banca Popolare di Bergamo S.p.A.	Habib Bank A.G. Zurich	Shanghai Pudong Development Bank Co., Ltd.
Banca Popolare di Sondrio Soc. Coop. a r.l.	HSBC Bank Canada	Shenzhen Development Bank Co., Ltd.
BANCA POPOLARE DI VICENZA - Società cooperativa per azioni	HSBC Trinkaus & Burkhardt (International) S.A.	Shinkin Central Bank
Banca Regionale Europea S.p.A.	HSH Nordbank AG	Shoko Chukin Bank, Ltd. (The)
Banco di Brescia S.p.A.	Investec Bank Limited	Silicon Valley Bank
Banco do Brasil S.A.	Japan Finance Corporation (traded as Japan Bank for International Cooperation)	Union Bank of Taiwan
Banco Popolare- Societa' Cooperativa	Juroku Bank, Ltd. (The)	Unione di Banche Italiane Società Cooperativa per Azioni
BANIF - BANCO INTERNACIONAL DO FUNCHAL, S.A.	Korea Development Bank (The)	Veneto Banca S.c.a.r.l.
Bank Hapoalim (Switzerland) Ltd	LGT Bank in Liechtenstein AG also known as: LGT Bank in Liechtenstein Ltd. LGT Banque de Liechtenstein S.A. LGT Banca di Liechtenstein S.A.	Verwaltungs- und Privat-Bank Aktiengesellschaft
Bank Leumi Le-Israel B.M.	LLOYDS TSB OFFSHORE LIMITED	Yamaguchi Bank, Ltd. (The)
BANK OF BEIJING CO., LTD.	Merrill Lynch Bank (Suisse) S.A.	Yamanashi Chuo Bank, Ltd.
Bank of Fukuoka, Ltd. (The)	Metropolitan Bank and Trust Company	Yuanta Commercial Bank Co., Ltd
Bank of Kyoto, Ltd. (The)	Nanto Bank, Ltd. (The)	
Bank of Yokohama, Ltd. (The)	National Bank of Canada	Deletion in 2010
Banque Cantonale de Genève	Nishi-Nippon City Bank, Ltd. (The)	Arab Bank plc
Banque Privee Edmond de Rothschild S.A.	Norinchukin Bank (The)	Banca Popolare di Novara - Società per Azioni
BARCLAYS BANK (SUISSE) S.A.	Ogaki Kyoritsu Bank, Ltd. (The)	Bank Julius Baer & Co. Ltd.
BSI LTD	Oita Bank, Ltd. (The)	CARIPRATO - Cassa di Risparmio di Prato S.p.A.
China Everbright Bank Co., Ltd	P.T. Bank Central Asia	
CHINA MINSHENG BANKING CORPORATION LIMITED	P.T. Bank Rakyat Indonesia (Persero)	
CLEARSTREAM BANKING S.A. Corporation Bank		

Table A Major Economic Indicators

	2006	2007	2008	2009	2010
I. Gross Domestic Product					
Real GDP growth (%)	7.0	6.4	2.3	(2.7)	6.8 ^(a)
Nominal GDP growth (%)	6.7	9.5	3.8	(3.3)	7.8 ^(a)
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	5.9	8.5	2.4	0.6	5.8 ^(a)
– Government consumption expenditure	0.3	3.0	1.8	2.3	2.7 ^(a)
– Gross domestic fixed capital formation of which	7.1	3.4	1.0	(3.9)	8.1 ^(a)
– Building and construction	(7.1)	(0.3)	6.8	(5.5)	6.7 ^(a)
– Machinery, equipment and computer software	19.2	3.0	(0.7)	(3.0)	6.3 ^(a)
– Exports	9.4	8.3	2.6	(10.1)	16.8 ^(a)
– Imports	9.1	9.1	2.3	(9.0)	17.3 ^(a)
GDP at current market prices (US\$ billion)	189.9	207.1	215.4	209.3	225.0 ^(a)
Per capita GDP at current market prices (US\$)	27,697	29,901	30,866	29,880	31,835 ^(a)
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	138.8	117.2	101.7	76.4	82.2 ^(a)
– Re-exports of goods	2,328.6	2,581.7	2,742.3	2,418.3	2,979.1 ^(a)
– Total imports of goods	2,576.3	2,852.5	3,024.1	2,703.0	3,395.1 ^(a)
– Merchandise trade balance	(109.0)	(153.7)	(180.1)	(208.2)	(333.8) ^(a)
Services trade					
– Exports of services	565.1	660.8	718.6	670.2	835.0 ^(a)
– Imports of services	287.9	332.2	366.5	340.6	396.6 ^(a)
– Services trade balance	277.2	328.6	352.1	329.5	438.4 ^(a)
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure ^(c)	229,413	234,815	315,112	289,025	303,490 ^(a)
Total government revenue	288,014	358,465	316,562	318,442	374,761 ^(a)
Consolidated surplus/deficit	58,601	123,650	1,450	29,417	71,271 ^(a)
Reserve balance as at end of fiscal year ^(d)	369,264	492,914	494,364	520,281	591,552 ^(a)
IV. Prices (annual change, %)					
Consumer Price Index (A)	1.7	1.3	3.6	0.4	2.7
Composite Consumer Price Index	2.0	2.0	4.3	0.5	2.4
Trade Unit Value Indices					
– Domestic exports	(2.1)	0.8	5.1	(0.2)	5.5
– Re-exports	1.1	2.4	3.8	1.2	4.6
– Imports	2.1	2.3	4.4	(0.1)	6.4
Property Price Indices					
– Residential flats	0.8	11.7	16.5	0.6	24.4 ^(a)
– Office premises	4.7	18.8	20.3	(9.7)	27.9 ^(a)
– Retail premises	2.8	12.4	11.4	0.5	33.0 ^(a)
– Flatted factory premises	26.8	25.9	18.2	(8.3)	31.2 ^(a)

Table A Major Economic Indicators (continued)

	2006	2007	2008	2009	2010
V. Labour					
Labour force (annual change, %)	1.1	1.6	0.5	0.8	(0.6)
Employment (annual change, %)	1.9	2.4	1.0	(1.1)	0.4
Unemployment rate (annual average, %)	4.8	4.0	3.6	5.4	4.4
Underemployment rate (annual average, %)	2.4	2.2	1.9	2.3	2.0
Employment ('000)	3,401	3,484	3,519	3,480	3,493
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	387.9	454.3	491.1	671.2	730.1
– M2 ^(e)	2,777.7	3,281.0	3,239.9	3,587.7	3,866.8
– M3 ^(e)	2,795.5	3,300.5	3,261.3	3,604.8	3,878.2
Total money supply					
– M1	491.6	616.7	645.8	901.8	1,017.2
– M2	5,054.3	6,106.3	6,268.1	6,602.3	7,136.2
– M3	5,089.7	6,139.8	6,300.8	6,626.8	7,156.2
VII. Interest Rates (end of period, %)					
Three-month interbank rate	3.84	3.31	0.89	0.13	0.33
Savings deposit	2.26	1.26	0.01	0.01	0.01
One-month time deposit	2.52	1.61	0.04	0.01	0.01
Banks' 'Best lending rate'	7.75	6.75	5.00	5.00	5.00
Banks' 'Composite rate'	2.86	2.29	0.68	0.11	0.21
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.775	7.802	7.751	7.756	7.775
Trade-weighted Effective Exchange Rate Index (Jan 2000=100)	94.3	88.6	88.3	86.7	83.6
IX. Foreign Currency Reserve Assets (US\$ billion) ^(f)	133.2	152.7	182.5	255.8	268.7
X. Stock Market (end of period figures)					
Hang Seng Index	19,965	27,813	14,387	21,873	23,035
Average price/earnings ratio	17.4	22.5	7.3	18.1	16.7
Market capitalisation (HK\$ billion)	13,248.8	20,536.5	10,253.6	17,769.3	20,942.3

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes repayment of bonds and notes issued in July 2004.

(d) Includes changes in provision for loss in investments with the Exchange Fund.

(e) Adjusted to include foreign currency swap deposits.

(f) Excludes unsettled forward transactions but includes gold.

Table B Performance Ratios of the Banking Sector ^(a)

	All Authorized Institutions				
	2006	2007	2008	2009	2010
	%	%	%	%	%
Asset Quality ^(b)					
As % of total credit exposures ^(c)					
Total outstanding provisions/impairment allowances	0.38	0.35	0.66	0.63	0.46
Classified ^(d) exposures:					
– Gross	0.59	0.48	0.83	1.10	0.60
– Net of specific provisions/individual impairment allowances	0.41	0.32	0.39	0.71	0.34
– Net of all provisions/impairment allowances	0.21	0.13	0.17	0.47	0.13
As % of total loans					
Total outstanding provisions/impairment allowances	0.71	0.59	0.88	0.96	0.71
Classified ^(d) loans:					
– Gross	1.05	0.75	1.23	1.61	0.83
– Net of specific provisions/individual impairment allowances	0.73	0.52	0.75	1.07	0.46
– Net of all provisions/impairment allowances	0.34	0.16	0.35	0.65	0.13
Overdue > 3 months and rescheduled loans	0.76	0.51	0.69	0.92	0.58
Profitability					
Return on assets (operating profit)	1.13	1.37	0.59	0.74	0.82
Return on assets (post-tax profit)	1.01	1.21	0.49	0.65	0.77
Net interest margin	1.29	1.32	1.30	1.11	1.02
Cost-to-income ratio	50.8	46.7	55.6	57.8	57.9
Bad debt charge to total assets	0.03	0.04	0.18	0.13	0.05
Liquidity					
Loan to deposit ratio (all currencies)	51.9	50.5	54.2	51.5	61.6
Loan to deposit ^(e) ratio (Hong Kong dollar)	74.7	71.0	77.6	71.2	78.1

Asset Quality

Delinquency ratio of residential mortgage loans
 Credit card receivables
 – Delinquency ratio
 – Charge-off ratio

Profitability

Operating profit to shareholders' funds
 Post-tax profit to shareholders' funds

Capital Adequacy

Equity to assets ratio ^(b)

Capital Adequacy Ratio (Consolidated) ^(f)

(a) Figures are related to Hong Kong office(s) only unless otherwise stated.

(b) Figures are related to Hong Kong office(s). For the locally incorporated AIs, figures include their overseas branches.

(c) Credit exposures include loans and advances, acceptances and bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

(e) Includes swap deposits.

(f) From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

Retail Banks				
2006 %	2007 %	2008 %	2009 %	2010 %
0.33	0.33	0.64	0.56	0.39
0.63	0.54	0.85	1.00	0.57
0.48	0.38	0.42	0.66	0.33
0.30	0.21	0.21	0.44	0.18
0.63	0.55	0.79	0.84	0.59
1.11	0.85	1.24	1.38	0.77
0.85	0.65	0.84	0.92	0.45
0.48	0.30	0.45	0.54	0.18
0.80	0.57	0.67	0.88	0.60
1.53	1.66	1.02	1.09	1.12
1.36	1.48	0.88	0.97	1.01
1.80	1.90	1.84	1.48	1.32
42.8	40.5	45.3	49.7	49.8
0.01	0.04	0.18	0.11	0.03
47.9	45.5	47.3	46.3	52.8
69.1	65.1	69.4	65.2	70.5

Surveyed Institutions				
2006 %	2007 %	2008 %	2009 %	2010 %
0.20	0.11	0.05	0.03	0.01
0.37	0.35	0.34	0.34	0.20
2.91	2.90	2.72	3.71	1.91

Locally Incorporated Licensed Banks				
2006 %	2007 %	2008 %	2009 %	2010 %
18.9	23.8	15.1	16.1	15.6
16.7	21.3	13.0	14.4	14.2
8.2	8.2	7.2	8.5	8.3

All Locally Incorporated Authorized Institutions				
2006 %	2007 %	2008 %	2009 %	2010 %
14.9	13.4	14.7	16.8	15.9

Table C Authorized Institutions: Domicile and Parentage

	2006	2007	2008	2009	2010
Licensed Banks					
(i) Incorporated in Hong Kong	24	23	23	23	23
(ii) Incorporated outside Hong Kong	114	119	122	122	123
Total	138	142	145	145	146
Restricted Licence Banks					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	0	0	0	1	1
(b) incorporated outside Hong Kong	8	8	6	5	5
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	20	18	17	16	13
(iii) Bank related	0	0	0	1	1
(iv) Others	3	3	4	3	1
Total	31	29	27	26	21
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	5	5	7	7	6
(b) incorporated outside Hong Kong	3	3	3	4	4
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	13	10	8	7	7
(iii) Bank related	3	3	2	2	2
(iv) Others	9	8	8	8	7
Total	33	29	28	28	26
All Authorized Institutions	202	200	200	199	193
Local Representative Offices	84	79	71	71	67

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	06	07	08	09	10	06	07	08	09	10	06	07	08	09	10
Asia and Pacific															
Hong Kong	11	11	10	10	10	-	-	-	-	-	10	10	9	9	7
Australia	4	4	4	4	4	-	-	-	-	-	-	-	-	-	-
Mainland China	13	12	13	14	14	2	2	1	2	2	2	2	3	3	2
India	9	11	11	12	12	1	-	-	-	-	2	1	1	1	1
Indonesia	1	1	1	1	1	2	2	2	1	1	1	-	-	-	-
Japan	11	11	11	10	10	2	2	2	2	1	4	3	3	3	3
Malaysia	4	4	4	3	3	1	1	1	1	0	1	1	1	1	1
Pakistan	1	1	1	1	1	-	-	-	-	-	2	2	2	2	2
Philippines	2	2	2	2	2	1	1	1	1	1	3	3	3	2	2
Singapore	4	4	4	4	5	-	-	-	-	-	-	-	-	-	-
South Korea	3	3	5	5	5	5	4	2	2	2	3	3	3	4	4
Taiwan	15	17	18	18	19	-	-	-	-	-	1	1	1	1	1
Thailand	1	1	1	1	1	4	4	4	4	4	-	-	-	-	-
Vietnam	-	-	-	-	-	-	-	-	-	-	1	1	1	1	1
Sub-total	79	82	85	85	87	18	16	13	13	11	30	27	27	27	24
Europe															
Austria	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Belgium	2	2	2	2	1	-	-	1	1	1	-	-	-	-	-
Denmark	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	7	7	7	8	9	3	3	3	3	3	-	-	-	-	-
Germany	7	8	7	5	4	-	-	-	-	-	-	-	-	-	-
Italy	6	4	4	4	4	-	-	-	-	-	-	-	-	-	-
Luxembourg	-	-	-	-	-	1	1	1	1	1	-	-	-	-	-
Netherlands	3	3	4	5	4	-	-	-	-	-	-	-	-	-	-
Spain	1	2	2	2	2	-	-	-	-	-	-	-	-	-	-
Sweden	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Switzerland	3	3	3	3	4	-	-	-	-	-	-	-	-	-	-
United Kingdom	10	10	11	10	11	1	1	1	1	0	-	-	-	-	1
Sub-total	41	41	42	41	41	5	5	6	6	5	-	-	-	-	1
Middle East															
Bahrain	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Iran	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
United Arab Emirates	-	-	-	2	2	1	1	1	1	1	-	-	-	-	-
Sub-total	1	1	1	3	3	1	1	1	1	1	-	-	-	-	-
North America															
Canada	5	5	5	5	5	1	1	1	1	1	-	-	-	-	-
United States	11	12	11	10	9	6	6	6	5	3	2	1	1	1	1
Sub-total	16	17	16	15	14	7	7	7	6	4	2	1	1	1	1
South Africa	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Bermuda	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-	1	1	-	-	-
Grand Total	138	142	145	145	146	31	29	27	26	21	33	29	28	28	26

Table E Presence of World's Largest 500 Banks in Hong Kong

Positions at 31.12.2010	Number of Overseas Banks ^(b)					Licensed Banks ^(c)				
	06	07	08	09	10	06	07	08	09	10
World Ranking ^(a)										
1-20	20	20	20	20	20	33	33	35	37	38
21-50	23	22	23	22	23	23	22	22	22	24
51-100	26	26	26	28	27	21	19	23	21	17
101-200	37	38	35	31	30	20	25	21	15	17
201-500	50	46	55	52	51	25	23	27	28	30
Sub-total	156	152	159	153	151	122	122	128	123	126
Others	55	59	46	52	48	16	20	17	22	20
Total	211	211	205	205	199	138	142	145	145	146

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from *The Banker*, July 2010 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices exceeds the number of overseas banks with presence in Hong Kong due to the multiple presence of some of the overseas banks.

(c) Consist of branches and subsidiaries of overseas banks.

Restricted Licence Banks ^(c)					Deposit-Taking Companies ^(c)					Local Representative Offices				
06	07	08	09	10	06	07	08	09	10	06	07	08	09	10
5	7	6	8	6	1	-	-	-	-	8	6	6	5	5
5	5	5	4	3	-	-	-	1	2	5	5	5	4	3
4	2	1	1	1	5	5	6	5	3	7	9	3	14	16
1	1	1	0	0	3	3	2	3	3	19	15	14	15	12
5	6	8	8	6	3	1	1	1	1	22	19	22	18	16
20	21	21	21	16	12	9	9	10	9	61	54	50	56	52
11	8	6	5	5	21	20	19	18	17	23	25	21	15	15
31	29	27	26	21	33	29	28	28	26	84	79	71	71	67

Table F Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions

(HK\$ billion)	2006			2007		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	1,917	550	2,468	2,185	777	2,962
– Inside Hong Kong ^(a)	1,832	294	2,126	2,057	400	2,457
– Outside Hong Kong ^(b)	86	256	342	128	377	504
Interbank lending	647	2,802	3,449	797	3,714	4,510
– Inside Hong Kong	304	198	502	346	269	615
– Outside Hong Kong	343	2,604	2,947	451	3,444	3,895
Negotiable certificates of deposit (NCDs)	60	43	103	66	28	93
Negotiable debt instruments, other than NCDs	536	1,081	1,617	499	1,190	1,688
Other assets	347	323	670	529	567	1,096
Total Assets	3,507	4,799	8,306	4,075	6,275	10,350
Liabilities						
Deposits from customers ^(c)	2,568	2,189	4,757	3,075	2,794	5,869
Interbank borrowing	518	1,739	2,257	605	2,357	2,961
– Inside Hong Kong	309	203	511	353	277	630
– Outside Hong Kong	210	1,536	1,746	251	2,080	2,331
Negotiable certificates of deposit	129	110	240	122	49	172
Other liabilities	678	374	1,052	852	497	1,348
Total Liabilities	3,894	4,412	8,306	4,653	5,697	10,350

Retail Banks

(HK\$ billion)	2006			2007		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	1,577	218	1,794	1,742	279	2,021
– Inside Hong Kong ^(a)	1,528	148	1,676	1,675	190	1,865
– Outside Hong Kong ^(b)	48	70	118	67	89	156
Interbank lending	425	1,023	1,449	470	1,367	1,837
– Inside Hong Kong	245	103	348	269	155	424
– Outside Hong Kong	180	920	1,100	201	1,211	1,413
Negotiable certificates of deposit (NCDs)	44	16	59	47	13	60
Negotiable debt instruments, other than NCDs	422	755	1,177	378	778	1,156
Other assets	279	165	444	391	328	719
Total Assets	2,747	2,177	4,924	3,029	2,764	5,793
Liabilities						
Deposits from customers ^(c)	2,283	1,466	3,749	2,674	1,763	4,437
Interbank borrowing	116	228	344	138	297	435
– Inside Hong Kong	51	35	86	69	44	114
– Outside Hong Kong	65	193	258	69	253	322
Negotiable certificates of deposit	76	83	159	67	37	104
Other liabilities	537	136	673	641	176	817
Total Liabilities	3,011	1,913	4,924	3,519	2,274	5,793

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total because of rounding.

2008			2009			2010		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
2,355	931	3,286	2,401	887	3,288	2,824	1,403	4,227
2,201	509	2,710	2,231	419	2,650	2,602	714	3,316
154	422	575	170	468	638	222	689	911
542	3,483	4,025	475	3,282	3,757	398	3,731	4,130
261	287	548	231	317	548	181	473	654
281	3,195	3,477	244	2,966	3,209	217	3,258	3,475
39	49	88	41	62	102	80	53	133
392	1,433	1,825	816	1,541	2,357	893	1,753	2,647
605	926	1,531	666	465	1,131	549	611	1,160
3,933	6,821	10,754	4,399	6,236	10,635	4,745	7,552	12,296
3,034	3,024	6,058	3,374	3,007	6,381	3,617	3,245	6,862
447	2,498	2,945	473	2,409	2,882	463	3,222	3,686
262	292	555	228	321	549	176	478	654
185	2,205	2,390	245	2,088	2,332	288	2,744	3,032
86	22	108	69	27	96	114	61	175
779	864	1,643	762	515	1,277	847	726	1,573
4,347	6,407	10,754	4,678	5,958	10,635	5,042	7,255	12,296

2008			2009			2010		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,870	366	2,236	1,963	352	2,315	2,310	622	2,932
1,787	258	2,044	1,861	229	2,090	2,185	408	2,592
83	108	191	102	124	226	126	214	340
368	1,205	1,573	263	1,162	1,425	172	1,437	1,610
200	172	372	168	186	353	112	284	396
168	1,034	1,201	96	976	1,072	60	1,153	1,213
27	25	52	28	30	58	54	27	81
293	1,074	1,367	692	1,104	1,795	620	1,262	1,882
457	602	1,060	477	292	769	431	399	830
3,014	3,273	6,288	3,424	2,940	6,364	3,587	3,747	7,334
2,695	2,036	4,731	3,012	1,992	5,004	3,276	2,280	5,556
118	356	474	165	265	430	133	486	620
52	72	124	42	83	124	38	291	330
66	284	350	123	182	305	95	195	290
40	13	53	25	11	36	41	22	63
566	464	1,029	625	269	894	683	413	1,096
3,420	2,868	6,288	3,827	2,536	6,364	4,133	3,201	7,334

Table G Major Balance Sheet Items by Region/Economy of Beneficial Ownership of Authorized Institutions

(HK\$ billion)		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2009	2,035	619	734	2,920	4,327	10,635
	2010	2,748	756	834	3,026	4,932	12,296
Deposits from Customers ^(a)	2009	1,433	163	389	1,226	3,170	6,381
	2010	1,701	151	361	1,181	3,469	6,862
Loans to Customers	2009	958	191	93	589	1,459	3,288
	2010	1,191	258	107	768	1,903	4,227
Loans to Customers Inside Hong Kong ^(b)	2009	747	140	86	381	1,296	2,650
	2010	919	175	98	486	1,639	3,316
Loans to Customers Outside Hong Kong ^(c)	2009	211	50	7	207	163	638
	2010	272	83	10	282	264	911

(a) Figures have been revised to include deposits from the Exchange Fund with maturity less than one month.

(b) Defined as loans for use in Hong Kong plus trade finance.

(c) Includes "others" (i.e. unallocated).

Figures may not add up to total because of rounding.

Table H Flow of Funds for All Authorized Institutions and Retail Banks

All Authorized Institutions

Increase/(Decrease) in (HK\$ billion)	2009			2010		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	47	(44)	3	423	516	939
– Inside Hong Kong ^(a)	30	(90)	(60)	371	295	666
– Outside Hong Kong ^(b)	17	46	63	52	221	273
Interbank lending	(68)	(200)	(268)	(76)	449	373
– Inside Hong Kong	(30)	29	(1)	(50)	157	107
– Outside Hong Kong	(37)	(230)	(267)	(27)	293	266
All other assets	487	(341)	146	(1)	351	350
Total Assets	466	(585)	(119)	345	1,316	1,661
Liabilities						
Deposits from customers ^(c)	340	(17)	323	244	238	481
Interbank borrowing	25	(89)	(64)	(9)	813	804
– Inside Hong Kong	(34)	29	(5)	(52)	157	105
– Outside Hong Kong	60	(118)	(58)	43	656	699
All other liabilities	(34)	(344)	(378)	130	246	376
Total Liabilities	331	(449)	(119)	364	1,297	1,661
Net Interbank Borrowing/(Lending)	93	112	204	67	364	432
Net Customer Lending/(Borrowing)	(293)	(27)	(320)	180	278	458

Retail Banks

Increase/(Decrease) in (HK\$ billion)	2009			2010		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	93	(14)	80	347	269	617
– Inside Hong Kong ^(a)	74	(29)	45	324	179	503
– Outside Hong Kong ^(b)	19	15	34	24	91	114
Interbank lending	(105)	(43)	(148)	(91)	275	184
– Inside Hong Kong	(33)	14	(19)	(55)	98	43
– Outside Hong Kong	(72)	(58)	(130)	(36)	177	142
All other assets	421	(277)	144	(93)	263	169
Total Assets	410	(334)	76	163	808	971
Liabilities						
Deposits from customers ^(c)	317	(44)	273	264	288	552
Interbank borrowing	46	(91)	(45)	(32)	221	190
– Inside Hong Kong	(11)	11	0	(3)	208	205
– Outside Hong Kong	57	(102)	(45)	(28)	13	(15)
All other liabilities	44	(197)	(153)	74	155	229
Total Liabilities	408	(332)	76	306	665	971
Net Interbank Borrowing/(Lending)	151	(47)	104	59	(54)	5
Net Customer Lending/(Borrowing)	(224)	31	(193)	84	(19)	65

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total because of rounding.

Table I Loans to and Deposits from Customers by Category of Authorized Institutions

(HK\$ billion)	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
2006								
Licensed banks	1,870	532	2,402	97	2,551	2,174	4,725	99
Restricted licence banks	24	17	41	2	14	13	26	1
Deposit-taking companies	23	1	24	1	3	2	5	-
Total	1,917	550	2,468	100	2,568	2,189	4,757	100
2007								
Licensed banks	2,127	749	2,876	97	3,056	2,782	5,839	99
Restricted licence banks	32	26	59	2	15	9	25	-
Deposit-taking companies	25	2	27	1	3	2	5	-
Total	2,185	777	2,962	100	3,075	2,794	5,869	100
2008								
Licensed banks	2,293	904	3,197	97	3,013	3,013	6,027	99
Restricted licence banks	35	24	59	2	15	9	24	-
Deposit-taking companies	27	3	29	1	6	2	8	-
Total	2,355	931	3,286	100	3,034	3,024	6,058	100
2009								
Licensed banks	2,352	859	3,211	98	3,358	3,000	6,358	100
Restricted licence banks	27	26	53	2	11	6	16	-
Deposit-taking companies	22	3	25	1	5	2	7	-
Total	2,401	887	3,288	100	3,374	3,007	6,381	100
2010								
Licensed banks	2,785	1,385	4,170	99	3,607	3,236	6,844	100
Restricted licence banks	17	14	31	1	6	7	13	-
Deposit-taking companies	23	4	26	1	4	2	6	-
Total	2,824	1,403	4,227	100	3,617	3,245	6,862	100

(a) Hong Kong dollar customer deposits include swap deposits.

A "-" sign denotes a figure of less than 0.5.

Figures may not add up to total because of rounding.

Table J Loans to Customers Inside Hong Kong by Economic Sector

All Authorized Institutions

Sector (HK\$ billion)	2006		2007		2008		2009		2010	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	152	7	183	7	186	7	175	7	274	8
Manufacturing	103	5	121	5	147	5	128	5	170	5
Transport and transport equipment	123	6	145	6	155	6	152	6	171	5
Building, construction and property development, and investment	492	23	578	24	687	25	684	26	846	26
Wholesale and retail trade	105	5	116	5	152	6	154	6	235	7
Financial concerns (other than authorized institutions)	185	9	251	10	283	10	191	7	244	7
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	60	3	58	2	57	2	52	2	51	2
– to purchase other residential property	535	25	564	23	593	22	647	24	745	22
– other purposes	182	9	221	9	226	8	222	8	256	8
Others	188	9	220	9	223	8	247	9	324	10
Total ^(a)	2,126	100	2,457	100	2,710	100	2,650	100	3,316	100

Retail Banks

Sector (HK\$ billion)	2006		2007		2008		2009		2010	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	124	7	147	8	147	7	131	6	208	8
Manufacturing	68	4	79	4	97	5	88	4	122	5
Transport and transport equipment	82	5	87	5	92	4	95	5	104	4
Building, construction and property development, and investment	397	24	460	25	536	26	555	27	682	26
Wholesale and retail trade	73	4	78	4	99	5	105	5	169	7
Financial concerns (other than authorized institutions)	76	5	88	5	106	5	87	4	111	4
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	60	4	58	3	57	3	52	2	51	2
– to purchase other residential property	522	31	551	30	579	28	634	30	734	28
– other purposes	152	9	178	10	188	9	186	9	209	8
Others	123	7	139	7	144	7	156	7	202	8
Total ^(a)	1,676	100	1,865	100	2,044	100	2,089	100	2,592	100

(a) Defined as loans for use in Hong Kong plus trade finance.

Figures may not add up to total because of rounding.

Table K Deposits from Customers

(HK\$ billion)	All Authorized Institutions				Retail banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
2006	238	933	1,397	2,568	219	924	1,140	2,283
2007	296	1,110	1,669	3,075	273	1,096	1,305	2,674
2008	321	1,254	1,459	3,034	295	1,239	1,161	2,695
2009	477	1,767	1,130	3,374	434	1,744	835	3,012
2010	511	1,835	1,270	3,617	462	1,811	1,002	3,276
Foreign Currency								
2006	104	426	1,659	2,189	70	373	1,024	1,466
2007	162	520	2,112	2,794	112	451	1,200	1,763
2008	155	691	2,178	3,024	102	610	1,324	2,036
2009	231	932	1,845	3,007	143	828	1,021	1,992
2010	287	1,078	1,880	3,245	181	956	1,143	2,280
Total								
2006	341	1,359	3,057	4,757	289	1,297	2,163	3,749
2007	459	1,629	3,781	5,869	385	1,547	2,506	4,437
2008	475	1,945	3,637	6,058	397	1,849	2,485	4,731
2009	707	2,699	2,975	6,381	576	2,572	1,856	5,004
2010	798	2,913	3,151	6,862	643	2,768	2,145	5,556

(a) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total because of rounding.

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions

Region/Economy (HK\$ billion)	2009			2010		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Asia and Pacific	819	(314)	505	1,214	(237)	977
Mainland China	60	(209)	(149)	762	(177)	585
Australia	279	46	325	247	54	301
South Korea	295	47	342	218	60	277
India	38	38	76	77	57	134
New Zealand	3	5	8	13	5	18
Malaysia	2	(1)	1	16	(5)	11
Sri Lanka	2	1	3	3	2	4
Vietnam	0	(1)	(1)	3	0	3
Bangladesh	1	0	1	2	0	2
Republic of Kazakhstan	1	0	1	1	1	2
Maldives	2	0	2	1	0	2
Cambodia	(1)	0	(1)	0	0	(1)
Myanmar	(1)	0	(1)	(1)	0	(1)
Papua New Guinea	0	0	0	0	(2)	(2)
Nepal	(3)	0	(3)	(3)	0	(3)
Thailand	(2)	(11)	(12)	6	(14)	(8)
Indonesia	(8)	(4)	(12)	(7)	(2)	(10)
Western Samoa	0	(9)	(9)	0	(10)	(10)
Brunei	(7)	(8)	(15)	(7)	(4)	(11)
Philippines	(22)	(14)	(36)	(14)	(7)	(21)
Macau SAR	(55)	(2)	(57)	(36)	(4)	(40)
Singapore	189	(99)	89	53	(95)	(41)
Japan	45	63	108	(166)	82	(84)
Taiwan	3	(152)	(149)	51	(174)	(122)
Others	(3)	(5)	(7)	(4)	(5)	(9)
North America	79	214	293	(103)	203	100
United States	55	211	266	(109)	195	85
Canada	25	3	27	6	9	15
Caribbean	71	(79)	(8)	35	(65)	(30)
Bahamas	55	(11)	45	61	(7)	54
Panama	0	1	1	1	4	4
Netherlands Antilles	0	3	3	0	1	1
Barbados	0	0	0	0	(2)	(2)
Bermuda	0	1	1	0	(2)	(2)
Cayman Islands	15	1	17	(26)	12	(14)
Others	0	(74)	(74)	0	(71)	(71)
Africa	(2)	(6)	(8)	0	(4)	(4)
South Africa	0	0	0	2	0	3
Nigeria	0	0	1	0	0	0
Mauritius	(2)	0	(2)	(2)	1	(1)
Liberia	0	(4)	(4)	0	(3)	(3)
Others	0	(3)	(4)	0	(3)	(3)

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions (continued)

Region/Economy (HK\$ billion)	2009			2010		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Latin America	9	(3)	6	4	1	5
Mexico	0	0	1	0	3	3
Brazil	2	(1)	1	3	(1)	2
Peru	0	0	0	0	1	1
Chile	7	0	7	0	1	1
Venezuela	0	(1)	(1)	0	0	0
Others	0	(2)	(2)	0	(3)	(3)
Eastern Europe	5	0	5	7	0	7
Western Europe	945	55	1,000	437	102	540
United Kingdom	512	(35)	477	219	(19)	200
France	178	43	221	136	44	180
Germany	38	31	68	59	44	103
Switzerland	117	(2)	115	92	(1)	90
Jersey	5	2	6	14	0	14
Denmark	7	8	15	4	8	12
Luxembourg	20	2	22	6	3	9
Netherlands	68	6	74	(7)	15	9
Sweden	9	2	12	5	3	8
Norway	10	0	10	5	0	5
Turkey	1	0	1	2	0	3
Cyprus	0	2	2	0	1	1
Iceland	1	0	1	1	0	1
Finland	1	1	2	0	0	0
Republic of Ireland	9	(3)	6	1	(1)	0
Guernsey	0	0	0	(1)	0	(1)
Isle of Man	0	0	0	0	(1)	(1)
Liechtenstein	0	0	0	0	(1)	(1)
Gibraltar	0	(1)	(1)	0	(1)	(1)
Malta	(2)	(6)	(8)	(4)	0	(4)
Austria	(3)	0	(3)	(5)	0	(5)
Belgium	19	1	20	(8)	0	(7)
Spain	(12)	3	(8)	(37)	3	(34)
Italy	(33)	2	(32)	(44)	4	(40)
Others	1	(1)	0	0	(1)	(1)
Middle East	26	31	57	9	57	65
United Arab Emirates	29	26	55	7	25	32
Qatar	1	4	5	2	28	30
Saudi Arabia	2	1	3	1	1	3
Kuwait	0	0	0	1	1	2
Egypt	0	1	1	0	1	1
Bahrain	(6)	0	(6)	(1)	1	0
Israel	0	0	0	0	(1)	(1)
Oman	(1)	0	(1)	(1)	0	(1)
Others	0	0	0	0	(1)	(1)
Others^(a)	83	4	87	89	4	93
Overall Total	2,036	(98)	1,937	1,692	61	1,753

(a) "Others" include economies not listed above and positions in relation to international organisations.

Figures may not add up to total because of rounding.

Abbreviations used in this Report

AI	– Authorized institution	GDP	– Gross Domestic Product
AML	– Anti-money-laundering	HIBOR	– Hong Kong Interbank Offered Rate
APEC	– Asia-Pacific Economic Co-operation	HKAB	– Hong Kong Association of Banks
ASEAN	– Association of Southeast Asian Nations	HKASs	– Hong Kong Accounting Standards
BCR	– Banking (Capital) Rules	HKDPB	– Hong Kong Deposit Protection Board
BDR	– Banking (Disclosure) Rules	HKEx	– Hong Kong Exchanges and Clearing Limited
BIS	– Bank for International Settlements	HKFRSs	– Hong Kong Financial Reporting Standards
BLR	– Best lending rate	HKICPA	– Hong Kong Institute of Certified Public Accountants
CAAP	– Capital adequacy assessment process	HKMA	– Hong Kong Monetary Authority
CAMEL	– Capital adequacy, Asset quality, Management, Earnings and Liquidity	HKMC	– Hong Kong Mortgage Corporation Limited
CAR	– Capital adequacy ratio	HKSAR	– Hong Kong Special Administrative Region
CBRC	– China Banking Regulatory Commission	IASB	– International Accounting Standards Board
CCASS	– Central Clearing and Settlement System	IRB	– Internal ratings-based approach approach
CCP	– Central counterparty	IMM	– Internal models approach approach
CCR	– Counterparty central risk	ISC	– Investment Sub-Committee
CEPA	– Closer Economic Partnership Arrangement	LCR	– Liquidity coverage ratio
CFT	– Counter-terrorist-financing	MFSC	– Monetary and Financial Stability Committee
CHATS	– Clearing House Automated Transfer System	MPF	– Mandatory Provident Fund
CLS	– Continuous Linked Settlement	PBoC	– People’s Bank of China
CMIM	– Chiang Mai Initiative Multilateralisation	PvP	– Payment-versus-Payment
CMU	– Central Moneymarkets Unit	QIS	– Quantitative impact study
CSDs	– Central Securities Depositories	RIs	– Registered institutions
CSSO	– Clearing and Settlement Systems Ordinance	RMB	– Renminbi
CU	– Convertibility Undertaking	RMC	– Risk Management and Compliance Division
DPS	– Deposit Protection Scheme	RTGS	– Real Time Gross Settlement
DvP	– Delivery-versus-Payment	SFC	– Securities and Futures Commission
EFAC	– Exchange Fund Advisory Committee	SPM	– Supervisory Policy Manual
EFBN	– Exchange Fund Bills and Notes	SRP	– Supervisory review process
EMEAP	– Executives’ Meeting of East Asia-Pacific Central Banks	TMA	– Treasury Markets Association
F/CY	– Foreign currency	TR	– Trade repository
FSB	– Financial Stability Board	VaR	– Value-at-Risk
G-20	– Group of Twenty		

Reference Resources

The *HKMA Annual Report* is published in April each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

An introduction to the Hong Kong Monetary Authority

HKMA Quarterly Bulletin (online publication)

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (online publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Third Edition)

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System (Second Edition)

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HKMA Background Brief No. 4 – Financial Infrastructure in Hong Kong

HKMA Background Brief No. 5 – Reserves Management in Hong Kong

Money and Banking in Hong Kong: A Historical Timeline

Educational leaflets on various topics including notes and coins and banking issues

HKMA publications may be purchased or obtained from the **HKMA Information Centre**, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. The HKMA Information Centre consists of an Exhibition Area and a Library. The Centre introduces the work of the HKMA and houses books, journals and other texts on central banking and related subjects. The Centre is open to the public six days a week.

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The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research reports, and features on topical issues.

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